LOVELY PROFESSIONAL UNIVERSITY

TRADE AND INTERNATIONAL ORGANIZATIONS

Edited By

Dr. Pavitar Parkash Singh

Printed by
USI PUBLICATIONS
2/31, Nehru Enclave, Kalkaji Ext.,
New Delhi-110019
for
Lovely Professional University
Phagwara

SYLLABUS

TRADE AND INTERNATIONAL ORGANIZATIONS

Objectives:

The course provides an understanding of international trade and investment theories. It is designed to better understand the implications of such theories as they relate to international trade management. It helps students deal with the opportunities and challenges created by the global environment.

Sr. No.	Content
1	Expenditure reducing & expenditure switching policies, Forms of Economic cooperation, Static & Dynamic effects of a custom union & free trade organization,
2	SAARC/SAPTA, ASEAN, Regionalism: EU & NAFTA,
3	Multilateralism & WTO, International Monetary System, East Asian crisis & lessons for developing countries,
4	FDI : types & issues, International Debt crisis, Functions of WTO/GATT, UNCTAD, IMF, World Bank & Asian Development Bank
5	India's trade policy: recent developments, India's Balance of Payment

CONTENT

Unit 1: Merits and Demerits of Fixed and Flexible Exchange Rate 1
Pavitar Parkash Singh, Lovely Professional University

Unit 2: Expenditure Reducing and Expenditure Switching Policies 9
Pavitar Parkash Singh, Lovely Professional University

Unit 3: Forms of Economic Cooperation 24
Pavitar Parkash Singh, Lovely Professional University

Unit 4: Static and Dynamic Effects of a Custom Union and Free Trade Organization 32
Pavitar Parkash Singh, Lovely Professional University

Unit 5: SAARC/SAPTA, ASEAN 43
Hitesh Jhanji, Lovely Professional University

Unit 6: Regionalism : EU and NAFTA 50
Hitesh Jhanji, Lovely Professional University

Unit 7: Multilateralism and WTO 58
Tanima Dutta, Lovely Professional University

Unit 8: International Monetary System 78
Tanima Dutta, Lovely Professional University

Unit 9: East Asian Crisis and Lessons for Developing Countries 86
Dilfraz Singh, Lovely Professional University

Unit 10: FDI : Types and Issues 93
Dilfraz Singh, Lovely Professional University

Unit 11: International Debt Crisis 111
Hitesh Jhanji, Lovely Professional University

Unit 12: Functions of WTO/GATT 126
Hitesh Jhanji, Lovely Professional University

Unit 13: UNCTAD, IMF, World Bank and Asian Development Bank 144
Dilfraz Singh, Lovely Professional University

Unit 14: India's Trade Policy : Recent Developments 159
Pavitar Parkash Singh, Lovely Professional University

Unit 15: India's Balance of Payment 173
Pavitar Parkash Singh, Lovely Professional University

Notes

Unit 1 : Merits and Demerits of Fixed and Flexible Exchange Rate

CONTENTS

Objectives
Introduction
1.1 Merits and Demerits of Fixed Exchange Rate
1.2 Merits and Demerits of Flexible Exchange Rate
1.3 Summary
1.4 Key-Words
1.5 Review Questions
1.6 Further Readings

Objectives

After reading this Unit students will be able to:

- Know the Merits and Demerits of Fixed Exchange Rate.
- Describe the Merits and Demerits of Flexible Exchange Rate.

Introduction

In the previous unit we discussed the various theories relating to the determination of exchange rate under different exchange rate regimes. The present unit discusses the exchange rate adjustment policies that have been in vogue from time to time with the establishment of the IMF. Before we discuss them, it is instructive to have a theoretical interlude relating to fixed and fluctuating exchange rates.

1.1 Merits and Demerits of Fixed Exchange Rate

Under fixed or pegged exchange rates all exchange transactions take place at an exchange rate that is determined by the monetary authority. It may fix the exchange rate by legislation or intervention in currency markets. It may buy or sell currencies according to the needs of the country or may take policy decision to appreciate or depreciate the national currency. The following arguments are usually advanced for and against the system of fixed exchange rates.

Merits of Fixed Exchange Rates

Economic Advantages of a Fixed Exchange Rate : As with a hard peg, a fixed exchange rate has the advantage of promoting international trade and investment by eliminating exchange rate risk. Because the arrangement may be viewed by market participants as less permanent than a currency board, however, it may generate less trade and investment.

As with a hard peg, the drawback of a fixed exchange rate is that it gives the government less scope to use monetary and fiscal policy to promote domestic economic stability. Thus, it leaves countries exposed to idiosyncratic shocks not shared by the country to which it has fixed its currency. As explained above, this is less of a problem than with a hard peg because imperfect capital mobility does allow for some deviation from the policy of the country or countries to which you are linked. But the shock would need to be temporary in nature because a significant deviation could not last.

The scope for the pursuit of domestic goals is greater for countries that fix their exchange rate to a basket of currencies — unlike a hard peg, the country is no longer placed at the mercy of the unique

Notes

and idiosyncratic policies and shocks of any one foreign country. One method for creating a currency basket is to compose it of the currencies of the country's primary trading partners, particularly if the partner has a hard currency, with shares set in proportion to each country's proportion of trade. If the correlation of the business cycle with each trading partner is proportional to the share of trade with that country, then the potential for idiosyncratic shocks to harm the economy should be considerably reduced when pegged to a basket of currencies. On the down side, baskets do not encourage as much bilateral trade and investment as a peg to a single currency because they reintroduce bilateral exchange rate risk with each trading partner.

Political Advantages of a Fixed Exchange Rate : In previous decades, it was believed that developing countries with a profligate past could bolster a new commitment to macroeconomic credibility through the use of a fixed exchange rate for two reasons. First, for countries with inflation rates that were previously very high, the maintenance of fixed exchange rates would act as a signal to market participants that inflation was now under control. For example, inflation causes the number of dollars that can be bought with a peso to decline just as it causes the number of apples that can be bought with a peso to decline. Thus, a fixed exchange rate can only be maintained if large inflation differentials are eliminated. Second, a fixed exchange rate was thought to anchor inflationary expectations by providing stable import prices. For a given change in monetary policy, it is thought that inflation will decline faster if people expect lower inflation.

After the many crises involving fixed exchange rate regimes in the 1980s and 1990s, this argument has become less persuasive. Unlike a currency board, a fixed exchange rate regime does nothing concrete to tie policymakers' hands and prevent a return to bad macroeconomic policy. Resisting the temptation to finance budget deficits through inflation ultimately depends on political will; if the political will is lacking, then the exchange rate regime will be abandoned, as was the case in many 1980s exchange rate crises. Thus burnt in the past, investors may no longer see a fixed exchange rate as a credible commitment by the government to macroeconomic stability, reducing the benefits of the fixed exchange rate. Furthermore, some currency board proponents claim that this lack of credibility means that investors will "test" the government's commitment to maintaining a soft peg in ways that are costly to the economy. By contrast, they claim that investors will not test a currency board because they have no doubt of the government's commitment.

For this reason, many economists who previously recommended fixed exchange rates on the basis of their political merits have shifted in recent years towards support of a hard peg. This has been dubbed the "bipolar view" of exchange rate regimes : growing international capital mobility has made the world economy behave more similarly to what models have suggested. As capital flows become more responsive to interest rate differentials, the ability of "soft peg" fixed exchange rate regimes to simultaneously pursue domestic policy goals and maintain the exchange rate has become untenable. As a result, countries are being pushed toward floating exchange rates (the pursuit of domestic goals) or "hard pegs" (policy directed solely toward maintaining the exchange rate). In this view, while "soft pegs" may have been successful in the past, any attempt by a country open to international capital to maintain a soft peg today is likely to end in an exchange rate crisis, as happened to Mexico, the countries of Southeast Asia, Brazil, and Turkey. Empirically, the trend does appear to be moving in this direction. In 1991, 65% of the world's 55 largest economies used "soft peg" exchange rate arrangements; in 1999, the number had fallen to 27%.

Although the international trend has been towards greater capital mobility and openness, it should be pointed out that there are still developing countries that are not open to capital flows. The "bipolar view" argument may not hold for these countries : without capital flows reacting to changes in interest rates, these countries may be capable of maintaining a soft peg and an independent monetary policy. This has been the case for China.

Fixed exchange rates have the following merits :

1. The case for fixed exchange rate between different countries is based on the case for a common currency within a country. A country having a common currency with a fixed value facilities trade increases production and leads to faster growth of the economy. Similarly, a country would benefit if it has a fixed value of its currency in relation to other countries. Thus fixed

exchange rates encourage international trade by making prices of goods involved in trade more predictable. They promote economic integration. As pointed out by Johnson, "The case for fixed rates is part of a more general argument for national economic policies conducive to international economic integration."

2. The second argument for a system of fixed exchange rates is that it encourages long-term capital flows in an orderly and smooth manner. There is no uncertainty and risk resulting from a regime of fixed exchange rates.
3. There is no fear of currency depreciation or appreciation under a system of fixed exchange rates. For instance, it removes fear that holding large quantities of foreign currency might lead to losses, if a currency's value drops. Thus it creates confidence in the strength of the domestic currency.
4. There is no fear of any adverse effect of speculation on the exchange rate, as speculative activities are controlled and prevented by the monetary authorities under a regime of fixed exchange rates.
5. Another advantage claimed by a system of fixed exchange rates is that it serves as an 'anchor' and imposes a discipline on monetary authorities to follow responsible financial policies with countries. "Inflation will cause balance of payments deficits and reserve loss. Hence the authorities will have to take counter-measures to stop inflation. Fixed exchange rates should, therefore, impose 'discipline' on governments and stop them from pursuing inflationary policies which are out of tune with the rest of the world."
6. Johnson favours fixed exchange rates in the 'banana republics' where foreign trade plays a dominant role. Flexible exchange rates in them lead to inflation and depreciation when the exchange rate falls.

Demerits of Fixed Exchange Rates

The following arguments are advanced against a system of fixed exchange rates :

1. The principle defect in the operation of a system of fixed exchange rates is the sacrifice of the objectives of full employment and stable prices at the alter of stable exchange rates. For example, balance of payments adjustment under fixed exchange rates of a surplus country can take place through a rise in prices. This is bound to impose large social costs within the country.
2. Again, under this system, the effects of unexpected disturbances in the domestic economy are transmuted abroad. "While a country may be protected by fixed exchange rates from the full consequences of domestic disturbances and policy mistakes, it has to bear a share of the burden of the disturbances and mistakes of others. For to the extent that excess demand 'leaks out' of the country where it was originally created, it 'leaks in' (via a balance of payments surplus) to that country's trading partner."
3. Under it, large reserves of foreign currencies are required to be maintained. Countries with balance of payments deficits must have large reserves if they want to avoid devaluation. If countries wish to remain on the fixed exchange rate system, they must hold large reserves of foreign currencies. This also imposes a heavy burden on the monetary authorities for managing foreign exchange reserves.
4. This system requires complicated exchange control measures which lead to malallocation of the economy's resources.
5. Another problem relates to the stability of the exchange rate. The exchange rate of a country vis-a-vis another country cannot remain fixed for sufficiently long period. Balance of payments problems and fluctuations in international commodity prices often compel countries to bring changes in exchange rates. Thus it is not possible to have rigidly fixed exchange rates.

In fact, a regime of fixed exchange rates presupposes uniformity of domestic policy objectives and response of prices to fluctuations in demand. Such a system would undoubtedly run into severe difficulties in the present-day world. This is because there is a reluctance to be committed to the harmonisation of domestic policy objectives; prices respond only in a limited fashion of fluctuations

Notes

in the pressures of demand, and elasticities of demand in international trade have in general turned out to be quite low, at least in the short run. For these reasons, a rigidly fixed exchange rate regime has never been advanced as serious possibility in any of the recent discussions of reform of the international monetary system.

1.2 Merits and Demerits of Flexible Exchange Rate

Flexible, *floating* or *fluctuating* exchange rates are determined by market forces. The monetary authority does not intervene for the purpose of influencing the exchange rate. Under a regime of freely fluctuating exchange rates, if there is an excess supply of a currency, the value of that currency in foreign exchange markets will fall. It will lead to depreciation of the exchange rate. Consequently, equilibrium will be restored in the exchange market. On the other hand, shortage of a currency will lead to appreciation of exchange rate thereby leading to restoration of equilibrium in the exchange market. These market forces operate automatically without any intervention on the part of monetary authorities. We study below the case for and against flexible exchange rates.

Merits of Flexible Exchange Rates

The following merits are claimed for a system of flexible exchange rates :

1. A system of flexible exchange rates is simple in the operative mechanism. The exchange rate moves automatically and freely to equate supply and demand, thereby clearing the foreign exchange market. It does not allow a deficit or surplus to build up and eliminates the problem of scarcity or surplus of any one currency. It also avoids the need to induce changes in prices and incomes to maintain or restore equilibrium in the balance of payments.
2. Under it, the adjustment is continual. The adjustment in the balance of payments are smoother and painless as compared with the fixed exchange rate adjustments. In fact, flexible exchange rates avoid the aggravation of pressures on the balance of payments and the periodic crises that follow disequilibrium in the balance of payments under a system of fixed exchange rates. There is an escape from the various corrective measures that are adopted by the governments whenever the exchange rate depreciates or appreciates.
3. Under this system, autonomy of the domestic economic policies is preserved. Modern governments are committed to maintain full employment and promote stability with growth. They are not required to sacrifice these objectives of full employment and economic growth in order to remove balance of payments disequilibrium under a regime of flexible exchange rates. As pointed out by Johnson, " The fundamental argument for flexible exchange rates is that they allow countries autonomy with respect to their use of monetary, fiscal and other policy instruments, by automatically ensuring the preservation of external equilibrium."
4. Since under a system of flexible exchange rates disequilibrium in the balance of payments is automatically corrected, there is no need to accommodate gold movements and capital flows in and out of countries.
5. There is no need for foreign exchange reserves where exchange rates are moving freely. A deficit country will simply allow its currency to depreciate in relation to foreign currency instead of intervening by supplying foreign exchange reserves to the other country to maintain a stable exchange rate. According to Sohmen, a system of flexible exchange rates removes the problem of international liquidity. The shortage of international liquidity is the result of pegged exchange rates and intervention by monetary authorities to prevent fluctuations beyond narrow limits. When exchange rates are flexible, speculators will supply foreign exchange to satisfy private liquidity needs. Individuals, traders, banks, governments and others would, of course, continue to hold liquid assets in the form of gold or foreign exchange, but these holdings would be working reserves for purposes other than the maintenance of a fixed external value of the country's currency.
6. As a corollary to the above, when foreign exchange rates move freely, there is no need to have international institutional arrangements like the IMF for borrowing the lending short-term funds to remove disequilibrium in the balance of payments.

Notes

7. Again, according to Sohmen, the system of flexible exchange rates re-inforces the effectiveness of monetary policy. If a country wants to increase output, it will lower interest rates under a regime of flexible exchange rates, the lowering of interest rates will result in an outflow of capital, a rise in the spot rate for the currency which will, in turn, cause exports to rise and imports to fall. The increased exports will tend to rise domestic prices, or income or both. Thus a favourable trade balance will reinforce the expansionary effects of lower interest rates on domestic spending, thereby making monetary policy more effective. The above process will be reversed if the country wants to fight inflation by raising interest rates.
8. A system of flexible exchange rates does not require the introduction of complicated and expansive trade restrictions and exchange controls. Thus the cost of foreign exchange restrictions is removed.
9. Again, as a corollary to the above, the world can get rid of competitive exchange rate depreciation and tariff warfare among nations and there shall be no need of forming custom unions and currency areas which are the concomitant results of the system of fixed exchange rates.

Demerits of Flexible Exchange Rates

The advocates of fixed exchange rates advance the following arguments against a system of flexible exchange rates :

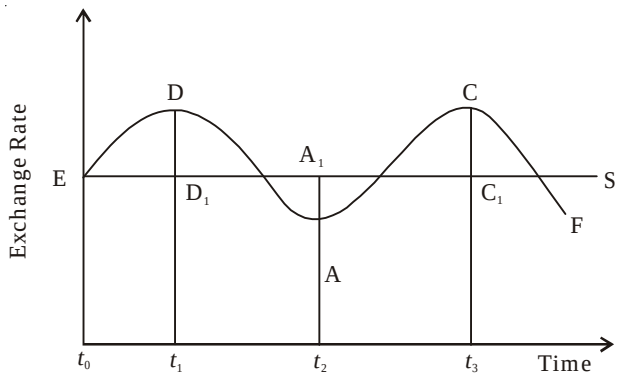
1. Critics of flexible exchange rates point out that market mechanism may fail to bring about an appropriate exchange rate. The equilibrium exchange rate in the foreign exchange market at a point of time may not give correct signals to concerned parties in the country. This may lead to wrong decisions and malallocation of resources with the country.
2. It is difficult to define a freely flexible exchange rate. It is not possible to have an exchange rate where there is absolutely no official intervention. Government may not intervene directly in the foreign exchange market, but domestic monetary and fiscal measures do influence foreign exchange rates. For instance, if domestic saving is more than domestic investment, it means that the country is a net investor abroad. The outflow of capital will bring down the exchange rate. All this may be due to the indirect impact of government policies. Further, in the absence of any understanding among governments about exchange rate manipulation, the system of flexible exchange rates might lapse into anarchy, for every country would try to establish favourable exchange rates with other countries. This may lead to retaliation among nations and result in war of exchange rates with disruptive effects on trade and capital movements. Thus some sort of understanding or agreement concerning exchange rates is implied in a regime of flexible exchange rates.
3. Another disadvantage of this system is that frequent variations in exchange rates, create exchange risks, breed uncertainty and impede international trade and capital movements. For instance, an Indian who imports from Japan and promises to pay in yen runs the risk that the rupee price of yen will rise above expected levels. And the Japanese exporter who sells for rupees runs the risk that the yen price of rupees will fall below expected levels. Similarly, exchange risks may be even more serious for long-term capital movements. This is because under a system of flexible exchange rates borrowers and lenders will be discouraged to enter into long-term contacts and the possibility of varying burden for servicing and repayment may be prohibitive.

   Bo Sodersten has shown how flexible exchange rates increase uncertainty for traders and have a dampening effect on the volume of foreign trade. Assume that a country is under a regime of flexible exchange rates, the general price level is stable and the balance of trade is in equilibrium. Suppose the demand for the country's exports decreases, this leads to depreciation of the country's currency which, in turn, raises import prices and brings a fall in imports. Consequently, importers will be adversely affected. At the same time, exporters will gain with the increase in the prices of export goods. But the volume of exports will decline whereby they will also be losers. Opposite will be the consequences when currency appreciates. Suppose there is an abnormal inflow of short-term capital to country A which tends to raise its exchange rate. This will, in turn, increase the cost of A's exports in terms of foreign currencies, thereby lowering the

Notes

levels of output, employment and income in its export industries. The rise of exchange rate will also lower the cost of imports, thus discouraging output and employment in A's import competing industries. Thus importers and exporters will be at a disadvantage and the volume of trade will decline. This is illustrated in terms of Sodersten's diagram, shown as Figure 1. The horizontal line *S* shows stable or fixed exchange rate, and the zig-zag line F shows flexible exchange rate. At time t_0 the exchange rate is the same E, under both flexible and fixed rate systems. At t_1, the currency depreciates and the flexible exchange rate moves to D while the fixed exchange rate is at the same level D_1(= E). Since import prices have risen, imports will be discouraged and exports will be encouraged. At time t_2 the currency appreciates and the flexible rate moves to A whereas the fixed rate remains at the same level A_1 (= E).

At A import prices fall. Imports are encouraged and exports are discouraged. So exports will be at a disadvantage at A than at A_1 and importers will gain at A than at A_1. Similar will be at time t_3 with fixed exchange rate at C_1 and the flexible exchange rate at C level. Thus fluctuations of the exchange rate around a trend value will increase risks for exports and imports that will adversely affect the volume of foreign trade.



Figgure 1.1

4. Under this system, speculation adversely influences fluctuations in supply and demand for foreign exchange. Critics argue on the basis of empirical evidence that speculation is destabilising which means that it aggravates fluctuations in exchange rate. "It is often said that speculators see a decline in the exchange rate as a signal for further decline, and that their actions will cause the movement in the exchange rate to be larger than it would be in the absence of speculation. In such a case, speculation is destabilising. Sodersten points out that "the limited experience from the 1920s seem to show that speculation at that time was destabilising. Since floating rates became common in 1973, fluctuations in exchange rates have been large. It seems that some of the excessive fluctuations have been caused by destabilising speculation." Such fluctuations increase uncertainties in trade and reduce the volume of foreign trade further.
5. Another serious drawback of a flexible exchange rate system is its inflationary bias. Critics argue that under a system of flexible exchange rates, a depreciation of the exchange rate leads to a vicious circle of inflation. Depreciation leads to a rise in import prices thereby making import goods more expensive. This leads to cost-push inflation. At the same time, export prices rise. Consequently, with the rise in the cost of living, money wages rise which, in turn, intensify inflation. But an appreciation of currency is unlikely to lead to a reduction in wages and prices when imports prices fall. This is because wages and prices are sticky downwards. This leads to an asymmetry which produces that Triffin calls *ratchet effect* that imparts an inflationary bias to the economy.
6. The main case against the system of flexible exchange rates is that it breaks up the world market. There is no one money which serves as a medium of exchange, unit of account, store of value and a standard of deferred payment. Under it, the world market for goods and capital would be divided. Resources allocation would be vastly sub-optimal. In fact, such a system clearly would not last long, according to Kindleberger.

Notes

From the above merits and demerits of fixed and flexible exchange rates, it is difficult to conclude that either rigidly fixed or freely floating exchange rates are likely to be put into practice.

Self-Assessment

1. Choose the correct options:

(*i*) Floating exchange rates

(*a*) tend to correct balance of payments imbalances

(*b*) reduce the uncertainties and risks associated with international trade

(*c*) increase the world's need for international monetary reserves

(*d*) tend to expand the volume of world trade

(*ii*) If Canada has floating exchange rates, and a capital account deficit

(*a*) Canada has a current account deficit

(*b*) Canada is losing international reserves

(*c*) Canada has a current account surplus

(*d*) Canada is gaining international reserves

(*iii*) If a nation has a current account deficit of 6 and a capital account surplus of 2

(*a*) the nation gains 8 in international reserves

(*b*) the nation loses 8 in international reserves

(*c*) the nation gains 4 in international reserves

(*d*) the nation loses 4 in international reserves

(*iv*) When the balance on Canada's official settlement account is positive

(*a*) Canada's balance on current + capital accounts is negative, and we are gaining international reserves

(*b*) Canada's balance on current + capital accounts is positive, and we are gaining international reserves

(*c*) Canada's balance on current + capital accounts is negative, and we are losing international reserves

(*d*) Canada's balance on current + capital accounts is positive, and we are losing international reserves

(*v*) Which of the following is a disadvantage of a flexible exchange rate system?

(*a*) nations must keep large reserves of gold or foreign currencies

(*b*) flexible rates usually tend to produce inflation

(*c*) uncertainty that tends to inhibit trade

(*d*) all of the above

1.3 Summary

- The present unit discusses the exchange rate adjustment policies that have been in vogue from time to time with the establishment of the IMF. Before we discuss them, it is instructive to have a theoretical interlude relating to fixed and fluctuating exchange rates.
- As with a hard peg, the drawback of a fixed exchange rate is that it gives the government less scope to use monetary and fiscal policy to promote domestic economic stability. Thus, it leaves countries exposed to idiosyncratic shocks not shared by the country to which it has fixed its currency. As explained above, this is less of a problem than with a hard peg because imperfect capital mobility does allow for some deviation from the policy of the country or countries to which you are linked. But the shock would need to be temporary in nature because a significant deviation could not last.

Notes

- In fact, a regime of fixed exchange rates presupposes uniformity of domestic policy objectives and response of prices to fluctuations in demand. Such a system would undoubtedly run into severe difficulties in the present-day world. This is because there is a reluctance to be committed to the harmonisation of domestic policy objectives; prices respond only in a limited fashion of fluctuations in the pressures of demand, and elasticities of demand in international trade have in general turned out to be quite low, at least in the short run.

1.4 Key-Words

1. Fixed exchange rate : A fixed exchange rate, sometimes called a pegged exchange rate, is also referred to as the Tag of particular Rate, which is a type of exchange rate regime where a currency's value is fixed against the value of another single currency or to a basket of other currencies, or to another measure of value, such as gold.

   A fixed exchange rate is usually used to stabilize the value of a currency against the currency it is pegged to. This makes trade and investments between the two countries easier and more predictable and is especially useful for small economies in which external trade forms a large part of their GDP.

2. Flexible exchange rate : A flexible exchange-rate system is a monetary system that allows the exchange rate to be determined by supply and demand. Every currency area must decide what type of exchange rate arrangement to maintain. Between permanently fixed and completely flexible however, are heterogeneous approaches.

1.5 Review Questions

1. What do mean by fixed exchange rate?
2. Explain the merits and demerits of fixed exchange rate.
3. Discuss Filexible exchange rate.

Answers: Self-Assessment

1. (*i*) (*b*) (*ii*) (*c*) (*iii*) (*c*) (*iv*) (*c*) (*v*) (*c*)

1.6 Further Readings

1. Dornbusch, Rudiger and Stanley Fischer (1980). \Exchange Rates and the Current Account." American Economic Review 70, 960 {71.
2. Frenkel, Jacob A. and Michael L. Mussa (1985). \Asset Markets, Exchange Rates, and the Balance of Payments: The Reformulation of Doctrine." See Jones and Kenen (1985), pp. 679{747.
3. Isaac, Alan G. (1989). \Wealth E_ects and the Current Account with Endogenous Terms of Trade." Journal of Macroeconomics 11(4), xxx.
4. Jones, Ronald W. and Peter B. Kenen, eds. (1985). Handbook of International Economics, Volume 2. Amsterdam: North Holland Publishing Co.
5. Kenen, Peter (1985). \Macroeconomic Theory and Policy: How the Closed Economy was Opened." See Jones and Kenen (1985), Chapter 13, pp. 625{677.
6. Kouri, Pentti J.K. (1976, May). \The Exchange Rate and the Balance of Payments in the Short Run and the Long Run: A Monetary Approach." Scandinavian Journal of Economics 78(2), 280{304.

Notes

Unit 2 : Expenditure Reducing and Expenditure Switching Policies

CONTENTS

Objectives
Introduction
2.1 The Expenditure Reducing or Changing Policies
2.2 The Expenditure Switching Policy : Devaluation
2.3 Summary
2.4 Key-Words
2.5 Review Questions
2.6 Further Readings

Objectives

After reading this Unit students will be able to:

- Discuss the Expenditure Reducing or Changing Policies.
- Explain the Expenditure Switching Policy.

Introduction

The need for BOP adjustment, particularly of deficit disequilibrium, is clear. A nation's ability to absorb deficits is broadly limited by its stock of official international reserves — gold and generally acceptable foreign currencies — and the willingness of foreign countries to hold its currency as part of their own international reserves. Accommodating short-term capital borrowings can help in prolonging BOP deficit adjustments, but they cannot be relied upon indefinitely. Another constraint to BOP adjustment is the desire on the part of countries to achieve high levels of national income and employment consistent with price stability. Internal balance cannot be sacrificed for the sake of external balance.

In the previous unit, we tried to show how BOP adjustment tends to come about more or less automatically under two different exchange rate systems — one, where the exchange rate is fixed but prices, interest rates, income levels and capital flows are free to fluctuate; and second, where there is freely fluctuating exchange rate system. For the effective working of this automatic adjustment mechanism, there is no need for any policy action by the government; in fact, government non-intervention is a condition.

It should be stressed, however, that neither of the two self-equilibriating systems conforms to reality. There is very little 'automaticity' in BOP adjustment in the real world. Government intervention, today, is a fact of life in all countries — developed or underdeveloped. The 'visible hand' of government is seen everywhere — in controlling prices, interest rates, income levels or exchange rates. Indeed, BOP adjustment has become largely a matter of policy. Government have come to use a wide variety of policy instruments to achieve BOP equilibrium; and the government policies designed to produce 'external balance' cannot afford to ignore questions related to 'internal balance'. As a matter of fact, in ordering national priorities, internal balance claims a definite precedence over external balance, practically, in every country in the world. What we have essentially today, are disequilibrium systems of national economies.

Let us now proceed to discuss the BOP adjustment methods or policy instruments. They can be grouped under three broad categories as follows :

Notes

(a) The Expenditure Reducing or Changing Policies.

(b) The Expenditure Switching Policy : Devaluation.

(c) Exchange Controls.

Each one of them merits a detailed discussion, which we will undertake in this unit.

2 .1 The Expenditure Reducing or Changing Policies

The *expenditure changing policies*, also called 'expenditure adjusting' policies, refer to the policies that are aimed at changing (reducing or increasing) the aggregate expenditure in the domestic economy. Countries facing BOP deficit due to trade deficits adopt expenditure reducing policies. In a macroeconomic framework, trade deficit (TD) can be measured as follows. We know that at equilibrium,

$$Y \equiv C + I + G + X - M$$

If M > X, $\quad M - X \equiv TD$

By substitution, Y at equilibrium can be expressed as

$$Y \equiv C + I + G - TD$$

Thus,

$$TD \equiv (C + I + G) - Y$$

This equation implies that there is trade deficit because (C + I + G) > Y, *i.e.*, aggregate expenditure exceeds aggregate income. It means that trade deficit can be reduced or eliminated by reducing the aggregate expenditure that equals C + I + G. Let us now discuss the working and effectiveness of these policy measures in eliminating the *BOP imbalances*. In this part of analysis, we will assume *a fixed exchange rate* and free flow of capital.

Did u know? The policies that are used to reduce the aggregate expenditure include : (i) *monetary policy*, (ii) *fiscal policy*, and (iii) *monetary-fiscal policy mix*.

BOP Adjustment through Monetary Policy

Monetary policy refers to the measures adopted by the monetary authority to increase or decrease the money supply and availability of credit.[1] A monetary policy aimed at increasing the money supply and availability of credit to the public is called **expansionary monetary policy** or 'easy money policy.' And, a monetary policy aimed at decreasing the money supply and availability of credit to the public is called **contractionary monetary policy** or 'dear money policy.' We will analyse here the working of monetary policy in correcting the adverse BOP position and in restoring equilibrium in the BOP, all other things remaining the same.

The working and effects of monetary policy are illustrated in Figure 19.1. Suppose that the internal economy of a country is in equilibrium at point E_1, the point of intersection between the IS and LM_1 schedules. The external balance (EB) at different combinations of income levels and interest rates is given by the EB schedule which is the same as BOP schedule. Note that EB schedule does not pass through the internal equilibrium point E_1. Therefore, the internal and external sectors are not

1. The monetary measures that are used to change the money supply include (a) bank rate, the rate at which central bank lends money to banks or discounts the bills of the commercial banks, (b) open market operation, *i.e.* buying and selling the government bond and treasury bills in the open market, and (c) statutory cash reserve ratio, the ratio of term deposits that commercial banks are, by statute, required to maintain in the form of cash reserves.

Notes

simultaneously in equilibrium. Note also that the initial internal equilibrium point E_1 is on the right side and below the external balance schedule EB. It means that the country is faced with a BOP deficit at income level OY_1 and interest rate Or_2.

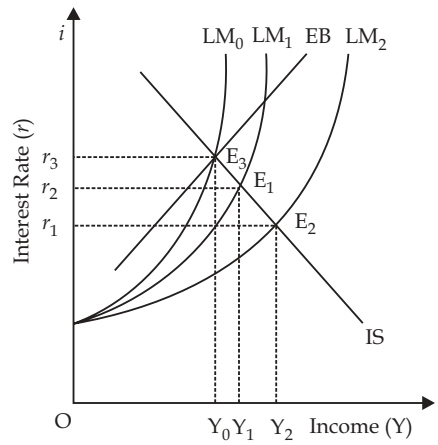


Figure 2.1: BOP Adjustment through Monetary Policy

Now the question arises : What kind of monetary policy would be helpful in solving the problems of BOP deficit and surplus and in achieving internal and external balance ? To answer this question, let us suppose that a country is facing BOP deficit. In that case, the answer is that a **contractionary monetary policy** would reduce the BOP deficit. Let us now examine what happens when the government adopts a *contractionary monetary policy*, that is, a policy of reducing money supply. When a contractionary monetary policy is adopted, it decreases money supply. The decrease in money supply reduces the BOP deficit in two ways.

On the one hand, a decrease in money supply shifts the LM_1 schedule leftward towards LM_0 and the internal equilibrium point upward to the left. This takes the internal equilibrium point closure to the EB schedule. It means reduction in the BOP deficits. The reason is, a decrease in money supply increases the rate of interest. Increase in the interest rate reduces domestic investment. A fall in investment reduces the level of income and hence the level of imports. Reduction in imports reduces the trade deficit and therefore the BOP deficit.

On the other hand, increase in the interest rate results in short-term capital inflow which too reduces the BOP deficit. As shown in Figure 19.1, a decrease in money supply shifts the LM schedule from LM_1 to LM_0. This shift increases the interest rate to Or_3. The rise in the domestic rate of interest works as an incentive for foreign investment. This causes inflow of foreign capital. The inflow of foreign capital reduces the capital account defficits. As a result, the BOP deficit decreases and it may disappear finally.

Let us now see what kind of monetary policy is adopted by a country to correct its BOP disequilibrium of *surplus* nature. In that case, the country adopts an **expansionary monetary policy**. When the government adopts a policy of monetary expansion, the schedule LM_1 will shift rightward to LM_2, all other things remaining the same, and the internal equilibrium shifts to point E_2. Point E_2 is below and to the right of the EB schedule. It means that monetary expansion would increase the BOP deficit and reduce BOP surplus. The reason is that monetary expansion reduces the rate of interest. This has a two-way effects on the economy. On the one hand, it increases the domestic investment which increases the level of income and increase in income increases imports, widening the gap between exports and imports. That is, monetary expansion enhances the trade deficit and reduces trade surplus. On the other hand, a lower interest rate leads to capital outflow which decreases capital account surplus. Thus, the combined effect of the monetary expansion is deterioration in the BOP surplus.

The conclusions that emerge from the analysis of effects of the monetary policy is that a contractionary monetary policy reduces the BOP deficits and helps in achieving internal and external balance, and an expansionary monetary policy reduces country's BOP surplus.

Notes

BOP Adjustment through Fiscal Policy

Before we explain the working and effectiveness of fiscal policy in bringing about BOP adjustment, let us recall that *fiscal policy* refers to the deliberate changes made by the government in its expenditure and taxation policies or both. Fiscal policy can be used as an effective tool of changing the aggregate demand and aggregate expenditure in the economy. Like monetary policy, a fiscal policy can be an **expansionary fiscal policy** or a **contractionary fiscal policy**. An expansionary fiscal policy increases the aggregate demand and a contractionary fiscal policy reduces the aggregate demand. A country adopting an expansionary fiscal policy increases government spending or decreases the level of taxation or adopts both the measures simultaneously. A country adopting a contractionary fiscal policy cuts down government spending or raises the level of taxation, or uses both measures simultaneously. What kind of fiscal policy is adopted depends on the causes and the nature of BOP disequilibrium and the need for BOP adjustment.

Let us now examine the effect of fiscal policy on the BOP deficit and BOP surplus. We will analyze first the effect of fiscal policy on BOP deficit—the major problem. With a view to avoiding complications that might arise due to other policy measures, we assume that the government uses only fiscal policy to influence country's balance of payments, all other factors remaining the same.

The effect of fiscal policy on the BOP is illustrated in Figure 19.2. Let us assume that a country is faced with BOP deficit and examine what kind of fiscal policy would be appropriate for restoring the BOP to equilibrium. Suppose that internal equilibrium of the country is given at point E_2, the point of intersection between the LM and IS_2 schedules and that country's external balance is given by schedule EB. Note that the internal equilibrium point E_2 falls below and to the right of the EB schedule. This indicates that the country is faced with a BOP deficit indicated by point J.

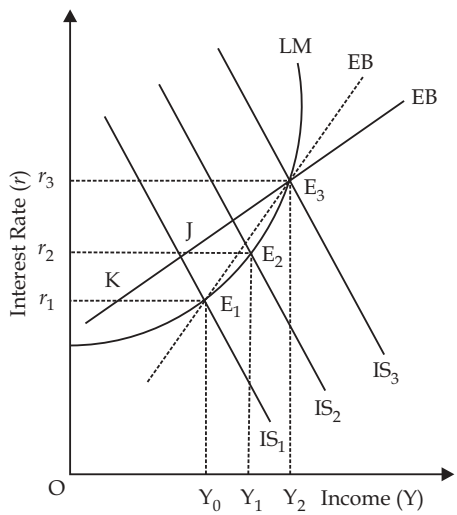


Figure 2.2: BOP Adjustment through Fiscal Policy

It may be added here that there is some ambiguity in the effectiveness of both *expansionary* and *contractionary* fiscal polices. To explain it further, let us examine the effect of contractionary and expansionary fiscal policies alternatively on the country's BOP position. Let us first look at the effect of a *contractionary fiscal policy* on the BOP deficit and internal and external balance.

When the government adopts a **contractionary fiscal policy**, leaving other things undisturbed, the schedule IS_2 shifts downward to IS_1. A new internal equilibrium is reached at point E_1, the point where schedule IS_1 intersects with LM schedule. At this point of equilibrium, the BOP deficit increases further as indicated by point K which is further away from equilibrium point E_1. That is, contractionary fiscal policy causes BOP to deteriorate. What is worse, the level of income decreases, causing increase in unemployment. The reason for the deterioration in the BOP is the decrease in interest rate from Or_2 to Or_1 which causes outflow of capital. Although, a contractionary fiscal policy decreases simultaneously the imports by decreasing national income, the outflow of capital overweighs the decrease in the imports caused by the decrease in income. Therefore, country's BOP position deteriorates.

Notes

It is, however, important to note that whether a contractionary fiscal policy worsens or improves EB depends on the slope of the EB schedule in relation to the LM curve. Given the slope of the LM schedule, for example, if EB schedule rotates anticlockwise, it will get closer to the equilibrium point E_1, showing improvement in EB, as shown by EB' schedule. It is however equally important to note that the improvement in EB achieved by contractionary fiscal policy results in a lower level of equilibrium income and employment and also at a lower rate of interest. Fall in the interest rate may cause outflow of capital which will have adverse effect on the economy.

Let us now examine the effect of **expansionary fiscal policy**. An expansionary fiscal policy will shift the schedule IS_2 upward to IS_3. Note that the schedules IS_3, LM and EB all intersect at point E_3. This implies that E_3 is the point of internal and external balance which determines the income level at OY_2 and interest rate at Or_3. Although imports increase due to increase in income, capital inflow and increase in imports are presumably in balance. Therefore, external sector is in balance with the internal sector.

The effect of expansionary fiscal policy on BOP may appear to be ambiguous. As noted above, the effect of expansionary fiscal policy depends on the slope of the EB schedule. If EB schedule has a higher slope as shown by the dashed schedule EB' and LM schedule is curvilinear, then there will be two equilibrium points E_1 and E_3. Then the country will have to make a choice between the expansionary fiscal policy and contractionary fiscal policy. An expansionary fiscal policy is however a clear choice as it gives a higher level of income and employment and solves the problem of BOP deficit.

Monetary-Fiscal Mix and BOP Adjustment

In the preceding sections, we have examined the effects of monetary and fiscal policies assuming the only one of these policies is adopted at a time. In practice, however, most countries use a monetary-fiscal mix to correct their adverse BOP. We have noted that a contractionary monetary policy is helpful in correcting the BOP deficit, whereas an expansionary fiscal policy is preferable for correcting the BOP deficit. So a country opting for using a monetary-fiscal mix for correcting its BOP deficit would adopt a combination of **contractionary monetary** and an **expansionary fiscal policy.** We will discuss here how a policy-mix works to correct the BOP deficit and to attain internal and external balance, assuming **fixed exchange rate** and relative interest-elasticity of capital mobility.

The working of monetary-fiscal mix is illustrated in Figure 19.3 which is a combination of Figures 19.1 and 19.2. Suppose that the initial internal equilibrium of a country is given at point E, the point of intersection between schedules IS_1 and LM_3. Since point E is below and to the right of EB schedule, the country has a BOP deficit. Now the problem before the country is how to correct the BOP deficit. To achieve this goal, the country has three alternative options : (i) to use only monetary policy, (ii) to use only fiscal policy, and (iii) to use a mix of monetary and fiscal policies. The effects of monetary and fiscal policies have already been discussed. This part of the analysis will however be repeated here briefly to show the links between the three options. We will then analyse the combined effect of monetary-fiscal mix.

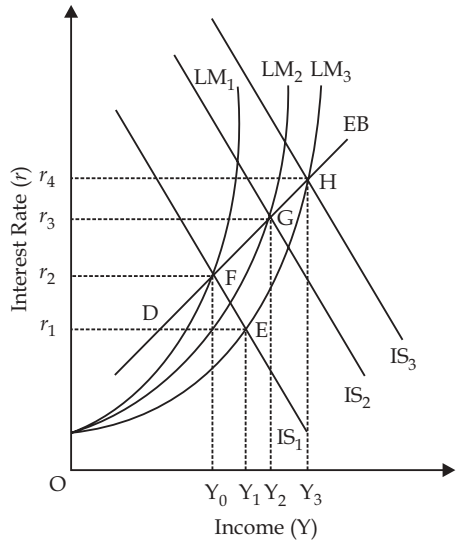


Figure 2.3: Monetary-Fiscal Policy-Mix for Eliminating BOP Deficit

Notes

Suppose that the country chooses to use only **monetary policy,** and adopts a contractionary monetary policy to correct its BOP deficit. The use of a contractionary monetary policy makes its original LM schedule (LM_3) shift leftward to LM_1 intersecting schedule EB at point F. Now all the three schedules, EB, LM_1 and IS_1, intersect at point F. Point F is therefore the point of internal and external balance. The BOP deficit is totally eliminated. But the country has to pay a high cost in terms of fall in the national income from OY_1 to OY_0 and a rise in the interest rate from Or_1 to Or_2. It means that the BOP deficit is eliminated at the cost of decrease in national income and increase in unemployment. This is, of course, a heavy cost of eliminating the BOP deficit.

Let us now look at the effects of **fiscal policy** in isolation. When a country decides to use only fiscal policy to eliminate its BOP deficit, it will have to use an expansionary fiscal policy. To begin the analysis, let us suppose that the economy is in equilibrium at point E with BOP deficit and the government uses expansionary fiscal policy. The use of an expansionary fiscal policy shifts the original IS schedule from IS_1 to IS_3 which intersects with schedules EB and LM_3 at point H. All the three schedules, EB, LM_3 and IS_3, intersect at point H. Point H is, therefore, the point of internal and external balance. The BOP deficit is totally eliminated. What are the other consequences ? The level of national income increases from OY_1 to OY_3 and interest rate increases from Or_1 to Or_4. This increase in national income and interest rate has a very high inflationary potential. It means that the BOP deficit is eliminated at the risk of high potential inflation. Inflation involves high economic and social costs. This solution may therefore not be socially and politically desirable.

Let us now examine the effect of **monetary-fiscal mix.** When the government decides to use a policy-mix, it will have to adopt a contractionary monetary policy combined with an expansionary fiscal policy. A policy-mix approach requires using an expansionary fiscal and a contractionary monetary policy. The expansionary fiscal policy shifts schedule IS_1 to IS_2 and contractionary monetary policy shifts schedule LM_3 to LM_2. In Figure 19.3, schedules IS_2, LM_2 and EB intersect at point G. Point G is therefore the point of internal and external balance. This solution is comparatively better and preferable as it mitigates the disadvantages of both monetary and fiscal policies used separately. Unlike monetary policy, it does not cause unemployment and decrease the level of income, and unlike fiscal policy, it does not create conditions for hyper inflation though some inflation will be there. A policy mix approach is, therefore, preferable to other options available to the country.

Assignment Dilemmas in Policy Mix

The use of monetary-fiscal mix in not as simple and straightforward as concluded above. The choice and implementation of monetary-fiscal mix is a complex problem in the real world. Complexity arises on account of the following two factors.

(i) **Lack of Perfect Knowledge and Accurate Data** : The policy makers, in general, do not have perfect knowledge about the shape and place of the IS and LM schedules. Nor do they have complete and accurate data about the economic variables used in the IS-LM model. The policy-makers have data, often inaccurate, only on national income, unemployment, inflation, interest rate and balance of payments. This is just not sufficient to determine the shape, slope and place of the IS and LM curves. Therefore, it is immensely difficult to formulate an optimum monetary-fiscal mix. Besides, what is largely unknown and unpredictable—but a crucial requirement in the formulation of an appropriate monetary-fiscal mix—is the possible outcome of interaction between the monetary and fiscal policies. It is therefore, extremely difficult to adjust the monetary and fiscal levers to find an optimal combination of monetary-fiscal policy mix.

(ii) **Disagreement on the Role and Effectiveness of Monetary and Fiscal Policies** : As discussed earlier, the economists disagree on the role and effectiveness of monetary and fiscal policies. The disagreement on the role and effectiveness of monetary and fiscal policies and the ensuing a prolonged debate has created more confusion rather than providing guidelines for finding an appropriate policy mix. The final choice is then made on the political and ethical grounds which conflict often with economic goals.

The nature and the classification of problems involved in policy choice is illustrated in Figure 19.4. The schedule EB is the same as in Figure 19.3. It represents the path of external balance. The vertical line, IB, represents the path of *internal balance.* It is drawn through the

possible points of intersection between the IS and LM schedules. The schedule IB need not necessarily be a vertical line. Depending on the placement of the IS and LM schedules, it may have a negative

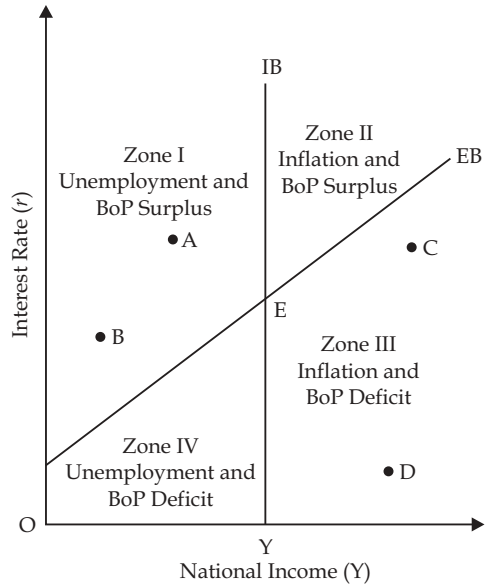


Figure 2.4: The Four Zones of Different Kinds of Internal and External Disequilibrium

slope or a positive slope. However, we proceed to analyse the conflicting results of different kinds of monetary fiscal mix by assuming a vertical IB schedule. As shown in Figure 19.4, schedules IB and EB intersect at point E. Point E is, therefore, the only point of simultaneous internal and external balance. The points on schedule IB are the points of only internal equilibrium, and points on schedule EB are the points of only external equilibrium. All other points in the diagram, *e.g.*, points A, B, C and D, are the point of both internal and external disequilibrium. The intersecting schedules IB and EB, divide the diagram into four zones of internal and external disequilibrium. Each of these zones represents different kinds of economic problem. The different kinds of economic problems associated with each zone is listed below.

Zone I : Unemployment and BOP surplus

Zone II : Inflation and BOP surplus

Zone III : Inflation and BOP deficit

Zone IV : Unemployment and BOP deficit

An economy which is not operating at point E or at any point on the IB and EB schedules is operating on a point in any of these four zones. From policy point of view, Zones I and III are the zones of dilemma. The dilemma is that no uniform policy can be adopted if the economy is operating on any two different points in any of these zones. For example, points A and B in Zone I need two different combinations of monetary and fiscal policies. At point A the authorities are required to cut down the government spending and to increase money supply in order to move towards point E. But, when the economy is operating at point B, the authorities will be required to do the opposite. Similarly, two opposite policies are required on points C and D in Zone III.

The situation is not as bad in Zones II and IV because, in these two zones, the direction of change in at least the government spending is predictable. For example, in Zone II the authorities are required to reduce the government spending irrespective of the point on which the economy is placed. Similarly, in Zone IV, the government spending has to be increased on any point in the zone. But, the direction of change in money supply remain uncertain as in case of Zones I and III.

Notes

The Mundellian Policy Assignment

Mundell suggested in 1962 and again in 1968 a solution to the problem of policy predicament discussed in the preceding section. We discuss here briefly the Mundellian approach to the problem of *policy assignment*. According to Tinbergen rule, *a policy instrument should be assigned a target which it can hit relatively most effectively*. Going by this rule, monetary policy or fiscal policy should be assigned a task which it can perform most successfully in achieving internal and external balance. Since monetary and fiscal policies have both their relative advantages and disadvantages, these policies need to be so combined that their positive effects are maximized and negative effects minimized.

Mundell's rule of policy assignment for the four different kinds of economic problems in four zones are summarized as follows :

Zone	Nature of Imbalance	Monetary Policy	Fiscal Policy
I	Unemployment and BOP surplus	Expansionary	Expansionary
II	Inflation and BOP surplus	Expansionary	Contractionary
III	Inflation and BOP deficit	Contractionary	Contractionary
IV	Unemployment and BOP deficit	Contractionary	Expansionary

However, Mundellian solution has its own problems. These policy assignment rules offer a stable solution to the problem of internal and external balance only when (i) policies are chosen judiciously and implemented without discretionary changes, and (ii) there is no time lag in the working of monetary and fiscal policies. These are big conditions, particularly, the condition regarding the time lag. Therefore, Mundell's solution is considered to be **unstable** and, therefore, impractible.

Notes

Mundell developed a *principle of effective market classification* and suggested a rule for efficacy and stability of policy measures following Tinbergen's rule.

Problems in Applying Mundellian Monetary-Fiscal Policy Mix

The monetary-fiscal policy-mix as a means to attaining internal and external balance has strong theoretical underpinning. In reality, however, this approach has serious practical problems.

One, the Mundellian approach assumes that policy-makers are fully aware of (i) the internal balance path (*i.e.*, IB schedule), (ii) the external balance path (*i.e.*, the EB schedule), (iii) the zone in which the economy is placed, and (iv) how away is the economy placed from the IB schedule. In reality, however, these parameters are unknown and difficult to determine.

Two, for lack of necessary data, determination of an exact combination of monetary and fiscal measures compatible with one another for achieving internal and external balance is an extremely difficult task. Therefore, some arbitrariness has to be there in the policy formulation. Besides, political considerations do affect the decision-making. Any mismatch between the monetary-fiscal mix on these accounts affects the efficacy of the policy mix.

Three, the monetary-fiscal mix is based on some predictable relationship between the interest rate and capital flows. This relationship may be disturbed after the implementation of the policy for some non-economic factors, *e.g.*, political uncertainty, labour unions, war, etc. For example, India was facing a double digit inflation—11.25 percent in June-July 2008. The GOI was in dilemma as to what mix of monetary and fiscal policies to adopt. Only interest rate was marginally raised, which had not proved to be effective.

Four, the Mundellian approach does not provide a 'true adjustment mechanism'. This approach considers capital flows as autonomous, whereas, in reality, a considerable part of capital flows is accommodating, not autonomous. The accommodating capital flows are not affected by the change in the interest rate. This condition may seriously affect the efficacy of Mundell's solution.

Notes

Finally, Mundellian approach assumes (implicitly) that other countries are not affected by the monetary-fiscal policy mix adopted by a country, and even if they are, they do not react. In reality, however, a great deal of conflict arises between the nations. Finding an appropriate monetary-fiscal mix compatible with that of other countries is rather an impossible task. And, even if a compatible monetary-fiscal mix is somehow worked out by trial and error, it may push the economy away from the equilibrium point rather than bringing it closer to the equilibrium.

2.2 The Expenditure Switching Policy : Devaluation

In the preceding section, we have discussed the *expenditure changing policies, viz.*, monetary and fiscal policies, aimed at changing the aggregate spending with the purpose of correcting the adverse BOP. We have discussed also the practical problems associated with expenditure changing policies and the problems related to monetary-fiscal mix. In this section, we discuss the *expenditure switching policies* to solve the problem of BOP *deficit* and their effectiveness.

The *expenditure-switching* policy is one that aims at attaining the internal and external balance by switching the domestic expenditure from imported to domestic goods or the other way round depending on the need of the country. The expenditure-switching policy works through the change in relative prices of imports and domestic goods. Under free market conditions, the relative prices of imports and domestic goods change on their own either due to **exchange depreciation** or **exchange appreciation.** Exchange depreciation or appreciation is the result of the market mechanism. The market determined *exchange appreciation* is often a major cause of BOP deficit as it increases imports and decreases exports. It does so because it makes imports cheaper than domestic goods. Therefore, the nations suffering from BOP deficit are forced to adopt policy measures to reverse the process, *i.e.*, to switch the domestic demand from foreign to domestic goods. The policy instrument that is generally used for expenditure-switching is **devaluation. Devaluation** is a deliberate policy action taken by the government to devalue the domestic currency in terms of gold or in terms of the foreign currency to which the domestic currency is tied. Devaluation has, in fact, been used as a major policy tool for expenditure switching combined, generally, with restrictive monetary and / or fiscal policy.

In this section, we discuss first the working mechanism of currency devaluation and then its effectiveness. Since BOP deficit is the major concern of most countries, we confine our discussion to how devaluation helps in eliminating BOP deficit. We discuss here the following aspects of devaluation as an expenditure-switching policy measure.

(i) Working mechanism of devaluation,

(ii) BOP adjustment under devaluations,

(iii) Effectiveness of devaluation, and

(iv) Empirical evidence of its effectiveness.

Working Mechanism of Devaluation

When the central bank of a country (RBI in India) reduces the value of the domestic currency officially in terms of foreign (reserve) currency, it is called devaluation. The objective of devaluation is to reverse the flow of domestic consumer expenditure from imported to domestic goods. Devaluation changes the exchange rate *ipso facto.* The immediate effect of change in the exchange rate is the change in the relative prices of imports and domestic goods. In effect, devaluation increases the price of imported goods in relation to the prices of domestic goods. Therefore, if demand for imports is price-elastic, the demand for imported goods decreases and the demand for their domestic substitutes increases. In the process, expenditure on imports decreases and that on the domestic goods increases. This is what is called 'expenditure-switching, *i.e.*, consumer expenditure is switched from foreign goods to domestic goods. Due to expenditure-switching, imports decrease in the devaluing country and exports from the country increase. This reverses the trade balance. This is how devaluation is supposed to correct the adverse BOP.

Let us now explain the mechanism by which devaluation helps in correcting BOP deficit in a two-country model under the following simplifying assumptions.

Notes

(i) There are only two countries, A and B, with currencies A_c and B_c, respectively;

(ii) There are only two goods, X and Y, involved in the foreign trade between the countries A and B.

(iii) Country A exports X to country B and imports Y, and country B exports Y and imports X from country A.

(iv) There is no capital movement between the two countries, A and B.

The mechanism by which devaluation eliminates the BOP deficit is illustrated in Figure 19.5. Panel (a) shows the trade in commodity Y. Suppose that the exchange rate between A's currency (A_c) and B's currency (B_c) is given as B_c 1 = A_c 5. Given the exchange rate, A's demand for B's exportable Y and B's supply schedule for Y are given as shown in panel (a). Note that A's demand schedule and B's supply schedule intersect at point K. Thus, the trade equilibrium between the two countries in respect of commodity Y is determined at 350 units of Y at price 30 B_c per unit.

Likewise, panel (b) shows the trade in commodity X between the two countries. At exchange rate B_c 1 = A_c 5, country B's demand schedule and country A's supply intersect at point R determining export and import of commodity X at 100 units at price 60 B_c per unit.

We can now work out pre-devaluation *trade balance* for country A from data given in panels (a) and (b) of Figure 19.5.

Pre-devaluation Trade Balance of Country A

A's import = 350 (Y) × B_c 30 = B_c	10,500
A's export = 100 (X) × B_c 60 = B_c	6,000
Pre-devaluation trade deficit = B_c	4,500

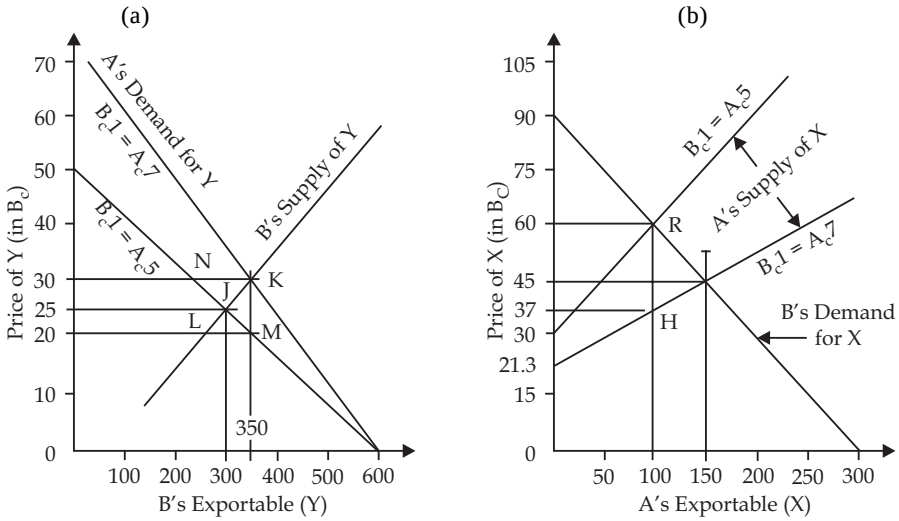


Figure 2.5: The Effects of Devaluation on Imports and Exports

Since, by assumption, there is no capital movement between the two countries, *trade deficit* equals the BOP *deficit*. As shown in pre-devaluation trade balance accounting, country A is thus faced with a BOP deficit of B_c 4,500. Now let us suppose that country A decides to use devaluation to correct its BOP deficit and devalues its currency by, say, 40% so that a new exchange rate is fixed at B_c 1 = A_c 7. The immediate effect of devaluation is the increase in the price of commodity Y (A's importable) in terms of A's currency. For example, the equilibrium price increases from A_c 150 (= 30 B_c × 5) to A_c 210 (= 30 B_c × 7). Assuming that A's demand for Y is price-elastic, its demand for Y decreases by NK as shown in panel (a). Since this applies to all the prices, A's demand schedule for Y shifts downward as shown in panel (a). As a result of shift in A's demand schedule (B's supply schedule remaining the same) trade is determined at point J. It shows that A's import of Y decreases from 350 units to 300 units.

Notes

What happens to A's exports after devaluation ? Due to devaluation of A's currency (A_c), B's currency is automatically appreciated. The rate of appreciation equals 28.58%.[2] It means that A's exportable (commodity X) becomes cheaper by 28.58% in terms of B's currency (B_c). As a result, A's supply curve shifts rightward as shown in panel (b). B's demand schedule for X remaining the same, A's new supply schedule intersects B's demand schedule at point T. The new equilibrium point shows decrease in the price of A's exportable (X) from B_c 60 to B_c 45. Consequently, B's demand for A's exportable X increases from 100 units to 150 units.

Let us now find the post-devaluation trade balance and the effect of devaluation on BOP deficit.

Post-devaluation Trade Balance

A's import = 300 (Y) × B_c 25 = B_c	7,500
A's export = 150 (X) × B_c 45 = B_c	6,750
Post-devaluation trade deficit = B_c	750

We can now find the effect of devaluation on A's BOP deficit by comparing the trade balance before and after devaluation. Our calculations show that devaluation reduces the trade deficit from B_c 4500 to B_c 750. It reduces, thereby, BOP deficit to the same extent.

Devaluation and Internal-External Balance

In the preceding section, we have shown how devaluation switches the domestic expenditure from imported goods to domestic goods; how it reduces imports and increases exports; and how it restores external balance. However, restoring external balance alone is not enough : external balance must coincide with internal balance. For, if there is internal imbalance, it may create conditions for decline in income and employment which may lead to external imbalance. In this section, we explain how devaluation—the expenditure switching policy instrument—can help restoring external balance with internal balance.

The process of restoration of internal and external balance is illustrated in Figure 19.6 in AD-AS model. Let us suppose that the aggregate demand (AD) and aggregate supply (AS) curves of a country, say A, are given as AD and AS curves in Figure 19.6 and country A in equilibrium at point E. Note that the external balance curve EB passes through the equilibrium point E. It means that country A has attained both internal and external balance at equilibrium point E.

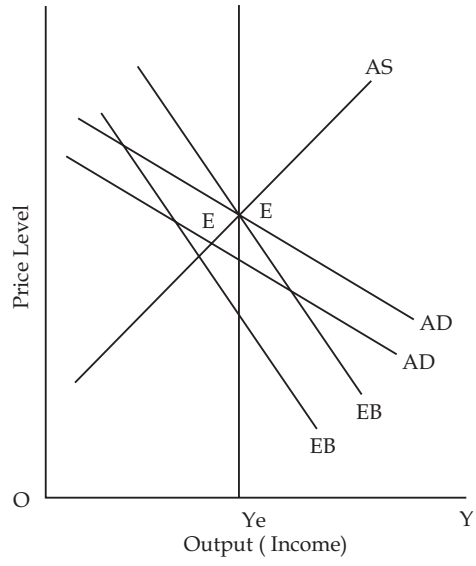


Figure 2.6: Devaluation and Internal-External Balance

2. The rate of appreciation = $\frac{7-5}{7}(100) = 28.58$.

Notes

Now suppose that for some extraneous reason, export of country A declines, resulting in fall in output, employment and in incomes. As a result, aggregate demand curve AD shifts downward to AD' shifting the equilibrium point to E'. This leads to fall in the imports and exports of the country. Consequently, the external balance curve EB shifts downward to the position of EB'. However, as shown in Figure 19.6, country A is in equilibrium at point E'. Note that point E' happens to fall above the EB' curve. It means that at point E', there is external imbalance with a trade deficit.

Let country A now devalue its currency. As a result, prices of its imports increase and prices of its export goods decrease. Assuming imports and exports are both price-elastic, imports of the country would decline and its exports would increase. As a result, its external balance curve EB' would shift upward to its original position of EB passing through equilibrium point E. Trade deficits would be wiped out. This marks the restoration of both internal and external balance. Whether devaluation of currency alone restores the internal and external balance in reality depends on a number of internal and external factors, like trade policy of other countries, reaction of other countries to devaluation by a country, the elasticity of exports and imports etc. These factors are discussed in the following section.

The Effectiveness of Devaluation : The Marshall-Lerner Condition

It may appear from the foregoing analysis that devaluation is a sure cure of BOP deficit. It may however not be true in reality. The effectiveness of devaluation depends on certain conditions. For example, decrease in imports due do devaluation depends on price and income elasticity of imports, availability of substitutes, and customs. However, the most important condition of the effectiveness of devaluation is, what is called, the **Marshall-Lerner condition**. The Marshall–Lerner condition states that *when the sum of the price-elasticities of the demand for imports of any two countries trading their goods between them is greater than unity, then devaluation (or exchange depreciation) increases exports and decreases imports*. In our example of countries A and B, the effect of devaluation on country A's BOP can now be summarized in terms of Marshall-Lerner condition as follows.

(i) *Devaluation reduces BOP deficit when the sum of price-elasticity of A's demand for imports and price-elasticity of B's demand for A's exportables, in absolute terms, is* **greater than unity**. This condition is satisfied by the demand curves given in Figure 19.5. Therefore, devaluation reduces the BOP *deficit*.

(ii) *Devaluation increases BOP deficits when the sum of price-elasticity of demand for imports of country A and the price-elasticity of demand for its exportable, in absolute terms, is* **less than unity**. To prove this point, let us look back at Figure 19.5. In case A's demand for Y is perfectly inelastic, then the devaluation would shift the equilibrium from point K to M in panel (a) of Figure 19.5. This indicates no change in A's imports. At point M, demand exceeds supply by LM. Therefore, import price moves up to point K. It means that devaluation is ineffective under this condition. On the other hand, if B's demand for X is perfectly inelastic, devaluation will make equilibrium shift from point R to H which means that A's export does not change. But, export price goes down from B_c 60 to B_c 37. As a result, A's export earning decreases. The final position is that A's import bill does not decrease and export earnings decrease. Consequently, A's BOP deficit increase due to devaluation.

(iii) *When the sum of price-elasticity of demand for importable of country A and the price-elasticity of demand for its exportable, in absolute terms, equals one, then devaluation leaves the trade balance of country A unchanged and hence the BOP remains unaffected.*

The Empirical Evidence and the J-Curve Effect

The empirical evidence shows the Marshall-Lerner condition (i) holds, in general, for all industrial nations, except for Australia and the UK. That is, the sum of price-elasticities of imports and exports for the industrialized nations have been found to be considerably higher than unity. It may, therefore, be concluded that devaluation is an effective method of correcting adverse BOP in the developed countries.

However, further emprical evidences show that this conclusion holds in the long run, not in the short run. In the short run, devaluation causes a deterioration in the BOP. The short-run deterioration in BOP is caused by the tendency of import prices to increase faster in the domestic market immediately after devaluation than the export prices, without much change in the quantities imported and exported.

Notes

The reason is that the existing export-imports deals cannot be reversed. Importers will have to import at post-devaluation higher prices, causing a high import bill. The result is deterioration in the BOP. In the *long run*, however, imports begin to decline and exports pick up at post-devaluation prices. Consequently, the deterioration in the trade balance is halted and over time BOP begins to improve. When the overall trend is plotted on a graph paper, it produces a J-shape curve, as shown in Fig. 19.7. The economists call it *J-curve effect* of devaluation.

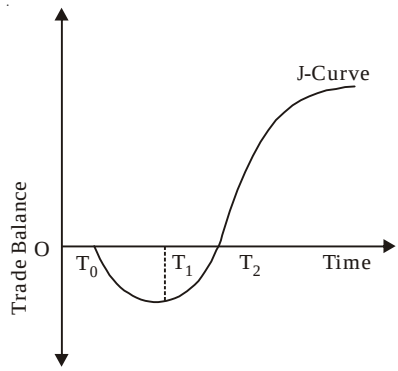


Figure 2.7: The J-Curve Effect

In Fig. 19.7, vertical axis measures balance of trade (X – M) and horizontal axis measure 'time'. Point T_0 marks the time of devaluation. As the figure shows, the balance of trade deteriorates immediately after devaluation, *i.e.*, during the period from T_0 to T_1. It begins to improve after time T_1 and deficit begins to decrease. It is only after some time, say time T_2, that devaluation becomes effective and balance of payment goes into surplus. The duration of period between point T_0 and T_2 varies from country to country.

Self-Assessment

1. **Choose the correct options:**

   (*i*) If a nation's balance on current account is positive and it has neither a deficit nor surplus in its overall balance of payments:

   (*a*) its imports exceed its exports

   (*b*) foreign purchases of its assets exceed its purchases of assets abroad

   (*c*) it has a trade deficit

   (*d*) it has a capital and financial account deficit

   (*ii*) Suppose the exchange rate is currently $1 = 6 Norwegian kroner. If a Big Mac costs $2.50 in the U.S. and there is purchasing power parity, the price of a Big Mac in Oslo is:

   (*a*) 40 kroner (*b*) 25 kroner

   (*c*) 15 kroner (*d*) 12.5 kroner

   (*iii*) A purchase of foreign reserves by a country's Central Bank would be reflected as:

   (*a*) An entry in a separate account off the balance of payments.

   (*b*) A credit in the financial account and a debit in the financial account.

   (*c*) A credit in the current account and a debit in the financial account.

   (*d*) A debit in the current account and a credit in the financial account.

   (*iv*) What does the term "balance of payments deficit" refer to?

   (*a*) A negative statistical discrepancy.

   (*b*) A positive statistical discrepancy.

   (*c*) A decline in official international reserves.

   (*d*) An increase in official international reserves.

Notes

(*v*) If the U.S. buys Web services from an Indian company, and the Indian company deposits the payments in the branch of an American bank, it will be reflected in the U.S. balance of payments as:

(*a*) A credit in the current account and a debit in the current account.

(*b*) A credit in the financial account and a debit in the financial account.

(*c*) A debit in the current account and a credit in the financial account.

(*d*) A credit in the current account and a debit in the financial account.

(*vi*) What is official settlements balance?

(*a*) Another name for the financial account.

(*b*) One of the accounts in the balance of payments.

(*c*) Another name for the capital account.

(*d*) Everything in the balance of payments except for the official foreign reserves.

2.3 Summary

- The need for BOP adjustment, particularly of deficit disequilibrium, is clear. A nation's ability to absorb deficits is broadly limited by its stock of official international reserves — gold and generally acceptable foreign currencies — and the willingness of foreign countries to hold its currency as part of their own international reserves. Accommodating short-term capital borrowings can help in prolonging BOP deficit adjustments, but they cannot be relied upon indefinitely.
- The *expenditure changing policies,* also called 'expenditure adjusting' policies, refer to the policies that are aimed at changing (reducing or increasing) the aggregate expenditure in the domestic economy. Countries facing BOP deficit due to trade deficits adopt expenditure reducing policies.
- *Monetary policy* refers to the measures adopted by the monetary authority to increase or decrease the money supply and availability of credit.[1] A monetary policy aimed at increasing the money supply and availability of credit to the public is called **expansionary monetary policy** or 'easy money policy.' And, a monetary policy aimed at decreasing the money supply and availability of credit to the public is called **contractionary monetary policy** or 'dear money policy.'
- The conclusions that emerge from the analysis of effects of the monetary policy is that a contractionary monetary policy reduces the BOP deficits and helps in achieving internal and external balance, and an expansionary monetary policy reduces country's BOP surplus.
- Practice, however, most countries use a monetary-fiscal mix to correct their adverse BOP. We have noted that a contractionary monetary policy is helpful in correcting the BOP deficit, whereas an expansionary fiscal policy is preferable for correcting the BOP deficit. So a country opting for using a monetary-fiscal mix for correcting its BOP deficit would adopt a combination of **contractionary monetary** and an **expansionary fiscal policy.**
- The *expenditure-switching* policy is one that aims at attaining the internal and external balance by switching the domestic expenditure from imported to domestic goods or the other way round depending on the need of the country. The expenditure-switching policy works through the change in relative prices of imports and domestic goods. Under free market conditions, the relative prices of imports and domestic goods change on their own either due to **exchange depreciation** or **exchange appreciation.**

2.4 Key-Words

1. Expenditure switching policy : It is a policy which government tends to switch the consumer's purchase on foreign goods to domestic goods whereas expenditure dampening policy which also known as expenditure reducing policy is a reducing the consumption of imported goods to ensure the balance of payment of a country to become worsen.

Notes

2.5 Review Questions

1. What is meant by expenditure reducing? Discuss.
2. Discuss expenditure reducing and expenditure switching policy.
3. What is the Mundellian Policy adjustment? Explain.

Answers: Self-Assessment

1. (*i*) (*d*) (*ii*) (*c*) (*iii*) (*b*) (*iv*) (*c*) (*v*) (*c*) (*vi*) (*d*)

2.6 Further Readings

Books

1. Dornbusch, Rudiger and Stanley Fischer (1980). \Exchange Rates and the Current Account." American Economic Review 70, 960 {71.
2. Frenkel, Jacob A. and Michael L. Mussa (1985). \Asset Markets, Exchange Rates, and the Balance of Payments: The Reformulation of Doctrine." See Jones and Kenen (1985), pp. 679{747.
3. Isaac, Alan G. (1989). \Wealth E_ects and the Current Account with Endogenous Terms of Trade." Journal of Macroeconomics 11(4), xxx.
4. Jones, Ronald W. and Peter B. Kenen, eds. (1985). Handbook of International Economics, Volume 2. Amsterdam: North Holland Publishing Co.
5. Kenen, Peter (1985). \Macroeconomic Theory and Policy: How the Closed Economy was Opened." See Jones and Kenen (1985), Chapter 13, pp. 625{677.
6. Kouri, Pentti J.K. (1976, May). \The Exchange Rate and the Balance of Payments in the Short Run and the Long Run: A Monetary Approach." Scandinavian Journal of Economics 78(2), 280{304.

Notes

Unit 3 : Forms of Economic Cooperation

CONTENTS

Objectives
Introduction
3.1 International Economic Cooperation
3.2 Coordination of Macroeconomic Policy and Exchange Rates
3.3 International Trade
3.4 Developing Country Debts
3.5 Summary
3.6 Key-Words
3.7 Review Questions
3.8 Further Readings

Objectives

After reading this Unit students will be able to:

- Discuss the International Economic Cooperation and International Trade.
- Explain Coordination of Macroeconoic Policy nd Exchange Rates.

Introduction

Although some form of economic cooperation has been a part of international political relations during most of this century, American interest in international economic cooperation has increased substantially in recent years. This heightened desire to coordinate economic policies with the other major economic powers is in part a response to the special problems of the 1980s : the sharp fluctuations in exchange rates, the massive shifts in the trade balance, and the explosive growth of debt among many of the developing countries.

The increased interest in international economic cooperation also reflects the more fundamental changes in the world economy that have been evolving over a longer period of time. The world economy has become more interdependent : international trade has increased relative to production for domestic markets and international capital markets have become larger and more active. In addition, the United States has lost the dominant economic position that it enjoyed in the early postwar years. Japan and the European Economic Community (EEC) have become major economic powers that compete effectively in trade and finance.

How has policy coordination evolved in this changing environment ? How have the changes in the world economy altered the problems and possibilities of international economic cooperation ? What are the prospects and potential benefits and costs of increased cooperation in the future ?

Co–operation in macroeconomic and exchange rate policies generally means redirecting and increasing the economic role of governments. In contrast, cooperation in international trade involves reducing the interference of governments in private markets. Experience with the international debt problem has shown little explicit intergovernmental cooperation except for the Paris Club negotiations that deal with debts to the governments themselves. It is useful therefore to begin by considering the macroeconomic and exchange rate coordination and then to turn to cooperation in international trade and in dealing with international debt.

Notes

3.1 International Economic Cooperation

The objective development of diverse economic, scientific, and technological ties among individual countries and groups of countries and between the socialist and capitalist socioeconomic and political systems, based on the principles of independence, equality, and mutual advantage. Essentially the process represents the intensification of the international division of labor.

The scientific and technological revolution, which has accelerated the international division of labor, and the growing economic strength of the USSR and of the entire world socialist system have increased the importance of international economic cooperation. Only after the appearance of socialism did genuine economic cooperation become possible, based on the principles of sovereignty and equality between states and peoples. The forms of economic cooperation within the socialist community and those within the capitalist economic system, while superficially similar, reflect the fundamental differences between the two opposing economic and sociopolitical systems.

Did u know? The world socialist economic system affects the nature of economic cooperation not only between capitalist and socialist countries but also between the developed capitalist countries and the developing countries.

As a result of the continuing scientific and technological revolution, no single country, not even the most developed, can produce with equal efficiency the entire range of modern products. Therefore individual countries or groups of countries attempt to limit the range of goods they produce and to produce them in huge quantities so as to meet not only their own needs but also the needs of other countries in exchange for the commodities that the other countries produce for export. In this way trade expands and a single world economy develops, each country providing primarily the goods it produces better and more cheaply than others.

International economic cooperation among the capitalist countries developed from simple forms of trade and exchange. At the imperialist stage, there arose a complex and diverse system of international industrial ties between monopolies and monopolistic associations (such as international cartels, syndicates, and concerns), and intergovernmental economic unions were formed. The capitalist division of labor arose and developed, closely linked with the world capitalist market. Within the capitalist system, international economic cooperation is accompanied by fierce competition among monopolies and countries, by the intensification of irreconcilable contradictions, by the growing effect of the law of uneven economic and political development of capitalist countries in the age of imperialism, and by the narrowing of imperialism's sphere of influence and the growth of the world socialist system.

International economic cooperation includes foreign trade, credit relations, cooperation between countries in extracting natural resources, compensation arrangements, and extensive scientific and technical cooperation—for example, trade in licenses to produce certain goods and to use certain technological methods, joint scientific studies, and collaboration on major technical projects, in the construction of plants and other enterprises, in geological exploration, and in training national personnel.

The expansion of international trade and other economic ties has been stimulated by the development of international credit. The USSR maintains credit agreements with many countries, primarily the socialist and the developing countries. Of the 2,765 plants and other enterprises being built with Soviet technical assistance, 1,898 are in socialist countries and 858 are in developing countries; 1,680 projects had been completed as of Jan. 1, 1973 (1,263 in socialist countries and 412 in developing countries). The Soviet Union offers credits to banks and businesses in the advanced capitalist countries. It is participating in the construction of a major metallurgical complex in France, providing machinery and equipment on credit. The Soviet Union is also seeking extensive long-term credits from the advanced capitalist countries, particularly to draw more rapidly into the economy the natural resources

Notes

of Siberia and the Soviet Far East and to modernize Soviet industry and agriculture. The capitalist countries also stand to gain from such arrangements. Their unused monetary reserves can be put to profitable use; their credits can be repaid in products they need, such as natural gas, petroleum, and metals; and they can raise their level of employment.

The Soviet Union has developed such cooperation on both a bilateral and a multilateral basis with socialist countries wishing to obtain Soviet fuel, mineral, and forest resources, and has attracted capital investments from these countries. It contributes its own capital to such projects both in other socialist countries and in developing countries. Industrial complexes have been built on Soviet territory under bilateral agreements with the FRG, Japan, France, Finland, and the United States.

Notes

An important form of international economic cooperation is the collaboration of two or more countries in building enterprises for extracting and utilizing natural resources.

International economic cooperation in the form of compensation arrangements is becoming increasingly common. After receiving credit and purchasing the necessary equipment and technology from another country, the USSR constructs enterprises to produce a commodity, repaying the credit with the commodity. The Soviet Union also participates in the construction of enterprises in other countries on the understanding that its credits and technical assistance will be repaid with the goods produced. It has concluded long-term compensation agreements (five, ten, or more years) for cooperation in extracting natural resources in countries to which it has extended credit.

Rapid scientific and technological progress, the increased scale of production, and the Soviet Union's economic goals require more rapid modernization of many enterprises and even entire industries, creating many opportunities for the development of scientific and technical cooperation. The Soviet Union is expanding its scientific and technical ties particularly with the COMECON countries, and it provides much technical assistance to developing countries. Hundreds of modern enterprises and other industrial units have been built abroad with the help of Soviet scientific and technological achievements, and tens of thousands of licenses, designs, and sets of technical data have been transferred. The sale and purchase of licenses to produce machines, instruments, or equipment or of licenses to employ technological processes for extracting or processing materials have become important in the USSR's economic relations with advanced capitalist countries. Companies in the United States, the FRG, Japan, France, and other countries are seeking to buy licenses in the USSR, and the Soviet Union in turn is purchasing an increasing number of licenses from these countries. This attests to the high level of Soviet technology, which is aiding the advance of technical ideas throughout the world and which is able to make use of the most recent scientific and technical developments abroad.

The various forms of international economic cooperation enable the Soviet Union and the other countries of the socialist community to benefit economically from specialization and cooperation within the scope of both the socialist and the world-wide division of labor, to bring natural resources into the economy more rapidly, and to accelerate the economic development of each country. A significant growth in the production of high-quality export goods allows the socialist countries to compete successfully on the world market with firms in the capitalist countries, to increase their sales and the influx of foreign currency, to raise the general quality of goods in the country, to increase output, and thereby to accomplish more effectively and rapidly their main task—that of raising the people's material and cultural living standard.

3.2 Coordination of Macroeconomic Policy and Exchange Rates

It is useful, however, to focus on the more explicit types of macro-economic and exchange rate coordination and, in this context, to consider two extreme positions. At one extreme is the idea that each country should manage its own domestic monetary and fiscal policies with a concern for its

Notes

own well-being only and without trying to take into account the effect of its policies on the other countries of the world. A government may understand that its economy is affected by the policies adopted elsewhere and that its own policies affect other countries but still choose to make its policy decisions unilaterally. At the other extreme is the view that each (industrial) country should formulate its economic policies in explicit coordination with every other (industrial) country so that the policies are chosen to maximize world economic welfare as a whole, or at least to achieve a configuration of policies from which no country can be made better off without making some other country worse off.

Although this statement of the alternatives might suggest that international coordination is unambiguously better than the uncoordinated pursuit of national self-interest, it is important to distinguish between the theoretical possibilities of idealized coordination and the realistic potential gains of practical coordination. In practice, despite its aspirations, international coordination may produce results that are not as satisfactory as those that result from each country's uncoordinated pursuit of national self-interest.

One reason why coordination may fail to achieve an improvement in world economic performance is that, as Stanley Fischer notes in his background paper, extensive statistical studies indicate that the monetary and fiscal policies of each country have only a relatively small effect on the level of economic activity and inflation in other countries. The potential gain from even perfect coordination is therefore likely to be small and easily overwhelmed in practice when the policies are less than ideal.

International policy coordination may fail to improve overall economic performance simply because the political officials who participate in these international negotiations choose policies that are politically convenient rather than economically sound. We know that this happens all too frequently at the domestic level.

Task Why should we expect the same officials to follow a higher standard just because they are engaged in an international negotiation ?

The process of international negotiation may also be counterproductive because it diverts attention and action from needed domestic policy changes. Governments may explicitly delay painful domestic policy changes as part of an international negotiating strategy designed to induce policy changes abroad that would make the domestic changes unnecessary. The emphasis on international negotiations may also rechannel domestic political pressures away from needed reforms. Recent experience provides ample examples of both dangers. Germany and Japan have failed to stimulate domestic demand enough because of their reliance on expectations of continued exchange rate stability. The U.S. Administration has diverted attention from the need for budget deficit reduction by emphasizing the favorable effects on U.S. exports of greater fiscal expansion abroad.

The ability of international macroeconomic coordination to permit countries to pursue more expansionary policies than would otherwise be possible is both a potential benefit and a potential danger. When a single country tries to expand by itself, it may soon find that rising imports create a balance of payments problem. A coordinated expansion by a group of trading partners can eliminate this balance of payments constraint and permit all of the countries to expand more than any of them could have done alone. When all economies are operating well below capacity, such coordinated expansion can provide gains for all. But the ability of coordination to circumvent the balance of payments constraint on expansionary policies also creates the temptation to overexpand. Without the automatic market check of a deteriorating balance of payments, governments may pursue inflationary policies that would otherwise be avoided. On balance, whether one regards the ability to achieve an expansion that would not be possible without coordinated action as a reason to favor coordination or to oppose it depends on the likelihood that governments will use that ability to pursue inflationary policies.

There is a further problem that arises because it is generally far more difficult to alter budget and tax policies than to change monetary policy. Macroeconomic coordination may in practice be limited to

Notes

a coordination of only monetary policies. This is particularly the case in the United States because fiscal policy is controlled by the Congress which, even when its majority is of the same party as the President, may be reluctant to enact the tax changes, particularly tax increases, that a President wants. But the reliance on monetary rather than fiscal policy will also be true in other countries because of the greater political attention generated by changes in fiscal policy and the greater difficulty of reversing expansionary fiscal changes if they turn out to be inappropriate.

A monetary expansion or contraction is not generally an appropriate substitute for a fiscal change. For example, while tighter monetary policy in the United States could offset the aggregate demand effect of large budget deficits, it would not reduce real interest rates. More generally, monetary and fiscal policies that have equal expansionary effects at home can have opposite effects on the rest of the world. A fiscal expansion that raises real interest rates and appreciates the currency will unambiguously raise foreign exports and thereby stimulate the foreign economy. In contrast, a monetary expansion that temporarily reduces real interest rates will depreciate the currency and thereby reduce foreign exports.

The need to rely on monetary policy rather than fiscal policy is particularly a problem when the international coordination focuses on exchange rate stabilization. If the United States had been induced to stabilize the dollar in the early 1980s, it would have done so by increasing the money supply rather than by cutting the budget deficit. This in turn would have increased the rate of inflation in the United States. Moreover, although the rise in inflation and in the price level would be sufficient to reduce the nominal value of the dollar, the real exchange rate might soon be back to the level that would have prevailed without any change in monetary policy. A commitment to exchange rate stabilization that leaves real exchange rates unchanged but causes higher inflation must be regarded as counterproductive.

3.3 International Trade

Although the primary source of the unprecedented rise of the U.S. trade deficit between 1982 and 1986 was the increase in the value of the dollar and therefore indirectly the growth of the U.S. budget deficit, the political response to the trade deficit has been an increase in attention to the specific problems of foreign competition and international trade practices. Unfortunately, much of this response has been a harmful backsliding from free trade to various sorts of restrictions on the flow of goods to the United States. Recent years have witnessed the cartelization of key international markets, the introduction of so-called voluntary restraints on a wide range of exports to the United States, and the tightening of U.S. import quotas on textiles with the threat of much more protectionism to come as a result of the pending trade legislation.

Of course, not all of the political response to the trade deficit has been harmful. The concern about the U.S. trade balance has spurred a more assiduous pursuit of policies aimed at reducing foreign import barriers, especially those of Japan and some of its East Asian neighbors. Although these policies cannot eliminate the massive U.S. trade deficit as long as the dollar remains overvalued, they can increase the opportunity for American firms and employees to do more in those areas where they have a comparative advantage.

Cooperation in international trade requires not active comanagement of the economic environment but a negotiated reduction in government interference with private flows of trade and investment. The golden rule of international trade is the double negative injunction : “Do not unto others what you would not have them do unto you.”

The major trade rounds of the past quarter century have been successful in achieving sharp reductions of tariffs and quotas. But now, as several of the conference participants noted, improving the international allocation of resources requires a reorientation of the trade negotiations.

Government subsidies to domestic industries engaged in international competition must be reduced. This is true of agricultural policies in every major industrial country. It is also increasingly true of a wide range of manufacturing industries in Europe as well as in many developing countries. Progress in these areas will be difficult not only because such subsidies restrain powerful domestic political

Notes

interests but also because it will involve extending international trade negotiations outside traditional lines into subjects previously regarded as domestic concerns.

A similar extension of international trade negotiations into domestic policies is required to reduce purchasing restrictions of government buyers in transportation and telecommunications and to improve the international allocation of investment, the production of services, and the protection of patents and other forms of intellectual property. The current Uruguay Round of trade negotiations has recognized the importance of these issues. Only time will tell whether the potential gains from a better international division of labor and the negotiating skills of the parties will together be powerful enough to overcome the powerful domestic interests that stand in their way.

3.4 Developing Country Debts

Despite the conference's overarching theme of international cooperation and coordination, a striking feature of the presentations and discussion about the less-developed countries' (LDC) debt problem was the virtual absence of explicit references to intergovernmental coordination. That aspect of the conference is of course just a reflection of the way the international debt problem has been handled in practice.

Despite the desire of some commercial bankers, academic economists, and others to get governments individually and collectively to play a larger part in the resolution of the debt problem, the governments have been understandably reluctant to assume such a role. When governments have acted, they have generally acted in a largely independent role. The United States provided several "bridge" loans at an early stage in the debt crisis until commercial bank and IMF funding could be arranged. The Japanese government is now proposing to provide longer term credits on a unilateral basis and through the IMF, the World Bank, and the regional development banks. Individual governments have modified domestic banking rules to strengthen their domestic banks and to encourage those banks to continue lending to the debtor countries, with an informal, ad hoc coordination of these banking "reforms" through the regular meetings of central bankers at the Bank for International Settlements. The only explicit intergovernmental coordination of policy was through the Paris Club meetings at which the governments acted in their roles as creditors of the specific borrowing nations. The IMF was the only official participant that played an explicit major role in dealing with the debts to private creditors.

Despite the very limited official government coordination in this area, there has been extensive private coordination among the commercial banks around the world. The coordination committees of representatives of the major commercial banks have negotiated with the individual debtor governments on behalf of all the creditor banks. The debt problem has been managed by private international cooperation rather than by government coordination.

Looking ahead, the key role for official international cooperation in dealing with the debt problem should be maintaining open markers for the exports of the debtor countries. To service their debts while maintaining politically acceptable economic growth, the debtor countries must export. An increase in their exports will require a reorientation of domestic policies by the debtor nations, but it will only be possible if the creditor nations keep their markets open. Since the open markets of each creditor nation help all other creditors, and since the creditor nations as a whole have strong financial, economic, and political interests in the successful evolution of the debt problem, there is a powerful case for a coordinated agreement to maintain open markets for the products of these countries.

Self-Assessment

1. Choose the correct options:

(*i*) Those groups of countries which seek mutual economic benefit from reducing interregional trade and tariff barriers are called:

(*a*) cartels. (*b*) strategic alliances.

(*c*) multinational market regions. (*d*) confederations.

(*e*) none of the above.

Notes

(*ii*) Successful economic union requires favorable conditions in all of the following areas EXCEPT:

(*a*) economics. (*b*) politics.

(*c*) culture. (*d*) religious.

(*e*) geography.

(*iii*) The demise of the ..... was the result of economically stronger members not allowing for the needs of the weaker ones.

(*a*) World Bank

(*b*) International Monetary Fund

(*c*) Latin American Free Trade Association (LAFTA)

(*d*) Council for Mutual Economic Assistance (COMECON).

(*e*) None of the above fits.

(*iv*) The ..... is the most basic economic integration and cooperation arrangement.

(*a*) free trade area (*b*) customs union

(*c*) common market (*d*) political union

(*e*) regional cooperation for development

(*v*) A(n) ..... provides its members with a mass market without barriers to impede the flow of goods and services. This is a lower level stage of economic partnership.

(*a*) free trade area (*b*) customs union

(*c*) common market (*d*) political union

(*e*) regional cooperation for development

(*vi*) ..... is a comprehensive trade agreement among Canada, Mexico, and the United States that creates one of the largest and richest markets in the world.

(*a*) MERCOSUR (*b*) NAFTA

(*c*) LAFTA (*d*) SETA

(*e*) USCANMEX

(*vii*) The comprehensive trade agreement that addresses doing business within North America is appropriately named:

(*a*) MERCOSUR. (*b*) NAFTA.

(*c*) LAFTA. (*d*) SETA.

(*e*) USCANMEX.

3.5 Summary

- Economic cooperation is part of the more important process of international political cooperation. Successful coordination of policies in the economic arena can strengthen political and national security ties. Unfortunately, however, all too often the process of international economic negotiation creates new sources of conflict and tensions as each participating country seeks to impose its own preferences and judgments on the economic policies of the other governments. In recent months some governments have resented U.S. pressures to pursue more stimulative fiscal and monetary policies than they thought prudent, and they have complained about the implicit threat of using the exchange rate as a weapon to force compliance with American views. There is a danger that the process of international cooperation in macro-economic and exchange rate management, despite its lofty aspirations, can be harmful politically as well as economically. While economic coordination and negotiation can, under the right circumstances, make a positive contribution to worldwide economic well-being, it is important not to exaggerate the potential gains from such coordination nor to pursue it in ways that threaten broader political harmony.

Notes

3.6 Key-Words

1. Comprehensive Economic and Trade Agreement : The Comprehensive Economic and Trade Agreement (CETA) is a proposed free trade and copyright agreement between Canada and the European Union. Many of its provisions on copyright are identical to controversial ACTA, which was recently rejected by the European Parliament; this has raised concerns with proponents of internet freedom and civil liberties.
2. Economic integration : Economic integration refers to trade unification between different states by the partial or full abolishing of customs tariffs on trade.

3.7 Review Questions

1. What is meant by international economic cooperation? Explain.
2. Discuss microeconomic policy.
3. Write a short note on International trade.

Answers: Self-Assessment

1. (*i*) (*c*) (*ii*) (*d*) (*iii*) (*c*) (*iv*) (*e*) (*v*) (*a*)
   (*vi*) (*b*) (*vii*) (*b*)

3.8 Further Readings

1. For a nontechnical discussion of this, see Martin Feldstein, "Correcting the Trade Imbalance," *Foreign Affairs*, Summer 1987.

Notes

Unit 4 : Static and Dynamic Effects of a Custom Union and Free Trade Organization

CONTENTS

Objectives
Introduction
4.1 The Trade Regimes
4.2 The Effects of Customs Union
4.3 Summary
4.4 Key-Words
4.5 Review Questions
4.6 Further Readings

Objectives

After reading this Unit students will be able to:

- Understand the Trade Regimes and the Effects of Customs Union.
- Discuss the conclusions and Recommondations.

Introduction

In the aftermath of the break-up of the Soviet Union, trade among the new independent states collapsed. Estimates vary, but the drop in volume terms may have been as much as 50% between 1992 and 1995 (see table 1). We have discussed the reasons and the consequences of this drastic decline elsewhere (Michalopoulos and Tarr, 1994; 1996).

The three Baltic countries decided, early on, to reorient their trade to Europe and the rest of the world; and all three have signed association agreements with the European Union.

The other twelve countries (members of the Commonwealth of Independent States (CIS)), attempted, mostly unsuccessfully, to maintain trade with each other through a variety of policy interventions, including through the establishment of a Free Trade Agreement (FTA).

The purpose of this unit is to analyze the economic implications of a customs union among transition economies, such as the one established by these four countries, for both existing and prospective members. The next section of the paper describes in broad terms the current trade regimes of the CIS, including the arrangements that govern trade with each other. The third section analyses the economic effects of the customs union, in part through the use of a partial equilibrium model described in detail in the appendix. The focus is on the effects of joining the customs union for countries which have not done so. As most CIS members are applying for accession to the WTO, this section also draws some implications of the customs union for WTO accession. The last section summarizes the policy conclusions and implications of the analysis. While the analysis focuses on the CIS countries, some of the findings may be of relevance to other countries in transition--for example, among the countries of the former Yugoslavia, that are considering the establishment of similar arrangements.

4.1 The Trade Regimes

While the trade policy framework continues to be evolving and varies considerably among countries, the following main features characterize the trade regimes of CIS members: On the import side, most countries have so far avoided the establishment of quantitative restrictions or licensing. But protectionist pressures are rising and leading to the imposition of such controls in some countries (e.g., Uzbekistan) or sectors (alcoholic beverages-- in Russia).

Notes

Did u know? In 1995 three countries, Belarus, Kazakstan and Russia established a customs union which the Kyrgyz Republic agreed to join in 1996.

The tariff regimes vary considerably, but on the whole countries have established few tariffs exceeding 30%. Some countries have low and uniform tariffs, e.g., Armenia's maximum tariff is 10% and the Kyrgyz Republic has a 10% uniform tariff); while in others the range goes up to 100% for a few items. In Russia, the average is about 13-14% with a range from 0 to 30% for most commodities, with some selected items considerably higher (see table 2 for details at a somewhat aggregated level).

On the export side, there has been significant dismantling of export controls in most countries; but controls of exports through state trading continues in some key exportables (cotton, oil and natural gas).

Trade with each other, is in principle free under the terms of the FTA. Imports are duty free, but it appears that export and foreign exchange controls in practice limit trade among some of the countries. Weaknesses in the payments systems continue to hamper trade, leading to continuing use of barter; but the previous state to state barter agreements have been by and large eliminated. Many countries have established a mixed VAT system: "origin" based for CIS trade and "destination" based with regard to the rest of the world. This means that with respect to CIS countries, imports are not taxed but domestic producers pay the VAT regardless of whether the good is exported or sold domestically. For the rest of the world, imports pay the VAT but exports are zero rated.

The Customs Union members negotiated a common external tariff based on the Russian tariff. But in the course of 1996, the three original members unilaterally introduced modifications to the external tariffs they applied to some commodities (Rietzler and Usmanova, 1996); also, as of the time of this writing, the Kyrgyz Republic had not taken any steps to introduce the common external tariff but instead continued to apply a uniform 10% tariff to imports from the rest of the world. All four countries are applying to the WTO on the basis of individual tariff schedules rather than as a custom union. Thus, at present, strictly speaking, there is no common external tariff for the Customs Union. But the agreements are still in place and the governments may pursue further steps towards their full implementation.

4.2 The Effects of Customs Union

There are two kinds of effects of customs unions, static and dynamic. The static effects relate to the impact of the establishment of the customs union on welfare. The analysis in this instance focuses on a comparison of the welfare of a country or groups of countries before and after the establishment of the customs union; thus the analysis is one of comparative statics.

The dynamic effects focus on the impact the customs union on the rate of output growth of a country or countries in the medium term. Many analysts have noted (Winters 1996) that supporters of customs unions and other regional preferential arrangements frequently find that the static welfare effects are typically small and possibly negative. They then focus on the potential dynamic benefits, which however, are difficult to define and even more difficult to measure.

In the case of the CIS countries, there is already a FTA among all members as well as a Customs Union (CU) among some of them however modified by specific exceptions for variation from a common external tariff. Hence the analysis of both dynamic and static effects has to compare the advantages and disadvantages of joining this specific customs union not just any one, and assumes that in principle the alternative to joining, is continuation of the FTA among the CIS; but the implications of a different alternative, under which countries that do not join the CU are excluded from the FTA area, also briefly examined.

Static Welfare Effects

The principal impact of joining the customs union would be to replace the external tariff of each of the countries with the common external tariff of the customs union. In general, under these

Notes

circumstances the benefits of joining the CU would depend to a considerable extent on the height and structure of each of the countries external tariff compared to that of the Customs Union external tariff. While in practice a Customs Union external tariff may not be in place at present, for purposes of analysis, the Russian tariff is a good proxy of the Customs Union external tariff that had been negotiated and will be used for the discussion in this unit. If a country such as Armenia or the Kyrgyz Republic with lower external tariffs were to substitute the Russian tariff for its own tariff structure, it would increase its unweighted average tariff to 13-14 percent (see table 2). More importantly, assuming that following accession of new members, the common external tariff is not changed, the Russian tariff exhibits considerably more dispersion compared with the tariff for some of the countries (typically between 0 and 30 percent),3 meaning that for selected highly protected products in Russia, the tariff would increase significantly. For other countries, adopting the common external tariff would mean actually reducing their average tariff.

Starting with Jacob Viner (1950), international trade economists typically analyze preferential trade arrangements, whether members of a FTA or a CU, in terms of trade creation and trade diversion. Trade creation in a product occurs, when additional imports come from partner countries which displace sales of inefficient domestic producers and these imports are at least as cheap as imports from non-partner countries. Trade creation results in improved welfare for the importing country for much the same reasons as increased trade improves a country's welfare. On the other hand, trade diversion occurs when suppliers in the rest of the world (who continue to face tariffs) are more efficient than partner suppliers, but additional partner country imports displace the more efficient suppliers. Trade diversion is typically (but not necessarily) welfare reducing since the home country must pay more to import the product from the less efficient partner country suppliers.

Although the general theory of regional trading arrangements is quite ambiguous in its conclusions, we believe some definitive conclusions are possible with respect to the specific customs union under consideration, at least for some of the CIS countries. Since the partner countries in the potential customs union already have tariff free access to the other CIS markets under the Free Trade Agreement, prices in these countries' markets cannot fall as a result of the customs union, i.e., there will be little welfare gain from trade creation. Whatever trade creation would occur, would come from third country suppliers in those products where the current external tariff in the country is higher than that of the Customs Union external tariff. Since welfare costs from a tariff increase with the square of the tariff rate, net welfare effects are little impacted by reductions in tariffs by a few percentage points say, from ten to seven percent. Rather what is crucial to the welfare effects are the changes that involve significant tariff increases.

Countries with Lower Tariffs Than in the Customs Union

Prospective partner country suppliers will have the potential, under the higher tariffs of the customs union, to raise prices to consumers in other CIS countries by the amount of the tariff preference over rest of world imports. In the model we present in the appendix, we assume that they will do so. A principal reason we believe they will do so is our judgment that advocates of the customs union propose it as a means of expanding protection for inefficient domestic industries throughout the CIS. That is, the customs union is an import substitution strategy for inefficient industries, where the structure of the tariff is high in those industries that exist in the customs union, especially in Russia. In the appendix, we elaborate some additional reasons why we believe they will do so. Thus, a key assumption of our model is that prospective members of the customs union face upward sloping supply curves from partner country suppliers who will raise prices by the extent of the tariff.

Moreover, since these countries have tariff free access to markets of the members of the customs union and to Russia in particular, the exporters from a CIS country joining the CU will not obtain improved access to the Russian market, which is by far the dominant market in the customs union. Thus, for countries like the Kyrgyz Republic and Armenia with already liberal external tariffs or others like Georgia and Moldova which are also pursuing generally liberal trade policies and assuming the common external tariff is not changed following their accession, the usual tradeoffs that must be considered in the evaluation of a preferential trade arrangement (trade diversion versus improved access and trade creation) do not apply. Thus, the CU would virtually result in pure trade diversion.

Notes

High tariff protection for such small economies is generally very inefficient and costly. Protection prevents the transmission of world prices to the economy and thereby prevents market signals from inducing resource reallocation to areas of comparative advantage in the economy. Experience has shown that over time, countries with high protection generally grow more slowly than those with low protection. Moreover, we show in the appendix that increasing an external tariff within the framework of a customs union with Russia and the other partners for a small CIS country, is much more costly than simply raising tariffs, without preferential treatment to the customs union members. In fact, in this example the customs union will be several times more inefficient and costly to the small country than simply raising tariffs to the rest of the world in a non-preferential manner.

Joining the customs union with a common external tariff such as that previously negotiated is so costly for several reasons: First, partner country suppliers can raise prices under the tariff protection they receive from preferential protection. Then for the quantities previously purchased from partner country suppliers, consumers in member countries with a previously lower external tariff will likely pay higher prices (excluding the tariffs) to partner country producers than they were paying prior to participation in the customs union, i.e., there is an adverse terms-of-trade effect on the initial quantities purchased from partner country suppliers. Second, since rest of world imports are subject to a higher tariff, there will be a diversion of sales away from rest of the world suppliers toward partner country suppliers.

This trade diversion entails two costs: (a) since the importing country does not collect any tariff revenue on imports from partner countries, there is a loss of the tariff revenue on these trade diverting imports; and (b) excluding the tariff, consumers will have to pay higher prices to partner country suppliers than they were paying to rest of world suppliers prior to participation in the customs union.

In their comprehensive theoretical treatment, Bhagwati and Panagariya (1996) describe a model in which partner country suppliers have perfectly elastic supply curves. This situation might be expected to apply if a country is forming a preferential trade area with a very large market, such as the European Union or NAFTA, because competition among many suppliers in the large market results in flat supply curves to the prospective new member country. In this case, there is a much larger likelihood of the preferential trade area being welfare increasing since the new member will not suffer a terms-of-trade loss on its purchases from the suppliers from the large market.

Countries with Higher Average Tariffs Than in the Customs Union

For countries with a higher average external tariff than that of the CU, the results are more ambiguous. On the one hand, in converting to the common external tariff, since the average tariff is lower than in the home country, there will be a number of products where the external tariff will be reduced.

Then there will be a welfare gain on those products where the external tariff is lowered Because there will be some trade creation from additional imports from rest of the world Suppliers (partner country suppliers already have tariff free access due to the FTA so no Additional trade creation is possible from CIS partners). On the other hand, the negotiated

Tariff of the CU is not uniform; rather it favors production of those products already produced in the CU. Even in countries with higher average tariffs than in the CU, their tariffs typically favor their home production. Substitution of the CU tariff will shift the tariff structure so that it favors the producers of the CU, i.e., tariffs will be high on the products produced in the CU and low on the products produced in the home country, and it is likely that even in countries with higher average tariffs, they will have to raise their external tariffs on many products produced in their partner countries. This will allow partner country producers to charge higher prices under the protection of higher tariffs on third country producers, a significant welfare loss that is likely to dominate. A choice available to a country in these circumstances is to lower its tariff on third countries, without joining the CU. This option offers the gains from the trade creation on the products where the external tariff is being lowered, without the losses of the trade diversion from having to pay higher prices to inefficient partner country suppliers.

Russia, Kazakstan and Belarus. Finally, briefly consider the welfare impact on Russia, Kazakstan and Belarus, the members of the Customs Union which had adopted the common external tariff.

Notes

Since the tariff structure favors production in these countries, then as more countries join the Customs Union, in the short run producers in these countries will gain additional profits and exports from the additional protection they receive against rest of world imports in the new partner country markets. Since the costs of protecting home producers will be borne in part by consumers in partner countries, the strategy has an initial appeal in the countries whose producers receive the high protection. But, because the benefits of a liberal trade regime to consumers are dispersed widely (presenting a free-rider problem where it is not typically worth it to individual consumers to lobby their governments for liberal trade actions) while the benefits of trade protection are concentrated in the industry receiving protection (which provides an incentive for the industry to lobby its government for protection), the kinds of preferential trade areas that will typically arise are those which are trade diverting (see Grossman and Helpman (1995)). Thus, in order for the existing members of the Customs Union to convince additional members to join, or at least to remain members over time, it is likely that the tariff structure will have to change in a way that offers protection to producers of other CIS countries, i.e., the existing members will have to offer protection in their markets to high priced products produced in non-member CIS states.

Caution A country will not participate in a Customs Union if the Customs Union offers neither enhanced protection for its producers nor widespread benefits for its consumers.

If the external tariff is adjusted to accommodate the inefficient producers of new members, although some of the producers of the existing member countries may still gain from a wider Customs Union, the benefits to the countries as a whole are going to be reduced and countries could become net losers. That is, the short-run gains to existing producers mask potential longer term costs of not opening up trade to the rest of the world. It is likely that the entire CIS is not collectively large enough to approximate world market efficiency in most products. Thus, a strategy of widening the protection of domestic producers through a Customs Union of a set of the CIS countries, is really an import substitution policy through protection on a slightly larger scale, a strategy that has retarded growth in many countries .

Revenue Effects

Due to the potential impact on the fiscal deficit, macro stabilization and inflation, governments must also be cognizant of the impact of preferential trade arrangements on their revenues. In this section, we examine various aspects of this question for the CIS countries.

Tariffs

Joining the customs union is likely to have negative revenue implications on Individual new members. As there will continue to be no tariffs on trade within the customs union, to the extent that rest of world imports are displaced, tariff revenue will be lost to the customs union. In addition, despite the fact that the customs union agreements stipulate that the tariff revenue will go to the country to whom the imports are destined, one can not overlook the potential administrative problems associated with obtaining tariff revenues from the customs offices of other member countries, especially given the weakness in tax reserve collections in all these countries. And there are other reasons to believe that revenues of imports from the rest of the world will be diminished. There are central administrative institutions of a customs union that will have to receive funding. Funding for the administration of the customs union or any centralized programs is typically done out of tariff revenue collected by the customs union.

Excise Taxes: Accession to the customs union will increase pressure on members to harmonize excise tax rates. These rates are presently rather diverse both within the CU countries and potential members. The tax revenue implications of unified rates would have to be assessed in each case individually.

Value Added Taxes. The dominant practice among the CIS countries is to apply the value added tax (VAT) on a mixed basis. That is, for trade outside of the CIS, imports are taxed but exports are not, the

Notes

"destination" system. For trade within the CIS, exports are taxed but imports are not, the "origin system." Participation in the customs union will require a value added tax that is harmonized with the system applicable in the customs union, i.e., the current mixed system. Berglas (1981) has shown that under certain assumptions (including flexible exchange rates) the origin or destination systems are equivalent and do not tax the trade regime if designed properly. Since the VAT rates of most CIS are approximately equalized, the allocation of real resources and trade flows among the other CIS countries is not seriously affected, but it is important to harmonize these taxes within a mixed system to avoid arbitrage and distortions.

What is more likely to be a problem with a mixed VAT system is the allocation of tax revenues. Even if the VAT rates are harmonized, countries with a trade deficit within the customs union and a trade surplus outside the customs union will experience an adverse transfer of VAT tax revenues toward the partners in the customs union with the opposite trade pattern. To illustrate, suppose the trade of Azerbaijan is balanced overall, but it imports exclusively from, say Russia, and exports exclusively outside the customs union, and that Russia has the opposite trade balance.

Since the destination system applies on trade outside of the CIS, and the origin principle applies on trade within the CIS, Azerbaijan would collect no VAT tax revenues (neither on its imports nor its exports), and Russia would collect all the VAT revenue on trade (Russia collects VAT on both its exports to Azerbaijan and its imports from the rest of the world). Thus, even though the mixed VAT system would not change relative prices and is therefore non-distortionary because there is no impact on the allocation of resources, in this example it would represent a transfer of VAT revenues from Azerbaijan to Russia.

Dynamic Effects

In general, there are two basic ways in which the rate of output growth can increase: First through a faster growth of factor inputs and second through increases in the growth of total factor productivity. Assuming no changes in population growth and in labor force participation rates, the growth of factor inputs essentially boils down to the rate of investment in human and physical capital. Total factor productivity on the other hand is thought to be dependent in the medium and long term on improvements in technology and knowhow.

More generally, access to a diverse mix of products including modern technology appears to be very important for the growth process. New and diverse technologies are constantly appearing and these new technologies allow an increase in the productivity of both capital and labor.

The question that needs to be addressed then is how a customs union among the CIS countries will affect output growth through its impact on access to technology that enhances productivity and through its effects on the rate of investment in human and physical capital.

There is some evidence that developing countries total factor productivity is positively related to the access of technology and knowledge embodied in imports from developed countries. In the case of CIS and other transition economies, access to diverse and modern intermediate products from world markets appears especially crucial as these economies attempt to transform themselves from an industrial structure that was inherited from the era of the former Soviet Union, i.e., that was outdated and frequently not based on comparative advantage. It is very important that these countries move away from reliance on technologies that are available only in the countries that were part of the former Soviet Union, since the most dynamic and modern technologies are found elsewhere. Yet, tariff protection for products that are produced in the customs union will discourage the introduction of new products and technologies from outside the customs union and free trade area, technologies that would boost the growth and development of the CIS members. Thus, on the question of enhancing growth through improvements in total factor productivity the effect of the customs union (and for that matter of the exisitng free trade area) on all its members is likely to be very negative.

There are several ways through which a customs union could affect the rate of investment in member countries: (a) through a change in tariffs and hence in the cost of imported capital equipment that changes the rate of return on investment and the rate of capital accumulation; (b) through affecting

Notes

the financial system and the overall stability and effectiveness of economic policies that improve the climate of investment; (c) by providing an incentive to foreign direct investment to locate and produce in the countries of the Union as opposed to exporting goods and services.

Unfortunately, it is difficult to make a credible case that these effects would be positive in the case of a customs union in the CIS. First, it is likely that the cost of imported capital would actually increase especially for some of the smaller members, as they could obtain capital goods more cheaply from third countries. Second, while there are plans for greater integration of the financial systems and economic policies of members which may have a positive impact on the climate of investment in the future, there is very little chance that any of this will happen in the immediate future. In fact, premature integration without adequate multilateral institutions may resurrect some of the problems of the recent past which contributed to instability. For example, the common ruble area of 1992-1993, without monetary coordination of the multiple central banks was a root cause of inflation and the problems of trade. The key challenge in all countries is how to improve the national environment for private sector development through the establishment of policies and institutions (for example better enforcement of contractual obligations) that improve the investment climate--policies that may best be pursued unilaterally in the near term. Third, it is possible that as result of the establishment of the customs union, there may be a positive effect on foreign investment that comes in to "jump" the common external tariff. How big this effect will be is hard to predict simply because there are so many other factors that constrain the inflow of foreign direct investment which countries need to address first and which are likely to have a far greater impact on foreign direct investment than the stimulus provided by the establishment of a customs union. More importantly, foreign direct investment which is in response to tariff jumping can cause the welfare and growth rate of the capital importing country to decline. The reason is tht foreign investment responds to the private return to capital, and the foreigners will repatriate profits based on their private returns; but when the sector is highly protected, the social return to investment in the sector is much lower than the private return.

In sum, while the dynamic effects of establishing or joining a customs union and of the exisiting Free Trade Area in the CIS are difficult to demonstrate, they are likely to be negative, especially because of the adverse effect of the preferential arrangements on technology and productivity improvements.

The Threat of the Loss of the Free Trade Agreement: In the event that a CIS country fails to join the customs union, there is some possibility that the members of the customs union would apply the common external tariff to the exports of that CIS country; that is, they may revoke their Free Trade Agreements. Although we must be cautious since the effects will vary from country to country and we do not have precise estimates, the net welfare impact of participation in the Free Trade Agreement is likely to be negative for most CIS countries; consequently, the threat of exposure to the common external tariff of the customs union is not an event that should be feared for most CIS countries.

The reasons are as follows: If Russia, Kazakstan and Belarus, withdraw from the Free Trade Agreements and apply the negotiated common external tariff of the customs union to exports from the other CIS countries, there would be economic impacts on both the imports and the exports of these CIS countries. Regarding imports, as explained in detail in the appendix, applying tariffs on imports from former partner countries in the CIS results in displacement of partner country imports by rest of world supply. This results in a gain in tariff revenue on these sales. Moreover, since partner country suppliers are likely, in many products, to lower their prices to the extent of reduction of the tariff on rest of world products (since marginally inefficient partner country suppliers will be forced out of the market as competition from rest of world producers becomes more intense), CIS consumers will be able to pay less to partner suppliers by the amount of the tariff, and this is a gain to their economic welfare. Moreover, permitting efficient imports from the rest of the world as opposed to preserving inefficient imports from partners in the former Soviet Union, is very productive in terms of breaking away from the outdated and inefficient technology of the Soviet past.

Weighed against this potential gain in welfare from application of tariffs on imports in the CIS is the loss in welfare from lost preferential access to the markets of countries in the Customs Union. Exporters from the CIS countries outside the Customs Union would no longer be able to obtain higher prices than producers from the rest of the world on exports to the countries in the Customs Union, since like

Notes

exporters from the rest of the world, their exports would also be subject to the tariff. But since the negotiated tariff of the Customs Union is based on the Russian external tariff, it tends to be high in those items important to Russian producers. That is, products important to the exports of the CIS tend to be inputs into production in Russia and therefore have relatively low tariffs in the Customs Union.

Although we must again be cautious since this effect will vary from country to country and we do not have precise estimates, this implies that most CIS countries outside Russia, Belarus and Kazakstan likely derive little terms of trade gain on their exports to the Customs Union, from the fact that they are in the Free Trade Agreement. That is, most CIS countries perhaps with the exception of Ukraine, would likely be able to sell the vast majority on their products in the same markets with small losses losses that are considerably smaller than the losses suffered by their consumers from having to pay higher prices to the exporters from the Customs Union.

Moreover, the dynamic effects of the free trade area could also be negative, for all its members. It would be desirable for CIS exporters to find alternate marketing channels outside of the CIS Customs Union countries. This would reduce dependence on a limited number of countries for markets and transportation facilities. Absent Free Trade Agreements, it will become even more imperative for exporters from the CIS to find alternate markets and marketing channels. Moreover, while finding new markets outside of the Customs Union countries may require a difficult adjustment period, the experience of the Baltic countries between 1992 and 1994 demonstrates that rapid adjustment is possible.

Converting the Free Trade Area to a Customs Union

Now consider the impact of imposing the common external tariff at the rate t', starting from the Free Trade Agreement in place. The supply curve including the tariff of the rest of the world and the new equilibrium price increases to PR (1+t'), where the quantity demanded for imports declines to M1. Partner country suppliers also receive this higher price and then the quantity they supply increases to Q1. The quantity supplied from the rest of the world declines to M1 - Q1.

The welfare costs to country A are strongly negative, and may be decomposed into three parts. First, there are consumer deadweight losses because country A consumers are induced to reduce their consumption of total imports from Mo to M1 in favor of alternate goods available that were previously less preferred (this could include domestic substitutes in this product category or goods in other product categories). These were equal to the triangle ADL in the initial equilibrium, but they increase to BCL. The difference is the shaded area ABCD, representing the increase in consumers' deadweight loss due to the common external tariff. Second, there is an increase in the triangle of producers' deadweight losses, from NGH to NFE.

The difference is the shaded area FEHG, representing the increase in producers' deadweight loss due to the imposition of the common external tariff. Partner country producers are able to obtain higher prices in country A, which attracts less efficient higher cost supply. Absent a tariff, supplies from the rest of the world would have been available at the price PR. Third, part of the higher prices received by partner country suppliers results in an increase in their profits or producers' surplus. The increase in partner country profits or producers surplus is HIJE; this is a transfer from country A consumers to producers in partner countries. Overall the loss of moving to the customs union, given that a Free Trade Agreement is already in place, is the sum of the three shaded areas in Figure 1: ABCD + FEHG + HIJE.

The losses to the economy of increasing tariffs through the common external tariff of the customs union, given a Free Trade Agreement, are considerably greater than non-preferential tariff increases from an average rate of t to t'. That is, if tariffs were applied in a non-preferential manner and were increased from t to t', the costs to the economy of the increase in the tariff would be the shaded area ABCD. The customs union imposes the additional costs equal to the areas FEHG and HIJE, representing inefficiency losses and transfers to partner country suppliers, respectively.

Combined Loss of the Customs Union and the Free Trade Agreement

The combined loss of the Free Trade Agreement and the customs union is larger than the loss of the customs union or the Free Trade Agreement alone and equals the triangle BCL plus the rectangle

Notes

MFEJ. A non-preferential tariff of rate t' would produce a welfare loss equal to the triangle BCL. The difference is equal to the area MFEJ which derives from the fact that consumers in country A pay higher prices to partner country producers than they would have to pay to rest of the world producers. The area MFEJ would be captured for country A as tariff revenue and not lost to the economy if the tariff were not preferential. Instead with a the combination Free Trade Agreement and customs union the area MFEJ is added to the losses of country A, thereby greatly magnifying the losses. The area MFEJ represents a combination of transfers to partner country suppliers (the area MNEJ) plus inefficiency (deadweight) losses of using marginally inefficient partner country suppliers (the triangle NFE). It is necessary to reduce this estimate of the losses by the increase in the terms of trade earned by exporters from country A on their sales within the PTA. Since the tariff primarily benefits existing Customs Union members, these gains may be expected to be small.

4.3 Summary

- For small CIS countries, with relatively open trade regimes, joining the Customs Union that has been established by several CIS members could be economically quite costly. These costs could be mitigated, but probably not fully offset, if as a consequence of the entry of new members, both the average level and the dispersion of the previously negotiated external tariff of the customs union were reduced. For these countries, maintaining an open trade regime without preferences is the best policy that maximizes welfare and growth prospects. It will also facilitate entry into the WTO, a key objective for these countries' trade policies.
- Even for the existing customs union members, and for others with more restrictive trade regimes than those of existing members, preferential arrangements that provide strong incentives to orient trade towards partners in the former Soviet Union contain significant long term risks. The main risks are that the preferences (through customs union or free trade arrangements) lock in traditional technologies and production structures, reduce innovation and competition, and hence result in inefficient industries that absorb scarce resources that could be better used elsewhere.
- The discussion has focused on preferences and a specific customs union arrangement among CIS countries. But it has relevance for preferential arrangements, including customs unions, that might be considered in the context of other country groupings in the CIS as well as in transition economies in Eastern Europe, e.g. former Yugoslavia. In this case as well, the main problems would arise from lack of competition and the absence of dynamic technology. The discussion is not intended to apply to countries in transition joining the EU, where different circumstances prevail which improve the prospects for economic benefits.
- The key difference between preferential arrangements among CIS members and other preferential arrangements (NAFTA, the EU) is that in the latter the markets are large enough to promote competition and encourage the flow of new technology which increase the probability that distortions introduced through preferences are more than offset by new trade creation and the dynamic effects of investment embodying new technology.
- We had advocated preferential arrangements for CIS members as useful transitional devices to mitigate the severe disruption of trade among the new independent states in the aftermath of the breakup of the Soviet Union (Michalopoulos and Tarr, 1992; 1994). Although based on duration of unemployment measures, two years appears to be a sufficient period of adjustment in market economies,11 there is no standard period for adjustment or transition; and the breakup of the Soviet Union clearly created unprecedented disruption which may have warranted a greater adjustment period. The new independent states have had five years to adjust to international competition. Given the inherited burden of inefficiencies that plagues a sizable portion of CIS industry, there are serious costs of continuing preferential arrangements indefinitely, and integrating more closely through a customs union at this time appears ill advised.

Notes

Self-Assessment

1. Choose the correct options:

(*i*) Which one of the following sets of countries contains only members of the European Union (EU)?

(*a*) France, Spain, Switzerland, UK

(*b*) Germany, Italy, Portugal, Sweden

(*c*) Denmark, Greece, the Netherlands, Poland

(*d*) Belgium, Greece, Italy, Portugal

(*ii*) If good X of country C faces a 10% tariff in country A and a 20% tariff in country B, but if A and B have free trade between each other, then A and B are part of which one (and only one) of the following types of groupings?

(*a*) Free trade area (*b*) Customs union

(*c*) Common market (*d*) Economic union

(*iii*) If country A forms a customs union with country B, then

(*a*) country B continues to get tariff revenue from country A's exports sent to B.

(*b*) all new trade between A and B because of the union is known as "trade creation".

(*c*) the welfare of A and B must necessarily be enhanced, especially if A and B begin to buy many items from each other that they used to buy from the :"outside world".

(*d*) A and B may especially benefit from the union if substantial economies of scale exist in some of the A and B industries.

4. If two countries remove all tariffs on each other's products and establish a common set of tariffs against the rest of the world, but take no further steps toward economic integration, these two countries have formed _____.

(*a*) a free trade area (*b*) a customs union

(*c*) a common market (*d*) an economic union

(*v*) Which of the following is considered to be a positive dynamic effect of integration?

(*a*) economic-of-scale effects

(*b*) reduced customs costs

(*c*) trade division

(*d*) the increased monopoly power of firms

4.4 Summary

- A tariff will induce inefficiency losses, but preferential trading areas with partners with upsloping supply curves greatly magnify the losses. This explains why preferential trade arrangements with small partner countries or with countries that may be expected to increase supply at higher protected prices can be expected to be very inefficient, more inefficient than non-preferential tariff protection at the same rate.

4.5 Key-Words

1. Trade Creation : When trade b/w custom union partners increases, this implies a shift in the Union to more efficient, competitive producers
2. Trade Diversion : When imports from the less expensive world market are replaced by imports from a higher cost/less efficient partner country within the customs union

* The government obtains tariff revenue on the imports from the rest of the world, equal to the rectangle GHAD, but imports from partner countries enter without paying tariffs.

Notes

3. Trade expansion : When lower market prices in one partner country stimulates total domestic demand which is satisfied by increased foreign trade with another partner country

4.6 Review Questions

1. What is meant by trade regimes?
2. Write a short note on the effects of Custom Union. Discuss.
3. Discuss the dynamic effects of custom union.

Answers: Self-Assessment

1. (*i*) (*d*) (*ii*) (*a*) (*iii*) (*d*) (*iv*) (*b*) (*v*) (*a*)

4.7 Further Readings

Books

1. Berglas, Eitan (1981), "Harmonization of Commodity Taxes: Destination, Origin and Restricted Origin Principles," Journal of Public Economics, 16, pp. 377-387.
2. Bhagwati, Jagdish and Anne Krueger (1973), Exchange Control, Liberalization and Economic Development, American Economic Review, 63 (2), May, 419-427.
3. Bhagwati, Jagdish and Arvind Panagariya (1996), "Preferential Trading Areas and Multilateralism: Strangers, Friends or Foes," in J. Bhagwati and A. Panagariya (eds.), The Economics of Preferential Trade Agreements, Washington D.C.: AEI Press.
4. Grossman, Gene and Elhanin Helpman (1995), The Politics of Free-Trade Agreements, The American Economic Review, 85 (4), 667-690.

Notes

Unit 5 : SAARC/SAPTA, ASEAN

CONTENTS

Objectives
Introduction
5.1 SAARC/SAPTA
5.2 ASEAN—INDIA
5.3 Summary
5.4 Key-Words
5.5 Review Questions
5.6 Further Readings

Objectives

After reading this Unit students will be able to:

- Know SAARC/SAPTA.
- Explain ASEAN—INDIA.

Introduction

There is a greater awareness now among the people of the region comprising SAARC that with joint efforts, today's knowledge economy, the enhanced purchasing power of the South Asian market with a quarter of humanity living in it, its yet untapped hydrocarbon reserves and the rich diversity of other resources, could yield huge dividends for its people and lend the region considerable political weight and economic clout in a gradually emerging multipolar world. Can one transform that awareness into the will to move ahead in that direction, fast enough to rub shoulders with other regional entities with the necessary degree of internal harmony and strength ? That would mean getting over problems that have beset SAARC so far.

First, there is the inadequacy of intra-SAARC trade. Without augmenting trade within the region and region's exports to the rest of the world, the South Asian dream of becoming a partner in Asia's march to the top of the economic ladder in this century is inconceivable. In Europe more than half the exports are intra-regional. In South Asia, they are just about 5%. Even if one adds the very vague figures of informal intra-SAARC trade to it, the figure would hardly reach 7%. The answer obviously lies in breaking existing barriers to trade within the region.

5.1 SAARC/SAPTA

SAARC commenced the process of liberalization eight years ago when in 1995 the Organization established the South Asian Preferential Trade Arrangement (SAPTA). During the last eight years four rounds of negotiations have been held among the member countries, exchanging lists of items for tariff concessions. So far more than 5000 items have been liberalized. Commendable though this endeavour may be, its pace has been far from satisfactory. First, the lists exchanged have rarely included items most traded bilaterally among the SAARC countries. Secondly, there have not been across the board reductions of tariffs, the process having been too selective in character. Obviously the liberalization process needs considerable lubrication for its wheels to move faster and more smoothly.

Significant complementarities exist among SAARC countries apart from just those of history and culture. There needs to be more active communication between the respective trade, business, finance and industry of the SAARC states and particularly of India and Pakistan, the two largest among

Notes

them, to ensure intra-SAARC trade expansion. In this connection one must hail the recent announcements by these two States encouraging people-to-people contacts followed by an exchange of business delegations. As the political climate in the region improves further and the liberalization process gathers momentum, the business community would move forward fast, taking advantage of the new opportunities and boosting up regional trade. With SAPTA coming into force a year from now, this process will surely receive a boost and it should become fully operational by 2016. That would need persistent effort so that we do not get stuck halfway through. Opening up more land and rail routes will provide further impetus.

Did u know? The SAFTA Agreement was signed on 6 January 2004 during Twelfth SAARC sumnit held in Islamabad Pakistan.

Simultaneously, exporters in the countries of the region have to be helped financially to take care of resource constraints. As financing imports through export earnings alone has not been a possibility for SAARC countries, and generation of internal resources to fill the gap has been equally difficult, dependence on external assistance tied to the source has been a marked practice. What is required is a discreet use of clearing and payment arrangements and promotion of mutually advantageous counter trade. In this context the idea of having a common South Asian Currency would be of enormous value. We need to move towards much closer cooperation for this to happen, to guard against misuse, money laundering and other considerations. As the EU experience has shown, a common currency demands strict fiscal controls and extensive monetary cooperation, which the region is still far from having.

Quality-Upsurge and Intra-SAARC Trade

South Asia has to contend with another factor that is emerging. Due to the impact of globalization, consumer taste has developed and is growing further in favour of goods from outside the region. As our experience shows, the only way to meet this challenge is to improve the quality of our products for our consumers and make them competitive against imported goods rather than clamp down on imports and fight the rising tide of globalization. If this calls for structural changes, these must be undertaken and in concert with countries of the region. Non-availability of exportable surpluses of preferred specifications, sub-standard quality of goods and services, and lack of standardization are major constraints to regional trade and its movement towards forging a South Asian Community. Low production efficiencies and high export competitiveness of the region have been quite an obstacle to increased intra-SAARC trade. To achieve the latter, South Asian countries should pay more attention to reducing trade imbalances amongst themselves. As the largest member of SAARC, India has a special responsibility for this. It should strive harder to reduce its surpluses in trade with other regional states by assisting them to produce more for the huge Indian market, reduce its protective mechanism vis-a-vis these countries and encourage more free trade arrangements with them as it has done with Nepal, Bhutan and recently Sri Lanka. Similarly, these countries should drop their inhibitions for developing closer and more open trade ties with India since in a climate of trust India's size and consumption capabilities will prove to be a boon to them rather than a bane. There is also the need to achieve greater standardization, and harmonization of documents such as letters of credit and complex customs procedures as the European Union has done, avoid delivery delays and enforce greater quality control. These steps are of crucial importance for a smooth flow of trade within the region.

Linkages and Transportation

To move towards a South Asian Community, the network of transport and transit facilities in the region has also to be considerably improved. Trade cannot move without its arteries being fluent. Lack of infrastructure is the enemy of development. It also comes in the way of fruitful regional cooperation. The absence of proper rail and road links among SAARC countries increases the cost of

Notes

such cooperation, disturbs delivery schedules and inhibits mutually advantageous business enterprises to develop. The logistics of freight movement are fundamental for trade. SAARC's Technical Committee on Transport and Communication has deliberated on these issues, but on the ground progress has been slow and inconsistent with the needs of the moment. Moreover, these deliberations have remained largely in the official domain and the great potential of the private sector has not been provided the right impetus.

Governments can play a very useful role in improving transport service facilities like railways, roads, shipping and ports. The possibilities of undertaking regional projects in this vital sector through private sector involvement are immense. There is also scope for cooperation in specific areas like inland waterways and coastal shipping. India, the only member of SAARC sharing land / sea borders with *all* the South Asian countries, has to take initiatives in upgrading these links but other regional partners must also overcome their inhibitions and come forward, seeking inspiration from the successful examples of Europe and NAFTA in fostering regional cooperation in this field among countries irrespective of their size.

The region should work on developing SAARC transport infrastructure and develop trunk routes of trade and development. It is high time that SAARC moved forward to establish an Infrastructure Fund, took up a couple of major infrastructure projects and implemented them so well that these would inspire confidence in SAARC's capability to deliver. The fund should focus on the improvement of the intra-SAARC border transport links that merit the most immediate attention. While all the member states have to do their part to create such a fund, India as the largest of them and having borders with all of them has a very major responsibility in the matter and must give the lead. In this respect, attention should be given to the Indian proposal at the meeting of the Council of Ministers in July 2004 for setting up a SAARC Infrastructure Fund for financing large collaborative projects.

New Dimensions

South Asian trade must also move more vigorously into the manufacturing and services sectors. From primary commodities it should fan out more and more into manufacturing and services trade. In the last two decades industrial joint ventures and transfer of technology have played a critical role in the growth of trade in regions such as ASEAN, the EU and NAFTA. International trade in services has also become a significant source of foreign exchange earnings. Joint ventures and technology transfers in manufacturing and services sectors constitute a major form of cooperation between enterprises of both developed and developing nations. SAARC states would stand much to gain by promoting such cooperation among them. While the signing of agreements on investment promotion and protection, avoidance of double taxation, and establishment of an Arbitration Council are important, SAARC needs to move away from mere trade in goods, as contemplated under SAPTA, to a new dimension of cooperation, embracing trade in services, and enhanced investment flows and cooperation in fiscal and monetary matters.

Sectors in which Joint Ventures and technology transfers are feasible are huge. These range from local market oriented ventures such as frozen food and fruit products to agro-based industries, textile and leather products, rubber and plastic products, mineral based industries, metal and metal products, chemicals, transport equipment, nonelectric machinery, electrical equipment, goods and machinery, and energy based industries.

Towards an Economic Union

The South Asian region offers a high potential for cooperation in such services as tourism and the hotel industry, consultancy services, services for small industry development, computer software, joint ventures for research and development, development finance, construction industry and banking. Taking advantage of the current foreign exchange position of the region as a whole, it would be useful to create a SAARC Reserve Fund as a source of financing debit balances. SAARC states should also undertake focal programs in the form of SAARC Technology Missions (SAARCTEMs) to improve agriculture and dairy development, using biotechnology. Similarly Joint SAARC Resource Surveys could be undertaken with a selective use of space technology and informatics to support sustainable

Notes

development. At the same time the South Asian countries should encourage joint eco-friendly use of the region's water and power resources by designing sub-regional projects for manufacturing, installing and maintaining energy systems including solar energy. These steps will take South Asia closer to the goal of becoming a Community and hopefully, somewhat later, help it evolve into South Asian Union. Towards this end, SAARC should create a high-powered Economic Council comprising Finance / Planning Ministers of each Member State to promote initiatives for regional economic, commercial, financial and monetary integration so vital to the emergence of an Economic Union.

Poverty Alleviation

We cannot face the world with full pride and dignity unless we eliminate the hydra of poverty that stalks our region. Each of our countries has the responsibility to concentrate on this theme individually and in concert with regional partners. It is obvious that while there is no substitute for each of our nation's individual efforts, SAARC should take the lead in promoting collaborative efforts to achieve poverty alleviation. It should be possible for the member States of SAARC to spare a proportion of their national allocations to meet the challenge of poverty for SAARC's collaborative efforts to that end. A common pool in the form of a SAARC Poverty Alleviation Fund should form the basis for such an effort. In this context one must welcome India's offer of US $ 100 million to set the ball rolling on this. Given the dimensions of the problem this is not a big amount but with other Member Countries chipping in, it should be possible for the SAARC Poverty Alleviation Fund to finance specific projects for implementation. Member States should also set up National Committees to consult with each other to monitor progress on such collaborative projects as well as devise programmes to implement the goals of the SAARC Social Charter. The region has a grave need to meet challenges jointly especially in combating diseases such as tuberculosis and HIV / AIDS. Fresh initiatives in this direction are necessary.

The academics analyzing the successes and failures of SAARC have long felt that it is important to create a regional forum for people's representatives from each member country to interact with their counterparts from others to discuss issues facing them regionally and to help develop regional cooperation. Establishment of a South Asian Parliamentary Forum would help achieve that objective.

An Oracle

More than half a century ago, at the first Asian Conference Pandit Jawahar Lal Nehru expressed the hope that the event would stand out in history as a landmark and said :

Strong winds are blowing all over Asia. Let us not be afraid of them but rather welcome them for only with their help can we build the Asia of our dreams. Let us have faith in these great new forces and the dream which is taking shape. Let us above all, have faith in the human spirit which Asia has symbolized for those long ages past.

More than anyone else, South Asia is a party to that dream and that spirit. In this twenty first century the continent of Asia has set its sights quite high and we stand closer to the fulfillment of that dream. And yet we are not so close. Much of that hope now rests on the next SAARC Summit in Dhaka, the thirteenth since its establishment. It was in Dhaka that SAARC's odyssey began when Bangladesh put us all together to think and work as a region. Let the Dhaka summit be the harbinger of a new dawn for the people of this historic region by taking several leaps forward.

Did u know? High on the heels of the Fifth EU-India Summit came the third ASEAN—INDIA Summit on November 11, 2004 at Vientiane, Laos.

It is a happy augury that India's regional relationships are developing a fresh thrust and a new momentum. In a world of shrinking distances, rising expectations and soaring new dreams, the human family has to learn to sink its differences and maximise cooperation all around to carve a new destiny. In that historic journey, entities like the EU, ASEAN and increasingly SAARC standout as important milestones. Regional cooperation will be propelled as much by the historic force of globalisation as by a new dynamism in bilateral equations.

Notes

For Asia to add this momentum would be necessary to bury the hatchet of earlier conflicts and rivalries and move from the security of weapons to the firmer security of regional and global cooperation, from the worn out concept of Mutually Assured Destruction to that of Mutually Assured Cooperation, from the battle for humanity's survival to that of growth for all. A brave new world beckons to us free of destitution, deprivation and discrimination if only we could heed its call and move towards it in one file, our steps in a harmonious blend.

5.2 ASEAN—INDIA

India's emphasis on the resurgence of Asia and cooperation with Asian nations in the post colonial era goes back to the days of the Asia Conference organized by Pandit Jawaharlal Nehru on the eve of India's independence, and the Bandung Conference later where the Indian leader offered *Panchsheel* as an alternative to the policy of deterrence that was shaping the cold war world. The countries of the South East Asian region and India have shared for thousand of years a priceless heritage of civilization and culture and of a very peaceful religious, social and economic interaction with each other. In this millennial relationship, all the societies extending from Myanmar to Indonesia along the Indian Ocean and from there to the Philippines in the Asia Pacific have had by dint of history and geography a close kinship and affinity with India. Today, like India again, they are pluralistic, multi ethnic societies. There also exists among them a multifaceted partnership through bilateral and multilateral links encompassing political, cultural, social, economic, scientific, technological, and security dimensions. These links constitute a solid foundation for taking ASEAN—INDIA partnership to greater heights and into new areas of growth and development.

Phnom Penh Summit

Since the First ASEAN—INDIA Summit held in Phnom Penh on November 2002 a number of agreements and understandings have already been reached between the two sides including the Framework Agreement on Comprehensive Economic Cooperation between ASEAN and India signed in Bali in October 2003 for realizing the full potential of ASEAN—INDIA Regional Trade and Investment Area (RTIA) and economic cooperation. At the Laos Summit in November last year the two sides committed themselves to promote a long term cooperative partnership, impart synergies to their complementarities and cooperate in a coordinated manner to accelerate and mutually reinforce sustainable growth and development, taking full advantage of their geographical contiguity. Both agreed to give high priority to development of regional infrastructure and road, rail, sea and air transportation links to increase physical connectivity that would facilitate greater movement of goods and people. In this connection they also agreed to facilitate travel and tourism between ASEAN and India by linking their tourist centres and to enhance synergies of tourist destinations. In addition, they agreed to promote cooperation in the fields of science and technology, and committed themselves to work through both conventional and innovative trade and economic arrangements to achieve freer movement of goods, services and investment.

The ASEAN Century

ASEAN and India agreed at the Laos summit to cooperate in human resource development, through capacity building, strengthening of institutions, training and entrepreneurship development focusing on small and medium enterprises. Apart from fostering cooperation to preserve their common cultural heritage, they agreed to promote people to people exchanges involving parliamentarians, the youth, artists, sport persons and representatives from business, industry, the media, and academic and *think-tank* institutions. The document on Partnership for Peace, Progress and Shared Prosperity signed on November 11, 2004 at the Third ASEAN—INDIA Summit also provides for strengthening cooperation at the United Nations and other multilateral fora, in particular WTO. It expresses support for early reforms of the United Nations and the Breton Woods institutions to make them more democratic and responsive to the priorities of the developing countries. The ASEAN—India Partnership document manifests a new urge on the part of ASEAN and India to jointly address the common challenges confronting the world, especially those relating to security such as the menace of international terrorism, other transnational crimes like trafficking in drugs, human trafficking, cyber

Notes

crimes, international economic crimes and environmental crimes, sea piracy and money laundering, through effective institutional linkages and programmes of cooperation.

As partners ASEAN and INDIA have also agreed to collaborate on the global plane in areas of general and complete disarmament and the non-proliferation of weapons of mass destruction under strict and effective international control. India sees its growing interaction with ASEAN as 'critical to fulfilling the promise of the 21st century being an Asian century' to use the words of Prime Minister Manmohan Singh. While launching the INDIA—ASEAN car rally at Guwahati on the eve of the third ASEAN—INDIA Summit, the Prime Minister called it 'a journey in to the future demonstrating the possibilities in trade, tourism and people to people contact by bringing all these countries together'. He was equally conscious however of the enormous benefits likely to accrue to India's north eastern region through an intensification of ties with ASEAN and its member countries and of which the sub-regional cooperation under BIMSTC is a part.

Milestones Covered

To give practical shape to the objectives of this newly envisaged partnership, the Laos document is accompanied by an Action Plan for the implementation of specific activities and projects that will be periodically reviewed in the light of the dynamic developments in the region and the world. With the signing of this document India joins the array of ASEAN partners such as China, Japan and South Korea. Our relationship with ASEAN has come a long way from the year 1991 when the first steps were taken to move towards a constructive relationship with ASEAN. I had the good fortune of being Secretary (East) in the Ministry of External Affairs at that time and visited several ASEAN countries with that intent. As a result India became a sectoral dialogue partner of ASEAN in 1992. India's trade with ASEAN countries has multiplied a few times since then and now stands at US $13 billion. It is targeted to reach US $30 billion by 2007. This is a far cry from the mid-1960's when India declined the offer to be a full member of ASEAN. The Partnership Agreement reached at Laos with ASEAN makes it possible for India to interact with the South East Asia community of 500 million people with a combined GDP of US $750 billion as a collectivity. ASEAN's integrative mechanisms and the success it has achieved as a regional body should also inspire greater confidence in SAARC (the South Asian Association for Regional Cooperation), as an instrument of change in the South Asian region.

Self-Assessment

1. Choose the correct options:

(*i*) The signing of % at its Islamabad Summit can be regarded as a landmark in the evolution of ..... .

(*a*) SAPTA, ASEAN (*b*) SAFTA, SAARC

(*c*) SAFTA.ASI-EAN (*d*) SAPTA, SAARC

(*ii*) What is SAARC?

(*iii*) What is SAPTA stands for?

(*iv*) What is SAFTA stands for?

5.3 Summary

- SAARC commenced the process of liberalization eight years ago when in 1995 the Organization established the South Asian Preferential Trade Arrangement (SAPTA). During the last eight years four rounds of negotiations have been held among the member countries, exchanging lists of items for tariff concessions. So far more than 5000 items have been liberalized.
- South Asia has to contend with another factor that is emerging. Due to the impact of globalization, consumer taste has developed and is growing further in favour of goods from outside the region. As our experience shows, the only way to meet this challenge is to improve the quality of our products for our consumers and make them competitive against imported goods rather than clamp down on imports and fight the rising tide of globalization.

Notes

- It is a happy augury that India's regional relationships are developing a fresh thrust and a new momentum. In a world of shrinking distances, rising expectations and soaring new dreams, the human family has to learn to sink its differences and maximise cooperation all around to carve a new destiny. In that historic journey, entities like the EU, ASEAN and increasingly SAARC standout as important milestones. Regional cooperation will be propelled as much by the historic force of globalisation as by a new dynamism in bilateral equations.
- For Asia to add this momentum would be necessary to bury the hatchet of earlier conflicts and rivalries and move from the security of weapons to the firmer security of regional and global cooperation, from the worn out concept of Mutually Assured Destruction to that of Mutually Assured Cooperation, from the battle for humanity's survival to that of growth for all. A brave new world beckons to us free of destitution, deprivation and discrimination if only we could heed its call and move towards it in one file, our steps in a harmonious blend.

5.4 Key-Words

1. Economic union : An economic union is a type of trade bloc which is composed of a common market with a customs union.
2. Upsurge : a sudden forceful flow.

5.5 Review Questions

1. Write a short note on Phnom Penh Summit.
2. Discuss the role of SAARC and SAPTA.
3. What are the objectives of Asean union?

Answers: Self-Assessment

1. (*i*) (*b*)

   (*ii*) SAARC stands for South Asian Association for Regional Co-operation. It is established on December 08,1985. It has 8 member countries. Member courtiers are

   1. Bangladesh, 2. India. 3. Pakistan. 4. Srilanka.5. Nepal. 6. Bhutan, 7. Maldives. 8. Afghanistan.

   (*iii*) SAARC Preferential Trading Arrangement.

   (*iv*) South Asian Free Trade Area.

5.6 Further Readings

1. Berglas, Eitan (1981), "Harmonization of Commodity Taxes: Destination, Origin and Restricted Origin Principles," Journal of Public Economics, 16, pp. 377-387.
2. Bhagwati, Jagdish and Anne Krueger (1973), Exchange Control, Liberalization and Economic Development, American Economic Review, 63 (2), May, 419-427.
3. Bhagwati, Jagdish and Arvind Panagariya (1996), "Preferential Trading Areas and Multilateralism: Strangers, Friends or Foes," in J. Bhagwati and A. Panagariya (eds.), The Economics of Preferential Trade Agreements, Washington D.C.: AEI Press.
4. Grossman, Gene and Elhanin Helpman (1995), The Politics of Free-Trade Agreements, The American Economic Review, 85 (4), 667-690.

Notes

Unit 6 : Regionalism : EU and NAFTA

CONTENTS

Objectives
Introduction
6.1 India and the European Union
6.2 North American Free Trade Agreement
6.3 Summary
6.4 Key-Words
6.5 Review Questions
6.6 Further Readings

Objectives

After reading this Unit students will be able to:

- Understand India and the European Union (EU).
- Discuss the North American Free Trade Agreement.

Introduction

Regionalism is a term used in international relations. Regionalism also constitutes one of the three constituents of the international commercial system (along with multilateralism and unilateralism). It refers to the expression of a common sense of identity and purpose combined with the creation and implementation of institutions that express a particular identity and shape collective action within a geographical region.

The first coherent regional initiatives began in the 1950s and 1960, but they accomplish little, except in Western Europe with the establishment of the European Communities. Some analysts call these initiatives "old regionalism". In the late 1980s, a new bout of regional integration (also called "new regionalism") began and still continues. A new wave of political initiatives prompting regional integration took place worldwide during the last two decades, while, in international trade, after the failure of the Doha round, regional and bilateral trade deals have mushroomed.

The European Union can be classified as a result of regionalism. The idea that lies behind this increased regional identity is that as a region becomes more economically integrated, it will necessarily become politically integrated as well. The European example is especially valid in this light, as the European Union as a political body grew out of more than 40 years of economic integration within Europe. The precursor to the EU, the European Economic Community (EEC) was entirely an economic entity.

Definition

Joseph Nye defined international region *"as a limited number of states linked by a geographical relationship and by a degree of mutual interdependence", and (international) regionalism as "the formation of interstate associations or groupings on the basis of regions"*. This definition, however, was never unanimously accepted, and some analysts noted, for example, that the plethora of regional organizations founded at the initiative of developing countries had not fostered the rapid growth of regionalism in the Third World. Other authors, such as Ernst B. Haas, stressed the need to distinguish the notions of regional cooperation, regional system, regional organization and regional integration and regionalism.

Notes

6.1 India and the European Union

The Summit

The European Union and India had held their first Summit in 2000. The progress made since then was so encouraging that by the middle of last year both sides agreed to establish a EU-India 'strategic partnership.' At the Fifth India-EU Summit on November 8, 2004 where India was represented by Prime Minister Dr. Manmohan Singh and EU by Dutch Prime Minister Dr. Jan Petar Balkenende, President of the European Council, both sides agreed to jointly workout a Comprehensive EU-India Action Plan for a Strategic Partnership and a new Joint Political Declaration, at the next Summit. They also agreed to hold regular, institutionalized parliamentary exchanges between the Indian Parliament and the European Parliament and to promote political interaction between the two sides by fostering cooperation between political parties and trade unions. Cooperation is also to be encouraged between business associations, universities and civil societies.

A new feature now will be the flow of students and scholars between the EU and India through an India specific scholarship programme under EU's project *Erasmus Mundus.* An Energy Panel will also be set up to coordinate joint efforts to ensure energy security in an increasingly volatile energy environment when the rising prices of the fuel are causing havoc particularly in developing societies. Both sides also agreed to organize EU-India Environment Forum and to exchange views and information on issues of mutual interest. Joint workshops on automotive engineering, genomic studies, life sciences and nano-technology will also be held with a view to meet the challenges of the future in a spirit of cooperation. On the wider global plane the European Union and India agreed at the last - Summit to install a dialogue on disarmament and non-proliferation. An agreement was reached 'to consider regular exchange of views on possibilities for cooperation on themes like resolution of conflicts.' These agreements provide a new dimension to EU-India relations for these indicate an interest on the part of both of them to act as global players in concert with each other. This has happened at a time of the enlargement of the EU to 25 countries covering the broad span of Europe all the way from the Atlantic to the Ural and the Arctic to the Mediterranean and in the context of the *Lisbon strategy* to make Europe the world's most competitive economy by 2010. Europe has established a new constitution for itself taking the European Union to a much higher stage of integration than foreseen by the Maastricht Treaty. An expanded Europe and a growing India throw up an enormous potential for a partnership for mutual benefit that the summit document seeks to crystallize.

Technology and Economic Cooperation

One of the highlights of the November 8, 2004 Joint India-EU statement is the decision to speed up the conclusion of an agreement for India joining the European Union's Galileo Global Positioning System as part of their strategic partnership. This satellite navigation project with its network of 30 satellites will become operational by 2008 and will provide a real alternative to the Global Positioning System being run by the US military that the US has the power to turn off selectively. It will guarantee the availability of highest quality signals over the Indian territory. India has agreed to invest money in this project appropriate to its participation in Galileo space, ground and user segments possibly to the tune of US $200 million. In terms of a strategic partnership India's participation under the Galileo satellite navigation project will stand on the same footing as its cooperation with the EU in the International Thermonuclear Experimental Reactor (ITER) project on fusion energy. The European Union and India already have a history of cooperation in the peaceful exploration and use of outer space. It has been moving forward on a regular basis through the European Space Agency and the Indian Space Research Organization. At the Fifth Summit, while India showed interest in EU's Galileo project, EU flagged its interest in India's *Chandrayaan-I* unmanned lunar exploration mission. It will include a payload of 55 *kg* of onboard instruments plus a 10 *kg* impactor for soft landing.

There is also a continuing strategic dialogue between India and the EU on the Information Society. In order to facilitate linkages in the area of research and technological developments, both sides agreed at the Fifth Summit to work towards a mutually acceptable mechanism to connect their information networks. EU and India have signed a MOU for a partnership programme providing for cooperation

Notes

in sectors of education, health and environment. Agreement has also been reached on developing a Disaster Management Prepareness Programme and a Trade and Investment Development Programme. The trade between the EU and India now stands at some 30 billion US dollars. The two sides have agreed to intensify their trade cooperation in order to expand bilateral trade and investment flows several times over. It is important that both India and the European Union create an enabling economic environment and increasing access to their growing markets to reap mutual benefits. Europe's investment in India stands now at around US $5.5 billion whereas in the realm of infrastructure alone there is scope for investment up to US $150 billion.

Other Areas of Strategic Partnership

Dr. Romano Prodi, President of the European Commission, showed a great deal of interest at the Summit in EU collaborating with India in the energy sector. He recognized that supply and demand in this sector were not in equilibrium looking at its worldwide dimension and called the situation 'dramatic'. He noted that Asia was waking up and the energy needs of counties like India and China, as of the rest of Asia, would grow phenomenally in the years to come. Their development must not get stopped, he said, due to lack of energy and EU should come forward to help bridge the gap. India's Prime Minister on his part pointed out that apart from energy, there were opportunities for the EU for investment in other infrastructure development sectors such as roads, rail, sea ports and airports. Europe could also take advantage of the new drive in India for productivity growth, its world-class institutes of science and technology and management education, and the boom in agriculture, biotechnology and pharmaceutical industry. Dr. Manmohan Singh said that India could be used as a research and development laboratory by the EU to its great advantage while enhancing job opportunities for Indian scientists and engineers. The Prime Minister also drew EU's attention to the vast network of India's banking system and large financial markets. He invited the European Union to look at India as an investment destination of promise and great potential. Citing India and EU as natural partners Dr. Manmohan Singh underlined shared values between the two of democracy, pluralism, rule of law, a free press and an independent judiciary. The strategic partnership between India and EU was vital, he said, for managing the challenges of global inter-dependence.

The European Union and India have also agreed to cooperate intensively on countering terrorism that is proving to be a menace to all their societies and to humankind at large. They will also push forward the Doha Development Agenda and the Framework Convention on Climate Change. They will take steps, too, for the promotion of tourism, enhancement of cooperation in the field of film production and distribution, conservation and restoration of works of art and monuments, scholarly exchanges between them, establishment of chairs on both sides for civilization studies and study of contemporary politico-economic systems under the Cultural Agreement signed at the fifth summit.

A Turning Point

The EU-India Fifth Summit thus marks a turning point in their relationship. While taking note of the ancient bonds between them as important cradles of civilization, the two sides manifested a strong will to meet the challenges of a new world facing them hand in hand as two poles of stability and as strong bastions of liberal democracy and market economy. India now greatly looks forward to a new level of cooperation with Europe from mere trade and investment, which remain very important, to a multiplicity of other areas impinging on human destiny such as space, science and technology, environment, peace and disarmament. Together India and Europe constitute more than a fourth of mankind and a vast chunk of this planet's natural resource. By putting their hearts, minds and resources together they can explore their potential to the fullest limit.

6.2 North American Free Trade Agreement

The **North American Free Trade Agreement (NAFTA)** is an agreement signed by the governments of Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The agreement came into force on January 1, 1994. It superseded the Canada—United States Free Trade Agreement between the U.S. and Canada.

Notes

NAFTA has two supplements : the North American Agreement on Environmental Cooperation (NAAEC) and the North American Agreement on Labor Cooperation (NAALC).

Negotiation and U.S. Ratification

Following diplomatic negotiations dating back to 1986 among the three nations, the leaders met in San Antonio, Texas, on December 17, 1992, to sign NAFTA. U.S. President George H. W. Bush, Canadian Prime Minister Brian Mulroney and Mexican President Carlos Salinas, each responsible for spearheading and promoting the agreement, ceremonially signed it. The agreement then needed to be ratified by each nation's legislative or parliamentary branch.

Before the negotiations were finalized, Bill Clinton came into office in the U.S. and Kim Campbell in Canada, and before the agreement became law, Jean Chrétien had taken office in Canada.

Notes SAARC created a free trade area of 1.6 billion people to Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

The proposed Canada-U.S. trade agreement had been very controversial and divisive in Canada, and the 1988 Canadian election was fought almost exclusively on that issue. In that election, more Canadians voted for anti-free trade parties (the Liberals and the New Democrats) but the split caused more seats in parliament to be won by the pro-free trade Progressive Conservatives (PCs). Mulroney and the PCs had a parliamentary majority and were easily able to pass the Canada-US FTA and NAFTA bills. However, he was replaced as Conservative leader and prime minister by Kim Campbell. Campbell led the PC party into the 1993 election where they were decimated by the Liberal Party under Jean Chrétien, who had campaigned on a promise to renegotiate or abrogate NAFTA; however, Chrétien subsequently negotiated two supplemental agreements with the new US president. In the US, Bush, who had worked to "fast track" the signing prior to the end of his term, ran out of time and had to pass the required ratification and signing into law to incoming president Bill Clinton. Prior to sending it to the United States Senate, Clinton introduced clauses to protect American workers and allay the concerns of many House members. It also required US partners to adhere to environmental practices and regulations similar to its own.

With much consideration and emotional discussion, the House of Representatives approved NAFTA on November 17, 1993, 234-200. The agreement's supporters included 132 Republicans and 102 Democrats. NAFTA passed the Senate 61-38. Senate supporters were 34 Republicans and 27 Democrats. Clinton signed it into law on December 8, 1993; it went into effect on January 1, 1994. Clinton while signing the NAFTA bill stated that "NAFTA means jobs. American jobs, and good-paying American jobs. If I didn't believe that, I wouldn't support this agreement."

Provisions

The goal of NAFTA was to eliminate barriers to trade and investment between the US, Canada and Mexico. The implementation of NAFTA on January 1, 1994 brought the immediate elimination of tariffs on more than one-half of Mexico's exports to the U.S. and more than one-third of U.S. exports to Mexico. Within 10 years of the implementation of the agreement, all US-Mexico tariffs would be eliminated except for some U.S. agricultural exports to Mexico that were to be phased out within 15 years. Most U.S.-Canada trade was already duty free. NAFTA also seeks to eliminate non-tariff trade barriers and to protect the intellectual property right of the products.

In the area of intellectual property, the North American Free Trade Agreement Implementation Act made some changes to the Copyright law of the United States, foreshadowing the Uruguay Round Agreements Act of 1994 by restoring copyright (within NAFTA) on certain motion pictures which had entered the public domain.

Notes

Mechanisms

NAFTA's effects, both positive and negative, have been quantified by several economists, whose findings have been reported in publications such as the World Bank's *Lessons from NAFTA for Latin America and the Caribbean*, *NAFTA's Impact on North America*, and *NAFTA Revisited by* the Institute for International Economics. Someargue that NAFTA has been positive for Mexico, which has seen its poverty rates fall and real income rise (in the form of lower prices, especially food), even after accounting for the 1994-95 economic crisis. Others argue that NAFTA has been beneficial to business owners and elites in all three countries, but has had negative impacts on farmers in Mexico who saw food prices fall based on cheap imports from US agribusiness, and negative impacts on US workers in manufacturing and assembly industries who lost jobs. Critics also argue that NAFTA has contributed to the rising levels of inequality in both the US and Mexico. Some economists believe that NAFTA has not been enough (or worked fast enough) to produce an economic convergence, nor to substantially reduce poverty rates. Some have suggested that in order to fully benefit from the agreement, Mexico must invest more in education and promote innovation in infrastructure and agriculture.

Investment

The US foreign direct investment (FDI) in NAFTA Countries (stock) was $357.7 billion in 2009 (latest data available), up 8.8% from 2008.

The US direct investment in NAFTA countries is in nonbank holding companies, and in the manufacturing, finance/insurance, and mining sectors. The foreign direct investment, of Canada and Mexico in the United States (stock) was $237.2 billion in 2009 (the latest data available), up 16.5% from 2008.

Industry

Maquiladoras (Mexican factories that take in imported raw materials and produce goods for export) have become the landmark of trade in Mexico. These are plants that moved to this region from the United States, hence the debate over the loss of American jobs. Hufbauer's (2005) book shows that income in the maquiladora sector has increased 15.5% since the implementation of NAFTA in 1994. Other sectors now benefit from the free trade agreement, and the share of exports from non-border states has increased in the last five years while the share of exports from maquiladora-border states has decreased. This has allowed for the rapid growth of non-border metropolitan areas, such as Toluca, León and Puebla; all three larger in population than Tijuana, Ciudad Juárez, and Reynosa.

Environment

For more details on this topic, see NAFTA's Impact on the Environment.

Securing U.S. congressional approval for NAFTA would have been impossible without addressing public concerns about NAFTA's environmental impact. The Clinton administration negotiated a side agreement on the environment with Canada and Mexico, the North American Agreement on Environmental Cooperation (NAAEC), which led to the creation of the Commission for Environmental Cooperation (CEC) in 1994. To alleviate concerns that NAFTA, the first regional trade agreement between a developing country and two developed countries, would have negative environmental impacts, the CEC was given a mandate to conduct ongoing *ex post* environmental assessment of NAFTA.

In response to this mandate, the CEC created a framework for conducting environmental analysis of NAFTA, one of the first *ex post* frameworks for the environmental assessment of trade liberalization. The framework was designed to produce a focused and systematic body of evidence with respect to the initial hypotheses about NAFTA and the environment, such as the concern that NAFTA would create a "race to the bottom" in environmental regulation among the three countries, or the hope that NAFTA would pressure governments to increase their environmental protection mechanisms. The CEC has held four symposia using this framework to evaluate the environmental impacts of NAFTA and has commissioned 47 papers on this subject. In keeping with the CEC's overall strategy of transparency and public involvement, the CEC commissioned these papers from leading independent experts.

Notes

NAFTA-related environmental threats instead occurred in specific areas where government environmental policy, infrastructure, or mechanisms, were unprepared for the increasing scale of production under trade liberalization. In some cases, environmental policy was neglected in the wake of trade liberalization; and measures against non-tariff trade barriers, threatened to discourage more vigorous environmental policy. The most serious overall increases in pollution due to NAFTA were found in the base metals sector, the Mexican petroleum sector, and the transportation equipment sector in the United States and Mexico, but not in Canada.

Agriculture

From the earliest negotiation, agriculture was (and still remains) a controversial topic within NAFTA, as it has been with almost all free trade agreements that have been signed within the WTO framework. Agriculture is the only section that was not negotiated trilaterally; instead, three separate agreements were signed between each pair of parties. The Canada-U.S. agreement contains significant restrictions and tariff quotas on agricultural products (mainly sugar, dairy, and poultry products), whereas the Mexico-U.S. pact allows for a wider liberalization within a framework of phase-out periods (it was the first North-South FTA on agriculture to be signed).

The overall effect of the Mexico-U.S. agricultural agreement is a matter of dispute. Mexico did not invest in the infrastructure necessary for competition, such as efficient railroads and highways, which resulted in more difficult living conditions for the country's poor. Mexico's agricultural exports increased 9.4 percent annually between 1994 and 2001, while imports increased by only 6.9 percent a year during the same period.

One of the most affected agricultural sectors is the meat industry. Mexico has gone from a small-key player in the pre-1994 U.S. export market to the 2nd largest importer of U.S. agricultural products in 2004, and NAFTA may be credited as a major catalyst for this change. The allowance of free trade removed the hurdles that impeded business between the two countries. As a result, Mexican farmers have provided a growing meat market for the U.S., leading to an increase in sales and profits for the U.S. meat industry. This coincides with a noticeable increase in Mexican per capita GDP that has created large changes in meat consumption patterns, implying that Mexicans can now afford to buy more meat and thus per capita meat consumption has grown.

Mobility of persons

According to the Department of Homeland Security Yearbook of Immigration Statistics, during fiscal year 2006 (*i.e.*, October 2005 through September 2006), 73,880 foreign professionals (64,633 Canadians and 9,247 Mexicans) were admitted into the United States for temporary employment under NAFTA (*i.e.*, in the TN status). Additionally, 17,321 of their family members (13,136 Canadians, 2,904 Mexicans, as well as a number of third-country nationals married to Canadians and Mexicans) entered the U.S. in the treaty national's dependent (TD) status. Because DHS counts the number of the new 1-94 arrival records filled at the border, and the TN-1 admission is valid for three years, the number of non-immigrants in TN status present in the U.S. at the end of the fiscal year is approximately equal to the number of admissions during the year. (A discrepancy may be caused by some TN entrants leaving the country or changing status before their three-year admission period has expired, while other immigrants admitted earlier may change their status *to* TN or TD, or extend TN status granted earlier).

Self-Assessment

1. Choose the correct options:

(*i*) Regionalism can be studied from any of the following perspectives EXCEPT

(*a*) Functional regions. (*b*) Non-governmental regions.

(*c*) Formal regions. (*d*) Vernacular regions.

(*e*) None of the above.

Notes

(*ii*) All of the following are regional trade organizations EXCEPT

(*a*) NAFTA. (*b*) NATO.

(*c*) the EU. (*d*) Mercosur.

(*e*) None of the above.

(*iii*) NAFTA is an agreement signed by the governments of

(*a*) Canada (*b*) Mexico

(*c*) the United States (*d*) All of these

(*iv*) NAFTA is implemented on

(*a*) Jan. 1994 (*b*) June 1993

(*c*) March 1990 (*d*) May 1998

6.3 Summary

- NAFTA (North American Free Trade Agreement) is the cooperation of free trade in North America that aims to facilitate member states in the fields of economics ranging from the release of tariffs and barriers to trade and the production of certain goods to the fair treatment of foreign investors to invest in their individual member countries (Krimawati). Its members are Canada, Mexico, and the United States. NAFTA is the second largest free trade area after the European (Vogel, 2009).
- United States and Canada have entered into free trade cooperation since 1988. Economic cooperation is limited to bilateral cooperation aimed at improving the condition of the Canadian economy worsened due to rising unemployment and the number of Canadian companies are moving their investment into the United States. Cooperation is considered as the embryo of the NAFTA.
- NAFTA was established in 1989 in Washington DC through trade agreement between Canada and the United States, which was attended by representatives of each. This agreement resulted in an agreement to eliminate or reduce tariffs between the two countries. In December 1992, NAFTA was signed by the presidents of the three countries, namely Brian Mulroney (Canada), Carlos Salinas de Gortari (Mexico), and George H. W. Bush (United States). The signing of NAFTA should be followed by a legislative ratification of the three countries. However, the United States legislature apparently alarming environmental and labor issues. Therefore, added the two agreements, each devoted to labor issues and environmental issues. Just beginning to be implemented NAFTA on January 1, 1994 (www.fas.usda.gov, 2009).
- Canada and Mexico are the second export market and the third largest for the United States. Commencing in 1992-1998, the value of U.S. agricultural exports increased by 26%, while accounting for 1997-1998, exports of food and food United States to Mexico increased from 881 million to 5.9 billion Dollars Dollars. This is the biggest level for 5 years in NAFTA. Mexico itself is a major target of U.S. food exports, and the United States have a supply of 75% of Mexican food imports. While Canada has been a stable market for U.S. food trade by increasing food exports by 10% every year from 1990 to 1998. Food in question is fruits, vegetables, snacks and other food consumption.
- Canada and Mexico needs the United States as an aid donor and the economies of both countries are deteriorating. For Canada and Mexico, NAFTA is the arena of competition among members. Mexico especially, most look very dependence on the United States in the economic sector.
- NAFTA can be regarded as one of the simplest forms of regionalism in the form of free trade areas. The relationship between the extent of member states in free trade relations in which each member benefits. Interests of members of the three countries in NAFTA of course not only on the economic sector. These countries also have a political interest, such as Mexico and Canada that require the United States to increase its bargaining position in economic assistance. NAFTA itself was established in order to offset the power of the new European Union.

Notes

- The question which then arises is whether the existence of NAFTA are still provides benefits to all three of its member countries? Is not the United States is seen as the "backbone" of the sustainability of NAFTA? And is not Canada and Mexico to be highly dependent on the United States? And whether NAFTA will evolve into regionalism at the higher levels? What is clear, there is NAFTA and lives today. Although losses were obtained not less, but it seems that the benefits gained by the three NAFTA countries to make enough to survive until today. NAFTA also has great potential to develop forms of cooperation as seen over the past few years of existence, NAFTA countries experiencing significant growth.

6.4 Key-Words

1. Disarmament : Disarmament is the act of reducing, limiting, or abolishing weapons. Disarmament generally refers to a country's military or specific type of weaponry. Disarmament is often taken to mean total elimination of weapons of mass destruction, such as nuclear arms. General and Complete Disarmament refers to the removal of all weaponry, including conventional arms.
2. Multilateral institutions : The international institutions which set the rules of international behaviour, for example the World Trade Organization.

6.5 Review Questions

1. What is meant by regionalism? Discuss.
2. Discuss the role of NAFTA.
3. Write a short note on India and the European Union.

Answers: Self-Assessment

1. (*i*) (*b*) (*ii*) (*b*) (*iii*) (*d*) (*iv*) (*a*)

6.6 Further Readings

1. Krimawati, Wawat. (?) NAFTA: North America Free Trade Agreement. [Accessed 18 May 2009]
2. Vogel, David. (2009) North American Free Trade Agreement. [Accessed 18 May 2009] 2009. North American Free Trade Agreement (NAFTA).
3. United States Department of Agriculture, Foreign Agricultural Service. [Accessed June 8, 2009]

Notes

Unit 7 : Multilateralism and WTO

CONTENTS

Objectives
Introduction
7.1 WTO (World Trade Organization)
7.2 Principles of the Multilateral Trading System Under the WTO
7.3 WTO Agreements : An Overview
7.4 Ministerial Conferences and Emerging Issues
7.5 Summary
7.6 Key-Words
7.7 Review Questions
7.8 Further Readings

Objectives

After reading this Unit students will be able to:

- Elucidate the Significance of WTO.
- Describe the Principles of the Multilateral Trading System under the WTO.
- Provide An Overview of WTO Agreements.

Introduction

The World Trade Organization (WTO) is the only international organization that deals with global rules of trade between nations. It provides a framework for conduct of international trade in goods and services. It lays down the rights and obligations of governments in the set of multilateral agreements discussed later in this chapter. In addition to goods and services, it also covers a wide range of issues related to international trade, such as protection of intellectual property rights and dispute settlement, and prescribes disciplines for governments in formulation of rules, procedures, and practices in these areas. Moreover, it also imposes discipline at the firm level in certain areas, such as export pricing at unusually low prices.

The basic objective of the rule-based system of international trade under the WTO is to ensure that international markets remain open and their access is not disrupted by the sudden and arbitrary imposition of import restrictions. Under the Uruguay Round, the national governments of all the member countries have negotiated improved access to the markets of the member countries so as to enable business enterprises to convert trade concessions into new business opportunities. The emerging legal systems not only confer benefits on manufacturing industries and business enterprises but also create rights in their favour. The WTO also covers areas of interest to international business firms, such as customs valuation, pre-shipment inspection services, and import licensing procedures, wherein the emphasis has been laid on transparency of the procedures so as to restrain their use as non-tariff barriers. The agreements also stipulate rights of exporters and domestic procedures to initiate actions against dumping of foreign goods. An international business manager needs to develop a thorough understanding of the new opportunities and challenges of the multilateral trading system under the WTO.

Notes

7.1 WTO (World Trade Organization)

The WTO came into existence on 1 January 1995 as successor to the General Agreements on Tariffs and Trade (GATT). Its genesis goes back to the post-Second-World-War period in the late 1940s when economies of most European countries and the US were greatly disrupted following the war and the great depression of the 1930s. Consequently a United Nations Conference on Trade and Employment was convened at Havana in November 1947. It led to an international agreement called Havana Charter to create an International Trade Organization (ITO), a specialized agency of the United Nations to handle the trade side of international economic cooperation. The draft ITO charter was ambitious and extended beyond world trade discipline to rules on employment, commodity agreements, restrictive business practices, international investment, and services. However, the attempt to create the ITO was aborted as the US did not ratify it and other countries found it difficult to make it operational without US support.

The combined package of trade rules and tariff concessions negotiated and agreed by 23 countries out of 50 participating countries became known as General Agreement on Tariffs and Trade (GATT): an effort to salvage from the aborted attempt to create the ITO. India was also a founder member of GATT, a multilateral treaty aimed at trade liberalization. GATT provided a multilateral forum during 1948-94 to discuss the trade problems and reduction of trade barriers. As shown in Exhibit its membership increased from 23 countries in 1947 to 123 countries by 1994. GATT remained a provisional agreement and organization throughout these 47 years and facilitated considerably, tariff reduction. During its existence from 1948 to 1994, average tariffs on manufactured goods in developed countries declined from about 40 per cent to a mere 4 per cent. It was only during the Kennedy round of negotiations in 1964-67, that an anti-dumping agreement and a section of development under the GATT were introduced. The first major attempt to tackle non-tariff barriers was made during the Tokyo round. The eighth round of negotiations known as the Uruguay Round of 1986-94 was the most comprehensive of all and led to the creation of the WTO with a new set up of agreements.

WTO vs GATT

The distinguishing features of WTO vis-a-vis erstwhile GATT are as follows :

- GATT remained a 'provisional' agreement and organization throughout 47 years during 1948 to 1994, whereas WTO commitments are permanent.

Exhibit : Multilateral Trade Rounds under GATT/WTO

Year	Round name	Subjects covered	Countries
1947	Geneva	Tariffs	23
1949	Annecy	Tariffs	13
1951	Torquay	Tariffs	38
1956	Geneva	Tariffs	26
1960-61	Dillon	Tariffs	26
1964-67	Kennedy	Tariffs and anti-dumping measures	62
1973-79	Tokyo	Tariffs, non-tariff measures, framework agreements	102
1986-94	Uruguay	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO, etc.	123

Notes

2001-present	Doha	Tariffs on goods, Non-agriculture market access (NAMA), special and differential treatment, trade facilitation, etc.	150

Source : WTO.

- GATT rules mainly applied to trade in goods, whereas WTO covers other areas, such as services, intellectual property, etc.
- GATT had contracting parties, whereas WTO has members.
- GATT was essentially a set of rules of the multilateral treaty with no institutional foundation, whereas WTO is a permanent institution with its own Secretariat.
- A country could essentially follow domestic legislation even if it violated a provision of the GATT agreement which is not allowed by the WTO.
- In WTO, almost all the agreements are multilateral in nature involving commitment of the entire membership, whereas a number of GATT provisions by the 80s were plurilateral and therefore selective.
- The WTO also covers certain grey areas, such as agriculture, textiles and clothing, not covered under the GATT.
- The dispute settlement system under the WTO is much more efficient, speedy, and transparent unlike the GATT system which was highly susceptible to blockages.

Why Should a Country Join the WTO ?

Despite the disciplinary framework for conduct of international trade under the WTO, countries across the world including the developing countries were in a rush to join the pack. The WTO has nearly 153 members, accounting for over 97 per cent of world trade. Presently, 34 governments hold observer status, out of which 31 are actively seeking accession, including large trading nations, such as Russia and Taiwan. The major reasons for a country to join the WTO are

- Since each country needs to export its goods and services to receive foreign exchange for essential imports, such as capital goods, technology, fuel, and sometimes even food, it requires access to foreign markets. But countries require permission for making their goods and services enter foreign countries. Thus countries need to have bilateral agreements with each other. By joining a multilateral framework like the WTO, the need to have individual bilateral agreements is obviated as the member countries are allowed to export and import goods and services among themselves.
- An individual country is unlikely to get a better deal in bilateral agreements than what it gets in a multilateral framework. It has been observed that developing countries had to commit to a greater degree to developed countries in bilateral agreements than what is required under the WTO.
- A country can learn from the experiences of other countries, being part of the community of countries and influence the decision-making process in the WTO.
- The WTO provides some protection against subjective actions of other countries by way of its dispute settlement system that works as an in-built mechanism for enforcement of rights and obligations of member countries.
- It would be odd to remain out of WTO framework for conducting international trade that has been in existence for about six decades and accounts for over 97 per cent of world trade. It may even be viewed as suspicious by others.

Functions of WTO

The major function of the WTO is to ensure the flow of international trade as smoothly, predictably, and freely as possible. This is a multilateral trade organization aimed at evolving a liberalized trade regime under a rule-based system. The basic functions of WTO are

Notes

- To facilitate the implementation, administration, and operation of trade agreements
- To provide a forum for further negotiations among member countries on matters covered by the agreements as well as on new issues falling within its mandate
- Settlement of differences and disputes among its member countries
- To carry out periodic reviews of the trade policies of its member countries
- To assist developing countries in trade policy issues, through technical assistance and training programmes
- To cooperate with other international organizations

Decision Making

A majority vote is also possible but it has never been used in the WTO and was extremely rare in the WTO's predecessor, GATT. The WTO's agreements have been ratified in all members' parliaments. Unlike other international organizations, such as the World Bank and the IMF, in WTO, the power is not delegated to the board of directors or the organization's head.

Did u know? WTO is a member-driven consensus-based organization. All major decisions in the WTO are made by its members as a whole, either by ministers who meet at least once every two years or by their ambassadors who meet regularly in Geneva.

Organizational Structure of the WTO

The organizational structure of WTO as summarized in Figure l, consists of the Ministerial Conference, General Council, council for each broad area, and subsidiary bodies.

First level : The Ministerial Conference

The Ministerial Conference is the topmost decision-making body of the WTO, which has to meet at least once every two years.

Second level : General Council

Day-to-day work in between the Ministerial Conferences is handled by the following three bodies:

- The General Council
- The Dispute Settlement Body
- The Trade Policy Review Body

In fact, all these three bodies consist of all WTO members and report to the Ministerial Conference, although they meet under different terms of reference.

Third level : Councils for each broad area of trade

There are three more councils, each handling a different broad area of trade, reporting to the General Council.

- The Council for Trade in Goods (Goods Council)
- The Council for Trade in Services (Services Council)
- The Council for Trade Related Aspects of Intellectual Property Rights (TRIPS Council)

Each of these councils consists of all WTO members and is responsible for the working of the WTO agreements dealing with their respective areas of trade. These three also have subsidiary bodies. Six other bodies, called committees, also report to the General Council, since their scope is smaller. They cover issues, such as trade and development, the environment, regional trading arrangements, and administrative issues. The Singapore Ministerial Conference in December 1996 decided to create new working groups to look at investment and competition policy, transparency in government procurement, and trade facilitation.

Notes

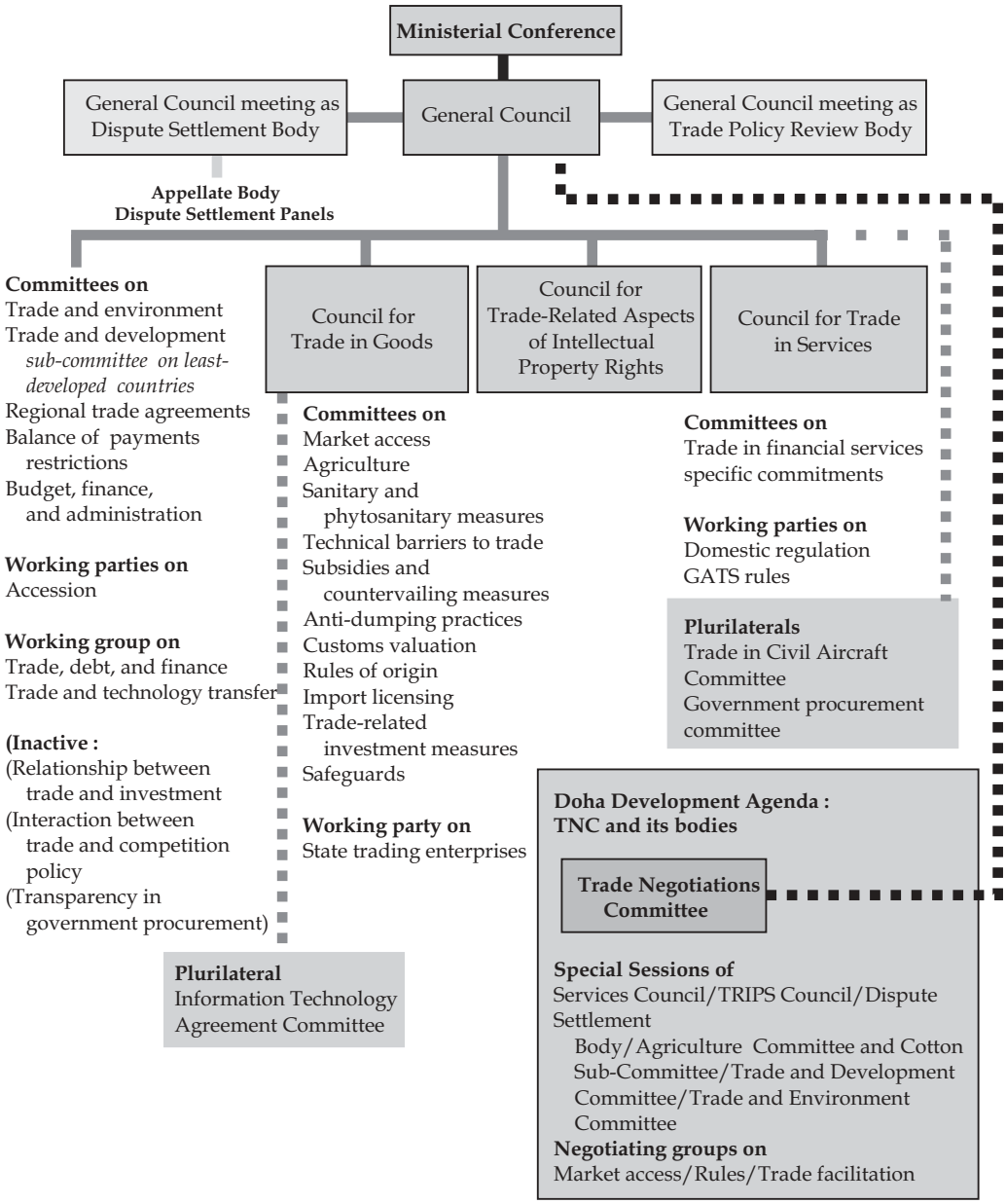


Figure 7.1 : WTO Structure

Notes

Fourth level : Subsidiary bodies

Each of the higher councils has subsidiary bodies that consist of all member countries.

Goods Council : It has 11 committees dealing with specific subjects, such as agriculture, market access, subsidies, anti-dumping measures, etc.

Services Council : The subsidiary bodies of the Services Council deal with financial services, domestic services, GATS rules, and specific commitments.

Dispute settlement body : It has two subsidiaries, i.e., the dispute settlement 'panels' of experts appointed to adjudicate on unresolved disputes, and the Appellate Body that deals with appeals at the General Council level.

Formally all of these councils and committees consist of the full membership of the WTO. But that does not mean they are the same, or that the distinctions are purely bureaucratic. In practice, the people participating in the various councils and committees are different because different levels of seniority and different areas of expertise are needed. Heads of missions in Geneva (usually ambassadors) normally represent their countries at the General Council level. Some of the committees can be highly specialized and sometimes governments send expert officials from their countries to participate in these meetings. Even at the level of the Goods, Services, and TRIPS councils, many delegations assign different officials to cover different meetings. All WTO members may participate in all councils, etc., except the Appellate Body, dispute settlement panels, textile monitoring body, and plurilateral committees.

The WTO has a permanent Secretariat based in Geneva, with a staff of around 560 and is headed by the Director-General. It does not have branch offices outside Geneva. Since decisions are taken by the members themselves, the Secretariat does not have the decision-making role that other international bureaucracies are given. The Secretariat's main duties are to extend technical support for the various councils and committees and the Ministerial Conferences, to provide technical assistance for developing countries, to analyse world trade, and to explain WTO affairs to the public and media. The Secretariat also provides some forms of legal assistance in the dispute settlement process and advises governments wishing to become members of the WTO.

7.2 Principles of the Multilateral Trading System Under the WTO

For an international business manager, it is difficult to go through the whole of the WTO agreements which are lengthy and complex being legal texts covering a wide range of activities. The agreements deal with a wide range of subjects related to international trade, such as agriculture, textiles and clothing, banking, telecommunications, government purchases, industrial standards and product safety, food sanitation regulations, and intellectual property. However, a manager dealing in international markets needs to have an understanding of the basic principles of WTO which form the foundation of the multilateral trading system. These principles are discussed below.

Trade without discrimination

Under the WTO principles, a country cannot discriminate between its trading partners and products and services of its own and foreign origin.

Most-favoured nation treatment : Under WTO agreements, countries cannot normally discriminate between their trading partners. In case a country grants someone a special favour (such as a lower rate of customs for one of their products), then it has to do the same for all other WTO members. The principle is known as Most-favoured nation (MFN) treatment. This clause is so important that it is the first article of the General Agreement on Tariffs and Trade (GATT), which governs trade in goods. MFN is also a priority in the General Agreement on Trade in Services (GATS, Article 2) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS, Article 4), although in each agreement, the principle is handled slightly differently. Together, these three agreements cover all three main areas of trade handled by the WTO.

Some exceptions to the MFN principle are allowed as under :

- Countries can set up a free trade agreement that applies only to goods traded within the group —discriminating against goods from outside.

Notes

- Countries can provide developing countries special access to their markets.
- A country can raise barriers against products that are considered to be traded unfairly from specific countries.
- In services, countries are allowed, in limited circumstances, to discriminate.

But the agreements only permit these exceptions under strict conditions. In general, MFN means that every time a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all its trading partners—whether rich or poor, weak or strong.

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

Gradual move towards freer markets through negotiations

Lowering trade barriers is one of the most obvious means of encouraging international trade. Such barrier includes customs duties (or tariffs) and measures, such as import bans or quotas that restrict quantities selectively. Since GATT's creation in 1947-48, there have been eight rounds of trade negotiations. At first these focused on lowering tariffs (customs duties) on imported goods. As a result of the negotiations, by the mid-1990s industrial countries' tariff rates on industrial goods had fallen steadily to less than 4 per cent. But by the 1980s, the negotiations had expanded to cover non-tariff barriers on goods, and to new areas, such as services and intellectual property. The WTO agreements allow countries to introduce changes gradually through 'progressive liberalization'. Developing countries are usually given longer period to fulfil their obligations.

Increased predictability of international business environment

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

One of the achievements of the Uruguay Round of multilateral trade talks was to increase the amount of trade under binding commitments. In the WTO, when countries agree to open their markets for goods or services, they 'bind' their commitments. For goods, these bindings amount to ceiling on customs tariff rates. A country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. In agriculture, 100 per cent of products now have bound tariffs. The result of this is a substantially higher degree of market security for traders and investors.

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

Promoting fair competition

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

Notes

The rules on non-discrimination—MFN and national treatment—are designed to secure fair conditions of trade. The WTO has also set rules on dumping and subsidies which adversely affect fair trade. The issues are complex, and the rules try to establish what is fair or unfair, and how governments can respond, in particular by charging additional import duties calculated to compensate for damage caused by unfair trade. Many of the other WTO agreements aim to support fair competition, such as in agriculture, intellectual property, and services. The agreement on government procurement (a 'plurilateral' agreement because it is signed by only a few WTO members) extends competition rules to purchases by thousands of government entities in many countries.

7.3 WTO Agreements : An Overview

WTO agreements are often referred to as 'trade rules' and hence the WTO is described as a 'rule-based' system. These rules are actually agreements negotiated by the member countries' governments. The WTO agreements fall in a broad structure of six main parts as under :

- An umbrella agreement (the agreement establishing WTO)
- Agreements for each of the three broad areas of trade covered by WTO
  - Goods
  - Services
  - Intellectual property
- Dispute settlement
- Reviews of governments' trade policies

The WTO agreements cover two basic areas—goods and services in addition to intellectual property. The agreements for goods under GATT deal with the following sector-specific issues, such as agriculture, health regulations for farm products (SPS), textiles and clothing, product standards, investment measures, anti-dumping measures, customs valuation methods, pre-shipment inspection, rules of origin, import licensing, subsidies and counter-measures, and safeguards. The specific issues covered by GATS include movement of natural persons, air transport, financial services, shipping, and telecommunications. Moreover, these agreements are dynamic rather than static in nature as they are negotiated from time to time. The new agreements can be added to the package. For instance, the Doha Development Agenda launched in the Doha Ministerial Conference is currently under negotiations.

General Agreement on Tariffs and Trade

The General Agreement on Tariffs and Trade (GATT) has significantly widened the access to international markets, besides providing legal and institutional framework. Under the WTO regime, countries can break the commitment (i.e., raise the tariff above the bound rate), but only with difficulty. To do so, a member country is required to negotiate with the countries most concerned and that could result in compensation for trading partners' loss of trade.

Opening Up of the Industrial Sector

Market access schedules under GATT include commitments of member countries to reduce the tariffs and not to increase the tariffs above the listed rates, that means the rates are bound. For developed countries, bound rates are the rates generally charged. Most developing countries have bound the rates somewhat higher than actual rates charged, so the bound rates can serve as a ceiling.

Reduction in tariffs : Individual member countries have listed their commitments to reduce the tariff rates in schedules annexed to the Marrakesh Protocol to the General Agreement on Tariffs and Trade, 1994, which is a legally binding agreement. Under these commitments, developed countries were to cut the average tariff levels on industrial products by 40 per cent in five equal instalments from 1 January 1995. However, the percentage of tariff reduction on some products of export interest to developing countries, such as textiles and clothing and leather and leather products is much lower than the average, as they are considered sensitive. A number of developing countries and economies-in-transition agreed to reduce their tariffs by nearly two-thirds of the percentage achieved by developed

Notes

countries. As a result, the weighted average levels of tariffs applicable to industrial products were expected to fall in a period of five years from

- 6.3 per cent to 3.8 per cent in developed countries
- 15.3 per cent to 12.3 per cent in developing countries
- 8.6 per cent to 6 per cent in the transition economies

Additional commitments were made under the Information Technology Agreement in 1997 wherein 40 countries accounting for more than 92 per cent of trade in information technology products, agreed to eliminate import duties and other charges on most of these products by 2000 and on a handful of the products by 2005. As with other tariff commitments, each participating country is applying its commitments equally to exports from all WTO members, i.e. on a most-favoured nation basis, even from members that did not make the commitments.

Tariff bindings : Besides the commitments to reduce tariffs, market access schedules represent commitments on the part of member countries not to increase the tariffs above the listed rates known as 'bound' rates. Binding of tariff lines has substantially increased the degree of market security for traders and investors.

Opening Up International Business Opportunities in Textiles

World trade in textiles and clothing had been subject to a large number of bilateral quota arrangements over the past four decades. The range of products covered by quotas expanded from cotton textiles under the short-term and long-term arrangements of the 1960s and early 1970s to an ever-increasing list of textile products made from natural and man-made fibres under five expansions of the multi-fibre agreement. From 1974 until the end of the Uruguay Round, the international trade in textiles was governed by the Multi-fibre Arrangement (MFA). This was a framework for bilateral agreements or unilateral actions that established quotas limiting imports into countries whose domestic industries were facing serious damage from rapidly increasing imports.

The quota system under MFA conflicted with GATT's general preference for customs tariffs instead of measures that restricted quantities. The quotas were also exceptions to the GATT principle of treating all trading partners equally because they specified how much the importing country was going to accept from individual exporting countries.

Since 1995, the WTO's Agreement on Textiles and Clothing (ATC) took over from the MFA and had been the WTO's significant agreement.

A Textiles Monitoring Body (TMB) supervised the implementation of the agreement. It monitored actions taken under the agreement to ensure that they are consistent, and reports to the Council on Trade in Goods and reviews the operation of the agreement. The TMB also dealt with disputes under the ATC. If they remain unresolved, the disputes could be brought to the WTO's regular Dispute Settlement Body.

General Agreement on Trade in Services

The General Agreement on Trade in Services (GATS) is the first and only set of multilateral rules governing international trade in services. Negotiated in the Uruguay Round, it was developed in response to the strong growth of the services economy over the past three decades and the greater potential for marketing services internationally brought about by the communications revolution. The GATS has three elements :

1. The main text containing general obligations and disciplines
2. Annexes dealing with rules for specific sectors
3. Individual countries' specific commitments to provide access to their markets, including indications where countries are temporarily not applying the most-favoured nation principle of non-discrimination.

General obligations and disciplines : The agreement covers all internationally-traded services, e.g., banking, telecommunications, tourism, professional services, etc. It also defines four ways (or 'modes') of trading services internationally :

Notes

Mode 1 : Services supplied from one country to another (e.g., international telephone calls), officially known as 'cross-border supply'

Mode 2 : Consumers or firms making use of a service in another country (e.g. tourism), officially 'consumption abroad'

Mode 3 : A foreign company setting up subsidiaries or branches to provide services in another country (e.g., foreign banks setting up operations in a country), officially 'commercial presence'

Mode 4 : Individuals travelling from their own country to supply services in another (e.g., fashion models or consultants), officially 'presence of natural persons'

Most-favoured-nation treatment : MFN also applies to the service sector, wherein a member country's trading partners are to be treated equally on the principle of non-discrimination. Under GATS, if a country allows foreign competition in a sector, equal opportunities in that sector should be given to service providers from all other WTO members. This applies even if the country has made no specific commitment to provide foreign companies access to its markets under the WTO. MFN applies to all services, but some special temporary exemptions have been allowed to countries that already have preferential agreements in services with their trading partners. Such exemptions are expected to last not more than 10 years.

Commitments on market access and national treatment : Individual countries' commitments to open markets in specific sectors and the extent of their openness has been the outcome of the Uruguay Round negotiations. The commitments appear in 'schedules' that list the sectors being opened, the extent of market access being given in those sectors (e.g., whether there are any restrictions on foreign ownership), and any limitation on national treatment (whether some rights granted to local companies will not be granted to foreign companies). For instance, if a government commits itself to allow foreign banks to operate in its domestic market, that is a market-access commitment. And if the government limits the number of licences it will issue, then that is a market-access limitation. If it also says foreign banks are only allowed one branch while domestic banks are allowed numerous branches, that is an exception to the national treatment principle.

These clearly defined commitments are 'bound'—like bound tariffs for trade in goods, and they can only be modified after negotiations with affected countries. Because 'unbinding' is difficult, the commitments are virtually guaranteed conditions for foreign exporters and importers of services and investors in the service sector.

Governmental services are explicitly carved out of the agreement and there is nothing in GATS that forces a government to privatize service industries. The carve-out is an explicit commitment by WTO governments to allow publicly funded services in core areas of their responsibility. Governmental services are defined in the agreements as those that are not supplied commercially and do not compete with other suppliers. These services are not subject to any GATS discipline, are not covered by the negotiations, and the commitments on market access and national treatment do not apply to them.

Transparency GATS stipulates that governments must publish all relevant laws and regulations, as set-up enquiry points within their bureaucracies. Foreign companies and governments can then use these inquiry points to obtain information about regulations in any service sector. Further, the member countries' governments have to notify the WTO of any change in regulations that apply to the services that fall under specific commitments.

Objectivity and reasonability of regulations : Since domestic regulations are the most significant means of exercising influence or control over services trade, the agreement says governments should regulate services reasonably, objectively, and impartially. When a government makes an administrative decision that affects a service, it should also provide an impartial means for reviewing the decision (e.g., a tribunal). GATS does not require any service to be deregulated. Commitments to liberalize do not affect governments' right to set levels of quality, safety, or price, or to introduce regulations to pursue any other policy objective. A commitment to national treatment, e.g., would only mean that the same regulations would apply to foreign suppliers as to nationals. Governments naturally retain their right to set qualification requirements for doctors or lawyers, and to set standards to ensure consumer health and safety.

Recognition : When two or more governments have agreements recognizing each other's qualifications (e.g., the licensing or certification of service suppliers), GATS says other members must also be given

Notes

a chance to negotiate comparable pacts. The recognition of other countries' qualifications must not be discriminatory, and it must not amount to protectionism in disguise. These recognition agreements have to be notified to the WTO.

International payments and transfers : Once a government has made a commitment to open a service sector to foreign competition, it must not normally restrict money being transferred out of the country as payment for services supplied (current transactions) in that sector. The only exception is when there are balance of payments difficulties, and even then the restrictions must be temporary and subject to other limits and conditions.

Progressive liberalization : As the Uruguay Round was only the beginning, GATS requires more negotiations, which began in early 2000 and formed part of the Doha Development Agenda. The goal is to take the liberalization process further by increasing the level of commitments in schedules.

Complexity of International Trade in Services

International trade in goods is a relatively simple idea to grasp—a product is transported from one country to another. Trade in services is much more diverse. Telephone companies, banks, airlines, and accountancy firms provide their services in ways quite different from each other. The GATS annexes cover some of the diversity as discussed here.

Movement of natural persons : This annex deals with negotiations on individuals' rights to stay temporarily in a country for the purpose of providing a service. It specifies that the agreement does not apply to people seeking permanent employment or to conditions for obtaining citizenship, permanent residence, or permanent employment.

Financial services : Instability in the banking system affects the whole economy. The financial services annex gives governments very wide latitude to take prudential measures, such as those for the protection of investors, depositors, and insurance policy holders, and to ensure the integrity and stability of the financial system. The annex also excludes from the agreement services provided when a government is exercising its authority over the financial system, e.g., central banks' services.

Telecommunications : The telecommunications sector has a dual role : it is a distinct sector of economic activity, and an underlying means of supplying other economic activities (such as, electronic money transfers). The annex says governments must ensure that foreign service suppliers are given access to the public telecommunications networks without discrimination.

Air transport services : Under this annex, traffic rights and directly related activities are excluded from GATS' coverage. They are handled by other bilateral agreements. However, the annex establishes that GATS will apply to aircraft repair and maintenance services, marketing of air transport services, and computer-reservation services.

The capabilities of services and areas of interests are vastly different in developed and developing countries. Developed countries have always been keen to use pressure tactics to access developing countries' markets in their areas of special interest, i.e., financial, and telecommunication services that received priority in the negotiation process. On the other hand, developed countries have been hesitant to open up their markets in the service sectors of interest to developing countries in Mode 4 and Mode 1.

India's efforts have been to secure binding commitments in Cross Border Supply of Services (Mode 1) and Movement of Natural Persons (Mode 4). Mode 4 objectives are driven by the competence of India's service professionals and Mode 1 objectives by its strong competitive edge in IT and IT enabled services (ITeS). India has been pushing for the elimination of the Economic Needs Test, clear prescription of the duration of stay, provisions for extension, etc. Some of these concerns have been addressed in the Hong-Kong Ministerial Declaration, which provides a direction for developing disciplines in domestic regulations.

Agreements on Anti-dumping Practices

The WTO agreement on anti-dumping allows governments to act against dumping where there is genuine (material) injury to the competing domestic industry. A product is considered to be dumped if

Notes

- The export price is less than the price charged for the same product in the exporting country, or
- It is sold for less than its cost of production

In order to do that, the government has to be able to show that dumping is taking place, calculate the extent of dumping (how much lower the export price is compared to the exporter's home market price), and show that dumping is causing injury or threatening to do so. Typically, anti-dumping action means charging extra import duty on the particular product from the particular exporting country in order to bring its price closer to the 'normal value' or to remove the injury to domestic industry in the importing country.

There are many ways of calculating whether a particular product is being dumped heavily or only lightly. The agreement narrows down the range of possible options. It provides three methods to calculate a product's 'normal value'. The main method is based on the price in the exporter's domestic market. When this cannot be used, two alternatives are available—the price charged by the exporter in another country, or a calculation based on the combination of the exporter's production costs, other expenses, and normal profit margins. And the agreement also specifies how a fair comparison can be made between the export price and what would be a normal price.

Anti-dumping measures can only be applied if dumping is hurting the industry in the importing country. Therefore, a detailed investigation has to be conducted according to specified rules first. The investigation must evaluate all relevant economic factors that have a bearing on the state of the industry in question. If the investigation shows dumping is taking place and domestic industry is being hurt, the exporting company can undertake to raise its price to an agreed level in order to avoid anti-dumping import duty.

Detailed procedures are set out on how anti-dumping cases are to be initiated, how the investigations are to be conducted, and on conditions for ensuring that all interested parties are given an opportunity to present evidence. Anti-dumping measures must expire five years after the date of imposition, unless an investigation shows that ending the measure would lead to injury.

Anti-dumping investigations are to end immediately in cases where the authorities determine that the margin of dumping is insignificantly small (defined as less than 2 per cent of the export price of the product.) Besides, the investigations also have to end if the volume of dumped imports is negligible, i.e., if the volume from one country is less than 3 per cent of total imports of that product, although investigations can proceed if several countries, each supplying less than 3 per cent of the imports, together account for 7 per cent or more of total imports.

Member countries are required to inform the committee on anti-dumping practices about all preliminary and final anti-dumping actions, promptly and in detail. When differences arise, members may consult each other and use the WTO's dispute settlement procedure.

India has been the leading user of anti-dumping measures in the world (Fig.2) followed by the US, the European Community, Argentina, South Africa, Australia, Canada, Brazil, China, and Turkey.

Emergency Protection from Imports

A WTO member may restrict import of a product temporarily (take 'safeguard' actions) if its domestic industry is seriously injured or threatened with injury caused by a surge in imports. Safeguard measures were always available under GATT (Article 19); however, they were infrequently used. A number of countries preferred to protect their domestic industries through 'grey area' measures—using bilateral negotiations outside GATT's auspices. They also persuaded exporting countries to restrain exports 'voluntarily' or to agree to other means of sharing markets. Agreements of this kind were reached at for a wide range of products among countries, e.g., automobiles, steel, and semiconductors.

The WTO agreements on safeguards prohibit 'grey-area' measures, and it set time limits (a sunset clause) on all safeguard actions. The agreement says members must not seek, take, or maintain any Voluntary Export Restraints (VERs), Orderly Marketing Arrangements (OMAs), or any other similar measure on the export or the import side. The bilateral measures that were not modified to conform with the agreement were phased out at the end of 1998. Countries were allowed to keep one of these measures an extra year (until the end of 1999), but only the European Union—for restrictions on imports of cars from Japan—made use of this provision.

Notes

Industries or companies may request safeguard action by their governments. The WTO agreement sets out requirements for safeguard investigations by national authorities. The emphasis is on transparency and on following established rules and practices, thus avoiding arbitrary methods. A safeguard measure should be applied only to the extent necessary to prevent or remedy serious injury and to help the industry concerned to adjust. Where quantitative restrictions (quotas) are imposed, they normally should not reduce the quantities of imports below the annual average for the last three representative years for which statistics are available, unless clear justification is given that a different level is necessary to prevent or remedy serious injury.

In principle, safeguard measures cannot be targeted at imports from a particular country. A safeguard measure should not last more than four years, although this can be extended up to eight years under special circumstances. When a country restricts imports in order to safeguard its domestic producers, in principle it must give something in return. To some extent developing countries' exports are shielded from safeguard actions. An importing country can only apply a safeguard measure to a product from a developing country if the developing country is supplying more than 3 per cent of the imports of that product, or if developing country members with less than 3 per cent import share collectively account for more than 9 per cent of total imports of the product concerned.

The WTO's Safeguards Committee oversees the operations of the agreement and is responsible for the surveillance of members' commitment. Member governments have to report each phase of a safeguard investigation and related decision making, and the committee review these reports.

Attempting to Reduce Non-tariff Barriers

In addition to import tariffs, an international firm faces a number of bureaucratic and legal issues in the target countries which hinders smooth flow of trade. Such barriers are generally employed to block market entry and often criticized as arbitrary as they lack transparency. Growing use of unconventional Non-Tariff Measures (NTMs), such as health and safety measures, technical regulations, environmental controls, customs valuation procedures, and labour laws by developed countries has become a major barrier to market access to exports from developing countries. Such trade barriers are considerably stiffer for products with lower value addition and technological content (agriculture products, textiles, leather products, etc.) products, which are of major interest to countries like India.

Import licensing procedures

Import licensing procedures are generally considered as complex and non-transparent with little predictability and had often been used to block market entry of foreign products. The agreement on Import Licensing Procedures attempts to simplify and bring transparency to import procedures. The agreement requires governments to publish sufficient information for international traders to know how and why licences are granted. It also describes how countries should notify the WTO when they introduce new import licensing procedures or change existing procedures. The agreement offers guidance on how governments should assess applications for licences. The agreement sets criteria for automatic issuance of some licences so that the procedures used do not restrict trade. Here, the agreement tries to minimize the importers' burden in applying for licences, so that the administrative work does not in itself restrict or distort imports. The agreement says agencies handling licensing should not normally take more than 30 days to deal with an application. However, 60 days are permitted when all applications are considered at the same time.

Customs valuation

For importers, the process of estimating the value of a product at customs presents problems that can be just as serious as the actual duty rate charged. The WTO agreement on customs valuation aims for a fair, uniform, and neutral system for the valuation of goods for customs purposes—a system that conforms to commercial realities, and which outlaws the use of arbitrary or fictitious customs values. The agreement provides a set of valuation rules, expanding and giving greater precision to the provisions on customs valuation in the original GATT.

Notes

The agreement recognizes that the prices obtained by different importers for the same product may vary. The mere fact that the price obtained by a particular importer is lower than that at which other importers have imported the product, cannot be used as a ground for rejecting the transaction value. Customs can reject the transaction value in such situations only if it has reasons to doubt the truth or accuracy of the declared price of the imported goods. Even in such cases it has to give importers an opportunity to justify their price and if this justification is not accepted, customs has to provide importers in writing the reasons for rejecting the transaction value and for determining the dutiable value by using other methods. Further, by providing importers the right to be consulted throughout all stages of the determination of value, the agreement ensures that the discretion available to customs for scrutinizing declared value is used objectively.

The agreement also requires national legislation on the valuation of goods to prove the following rights to importers :

- Right to withdraw imported goods from customs, when there is likely to be a delay in the determination of customs value, by providing sufficient quantities, in the form of surety or a deposit, covering the payment of customs duties for which goods may be liable
- Right to expect that any information of a confidential nature that is made available to customs shall be treated as confidential
- Right to appeal, without fear of penalty, to an independent body within the customs administration and to judicial authority against decisions taken by customs

Notes

The basic aim of the agreement is to protect the interests of firms engaged in international trade by requiring that customs should accept the price actually paid by the importer in the particular transaction for determining dutiable value. This applies to both arms-length and related-party transactions.

Pre-shipment inspection

Pre-shipment inspection is the practice of employing specialized private companies (or 'independent entities') to check shipment details—essentially price, quantity, and quality—of goods ordered overseas. The basic purpose of pre-shipment inspection is to safeguard national financial interests (preventing capital flight, commercial fraud, and customs duty evasion, for instance) and to compensate for inadequacies in administrative infrastructures.

The Pre-shipment Inspection Agreement places obligations on governments which use pre-shipment inspection. Such obligations include non-discrimination, transparency, protection of confidential business information, avoiding unreasonable delay, the use of specific guidelines for conducting price verification, and avoiding conflicts of interest by the inspection agencies. The obligations of exporting members towards countries using pre-shipment inspection include non-discrimination in the application of domestic laws and regulations, prompt publication of those laws and regulations, and wherever requested, the provision of technical assistance.

The agreement establishes an independent review procedure administered jointly by the International Federation of Inspection Agencies (IFIA), representing inspection agencies, and the International Chamber of Commerce (ICC), representing exporters. Its purpose is to resolve disputes between an exporter and an inspection agency.

Rules of origin

'Rules of origin' are used as the criteria to define where a product was made. They are an essential part of trade rules because a number of policies, such as quotas, preferential tariffs, anti-dumping actions, countervailing duty (charged to counter export subsidies), etc., discriminate between exporting countries. Rules of origin are also used to compile trade statistics, and for 'made in...' labels that are

Notes

attached to products. This is complicated by globalization and the way a product can be processed in several countries before it is ready for the market.

The Rules of Origin Agreement requires WTO members to ensure that their rules of origin are transparent; that they do not have restricting, distorting, or disruptive effects on international trade. The Rules are administered in a consistent, uniform, impartial, and reasonable manner. For the longer term, the agreement aims for common (harmonized) rules of origin among all WTO members, except in some kinds of preferential trade, e.g., countries setting up a free trade area are allowed to use different rules of origin for products traded under their free trade agreement.

Agreement on Trade Related Investment Measures

When investment is the mode of international business expansion, the host governments often impose conditions on foreign investors to encourage investments in accordance with certain national priorities. The Agreement on Trade Related Investment Measures (TRIMs) recognizes that certain measures can restrict and distort investment. It stipulates that no member shall apply any measure that discriminates against foreigners or foreign products (i.e., violates 'national treatment' principles in GATT). It also outlaws investment measures that lead to restrictions in quantities (violating another principle in GATT) and measures requiring particular levels of local procurement by an enterprise ('local content requirements'). It also discourages measures which limit a company's imports or set targets for the company to export ('trade balancing requirements').

However, countries are not prevented from imposing export performance requirements as a condition for investment. They are also not prohibited from insisting that a certain percentage of equity should be held by local investors or that a foreign investor must bring in the most up-to-date technology or must conduct a specific level or type of R&D locally. Under the agreement, countries must inform fellow-members through the WTO of all investment measures that do not conform to the agreement.

Plurilateral Agreements

All WTO agreements except four agreements, originally negotiated under the Tokyo Round became multilateral agreements. The four exceptions are known as plurilateral agreements as they had a limited number of signatories.

Fair trade in civil aircraft

The Agreement on Trade in Civil Aircraft entered into force on 1 January 1980 which presently has 30 signatories. The agreement eliminates import duties on all aircrafts other than military aircrafts, and their parts and components. The agreement also contains disciplines on government-directed procurement of civil aircraft and inducements to purchase, as well as on governmental financial support for the civil aircraft sector.

Opening up of competition in government procurement

In most countries, the government and its agencies together are the biggest purchasers of goods of all kinds, ranging from basic commodities to high-technology equipment. At the same time, the political pressure to favour domestic suppliers over their foreign competitors can be very strong. It poses considerable barriers to international marketing firms in these countries.

An Agreement on Government Procurement was first negotiated during the Tokyo Round and entered into force on 1 January 1981 with a view to open up as much of this business as possible to international competition. The agreement was designed to make laws, regulations, procedures, and practices regarding government procurement more transparent and to ensure that they do not protect domestic products or suppliers, or discriminate against foreign products or suppliers. A large part of the general rules and obligations concern tendering procedures.

The Agreement on Government Procurement under the WTO became effective on 1 January 1996 and extends coverage to services (including construction services), procurement at the sub-central level (e.g., states, provinces, departments, and prefectures), and procurement by public utilities. It also reinforces rules guaranteeing fair and non-discriminatory conditions of international competition.

Notes

For instance, governments are required to put in place domestic procedures by which aggrieved private bidders can challenge procurement decisions and obtain redress in the event such decisions were made inconsistently with the rules of the agreement. The agreement applies to contracts worth more than specified threshold values.

The International Dairy Agreement and International Bovine Meat Agreement, the two plurilateral agreements, were scrapped at the end of 1997. Countries that had signed the agreements decided that the sectors were better handled under the Agriculture and Sanitary and Phytosanitary agreements.

Ensuring Transparency in Trade Policy

An international marketing firm needs to know as much as possible the conditions of trade in the target market. The Trade Policy Review Mechanism (TPRM) aims to achieve transparency in regulations in the following ways :

(a) Governments have to inform the WTO and fellow-members of specific measures, policies, or laws through regular 'notifications'.

(b) The WTO conducts regular reviews of individual countries' trade policies, i.e., trade policy reviews.

The objectives of trade policy review are :

- To increase the transparency and understanding of countries' trade policies and practices, through regular monitoring
- To improve the quality of public and inter-governmental debate on the issues
- To enable a multilateral assessment of the effects of policies on the world trading system

The reviews focus on members' own trade policies and practices. But they also take into account countries' wider economic and developmental needs, their policies and objectives, and the external economic environment that they face. These 'peer reviews' by other WTO members encourage governments to follow more closely the WTO rules and disciplines and to fulfil their commitments. These reviews enable outsiders to understand a country's policies and circumstances, and they provide feedback to the reviewed country on its performance in the system.

Over a period of time, all WTO members were to come under scrutiny. The frequency of the reviews depends on the country's size.

- The four biggest traders—the European Union, the US, Japan, and Canada (the 'Quad')—are examined approximately once every two years.
- The next 16 countries (in terms of their share of world trade) are reviewed every four years.
- The remaining countries are reviewed every six years, with the possibility of a longer interim period for the least developed countries.

For each review, two documents are prepared—a policy statement by the government under review, and a detailed report written independently by the WTO Secretariat. These two reports, together with the proceedings of the Trade Policy Review Body's meetings are published; these publications which may be consulted while making strategic business decisions.

7.4 Ministerial Conferences and Emerging Issues

The highest decision-making body in the WTO is the Ministerial Conference (MC) that has to take place once in two years. Six ministerial conferences have taken place so far and have generated a lot of debate and controversies across the world, as discussed here.

Singapore Ministerial Conference

The first MC took place at Singapore during 9–13 December 1996 and reviewed the operations post-WTO. Major developed countries brought in proposals to start negotiations in some new areas, such as investment, competition policy, government procurement, trade facilitation, and labour standards. This evoked a lot of controversy. Significant pressure was built up by the developed countries for all members to accept their proposals; this was strongly opposed by developing nations. However, an agreement was finally reached to set up working groups to study the process of the relationship between investment and trade, competition and trade, and transparency in government procurement.

Notes

These are generally termed as Singapore issues. The subject of trade facilitation was to be studied in the Council for Trade in Goods.

Conclusion of Information Technology Agreement was an important decision made during the Singapore Ministerial Conference based on the proposal brought by developed countries to have an agreement on zero duty on import of information technology goods.

Geneva Ministerial Conference

The second MC, held at Geneva (Switzerland) during 18–20 May 1998, discussed implementational concerns of developing and least developing countries that led to establishment of a mechanism for evaluation of implementation of individual agreements.

The US-sponsored proposals for zero duty on electronic commerce were discussed and an agreement was reached to maintain status-quo on the market access conditions for electronic commerce for 18 months. The agreement on status-quo actually meant that there would be zero duty on e-commerce since no country had been imposing duty on this mode of trade. A declaration on global electronic commerce was also adopted.

Electronic commerce was defined as the mode of commerce in which all operations of trade would be conducted through the electronic medium; these operations include placing the order, supplying the product, and making the payment. They also include sale and transfer of goods through electronic medium, such as music and cinematographic products, architectural and machine drawings and designs, etc. However, the sale in which goods are physically transferred to the buyer would not be considered e-commerce.

Seattle Ministerial Conference

The third MC, held in Seattle (US) from 30 November to 3 December 1999, witnessed dramatic changes in negotiations as the developing countries made intense preparations for the conference unlike in the previous MCs wherein issues brought in by the developed countries were chiefly discussed. In Seattle too developed countries tried to push forward new issues, such as investment, competition policy, government procurement, trade facilitation, and labour standards. However, developing countries insisted upon priority attention to their proposals as these were related to the working of the current agreement, before any new issue could be considered. No agreement on the issues could be arrived at, leading to a total collapse of the MC with a lot of confusion and without any decision.

Doha Ministerial Conference

The fourth MC held during 9–14 November 2001, at Doha in Qatar further built up the divide between the developed and the developing countries in the WTO. On the one hand, developed countries were keen on formally pushing forward a new round of multilateral trade negotiations, which would include the issues of investment, competition policy, transparency in government procurement, and trade facilitation. On the other hand, there was stiff resistance from developing countries to initiating a new round as they felt that they were still in the process of comprehending the implications of the last round, i.e., the Uruguay Round, of multilateral trade negotiations.

Finally a comprehensive work programme was adopted at the end of Doha MC. Although formally it was not called a new round of negotiations, the work programme had all the attributes of a fresh round of multilateral trade negotiations. Members decided to work out modalities for negotiations on the Singapore issues and then start negotiations on the basis of the modality to be agreed by explicit consensus. It was also agreed upon to make Special and Differential (S&D) treatment for developing countries more precise, effective, and operational.

The main commitments of the Doha Declaration were.

- To continue the commitment for establishing a fair and market-oriented trading system through fundamental reform of support and protection of agricultural markets, specifically through
  - — Substantial improvements in market access
  - — Reductions of all forms of export subsidies, with a view of phasing them out
  - — Substantial reductions in trade distorting domestic support

Notes

- To give developing countries Special and Differential Treatment in negotiations to enable them effectively to take into account their development needs
- To ensure negotiations on trade in services aimed at promoting the economic growth of all trading partners and the development of developing and least developed countries
- To reduce or eliminate tariffs and non-tariff barriers in non-agricultural markets, in particular on products of export interest to developing countries
- Doha Development Agenda (DDA) is a 'single undertaking' that means nothing is agreed until everything is agreed.

Cancun Ministerial Conference

The fifth MC was held in Cancun (Mexico) during 10–14 September 2003 under heightened strain between the major developed and developing countries. Developing countries believed that heavy subsidies on production and exports of agriculture in developed countries had been grievously harming their agriculture which is means of livelihood of their major population unlike in developed countries. There was hardly any significant action perceived on the part of the developed countries in the areas of implementation of issues and Special and Differential Treatment. On the other hand, developed countries insisted upon starting the negotiations on the Singapore issues. Under this atmosphere of complete apprehension, anger, and mistrust, no agreement could be reached and the MC terminated without any comprehensive declaration.

The Hong Kong Ministerial Conference

The sixth MC took place in Hong Kong during 13–18 December 2005. It called for conclusions in 2006 of negotiations launched at Doha in 2001 and establishment of targets and time frames in specific areas. The key outcomes of the Hong Kong Ministerial Conference included

- Amendment to TRIPS agreement reaffirmed to address public health concerns of developing countries.
- Duty free, quota free market access for all LDC products by all developed countries.
- Resolved complete Doha work programme and finalized negotiations in 2006.
- Elimination of export subsidies in cotton by developed countries in 2006; reduction of trade distorting domestic subsidies more ambitiously and over a shorter period.
- Elimination of export subsidies in agriculture by 2013 with substantial part in the first half of the implementation period. Developing countries, such as India will continue to have right to provide marketing and transport subsidies on agricultural exports for five years after the end date for elimination of all forms of export subsidies.
- The agreement that the three heaviest subsidizers, i.e., the European Union, the US, and Japan, were to attract the highest cut in their trade distortion domestic support. Developing countries like India with no Aggregate Measurement of Support (AMS) will be exempt from any cut on *de minimus* (entitlement to provide subsidies annually on product-specific as well as non-product specific basis each up to 10 per cent of the agricultural production value) as well as on overall levels of domestic trade distortion support (consists of the AMS, the Blue Box, and *de minimus*).
- Establishment of modalities in agriculture and Non-Agriculture Market Access (NAMA).
- The agreement that developing countries were to have flexibility to self-designate appropriate number of tariff lines as special products. In order to address situations of surge in imports and fall in international prices, both import quantity and price triggers have been agreed under the Special Safeguard Mechanism for developing countries.
- The agreement that in NAMA and Special and Differential Treatment (S&DT), elements such as flexibility and less-than-full reciprocity in reduction commitments for developing countries reassured.
- No sub-categorization of developing countries when addressing concerns of small, vulnerable economies.

Notes

Subsequently, at the General Council meeting held at Geneva on 31 July 2006, an agreement was reached on the framework in order to conduct the negotiations. Preliminary agreements were reached on broad approaches, especially in the areas of agriculture and industrial tariffs. It was decided to drop the three Singapore issues on investment, competition policy, and government procurement whereas negotiations on trade facilitation were to follow.

The Deadlock In WTO Negotiations

Despite intensive negotiations, deadlines were missed and negotiations across all areas of the Doha work programme were suspended mainly due to lack of convergence on major issues in agriculture and NAMA in July 2006. Agriculture remains the most contentious issue in the recent Ministerial Conferences, widening the developed-developing country divide. Major developed countries continue to give high amount of subsidies to their farmers. Interestingly, developed countries have fulfilled their obligation of reduction in reducible subsidy in technical terms despite increasing the absolute amount of subsidy. Besides, the EU and the US continue to give export subsidies as well. Ironically, developed countries are pressurising developing countries to reduce their tariffs substantially. This poses a threat to the domestic farming sector of developing countries, which has got serious socio-economic and political implications. This makes negotiations in agriculture extremely complex. Developed countries, on the other hand, are keen on market access for their industrial products.

Self-Assessment

1. Choose the correct options:

(*i*) The sixth WTO ministerial conference was held in _____ from 13 December - 18 December 2005.

(*a*) Macau (*b*) Hong Kong

(*c*) United States (*d*) Philippines

(*ii*) Designated name for the _____ (commonly known as Taiwan)

(*a*) Vietnam (*b*) Philippines

(*c*) People's Republic of China (*d*) Republic of China

(*iii*) Which of the following languages is spoken in World Trade Organization?

(*a*) Sardinian language (*b*) Spanish language

(*c*) Italian language (*d*) Venetian language

(*iv*) What is the leader of World Trade Organization called?

(*a*) Governor General of Tuvalu (*b*) Malaysian general election, 2008

(*c*) List of Secretaries General of ASEAN

7.5 Summary

- The World Trade Organization (WTO) is the only international organization that deals with global rules of trade between nations. It provides a framework for conduct of international trade in goods and services. It lays down the rights and obligations of governments in the set of multilateral agreements discussed later in this chapter. In addition to goods and services, it also covers a wide range of issues related to international trade, such as protection of intellectual property rights and dispute settlement, and prescribes disciplines for governments in formulation of rules, procedures, and practices in these areas. Moreover, it also imposes discipline at the firm level in certain areas, such as export pricing at unusually low prices.
- WTO also covers areas of interest to international business firms, such as customs valuation, pre-shipment inspection services, and import licensing procedures, wherein the emphasis has been laid on transparency of the procedures so as to restrain their use as non-tariff barriers. The agreements also stipulate rights of exporters and domestic procedures to initiate actions against dumping of foreign goods. An international business manager needs to develop a thorough

understanding of the new opportunities and challenges of the multilateral trading system under the WTO.

- Formally all of these councils and committees consist of the full membership of the WTO. But that does not mean they are the same, or that the distinctions are purely bureaucratic. In practice, the people participating in the various councils and committees are different because different levels of seniority and different areas of expertise are needed. Heads of missions in Geneva (usually ambassadors) normally represent their countries at the General Council level. Some of the committees can be highly specialized and sometimes governments send expert officials from their countries to participate in these meetings. Even at the level of the Goods, Services, and TRIPS councils, many delegations assign different officials to cover different meetings. All WTO members may participate in all councils, etc., except the Appellate Body, dispute settlement panels, textile monitoring body, and plurilateral committees.
- The WTO is sometimes described as a 'free trade' institution, but that is not entirely accurate. The system does allow tariffs and, in limited circumstances, other forms of protection. More accurately, it is a system of rules dedicated to open, fair, and undistorted competition.
- The WTO agreements cover two basic areas—goods and services in addition to intellectual property. The agreements for goods under GATT deal with the following sector-specific issues, such as agriculture, health regulations for farm products (SPS), textiles and clothing, product standards, investment measures, anti-dumping measures, customs valuation methods, pre-shipment inspection, rules of origin, import licensing, subsidies and counter-measures, and safeguards.

7.6 Key-Words

1. GATT : General Agreement on Tariffs and Trade, an international treaty (1948-94) to promote trade and economic development by reducing.
2. WTO : The World Trade Organization (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.

7.7 Review Questions

1. What is multilateralism? Discuss.
2. What are the functions of WTO? Discuss.
3. Discuss the principles of the Multilateral trading system.

Answers: Self-Assessment

1. (*i*) (*b*) (*ii*) (*d*) (*iii*) (*b*) (*iv*) (*d*)

7.8 Further Readings

1. Krimawati, Wawat. (?) NAFTA: North America Free Trade Agreement. [Accessed 18 May 2009]
2. Vogel, David. (2009) North American Free Trade Agreement. [Accessed 18 May 2009] 2009. North American Free Trade Agreement (NAFTA).
3. United States Department of Agriculture, Foreign Agricultural Service. [Accessed June 8, 2009]

Notes

Unit 8 : International Monetary System

CONTENTS

Objectives
Introduction
8.1 Meaning of International Monetary System
8.2 The Bretton Woods System
8.3 The Present International Monetary System
8.4 Summary
8.5 Key-Words
8.6 Review Questions
8.7 Further Readings

Objectives

After reading this Unit students will be able to:

- Know the Meaning of International Monetary System.
- Discuss the Bretton Woods System.
- Explain the Present International Monetary System.

Introduction

The period 1870-1914, is considered as the classical gold standard period. The centre of world trade and finance was London, and the major currencies led by the British sterling were convertible into gold at given parities. There was no major currency crisis during this period and no major currency had to be devalued or revalued. International trade and finance proceeded smoothly; goods and factors moved across national frontiers with great degree of freedom. Trade restrictions, not altogether unknown, were not generally used for purposes of the balance of payments adjustments. Deficits and surpluses were to be corrected by internal deflation and inflation.

International liquidity consisted of gold, and British sterling played the role of a reserve currency during this period. Sterling constituted an important component of international liquidity, and sterling was widely used in the settlements of balance of payments obligations. The period was characterised by relatively stable exchange rates. This was the nature of the world monetary system on the eve of World War I. If the success of the international monetary system is judged by (a) the facility for unrestricted trade in goods and services, (b) adequate amount of international liquidity, and (c) relatively fixed exchange rates, the period of 1870-1914 may be considered as the successful period of the world monetary system, World war I ended all this.

The inter-war period was characterized by international monetary and exchange rate chaos. The gold standard was abandoned; trade and tariff restrictions came into prominence; exchange rates were no longer stable, competitive exchange rate changes and beggar-my-neighbour policies became the order of the day. A need was felt to put an end to all this and build, instead, a system of international monetary arrangements in which countries could follow policies directed towards full employment and stable prices without creating problems for others.

The Bretton Woods System rested on two pillars : the maintenance of stable exchange rates and multilateral credit mechanism institutionalized in the IMF. In order that exchange rate changes are conducted in an orderly manner, the authors of the Bretton Woods Agreement insisted on the IMF approval for exchange rate changes beyond 10 per cent. The Fund would permit changes beyond 10 per cent only if it was satisfied that a 'fundamental disequilibrium' existed in the member country's balance of payments. The second pillar of the system was the arrangement for international liquidity.

Notes

There was to be a pool of member countries' currencies, contributed on the basis of the quota system fixed for the member countries, which would enable the Fund to act as a 'lender of last resort'.

The Bretton Woods System never worked, the way its authors had intended. More specifically, the threat to the Bretton Woods System arose out of two changes : (a) the expanded role of the US dollar as international currency and a widely accepted asset, and (b) the exchange rate rigidity that developed over time. Let us briefly explain these two problem spots.

At the end of World War II the United States held more than three-fourths of the world's stock of monetary gold, and accounted for half of the world's GMP. For these reasons, the US dollar came to be regarded as international money. Countries of the world began to hold their official reserves in the form of US dollars. The US dollar was not only as good as gold, it was in fact better than gold because dollar holding (as reserves) earned interest while gold did not. The US balance of payments deficits after 1958 kept the entire world monetary system liquid. The steady accumulation of US dollars by the foreign countries, especially of Europe, posed a threat to the stability of dollar as an international reserve currency.

The second threat to the stability of the Bretton Woods System was the rigidity of exchange rates that developed in reality. Notwithstanding some exchange rate adjustments during the early 1950s, the world monetary system had, by 1960s, become a disequilibrium system characterized by persistent deficits and surpluses. The Bretton Woods System failed to achieve equilibrium exchange rate stability.

The US dollar build up in the hands of the foreign central banks was the direct result of deep and persistent US payments deficits. Even as early as 1964, the US dollar accumulations held by the foreign countries equalled the total gold holdings of the United States. This excess accumulation of US dollars in foreign countries led to unwillingness of the foreign central banks to hold US dollar as currency reserves. The value of dollar began to depreciate, and the gold price began to shoot up after 1968. In March 1968, the United States and the European countries agreed to establish, at the US request, the so-called Two-tier Gold Market. This measure separated the private gold market from the official gold market in which the central banks bought and sold gold to each other. The price of gold in the private market might rise above US $35 an ounce, but the central banks continued to deal in gold with each other at the fixed price of US $35 an ounce. (Since the time the US enacted the Gold Reserve Act of 1934, the US government had undertaken to buy or sell unlimited quantities of gold at a fixed price of US $35 an ounce). The European countries agreed not to press the United States to convert their US dollar accumulations into gold. The US dollar became virtually inconvertible into gold in 1968.

8.1 Meaning of International Monetary System

International monetary system refers to the system prevailing in world foreign exchange markets through which international trade and capital movements are financed and exchange rates are determined. We discuss below the international monetary system since the end of the World War II.

8.2 The Bretton Woods System

Did u know? The Bretton Woods System finally collapsed in 1971, and this was caused by the so-called Dollar Crisis of 1971. The dollar crisis stemmed from the US balance of payments deficits.

During the period preceding World War I almost all the major national currencies were on a system of fixed exchange rates under the international gold standard. This system had to be abandoned during World War I. There were fluctuating exchange rates from the end of the War to 1925. Efforts were made to return to the gold standard from 1925. But it collapsed with the coming of the Great Depression. Many countries resorted to protectionism and competitive devaluations—with the result that world trade was reduced to almost half. But depression completely disappeared during World War II.

Notes

In July 1944, the allied countries met at Bretton Woods in the USA to avoid the rigidity of the gold standard and the chaos of the 1930s in international trade and finance and to encourage free trade. The new system was the present International Monetary Fund (IMF) which worked out an *adjustable peg system*.

Under the Bretton Woods system exchange rates between countries were set or pegged in terms of gold or the US dollar at $ 35 per ounce of gold. This related to a fixed exchange rate regime with changes in the exchange within a band or range from 1 per cent above to 1 per cent below the par value. But these adjustments were not available to US which had to maintain the gold value of dollar. If the exchange rate hit either of the bands, the monetary authorities were obliged to buy or sell dollars against their currencies. Large adjustments could be made where there were "fundamental disequilibrium" (i.e. persistent and large deficits or surpluses) in BOP with the approval of the IMF and other countries. Member countries were forbidden to impose restrictions on payments and trade, except for a transitional period. They were allowed to hold foreign reserves partly in gold and partly in dollars. These reserves were meant to incur temporary deficits or surpluses by member countries, while keeping their exchange rates stable. In case of a BOP deficit, there was a *reserve outflow* by selling dollar and *reserve inflow* in case of a BOP surplus.

Reserve outflows were a matter of concern under the Bretton Woods system. So the IMF insisted on expenditure reducing policies and devaluation to correct BOP deficit. Temporary BOP deficits were also met by borrowing from the Fund for a period of 3 to 5 years. A country could borrow from the Fund on the basis of the size of its quota with it. The loans made by the IMF were in convertible currencies.

The first 25 per cent of its quota was in *gold tranche* which was automatic and the remaining under the *credit tranches* which carried high interest rates. To provide long-term loans the World Bank (or IBRD) was set in 1946 and subsequently its two affiliates, the International Finance Corporation (IFC) in 1956 and International Development Association (IDA), in 1960. For the removal of trade restrictions, the *General Agreement on Tariffs and Trade* (GATT) came into force from January 1948. To supplement its resources, the and started borrowing from the ten industrialised countries in order to meet the requirements of the International monetary system under General Agreements to Borrow (GAB) from October 1962. Further, it created Special Drawing Rights (SDRs) is January 1970 to supplement international reserves to meet the liquidity requirements of its members. The Bretton Woods system worked smoothly from 1950s to mid 1960s. During this period world output increased and with the reduction of tariffs under the GATT, world trade also use.

The Breakdown of the Bretton Woods System

The following are the principal causes and sequences of the breakdown of the Bretton Woods system.

1. **Built-in Instability :** The Bretton Woods System had a built-in instability that ultimately led to its breakdown. It was an adjustable peg system within plus or minus 1 per cent of the par value of $35. In case of fundamental disequilibrium, a country could devalue its currency with the approval of the IMF. But countries were reluctant to devalue their currencies because they had to export more goods in order to pay for dearer imports from other countries. This led countries to rely on deflation in order to cure BOP deficits through expenditure-reducing monetary-fiscal policies. The UK often restored to deflation such as in 1949, 1957 and 1967.
2. **The Triffin Dilemma :** Since the dollar acted as a medium of exchange, a unit of account and a store of value of the IMF system, every country wanted to increase its reserves of dollar which led to dollar holdings to a greater extent than needed. Consequently, the US gold stock continued to decline and the US balance of payments continued to deteriorate. Robert Triffin warned in 1960 that the demand for world liquidity was growing faster than the supply because the incremental supply of gold was increasing little. Since the dollar was convertible into gold, the supply of US dollars would be inadequate in relation to the liquidity needs of countries. This would force the US to abandon its commitment to convert dollars into gold. This is the Triffin Dilemma which actually led to the collapse of the Bretton Woods System in August 1971.
3. **Lack of International Liquidity :** There was a growing lack of international liquidity due to increasing demand for the dollar in world monetary markets. With the expansion of world

Notes

trade, BOP deficits (and surpluses) of countries increased. This necessitated the supply of gold and of the dollar. But the production of gold in Africa was increasing very little. This led to larger demand and holdings of the dollar. Countries also wanted to have more dollar holdings because they earned interest. As the supply of dollars was inadequate in relation to the liquidity needs of countries, the US printed more dollars to pay for its deficits which other countries accepted as reserves.

Did u know? The Bretton Woods System finally collapsed in 1971, and this was caused by the so-called Dollar Crisis of 1971. The dollar crisis stemmed from the US balance of payments deficits.

4. **Mistakes in US Policies :** The BOP deficits of the US became steadily worse in the 1960s. To overcome them, the policies adopted by the US government ultimately led to the world crises. Rising US government expenditure in the Vietnam War, the financing of US space programme and the establishment of the "Great Society" (social welfare) programme in the 1960s led to large outflow of dollar from the US. But the US monetary authority (FED) did not devalue the dollar. Rather, it adopted monetary and fiscal measures to cut its BOP deficit.
5. **Destabilising Speculation :** Since countries with "fundamental disequilibrium" in BOP were reluctant to devalue their currencies and also took time to get the approval of the IMF, it provided speculators an opportunity to resort to speculation in dollars. When devaluations were actually made, there were large doses of devaluation than originally anticipated. This was due to destabilising speculation which made controls over capital flows even through monetary-fiscal measures ineffective. This was the immediate reason for the UK to devalue the pound in 1967.
6. **Crisis of Confidence and Collapse :** The immediate cause of the collapse of the Bretton Woods System was the eruption of a crisis of confidence in the US dollar. The pound had been devalued in November 1967. There was no control over the world gold market with the appearance of a separate price in the open market. The immediate cause for the collapse of the Bretton Woods System was the rumour in March 1971 that the US would devalue the dollar. This led to a huge outflow of capital from the US. On 15 August 1971, the US suspended the conversion of dollars into gold when some small European central banks wanted to convert their dollar reserves into gold at the US. It refused to intervene in the foreign exchange markets to maintain exchange rate stability and imposed a 10% import surcharge. Thus the main cause of breakdown of the Bretton Woods System was the problems of liquidity, adjustment and confidence. The increase in liquidity (international reserves) was in the form of dollars arising from BOP deficits of the US. But as the US was unable to adjust its deficits and excessive dollars accumulated in foreign countries, there was a *crisis* of *confidence* in the dollar and the Bretton Woods System brokedown.

8.3 The Present International Monetary System

At the beginning of March 1973 India, Canada, Japan, Switzerland, the UK and several smaller countries had floating exchange rates. However, the *"joint float"* of the EEC countries continued even after March 1973 and was now called the *"snake in the lake"*, as there was no band within which the EEC currencies could fluctuate relative to other currencies. In March, 1979 the European Monetary System (EMS) was formed which created the European Currency Unit (ECU) which is a "basket" currency of a unit of account consisting of the major European currencies. The EMS limits the internal exchange rate movement of the member countries to not more than 2.25 per cent from the "central rates" with the exception of Italy whose lira can fluctuate up to 6 per cent.

In the meantime, the *Jamaica Agreement* of January 1976 (ratified in April 1978) formalised the regime of floating exchange rates under the auspices of the IMF. A number of factors forced the majority of member countries of the IMF to float their currencies. There were large short-term capital movements and central banks failed to stop speculation in currencies during the regime of adjustable pegs. The

Notes

oil crisis in 1973 and the increase in oil prices in 1974 led to the great recession of 1974-75 in the industrial countries of the world. As a result "the dollar went into a rapid decline, which, by late 1978, had such alarming proportions that the United States government finally decided on a policy of massive intervention in order to prevent a further fall in the value of the dollar". At last, the system of managed floating exchange rates had come to stay by 1978. By the *Second Amendment of the IMF Charter* in 1978, the member countries are not expected to maintain and establish par values with gold or dollar. The Fund has no control over the exchange rate adjustment policies of the member countries. But it exercises international "surveillance" of exchange rate policies of its members.

The Second Amendment has reduced the position of gold in the global monetary system in the following ways by : (a) abolishing the official price of gold; (b) delinking it with the dollar in exchange arrangements; (c) eliminating the obligations of the Fund and its members to transfer or receive gold; and (d) selling a part of Fund's gold holdings.

The Second Amendment has also made SDRs as the chief reserve assets of the global monetary system whose value is expressed in currencies and not gold. It is now a unit of account, a currency peg and medium of transactions.

The present international monetary system of floating exchange rates is not one of free flexible exchange rates but of "managed floating". It has rarely operated without government intervention. Periodic intervention by governments has led the system to be called a "managed" or "dirty" floating system. In 1977, when the intervention was very heavy, it was characterised as a "filthy" float. When Governments do not intervene, it is a "clean" float. But the possibilities of a clean float are very remote. Thus a system of managed floating exchange rates is evolving where the central banks are trying to control fluctuations of exchange rates around some "normal" rates even though the Second Amendment of the Fund makes no mention of normal rates.

"The present international monetary system has also evolved in a number of important ways, including new allocation of SDRs, increased nations' quota in the IMF, renewal of the General Agreements to Borrow (GAB), the abolishment of the official gold price, and the formation of the European Monetary System (EMS) and the Euro Currency."

The US is the major country which has been influencing the global monetary system. It has permitted the dollar to float in relation to other currencies with occasional interventions when the dollar has reached extreme highs or lows. When the dollar was extremely high (appreciating), the G-5 (US, UK, Germany, Japan and France) agreed to intervene to bring the dollar down by the *Plaza Accord* in September 1985. Subsequently, the dollar depreciated substantially i.e. by more than 50% relative to the yen. By early 1987, the dollar had become undervalued and by the *Louvre Accord*, the G-7 countries (G-5 plus Canada and Italy) agreed to cooperate in keeping their exchange rates around their current levels at that time. "The Louvre Accord was successful in stabilising exchange rates for the rest of the year. Since then there seems to have been a consensus that exchange rates should be broadly stabilised, but there is little overt cooperation *among countries."*

Its Problems

The present international monetary system is faced with excessive fluctuations and large disequilibria in exchange rates. Often countries, both developed and developing, have been faced with either excessive appreciation or depreciation of their currencies in relation to the dollar which continues to dominate the world monetary system. Even the newly created Euro of the EU which was supposed to be a strong currency has been depreciating considerably since its inception against the dollar. This has adversely affected the world trade.

Reform of the Present International Monetary System

Economists have suggested a number of measures in order to avoid the excessive fluctuations and large disequilibria in exchange rates for reforming the present world monetary system.

1. **Coordination and Cooperation of Policies** : A few economists, and McKinnon in particular, suggested international co-operation and co-ordination of policies among the leading developed

countries for exchange rate stability. According to McKinnon, the US, Germany and Japan should have the optimal degree of exchange rate stability by fixing the exchange rates among their currencies at the equilibrium level based on the purchasing power parity. Thus they would co-ordinate their monetary policies for exchange rate stability.

2. **Establishing Target Zones** : Williamson called for the establishment of target zones within which fluctuations in exchange rates of major currencies may be permitted. According to him, the forces of demand and supply should determine the equilibrium exchange rate. There should be an upper target zone of 10% above the equilibrium rate and a lower target zone of 10% below the equilibrium exchange rate. The exchange rate should not be allowed to move outside the two target zones by official intervention. In February 1987, the leading five developed countries agreed under the Louvre Agreement to have some sort of target zones for the stability of exchange rates among their currencies. Despite official intervention by these countries, the exchange rates continued to fluctuate within wide margins than agreed upon at Louvre. Thus Williamson's proposal has since been discarded being impracticable.
3. **Improving Global Liquidity** : The reform package of the present world monetary system should improve global liquidity. As a *first* step, both BOP deficit and surplus countries should take steps to reduce a persistent imbalance through exchange rate changes via internal policy measures. *Second,* they should also cooperate in curbing large flows of "hot money" that destabilise their currencies. *Third,* they should be willing to settle their BOP imbalances through SDRs rather than through gold or dollar as reserve assets. *Fourth,* there should be increasing flow of resources to the developing countries.
4. **Leaning Against the Wind** : To reduce the fluctuations in exchange rates, the IMF *Guidelines for the Management of Floating Exchange Rates,* 1974 suggested the idea of leaning against the wind. It means that the central banks should intervene to reduce short-term fluctuations in exchange rates but leave the long-term fluctuations to be adjusted by the market forces.
5. Richard Cooper suggests a global central bank with a global currency which should be a global lender of last resort.
6. Jaffrey Sachs proposes the creation of an international bankruptcy court which should deal with countries.
7. George Soros opines that the IMF should set ceilings for external finance for each country beyond which access to private capital need not be insured. But there should be mandatory insurance by an international credit insurance corporation.
8. Paul Krugman suggests reintroduction of capital controls as a "least bad response" to an international crisis.
9. **Objective Indicators** : To iron out exchange rate fluctuations, the IMF Interim Committee suggested the adoption of such objective indicators as inflation-unemployment, growth of money supply, growth of GNP, fiscal balance, balance of trade and international reserves. The variations in these indicators require the adoption of restrictive monetary-fiscal measures to bring stability in exchange rates.

Self-Assessment

1. **Choose the correct options**:

   (*i*) Which of the following could result from a current account surplus that is too large?

   (*a*) Capital flight

   (*b*) Excessive investment expenditure.

   (*c*) Excessive consumption expenditure.

   (*d*) Difficulties for domestic creditors in collecting their money.

   (*e*) Excessive foreign debt.

Notes

(*ii*) Which of the following could result from a current account deficit that is too large?

(*a*) Excessive net outflows of financial assets.

(*b*) Investment expenditure that is too low.

(*c*) Difficulties for domestic creditors in collecting their money.

(*d*) Government spending that is too low.

(*e*) Growing foreign debt.

(*iii*) An expenditure switching policy

(*a*) could have been caused by devaluations or revaluations under the Bretton Woods system.

(*b*) causes people to switch from saving to spending, thereby allowing the economy to grow.

(*c*) is unable to restore an external balance and an internal balance at the same time.

(*d*) alters the level of aggregate expenditure.

(*e*) will not affect the current account balance.

(*iv*) The price-specie-flow mechanism

(*a*) restores external balances through movements of gold, silver or other international forms of money.

(*b*) is the practice of selling domestic assets to prevent a current account deficit.

(*c*) was established in 1900 under the gold standard.

(*d*) is a commitment by central banks to exchange currency for gold.

(*e*) Was first described by Adam Smith in 1776.

(*v*) Which of the following helped to end the gold standard in the 1930s?

(*a*) An increase in the volume of international trade.

(*b*) Rapid increases in production that led to deflation with a limited quantity of gold.

(*c*) Beggar-thy-neighbor trade policies.

(*d*) Discoveries of gold that led to worldwide inflation.

(*e*) An insufficient world supply of gold.

8.4 Summary

- International liquidity, as distinguished from developmental capital, is a sum of official foreign reserves held by the individual countries of the world and the IMF. International liquidity is a concept related to the balance of payments but not economic development of the countries. There will, however, be an indirect connexion between international liquidity and economic development, since the latter is closely related to the balance of payments position of the countries, particularly of the underdeveloped countries of the so-called Third World.
- A certain level of international liquidity is necessary in order to keep the international trade and monetary transactions running smoothly. A shortage of international liquidity hampers international trade expansion, and an excess supply of international liquidity would cause world monetary expansion and global inflationary upsurge. Today's world is characterized by inadequacy of international liquidity rather than excess.
- International liquidity problem can be solved by international arrangements for augmenting international reserves like gold and reserve assets including the SDRs. This has its own limits usually associated with supply constraints. The only durable solution to international liquidity problem particularly of the Third World countries facing monumental balance of payments deficits, lies in the willingness of the surplus countries of the advanced world to take policy measures to reduce their balance of payments surpluses. This will make the world less protectionist as well.
- The period, 1870-1914, was one of international gold standard, relatively free trade and factor movements, and of stable exchange rates. The inter-war period was characterized by

international monetary and exchange rates, international cooperation and trade and tariff negotiations 1971 marked the end of the fixed exchange rate regime when the Bretton Woods System collapsed. Today we are living in a world of flexible exchange rates. The SDRs are gradually replacing gold, the US dollar and other reserve assets as a scale of valuation of international reserves and exchange rates. The Bretton Woods System no longer exists, and no new system has been created to replace it.

- The IMF is still the main source of international liquidity, and the SDRs constitute a new source of international liquidity, similar to the discovery of new gold mines.

8.5 Key-Words

1. Monetary System : medium of exchange: anything that is generally accepted as a standard of value and a measure of wealth in a particular country or region
2. Bretton Wood System : The Bretton Woods system of monetary management established the rules for commercial and financial relations among the world's major industrial states in the mid-20th century. The Bretton Woods system was the first example of a fully negotiated monetary order intended to govern monetary relations among independent nation-states.

8.6 Review Questions

1. What do you mean by monetary system? Discuss international monetary system.
2. Write a short note on Bretton Wood System.
3. What are the causes of the breakdown of Bretton Wood System? Discuss.

Answers: Self-Assessment

1. (*i*) (*d*) (*ii*) (*e*) (*iii*) (*a*) (*iv*) (*a*) (*iv*) (*c*)

8.7 Further Readings

1. Krimawati, Wawat. (?) NAFTA: North America Free Trade Agreement. [Accessed 18 May 2009]
2. Vogel, David. (2009) North American Free Trade Agreement. [Accessed 18 May 2009] 2009. North American Free Trade Agreement (NAFTA).
3. United States Department of Agriculture, Foreign Agricultural Service. [Accessed June 8, 2009]

Notes

Unit 9 : East Asian Crisis and Lessons for Developing Countries

CONTENTS

Objectives
Introduction
9.1 The Asian Financial Crisis
9.2 Lessons of Developing Country Crises
9.3 Summary
9.4 Key-Words
9.5 Review Questions
9.6 Further Readings

Objectives

After reading this Unit students will be able to:

- Describe the Asian Financial Crisis.
- Explain the Lessons of Developing Country.

Introduction

As it turned out, in 1997 Asian economies did indeed experience a severe financial crisis. And with the benefit of hindsight, several weaknesses in their economic structures—some shared by Latin American countries that had gone through crises—became apparent. Three issues in particular stood out :

1. **Productivity** : Although the rapid growth of East Asian economies was not in any sense an illusion, even before the crisis a number of studies had suggested that some limits to expansion were appearing. The most surprising result of several studies was that the bulk of Asian output growth could be explained simply by the rapid growth of production *inputs*—capital and labor—and that there had been relatively little increase in productivity, that is, in output per unit of input. Thus in South Korea, for example, the convergence toward advanced-country output per capita appeared to be mainly due to a rapid shift of workers from agriculture to industry, a rise in educational levels, and a massive increase in the capital-labor ratio within the nonagricultural sector. Evidence for a narrowing of the technological gap with the West was unexpectedly hard to find. The implication of these studies' conclusions was that continuing high rates of capital accumulation would eventually produce diminishing returns, and, possibly, that the large financial inflows taking place were not justified by future profitability after all.
2. **Banking regulation** : Of more immediate relevance to the crisis was the poor state of banking regulation in most Asian economies. Domestic depositors and foreign investors regarded Asian banks as safe, not only because of the strength of the economies, but because they believed that governments would stand behind the banks in case of any difficulties. But banks and other financial institutions were not subject to effective government supervision over the kinds of risks they were undertaking. As the experience in Latin America should have made clear, moral hazard was present in spades. Despite this, several of the East Asian countries had eased private access to financial inflows in the 1990s, and foreign money was readily available both to East Asian banks and directly to East Asian corporate borrowers. Because of original sin, foreign debts were fixed in foreign-currency terms.

Notes

In several Asian countries, close ties between business interests and government officials appear to have helped foster considerable moral hazard in lending. In Thailand, so-called finance companies, often run by relatives of government officials, lent money to highly speculative real estate ventures; in Indonesia, lenders were far too eager to finance ventures by members of the president's family. These factors help to explain how, despite high saving rates, East Asian countries were led to invest so much that their current accounts were in deficit prior to the crisis.

Some analysts have suggested that excessive lending, driven by moral hazard, helped create an unsustainable boom in Asian economies, especially in real estate, that temporarily concealed the poor quality of many of the investments; and that the inevitable end of this boom caused a downward spiral of declining prices and failing banks. However, while moral hazard was certainly a factor in the runup to crisis, its importance remains a subject of considerable dispute.

3. **Legal framework** : One important weakness of Asian economies only became apparent after they stumbled : the lack of a good legal framework for dealing with companies in trouble. In the United States, there is a well-established procedure for bankruptcy—that is, for dealing with a company that cannot pay its debts. In such a procedure, the courts take possession of the firm on behalf of the creditors, then seek to find a way to satisfy their claims as well as possible. Often this means keeping the company in existence and converting the debts it cannot pay into ownership shares. In Asian economies, however, bankruptcy law was weak, in part because the astonishing growth of the economies had made corporate failures a rare event. When times did turn bad, a destructive impasse developed. Troubled companies would simply stop paying their debts. They then could not operate effectively because nobody would lend to them until the outstanding debts were repaid. Yet the creditors lacked any way to seize the limping enterprises from their original owners.

   Of course, every economy has weaknesses, but the performance of the East Asian economies had been so spectacular that few paid much attention to theirs. Even those who were aware that the "miracle" economies had problems could hardly have anticipated the catastrophe that overtook them in 1997.

9.1 The Asian Financial Crisis

The Asian financial crisis is generally considered to have started on July 2, 1997, with the devaluation of the Thai baht. Thailand had been showing signs of financial strain for more than a year. During 1996 it became apparent that far too many office towers had been built; first the nation's real estate market, then its stock market, went into decline. In the first half of 1997 speculation about a possible devaluation of the baht led to an accelerating loss of foreign exchange reserves, and on July 2 the country attempted a controlled 15 percent devaluation. As in the case of Mexico in 1994, however, the attempted moderate devaluation spun out of control, sparking massive speculation and a far deeper plunge.

Notes

Thailand itself is a small economy. However, the sharp drop in the Thai currency was followed by speculation against the currencies first of its immediate neighbor Malaysia, then of Indonesia, and eventually of the much larger and more developed economy of South Korea.

All of these economies seemed to speculators to share with Thailand the weaknesses previously listed; all were feeling the effects in 1997 of renewed economic slowdown in their largest industrial neighbor, Japan. In each case, governments were faced with awkward dilemmas, stemming partly from the dependence of their economies on trade, partly from the fact that domestic banks and

Notes

companies had large debts denominated in dollars. If the countries simply allowed their currencies to drop, rising import prices would threaten to produce dangerous inflation, and the sudden increase in the domestic-currency value of debts might push many potentially viable banks and companies into bankruptcy. On the other hand, to defend the currencies would require at least temporary high interest rates to persuade investors to keep their money in the country, and these high interest rates would themselves produce an economic slump and cause banks to fail.

All of the afflicted countries except Malaysia turned to the IMF for assistance and received loans in return for implementation of economic plans that were supposed to contain the damage : higher interest rates to limit the exchange rate depreciation, efforts to avoid large budget deficits, and "structural" reforms that were supposed to deal with the weaknesses that had brought on the crisis in the first place. Despite the IMF's aid, however, the result of the currency crisis was a sharp economic downturn. All of the troubled countries went from growth rates in excess of 6 percent in 1996 to a severe contraction in 1998.

Worst of all was the case of Indonesia, where economic crisis and political instability reinforced each other in a deadly spiral, all made much worse by a collapse of confidence by domestic residents in the nation's banks. By the summer of 1998 the Indonesian rupiah had lost 85 percent of its original value, and few if any major companies were solvent. The Indonesian population was faced with mass unemployment and, in some cases, with inability to afford even basic foodstuffs. Ethnic violence broke out.

As a consequence of the collapse of confidence, the troubled Asian economies were also forced into a dramatic reversal of their current account positions : They moved abruptly from sometimes large deficits to huge surpluses. Most of this reversal came not through increased exports but through a huge drop in imports, as the economies contracted.

Currencies stabilized throughout crisis-stricken Asia and interest rates decreased, but the direct spillover from the region's slump caused slowdowns or recessions in several neighboring countries, including Hong Kong, Singapore, and New Zealand. Japan and even parts of Europe and Latin America were feeling the effects. Most governments continued to take IMF-prescribed medicine, but in September 1998 Malaysia—which had never accepted an IMF program—broke ranks and imposed extensive controls on capital movements, hoping that the controls would allow it to ease monetary and fiscal policy without sending its currency into a tailspin. China and Taiwan, which maintained capital controls and had current account surpluses over the pre-crisis period, went largely unscathed in the crisis.

Fortunately, the downturn in East Asia was "V-shaped" : After the sharp output contraction in 1998, growth returned in 1999 as depreciated currencies spurred higher exports. Not all of the region's economies fared equally well, and controversy remains over the effectiveness of Malaysia's experiment with capital controls. In general, investment rates have remained depressed and current accounts have remained in surplus, sometimes substantially so.

Spillover to Russia

Asia's woes sparked a general flight by investors from emerging markets, putting severe pressure on the economic policies of distant developing nations. Russia was affected soon after.

Starting in 1989, the countries of the Soviet bloc, and ultimately the Soviet Union itself, shook off communist rule and embarked on transitions from centrally planned economic allocation to the market. These transitions were traumatic, involving rapid inflation, steep output declines, and a phenomenon that had been largely unknown in planned economies—unemployment. Such beginnings were inevitable. In most of the formerly communist countries nearly the entire economy had to be privatized. Financial markets and banking practices were largely unknown, there was no legal framework for private economic relations or corporate governance, and initial property rights were ambiguous. States lacked the modern fiscal machinery through which industrial countries design and collect taxes, and given the cautious attitude of foreign investors and the absence of domestic capital markets, the monetary printing press was the only way to finance needed social expenditures.

Notes

By the end of the 1990s, a handful of East European economies including Poland, Hungary, and the Czech Republic had made successful transitions to the capitalist order. Not surprisingly each of these countries was geographically close to the EU and had a recent tradition (prior to Soviet occupation in the late 1940s) of industrial capitalism, including a body of contract and property law. Many of the other successor states that emerged from the wreckage of the Soviet Union were still faring quite badly even as the 20th century ended. The largest was Russia, which retained much of the nuclear weaponry left by the Soviet Union.

Over the course of the 1990s, Russia's weak government was unable to collect taxes or even to enforce basic laws; the country was riddled with corruption and organized crime. It is no wonder that measured output shrank steadily and that inflation was hard to control, so that at the end of the 1990s most Russians were substantially worse off than under the old Soviet regime. In 1997, the government managed to stabilize the ruble and reduce inflation with the help of IMF credits, and the economy even managed to eke out a (barely) positive GDP growth rate that year. However, the government had slowed inflation by substituting borrowing for seigniorage; neither the government's attempts to collect taxes or reduce spending were very successful, and the state debt therefore had ballooned. When, in addition, the prices of oil and other key Russian commodity exports were depressed by the crisis in Asia, investors began to fear in the spring of 1998 that the ruble, like many of the Asian currencies the year before, was in for a steep devaluation. Interest rates on government borrowing rose, inflating Russia's fiscal deficit.

Despite Russia's failure to abide by earlier IMF stabilization programs, the Fund nonetheless entered into a new agreement with its government and provided billions to back up the ruble's exchange rate. The IMF feared that a Russian collapse could lead to renewed turbulence in the developing world, as well as posing a nuclear threat if Russia decided to sell off its arsenal. In mid-August 1998, however, the Russian government abandoned its exchange rate target; at the same time as it devalued, it defaulted on its debts and froze international payments. The government resumed printing money to pay its bills and within a month the ruble had lost half its value. Despite Russia's rather small direct relevance to the wealth of international investors, its actions set off panic in the world capital market as investors tried to increase their liquidity by selling emerging market securities. In response, the U.S. Federal Reserve lowered dollar interest rates sharply, possibly averting a worldwide financial collapse. Russia's output recovered in 1999 and growth was rapid afterward, helped by higher world oil prices.

9.2 Lessons of Developing Country Crises

The emerging market crisis that started with Thailand's 1997 devaluation produced what might be called an orgy of finger-pointing. Some Westerners blamed the crisis on the policies of the Asians themselves, especially the "crony capitalism" under which businesspeople and politicians had excessively cozy relationships. Some Asian leaders, in turn, blamed the crisis on the machinations of Western financiers; even Hong Kong, normally a bastion of free market sentiment, began intervening to block what it described as a conspiracy by speculators to drive down its stock market and undermine its currency. And almost everyone criticized the IMF, although some said it was wrong to tell countries to try to limit the depreciation of their currencies, others that it was wrong to allow the currencies to depreciate at all.

Nonetheless some very clear lessons emerge from a careful study of the Asian crisis and earlier developing-country crises in Latin America and elsewhere.

1. **Choosing the right exchange rate regime** : It is perilous for a developing country to fix its exchange rate unless it has the means and commitment to do so, come what may. East Asian countries found that confidence in official exchange rate targets encouraged borrowing in foreign currencies. When devaluation occurred nonetheless, much of the financial sector and many corporations became insolvent as a result of extensive foreign-currency denominated debts. The developing countries that have successfully stabilized inflation have adopted more flexible

Notes

exchange rate systems or moved to greater flexibility quickly after an initial period of pegging aimed at reducing inflation expectations. When they have not done this, they have tended to experience real appreciations and current account deficits that leave them vulnerable to speculative attack. Even in Argentina, where the public's fear of returning to the hyperinflationary past instilled a widely shared determination to prevent inflation, a fixed exchange rate proved untenable over the long term.

2. **The central importance of banking** : A large part of what made the Asian crisis so devastating was that it was not purely a currency crisis, but rather a currency crisis inextricably mixed with a banking and financial crisis. In the most immediate sense, governments were faced with the conflict between restricting the money supply to support the currency and the need to print large quantities of money to deal with bank runs. More broadly, the collapse of many banks disrupted the economy by cutting off channels of credit, making it difficult for even profitable companies to continue business. This should not have come as a surprise in Asia. Similar effects of banking fragility played roles in the crises of Argentina, Chile, and Uruguay in the 1980s and of Mexico in 1994-1995, and even in those of industrial countries like Sweden during the 1992 attacks on the EMS. Unfortunately, Asia's spectacular economic performance prior to its crisis blinded people to its financial vulnerabilities. In the future, wise governments will devote a great deal of attention to shoring up their banking systems to minimize moral hazard, in the hope of becoming less vulnerable to financial catastrophes.

3. **The proper sequence of reform measures** : Economic reformers in developing countries have learned the hard way that the order in which liberalization measures are taken really does matter. That truth also follows from basic economic theory : The principle of the *second best* tells us that when an economy suffers from multiple distortions, the removal of only a few may make matters worse, not better. Developing countries generally suffer from many, many distortions, so the point is especially important for them. Consider the sequencing of financial account liberalization and financial sector reform, for example. It is clearly a mistake to open up the financial account before sound safeguards and supervision are in place for domestic financial institutions. Otherwise, the ability to borrow abroad will simply encourage reckless lending by domestic banks. When the economy slows down, foreign capital will flee, leaving domestic banks insolvent. Thus, developing countries should delay opening the financial account until the domestic financial system is strong enough to withstand the sometimes violent ebb and flow of world capital. Economists also argue that trade liberalization should precede financial account liberalization. Financial account liberalization may cause real exchange rate volatility and impede the movement of factors of production from nontraded into traded goods industries.

4. **The importance of contagion** : A final lesson of developing country experience is the vulnerability of even seemingly healthy economies to crises of confidence generated by events elsewhere in the world—a domino effect that has come to be known as **contagion.** Contagion was at work when the crisis in Thailand, a small economy in Southeast Asia, provoked another crisis in South Korea, a much larger economy some 7,000 miles away. An even more spectacular example emerged in August 1998, when a plunge in the Russian ruble sparked massive speculation against Brazil's real. The problem of contagion, and the concern that even the most careful economic management may not offer full immunity, has become central to the discussion of possible reforms of the international financial system, to which we now turn.

Did u know? Mexico's experience since 1995 shows that larger developing countries can manage quite well with a floating exchange rate, and it is hard to believe that, if Mexico had been fixing, it would have survived the Asian crisis repercussions of 1998 without a currency crisis of its own.

Notes

Self-Assessment

1. Choose the correct options:

(*i*) The Asian financial crisis is generally considered to have started on July 2

(*a*) 1988 (*b*) 1997

(*c*) 1999 (*d*) 1990

(*ii*) By the end of 1990s, a handful of East European economies including-----had made successful transitions to the capitalist order.

(*a*) Poland (*b*) Hungary

(*c*) Czech Republic (*d*) All of these

9.3 Summary

- The most surprising result of several studies was that the bulk of Asian output growth could be explained simply by the rapid growth of production *inputs*—capital and labor—and that there had been relatively little increase in productivity, that is, in output per unit of input. Thus in South Korea, for example, the convergence toward advanced-country output per capita appeared to be mainly due to a rapid shift of workers from agriculture to industry, a rise in educational levels, and a massive increase in the capital-labor ratio within the nonagricultural sector. Evidence for a narrowing of the technological gap with the West was unexpectedly hard to find.
- In Asian economies, however, bankruptcy law was weak, in part because the astonishing growth of the economies had made corporate failures a rare event. When times did turn bad, a destructive impasse developed. Troubled companies would simply stop paying their debts. They then could not operate effectively because nobody would lend to them until the outstanding debts were repaid. Yet the creditors lacked any way to seize the limping enterprises from their original owners.
- The Asian financial crisis is generally considered to have started on July 2, 1997, with the devaluation of the Thai baht. Thailand had been showing signs of financial strain for more than a year. During 1996 it became apparent that far too many office towers had been built; first the nation's real estate market, then its stock market, went into decline. In the first half of 1997 speculation about a possible devaluation of the baht led to an accelerating loss of foreign exchange reserves, and on July 2 the country attempted a controlled 15 percent devaluation.
- Asia's woes sparked a general flight by investors from emerging markets, putting severe pressure on the economic policies of distant developing nations. Russia was affected soon after.
- The emerging market crisis that started with Thailand's 1997 devaluation produced what might be called an orgy of finger-pointing. Some Westerners blamed the crisis on the policies of the Asians themselves, especially the "crony capitalism" under which businesspeople and politicians had excessively cozy relationships. Some Asian leaders, in turn, blamed the crisis on the machinations of Western financiers; even Hong Kong, normally a bastion of free market sentiment, began intervening to block what it described as a conspiracy by speculators to drive down its stock market and undermine its currency.

9.4 Key-Words

1. Financial crisis : The term financial crisis is applied broadly to a variety of situations in which some financial assets suddenly lose a large part of their nominal value. In the 19th and early 20th centuries, many financial crises were associated with banking panics, and many recessions coincided with these panics. Other situations that are often called financial crises include stock market crashes and the bursting of other financial bubbles, currency crises, and sovereign defaults.

Notes

2. Reform measures : Reform means the improvement or amendment of what is wrong, corrupt, unsatisfactory, etc. The use of the word in this way emerges in the late 1700's and is believed to originate from Christopher Wyvill's Association movement which identified "Parliamentary Reform" as its primary aim.

   Reform is generally distinguished from revolution. The latter means basic or radical change; whereas reform may be no more than fine tuning, or at most redressing serious wrongs without altering the fundamentals of the system. Reform seeks to improve the system as it stands, never to overthrow it wholesale. Radicals on the other hand, seek to improve the system, but try to overthrow whether it be the government or a group of people themselves.

9.5 Review Questions

1. Discuss the Asian Financial crisis. What were the main issues for this crisis?
2. Briefly explain the developing country crises.

Answers: Self-Assessment

1. (*i*) (*b*) (*ii*) (*d*)

9.6 Further Readings

1. Krimawati, Wawat. (?) NAFTA: North America Free Trade Agreement. [Accessed 18 May 2009]
2. Vogel, David. (2009) North American Free Trade Agreement. [Accessed 18 May 2009] 2009. North American Free Trade Agreement (NAFTA).
3. United States Department of Agriculture, Foreign Agricultural Service. [Accessed June 8, 2009]

Notes

Unit 10: FDI : Types and Issues

CONTENTS

Objectives
Introduction
10.1 Types of FDI
10.2 Issues of FDI
10.3 Summary
10.4 Key-Words
10.5 Review Questions
10.6 Further Readings

Objectives

After reading this Unit students will be able to:

- Explain the Types of FDI.
- Discuss the Issues of FDI.

Introduction

Foreign direct investment (FDI) has grown dramatically as a major form of international capital transfer over the past decade. Between 1980 and 1990, world flows of FDI—defined as cross-border expenditures to acquire or expand corporate control of productive assets—have approximately tripled. FDI has become a major form of net international borrowing for Japan and the United States (the world's largest international lender and borrower, respectively). Direct investment has grown even more rapidly of late within Europe.

To what extent is this sudden worldwide surge in FDI explained by traditional theories ? These theories predict the scale and scope of multinational enterprises by looking to differences in competitive advantage, across firms or countries, that might lead to the extension of corporate control across borders. So, for example, better technology, management capability, and product design; stronger consumer allegiance; and greater complementarities in production or use of technology can allow a domestic firm to control foreign assets more productively than would a foreign firm and could therefore predicate direct investment. In many cases, these theories also explain why an enterprise's alternatives to FDI—domestically based production or licensing of foreign-based production—are less efficient than direct control of foreign-based operations.

Traditional theories are very useful for explaining basic long-term patterns of FDI. For example, they help understand the behavior of U.S. firms during the post-World War II period (the experience on which these theories were honed). At that time, advanced U.S. firms were superior in technology and well established in foreign markets. U.S. firms tended to move overseas to retain competitive access (or to preempt competitors' access) to those markets and, in the process, met with relatively little competition.

These theories also help us understand why the tide of U.S. FDI flows has slowly turned. The evolution of the United States from a home for domestically based multinationals to a host for foreign-based multinationals is probably the single most obvious sign of change in FDI today. This development basically coincides with the waning (and even disappearance) of U.S. firms' former competitive advantages. It is obvious to today's consumer that European-, Japanese, and Canadian-based firms have developed advantages that allow them to control certain assets in the United States more efficiently than would U.S.-based firms.

Notes

In spite of their successes, however, the traditional theories leave many recent features of FDI unexplained. First, it is hard to believe that the tide of underlying competitive advantage followed closely (or at all) the behavior of total FDI flows over the last decade : very rapid increases from 1979 through 1981, strong declines from 1982 through 1985, and then increases of unprecedented size from 1986 through 1990. One would have expected changes in national competitive advantages to be reflected in more steady trends. Second, to the extent that any developments happen quickly, one might have expected that they would occur in a single industry at a time—say, the automobile producers of Japan—as shocks to competitive ability come to be reflected in world ownership patterns. Yet the surges of the past fifteen years take place across virtually all industries simultaneously.

The recent FDI surges in U.S. inflows and Japanese outflows illustrate these two features. Japanese FDI overall, which historically was small, exploded across all industries in the latest surge, experiencing in the aggregate a seven-fold increase from 1985 to 1989. During this surge, both U.S. inflows and Japanese outflows were particularly large and fast-growing in real estate and financial services. In these industries, however, there was little evidence of meaningful change in competitive advantage. Particularly puzzling is the case of Japanese banks, which during the latest surge went on a much-publicized binge in acquiring foreign affiliates. Many of the involved banks were actually noted for their apparently inefficient operations and low profitability in comparison with U.S. and European companies. These facts suggest that existing theories do a good job of explaining neither the timing or magnitude of surges nor their broad cross-industry composition.

10.1 Types of FDI

FDI flows into an economy through many mediums, and the type of flow determines its multiplier effects on an economy. This chapter discusses the categorisation of FDI into five broad types, viz. export-oriented investment, market-development investment, government-initiated investment, acquisition investment and greenfield investment, and the motivation for such investments in an economy.

Export-oriented Investment

Export-oriented investment is described by Reuber as the type of investment that reflects a wide range of considerations such as the desire to develop secondary and more diversified sources of supply by way of obtaining lower-cost products to be used either as inputs or for sale elsewhere.

Firms serving established markets at home or internationally frequently seek new sources of inputs, including raw materials, components and parts, as well as finished products. This reflects a wide range of considerations, such as the desire to develop secondary and more diversified sources of supply and the possibility of obtaining lower-cost products. Examples of this type of investment are found in the raw materials sector. Generally, such foreign investors are mainly interested in extracting products from the host country and selling them abroad through established market channels. In making such investments, firms sometimes also create a supporting infrastructure such as housing, hospitals and schools. This investment focuses on the needs of a particular market which is largely or entirely outside the host country.

The World Investment Report advocates that this type of investment is made with the intention of the investor to improve its competitive position at home or internationally by taking advantage of the lower cost of production that host countries offer, where lower cost is indicated by some of the following, amongst others : incentives from the host country, abundance of skilled and semi-skilled labour with concurrent relatively lower wages, and political and monetary stability. With this type of investment, investors attach little significance to host countries' markets. The major factors with regard to the determination of the location of the investments are cost, as explained above, and the reliability of production.

This investment is geared towards the production of component parts. After production, the components are normally exported to a central location or to a country other than the host country for assembly into finished goods, confirming the fact that this investment is made with the object of taking advantage of the lower-cost environment in a host country.

Notes

Export-oriented investment tends to be highly profitable even in the short term. The investing company's control over the market and the rapid depreciation of its investment is made possible by high cash throw-off and is sometimes enhanced by technological obsolescence. If competitive conditions become less favourable in the host country relative to somewhere else then the firm can move its investment quite quickly. Moreover, because of this high mobility, countries can easily find themselves competing with each other in making concessions to such investors in order to make their investment platforms more attractive, which in turn reduces the risk of this type of investment and hence an advantage to both the host country and the investor.

Reuber states that this type of investment is less commonly found producing final products for sale directly to consumers abroad. One may speculate on a variety of reasons for this, such as the difference in comparative advantage associated with different parts of the production process, handling and transportation costs, the reluctance of investors to assume the risk of relying entirely on any country for the production of a full product line, and the advantages from the standpoint of sale and the service of having final assembly take place in the major markets where the product is sold, as in most cases the host country's markets are more oriented to raw materials.

There are many ways by which export-oriented FDI can help to enhance a host country's manufacturing and export competitiveness. In order to attract this type of investment and to ensure that the investment translates into development gains, a host country needs to find the most effective ways of making the choice of locations as well as the target segments conducive to the kind of export activities the host country aims to foster. In today's rapidly globalising world, successful exporting needs not only competitive products, but also marketing expertise and access to international markets. Giving greater access to export-oriented FDI can provide major benefits to the host country in this respect, especially in markets in which established brand names and large distribution networks are important assets. This type of investment can also be an effective means of providing resources such as skills, training, technology, capital goods and intermediate inputs needed to exploit a country's existing comparative advantages.

The most prominent role played by this type of FDI in the exports of developing countries is in the manufacturing sector. In this sector, foreign affiliates tend to be leaders in export-oriented investment and in marketing. The impact of foreign affiliates on the domestic entities' export activities can be both direct and indirect. Direct effects occur when exporting foreign affiliates establish backward linkages with local firms which then become indirect exporters. Indirect effects of the presence of export-oriented foreign affiliates occur when local firms manage to copy the operations of foreign affiliates, employ staff of foreign affiliates, and benefit from improvements in infrastructure and reduction in trade barriers undertaken in response to demand by the host country for foreign operations / investors.

Market-development Investment

Unlike the export-oriented type of FDI, the objective of making a market-initiated type of FDI is to sell the final output in the host country's market. However, a common feature of both types is that they thrive on feasibility of reduction in production cost. Another key consideration by the investor is the potential growth in the size of the host country's market in the long term. Although in the short to medium term the investment may not yield the expected return, if the long-term view is that the host country's market will grow in size and hence become profitable, the investment may then be undertaken. The growth in the host country's market is, however, dependant on the general economic outlook of the host country and hence the macroeconomic variables and the effectiveness of the economic reform policies, other policy directives like tariffs, trade controls, taxes, subsidies and so forth, as well as various regulations imposed on foreign investors by the host country, become fundamental to the decision to invest.

The policies referred to in the previous paragraph are for the most part general in scope. They apply to foreign investment generally or to broad sectors of the economy rather than to particular projects or industries. Moreover, many of these policies confer the same advantage on domestic industries. The initiative to undertake such investment is taken by the investor and although the incentives provided by the host country frequently have some influence on the decisions made, investors may

Notes

view many of these incentives as uncertain over time and marginal in importance by comparison with long-term market considerations.

Market-development investment is marked by many uncertainties of the most central kind from a business standpoint : How quickly will a market develop ? Can the firm speed up the market-development process ? What share of the market can the firm capture ? Owing to these and other uncertainties regarding product acceptance and market development, many manufacturing firms are likely to prefer to explore the market initially by exporting. As the market develops and investors' knowledge and confidence grow, and they become more familiar with the risk involved, they may expand gradually into assembly activities.

This type of investment may be illustrated by the following examples, as reported in Reuber. A major manufacturer of tractors approached the Brazilian market by exporting initially and working directly with Brazil to establish a strong local distribution network. This required extensive training of Brazilian distributors, not only in how to sell tractors but also in how to use, service and repair them. In many cases certain business practices were also transferred, such as inventory control for parts and record keeping for internal control purposes. The Brazilian distributors were allowed to make attractive margins in return for their inputs. The distribution system added more value to the host country than did the company's eventual manufacturing activities. Furthermore, after the firm had developed a large-enough market to begin the integrated manufacture of tractors in Brazil, the distribution network proved effective in handling imported combines and other farm equipment as well. The firm's next step was to develop the integrated manufacture of combines in Brazil, and the gradual diversification of the product range is expected to continue into the future.

A second example in Reuber relates to a major US chemical company which bought out the only local plastics manufacturer in a small Latin American country and operated on a reasonably profitable basis. The American firm was not very interested in the modest return available from the existing firm, but was interested in the potential returns after market development and the related infusion of technology. Their long-term objective was to create a technologically advanced self-contained plastics industry in the host country as they knew that the existing manufacturer was operating with old technology and that the inferior quality of the output limited the number of possible end users. Furthermore, the size of the market as it stood was less than half that required to justify building the new facilities using new technology needed to bring about market growth. The American firm's strategy in the light of these conditions was three-fold :

(i) to develop the country's market potential; (ii) to export more sophisticated products from other countries to the host country; and (iii) to build a new plant with advanced modern technology in the host country after the market had developed to a sufficient level. An important feature of such a strategy is that it is very long term in its conception. This strategy also looks more creative and will benefit both the investor and host country.

Market-development FDI takes many different forms. A major aluminium company began its operations in India by selling aluminium pans and utensils door to door. Over time this led to fabricating activities, bauxite mining and smelting within India, thus forming a well-integrated local industry. The key feature to be noted in this process is that the building of production facilities followed the development of demand, and that the development of demand was a risky and time-consuming activity requiring extensive transfers of managerial and technological skills.

With this type of investment, host countries have considerable bargaining power in their relationship with the investors seeking to establish a foothold in their domestic markets.

As the economy expands, new investors are attracted, creating some competition among investors for available market opportunities. In these circumstances, it may be possible not only to reduce any concessions that may have been extended to foreign investors initially but also to insist on certain concessions from these investors relating to such matters as local ownership, local content in products and reinvestment without interfering significantly with the inflow of investment.

Notes

Government-initiated Investment

In comparison with the export-oriented and market-development types of FDI, government-initiated type of FDI occurs through the provision of substantial incentive structures to investors by a host country's government. These are accepted by investors whereas market as well as cost conditions may have precluded them from investing in the host country under normal or "no-incentive" circumstances. For example, in South Africa the incentive takes the following forms : relaxed foreign exchange controls, tax concessions to investors who partake in national development projects such as Coega in Port Elizabeth, indirect subsidies through the provision of specific infrastructural requirements by investors, ease of repatriation of investments and many other kinds of government support services.

To protect the host country and also to make the option of providing incentives to foreign investors efficient, such incentives are directed at specific projects or industries. Additionally, incentives are given by host country governments in order to attract foreign investors to either less-developed regions or regions which require improvement in certain sectors. For example in South Africa, it is understood that the Industrial Development Corporation of South Africa has allocated investment opportunities to each of the nine provinces.

The following illustration from Reuber seems typical of this kind of investment. A country decided that the time had come to displace imports of synthetic rubber with those produced locally. The country was short of hard currency and lacked the technological skills to produce competitive products. To overcome these problems, it sought a joint venture arrangement with another country which held only a small share of the host country's market as an exporter to the country. This country considered it worthwhile to supply funds and technology in order to obtain a substantial minority interest in the venture and thereby increase its market share. The participating country continued to maintain its own independent distributors, although subsequently the host country decided to set up its own distributor to handle a portion of the output under a market-sharing arrangement. The plan was to produce specialised grades locally as sales volumes rose to the point where production costs became internationally competitive. The host country, however, pressed for local manufacture much earlier than the participating country felt justified in doing by economic considerations. Import-displacement investment of this kind accelerated the transfer of production and technology but at the cost of considerably higher prices for the domestic economy. This cost was justified by the government on the grounds that it yielded a variety of intangible non-quantifiable external effects, such as the development of local management and technical skills, improved technology and series of beneficial spill-over effects on the local industries.

Host-country governments have historically played an important role in attracting or excluding FDI through subsidies, which is one of the most effective ways of stimulating the flow of FDI. Subsidies take a number of different forms. They serve to reduce the risk premium of locating abroad and so they may directly influence a firm's cost structure. One example of a subsidy which affects the firm's risk premium would be the provision of public education to increase literacy within the country. All firms benefit from a more educated populace. In contrast, a subsidy could be aimed at reducing a particular firm's or industry's costs of providing on-the-job training. A risk-reducing subsidy, such as the provision of social overhead capital, has direct economy-wide benefits while a cost-reducing subsidy benefits a select firm or group of firms.

Given the framework of analysis presented above, a government-sponsored subsidy would have the unequivocal effect of increasing the probability of a firm's move to an investment location. Under the cases presented above, the view by investors is that a subsidy does not in itself reduce or compensate firms for locational risk, but does increase the risk premium for investors, i.e. a subsidy is not seen as a positive factor in a firm's cost structure or the "riskiness of a foreign location" decision making. However, this does not necessarily imply that a subsidy is independent of the firm's profit-maximising level of output.

Notes

As an incentive to FDI, a host government can tailor subsidies to reflect the relative importance of the cost or risk factor in a firm's decision to locate in the host country. Krueger indicates that the objective of this type of investment is generally rooted in the desire of a country to increase employment and output, to encourage certain kinds of activities, to promote regional development within the host country, to improve the balance of payments and to alleviate the scarcity of hard currency. Tyler argues that although such policies do not necessarily imply investment in import-displacing industries, this in fact has been the most common practice in the past.

Government-initiated investment, despite its benefits, inevitably creates a high degree of interdependence between the investor and the host-country government, and an uncertain environment for both parties. Home-country government may also be drawn into the arrangements directly or indirectly. Given that the success of the incentive depends largely on the continuation of the host country's subsidies in various forms, the investor loses much of his bargaining power once the investment is committed. The investor is therefore likely to demand excessively favourable terms at the outset as a condition for making the investment to compensate for the possible erosion of these terms once a commitment is made. The host government for its part tends to be excessively generous in the first instance in the hope of being able to change the terms of its support once investments have been committed. On this basis, the stage is set for relatively difficult relationships to develop between investors and governments. Owing to their interdependence and in order to minimise conflict, investment of this kind tends to give greater emphasis to joint ventures, minority interests for foreign investors and other conditional forms of FDI.

10.2 Issues of FDI

In 2006, the proposed acquisitions of major operations in six major U.S. ports by Dubai Ports World (DP World) and of Unocal by the China National Offshore Oil Corporation (CNOOC) sparked intense concerns among some Members of Congress and generated a debate over what role foreign investment, particularly foreign acquisitions of certain types of firms, plays in U.S. national security. The United States actively promotes the national treatment of foreign investors as an international standard. This open-door policy stands in marked contrast to several provisions of law, various Executive Orders, and extensive efforts aimed at limiting foreign access to the Nation's industrial base, especially in sectors deemed to be critical to the economy or to areas of importance to national security. In addition, some Members of Congress and others are concerned about the extent to which foreign government-owned companies should be allowed access to the Nation's industrial base and technology through foreign direct investment.

This dual role means that globalization, or the spread of economic activity by firms across national borders, has become a prominent feature of the U.S. economy and that through direct investment the U.S. economy has become highly enmeshed with the broader global economy. Foreigners invested $180 billion in U.S. businesses and real estate in 2006 and invested $277 billion in 2007, according to data published by the Department of Commerce, as **Figure 27.1** shows. The rise in the value of foreign direct investment includes an upward valuation adjustment of existing investments. According to the United Nation's *World Investment Report,* global foreign direct investment flows increased by 38% in 2006, 29% in 2005, and 27% in 2004, after three years of declining flows.

Did u know? The United States is unique in that it is the largest foreign direct investor in the world and also the largest recipient of foreign direct investment.

New spending by U.S. firms on businesses and real estate abroad, or U.S. direct investment abroad, rose sharply in 2006 to $235 billion up from the $8 billion net in 2005. New investments in 2007 likely exceeded $330 billion, according to balance of payments data published by the Department of

Notes

Commerce. The drop in U.S. direct investment abroad in 2005 reflects actions by U.S. parent firms to reduce the amount of reinvested earnings going to their foreign affiliates for distribution to the U.S. parent firms in order to take advantage of one-time tax provisions in the American Jobs Creation Act of 2004.

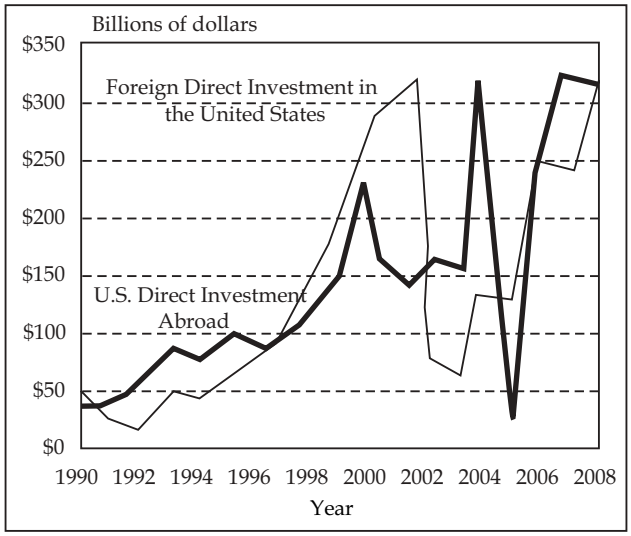


Figure 10.1: Foreign Direct Investment in the United States and the U.S. Direct Investment Abroad, Annual Flows, 1990-2008

Source : CRS from U.S. Department of Commerce data

Notes

The drop in U.S. direct investment abroad in 2005 reflects actions by U.S. parent companies to take advantage of a one-time provision.

The cumulative amount, or stock, of foreign direct investment in the United States on a historical cost basis increased by $195 billion in 2006 to about $1.8 trillion. This marks an 8% increase over the previous year and a significant change from the decline in foreign investment spending that has occurred since 2000. The rise in the value of foreign direct investment includes an upward valuation adjustment of existing investments and increased investment spending that was driven by the relatively stronger growth rate of the U.S. economy, the world-wide resurgence in cross-border merger and acquisition activity, and investment in the U.S. manufacturing, information and depository institutions as overseas banks and finance and insurance companies sought access to the profitable U.S. financial market.

U.S. Policy toward Direct Investment

With some exceptions for national security, the United States has long been considered one of the most receptive economies in the world to foreign direct investment. Indeed, over the past 50 years, the United States has led efforts to negotiate internationally for reduced restrictions on foreign direct investment, for greater controls over incentives offered to foreign investors, and for equal treatment under law of foreign and domestic investors. In 1977, the Carter Administration issued a policy statement on foreign direct investment that can be summarized by the neutrality clause : the United States will neither encourage nor discourage the inflow or outflow of international investment. The policy statement also indicated that

Notes

> international investment will generally result in the most efficient allocation of economic resources if it is allowed to flow according to market forces; there is no basis for concluding that a general policy of actively promoting or discouraging international investment would further the U. S. national interest; unilateral U. S. Government intervention in the international investment process could prompt counteractions by other governments with adverse effects on the U. S. economy and U. S. foreign policy; and the United States has an important interest in seeking to assure that established investors receive equitable and non-discriminatory treatment from host governments.

This statement is based on an assessment that the free flow of international investment generally will result in the most efficient allocation of economic resources if it is allowed to flow according to market forces. During the Reagan Administration, the neutrality statement was clarified to include three related objectives. These objectives include the liberalization of barriers and the reduction of distortions to international investments abroad, the encouragement of a greater role for private foreign investment in the economic development of less developed countries (LDCs), and the maintenance of the maximum degree of openness of the U.S. economy to the contribution of foreign direct investment.

The Clinton Administration's policy toward inward and outward direct investment can best be characterized by its support for the Multilateral Agreement on Investment (MAI). The Agreement was expected to be a comprehensive international agreement on foreign investment among the most economically developed countries in the world, as represented by the Organization for Economic Cooperation and Development (OECD). In addition, the Agreement was intended to address various issues, including formal barriers to direct investment, discriminatory treatment, dispute settlement mechanisms, and legal and regulatory uncertainties abroad, that hamper the flow of investment funds. Ultimately, a range of unresolved issues among the OECD Ministers combined with concerns by some groups in the United States to undermine support for the Agreement. In particular, some groups were concerned that the requirement for "national treatment" in the Agreement could have created legal problems for state and local governments that enforce environmental, labor, and other corporate practices that could have been considered discriminatory.

Did u know? On May 10, 2007, President Bush released his policy statement on open economies.

The statement offered strong support for the international flow of direct investment. In part, the statement reads:

> A free and open international investment regime is vital for a stable and growing economy, both here at home and throughout the world. The threat of global terrorism and other national security challenges have caused the United States and other countries to focus more intently on the national security dimensions of foreign investment. While my Administration will continue to take every necessary step to protect national security, my Administration recognizes that our prosperity and security are founded on our country's openness.
>
> As both the world's largest investor and the world's largest recipient of investment, the United States has a key stake in promoting an open investment regime. The United States unequivocally supports international investment in this country and is equally committed to securing fair, equitable, and nondiscriminatory treatment for U.S. investors abroad. Both inbound and outbound investment benefit our country by stimulating growth, creating jobs, enhancing productivity, and fostering competitiveness that allows our companies and their workers to prosper at home and in international markets. My Administration is committed to ensuring that the United States continues to be the most attractive place in the world to invest. I urge other nations to join us in supporting an open investment policy and protecting international investments.

Notes

In addition to this statement of general support, the Bush Administration issued a policy statement that commits the Administration to four objectives :

- Reinforce the principle that a domestic climate conducive to foreign investment strengthens national security. Meeting the challenges of a post-9/11 world need not require securing one at the expense of the other. The United States recognizes that growing inflows of foreign investment are necessary to expand levels of employment, innovation, and competitiveness in this country. Only those safeguards that are clearly necessary to protect our national security should be maintained.
- Actively target unreasonable and discriminatory barriers to investment. The United States encourages a broad acceptance of the national-treatment principle in all countries and places a premium on the protection of U.S. investments abroad. The United States opposes measures that distort international investment flows, including trade-related or other performance requirements, discriminatory treatment of foreign investment, and expropriation without compensation. In turn, when countries promise to protect investment and eliminate such distortions, investors must have the ability to enforce those binding promises in neutral international settings that are free from the political intervention of governments. Further, countries need to be responsive to the needs of investors for access to innovative cross-border financial services. The United States will continue to allow foreign investors open and fair access to investment opportunities under our statutes and regulations and in accordance with international law, and will continue to welcome investment through programs such as the Invest in America initiative.
- Work with our partners in the WTO to strengthen the rules-based trading system so that it continues to promote open markets, trade reform and new opportunities for development and growth. My Administration is committed to completing the Doha Development Round with an agreement that opens markets for goods and services, ensures reform of agriculture and strengthens WTO rules, including in key areas such as trade facilitation. The predictability, certainty, and transparency of the system enhance opportunities for international investment by building investor confidence.
- Promote an international environment in which international investment can make the greatest contribution to the development process. The United States has initiated the Millennium Challenge Account, which assists developing countries that create and maintain sound policy environments, including governing justly, investing in people, and encouraging economic freedoms. Through our bilateral and multilateral economic assistance programs, the United States will continue to explore ways to increase both public and private capital flows and support international investment in the developing world. As countries continue to adopt free market principles and democratic reforms, international investment is necessary to nurture market-oriented development and reduce debt service burdens. Economic freedom is one of the single greatest antidotes to poverty worldwide, and a positive link exists between the liberalization of investment flows and greater international trade.

Foreign Direct Investment in the U.S. Economy

Foreigners invest in the U.S. economy in a number of ways and for a number of reasons. These investments can be divided roughly into two broad categories, portfolio investments, or investments in corporate stocks and bonds and U.S. government securities, and direct investment, or investments in U.S. businesses and real estate. In 2008, foreigners invested over $2.0 trillion dollars in the U.S. economy, $320 billion of which was in direct investment, with the rest of the funds invested in the broader category of portfolio investment. Typically, the Department of the Treasury tracks portfolio investments since a substantial part of these investments is in U.S. Treasury securities. The Treasury Department has shared responsibilities for tracking direct investment with the Department of Commerce, because the Commerce Department's Bureau of Economic Analysis conducts surveys of

Notes

direct investment that provide the basic data on such investments. The Treasury Department, however, takes the lead in negotiating international agreements on the treatment of direct investment and it chairs the inter-agency Committee on Foreign Investment in the United States, which represents the President as the chief federal government organization responsible for overseeing the national security implications of foreign investment in the economy.

The United States is widely recognized as the premier location for foreign firms to invest, as evidenced by the data in Table 1. According to the United Nation's *World Investment Report*, the United States had received a cumulative amount of $3.1 trillion in foreign direct investment by year-end 2008, more than double the $1.5 trillion invested in the United Kingdom, the next single largest host to foreign direct investment, and it accounted for nearly 20% of the total cumulative amount of foreign direct investment among all nations. The United States is also the largest foreign investor in the world, with over $2.3 trillion invested abroad. According to the U.N. report, of the $12.5 trillion in the total cumulative amount of foreign direct investment among all nations, the most economically advanced developed economies were host to 70% of this amount. From 1980 to 1990, this share increased sharply from 56% of total amount of foreign direct investment to 79%. From 1990 to 1995, the developed country share fell slightly to about 70%, where it has stayed relatively stable over the past decade.

Table 1 : Foreign Direct Investment Inward Position

(in billions of U.S. dollars)

	1985	1990	1995	2000	2006	2008
World	$972.2	$1,789.3	$2,992.1	$5,810.1	$11,998.8	$16,205.7
Developed Economies	569.7	1,416.9	2,035.8	4,031.3	8,453.8	13,623.6
Western Europe	285.0	815.2	1,213.0	2,293.8	5,717.2	8,997.4
European Union	267.1	768.2	1,136.0	2,180.7	5,434.3	8,086.8
France	36.7	86.8	191.4	259.8	782.8	1,397.0
Germany	36.9	111.2	192.9	271.6	502.4	1,450.9
United Kingdom	64.0	203.9	199.8	438.6	1,135.3	1,510.6
United States	184.6	394.9	535.5	1,256.9	1,789.1	3,162.0
Canada	64.7	112.8	123.3	212.7	385.2	520.4
Developing Economies	402.5	370.3	916.7	1,707.6	3,155.9	2,356.6
Africa	33.8	58.4	77.3	153.2	315.1	98.0
Latin America	80.1	118.1	200.1	481.0	908.6	561.4
Asia	288.5	380.2	636.5	1,073.4	1,932.2	1,697.3

Source : *World Investment Report*, United Nations Council on Trade and Development, various issues.

The Costs and Benefits of Foreign Direct Investment

Generally, economists conclude that direct investment benefits both the home and the host country and that the benefits of such investment outweigh the costs. Some groups within the U.S. economy, however, are concerned about the potentially negative effects of inward and outward direct investment. Most economists argue that free and unimpeded international flows of capital, such as direct investment, positively affect both the domestic (home) and foreign (host) economies. For the home

Notes

country, direct investment abroad benefits individual firms, because firms that invest abroad are better able to exploit their existing competitive advantages and are able to acquire additional skills and advantages. This tends to further enhance the competitive position of these firms both at home and abroad and shifts the composition and distribution of employment within the economy toward the most productive and efficient firms and away from the less productive firms.

Some observers argue that U.S. direct investment abroad supplants U.S. exports, jobs, and research and development funds, thereby reducing employment and wages in the U.S. economy. Others are concerned that outward direct investment alters the industrial composition of domestic production and trade flows, which can affect the sectoral and regional distribution of employment and the relative demand for skilled and unskilled labor. For the home country, overseas investment may lead some firms to shift parts of their production abroad, thereby supplanting some domestic production with imports from abroad, but most studies indicate that, on balance, direct investment abroad increases U.S. exports and helps sustain employment and wages at home. Intra-company trade is a relatively new feature of the U.S. economy, but can be expected to increase as the economy becomes even more globalized. In 2007, U.S. parent companies accounted for more than half of all U.S. exports and more than one-third of U.S. imports.

Furthermore, about half of the exports by U.S. parent companies was to their foreign affiliates. At the same time, the U.S. affiliates of foreign firms accounted for 20% of U.S. exports and 25% of U.S. imports.

Globally, a relatively small share of the production of U.S. foreign affiliates makes its way back into the U.S. economy. In 2007 the foreign affiliates of U.S. multinational firms exported about 10% of their production back to the United States, but two-thirds of their production was sold within the host country and the rest was exported to other foreign countries. Foreign direct investment also supports U.S. exports to areas where formal restrictions to exports exist. In addition, by expanding and supporting development in foreign markets, direct investment spurs improvements in foreign economies, which in turn, creates new markets for U.S. goods. Direct investment also seems to be associated with a strengthened competitive position, a higher level of skills of the employees, and higher incomes of firms that invest abroad.

As a host country, the United States benefits from inward direct investment because the investment adds permanently to the Nation's capital stock and skill set. Direct investment also brings technological advances, since firms that invest abroad generally possess advanced technology, processes, and other economic advantages. Such investment also boosts capital formation, contributes to a growth in a competitive business environment and to productivity. In addition, direct investment contributes to international trade and integration into the global trading community, since most firms that invest abroad are established multinational firms.

On the cost side, critics of foreign investment argue that some U.S. firms may invest abroad, and thereby shift some resources from activities within the United States, in order to take advantage of abundant natural resources, low-cost labor, or relaxed environmental and labor laws. Indeed, about one-third of U.S. direct investment abroad is in developing countries, where economic conditions are markedly different from those in the United States or in many parts of Europe. In some cases, firms that invest abroad may shift production from the United States to a foreign location from which it might export back to the United States products that it previously had produced in the United States, but this does not seem to be a major activity of the foreign affiliates of U.S. firms. Such offshoring of production, or globalization, has grown over the last decade as many developing economies have dropped formal restrictions on foreign investment, but much of this investment seems to be geared toward producing for the local market, or for exports to neighboring countries.

The data in Table 2 show the extent and influence of U. S. and foreign multinational firms in the U.S. economy. In 2007, the latest year for which comprehensive data are available, foreign firms had a total of nearly 11,000 affiliates operating in the United States. These affiliates were present in every State and in every economic activity, where such activity is not prohibited by law.

Notes

Table 2 : Select Data on U.S. Multinational Companies and on Foreign Firms Operating in the United States, 2007

(in millions of dollars unless otherwise indicated)

	U.S. Multinational Companies		U.S. Affiliates of Foreign Firms
	Parent Companies	Foreign affiliates	
Number of firms	2,270	26,342	10,941
Employment (thousands)	22,003.1	11,737.5	3,397.4
Employee compensation	$1,392,180	$475,595	$433,065
Gross product	$2,588,811	$1,117,585	$657,558
Total assets	$19,964,935	$14,201,291	$12,732,967
Sales	$8,614,733	$5,517,143	$3,553,593
Taxes	$257,292	$179,922	$57,731
R&D Expenditures	N.A.	$35,019	$44,158

Source : U.S. Direct Investment Abroad : Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2007 Estimates; and Foreign Direct Investment in the United States: Operations of U.S. Affiliates of Foreign Companies, Preliminary 2007 Estimates. Bureau of Economic Analysis, 2009.

Foreign firms employed 3.4 million U.S. workers and paid $433 billion in wages and compensation. In 2007, 40% of the foreign firms' employment was in the manufacturing sector, more than twice the share of manufacturing employment in the U.S. economy as a whole. By comparison. U.S. multinational companies employed over 22 million workers in the U.S. economy and the foreign affiliates of these U.S. parent companies employed nearly 12 million workers in nearly 30 thousand firms abroad. The foreign affiliates of U.S. firms had 60% more in the value of their gross product than the affiliates of foreign firms operating in the United States, had a greater value of assets, higher sales, and paid three times as much in taxes.

The affiliates of foreign firms spent $205 billion in the United States in 2007 on new plant and equipment, imported $550 billion in goods and services and exported $228 billion in goods and services. Since 1980, the total amount of foreign direct investment in the economy has increased eight-fold and nearly doubled as a share of U.S. gross domestic product (GDP) from 3.4% to 6.4%. It is important to note, however, that these data do not imply anything in particular about the role foreign direct investment has played in the rate of growth of U.S. GDP.

Foreign-owned establishments, on average, have far outperformed their U.S.-owned counterparts. Although foreign-owned firms account for less than 4% of all U.S. manufacturing establishments, they have had 14% more value added on average and 15% higher value of shipments than other manufacturers. The average plant size for foreign-owned firms is much larger—five times—than for U.S. firms, on average, in similar industries. This difference in plant size apparently rises from an absence of small plants among those that are foreign-owned. As a result of the larger plant scale and newer plant age, foreign-owned firms have paid wages on average that were 14% higher than all U.S. manufacturing firms, had 40% higher productivity per worker, and 50% greater output per worker than the average of comparable U.S.-owned manufacturing plants. Foreign-owned firms also display higher capital intensity in a larger number of industries than all U.S. establishments.

Differences between foreign-owned firms and all U.S. firms should be viewed with some caution. First, the two groups of firms are not strictly comparable : the group of foreign-owned firms comprises a subset of all foreign firms, which includes primarily very large firms; the group of U.S. firms includes all firms, spanning a broader range of sizes. Secondly, the differences reflect a range of additional factors, including the prospect that foreign firms which invest in the United States likely are large firms with proven technologies or techniques they have successfully transferred to the United States. Small foreign ventures, experimenting with unproven technologies, are unlikely to want the added

Notes

risk of investing overseas. Foreign investors also tend to opt for larger scale and higher capital-intensity plants than the average U.S. firm to offset the risks inherent in investing abroad and to generate higher profits to make it economical to manage an operation far removed from the parent firm.

Most economists conclude that foreign investment benefits the host economy because such investment adds permanently to the capital stock of the economy and increases the total amount of capital in the economy. While these conclusions seem generally to be true, they probably should be tempered somewhat relative to foreign direct investment in the United States. The data in Table 3 show the inflows and outflows of capital in the U.S. economy over the past eight years that are associated with direct investment. The data indicate that firms can raise funds in three different ways : they can borrow it from the parent company as an intercompany debt transfer; they can raise the funds in the domestic economy in the form of equity capital, or they can raise their funds internally from profits generated by the firm and used as reinvested earnings.

The data in Table 3 indicate that over the eight-year period 1999-2006, 8% of the funds foreign firms used to invest in U.S. businesses came from the foreign parent company in the form of intercompany debt. The rest of the funds foreign investors used to invest in U.S. businesses was raised in the United States, not imported from abroad. Equity capital raised in the U.S. capital markets accounted for 77% of the share of the funds foreign firms used to invest, with the rest, 15%, generated from the reinvested earnings of the foreign firms. In comparison, the overseas affiliates of U.S. parent firms raised the largest part of their funds—72%—from the reinvested earnings of the affiliates, partly reflecting the older, more mature nature of the investments. Of the rest of the funds, 42% was raised through the equity capital markets in the host country, and 6% was raised through intercompany debt.

Table 3 : U.S. Direct Investment Abroad and Foreign Direct Investment in the U.S. Economy, Annual Flows 1999-2006

(in billions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007	2008
U.S. Direct Investment Abroad								
Capital	$142.3	$154.5	$149.6	$316.2	$3.6	$244.9	$398.6	$332.0
Equity capital	60.9	42.7	35.5	133.2	61.9	49.0	174.9	90.2
Reinvested earnings	69.8	85.3	121.0	162.9	—10.3	217.3	238.9	251.5
Intercompany debt	11.6	26.5	— 6.6	20.0	—15.4	— 21.3	— 15.3	— 9.7
Foreign Direct Investment in the United States								
Capital	$167.0	$84.4	$63.7	$146.0	$112.6	$243.1	$275.7	$319.7
Equity capital	140.9	105.3	93.4	92.9	70.7	115.0	155.0	250.2
Reinvested earnings	— 33.9	1.6	14.5	49.5	41.7	69.1	49.4	54.6
Intercompany debt	60.0	— 22.6	— 44.0	3.5	0.2	59.0	71.0	15.0

Source : U.S. Department of Commerce.

Supporters of foreign direct investment also highlight the number of jobs created by foreign investment in the economy. In the case of foreign direct investment in the U.S. economy, however, the employment picture is somewhat unclear. While foreign direct investment on the whole does support and contribute to existing employment in the economy, the particular nature of the investment makes it difficult to

Notes

assess the full contribution of this investment to the overall employment picture. Foreign firms can invest in the U.S. economy in three ways : by adding to current investments; by establishing a new venture, termed, a "greenfield" investment; or by acquiring an existing U.S. business. The data in Table 4 exclude additions to employment that can be accounted for by on-going foreign-owned firms and focus on U.S. businesses that are acquired or are newly established by foreign investors.

The data in Table 4 also indicate that during the 1998-2008 period, acquisitions of existing U.S. firms accounted for nearly 90% of the assets of the businesses that were either newly established or acquired by foreign investors, 95% of the increases in employment, 92 % of the sales, and 91% of the investment outlays. As a result, employment associated with acquisitions of established U.S. firms accounts for a large part of the total number of employees of foreign firms that currently are operating in the United States. It is likely that such acquisitions help to sustain the level of employment of the acquired firms, but it is difficult to estimate how much new employment is added to the economy as a result of the extensive role foreign acquisitions play in the economy. It also is unclear what long-term impact these acquisitions are having on employment among the acquired firms. In some cases, foreign firms may use their acquisitions as a springboard to expand their operations and, therefore, their employment in the United States, in other circumstances, they may use an acquisition to consolidate or to streamline other operations, which may result in reducing their level of employment.

Table 4 : U.S. Businesses Acquired or Established by Foreign Investors

(in millions of dollars, unless otherwise indicated)

	U.S. business enterprises acquired					U.S. business enterprises established			
	Total assets	Total assets	Sales	Number of empl.	Investment outlays	Total Assets	Sales	Number of empl.	Investment outlays
1998	$274,349	$218,483	$147,434	603,385	$182,357	$55,866	$17,471	21,199	$32,899
1999	454,012	430,226	115,534	589,311	265,127	23,786	8,718	13,368	9,829
2000	482,021	463,142	153,525	748,952	322,703	18,879	7,204	21,068	12,926
2001	382,308	311,220	90,778	335,088	138,091	71,087	18,131	74,879	9,017
2002	105,516	92,800	51,945	211,679	43,442	12,716	3,735	6,808	11,077
2003	219,072	198,474	51,376	161,607	50,212	20,598	3,173	4,449	13,379
2004	308,638	252,481	60,592	199,227	72,738	56,127	6,744	12,366	13,481
2005	181,846	148,695	65,188	230,825	73,997	33,151	1,953	5,045	17,393
2006	356,541	343,454	78,395	214,660	148,604	13,086	868	686	16,999
2007	411,777	377,551	159,438	487,000	223,616	34,226	3,240	9,598	28,301
2008	895,733	872,291	176,657	364,469	242,798	23,443	6,284	4,036	17,564

Source : Anderson, Thomas, Foreign Direct Investment in the United States : New Investment in 2008. *Survey of Current Business*, June 2009.

As Table 5 shows, acquisition activity is not limited to foreign firms, but is a well-established feature of the overall business climate in the United States. In terms of the number of acquisitions that were completed, 1998 stands out as the most active year, with over 10,000 deals completed. As the U.S. economy posted strong economic growth through the later 1990s and into the early 2000s, such acquisition activity remained strong among all three groups : U.S. firms acquiring U.S. firms; foreign firms acquiring U.S. firms and U.S. firms acquiring foreign firms. On average over the 10-year period, nearly 8,000 acquisitions were completed each year among the three types of investments. The share of these transactions accounted for by foreign acquisitions of U.S. firms grew by 50% over the 1998-2007 period, rising from 8% of all acquisition transactions in 1998 to nearly 15% of all transactions in 2007. Merger and acquisition activity slowed markedly in 2008 and 2009 as the financial crisis and economic slowdown reduced corporate profits and substantially reduced access to financial resources.

Notes

Table 5 : U.S. and Foreign Acquisition Activity, 1997-2006

	Total Acquisitions		U.S. Acquisitions U.S. Companies		Foreign Acquisitions of U.S. Companies		U.S. Acquisitions of Foreign Companies	
Year	Number of Deals	$ Billions	Number of Deals	$ Billions	Number of Deals	$ Billions	Number of Deals	$ Billions
1997	8,479	$771.0	6,317	$606.3	775	$84.9	1,387	$80.3
1998	10,193	1,373.8	7,575	1,019.6	971	227.0	1,647	127.2
1999	9,173	1,422.9	6,449	1,005.1	1,148	264.0	1,576	153.8
2000	8,853	1,781.6	6,032	1,304.6	1,264	338.0	1,557	139.0
2001	6,296	1,155.8	4,269	838.3	923	204.3	1,104	113.2
2002	5,497	625.0	3,989	450.4	700	85.5	808	89.1
2003	6,169	525.5	4,539	352.8	750	82.0	880	90.7
2004	7,102	855.3	5,140	628.6	822	104.1	1,140	122.6
2005	7,600	996.9	5,463	733.9	977	112.7	1,160	150.3
2006	8,621	1,434.4	6,105	1,015.5	1,142	200.9	1,374	218.0
2007	9,167	1,737.8	6,343	1,151.0	1,343	321.2	1,481	265.5

Source : *Mergers & Acquisitions*, February 2007.

Another notable feature of the data is the way in which foreign acquisitions of U.S. firms and U.S. acquisitions of foreign firms seem to rise and fall in tandem. As the rate of U.S. economic growth slowed in the early 2000s, acquisition activity slowed not only in the United States, but for U.S. acquisitions abroad as well. Figure 2 and Figure 3 show the number of deals and the value of those deals for U.S. acquisitions of foreign firms and foreign acquisitions of U.S. firms, respectively. In both cases, the number of deals and the value of those deals dropped between 2000 and 2002 for both U.S. and foreign firms before activity rebounded after 2002. Such similarities in the acquisition activity of U.S. and foreign firms seem to be counter-intuitive in that those forces that draw U.S. firms to invest abroad should theoretically be separate from those factors that draw foreign firms to invest in the United States.

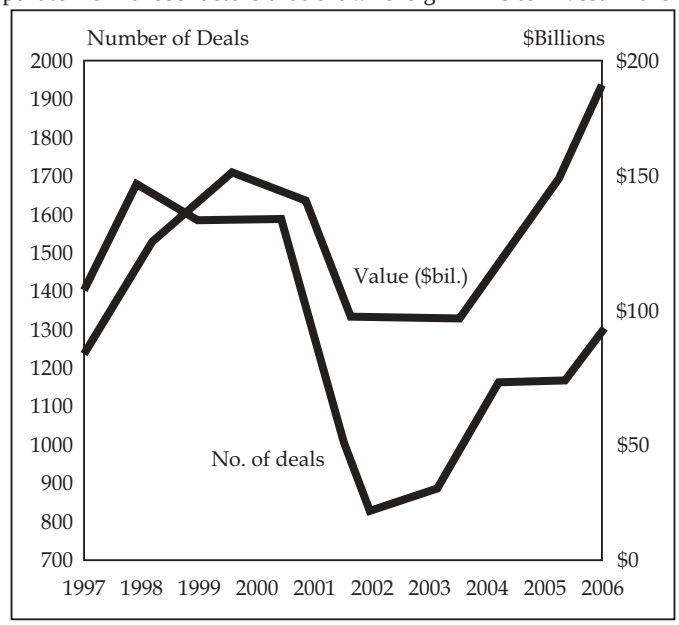


Figure 2 : U.S. Acquisitions of Foreign Companies

Source : *Mergers and Acquisitions*

Notes

In some respects, foreign investment in the United States and U.S. investment abroad should operate as substitutes, so that both U.S. and foreign firms would be expected to invest in the United States when the U.S. economic growth rate was strong relative to other advanced economies and both U.S. and foreign firms would be expected to invest elsewhere when the relative rate of U.S. economic growth was weak. Instead U.S. investment abroad is strong when foreign investment in the United States is strong and U.S. investment abroad is weak when foreign investment in the United States is weak. The two trends likely reflect the impact the US. economy has on the global economy and particularly on Western Europe, where much of the U.S. overseas investment and acquisition activity is concentrated. As a result, when the rate of economic growth in the United States is strong, foreign firms are drawn to invest in U.S. businesses. In addition, the stronger rate of economic growth in the United States enhances the profit position of U.S. firms which encourages them to increase their investments both at home and abroad as U.S. economic activity also boosts economic performance in Western Europe and among other developed economies that have become increasingly linked with the U.S. economy.

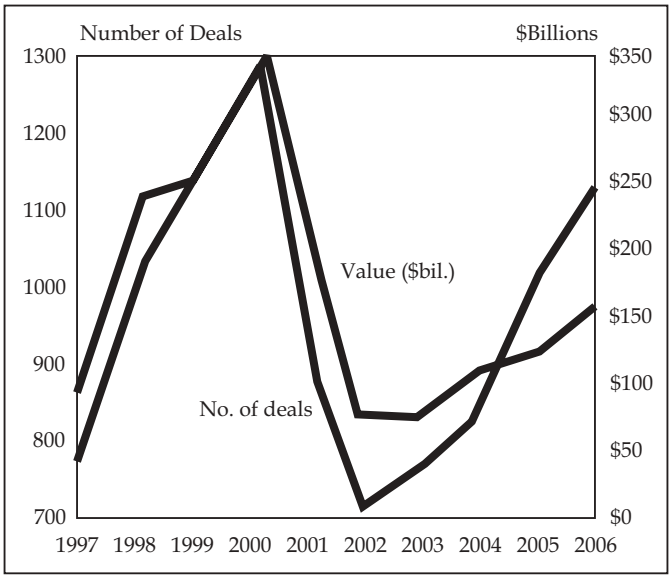


Figure 3 : Foreign Acquisitions of U.S. Companies

Source : *Mergers and Acquisitions*

Notes Who benefits from foreign investment?

Self -Assessment

1. Choose the correct options:

(*i*) Foreign direct investment:

I. Increases the domestic country's stock of capital and therefore can increase productivity

II. Can bring new technologies to poorer countries

III. Causes some of the income earned from the investment to exit the country that received the investment

(*a*) II and III only (*b*) I only

(*c*) II only (*d*) I, II, and III

(*e*) I and III only

Notes

(*ii*) Which of the following are viable methods by which industrially advanced countries (IACs) can help less-developed countries (LDCs) that are stuck in poverty?

I. Provide foreign economic aid through the Agency for International Development (AID)

II. Give loans through the International Monetary Fund (IMF) and other private banks

III. Take control of policymaking for the LDC's government

IV. Transfer workers from LDCs to IACs

(*a*) I and IV (*b*) I, II, and III

(*c*) IV only (*d*) I and II

(*e*) II and III

(*iii*) In addition to income per capita, what other measures are indicators of a country's standard of living?

(*a*) Infant mortality rate (*b*) All of these

(*c*) Illiteracy rate (*d*) Per capita energy consumption

10.3 Summary

- A host country's decision on which type of investment to pursue is made within a wide range of interests and a variety of complex objectives. Such decisions are necessarily characterised by considerable uncertainty and risk as each type of FDI comes with its own benefits and drawbacks although the net result appears to be that FDI does have a positive effect on an economy's growth and development.
- Five different types of FDI were discussed, namely : export oriented, market development, government initiated, greenfield, and mergers and acquisitions. Distinguishing government-initiated investment projects from other types of investment projects is difficult and necessarily imprecise because virtually all foreign investment projects in less-developed countries (LDCs), including export-oriented and market-development projects, receive government encouragement through subsidies in one form or another. However, the distinction becomes difficult to draw when other forms of FDI are supplemented with other government investment incentives. The distinction between export-oriented investments and those oriented to local sales (i.e. market development) is more firmly based than that between market-development and government-initiated investment. Thus the distinction between these types of investments is more hazy and difficult to interpret. The differences in the origin and determinants of these two types of investment suggest that the distinction is of some value even though the statistical differences between these two categories are open to greater question and must be interpreted with considerably more caution than the difference between export- and locally oriented projects.
- The UNCTAD report concludes that it is difficult to distinguish between the impact of greenfield and acquisition types of FDI on a host country. UNCTAD also observes that there are broader policy concerns regarding the weakening of the national enterprise sector, loss of control over the direction of economic development, and the pursuit of social, cultural and political goals resulting from the activities of MNEs. The basic question here is what role foreign firms should play in an economy, regardless of whether they enter through greenfield investment or cross-border M&As. In light of potential host-country consideration of the need for a specific type of FDI, Wei states that : Each country needs to make its own judgement in the light of its conditions and needs and in the framework of its broader development objectives. It also needs to be aware of - and to assess-the trade-offs involved, whether related to efficiency, output growth, the distribution of income, access to markets or various non-economic objectives.
- With this in mind, the focus of the study in the next chapter will be on the effects of FDI on an economy.

Notes

10.4 Key-Words

1. Access Policy : Policies that govern the use of IMF resources by its members, including access limits set in terms of members' quotas. The access policy, including annual and cumulative limits, under the credit tranches and the Extended Fund Facility (EFF) are reviewed each year. Access under other facilities also is reviewed periodically. Access under the Supplemental Reserve Facility (SRF) and the Contingent Credit Line (CCL) are not subject to limits in relation to quotas.
2. Interest Rate : The fixed charge or return, usually expressed on an annual basis, on a financial asset expressed as a percentage of the price of the asset.

10.5 Review Questions

1. What is foreign direct investment and the rules & regulation in India related fdi
2. What does FDI stand for ? Why do mncs opt for fdi to enter international market ?
3. Did India slip from 8th to 14th on the global FDI chart ?
4. Why is international investment important?

Answers: Self-Assessment

1. (*i*) (*d*) (*ii*) (*d*) (*iii*) (*b*)

10.6 Further Readings

1. Krimawati, Wawat. (?) NAFTA: North America Free Trade Agreement. [Accessed 18 May 2009]
2. Vogel, David. (2009) North American Free Trade Agreement. [Accessed 18 May 2009] 2009. North American Free Trade Agreement (NAFTA).
3. United States Department of Agriculture, Foreign Agricultural Service. [Accessed June 8, 2009]

Notes

Unit 11 : International Debt Crisis

CONTENTS

Objectives
Introduction
11.1 Evolution and Size of the Problem
11.2 The External Indebtness of Developing Countries
11.3 Ability of LDCs to Meet Debt Service Obligations
11.4 Summary
11.5 Key-Words
11.6 Review Questions
11.7 Further Readings

Objectives

After reading this Unit students will be able to:

- Know the Evolution and Size of the Problem.
- Explain the External Indebtness of Developing Countries.
- Describe the Ability of LDCs to Meet Debt Service Obligations.

Introduction

Until the summer of 1982, the external debt problems of Eastern bloc and less developed countries (LDCs) were regarded as benign, or were ignored, by nearly all international financial and economic analysts and policy makers. Now, most observers share the conviction that these problems pose a current threat to the free world's financial and economic health and stability and must be dealt with quickly and forcefully. This study focuses on the present crisis. Longer term issues raised by the external indebtedness of Eastern bloc nations and LDCs will be dealt with in later studies.

By all accounts, the external debts of Eastern bloc nations and LDCs are enormous. Government officials, financiers, economists, and the news media are urging that these countries be given help to cope. In opening hearings on "International Financial Markets and Related Problems" before the Committee on Banking, Finance, and Urban Affairs of the House of Representatives on 21 December 1982, Chairman St. Germain referred to this call for help as the "conventional wisdom." He said, "These hearings . . . come against a backdrop of news reports about impending requests for an enormous new funding of the International Monetary Fund. The conventional wisdom suggests that the Congress should quickly and quietly vote the new funds, accept the Administration's and the Federal Reserve's rationale, and ask questions later—if at all." But, should the United States help these countries ? If so, how ? These are the current policy questions. My purpose is to clarify the issues involved and to provide guidance to the public and to policy makers who must resolve them.

From 1973 to 1982, Eastern bloc nations and LDCs and their residents greatly increased their borrowings from lenders in the United States and other developed free world countries. Few worried as the external debts of these countries and their residents mounted. Now, however, their debts are viewed ominously. They are regarded as serious threats to world trade, political moderation in LDCs, and to the financial and economic health and stability of the United States and other developed free world nations.

Concern is growing over whether some Eastern bloc nations and LDCs will be able to service their debts. Defaults have been avoided to date only because the United States and other developed free world countries and the Bank for International Settlements (BIS) have provided emergency "bridge"

Notes

loans, private creditors have postponed scheduled loan repayments and extended new credits, and the International Monetary Fund (IMF) has granted timely longer-term loans.

Some analysts worry that smaller banks, which have gone along until now with postponing scheduled loan repayments and extending new credits, will soon balk, especially at extending new credits. In part, smaller banks do not want to assume additional risks. In addition, their access to dollar deposits, especially in the Eurodeposit market, has been constrained in recent months by depositors' "flight to quality." Thus, even smaller banks that want to participate in extending new credits to debtor nations and their residents are finding it difficult at the present time. This increases the pressure on large banks, and some of them are thought to be growing nervous about increasing their exposure to defaults by Eastern bloc nations and LDCs.

To some observers, the United States is caught in dangerous waters where, like the straits between Scylla and Charybdis, avoiding one disaster leads to another. If defaults and political change were the only dangers, we could steer a course between the two. But, in setting our policy course, it would be a mistake to assume that these are the *only or even the greatest dangers we face*. The greater peril may lie in the side effects of policies adopted to help debtor nations cope.

The remaining sections of this study examine the evolution and dimensions of the external debt problem confronting the Eastern bloc nations and LDCs; the logic of the popular worst-case scenarios and the more likely sequence of events; and solutions to the current Eastern bloc and LDC debt crisis.

11.1 Evolution and Size of the Problem

How Did It Happen ?

The external debts of non-OPEC developing countries grew only moderately before the quadrupling of oil prices in late 1973 and early 1974. At the end of 1973, their medium-and long-term indebtedness was about $100 billion.[1]After 1973, as Chairman Willard C. Butcher of the Chase Manhattan Bank observed, "the pace of lending accelerated with the world's major banks playing the leading role." By the end of 1982, non-OPEC developing countries' medium-and long-term indebtedness was $520 billion.

The 1973 and 1974 increases in oil prices provided both financial resources and motive for a jump in external borrowing by non-OPEC developing countries. The increases in oil prices generated huge current account surpluses for OPEC members. Every year, billions of dollars were transferred to OPEC members from oil importing nations. The aggregate current account surplus of OPEC member nations rose from only $7 billion in 1973 to $68 billion in 1974.

In the mid-1970s, while planning what to import, Saudi Arabia and other OPEC members used their new surpluses to purchase deposits from free-world banks, thereby providing financial resources for expanded bank lending to non-OPEC developing countries. At the same time, higher oil prices caused non-OPEC developing countries greatly to increase their credit demands. Non-oil producing countries had to do so in order to finance the huge current account deficits they experienced as they sought to maintain physical oil imports at pre-1973 levels and to continue to provide for growth through capital imports. Oil producing countries outside OPEC, such as Mexico, did so in order to develop their oil resources and to provide for growth in other sectors of their economies.

The match was obvious. In the mid-1970s, banks recycled OPEC's surpluses to non-OPEC developing nations. If banks had not matched the new petro-deposits to the new credit demands of non-OPEC developing nations, if they had loaned the funds to other entities instead, some of these other entities or those to whom the funds were transferred, further down the line, would have done the recycling. Where arbitrage opportunities exist, there are certain to be arbitragers.

1 Estimates of indebtedness usually exclude short-term debt; that is, debt with an original maturity of less than one year. However, the magnitude of the problem is reasonably accurately measured by medium- and long-term debt alone because the short-term foreign financial liabilities of non-OPEC developing countries are not significantly larger than their short-term foreign financial assets.

Notes

By 1978, the OPEC current account surpluses virtually disappeared as OPEC nations more closely matched imports to exports. They quickly reappeared as a result of the effects of the Iranian revolution on oil prices in 1979 and 1980. However, by 1982, they had dwindled once again.

The credit appetites of non-OPEC developing nations did not decline as the current account surpluses of OPEC members fell in 1978 and again after 1980. As David P. Dod of the Federal Reserve Board's Division of International Finance pointed out (*Federal Reserve Bulletin*, September 1981) : "An increase in public-sector and private borrowing combined has been necessary in view of economic policies in developing countries that have contributed to higher, sustained deficits in the current account of their balance of payments." The underlying policies were extremely rapid money growth and huge budget deficits continuing year after year. These policies produced inflation. With exchange rates fixed or at least sticky, inflation reduced exports and increased imports, and thus acted to increase current account deficits.

Non-OPEC developing countries had to borrow to finance their current account deficits or else abandon the policies that were perpetuating the deficits. Not all of them perpetuated inflationary policies. Some, especially in Asia, reduced money growth in the early 1980s. But some Latin American nations pursued inflationary policies throughout the late 1970s and early 1980s. These countries had to borrow.

Banks in the United States and other developed free world countries were eager to lend to Eastern bloc nations and LDCs in the late 1970s and early 1980s in part because they underestimated the risks, but also because lending opportunities in their own markets were squeezed. Their own market opportunities were squeezed because real wages increased unsustainably, especially in Western Europe. European trade unions were able to raise nominal wage rates faster than prices were rising. As a result, the demand for loans by businesses in Western Europe was dampened, and U.S. and other multinational banks limited their lending activities in Western Europe and expanded them in the United States and Eastern bloc nations and LDCs. And because the increased competition from multinational banks in U.S. markets left many primarily domestically oriented U.S. banks with fewer loan customers in the United States, many of these banks were impelled to begin or to step up their lending to Eastern bloc nations and LDCs.

Notes The ratio of wages to Gross Domestic Product in most major Western European countries increased substantially in the late 1970s.

The Organization for Economic Cooperation and Development (OECD), in its *External Debt of Developing Countries* 1982 *Survey* [*hereafter*, 1982 *Survey*], estimates that bank medium- and long-term loans to non-OPEC developing countries increased from $69 billion at year-end 1977 to $182 billion at year-end 1982, an increase of $113 billion. Other private lending to borrowers in these countries increased from $20 billion to $46 billion. These loans do not include credits to finance exports to these countries, which jumped from $45 billion to $105 billion during the same period.

Export credits aside, the new private credits to non-OPEC developing country borrowers were used to finance private business investments and government construction and development plans, including delivery of extended and upgraded education services. However, some of the new credits were used to finance increased consumption. Not all of the investments that were made with the new loans were sound, nor were all of the construction and development plans sensible. Further, parts of some loans were dissipated in corruption. By the second half of 1982, it was clear that there were problems.

Referring to the massive debt structure built up in recent years, Wall Street financial analyst Henry Kaufman said (*Washington Post*, 19 September 1982) : "It has financed . . . not a large amount of economic efficiency, but for a long while a large amount of inflation. But now we have it, it is there, it has a maturity schedule and it has an interest payment." A comprehensive analysis of what went wrong would not help us to clarify whether the United States should help debtor nations to cope, and, if so, how; nor would it provide guidance to the public and to policy makers, who must resolve

Notes

the issues. To most analysts, however, it is clear that lenders as well as borrowers are to blame for the abuses and excesses that occurred.

The OECD put it this way in its 1982 *Survey* : "It appears in retrospect that certain developing countries have borrowed unwisely (as indeed have some other borrowers), using some of the resources to finance consumption and investments of dubious value, rather than to strengthen their productive potential." They were able to do so because creditors, primarily banks, did not constrain their lending by adhering to normal prudent standards. Rather, "overeagerness by banks to lend has sometimes allowed borrowing governments to delay necessary adjustments."

Some would absolve banks from blame. They argue that banks would have been less eager to lend to developing countries if they had reliable, current information about the total indebtedness of the countries to whom they were lending. Through 1982, each bank had timely information only on its own loans. However, the argument is not persuasive. One large regional bank, the National Bank of Detroit, as reported by Sanford Rose of the *American Banker*, stopped lending to Mexico by the end of 1981 based on an in-house analysis of the risk involved. Furthermore, all banks should have understood the risk of operating without full information and tempered their eagerness to lend to developing countries accordingly. As it was, some banks made loans in excess of their capital to countries that are now having trouble meeting their debt-service obligations.

Regardless of how much blame should be assigned to borrowers and how much to lenders, by the summer of 1982 it was clear that some LDCs and Eastern bloc nations were having trouble servicing their debts, that their bankers were becoming concerned and reluctant to extend new credits and in some cases to renew maturing credits, and that some banks, including some in the United States, had made loans to these countries in excess of their capital, some-times in disregard of the advice of in-house specialists on sovereign risk. These elements define the current crisis.

Those who look for proximate causes will tie the emergence of the present debt crisis to the 1981 to 1982 disinflation and recession. During recessions, especially when accompanied by substantial disinflation (to build a springboard for sustainable growth), as in 1982, debts are not easily serviced by debtors, nor are they automatically renewed by lenders. This view of the emergence of the debt problem has been popularized by the press. The *New York Times*, for example, wrote on 9 January 1983, that "what has really gone wrong in the third world can be traced to the weak world economy rather than to an overextension of credit by greedy commercial bankers or extravagant borrowing by imprudent leaders of developing nations." The *Washington Post* wrote on the same day, "The recession has sent to the brink of bankruptcy countries once thought to be impeccable credit risks . . . [depressing] demand prices for commodities that are the mainstay of the developing world."

However, disinflation and recession in the 1981 to 1982 period did not occur in an historical vacuum but followed a wave of inflation that began in 1977. The debt crisis can be tied to that inflationary surge. Advocates of this view need not dispute that the debt build-up financed "a large amount of inflation," as Kaufman pointed out, or that initially the inflation was associated with robust growth figures. Early on, the chain of causation definitely runs from debt accumulation and money creation to inflation and growth. Later on, however, the chain of causation runs the other way—from inflation to debt accumulation and recession. Inflation undermines household, business, and government balance sheets. It creates an atmosphere in which debtors flourish and become eager to borrow, often without regard to risk, while lenders downgrade risks. As a result, careless practices creep into the lending process and indebtedness increases dangerously. At the same time, even if it is periodically ratcheted upward, inflation inevitably produces recessions. Since, as balance sheets deteriorate, production and spending fall, especially capital formation and investment spending.

The inflationary surge of the late 1970s to 1981 is legitimately viewed as the underlying cause of the present debt crisis. The 1981 to 1982 recession period was the trigger event. The recession suppressed demands for goods and services generally, and because commodity and raw materials markets are relatively competitive, commodity and raw materials prices declined relatively more than the prices of intermediate and finished goods. In fact, the latter continued to increase on average.

On balance, non-OPEC developing countries export commodities and raw materials and import intermediate and finished goods. Thus, the 1981 to 1982 recession raised their trade and current

Notes

account deficits. At the same time, at least until recently, high interest rates raised the costs of financing current account deficits and refinancing maturing debt. As a result, many non-OPEC developing countries have found it difficult—and sometimes impossible—to meet their debt service obligations.

High interest rates, which resulted primarily from the inflationary surge that preceded the 1981 to 1982 recession, had an even more devastating impact on the ability of some LDCs to meet their debt-service obligations. During the inflationary surge of the late 1970s, the interest rates at which Eastern bloc nations and LDCs borrowed were generally below the U.S. inflation rate. As a result, the real cost of carrying external debts was negative during this period. However, market interest rates rose dramatically in the 1979 to 1981 period, only recently have they dropped below 1979 levels. As short-term market interest rates rose, loan rates also rose both on new and maturing loans and on debt subject to variable or floating interest rates. In 1981 and the first half of 1982, the interest rates paid on debt subject to floating interest rates averaged substantially higher than the U.S. inflation rate. For nations with a large part of their debt consisting of floating-rate loans, the consequences were deadly.

The OECD 1982 *Survey* estimates that for Argentina, Brazil, Mexico, and their residents, "about three-quarters of their total [gross] debt was due to private markets at variable interest rates and without official support from OECD governments [compared with under 20 percent for most developing countries]." A 1 percentage point increase in the London Interbank Offered Rate (LIBOR) means an increase in yearly net interest payments, calculated on 1982 indebtedness, of $593 million for Mexico, $455 million for Brazil, and $205 million for Argentina. It is easy to see how higher interest rates in the 1981 to 1982 period greatly strained the abilities of these nations to meet their debt service obligations.

That will reduce the burden of their debts. But even though the bomb need not go off, and in my view won't, it might. The merchandise trade surpluses of developing nations will not increase automatically in future years. Investment income will not necessarily grow. Loan interest rates, which have fallen substantially since the spring and summer of 1981, might rise again. If the trade and investment accounts of developing nations do not improve, or if they worsen, and if interest rates rise again, then in the absence of generous loan reschedulings or heroic official aid, widespread, major formal defaults are inevitable. It is important, therefore, to understand how widespread, major debt repudiation would affect the U.S. banking and monetary systems and how it would affect U.S. exports, GNP, and employment. Whether we should help developing nations cope with their debts depends crucially on the analyses of these issues. Before analyzing these issues, however, it is useful to discuss the dimensions of the external debts of Eastern bloc and less developed countries, the exposure of U.S. banks, the abilities of individual countries where U.S. bank loans are concentrated to meet their debt service obligations, and whether our banks have enough capital to absorb defaults.

Did u know? The "debt-bomb" can be disarmed. Economic recovery is under way in the United States and other developed countries. That will increase developing countries' capacities to service their external debts. Interest rates are down.

11.2 The External Indebtedness of Developing Countries

How much do Eastern bloc nations and LDCs owe in total ? Hobart Rowan wrote (*Washington Post*, 19 October 1982) : "No one really knows." But he reported that "a high-level World Bank official said that if everything were known about the super-secret world of banking, the real global total would probably add up to something close to $750 billion." Official estimates are somewhat lower.

The World Bank estimates that at year-end 1981 the medium- and long-term debts of 98 developing countries totaled $462 billion. The International Monetary Fund estimates that the medium- and long-term external debts of non-oil developing countries totaled $437 billion at year-end 1981 and rose to $502 billion at year-end 1982. The OECD estimates that the outstanding disbursed medium- and long-term external debts of non-OPEC developing countries, including Eastern bloc nations, totaled $445 billion at year-end 1981 and increased to $520 billion at year-end 1982. Including members of OPEC, the medium- and long-term indebtedness of the world's developing countries is estimated to have been $530 billion at year-end 1981 and to have increased to $626 billion at year-end 1982.

Notes

Official estimates exclude short-term debt; that is, debt with an original maturity of less than one year. The 1982 gross short-term external indebtedness of developing countries exceeded $120 billion for non-OPEC developing countries and may have been as much as $175 billion for all developing countries. However, the short-term foreign assets of developing countries, including non-OPEC developing countries, are about the same as their short-term foreign debts. Thus, it is appropriate to ignore short-term debt in estimating the total external indebtedness of developing countries. In contrast, the medium- and long-term foreign assets of developing countries fall far short of their total external medium- and long-term debts.

The OECD data show that U.S. and other free world bank medium-and long-term loans other than export credits were $182 billion,[2] or 35 percent of the grand total, and that more than 20 percent of all loans were at "concessional" rates and terms. From an analytical standpoint, the importance of the first fact is that exposure of the free world's banking system to defaults by Eastern bloc nations and LDCs is much less than their total indebtedness; excluding export credits, it was $182 billion at year-end 1982. The importance of the second fact is that the burden of the external debts of developing countries cannot be gauged by looking only at the size of their debts.

The total medium- and long-term debt of Eastern bloc nations and LDCs and the bank subtotal are dramatic statistics, but they are not meaningful ones, since they differ depending on what nations are aggregated in estimating them, and the bank debt subtotal also depends on whether export credits are included. Moreover, the fact is that there is no aggregate Third World debt problem. Banks are exposed significantly in some developing countries and hardly at all in others. Further, different countries have different capacities to handle debt, and their capacities will be affected differently by the same event; for example, by a change in the price of oil or in interest rates. Debt, as the OECD points out, is "a phenomenon which manifests itself at the level of individual countries, rather than in aggregates and averages." *Country specific data on the exposure of U.S. banks* and the ability of LDCs to service their external debts are discussed in the sections that follow.

Exposure of U.S. Banks

In its *1982 Survey*, the OECD estimated that if all borrowers, sovereign and private, in all non-OPEC developing countries in Eastern Europe, Latin America, the Caribbean, Asia, and Africa repudiated their year-end 1982 external debts, U.S. and other free world banks would face balance sheet write-offs of $159 billion. The OECD, in its tabulation of data on "Lending and 'Exposure' of Banks to Non-OPEC Developing Countries," provided the following estimates of outstanding disbursed amounts at year-end 1982 :

Bank Credits and Exposure	$ Billion
1. Short-term credits	134
2. Medium- and long-term credit	231
A. Officially guaranteed export credits	49
B. Financial loans and credits	182
3. Total outstanding (1 + 2)	365
4. Deposits with BIS banks	157
5. Total net bank "exposure" (3 — 4)	208
6. Net bank "exposure" excluding guaranteed export credits (5 — 2A)	159

2 In testimony before the House Banking Committee on 2 February 1983, Federal Reserve Board Chairman Paul A. Volcker stated that non-OPEC developing countries owed banks here and abroad $268 billion and their total debt was $550 billion in mid-1982. However, the Federal Reserve's $268 billion subtotal includes certain export credits that are not included in the OECD's $182 billion subtotal. This accounts for the major part of the difference between the two figures.

Notes

The 1982 exposure of U.S. banks was less. Data from the Federal Reserve Board's June 1982 *Country Exposure Lending Survey* show that, as of June 1982, adjusted for guarantees, U.S. banks were owed $343.6 billion by foreign borrowers. However, $196.7 billion of this total was owed by borrowers in developed countries. With the exception of Spain, the risk of default by borrowers in developed countries is trivial. Borrowers in non-OPEC developing countries in Eastern Europe, Latin America, the Caribbean, Asia, and Africa owed $108.2 billion to U.S. banks at mid-year 1982. Of this amount, $69.6 billion was owed by borrowers in Latin American and Caribbean countries and $27.7 billion by borrowers in Asian countries.

The Federal Reserve Board data also show that the nine largest U.S. banks were owed $65.6 billion by borrowers in non-OPEC developing countries. The next fifteen largest banks were owed $21.7 billion, and all other banks were owed $21.1 billion by borrowers in these countries. Loans to borrowers in Eastern Europe, Latin America, the Caribbean, Asia, and Africa comprised 32 percent of all foreign loans made by the nine largest banks, 33 percent made by the next fifteen largest banks, and 29 percent made by all other banks.

Using the Federal Reserve Board's survey data, a country-by-country examination of U.S. banks' foreign loans show concentrations to borrowers in seven non-OPEC developing countries : Argentina, Brazil, Chile, and Mexico in Latin America, and Korea, the Philippines, and Taiwan in Asia. The exposure of U.S. banks to defaults by borrowers in these seven countries was $79.5 billion in mid-1982. Nearly 75 percent of all U.S. bank lending to non-OPEC developing nations was to these seven countries : $25.2 billion was to Mexico, $20.5 billion to Brazil, $8.8 billion to Argentina, $6.1 billion to Chile, $9.2 billion to South Korea, $5.3 billion to the Philippines, and $4.4 billion to Taiwan.

It appears, then, that among non-OPEC developing countries, U.S. banks would be highly exposed if Mexico and Brazil repudiated their debts, and exposed to a significant extent if South Korea, Argentina, Chile, the Philippines, and Taiwan defaulted. This is not to say that formal defaults by borrowers in other nations would not prove troublesome. Among OPEC nations, however, the exposure of U.S. banks *in June 1982 was significant (over $3 billion) only in Venezuela*, where U.S. banks were owed $10.7 billion. Among developed nations, exposure was substantial in all G-10 [Group of Ten] countries, plus Switzerland, Australia, Denmark, Norway, South Africa, and Spain. Of these countries, however, the risk of default is considered trivial except in the case of Spain, where it is considered low but nontrivial. U.S. banks were owed $6.7 billion by borrowers in Spain at midyear 1982.

11.3 Ability of LDCs to Meet Debt Service Obligations

The OECD *1982 Survey* estimates that debt service payments of developing countries on their medium- and long-term external debts reached $131 billion during 1982, with interest payments accounting *for $60 billion and amortization for $71 billion*. For non-OPEC developing countries, interest payments were $50 billion and amortization $49 billion. Debt service payments by these countries to banks totalled $48 billion.

The OECD data on medium- and long-term indebtedness show that in 1982,51 percent of the aggregate external debts of non-OPEC developing countries ($266 billion divided by $520 billion), 64 percent of their total debt-service payments ($63.3 billion divided by $93.8 billion), and 67 percent of their interest payments ($33.2 billion divided by $49.7 billion) was held and paid by borrowers in newly industrializing countries (NICs). NICs—the most advanced and developed LDCs—paid more interest relative to their indebtedness than other non-OPEC developing countries. The data also indicate *that both interest payments and total debt service (interest plus amortization)* were somewhat higher percentages of both exports and GNP for NICs than for low income countries (LICs), middle income countries (MICs), and OPEC members.

The ratios of interest payments and total debt service payments to exports and GNP for NICs as a group are not crisis numbers. For example, 15 percent of aggregate NIC export earnings and 3.3 percent of GNP would fully cover the interest payments on NIC medium-and long-term external debts. However, it is not the group totals and ratios that matter. As the OECD notes, "Especially within the group of the NICs, there are enormous differences in the debt-service ratios of individual countries."

Notes

Country specific data show that nearly 45 percent of the total $131 billion debt-service payments made by developing countries in 1982 were made by Mexico, Brazil, Argentina, Chile, Venezuela, South Korea, the Philippines, and Taiwan—the developing countries where the exposure of U.S. banks to debt repudiation is significant. Debt service payments by these countries, plus Spain, in 1982, and the amounts they owed to U.S. banks at midyear 1982 are given in Table 1. Spain is a developed country, but since some analysts consider the risk that it will default to be nontrivial, it is listed here.

Table 1

Debt Service Payments by Developing Countries
(Billions of Dollars)

Country	Estimated Debt Service Payments in 1982	Amount Owed U.S. Banks at Midyear 1982
Mexico	18.5	25.2
Brazil	15.2	20.5
Venezuela	7.8	10.7
Spain	5.7	6.6
Argentina	4.9	8.8
South Korea	4.8	9.2
Chile	3.3	6.1
Philippines	2.1	5.3
Taiwan	2.0[a]	4.4
Total	**64.3**	**96.8**

[a]A precise estimate for Taiwan is not available. The figure given is a maximum.

SOURCES : OECD and Federal Reserve Board.

Traditionally, the ability of a nation to service its medium- and long-term external debts is measured by comparing its total debt-service charges (interest plus amortization) to its exports and its GNP, taking into account its reserves. These data are available only with a lag, however. Data for 1981 and 1982 are now available (see Table 2), but they indicate only what was true, not what is now true.

Table 2

Estimated Medium- and Long-Term Debt Service Payments, Reserves, Exports, and GNP for Countries Where There Is a Nontrivial Chance of Default and U.S. Banks Are Significantly Exposed, 1981 and 1982

(Billions of Dollars)

Country	Debt Service Payments 1982	Reserves 1981	Exports 1982	GNP 1981	Ratio of Debt Service to	
					Exports	GNP
Mexico	18.5	4.2	26.3	230.7	.70	.080
Brazil	15.2	6.7	27.0[a]	274.2	.56	.063

Notes

Argentina	4.9	3.4	12.0	152.1[b]	.41	.024
Chile	3.3	3.3	6.1[a]	31.4	.54	.099
Venezuela	7.8	8.7	24.5[a]	67.0	.32	.090
South Korea	4.8	2.7	27.6[a]	63.4	.17	.063
Philippines	2.1	2.3	8.5[a]	39.7	.25	.040
Taiwan[c]	2.0	—	—	—	—	—
Spain	5.7	11.4	20.5[a]	—	.28	—

[a]1981.

[b]1980.

[c]Data are not available for Taiwan as it is not a member of the IMF.

SOURCES : World Bank, OECD, IMF.

Conditions now, early in 1983, are very different from what they were in 1981 and 1982; and they are almost certain to change as time passes. As conditions change, the debt-burden ratios change. In addition, traditional comparisons sometimes are distorted. For example, a financially strained country might shorten the maturity of its debt, reducing its payments to service its medium- and long-term debts. Thereby, its medium- and long-term debt-service ratios would be improved, even though its problems had worsened.

Because of the inevitability of change and the possibility of data distortions, the data for 1981 and 1982 must be used with utmost caution. With this caveat in mind, the data assembled in Table 2 show that the debt-service ratios of South Korea, the Philippines, and Spain were below or close to 1982 averages for all non-OPEC countries and that Venezuela's debt service to exports ratio was only moderately above the average. Further, Spain and Venezuela had large reserves at the end of 1981, although there are reports that they fell in 1982. In short, South Korea, the Philippines, Spain, and Venezuela were well able to service their debts in the 1981 to 1982 period, while Mexico, Brazil, Argentina, and Chile had difficulties. Brazil and Mexico were the most financially strained.

Economic conditions have changed in recent months. On the whole, it appears that it will be easier for all of the nations listed in Tables 1 and 2, excepting possibly Mexico and Venezuela, to service their debts in 1983 than it was in 1981 and 1982. First, it now seems clear that interest rates will be much lower, on average, in 1983 than in 1981 and 1982. As a result, all debtor nations will find it somewhat easier to service their debts in 1983 than in 1981 and 1982, especially nations with high proportions of their total debt in floating interest rate loans. A 1 percentage point decrease in LIBOR decreases Mexico's annual debt service payments by $593 million, Brazil's by $455 million, and Argentina's by $205 million. The calculations, which are based on 1982 indebtedness, assume constant spreads between floating loan rates and LIBOR. These are significant reductions. For Mexico, debt service payments are reduced by 3.2 percent for each percentage point reduction in loan rates; for Brazil, by 3 percent; and for Argentina, by 4.2 percent. LIBOR has fallen about 7 percentage points since mid-1982.[3] Even though spreads have increased some-what, it is clear that in 1983, Mexico, Brazil, and Argentina will find it much easier to service their external debts than they did in 1981 and 1982.

Second, we are likely to see lower oil prices in 1983. A fall in the price of oil will decrease Mexico's and Venezuela's export earnings, decreasing their ability to service their debts. At the same time, lower oil prices will increase the ability of the other seven nations to service their debts, since their expenditures on imports will decrease. Interest rates could also decline further, helping even Mexico and Venezuela meet their debt service charges, although perhaps not enough to offset the loss of export earnings. Finally, partly as a result of the fall in the world price of oil, a stronger recovery from the recession that has afflicted developed countries is now expected. For most nations, this too will enhance their ability to service their debts.

Notes

Based on conditions as they now appear (early 1983), only Mexico and possibly Venezuela among countries where U.S. bank loans are concentrated and there is a nontrivial chance of default will have difficulty meeting their debt service obligations in the foreseeable future. Even these countries have improved prospects compared to the 1981 to 1982 period in some respects.

Will Defaults Depress World Trade ?

World trade depends strategically on the continued availability of finance. As stated in OECD's *1982 Survey*, "In most DAC [Developed Assistance Committee] countries, a substantial part of bank credits to LDCs is related to export financing." The *Survey* estimates that export credits extended by the United States and other DAC countries to non-OPEC developing countries totaled more than $100 billion at year-end 1982. DAC export credits were 20 percent of the total medium- and long-term external indebtedness of non-OPEC developing countries. These credits define the rock-bottom estimate of the importance of finance to trade between developed and non-OPEC developing countries.[4] In a more fundamental sense, however, nearly all of the external credit provided to non-OPEC developing nations and their residents is used to finance imports, reflecting the consideration that current account deficits have to be financed by borrowing or direct investment. If the required financing is not forthcoming, imports are likely to have to be cut to close the gap.

Debt repudiation by some non-OPEC developing countries would decrease lending by current creditors to the countries that defaulted. Creditors as yet not involved in lending to these countries could become emboldened to start lending to them, since their slates would now be free and clear of burdensome loans. But it is unlikely that new creditors would fully take up the slack. Formal defaults also would reduce unguaranteed lending by private creditors in developed countries to solvent developing countries and their residents. Default risks might even be revised upwards for loans to developed countries and their residents, which would reduce lending to those borrowers. It is almost a certainty, then, that if there are widespread, major formal defaults, there will be less private unguaranteed finance to lubricate the engines of international trade.

To some extent, less finance would be needed because the current account deficits of nations in default would be reduced since they will not be paying interest. However, it seems unlikely that some shortfall in export finance will not emerge. Unless the gap is filled by guaranteed loans, official aid, multilateral assistance, or loans from CMEA countries (an improbable outcome), imports would have to be cut by most nations, especially developing nations. As a corollary, exporters would have to retrench, especially in developed countries.

Dr. Otto Emminger, former president of the German Federal Bank, told the Fifth Quadrangular Conference of the Center for Strategic Studies in September 1982 that

> a general move toward underlending would have on major effect. It would deprive a great number of developing countries of an essential source of balance-of-payments financing. . . . Last year the banks provided, on a net basis, $35 billion for the financing of developing countries. That is about one-half of the total net borrowing of these countries in this year. Now if there is too abrupt a cessation, or decline, in this lending, there may be a financing gap that cannot easily be filled by other institutions. And this might force a number of deficit countries to restrict their imports very sharply.

It is clear that the effects of formal debt repudiation on international financial flows and thereby on export and import industries through-out the free world would not be pleasant. But it is easy to overstate the case.[5] Another Great Depression can be ruled out.

Will Defaults Lead to Another Great Depression ?

Discussions of the debt problems of Eastern bloc nations and LDCs are haunted by the specter of the 1930s. If the problems are not solved, so the story goes, if some of the nations are compelled (or impelled) to repudiate their external debts, the end result will be another Great Depression, an economic contraction on the order of magnitude suffered in the 1930s.

Notes

How could this happen ? In the most popular nightmare scenario, the chain of causation leads from defaults to the collapse of the U.S. banking and monetary systems to the collapse of economic activity. But, as discussed earlier, this hypothesis assumes perverse actions by the bank regulators and irresponsible behavior by the monetary authorities.

The analytical road from defaults by LDCs to another Great Depression does not have to pass through the collapse of our banking and monetary systems. A very different chain of causation has been hypothesized. It passes through the collapse of international trade.

Time magazine, in its 10 January 1983, cover story "The Debt-Bomb Threat," reported :

> The nations that buy many of the industrialized world's goods are the same ones that have borrowed so heavily. Any economic contraction on their part would boomerang back in the form of less demand by them for imports. The resulting deepening recession, so the theory goes, would further hurt the poorer countries, and so on and on. Once started, the process would be difficult to stop. The development dreams of the third world would come to a halt, stock markets would tumble, unemployment would soar, and world economic conditions would rival those of the 1930s.

To demonstrate that a lot is at stake, *Time* noted that :

> More than 40 percent of U.S. exports of commodities and services and one American manufacturing job in 20 hinge on sales to developing countries.

There is an element of truth in *Time's* scenario, but its conclusion is much too dismal. No doubt economic contraction in LDCs would compel a very painful adjustment in the United States. It would not, however, lead to an unending downward spiral of economic activity. Trade with developing nations would not cease if some repudiated their external debts. Even if it did, the effects on U.S. production and employment and unemployment would be far from cataclysmic.

The figures presented by *Time* cannot be used as is in evaluating the magnitude of the effects decreased exports to the developing world would have on total U.S. output and employment. Stating that 40 percent of U.S. commodity and service exports and one out of every twenty manufacturing jobs "hinge on sales to developing countries" can be misleading.

First, the term "developing countries" is too broad. It includes OPEC members, countries that do not find it difficult to service their debts, and countries whose external debts are largely to international agencies and other official lenders, often at low concessional interest rates. On average, OPEC members are creditor nations, and it is difficult to believe that those non-OPEC countries that can service their debts or that receive loans at concessional rates will repudiate them. At most, trade with these countries will fall only marginally, even if there are widespread loan defaults by other developing nations.

Second, it is difficult to believe that trade with nations that repudiate their external debts will be reduced to zero. At least some trade-related financial arrangements will be continued. Some new ones, with creditors as yet not involved, could be started; the slates of debtor nations will be wiped clean by their defaults and thus it will be relatively less risky to lend to them now. Alternatively, nations that default can use the money they get from exporting to finance imports on a cash basis; they will no longer be paying interest. There also will be barter and so-called countertrade arrangements where exporters accept goods from cash-short countries that can be exchanged for dollars or for other goods.

Third, although one in twenty U.S. manufacturing jobs and 40 percent of U.S. exports may "hinge on sales to developing countries," today only one job in five in the United States is a manufacturing job and exports are only 12 percent of GNP. Thus, only one in every hundred jobs and 4.8 percent of GNP "hinge on sales to developing countries" (where $.01 = .05 \times .20$ and $.048 = .40 \times .12$).

Finally, it must be understood that in market economies contractions of some sectors are eventually compensated for by expansions of other sectors. If trade declines, some of the resources previously employed in export industries will relocate in industries that produce goods and services previously imported, or close substitutes for them. There is an equilibrating mechanism at work, even though it does not work instantly or painlessly.

Notes

Taking these several factors into consideration, the effects of the falloff in U.S. exports that could be expected to result from major and widespread debt repudiation by developing countries would not be large enough to create another 1930s depression. Given the state of the art, it is impossible to say by how much U.S. real GNP would fall and unemployment would rise in the event of widespread, major defaults; but, all things considered, the fall in GNP is unlikely to exceed 1.5 percent and the rise in unemployment is unlikely to exceed 0.5 percent. These estimates are set forth as benchmarks for putting the debt crisis in perspective and helping to evaluate proposed solutions. I make no claim about their accuracy other than that they do not appear unreasonable.

What is Likely to Happen ?

Even though permanent default is not in the long-run interests of debtor nations, their short-run interests might be served by debt repudiation. Former Secretary of State *Henry Kissinger* has warned (*Newsweek*, 24 January 1983) :

> Because the debtors can never escape their plight unless they receive additional credits, the comforting view has developed that no debtor country would dare default and wreck its creditworthiness. Unfortunately political leaders march to a different drummer than financial experts. They see the political interests of their country through the prism of their own survival. If pushed into a corner, a political leader may well seek to rally populist resentment against foreign "exploiters." This will surely occur if the so-called rescue operation concentrates primarily on the repayment of interest. A blow-up is certain sooner or later if debtor countries are asked to accept pro-longed austerity simply to protect the balance sheets of foreign banks.

William Ogden, vice president of the Chase Manhattan Bank, recognized—as did Kissinger—that if permanent defaults are to be avoided, debtors must be "economically capable of servicing debt over the long run [and] not so committed to ideological objectives as to give little if any weight to achieving reasonable long-run performance. . . ." He told the Manhattan Institute for Policy Research (22 October 1982) that if these conditions were satisfied,

> there is a *negligible* risk of permanent default or debt denial in sovereign lending because sovereign borrowers cannot cease to exist. Permanent default implies both a long-term loss of access to international private capital markets and a sharply reduced ability to utilize the international financial service network that is essential to the ordinary conduct of foreign trade. It implies that the great bulk of the international trade of a country in permanent default must be carried out on a government-to-government barter basis. Such restrictions would enormously circumscribe the pace of economic development for a country so affected. The negligible risk of permanent default arises out of the borrowing countries' perceptions of self-interest.

One need not agree with Ogden that nations that repudiate their debts will lose access to international private capital markets. By eliminating their debts to current creditors, these nations become A-l risks to new creditors. Nonetheless, his conclusion, that debtor nations would rather not default and will not do so unless "pushed into a corner," is reasonably assumed. Financially strained debtor nations will take measures that involve reasonable costs and risks to avoid default, particularly if their creditors will "work with them."

The risk of formal debt repudiations also depends on the behavior of creditors. Formal defaults are not in their best interests, so the threat of default is likely to trigger offers by creditors that debtors will find difficult to refuse, or suggestions by debtors that creditors will find agreeable. Specifically, creditors faced with impending defaults will offer to or agree to delay scheduled loan principal.

Notes

Self-Assessment

1. **Choose the correct options:**
   - (*i*) Which countries, besides Greece, have economies that are especially burdened by debt?
     - (*a*) Germany, Britain, and France
     - (*b*) Portugal, Spain, and Italy
     - (*c*) Bulgaria, the Czech Republic, and Slovakia
     - (*d*) Norway, Denmark, and the Netherlands
   - (*ii*) If Greece were to default on its debt,
     - (*a*) the Greek government would be unable to borrow money.
     - (*b*) other countries' economies could suffer as well.
     - (*c*) lenders that Greece owes money would not be paid back.
     - (*d*) All of the above.
   - (*iii*) The BEST meaning of "austerity measures" is
     - (*a*) periods of economic difficulty.
     - (*b*) legislation to prevent bankruptcy.
     - (*c*) Policies to cut government costs steeply.
     - (*d*) strict conditions on loans.
   - (*iv*) What is the eurozone?
     - (*a*) a common currency union of 16 European countries
     - (*b*) the area affected by the "contagion" of the Greek debt crisis
     - (*c*) an atmospheric layer above the continent of Europe
     - (*d*) another name for the European Union.
   - (*v*) What spurred the riots in Athens in October 2011?
     - (*a*) banks willingness to take a "haircut" on their Greek debt
     - (*b*) a government plan to drop the euro for the drachma
     - (*c*) austerity measures passed by the Greek parliament
     - (*d*) tax cuts imposed on wealthy Greek politicians.

11.4 Summary

- By all accounts, the external debts of Eastern bloc nations and LDCs are enormous. Government officials, financiers, economists, and the news media are urging that these countries be given help to cope. In opening hearings on “International Financial Markets and Related Problems” before the Committee on Banking, Finance, and Urban Affairs of the House of Representatives on 21 December 1982, Chairman St. Germain referred to this call for help as the “conventional wisdom.” He said, “These hearings . . . come against a backdrop of news reports about impending requests for an enormous new funding of the International Monetary Fund. The conventional wisdom suggests that the Congress should quickly and quietly vote the new funds, accept the Administration’s and the Federal Reserve’s rationale, and ask questions later—if at all.” But, should the United States help these countries ? If so, how ? These are the current policy questions. My purpose is to clarify the issues involved and to provide guidance to the public and to policy makers who must resolve them.
- To some observers, the United States is caught in dangerous waters where, like the straits between Scylla and Charybdis, avoiding one disaster leads to another. If defaults and political change were the only dangers, we could steer a course between the two. But, in setting our policy course, it would be a mistake to assume that these are the *only or even the greatest dangers we face*. The greater peril may lie in the side effects of policies adopted to help debtor nations cope.

Notes

- The external debts of non-OPEC developing countries grew only moderately before the quadrupling of oil prices in late 1973 and early 1974. At the end of 1973, their medium-and long-term indebtedness was about $100 billion. After 1973, as Chairman Willard C. Butcher of the Chase Manhattan Bank observed, "the pace of lending accelerated with the world's major banks playing the leading role." By the end of 1982, non-OPEC developing countries' medium- and long-term indebtedness was $520 billion.
- The credit appetites of non-OPEC developing nations did not decline as the current account surpluses of OPEC members fell in 1978 and again after 1980. As David P. Dod of the Federal Reserve Board's Division of International Finance pointed out (*Federal Reserve Bulletin*, September 1981) : "An increase in public-sector and private borrowing combined has been necessary in view of economic policies in developing countries that have contributed to higher, sustained deficits in the current account of their balance of payments." The underlying policies were extremely rapid money growth and huge budget deficits continuing year after year. These policies produced inflation. With exchange rates fixed or at least sticky, inflation reduced exports and increased imports, and thus acted to increase current account deficits.
- The OECD put it this way in its 1982 *Survey* : "It appears in retrospect that certain developing countries have borrowed unwisely (as indeed have some other borrowers), using some of the resources to finance consumption and investments of dubious value, rather than to strengthen their productive potential." They were able to do so because creditors, primarily banks, did not constrain their lending by adhering to normal prudent standards. Rather, "overeagerness by banks to lend has sometimes allowed borrowing governments to delay necessary adjustments."
- The OECD data show that U.S. and other free world bank medium-and long-term loans other than export credits were $182 billion, or 35 percent of the grand total, and that more than 20 percent of all loans were at "concessional" rates and terms. From an analytical standpoint, the importance of the first fact is that exposure of the free world's banking system to defaults by Eastern bloc nations and LDCs is much less than their total indebtedness; excluding export credits, it was $182 billion at year-end 1982. The importance of the second fact is that the burden of the external debts of developing countries cannot be gauged by looking only at the size of their debts.
- The OECD *1982 Survey* estimates that debt service payments of developing countries on their medium- and long-term external debts reached $131 billion during 1982, with interest payments accounting *for $60 billion and amortization for $71 billion*. For non-OPEC developing countries, interest payments were $50 billion and amortization $49 billion. Debt service payments by these countries to banks totalled $48 billion.
- World trade depends strategically on the continued availability of finance. As stated in OECD's *1982 Survey*, "In most DAC [Developed Assistance Committee] countries, a substantial part of bank credits to LDCs is related to export financing."

11.5 Key-Words

1. Credit appetite : The phrase 'risk appetite' is a buzz phrase in search of a single clear meaning. It means different things - often not very clearly - to different people, when they have any concept for it at all. Credit risk appetite is expressed both in terms of credit risk economic equity and in terms of the impact of credit risk on earnings volatility.

   Credit risk appetite is set by the board and is described and reported through a suite of metrics derived from a combination of accounting and credit portfolio model parameters which in turn use the various credit risk rating systems as inputs. These metrics are supplemented by a variety of policies, sector caps and limits to manage concentration risk at an acceptable level.

2. External Indebtedness : External debt (or foreign debt) is that part of the total debt in a country that is owed to creditors outside the country. The debtors can be the government, corporations or private households. The debt includes money owed to private commercial banks, other governments, or international financial institutions such as the International Monetary Fund (IMF) and World Bank. Note that the use of gross liability figures greatly distorts the ratio for countries which contain major money centers, e.g. United Kingdom, because of London's role as a major money centre. Contrast Net international investment position

11.6 Review Questions

1. How will defaults lead to another Great Depression?
2. Write a short note on the indebtedness of Developing Countries.
3. How do LDCs meet debt service obligations?

Answers: Self-Assessment

1. (*i*) (*b*) (*ii*) (*d*) (*iii*) (*c*) (*iv*) (*a*)

11.7 Further Readings

1. Krimawati, Wawat. (?) NAFTA: North America Free Trade Agreement. [Accessed 18 May 2009]
2. Vogel, David. (2009) North American Free Trade Agreement. [Accessed 18 May 2009] 2009. North American Free Trade Agreement (NAFTA).
3. United States Department of Agriculture, Foreign Agricultural Service. [Accessed June 8, 2009]

Notes

Unit 12 : Functions of WTO/GATT

CONTENTS

Objectives
Introduction
12.1 Impact of WTO on Various Aspects of Indian Economy
12.2 Geneva Framework of WTO and India
12.3 WTO
12.4 Uruguay Round Final Act and Its Implications for India
12.5 Social Clause in GATT
12.6 Summary
12.7 Key-Words
12.8 Review Questions
12.9 Further Readings

Objectives

After reading this Unit students will be able to:

- Discuss the Impact of WTO on Various Aspects of Indian Economy.
- Know Geneva Framework of WTO and India.
- Explain Uruguay Round Final Act and Its Implications for India.
- Describe Social Clause in GATT.

Introduction

The General Agreement on Tariff and Trade (GATT) was established in 1948 in Geneva to pursue the objective of free trade in order to encourage growth and development of all member countries. The principal purpose of GATT was to ensure competition in commodity trade through the removal or reduction of trade barriers. The first seven rounds of negotiations conducted under GATT were aimed at stimulating international trade through reduction in tariff barriers and also by reduction in non-tariff restrictions on imports imposed by member countries. GATT did provide a useful forum for discussion and negotiations on international trade issues.

The Uruguay Round of Negotiations—8th Round of GATT

The 8th round of Multi-lateral Trade Negotiations, popularly known as Uruguay Round (since it was launched at Punta del Este in Uruguay) was started in September 1986 at a special session of GATT Contracting Parties held at Ministerial level. World trade had undergone a structural change during the four decades since the establishment of GATT in 1948. The share of agriculture in world merchandise trade which was 46 percent in 1950 had declined to 13 percent in 1987. Simultaneously, the structure of employment and the contribution of various sectors to GDP of developed countries had undergone a qualitative change. The share of the service sector in the GDP of developed countries was rapidly increasing. It ranged between 50 to 70 per cent of the GDP by 1986. The share of employment in the service sector was also increasing. For instance, in USA, services represented two-thirds of GDP and employed over 70 per cent of work force. In 1980, US exports of services amounted to $ 35 billion. In the commodity sector, the comparative cost advantages had moved in favour of Japan and several other newly industrialised nations. These factors impelled developed countries, under the leadership of USA to take the initiative of bringing service sector into trade

Notes

negotiations.

Thus, the Uruguay Round (UR) contained the mandate to have negotiations in 15 areas. In Part I, negotiations on Trade in Goods were to be conducted in 14 areas and in Part II negotiations on Trade in services were to be carried out.

Part I (Trade in Goods) declaration in UR contained the following : (1) Tariffs, (2) Non-tariff measures, (3) Tropical products, (4) Natural resource-based products, (5) Textiles and clothing, (6) Agriculture, (7) GATT articles, (8) Safeguards, (9) MTN (Multilateral Trade Negotiations) agreements and arrangements, (10) Subsidies and countervailing measures, (11) Dispute settlement, (12) Trade Related Aspects of Intellectual Property Rights (TRIPs), (13) Trade Related Investment Measures (TRIMs) (14) Functioning of the GATT systems (FOGS).

Thus, besides the traditional GATT subjects such as tariff and non-tariff barriers and improvement in GATT rules and disciplines on subsidies and countervailing measures, anti-dumping measures etc., certain new areas such as Trade Related Aspects of Intellectual Property Rights (TRIPs), Trade Related Investment Measures (TRlMs) and Trade in Services were included for the first time for negotiations.

These negotiations were expected to be concluded in four years, but on account of differences in participating countries on certain critical areas, such as agriculture, textiles, TRIPs and anti-dumping measures, agreement could not be reached. To break this deadlock, Mr. Arthur Dunkel, Director General of GATT compiled a very detailed document, popularly known as Dunkel Proposals and presented it before the member-countries as a compromise document. The Dunkel Proposals culminated into the Final Act on December 15, 1993 and India signed the agreement along with 117 nations on April 15, 1994.

12.1 Impact of WTO on Various Aspects of Indian Economy

India, being a founder member of the WTO, has been following the WTO decisions, but as a consequence, certain effects on the Indian economy have become evident.

1. Effects on Indian Industry

WTO has been urging India to lower import duties, remove controls on consumer goods imports, reduce quantitative restrictions, etc. Under the Uruguay Round Agreement, India offered to reduce tariffs on capital goods, components, intermediate goods and industrial raw materials to 40% in case our tariffs were above that percentage; to 25% in case our tariffs were between 25 to 40 per cent and to bind the tariff ceiling at 25 per cent in case our tariffs were below that percentage. This reduction in tariffs was to be achieved by the year ending 2000.

Since India scrupulously followed the agreement, the tariffs have been reduced year after year to conform with the WTO provisions. As the protection afforded by import duties gradually disappeared, Indian industry had to face increasing competition from foreign goods. Confederation of Indian Industry (CII), the apex body expressed its disapproval against duty-free status of capital goods sector. As a result, CII estimated that indigenous capital goods industry on a conservative estimate lost orders worth ` 5,000 crores from foreign countries. Instead of ensuring level playing field, indigenous industry has to pay excise, sales tax, octroi, turnover tax while imported goods are allowed duty-free access to our market. Not only the entire manufacturing industry is faced with a crisis, even machine tools industry, gensets and boiler producers are put at a serious disadvantage. Consequently, imports of finished products are displacing indigenously produced products. As a result, many industrial units are being closed and cheap imports have become an important cause of recession in Indian industry.

India was maintaining quantitative restrictions in the form of quotas, import and export licences on 2,700 agricultural commodities, textile and industrial products. United States along with Australia, New Zealand, Switzerland, European Economic Community and Canada complained to the WTO Dispute Settlement Machinery that these QRS were inconsistent with WTO norms. The dispute settlement panel gave its verdict against India. India went in appeal, but the WTO panel on 23rd August 1999 rejected India's appeal against QRs.

As a result, although India could continue QRRs till March 2003, the process was hastened and

Notes

QRS on all items were removed. This has opened the floodgates for foreign consumer goods to enter the Indian market, thereby seriously damaging Indian industry.

Impact of import of Second Hand Cars in India : The Government of India allowed the import of second hand cars into India. This policy has seriously hit Indian automobile industry. Mr. Rahul Bajaj described this as "anti-national and anti-India Act". In fact, experience the world over has shown that wherever second hand imported cars are allowed, they seriously damage domestic industry. Japanese used cars virtually destroyed New Zealand car industry. Even Mr. Phil Spender, Managing Director, Ford India reacting to the policy of permitting used cars said: "If the government asks us what to do (about the used cars), I'll be the first to volunteer ways to keep used cars imports out of India". Even other CEOs of MNCs who have invested in the Indian automobile market expressed similar sentiments. Mr. Richard Swano, M.D. General Motors is of the opinion that the import tariff on used cars should be 100% and not 40-50 per cent.

Similarly, if India allowed the import of used machine tools, it is likely to have serious repercussions on capital equipment manufactures.

Import of Chinese Goods : In recent years, Chinese goods are flooding the Indian markets. They include battery cells, cigarette lighters, locks, car stereos, energy saving lamps, VCD players, wrist watches, toys, fans, electric ovens and a large variety of consumer articles. Since China has become a member of the WTO, this is going to create another problem because action against Chinese dumping of goods can be taken only within WTO provisions. Not only that, Chinese goods are coming through normal channels of trade, they are also being smuggled via Nepal at zero duty. A very porous border from Nepal has increased clandestine imports from China. Both regular and clandestine imports from China are making serious forays into the Indian markets, thus hurting quite a large range of consumer goods industries. It is very difficult to prepare an anti-dumping case against China, since it is virtually impossible to obtain information required from Chinese sources due to non-transparent nature of Chinese economy. Dr. B .R. Sabade is of the view. "It is extremely difficult to make a case about dumping of Chinese goods. Government can impose a preliminary duty, introduce a trigger price mechanism or declare China as a non-market economy".

2. Impact of WTO on SSI Units

WTO agreements do not discriminate on the basis of size of industries or enterprises. In the WTO regime, reservations may have to be withdrawn, preferential purchase and other support measures may not be available and thus SSIs have to compete not only with the large units within the country, but also with cheap imported products. SSIs are thus losing their markets to cheap imported products. Consequently, a very large number of SSI units are becoming sick or have closed down. Thus, the SSI sector which accounts for 40 per cent of manufacturing output, 50 per cent of employment and over 33 per cent of exports is in jeopardy. Next to agriculture, this sector is the principal source of employment accommodating 18 million persons. The rule of survival of the fittest is being applied to this sector and in their game, only a few able ones will be able to survive. Dumping of Chinese goods has seriously affected SSI sector. The real difficultly with the SSI sector is that it does not have adequate resources to prepare the case for anti-dumping duties in view of the prohibitive costs of anti-dumping investigation. The SSIs can not collect detailed information on individual products required by the anti-dumping directorate to establish a complete case. Consequently, small industries continue to suffer due to such dumping policy.

Not only that, the entry of multinationals in ordinary consumer goods like ice cream, **agarbatti** manufacture, food processing, mineral water etc. is also adversely affecting the SSI sector since these were the traditional areas of this sector. In soft drinks, the entry of powerful Coca Cola and Pepsi have eliminated practically all small units engaged in the manufacture of aerated water. MNCs are not interested in hi-tech products. Rather they prefer low technology, quick profit yielding and large volume products with regular demand throughout the year. In the name of consumer interests, MNCs continue to swallow SSIs and eliminate them from the market.

Notes

3. Double Standards of Developed Countries

The basic question is : Developed countries demand so many concessions and reduction of tariffs from the developing countries, but are they encouraging free flow of trade, capital and technology across states; or are they using globalisation to their advantage ? It would be of interest to consider certain issues :

Unfair Game in Agreements on Textiles : India is quite competitive in textiles. But developed countries through various protectionist measures deny access to cost efficient textile producers. These measures take the form of anti-dumping duties, unilateral change in the rule of origin and unjustifiable foisting of environmental issues. All these measures are taken to protect domestic industry in developed countries and thus, these measures hamper free flow of Indian textile exports.

Developed countries have proposed ten long years to reduce quotas in their domestic textile industries, but they pressurise the developing countries to reduece their tariffs, remove quantitative restrictions, introduce Intellectual Property Rights (IPRs) etc. immediately. Obvious developed countries play an unfair game so far as textile agreements are concerned.

The United States has signed WTO agreements with the proviso that all such agreements will have to be passed by the US Congress, being a sovereign body. There is another assurance given by the US President to the Congress. In case, the decisions of Dispute Settlement Machinery of WTO go against the United States, they will be reviewed by US justices. If they find the decisions unfair, the US has unilaterally reserved for itself right to walk out of the WTO.

Criticising this big brother like attitude, some commentators believe that the rule makers are not going to tolerate being over-ruled. Many of the US laws like Section 301 of US Trade Act is clearly a violation of WTO agreement. This matter was considered by the Dispute Settlement Panel of WTO which gave its verdict that those laws are WTO compliant. This has emboldened the US to continue to use unilateral action against countries that are not considered by US administration as compliant with US trading interests. It passes one's comprehension how the US Congress should be considered as a super-body over the WTO, while the parliaments of other members of the WTO, especially the developing countries, are denied this right. Although sixteen countries petitioned against the US, but since WTO has supported the US position.

Fourthly, reduction and elimination of tariffs in non-agricultural goods and other barriers, particularly on products that are important to developing countries, is mother major gain for India.

Fifthly, WTO ministerial declaration has stressed the need for establishing a system of registration for wines and spirits known by the region where they are made like champagne. Extension of this geographical indication to other items like basmati rice will also be looked into.

Lastly, US agreed to review anti-dumping rules, but there is a fear that this may not be achieved unless the developing countries build up strong pressure on the US to do so.

Gains for India

The Commerce and Industry Minister who represented India at the Doha WTO Conference succeeded in sending a strong message that India can no longer be ridden roughshod over by the developed countries, more especially US and the European Union. The biggest gain was that WTO chairman declared that negotiations on Sinapore issues–investment, competition, labour standards and environment would be held only after an "explicit concensus" was reached at the Fifth Ministerial. Such a concensus may not be easy to emerge even in 2003, keeping in view the reservations expressed by the developing nations at the Doha Conference.

Another major gain was that instead of opening discussion on new issues, it was agreed under pressure from India and other developing countries that it would be more advisable to undertake an exercise on a more complete implementation of Uruguay Round recommendations. This would involve review of bottlenecks and constraints arising out of the roadblocks in the way of fulfillment of their obligations by the developed countries. This would be particularly directed towards the US, Japan and countries of the European Union to open markets to products in which the developing countries enjoyed a comparative advantage.

Notes

The anti-dumping laws of the US were another painful thorn in the flesh of countries like India in respect of steel and other allied items of manufacture. This was taken up strongly by India and other member countries. The pressure built on US was so strong that the US was forced to promise a toning down of its policies and I legislation pertaining to anti-dumping laws.

Now that the WTO has appointed a 9-member committee to which the key issue of Trade Related Intellectual Property Rights (TRIPS) has been referred to, it is hoped that the WTO will find a structural change in its functioning and decision-making. The agenda, henceforth, will not be set by the US and European Union (EU), but the developing countries would also be able to air their views more freely so that the WTO does not operate to the dictates of US and the European Union, but becomes a more democratic forum, in the real sense of the term. India and Brazil are members of the committee and they would be able to place the view of developing countries with the same strength with which they presented and articulated the arguments in the WTO Conference at Doha.

12.2 Geneva Framework of WTO and India

India along with the group of G-20 countries took the initiative to voice the strong feeling of the majority of developing countries at Cancun in 2003. Mr. Arun Jaitley, the then Commerce and Industry Minister speaking on the 10th September 2003 stated :

"The plight of farmers in developing countries was directly linked to the level and kind of subsidy extended to farmers in the advanced countries."

"OECD governments support sugar producers at the rate of $ 6.4 billion annually—a sum nearly equal to all developing countries exports. Subsidies to cotton growers in a developed country totalled $ 3.7 billion last year, which is thrice the country's foreign aid to Africa. The agricultural subsidies provided by OECD countries are more than six times what they spent on official development assistance for developing countries." It was alleged that the OECD countries provided domestic support of the order of $ 320 billion to their farmers, thus enabling them an unequal bargaining power against farmers of developing countries. OECD farmers were thus able to push subsidised agricultural exports to the developing countries impacting adversely on the interests of farmers in developing and least developed countries. The Cancun round ended in fiasco because of the stubborn attitude of the representatives of US and EU countries, not to discuss reduction of agricultural subsidies, but to push the Singapore issues, viz. investment, competition, government procurement and trade facilitation. Since India, Brazil, China, Indonesia, Egypt, Malaysia, Philippines, Bangladesh including other developing countries voiced their strong opposition to the Cancun (2003) draft, the negotiations ended in total failure.

At the Geneva meeting in July 2004, efforts were made to discuss the concerns of the developing countries. India was represented by Commerce and Industry Minister Mr. Kamal Nath. The Indian Government has claimed that it has been able to extract substantial gains on the export of industrial goods and services. It has also been able to safeguard the interests of the farmers. The major gains claimed are :

Firstly, out of four contentious issues which the developed countries wanted to be included in the Doha Round, three issues, namely, investment, competition policy and government procurement have been dropped from the agenda. Only trade facilitation will be taken up for consideration.

Secondly, developed countries have agreed to do away with direct and indirect subsidies provided to their exports. They have also promised to bring about substantial reduction of domestic support provided to their farmers. In particular, the Geneva framework requires that there would a minimum reduction in such support to 80 per cent of the pre-existing levels in the very first year and throughout the period of implementation.

Thirdly, the developed countries have recognised the need for special and differential treatment for developing countries in terms of quantum of tariff reduction, tariff rate quota expansion, number and treatment of sensitive products and the length of implementation period.

Fourthly, developing countries have the right to identify the number of special products, based on

Notes

the criteria of food security, livelihood security and rural development needs, which would be eligible for flexible treatment.

Lastly, a Special Safeguard Mechanism has been provided in the framework against disruptive imports, the details of which are to be worked out. The developed countries have also accepted the adoption of less-than-full reciprocity principle for developing countries.

Commerce Minister Kamal Nath recounting the achievements at Geneva in the new WTO framework listed the following :

1. Zero-to-zero tariff approach will not be binding on all sectors. It implies that India can choose the sectors and products whose zero-duty imports will be allowed. This will enable India check a flood of imports in areas where we are not competitive. This will help to safeguard the interests of domestic industries.
2. On the agricultural front, the biggest achievement seems to be the two windows open for developing countries like India to place the products of their choice in Special Products and Sensitive Products windows. Special product windows can be used by developing countries to block flooding of imports of a particular product. The Commerce Minister believes that these two windows will help India to effectively block US and EU access to our agricultural markets.
3. On the question of promoting cost-effective quality services, the framework gives a bigger push to Mode-4 Services. However, the Government concedes that restrictive policy regime vis-a-vis services may hinder their growth.

On balance, it may be stated that WTO Framework Agreement has made a break-through in world trade negotiations. There are significant gains made, but the moot question is : Will the developed countries permit the developing countries to realise these gains in the near future ? The critics are not very sure because as has been argued by former Commerce Minister Arun Jaitley, C.P. Chandrasekhar and Jayati Ghosh of JNU, Devinder Sharma and Rupa Chanda of IIM Bangalore : for, the devil is in the details. Members have only agreed to a framework. The actual modalities need to be worked out.

It is argued that India has pinned down developed countries to reduce and eliminate export subsidies. But no date has been specified. The time table for this will be negotiated in Hong Kong. So, at the present moment, this can give us a notional satisfaction.

The subsidies take three forms : (a) Amber Subsidies are intended to encourage more production; (b) Blue Box provide incentives to limit production; and (c) Green Box subsidies are provided in the name of environment and livestock. The total subsidies provided by the developed countries are $ 320 billion per year or nearly $ 1 billion per day. The most unfortunate part of the negotiations is that the Blue Box subsidies have been legitimized. The declaration states : "Members recognised the role of the Blue Box for promoting agricultural reforms." Similarly, the declaration accepts that the Green Box subsidies will not in future be subject to any reduction in subsidies. This implies that we have shut the doors so far as reduction in Blue Box and Green Box subsidies is concerned. Arun Jaitley in a sharp comment argues : "We have painted ourselves in a corner by legitimizing the existence of Green Box and the Blue Box. We have not only hurt ourselves in the Doha round but accepted a principle that will continue to haunt us in future rounds.... We can rejoice that there would be a capping on the expanded Blue Box and an overall reduction." The developed countries can feel relieved that the Green Box is wholly outside any reduction commitment and jugglery of box shifting would effectively prevent any reduction in the quantum. The colour of subsidies may change but will the quantum be substantially reduced ?" (*Hindustan Times*, August 11, 2004). Critics, therefore, are of the opinion that the developed countries have emerged as the winners in this game of negotiations and have been able to extract a framework which would strengthen the bargaining position of US and EU in the future round of negotiations.

However, the inclusion in the 'Sensitive' or 'Special Product Category' will need the approval of the WTO. This requires evidence to prove that inclusion in Special Category is based on the criteria of food security, livelihood security and rural development needs or is based against disruptive imports. For instance, India produces about 250 crops whereas Europe does not grow more than 25 crops. Devinder Sharma is right when he argues : "For Europe, getting a score of crops protected under 'sensitive' and 'special products' will be justified. But to expect WTO to accord 'special product' status to over 200 crops from India would be asking for impossible." (*Business Line,* August 5, 2005)

Notes

Another area which is very important for India is the non-agricultural market access (NAMA) which has a high potential to increase our share in exports to US and EU. The broad modalities proposed in the framework have not been accepted by members. In the area of services in which India has strong interest, there is total absence of specificity. This is very disappointing.

Lastly, it has to be noted that two stalwarts among G-20 who spearheaded the interests of the developing countries at Doha and later at Cancun, joined "by invitation" the FIPs groups (Five Interested Parties) which included US and EU representing the developed countries, Australia representing the Cairns group of agricultural exporters with India and Brazil representing the developing countries. All this was intended with the clear objective that if India and Brazil can be softened, then it would become much easier to make inroads into the G-20 group. Chandrasekhar and Jayati Ghosh lament : "These claims of success not withstanding, the creation of FIPs, the inclusion of India along with Brazil, in the grouping and the nature of the framework agreement that FIPs was instrumental in forging, has weakened the developing country camp, which G-20 was expected to strengthen." (*Business Line,* August 10, 2004) This explains why India and Brazil did not take up the specific cause of African nations related with the elimination of cotton subsidies. It is really amazing that US supports its 25,000 cotton growers to the extent of $ 3.7 billion. Average subsidy per grower works out to be $ 1,48,000 which in 2002 is more than 4 times the per capita GDP in United States. The Cancun talks were deadlocked on this issue. The EU has withdrawn aid to Kenya, the most vocal of the African countries to the tune of $ 60.2 million on July 21,2004 on the pretext of 'bad governance' Although the framework pays lip sympathy and "recognises the vital importance of this sector to certain LDC members" but instead of taking specific decision on the issue "promises to work to achieve results expeditiously."

To conclude, it may be pointed out that though developed countries have agreed to reduce subsidies, yet when the issue is probed in detail, it comes out very clearly that the developed countries have been successful in creating an illusion, without conceding anything substantial. The Framework Agreement leaves several vital issues for further negotiations. By creating FIPs, the developed countries have been able to break the resistance of two most powerful advocates of the interests of developing countries, thereby weakening the G-20 camp. In the light of all these developments, there is no cause for jubilation over the achievement of WTO Framework Agreement at Geneva.

Bilateral and Regional Cooperation

We understand that WTO continues to be at the center of India's trade negotiation. Given the fact that it is difficult to arrive at a consensus on contentious issues related to trade in goods, services and investment, and regional cooperation would continue to feature for a long time in world trade, India has been active in regional and bilateral trading arrangements in recent years. RTAs, which help in expanding India's export market, are considered as "building blocks" towards the overall objective of trade liberalization and multilateral negotiations.

Some of the recent developments with regard to Bilateral and Regional Trade Agreements (whether concluded or under negotiations) are listed as follows :

1. **Indian-ASEAN CECA (FTA)** : A Framework Agreement on Comprehensive Economic Cooperation between ASEAN and India was signed by the Prime Minister of India and the Heads of Nations / Governments of ASEAN members during the Second ASEAN-India Summit on October 8, 2003 in Bali, Indonesia. The agreement on Trade in Goods was signed on August 13, 2009. The India-ASEAN Trade in Goods Agreement has come into effect on January 1, 2010. The Agreements provides for elimination of basic customs duty on 80 per cent of the tariff lines accounting for 75 per cent of the trade in a gradual manner. Negotiations towards trade in a services and investment are expected to conclude by August 2010.

   The signing of the ASEAN-India Trade in Goods Agreement paves the way for the creation of one of the world's largest free trade areas (FTA) – market of almost 1.8 billion people with a combined GDP of US$ 2.75 trillion. The ASEAN-India FTA will see tariff liberalization of over 90 percent of products traded between the two dynamic regions, including the so-called "special products," Such as palm oil (crude and refined), coffee, black tea and pepper. Tariffs on over 4,000 product lines will be eliminated by 2016, at the earliest.

Notes

Critics of this agreement argue that libralising trade in special products like palm oil, coffee, tea, coconut etc will have serious implications on livelihood of farmers engaged in the production of these commodities.

2. **India-South Korea Comprehensive Economic Partnership Agreement (CEPA)** : The Agreement was signed on August 7, 2009. This happens to be India's first FTA within OECD country. Under this agreement tariff will be reduced or eliminated on 93 per cent of Korea's tariff lines and 85 per cent of India's tariff lines.
3. **India-Japan CEPA** : Agreements in goods, services and investment are under negotiation. So far more than a dozen meetings of Joint Task Force have taken place in this regard.
4. **India-EU Trade and Investment Agreement** : A broad-based bilateral Trade & Investment Agreement is being negotiated with the EU. Negotiations cover trade in goods, services and investment, sanitary and phyto sanitary measures, technical barriers to trade, rules of origin, trade facilitation and customs cooperation, competition, trade defence mechanism, Government procurement, dispute settlements, Intellectual Property Rights (IPR) and Geographical Indications (GIs).

There are many issues of concern in the EU-India FTA. According to the critics this FTA is going to have an adverse impact on livelihood of Indian people. According to a study commissioned by the European Commission itself, the FTA would increase EU exports to India by $17-18 billion while India's export would increase by around $5 billion only. The impact of reducing as many as 95% of our import duties down to zero or close to zero percent in seven years will result in import surges—especially since EU agriculture imports in particular are heavily subsidized in a wide range of products such as sugar, dairy, tomato paste, poultry, to name a few. Because the EU FTA will do nothing to curb EU subsidies—farmers and farm workers will be hard hit by our steep reduction of import duties. Moreover, a rapid reduction of import duties, combined with ease of entry of European agro-processing and retail Firms through the services and investment chapter of the FTA will dramatically impact how food is produced and sold in this country. Indian farmers and workers will not be able to bargain against the power of Europe's multinational retail firms.

12.3 WTO

The World Trade Organization (WTO) is an organization that intends to supervise and liberalize international trade. The organization officially commenced on January 1, 1995 under the Marrakech Agreement, replacing the General Agreement on Tariffs and Trade (GATT), which commenced in 1948. The organization deals with regulation of trade between participating countries; it provides a framework for negotiating and formalizing trade agreements, and a dispute resolution process aimed at enforcing participants' adherence to WTO agreements, which are signed by representatives of member governments and ratified by their parliaments. Most of the issues that the WTO focuses on derive from previous trade negotiations, especially from the Uruguay Round (1986-1994).

The organization is attempting to complete negotiations on the Doha Development Round, which was launched in 2001 with an explicit focus on addressing the needs of developing countries. As of June 2012, the future of the Doha Round remains uncertain: the work programme lists 21 subjects in which the original deadline of 1 January 2005 was missed, and the round is still incomplete. The conflict between free trade on industrial goods and services but retention of protectionism on farm subsidies to domestic agricultural sector (requested by developed countries) and the substantiation of the international liberalization of fair trade on agricultural products (requested by developing countries) remain the major obstacles. These points of contention have hindered any progress to launch new WTO negotiations beyond the Doha Development Round. As a result of this impasse, there has been an increasing number of bilateral free trade agreements signed. As of July 2012, there are various negotiation groups in the WTO system for the current agricultural trade negotiation which is in the condition of stalemate.

WTO's Current Director-General is Pascal Lamy, who leads a staff of over 600 people in Geneva, Switzerland.

Notes

Some of the important functions and objectives of WTO are :

Functions of WTO

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

(i) The WTO shall facilitate the implementation, administration and operation and further the objectives of this Agreement and of the Multilateral Trade Agreements, and shall also provide the frame work for the implementation, administration and operation of the plurilateral Trade Agreements.

(ii) The WTO shall provide the forum for negotiations among its members concerning their multilateral trade relations in matters dealt with under the Agreement in the Annexes to this Agreement.

(iii) The WTO shall administer the Understanding on Rules and Procedures Governing the Settlement of Disputes.

(iv) The WTO shall administer Trade Policy Review Mechanism.

(v) With a view to achieving greater coherence in global economic policy making, the WTO shall cooperate, as appropriate, with the international Monetary Fund (IMF) and with the International Bank for Reconstruction and Development (IBRD) and its affiliated agencies.

Objectives of WTO

Important objectives of WTO are mentioned below:

(i) to implement the new world trade system as visualised in the Agreement;

(ii) to promote World Trade in a manner that benefits every country;

(iii) to ensure that developing countries secure a better balance in the sharing of the advantages resulting from the expansion of international trade corresponding to their developmental needs;

(iv) to demolish all hurdles to an open world trading system and usher in international economic renaissance because the world trade is an effective instrument to foster economic growth;

(v) to enhance competitiveness among all trading partners so as to benefit consumers and help in global integration;

(vi) to increase the level of production and productivity with a view to ensuring level of employment in the world;

(vii) to expand and utilize world resources to the best;

(viii) to improve the level of living for the global population and speed up economic development of the member nations.

12.4 Uruguay Round Final Act and Its Implications for India

A big offensive was launched by the Left Parties, the Janata Dal and the Bharatiya Janata Party against the acceptance of Dunkel Proposals. The basic thrust of the attack was that the Government has surrendered its sovereignty under pressure from the US Government and the multinationals. There is no doubt that some of the criticisms were politically motivated and value-loaded, and it would be correct to say that to some extent, they were misleading. On the other hand, there is no doubt that the claim of the Government of India, that as a consequence of UR agreement, Indian exports would rise at the rate of $ 2 billion per year is exaggerated.

It would be appropriate to study the implications of GATT agreement in various areas :

A. Reduction in basic duty and export subsidies

On tariffs, India has promised to reduce the basic duty by 30%. This duty reduction was to be effected over a period of 6 years and was to cover raw materials, intermediates and capital goods. This,

Notes

however, did not include agricultural products, petroleum products, fertilizers and some non-ferrous metals like zinc and copper. These tariff reductions were also a part of the package of economic reforms undertaken in India and had had been recommended by the Chelliah Committee.

The GATT agreement stipulates that anti-dumping proceedings will be terminated if the volume of dumped imports from a particular country is less than 1% of the domestic market. The only exception is instances where dumping countries collectively account for more than 2.5 per cent of the domestic market. Anti-dumping proceedings will be terminated if the margin of dumping is less than 2%. These clauses do help India to protect its exports from anti-dumping investigations. It would have been much better for India, had the figure of dumped imports as a share of domestic market been more than 1%.

Effect of TRIPS on the Indian Economy

Some critics are of the view that Trade-Related Intellectual Property Rights (TRIPs) as embodied in the GATT agreement will have disastrous effects on our economy, more especially in two vital areas i.e., pharmaceuticals and agriculture. Both these areas affect the well-being of the people.

TRIPs requires an understanding about the scope of the new patent regime. Under TRIPs patents shall be available for any invention whether product or process in all fields of industrial technologies.

Patent protection will be extended to micro-organisms, non-biological and micro-biological processes and plant varieties. This implies that the entire industrial and agricultural sectors and to an extent bio-technology sector will be covered under the patent provisions.

A very dangerous provision has been introduced in patent protection and this relates to changing the philosophy of the patent regime whereby products, imported or locally produced, will be covered under patent protection without any discrimination. This implies that the patent regime not only tries to establish manufacturing monopoly but it also intends to establish import monopoly. In this situation, the patent-holder would resort to imports only and the national government would not be able to exercise any price control on the imported products. This provision will help the patent-holder to defy all price control measures.

Patent Regime and Pharmaceuticals and Drugs

Patent regime, the critics are of the view, will affect the drug prices seriously. Currently, these prices are very low in India—thanks to the Indian Patent Act, 1970. Since the enforcement of this Act, Indian pharmaceutical and drug industry progressed rapidly and was able to provide life saving drugs very cheaply. Besides this, it was able to earn foreign exchange to the tune of ` 2,386 crore in 1996-97.

Under the new patent regime, according to Mr. B.K. Keayla, Convener, National Working Group on Patent Laws, about 70% of the drugs will be covered under the new patent laws. Consequently, under TRIPs heavy payments will have to be made to patent holders and consequently, it is feared that this would result in the prices of drugs going up 5 to 10 times. At present, only 30 per cent of the population can afford modern drugs and if the GATT agreement is accepted, another 20 per cent of the population will lose health cover, leaving only 10 per cent population access to modern drugs. Such a policy has dangerous implications for the health of our population.

Mr. B.K. Keayla gives two specific examples about drugs marketed by the same MNC in different countries. In India, there is a process patent of these drugs, but in other countries, they are covered under product patent. The price differential is so large that it compels one to rethink whether the introduction of product patent in India, would not push the prices of drugs in India as well to very high levels.

There is a large body of opinion which does not subscribe to the Government view. In a country, which is plagued by mass poverty, it is very essential that life saving drugs and other basic medicines should be available at affordable and low price. This can be achieved only through control over the prices of drugs. The GATT agreement tends to alter it. There is a genuine fear that drug prices will rise, more so in view of the fact that the Multinationals are able to corner excessive profits in other countries, but are not able to penetrate in India so far as price control on drugs is concerned. The

Notes

Government has to be very cautious. There is no doubt that the government has a period of 10 years to shift to product patent regime in drugs, but the multinationals can create situations even before that so as to force the government to amend the Patents Act earlier or create conditions of artificial scarcity. The drug market is even now facing this phenomenon of the disappearance of a particular drug for sometime in the market and its reappearance later at a higher price. During 1994-95 and 2000-2001 taken together, price index of drugs and medicines increased by 87.1 per cent as against the overall increase in price index by 35.9 per cent. This rise is taking place despite drug price control, but in case freedom is given to multinationals, there is a fear that drug prices would rise at a much sharper rate, hitting the health cover of the common man. In a very angry comment, Mr. B.K. Keayla writes : "The argument that the new patent regime would affect only 10-15 per cent of turnover is totally wrong and silly.

Mr. Bibek Debroy does not share the pessimism of Mr. B.K. Keayla. He believes that there is a lot of exaggeration about the supposed increase in drug prices. Arguments based on cross-country comparisons should not be taken seriously. The Essential Drugs List published by the World Health Organization (WHO) has a little over 250 entries. Less than 10 per cent of these are covered by patents world-wide. The rest have all become generic and there is no need to grant a fresh round of patent protection to these. Mr. Bibek Debroy, therefore, concludes : "The price rise will be pertinent for these existing drugs, but not for the new drugs that arrive on the international market every year. If the patent protection is not changed, these new drugs may not be marketed in India at all.

However, the critics do not agree to the defence given by the Government or certain economists. Multinationals do have the capacity to create scarcities or withdraw the existing drugs and get them registered under new product patents. The Government has, therefore, to continue with the Drug Price Control Order so far as essential drugs are concerned. It has also to regulate the prices of other drugs, failing which medical treatment in many ailments will be beyond the reach of the poor and middle classes. Already, the situation has been changing in this direction with the growing trend of privatization in health.

Patent or Patent-like Protection in Agriculture

Dunkel Final Act has made important changes concerning patenting or granting patent-like protection in agriculture. The principal feature of the TRIPs text demands that protection be extended to micro-organisms, non-biological and micro-biological processes and plant varieties. Article 27 of TRIPs Text states that India may provide for protection of plant varieties either by patent or by an effective **sui generis** system or by a combination thereof. This system shall be enforced at the end of the transitional period of 10 years.

It may be emphasized that traditionally, under GATT, most patent systems have excluded sectors such as agriculture, food and health outside its orbit. Some developed countries created a separate **sui generis** system which granted intellectual property rights to plant breeders. This was codified in 1961 under the International Union for the Protection of New Varieties of Plants (UPOV). In 1978, USA was allowed to join UPOV members union without changing its laws. However, UPOV has continued to be an organisation mainly of the developed countries.

Under the UPOV convention of 1978, the plant breeder of a new variety had an almost total monopoly of producing and marketing his variety of seeds through trade channels. His right under TRIPs was subject to only two exceptions : (1) The Breeder's exemption, which permitted any other breeder to use the protected variety for breeding purposes; and (2) the Farmer's Exemption which gave the farmer the right to retain protected seeds from his harvest to plant the next crop. This convention was limited to 24 plants and the period of protection ranged from 15 to 18 years.

This convention was modified in 1991 and the revised UPOV treaty empowers higher standards of protection to plant breeders, thereby strengthening the monopoly rights of the breeder of a new variety. Under the revised UPOV treaty (1991), the breeder had to pay royalty to the Plant Breeder Right (PBR) holder, if his new variety resembled the protected variety in any trait. Similarly, the farmer was not automatically permitted to use farm-saved-seeds of protected variety to sow the next crop. He had either to pay compensation for use of seeds or obtain the approval of the breeder. Most

of the Plant Breeders were giant MNCs who work with the sole intention of profit maximization. They would be reluctant to grant approvals to farmers, who would otherwise be forced to purchase seeds from MNCs. Under UPOV (1991), all plant genes and species would be provided protection for a period ranging from 20 to 25 years.

Moreover, UPOV (1991) stipulates that **sui generis** system to be created should be "effective" so that it provides real protection to PBR-holders. But who will judge the effectivity of the law framed by India for the purpose. The answer is : The Council of TRIPs under article IV.5 of the agreement establishing Multi-lateral Trade Organisation (MTO).

The Government of India has been under constant attack that the **sui generis** (Plant Breeder Rights) system is against the interests of the farmers and would act as an impediment to the development of new plant varieties. Mr. Pranab Mukherjee, former Minister of Commerce, stated in this connection: "While reasonable protection should be provided to plant breeders who develop new varieties under the Agreement, the right of farmers and researchers will also be fully protected. In the **sui generis** legislation which is being drafted for the purpose, the interests of the farmers will be safeguarded."

There is a lot of divergence between what the Government says and what it is doing in this regard. This is evident from the draft Plant Varieties Act, 1993 circulated by the Government in February 1994.

Notes The **sui generis** system under which PBR-holders are granted rights is just a change in nomenclature in place of the patent system.

Patent (Amendments) Bill and Seeds Act (2004)

The Government introduced the Patent (Third Amendment) and Seeds Act (2004). In the name of quality of seeds, the Government has stipulated that seed growers should get their seeds patented. In case, this is not done, the farmers will not be allowed to exchange their seeds with other farmers. Compulsory registration of seed combined with the power to seed inspectors to enter and search premises (which implies in the case of Indian farmers farmers' fields and huts) is the hallmark of this legislation.

It would be worth while to examine the implications of this policy for Indian farmers.

Firstly, for hundreds of years, farmers have sown seeds, harvested crops and exchange seeds with farmers in the neighbouring areas. These indigenous varieties are the basis of our ecological and food security. For instance, coastal farmers evolved salt resistant varieties. Bihar and Bengal farmers have evolved food resistant varieties. Drought resistant varieties were developed by farmers of Rajasthan. Similarly, farmers in the Himalayas have developed frost resistance varieties. Indian farmers, being not highly educated do not understand the complications involved in getting their seeds registered. The Multinational agents can buy these seeds and get them registered prior to our farmers. They will then be in a position to file cases against these farmers for bartering these seeds with their neighbours.

International experience also strengthens this fear. Dr. Vandana Shiva has examined this question in depth. She quotes a case filed by the British Society for Plant Breeders in 1995 which decided to proceed with a high profile court case against a farmer to make selling of potato seeds by farmers to other farmers as illegal in Scotland. The farmer was forced to pay a fine of £ 30,000 as compensation to cover royalties lost to the seed industry by direct farmer-to-farmer exchange. Existing United Kingdom and European Union laws thus prohibit farmer from exchanging uncertified seeds.

The same experience is repeated in U.S. to prevent farmer-to-farmer exchange as illegal. As grow, a commercial company filed a suit against winterboers on the ground that their intellectual property rights (IPRs) were violated by the Winterboer farmers who in their 500-acre farm in Iowa were growing seeds. The Winterboers pleaded that under the Plant Variety Act of US, farmers had the right to sell

Notes

seed, provided both the farmer and the seller were farmers. They won the case. Subsequently, under pressure from seeds industry, the Plant Variety Act was amended and the farmer's right to save and exchange seeds was declared illegal.

Dr. Vandana Shiva on the basis of these experiences concludes : 'The Seed Act in designed to 'enclose' the free economy of farmers' seed varieties. Once farmers' seed supply is destroyed through compulsory registration by making it illegal to plant unlicensed varieties, farmers are pushed into dependency on corporate monopoly of patented seeds. The Seed Act is therefore the hand maiden of the Patent Amendment Acts, which have introduced patent on seed.

Secondly, it may be noted that prior to this Act as a result of globalization, 80 per cent of the seeds were farmers' own varieties which have been saved, produced and exchanged freely. The balance of 20 percent was supplied by the public sector seed companies. Under pressure from World Bank, the Seed Policy of 1988 started to dismantle the robust public sector in favour of private sector companies and multinationals. This is made clear in the objectives of the Seed Act 2004 which is aimed at replacing farmers' saved seeds with seeds from private sector seed industries.

Thirdly, the Seed Act introduces Inspector Raj and gives the inspectors the power to enter and search premises, even to break open any container and any door. This is tantamount to the creation of a 'Seed Police'. The fine for seed exchange and barter of unregistered seed is up to ` 25,000.

In a very angry comment, Dr. Vandana Shiva states : The2004 Seed Act has nothing positive to offer to farmers in India but offer a promise of a monopoly to private seed industries, which has already pushed thousands of our farmers to suicide through dependency and debt caused by unreliable, high dependency and non-renewable seeds." The 1996 Act used to serve the country well and should have been continued "It is the MNC seed industry that need regulation and not the small farmers of our country without whose seed freedom the country will have no food sovereignty and food security."

Fourthly, methods of agriculture were excluded from patentability in the Indian Patent Act, 1970 to ensure that the seed, the first link in the food chain, was held as a common property resource in the public domain. The farmers were guaranteed the inalienable right to save, exchange and improve upon the seed. But subsequent amendments of 1970 Act have opened the floodgates for patenting of genetically engineered seeds. It needs to be emphasized that patents are monopolies and they grant exclusive rights which prevent farmers from producing, saving and exchange of seeds from farmer-to-farmer. In other words, patents on seed convert seed saving into an "intellectual property right."

The entire controversy veers round corporate rights versus farmers' rights. The US Government in collusion with WTO has been demanding monopoly protection for Transnational Corporation (TNCs) which control seed industry. It implies that under the garb of globalisation, whereas greater emphasis should be given to liberalization and competition should have been promoted, the Plant generatic resources (PGR) legislation aims to create monopoly through the agency of IPRs. In other words, PGR legislation is a conflict between farmers and seed industry and between the public domain and private profits, between an agriculture that produces and reproduces diversity and that consumes diversity and produces uniformity.

Prof. Borlaug stated in a very forth-right manner : "We battled against patenting. Late Glen Anderson (of International Wheat and Maize Research Institute) and I went on record in India as well as other places against patenting and always stood for free exchange of germ plasm."

The new Seed Act proposed in 2004 could for ever destroy farmers rights and thus destroy biodiversity of our seeds and crops. It robs the farmers of their freedom and establishes a seeds dictatorship. Such a dangerous legislation is anti-farmer as it establishes TNC totalitarianism. It should, therefore, be scrapped.

Did u know?

Norman Borlaug, the scientist who pioneered the Green Revolution and was the recipient of Nobel Peace Prize at a press conference held on 8th February 1996 expressed his concern against private companies and TNCs gaining control of the plant genetic resources seeds and patenting plants.

Notes

TRIPS, Haldi and Neem

India's ancient use of Haldi (Turmeric) was sought to be patented under the American Law in 1995. Luckily for India, Dr. R. A. Mashelkar, Director General of Council of Scientific and Industrial Research challenged it. The US patent office acknowledged its mistake and cancelled the patent on 'Haldi'.

An American company has been granted a patent right for Neem as a pesticide. Basmati rice, which was a universal variety in India, has been patented as Kasmati and Texmati. Danger lurks with regard to Tulsi (Basil) plant. These are a few cases of biopiracy of India's herbal wealth and to prevent huge losses, India will have to undertake huge documentation about the use of its herbal wealth.

TRIMS and its Impact on India

Trade Related Investment Measures (TRIMs) were initiated by the US in 1980 since it was losing ground in competition in goods to Japan and other newly industrialised nations of East Asia and intended to recover its lost ground through trade in services. Although GATT had never discussed the idea of trading in services as part of the earlier seven rounds of negotiations, the USA tried to sell this idea in the 8th Round of GATT negotiations. The principal objective was to benefit the Multinational Corporations (MNCs) so that they could undertake investment in financial services, telecommunications, marketing so as to boost world trade.

The main provisions provided in the TRIMs text ensure that Governments shall not discriminate against foreign capital. In other words, the TRIMs text compels member countries to give national treatment to foreign capital. The main features of the TRIMs text are :

(i) All restrictions on foreign capital/investors/ companies should be scrapped.

(ii) The foreign investor shall be given the same rights in the matter of investment as a national investor.

(iii) No restrictions will be imposed on any area of investment.

(iv) Nor will there be any limitation on the extent of foreign investment—even 100 per cent foreign equity will be permitted.

(v) Imports of raw materials and components will be allowed freely.

(vi) Foreign investor will not be obliged to use local products and materials.

(vii) Export of part of the output will no longer be mandatory.

(viii) Restrictions on repatriation of dividend, interest and royalty will be eliminated.

(ix) There will be a complete exclusion of provisions like phased manufacturing programme which is intended to increase the indigenous content in manufacture.

Textiles and Clothings

GATT agreement has made certain proposals to liberalise the trade of textiles and clothings. These proposals are very important for developing countries since textile exports constitute the single most important item of their export. Ironically, developed countries who claim to be the greatest champions of free trade have imposed most comprehensive quota restrictions under the multi-fibre agreement (MFA). The Act proposes to phase out MFA quotas over a ten year period (1993 to 2003) and to fully liberalise the textile sector at the end of the ten year period.

The Act has divided the 10-year period into three phases of three, four and three years. In the first phase 16 per cent of the textile exports to the developed countries will be liberalised, to be followed by 17 per cent in the second phase and another 18 per cent in the third phase. Thus at the end of the 10-year period, only 51 per cent of textile market will be liberalised. Thus, a substantial portion (49 per cent) shall have to wait for the second wave of liberalisation after 2003 AD. What is intriguing is that textiles are defined in such a way that textile sector includes items that are not currently under quota restrictions in developed countries. Thus, instead of creating real liberalisation and withdrawing non-tariff restrictions, the myth of liberalisation has been created. The Ministry of Commerce has made this point clear : "It is a fact that the textile agreement is not evenly balanced in the sense in the initial years, there is minimal liberalisation and significant steps for liberalisation are left only to the

Notes

last three years. This is one of the points of dissatisfaction for India and we are strongly urging the importing countries to bring forward the liberalisation process."

12.5 Social Clause in GATT

A very startling proposal was made in the context of the finalisation of the GATT agreement towards the end of March 1994. This proposal, commonly referred to as "social clause" was moved by US to be incorporated in the Marakkesh Declaration. The US representative proposed under the social clause to levy a countervailing duty on imports from developing countries aimed at offsetting the low labour costs prevailing there. In plain language, the proposal implied the following : If a shirt in India cost ` 50, while it cost ` 200 in the US, then this differential was largely a consequence of the difference in labour costs. To remove this differential advantage, Indian exports to the USA would have to pay a duty aimed at neutralising the cost advantage. The social clause, it was stated, is motivated by humanitarian concern, so that the developing countries adopt proper standards of living for the workers and pay their labour better wages.

Experts in developing countries were shocked by this proposal since it aimed at blunting the only competitive edge of the Third World countries. Experts described the humanitarian argument no more than a moth-eaten fig leaf. The only purpose of getting suddenly concerned about the plight of labour in the Third World was their deep desire to deprive developing countries of their only competitive advantage. They know that as far as technology is concerned, developing countries are at a historical disadvantage. Developing countries have now to pay high price for getting technology from the developed countries. If this clause is introduced, Indian products will become unsaleable in the USA and the other countries of the European Community. Ironically, it would imply that the poorer nations will be forced to pay for the fact that they are poor.

Critics are of the view that this move is a continuation of the Harkin Bill which calls upon the US Department of Labour to annually identify goods made with the use of child labour and the countries exporting them. If this Bill is passed, US Government will ban the import of these items, severely affecting India's export of carpets, gems and jewellery, textiles and garments etc. The social clause is, therefore, aimed at countries like India so that the advantage to the developing world is destroyed and their capacity to export manufactured goods is seriously crippled. In the end, these countries should be allowed to export raw materials like cotton and iron ore and import garments and steel. It would really revive the days of colonialism. Mr.Pranab Mukherjee, former Minister of Commerce, stoutly opposing the linkage between social policy concerns, like labour standards, and trade clearly stated at Marakkesh on April 13, 1994 : "I would like to state categorically that while we are strongly committed to internationally recognised labour standards, we see no merit whatsoever in the attempt to force linkages where they do not exist. Trade policy cannot be made the arbiter of all concerns."

The social clause proposal became the rallying point of G-15 states and the Malaysian Prime Minister Mahathir Mohammed launched a diatribe against the provision. The unanimous opinion of the G-15 countries was that the social clause proposal would hit their economies adversely and thus aggravate the problem of balance of payments, rather than help them to bridge the BOP gap. Due to the combined strength of G-15 countries, the US government had to face a retreat and the issue was deferred.

The Fifth Conference of the Labour Ministers of Non-aligned and other developing countries held in Delhi from January 19-23,1995 dismissed the "social clause" as "totally unacceptable". It asserted : The proposed linkage would negate the benefits of trade liberalisation and aggravate problems of unemployment and distress. Delhi Declaration came down heavily on the coercive aspect of proposed linkage and stated : Any form of coercion on the labour standards issue is violative of the constitution of International Labour Organisation (ILO). The declaration further emphasised that "the application of unilateral coercive economic measures by the developed countries aimed at the Third World countries with a view to obtaining economic or political advantage is unacceptable".

There is another proposal to introduce an environmental protection clause with the intention of forcing the developing countries to pay for the alleged destruction of environment. Experts are of the view that a more discriminatory provision than this is hard to imagine since three-fourth of the damage to world ecological environment has been caused by the developed world over the last two centuries. It

is really ironical, the developed countries have the cheek to ask the developing countries in the face of these facts to pay for the sins of the developed world.

There is no end to the innovative machinations which the developed countries initiate to force the developing countries into submission to their proposals. The temporary withdrawal of the social clause should not be seen as a victory of the developing countries, it is quite possible that USA may revive it. The question that need to be posed as a counterpoint is : Should developing countries, on the basis of human considerations, impose countervailing duties on US goods till such time that the Blacks in America are assured equality of treatment ? Are not labour standards with reference to Blacks important, if the linking of social concerns to trade policy, is pushed to its logical conclusions. Thus, there is a need for vigilance and combined resistance by Third World countries so that the enlarged scope of GATT is not used to their disadvantage.

Self-Assessment

1. Choose the correct options:

(*i*) Which of the following is NOT an argument to support free trade?

(*a*) Free trade limits the influence of special-interest groups.

(*b*) Free trade allows firms to exploit economies of scale.

(*c*) Free trade is always welfare-improving because those who gain can compensate those who lose.

(*d*) Free trade leads to efficient allocation of resources.

(*ii*) What is the essence of the "terms-of-trade" argument against free trade?

(*a*) A large country can improve its terms-of-trade by subsidizing exports, and the optimal export subsidy is positive.

(*b*) Terms-of-trade is an important policy tool that is not available if the government commits to free trade.

(*c*) A large country can improve its terms-of-trade by imposing tariffs, and the optimal tariff is positive.

(*d*) A small country cannot affect its terms-of-trade, so it might as well impose tariffs to raise government revenues.

(*iii*) What particular market failure does the "market failure argument" against free trade refer to?

(*a*) Any market failure that occurs in the tradable sector.

(*b*) Environmental externalities.

(*c*) Knowledge and technology spill-overs.

(*d*) Unemployment.

(*iv*) The "theory of the second best" states that:

(*a*) Free trade is only the "second best" policy, after the optimal tariff.

(*b*) Free trade is only desirable if everything else works properly.

(*c*) There is always an alternative solution if the first best is not feasible.

(*d*) Trade intervention is the best policy for dealing with domestic market imperfections.

(*v*) What is the main reason explaining why agriculture enjoys protective tariffs in the U.S.?

(*a*) Low wages in the agriculture sector would fall even further in the absence of protection.

(*b*) The "infant industry" argument.

(*c*) Unfair competition from European agriculture.

(*d*) Producers (who gain) are well organized, while consumers (who lose) are not.

(*e*) Environmental and health concerns force the government to restrict non-compliant imports.

Notes

(*vi*) Why are international negotiations important in order to reduce tariff rates worldwide?

(*a*) Large countries can impose policy restriction on smaller countries.

(*b*) Special-interest groups cannot affect international negotiations.

(*c*) They help avoid trade wars.

(*d*) The world as a whole gains from free trade.

12.6 Summary

- A survey of the globalisation policies followed in India reveals that the promised benefits of globalisation in the form of sharp increase in GDP, exports, foreign direct investment, reduction of poverty, deceleration of unemployment could not be realised by India during the 1990s. Globalisation has adversely affected Indian industry, it has enabled the developed countries to push their exports to India at a much faster rate, but did not facilitate the process of access to international markets; small scale industry has suffered due to the policy of dumping practised by developed countries, more especially in consumer goods. The most distressing part of the story is the double standards practised by the developed countries which manifest in the form of unfair agreement on textiles; a policy marked by a bias in favour of the farmers of developed countries as against the poor farmers in India. Developed countries brought forth spurious environmental and social issues to prevent the exports from India of such commodities in which the country possessed comparative advantage Mr VS Vyas rightly points out : "The international agreements, particularly under World Trade Organisation (WTO) have not helped the developing countries as was professed at the time of the establishment of WTO". All these factors have resulted in an erosion of faith in globalisation as the new "mantra" for stimulating development in India.
- There is no doubt that in a world of unequal partners, multilateratism is superior to bilateralism and if some concessions are to be extracted from strong partners belonging to US and European Community, then the combined strength of the developing countries can exercise a stronger pull in their favour. One redeeming feature of the GATT is that there is the principle of one country, one vote. However, the developed countries are able to pressurise the developing countries by various new devices, more especially through intellectual property rights and TRIMs. Although the Government of India is claiming that very substantial benefits are likely to accrue as a consequence of GATT agreement, but it is premature to reach any definite conclusion. The Final Act is such a big document that it has wheels-within-wheels and the thrust of the Act is to toe the line of developed nations. Mr. R.K. Khurana of the India International Centre has rightly summed up the position : "The consensus, however, is that the Uruguay Round has been a game in which the more powerful nations lay down the rules. Unfortunately, India is not one among the powerful trading nations and it is, therefore, doubtful if the country could have achieved anything significantly more than what our negotiations have managed."
- The history of GATT reveals that whenever newly industrialised nations have challenged the competitive strength of the developed Countries, they have immediately retaliated by imposing both tariff and non-tariff barriers. They have now enlarged these in the form of TRIPs and TRIMs. The innovation of the social clause was also conceived with the same intention of blunting the competitive advantage of developing nations. This game will continue. The solution lies in the fact that the developing nations should take advantage of the multi-lateral trade organisations and show their combined strength by closing their ranks, rather than surrender their sovereignty one after another. To say that there is no alternative is a defeatist solution. Now that China has also been admitted to WTO, both China and India should work together to assert a fair and just treaty among the trading partners of WTO, rather than pushing down the throat of the weak, the will of the strong partner(s).

Notes

12.7 Key-Words

1. International negotiations : Negotiating abroad requires the ability to meet special challenges and deal with the unknown. Even those experienced in cross-cultural communication can sometimes work against their own best interests during international business negotiations. Skilled negotiators know how to analyze each situation, set up negotiations in ways that are advantageous for their side, cope with cultural differences, deal with foreign bureaucracies, and manage the negotiation process to reach a deal.
2. Tariff rates : A tax imposed on imported goods and services. Tariffs are used to restrict trade, as they increase the price of imported goods and services, making them more expensive to consumers. They are one of several tools available to shape trade policy.
3. Free trade : A free-trade area is a trade bloc whose member countries have signed a free-trade agreement (FTA), which eliminates tariffs, import quotas, and preferences on most (if not all) goods and services traded between them. If people are also free to move between the countries, in addition to FTA, it would also be considered an open border. It can be considered the second stage of economic integration.

12.8 Review Questions

1. What is the impact of WTO on various aspects of Indian Economy? Explain.
2. What are the functions of WTO? Discuss.

Answers: Self-Assessment

1. (*i*) (*c*) (*ii*) (*c*) (*iii*) (*a*)
   (*iv*) (*b*) (*v*) (*d*) (*vi*) (*c*)

12.9 Further Readings

1. Krimawati, Wawat. (?) NAFTA: North America Free Trade Agreement. [Accessed 18 May 2009]
2. Vogel, David. (2009) North American Free Trade Agreement. [Accessed 18 May 2009] 2009. North American Free Trade Agreement (NAFTA).
3. United States Department of Agriculture, Foreign Agricultural Service. [Accessed June 8, 2009]

Notes

Unit 13 : UNCTAD, IMF, World Bank and Asian Development Bank

CONTENTS

Objective
Introduction
13.1 The UNCTAD and Development
13.2 International Monetary Fund
13.3 The World Bank
13.4 Asian Development Bank
13.5 Summary
13.6 Key-Words
13.7 Review Questions
13.8 Further Readings

Objectives

After reading this Unit students will be able to:

- Explain the UNCTAD and Development.
- Know the International Monetary Fund.
- Discuss the World Bank and Asian Development Bank.

Introduction

The United Nations Conference on Trade and Development (UNCTAD) was established in 1964 following he growing dissatisfaction with the operation of such international institutions as the IMF and the GATT. These institutions favoured the developed countries and failed to tackle the special trade and development problems of the LDCs. The GATT, in particular, being committed to free trade, reduction of tariffs and abolition of preferences and import restrictions, did not pay any attention to proposals to stabilise commodity prices and give preferential treatment to LDCs in trade with developed countries.

The first step towards the creation of UNCTAD was taken when the UN General Assembly declared the 1960s as the United Nations Development Decade in December 1961. By so doing, it recognised the need for adopting measures by developed countries to bridge the gap between the rich and poor nations through trade and aid. It was on the recommendations of the UN Economic and Social Council in July 1963 for convening a conference on trade and development that the UN General Assembly convened the first UNCTAD at Geneva in l964.

Accordingly, the UNCTAD I was held at Geneva in 1964. Since then such conferences have been held normally every four years : UNCTAD II at New Delhi, 1968; UNCTAD III at Santiago, 1972; UNCTAD IV at Nairobi, 1976; UNCTAD V at Manila, 1979; UNCTAD VI at Belgrade, 1983; UNCTAD VII at Geneva, 1987; UNCTAD VIII at Cartagena (Columbia), 1992; and UNCTAD IX at Midrand (South Africa), 1996.

Notes

13.1 The UNCTAD and Development

ORGANISATION

The UNCTAD is a permanent organ of the UN General Assembly with its headquarters at Geneva. It has a Secretariat. UNCTAD VIII agreed upon a new organisational structure for the UNCTAD which has been in operation since April 1992. It includes the following :

Conference : The (UNCTAD) Conference consisted of 188 members as on April 1996.

Secretariat : The UNCTAD is run by a secretariat under the Secretary-General who is elected by the members. The organisational entities of the secretariat are the executive direction and management, the administrative service and inter-governmental support services. Other organisational institutions of the secretariat are detailed below.

Trade and Development Board : An executive body known as the Trade and Development Board which meets twice a year in Regular Session and in Special Session as required. It takes policy decisions when the Conference is not in session. It is composed of 55 members elected from among the Conference Members on the basis of equitable geographical distribution.

Executive Committee : There is an Executive Committee of the Board which is composed of the permanent representatives of member states deputed to the UNCTAD in Geneva. It meets periodically, usually every month.

Standing Committees : The Board is assisted in its functions by four new standing committees relating to commodities, poverty alleviation, economic co-operation among developing countries, and services. These Committees make studies and prepare reports from time to time, especially for the Conference to be held.

Special Committee : There is a Special Committee on Preferences.

Divisions : In response to the new orientation for working, resulting from UNCTAD IX, the UNCTAD secretariat has been reorganised to make it more performance-driven and to improve its quality of service. The secretariat now consists of four divisions (or groups) instead of nine previously. They are : (1) Division on Globalisation and Development Strategies ((DGDS); (2) Division on International Trade in Goods and Services and Commodities (DITGSC); (3) Division on Investment, Enterprise Development and Technology (DIEDT); and (4) Division on Services Infrastructure for Development and Trade Efficiency (DSIDTE). These divisions are responsible for helping the developing countries reap the benefits of globalisation to attain sustainable development.

In addition, the Secretary-General of the UNCTAD has established an office of the Special Coordinator for least developed, landlocked and island developing countries. Its aim is to prevent further marginalism of least developed countries in the world economy and to solve their specific problems.

The various committees and divisions have fixed terms. The divisions can bring in national experts so that their deliberations are enriched with national experience and empirical evidence. Non-governmental experts are also invited to participate both in the divisions and in the public sessions of the Board. They can also act in an advisory capacity to the Committees.

The Secretariat publishes an annual report based on the studies made by the Committees.

FUNCTIONS OF UNCTAD

The UNCTAD is expected to perform the following functions as laid down by the UN General Assembly :

1. To promote international trade between countries with different socio-economic systems, especially for accelerating the economic development of LDCs.
2. To formulate principles and policies of international trade and related problems of economic development.
3. To make proposals for putting the said principles and policies into effect, and to take such steps which may be relevant towards this end.
4. Generally, to review and facilitate the co-ordination of activities of other institutions within the UN system in the field of international trade and related problems of economic development.

Notes

5. To be available as a centre for harmonious trade related development policies of government, and regional economic groupings.

Objectives and Achievements of UNCATED

UNCTAD is supposed to fulfil the following objectives which have been evolved gradually of the various conferences : (1) trade in primary commodities, (2) trade in manufactured goods, (3) development financing, (4) technology transfer, and (5) economic co-operation among developing countries. We discuss below the extent to which UNCTAD has been successful in achieving these objectives.

Trade in Primary Commodities

The UNCTAD has been active in the international commodity arrangements since its inception. LDCs want to expand the market for their traditional exports of primary commodities. Developed countries place restrictions on the exports of the latter in such forms as licensing, quotas, tariffs, health and packaging regulations, etc. and provide subsidies to domestic producers. Such trade restrictions tend to be higher for processed products than for unprocessed. Besides, exports from LDCs have been subject to wide fluctuations. Consequently, there has been a continual deterioration in the terms of trade of primary products of the LDCs in relation to the export of manufactured products from the developed countries.

Since UNCTAD II, the LDCs have been insisting on International Commodity Agreements (ICA) to stabilise the prices and markets for their exports of primary products. These agreements seek : (1) to stabilise the price of the commodity concerned so as to reduce price fluctuations and the resulting instability in the economies of the producing LDCs; and (2) to increase its price to compensate for the fast worsening in the terms of trade of the LDCs.

At UNCTAD IV (Nairobi), in 1976 it was proposed to have an Integrated Programme for Commodities (IPC), and to create a common fund for buffer stock financing. The proposal was to negotiate international commodity agreements to stabilise the prices of 18 commodities, ten of which were to be included in the initial buffer stock scheme. This programme led to the international commodity agreements on only cocoa (1981) and rubber (1980). UNCTAD VI (Belgrade) in 1983 also emphasised the importance of negotiating ICAs for ten commodities. Of the five agreements on commodities—coffee, cocoa, sugar, tin and rubber—only that for rubber is still in operation.

UNCTAD VII had a Subsidiary Committee on Commodities and UNCTAD VIII set up a Standing Committee on Commodities for making recommendations to the TDB.

It was at UNCTAD VII (Geneva) that a Common Fund for commodities under the IPC became operational after a number of countries ratified it or expressed their intentions to do so. New pledges announced at UNCTAD VII raised its total pledged capital to 66.9 per cent $ 4.7 billion fund, allowing it to become operational.

Notes

The UNCTAD IV proposed for a $ 6 billion Common Fund in 1976 to create and finance international buffer stock of ten storable commodities.

Economic Cooperation Among LDCs

UNCTAD II held at New Delhi in 1968 emphasised for the first time the need for promoting international co-operation and self-reliance among the LDCs. UNCTAD VI held at Belgrade in June 1983 again emphasised the need for co-operative efforts among LDCs through widening the scope of preferential trading arrangements, harmonising industrial development programmes through infrastructural facilities, particularly in respect of shipping services and simple payment mechanism under common clearing system.

The first step towards economic co-operation among LDCs was taken at the ministerial meeting of G-77 held at New York in October 1982 when it was decided to launch the Global System of Tariff Preferences (GSTP). In 1984, the UNCTAD organised two meetings where intensive technical level discussions were held in drafting the ground rules procedures for GSTP negotiations. Another

Notes

ministerial conference held at New Delhi in July 1985 decided to conclude the first round of GSTP negotiations in May 1987, on the eve of UNCTAD VII. GSTP is a major initiative of developing countries to expand mutual trade through grant of tariff and non-tariff concessions and other measures such as long-term contracts under the UNCTAD.

Besides increasing trade, UNCTAD VI recommended the initiation or strengthening of a number of cooperative measures in the fields of research and development, design and engineering among LDCs. Harmonisation of LDCs policies, rules, regulations, laws and practices governing technology in all its aspects, training and exchange of personnel, including cooperative exchange of skills, establishment of preferential arrangements for the transfer and development of technology, technological cooperation in specific areas and sectors of critical importance. The possibilities of cooperation of technological transfer among LDCs exist for particularly the following four sectors : capital goods, human skills, energy, and food production and processing. However, possibilities in other sectors of their economies cannot be ruled out.

The UNCTAD V held at Manila in May-June 1979 passed a resolution relating to liner shipping. Among other things, the resolution included provisions aimed at enhancing the position of LDCs as both providers and users of liner shipping. It urged the LDCs to cooperate among themselves in pooling information regionally on cargo movements and service requirements, and to ensure the establishments or strengthening of national and regional shippers' organisations. The Belgrade Conference (UNCTAD VI) entrusted the UNCTAD secretariat with the task of carrying out studies on ship and port finance, structure of the global shipping industry, policies and practices of governments in respect of investment in and support of shipping etc.

UNCTAD VI also hinted at a simpler payments mechanism under a common clearing system. This is another area which can provide considerable encouragement to co-operation among LDCs. Further, the developed countries insist that the existing international institutions like the IMF and World Bank should be strengthened financially so that they may provide larger aid to LDCs to tide over their balance of payments and debt problems. But the LDCs call for the setting up of a new financial institution which should exclusively cater to their special financial requirements in fields such as joint ventures, development projects, export credit, commodity price stabilisation, and regional payments support, and long-term investment to expand trade in food and primary products, and for storage, processing and transport. So far no progress has been made in this direction.

UNCTAD VII also stressed the importance of economic co-operation among developing countries on the lines of the previous conference. It was UNCTAD VIII which set up a new Standing Committee on Economic Co-operation among developing countries to study and report on all facets of cooperation to the TDB.

There are many factors which stand in the way of economic co-operation among the LDCs. The economies of LDCs are highly competitive in nature. They have limited import capacity, inadequate credit facilities, chronic foreign exchange shortage, and prejudice against the goods traded among themselves. Consequently they prefer to trade with developed countries even though goods manufactured by LDCs are cheaper and of high quality. However, some of the LDCs suffer from other limitations which prevent them from entering into trade with other LDCs. These are technological backwardness, shortage of key inputs, high cost of production, lack of competitive strength and weak marketing structure. The various problems listed above can be overcome by mutual help and trust among LDCs of region and working in close cooperation among themselves. UNCTAD is a forum where they can meet, discuss and formulate plans for regional economic co-operation.

New Issues

During the late 1980s, a large number of developing countries changed their economic policies to a market orientation, and began the process of structural adjustments involving exchange rate alignments and outward-looking liberalisation of their economies. In the early 1990s, socialist countries of Eastern Europe and the Soviet Union had disintegrated and adopted the market-oriented reforms. It was against this background that UNCTAD VIII met at Cartagena in February 1992. The proceedings at UNCTAD VIII emphasised global cooperation rather than confrontation, the need for negotiations and promotion of knowledge-based policies.

Notes

UNCTAD VIII had five key areas on the agenda : resources for development, international trade, technology, services, and commodities. In order to evolve consensus on these issues, the conference decided that the focus should be on their analysis rather on negotiations. It was, therefore, agreed that the UNCTAD should have a new structure on the lines of the OECD secretariat so that it could devote itself to the analysis of issues which was set up in April 1992, as detailed above. Thus UNCTAD VIII focussed on new issues such as services and sustainable development and on its new organisational structure.

The UNCTAD IX held at Midrand (S.A.) in May 1996 urged its members to provide more resources for sustainable development and debt relief to developing countries and to carry on the issues relating to technology, services and commodities in the light of the WTO Agreement 1994 of the GATT.

AN APPRAISAL OF UNCTAD

Since the UNCTAD is a conference, it added a group approach to negotiations. Till UNCTAD VII, there were four groups : Group A of the developed countries, the Group of 77 of developing countries (G-77), Group C of China, and Group D of the socialist countries of Eastern Europe. These groups were pitted against each other in a giant conference invariably every four years. Now there are only two groups—the developing and developed countries.

During the 1970s, with the breakdown of the Bretton Woods system, oil crisis, inflationary pressure and accumulation of debt by many LDCs, the UNCTAD became a large debating forum between the North and the South.

During the 1980s some of the newly industrialised developing countries had impressive growth rates, while others had disappointingly low growth rates. The developing countries experienced declines in their commodity prices and terms of trade. Their debts mounted and international aid flows were inadequate. On the other hand, many developed countries faced recessionary tendencies. Consequently, there was nothing but hot air at the UNCTAD conferences. There was disillusionment among the developing countries because of the hardening attitude of the developed countries towards almost every issue raised by the former at the conferences. As pointed out by *The Economist*, London, the UNCTAD was "a political circus". So each UNCTAD was a non-event that led to its failure to come to any agreement.

Despite long debates and disagreements at each conference, the UNCTAD has played a key role in the emergence of GSP, a maritime shipping code, commodity agreements to stabilise the volatile prices of primary product exporters, special international programmes to help the developing countries, and international aid targets.

The UNCTAD was set up in 1964 as an international forum to discuss and analyse trade related development issues which might lead to negotiations between the developed countries and LDCs.

IMF, The World Bank and Affiliates, and ADB

The world emerged into a new monetary system transcending the frontiers of individual countries, after the conference at Bretton Woods, where John Maynard Keynes dominated the proceedings with his startling *macro* concepts. It was in pursuance of the covenants established at Bretton Woods that the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD) or the World Bank, and such other international institutions were set up and started functioning.

The par value system, the quota system, the drawings and repurchases of currencies were the principal characteristics of the performance of the IMF. In the early 1970s, as a sequel to the devaluation of the dollar, both the par value system and fixed exchange rates came to an abrupt end, and the different currencies of the world started to *float*. Ten European countries linked themselves together in a *joint float* against the dollar and other currencies.

Notes

Such a policy of drift could not be allowed to continue and an important amendment to the IMF Charter came about in 1978, bringing about sweeping changes. The role of gold was drastically diluted, special drawing rights (SDRs) of member countries became decisively important to currency arrangements, and finally the surveillance of the Fund was established in a big way.

There could no longer be a devaluation without prior approval of the Fund. Finally, the IMF introduced the *conditionality arrangement*, generating much controversy and apprehension in the Third World.

Meanwhile the IBRD first engaged itself in financing the reconstruction of the war-ravaged economies of the world, particularly in Europe. Thereafter, as it became the World Bank, it has performed yeoman service in financing growth particularly in the developing economies of the world including the Third World.

13.2 International Monetary Fund

The International Monetary Fund—also known as the "IMF" or the "Fund"—was conceived at a United Nations conference convened in Bretton Woods, New Hampshire, U.S. in July 1944. The 45 governments represented at that conference sought to build a framework for economic cooperation that would avoid a repetition of the disastrous economic policies that had contributed to the Great Depression of the 1930s.

The IMF is an international organization of 184 member countries. It was established to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment (Figure 30.1).

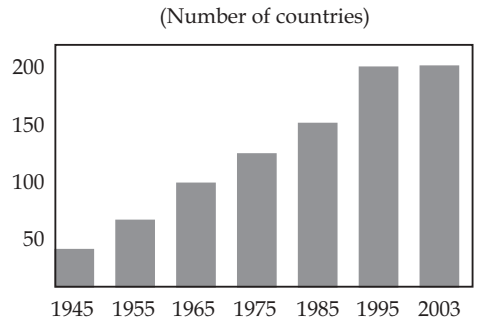


Figure 13.1 : Growth in IMF Membership, 1945-2003.

Since the IMF was established its purposes have remained unchanged but its operations—which involve surveillance, financial assistance, and technical assistance—have developed to meet the changing needs of its member countries in an evolving world economy.

Fast Facts

1. Current membership : 184 countries
2. Staff : approximately 2,700 from 141 countries
3. Total Quotas : $ 327 billion (as of 28/2/05)
4. Loans outstanding : $ 90 billion to 82 countries, of which $ 10 billion to 59 on concessional terms (as of 28/2/05)
5. Technical Assistance provided : 367 person years during FY2004
6. Surveillance consultations concluded : 115 countries during FY2004, of which 92 voluntarily published their staff reports

Responsibilities

1. Promoting international monetary cooperation
2. Facilitating the expansion and balanced growth of international trade

Notes

3. Promoting exchange stability
4. Assisting in the establishment of a multilateral system of payments, and
5. Making its resources available (under adequate safeguards) to members experiencing balance of payments difficulties.

Activities

More generally, the IMF is responsible for ensuring the stability of the international monetary and financial system—the system of international payments and exchange rates among national currencies that enables trade to take place between countries. The Fund seeks to promote economic stability and prevent crises; to help resolve crises when they do occur; and to promote growth and alleviate poverty. It employs three main functions—surveillance, technical assistance, and lending—to meet these objectives.

1. The IMF works to promote global growth and economic stability—and thereby prevent economic crisis—by encouraging countries to adopt sound economic policies.
2. Surveillance is the regular dialogue and policy advice that the IMF offers to each of its members. Generally once a year, the Fund conducts in-depth appraisals of each member country's economic situation. It discusses with the country's authorities the policies that are most conducive to stable exchange rates and a growing and prosperous economy. The IMF also combines information from individual consultations to form assessments of global and regional developments and prospects. Its views are published twice each year in the World. Economic Outlook and the Global Financial Stability Report.
3. Technical assistance and training are offered—mostly free of charge—to help member countries strengthen their capacity to design and implement effective policies. Technical assistance is offered in several areas, including fiscal policy, monetary and exchange rate policies, banking and financial system supervision and regulation, and statistics.
4. In the event that member countries do experience difficulties financing their balance of payments, the IMF is also a fund that can be tapped to help in recovery.
5. Financial assistance is available to give member countries the breathing room they need to correct balance of payments problems. A policy program supported by IMF financing is designed by the national authorities in close cooperation with the IMF, and continued financial support is conditional on effective implementation of this program.
6. The IMF is also actively working to reduce poverty in countries around the globe, independently and in collaboration with the World Bank and other organizations.
7. The IMF provides financial support through its concessional lending facility—the Poverty Reduction and Growth Facility (PRGF)—and through debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative.
8. In most low-income countries, this support is underpinned by Poverty Reduction Strategy Papers (PRSP). These papers are prepared by country authorities—in consultation with civil society and external development partners—to describe a comprehensive economic, structural and social policy framework that is being implemented to promote growth and reduce poverty in the country.

IMF Governance and Organization

The IMF is accountable to the governments of its member countries. At the apex of its organizational structure is its Board of Governors, which consists of one Governor from each of the IMF's 184 member countries. All Governors meet once each year at the IMF-World Bank Annual Meetings; 24 of the Governors sit on the International Monetary and Finance Committee (IMFC) and meet twice each year. The day-to-day work of the IMF is conducted at its Washington DC headquarters by its 24-member Executive Board; this work is guided by the IMFC and supported by the IMF's professional staff. The Managing Director is Head of IMF staff and Chairman of the Executive Board, and is assisted by three Deputy Managing Directors.

Notes

The IMF's resources are provided by its member countries, primarily through payment of quotas, which broadly reflect each country's economic size. The total amount of quotas is the most important factor determining the IMF's lending capacity. The annual expenses of running the Fund are met mainly by the difference between interest receipts (on outstanding loans) and interest payments (on quota "deposits").

India's quota and ranking : India's current quota in the IMF is SDR (Special Drawing Rights) 4,158.2 million in the total quota of SDR 212 billion, giving it a share holding of 1.961%. India's relative position based on quota is 13. However based on voting share, India (together with its constituency countries, viz., Bangladesh, Bhutan and Sri Lanka) is ranked 21.

13.3 The World Bank

The World Bank is one of the world's largest sources of funding and knowledge to support governments of member countries in their efforts to invest in schools and health centres, provide water and electricity, fight disease and protect the environment.

The World Bank is not a 'bank' in the common sense. The World Bank is an international organization owned by the 184 countries—both developed and developing—that are its members.

Since it was set up in 1944 as the International Bank for Reconstruction and Development. The number of member countries increased sharply in the 1950s and 1960s, when many countries became independent nations. As membership grew and their needs changed, the World Bank expanded and is currently made up of five different agencies.

All support to a borrowing country is guided by a single strategy (in the case of Afghanistan it is the 'Transitional Support Strategy') that the country itself designs with help from the World Bank and many other donors, aid groups, and civil society organizations.

Difference between the World Bank and a Commercial Bank

While it lends and even manages funds much like a regular bank, the World Bank is different in many important ways. The financial support and advice the World Bank provides its member countries is designed to help them fight poverty. And unlike commercial banks, the World Bank often lends at little or no interest to countries that are unable to raise money for development anywhere else.

Countries that borrow from the World Bank also have a much longer period to repay their loans than commercial banks allow. In some cases, they don't have to start repaying for ten years.

Basically, the World Bank borrows the money it lends. It has good credit because it has large, well-managed financial reserves. This means it can borrow money at low interest rates from capital markets all over the world and channel it to developing countries, often at much lower rates of interest than what markets would charge these countries.

Loans

The World Bank offers two basic types of loans : investment loans for goods, work and services to support economic and social development projects in a broad range of sectors; and adjustment loans to support policy and institutional reforms.

During loan negotiations, the World Bank agrees with the borrowing country on the development objective of the project or program, outputs, performance indicators (to measure the impact and success of the project) and a plan to put it all into practice. Once a loan is approved and becomes effective, the borrower puts the project or program into practice according to the terms agreed with the World Bank.

The World Bank supervises how each loan is used and evaluate the results. All loans are governed by operational policies, which make sure that operations are economically, financially, socially and environmentally sound.

Notes

Shareholders

The World Bank is run like a cooperative, with member countries as shareholders. The number of shares a country has is based roughly on the size of its economy. The United States is the largest single shareholder, with 16.41% of the votes, followed by Japan (7.87%), Germany (4.49%), the United Kingdom (4.31%) and France (4.31%). The rest of the shares are divided among the other member countries.

Every member government is represented by an Executive Director. The five largest shareholders (France, Germany, Japan, the United Kingdom and the United States) appoint an executive director each, while other member countries are represented by 19 Executive Directors.

The 24 Executive Directors make up our Board of Directors. They normally meet twice a week to oversee business, including reviewing loans and guarantees; new policies; the administrative budget; country support strategies; and borrowing and financial decisions.

Chander Mohan Vasudev is the Executive Director for India. He also represents Bangladesh, Bhutan, and Sri Lanka.

How the World Bank Works in India ?

The World Bank does not operate alone. In India, the Bank works with multiple development partners : The Government, other bilateral and multilateral donor organizations, nongovernmental organizations (NGOs), the private sector, and the general public— including academics, scientists, economists, journalists, teachers and local people involved in development projects. The Bank's method of operation is not to implement "World Bank projects" but to provide financing and advice for projects which are owned and supported by the Indian people and which are a logical part of a comprehensive and efficient overall development agenda.

How are Priorities Selected ?

Working with the government and civil society, the World Bank has developed an action plan known as the India Country Assistance Strategy (CAS) which describes *what kind of support* and *how much* could be provided to the country beginning in 2001 and covering a period of around three years. The CAS directly supports the government's Five-Year Plan and focuses on strengthening the enabling environment for development and sustainable growth and supporting critical interventions of special benefit to the poor and disadvantaged. In 2002, the World Bank completed a progress report on the CAS. It is also in the process of developing a new CAS.

Studies and Reports

The World Bank also produces studies and reports based upon its own analysis of a given issue. Topics of research come from the Bank's Country Assistance Strategy. This research is intended to provide an unbiased perspective on a range of specific development challenges.

Additional studies include reviews of economic policies (Country Economic Memoranda), fiscal spending (Public Expenditure Review), environmental reviews (Environmental Action Plan), and other specific topics.

Further discussion of development issues is promoted though workshops and other events. These events bring together groups such as government, media, and civil society organizations to discuss how best to move forward on a given issue.

Projects

As outlined in the support strategy, India develops its own projects with World Bank financing and technical support. The project cycle outlines the process of identifying, financing, implementing, and evaluating projects. Various financing options are available based upon the type of assistance needed. Loans or credits (interest-free loans) for these projects are then submitted for approval to the Executive Directors, the World Bank's decision-making body which represents all member countries.

Notes

It is important to note that the implementation of projects is managed by the Government itself. The government designates an office, referred to as the Implementing Agency, which is responsible for aspects such as procurement and selection of consultants and day to day work, monitoring and evaluation.

Operational Policies set guidelines to ensure that projects meet the World Bank's own criteria such as social and environmental standards. Project evaluations are conducted to capture and share lessons for future reference.

India : Country Assistance Strategy

This Country Assistance Strategy (CAS) for the period FY05-08 seeks to build a strong partnership with the Government of India, and, its overarching challenge will be how to maximize, and leverage Bank resources, to significantly scale up impacts, improve the quality of life of the poorest citizens, and help India achieve the Millennium Development Goals (MDGs). Three strategic principles will underpin the Bank's work : (1) focusing on outcomes; (2) applying selectivity; and, (3) expanding the Bank's role as a politically, realistic knowledge provider, and generator. This expansion will primarily be in (a) infrastructure—transport, power, water supply and sanitation, irrigation, and urban development; (b) human development—education, health, social protection; and, (c) rural livelihoods, emphasizing on community-driven approaches. During the period, important shifts are envisioned in the use of new approaches, i.e., cofinancing, and sector-wide approaches, where the Bank will seek engagement, and partnerships for this assistance. While the strategy will retain a reform, and performance-based approach to the states, it will change in the ways intended to engage with the largest, and poorest states, through policy dialogues on cross-cutting reforms—fiscal management, governance, service delivery, power sector, and investment climate. The CAS calls for enhanced focus on major analytical work, and a substantially higher level of International Development Association (IDA) resources, while the Bank's lending would fall within a range limited by an upper bound, which will require strong reform performance, and a strengthened pace of project preparation.

International Development Association

The International Development Association (IDA) is the part of the World Bank that helps the earth's poorest countries reduce poverty by providing interest-free loans and grants for programs aimed at boosting economic growth and improving living conditions. IDA funds help these countries deal with the complex challenges they face in striving to meet the Millennium Development Goals (MDGs). They must, for example, respond to the competitive pressures as well as the opportunities of globalization; arrest the spread of HIV / AIDS; and prevent conflict or deal with its aftermath.

IDA's long-term, no-interest loans pay for programs that build the policies, institutions, infrastructure and human capital needed for equitable and environmentally sustainable development. IDA's goal is to reduce inequalities both across and within countries by allowing more people to participate in the mainstream economy, reducing poverty and promoting more equal access to the opportunities created by economic growth.

IDA's Borrowers

IDA lends to those countries that had an income in 2002 of less than $ 865 per person and lack the financial ability to borrow from IBRD. Some "blend borrower" countries like India and Indonesia are eligible for IDA loans because of their low per person incomes but are also eligible for IBRD loans because they are financially creditworthy. Eighty-one countries are currently eligible to borrow from IDA. Together these countries are home to 2.5 billion people, half of the total population of the developing world. Most of these people, an estimated 1.5 billion, survive on incomes of $ 2 or less a day.

IDA Lending

IDA credits have maturities of 20, 35 or 40 years with a 10-year grace period before repayments of principal begins. IDA funds are allocated to the borrowing countries in relation to their income levels and record of success in managing their economies and their ongoing IDA projects. There is no interest charge, but credits do carry a small service charge, currently 0.75% on funds paid out.

Notes

In fiscal year 2003 (which ended June 30, 2003), IDA commitments totalled $ 7.4 billion and it had paid out $ 7.0 billion. New commitments in FY03 comprised 141 new operations in 56 countries. Fifty-one per cent of new commitments went to Sub-Saharan Africa, 28% to South Asia, 8% to East Asia and the Pacific, 8% to Eastern Europe and Central Asia, and the remainder to poor countries in North Africa and in Latin America.

Since 1960, IDA has lent $ 142 billion to 108 countries. Annual lending figures have increased steadily and averaged about $ 7.4 billion over the last three years. Most loans address basic needs, such as primary education, basic health services, and clean water and sanitation. IDA also funds projects that safeguard the environment, improve conditions for private business, build infrastructure, and support reforms to liberalize countries' economies and strengthen their institutions. All these projects pave the way toward economic growth, job creation, higher incomes and better living conditions.

IDA Funding

While the IBRD raises most of its funds on the world's financial markets, IDA is funded largely by contributions from the governments of the richer member countries. Their cumulative contributions since IDA's beginning up to the end of June 2003 totaled US $ 118.9 billion equivalent. Additional funds come from IBRD's income and from borrowers' repayments of earlier IDA credits.

Donors get together every three years to replenish IDA funds. Donor contributions accounted for more than half of the US $ 23 billion in the IDA13th replenishment which financed projects over the three-year period ending June 30, 2004. The largest pledges to IDA13 were made by the United States, Japan, Germany, United Kingdom, France, Canada and Italy, but less wealthy nations also contribute to IDA. Turkey and Korea, for example, once IDA borrowers, are now donors. Countries currently eligible to borrow from IBRD (but not from IDA)—Argentina, Brazil, Czech Republic, Hungary, Mexico, Poland, Russia, the Slovak Republic, and South Africa—are also IDA 13 donors. Other contributors include Australia, Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Israel, Kuwait Luxembourg, Netherlands, New Zealand, Norway, Portugal, Saudi Arabia, Singapore Spain, Sweden and Switzerland.

To increase openness and help ensure that IDA's policies are responsive to country needs and circumstances, representatives from each IDA region were invited to take part in the IDA 13 replenishment negotiations. The number of borrower representatives was further expanded—to a total of nine—at the first meeting of the IDA14 replenishment negotiations, held in Paris in February 2004. As was the practice in IDA13, background policy papers will be publicly released, as will a draft of the replenishment report prior to its finalization.

International Finance Corporation

The International Finance Corporation (IFC) promotes sustainable private sector investment in developing countries as a way to reduce poverty and improve people's lives. IFC is a member of the World Bank Group and is headquartered in Washington, DC. It shares the primary objective of all World Bank Group institutions : to improve the quality of the lives of people in its developing member countries—IFC Mission Statement.

Established in 1956, IFC is the largest multilateral source of loan and equity financing for private sector projects in the developing world. It promotes sustainable private sector development primarily by :

- Financing private sector projects located in the developing world.
- Helping private companies in the developing world mobilize financing in international financial markets.
- Providing advice and technical assistance to businesses and governments.

Ownership and Management

IFC has 177 member countries, which collectively determine its policies and approve investments. To join IFC, a country must first be a member of the IBRD. IFC's corporate powers are vested in its Board

Notes

of Governors, to which member countries appoint representatives. IFC's share capital, which is paid in, is provided by its member countries, and voting is in proportion to the number of shares held. IFC's authorized capital is $ 2.45 billion. Statement of Capital Stock and Voting Power.

The Board of Governors delegates many of its powers to the *Board of Directors*, which is composed of the Executive Directors of the IBRD, and which represents IFC's member countries. The Board of Directors reviews all projects.

The President of the World Bank Group, James D. Wolfensohn, also serves as IFC's president. IFC's Vice President, Operations and Acting Executive Vice President, Assad Jabre, is responsible for the overall management of day-to-day operations.

Although IFC coordinates its activities in many areas with the other institutions in the World Bank Group, IFC generally operates independently as it is legally and financially autonomous with its own Articles of Agreement, share capital, management and staff.

Funding of IFC's Activities

IFC's equity and quasi-equity investments are funded out of its net worth : the total of paid in capital and retained earnings. Strong shareholder support, triple-A ratings, and the substantial paid-in capital base have allowed IFC to raise funds for its lending activities on favourable terms in the international capital markets.

India and IFC

Since 1956, IFC has invested in 153 companies in India, providing nearly $ 2.8 billion in financing for its own account and $ 525 million for the accounts of participants in IFC's loan syndication program.

Our held portfolio of $ 1.2 billion (as of March 2005) makes India our third largest country of operations. In recent years, we have grown our business substantially, with new commitments reaching $ 284 million in FY 2004.

To reduce poverty and promote sustainable economic growth, we believe that India needs a vibrant private sector which will :

1. Increase the availability of high-quality infrastructure.
2. Accelerate rural growth.
3. Develop competitive manufacturing and service industries.
4. Strengthen the financial sector.

We are therefore focusing our activities on supporting :

1. Private sector involvement in infrastructure financing.
2. Restructuring and modernization of the manufacturing and services sectors to become internationally competitive.
3. The development of new financial institutions and products.

We are committed to working on the frontiers of private investment, helping bring commercial disciplines and entrepreneurial dynamism to new areas of the economy. We therefore also support private investment in health and education, and innovative applications of information technology.

13.4 Asian Development Bank

The Asian Development Bank (ADB), a multilateral development bank, was established in 1966 under the Agreement Establishing the Asian Development Bank (Charter) which is binding upon the member countries which are its shareholders. The purpose of ADB is to foster economic growth and cooperation in Asia and the Pacific region and to contribute to the economic development of the developing member countries in the region collectively and individually. ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve living conditions and quality of life. ADB's strategy for reducing poverty rests on three pillars : sustainable economic growth, inclusive social development, and governance for effective policies and institutions.

Notes

As of December 31, 2004, ADB had 63 members consisting of 45 regional members, including Japan, Australia, and New Zealand, and 18 nonregional members, including the United States, Canada and 16 European countries. The regional members provided 63.2% of ADB's capital and the nonregional members provided 36.8% of its capital during the previous fiscal year. The membership of ADB reflects the intention of the founders that, while its operations should be limited to the region, it should incorporate the active participation and financial resources of developed nations outside the region. The percentage of voting power in ADB's affairs held by the respective members is related, but is not directly proportional, to their capital subscriptions. As of December 31, 2004, the aggregate voting power of the developed member countries, which include all nonregional members plus Japan, Australia, and New Zealand, represented approximately 54.6% of the total. The members and their respective voting power and subscriptions to ADB's capital stock as of December 31, 2004 are set forth in Appendix VII of the Financial Statements.

ADB's primary activity is making loans to finance projects or programs located within the territories of its developing member countries. Such activity is divided into ordinary operations and special operations, for which separate financial statements are maintained. Ordinary operations are financed from ordinary capital resources and special operations are financed from Special Funds resources, most of which are contributed by members. Under the Charter, ADB's ordinary capital resources and the Special Funds resources must at all times be held and used entirely separately from each other.

In addition to its lending operations, ADB issues guarantees, makes equity investments and participates in underwriting equity funds. ADB also extends technical assistance in the form of grants or loans for project preparation and evaluation, development planning and other purposes. ADB also provides policy dialogues and advisory services and mobilizes financial resources through its cofinancing operations tapping official, commercial, and export credit sources to maximize the development impact of its assistance. To complement ADB's activities in development research and training, ADB has established the ADB Institute, a subsidiary body of ADB, located in Tokyo, Japan.

Operational Policies

ADB is authorized under the Charter to make, participate in or guarantee loans to its developing member countries or their governments, to any of their agencies or political subdivisions, and to public or private enterprises operating within such countries, as well as to international or regional entities concerned with economic development in the region. Such loans are made only for projects or programs of high developmental priority. ADB provides financing to its borrowers to cover foreign exchange expenditures incurred in a project and also finances local currency expenditures in certain cases. ADB requires its borrowers to absorb exchange risks attributable to fluctuations in value of the currencies which it has disbursed.

In evaluating the projects that it may finance, ADB considers such factors as economic, social, environmental, technical, institutional and financial feasibility, effect on the general development activity of the country concerned, contribution to economic development, capacity of the borrowing country to service additional external debt, effect on domestic savings, balance of payments effects, impact of new technologies on productivity, and expansion of employment opportunities. In response to the changing needs and imperatives of the developing member countries and the international environment, ADB has declared poverty reduction to be its overarching goal. ADB supports this goal by providing loans and grants to promote sustainable economic growth, social development, and good governance. To broaden and deepen the impact of its interventions, ADB promotes the role of the private sector in development, supports regional cooperation and integration, and addresses environmental sustainability in all its loans.

Goal

ADB's overarching goal is to reduce poverty in Asia and the Pacific. It helps improve the quality of people's lives by providing loans and technical assistance for a broad range of development activities.

ADB is a multilateral development finance institution that engages in mostly public sector lending for development purposes in its developing member countries. ADB's clients are its member governments, who are also its shareholders.

Notes

ADB and India

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve their living conditions and quality of life. ADB pursues a strategic agenda—sustainable economic growth, inclusive social development, and governance for effective policies and institutions—with three crosscutting themes : private sector development, regional cooperation, and environmental sustainability.

ADB's main instruments in providing help to its developing member countries are policy dialogues, loans, technical assistance, grants, guarantees, and equity investments. In 2003, ADB's total lending volume was US $ 6.1 billion. Technical assistance, which is used for preparing and implementing projects, supporting advisory activities, and undertaking regional activities, amounted to US $ 176.5 million. Grants totaling US $ 483.5 million were also provided.

ADB was established in 1966. India was one of its 31 founding members. ADB's headquarters is in Manila. It has 23 offices around the world. ADB's staff numbers more than 2,000 employees from over 50 countries.

Loans and Technical Assistance

Nine loans for seven projects totaling US $ 1.5 billion were approved in 2003. They were for development of rural roads, state roads, and national highways; urban water supply and environment improvement; and power development. Twenty-two technical assistance projects totaling US $ 14.7 million were also approved. Cumulative ADB lending to India as of 31 December 2003 was US $ 13.32 billion.

Self-Assessment

1. Choose the correct options

(*i*) Which of the following are not third-world regions?

(*a*) Latin America. (*b*) Asia.

(*c*) Africa. (*d*) Australia.

(*ii*) Which of the following countries are not newly industrialized countries (NICs)?

(*a*) Taiwan. (*b*) North Korea.

(*c*) Singapore. (*d*) Hong Kong.

(*iii*) Which country is not a transitional economy

(*a*) China. (*b*) Russia.

(*c*) Hungary. (*d*) Mexico.

(*iv*) The poorest region of the world is

(*a*) the Middle East. (*b*) sub-Saharan Africa.

(*c*) Asia. (*d*) Latin America.

(*v*) Of the world's population, what portion lives in developing countries?

(*a*) approximately 35%. (*b*) approximately 80%.

(*c*) nearly 10 billion people. (*d*) less than 1 billio people.

(*vi*) In which of the following countries would you expect material lifestyles to be most like those in the United States?

(*a*) Nigeria. (*b*) Japan.

(*c*) India. (*d*) Mali.

13.5 Summary

- The UNCTAD secretariat has been doing yeoman's service to LDCs through its annual and other reports which highlight their trade, finance and debt problems vis-a-vis developed

Notes

countries. In fact, the detailed reports prepared by it before each conference have created a new climate of thought with regard to the problems and needs of LDCs. These are again discussed at other international forums such as the IMF, World Bank, OECD, EEC, NAM, etc. Often, positive measures follow such as larger aid by the World Bank and OECD, giving more trade concessions by EEC to LDCs, etc. As such the UNCTAD reflects the sentiments, hopes and aspirations of LDCs in a world still dominated by the developed countries, both politically and economically.

- The days of the gold standard are over. We now operate in a new world with a neoteric and growth oriented international monetary system. It is clear that India must move forward with the rest of the world, and make the most of the many options and opportunities open to it. The strategies of development, both for the internal economy as well as for international trade and commerce, must be attuned to such requirements and propensities.
- There is still a bias in the world bodies against the Third World. Besides the conditionalities profounded by the IMF, the World Bank and its affiliates are not always in the best interest of the countries being granted finance. These are very often linked to the interest of the developed world. As for ADB India has been on several occasions treated as the unwanted cousin. However, all intermodal financial organizations are going through and will go through the changes in outlook and facilities. It is to be expected that these organizations will carry greater responsibilities about socioeconomic development of the Third World than hitherto.

13.6 Key-Words

1. UNCTAD : The United Nations Conference on Trade and Development (UNCTAD) was established in 1964 as a permanent intergovernmental body. It is the principal organ of the United Nations General Assembly dealing with trade, investment, and development issues.
2. Shareholders : A shareholder or stockholder is an individual or institution (including a corporation) that legally owns a share of stock in a public or private corporation.

13.7 Review Questions

1. Explain the role of UNCTAD and development.
2. What is the role of international monetary fund? Discuss.

Answers: Self-Assessment

1. (*i*) (*d*) (*ii*) (*b*) (*iii*) (*d*)
   (*iv*) (*b*) (*v*) (*b*) (*vi*) (*b*)

13.8 Further Readings

1. Krimawati, Wawat. (?) NAFTA: North America Free Trade Agreement. [Accessed 18 May 2009]
2. Vogel, David. (2009) North American Free Trade Agreement. [Accessed 18 May 2009] 2009. North American Free Trade Agreement (NAFTA).
3. United States Department of Agriculture, Foreign Agricultural Service. [Accessed June 8, 2009]

Notes

Unit 14 : India's Trade Policy : Recent Developments

CONTENTS

Objectives
Introduction
14.1 India's Foreign Trade Policy
14.2 Export Import Policy
14.3 Foreign Trade Policy
14.4 Summary
14.5 Key-Words
14.6 Review Questions
14.7 Further Readings

Objectives

After reading this Unit students will be able to:

- Explain India's Foreign Trade Policy.
- Know Export-Import Policy.
- Describe Foreign Trade Policy.

Introduction

Advanced countries like Germany, U.S.A., Japan and others used their trade policy to (a) restrict their imports and provide a sheltered market for their own industries so that they could develop rapidly, and, (b) promote their exports so that their expanding industries could secure foreign markets. In other words, trade policy played a significant role in the development of the advanced countries. India, however, did not have a clear trade policy before Independence, though some type of import restriction—known as discriminating protection—was adopted since 1923 to protect a few domestic industries against foreign competition. It was only after Independence that a trade policy as part of the general economic policy of development was formulated by India.

Main features of India's trade policy

On the import side, India has been in a disadvantageous position vis-a-vis advanced countries which are capable of producing and selling almost every commodity at low prices. This meant that India could not develop any industry without protecting it from foreign competition. Import restriction—commonly known as protection—was thus essential to protect domestic industries and to promote industrial development. Since Independence, the Government of India has broadly restricted foreign competition through a judicious use of import licensing, import quotas, import duties and, in extreme cases, even banning import of specific goods. The Mahalanobis strategy of economic development through heavy industries, which India adopted since the Second Plan, called for (a) banning or keeping to the minimum the import of non-essential consumer goods, (b) comprehensive control of various items of imports, (c) liberal import of machinery, equipment and other developmental goods to support heavy-industries based economic growth, and (d) favourable climate for the policy of import substitution.

On the export side : To pay for its essential imports and to minimise dependence on foreign countries expansion of exports was very essential. It was also realised that the market for many goods within India may not be adequate to absorb that entire domestic production and hence a search for markets else where was a necessity. The Indian Government had to play an important role to promote exports

Notes

through setting up trading institutions, and through fiscal and other incentives. Vigorous export promotion was emphasised after the Second Plan to earn foreign exchange to overcome the acute foreign exchange crisis. In the 1970's, importance of export promotion was again emphasised because of mounting debt service obligations and the goal of self-reliance (with zero net aid).

Phases of India's trade policy

Five distinct phases in India's trade policy can be noted : the first phase pertains to the period 1947-48 to 1951-52, the second phase covering the period 1952-53 to 1956-57 and the third phase after 1956-57 to June, 1966; the fourth phase started after devaluation of the Rupee in june 1966 and the last phase after 1975-76.

During the first phase up to 1951-52, India could have liberalised imports but on account of the restrictions placed by the U.K. on the utilisation of the sterling balances, she had to continue wartime controls. Since our balance of payments with the dollar area was heavily adverse, an effort was made to screen imports from hard currency areas and boost up exports to this area so as to bridge the gap. This also necessitated India to devalue her currency in 1949. By and large, the Import policy continued to be restrictive during this period. Besides this, restrictions were also placed on exports in view of the domestic shortages.

During the second phase (1952-53 to 1956-57) liberalisation of foreign trade was adopted as the goal of trade policy. Import licences were granted in a liberal manner. An effort was also made to encourage exports by relaxing export controls, reducing export duties, abolishing export-quotas and providing incentives to exports. Liberalisation led to a tremendous increase in our imports but exports did not rise appreciably. Consequently, there was fast deterioration in our foreign exchange reserves. This necessitated a reversal of trade policy.

During the third phase which began in 1956-57, the trade policy was re-oriented to meet the requirements of planned economic development. A very restrictive import policy was adopted and the import controls further screened the list of imported goods. On the other hand, a vigorous export promotion drive was launched. The trade policy assumed that a lasting solution to the balance of payments problem lies in the promotion and diversification of our export trade. Not only should the export of traditional items be expanded, but export of newer items should also be encouraged. Similarly, import substitution industries should also be encouraged so that dependence on foreign countries be lessened. It was in this period that India's trade policy was thoroughly reviewed by the Mudaliar Committee (1962).

The fourth phase started after the devaluation of the rupee in June, 1966. During this period trade policy attempted to expand exports and strangely liberalised imports too. Actually, export promotion was given a big post through the acceptance and implementation of the commendations of the Mudaliar Committee (1962). The major recommendations included increased allocation of raw materials to export-oriented industries, income tax belief on export earnings, export promotion through import entitlement, removal of disincentives, and setting up of export Promotion Advisory Council, a Ministry of international Trade, etc. When these export promotion measures did not succeed and adverse balance of payments persisted, the Government of India undertook devaluation of the rupee in 1966 as a major step to check imports and boost exports. Initially devaluation was not successful and the adverse balance of payments worsened during the Annual Plans. But during the Fourth Plan, the trade policy was quite successful in restricting imports and promoting exports. This period continued till 1975-76.

During the last phase (1975-76 onwards), the Government adopted a policy of import liberalisation, with a view to encourage export promotion. During Janata rule (1977-79) import liberalisation was also adopted to augment domestic supply of essential goods and to check rise in price level. Import-export policy of the Indian Government attempted to achieve such objectives as : (i) to provide further impetus to exports; (ii) to provide support to the growth of indigenous industry; (iii) to provide for optimum utilisation of the country's resource endowments, especially in man-power and agriculture; (iv) to facilitate technology up-gradation with special emphasis on export promotion and energy conservation; (v) to provide a stimulus to those engaged in exports and in particular, to manufacturing units contributing substantially to the export efforts; and (vi) to effect all possible savings in imports.

Notes

Thus, it is clear that the purpose of trade policy has been to stimulate economic growth and export promotion via import liberalisation.

While framing the export-import policy (1985), the Government was guided by the recommendations of Abid Hussain Committee. Whereas the Committee emphasized the need for striking a balance between export promotion and import substitution, the Government in its wave of import liberalisation permitted a much greater quantum of imports in the name of export promotion and capital goods imports for technological upgradation. Thus, grave distortions appeared in the process of implementation of the recommendations of the Committee.

The first major attempt at liberalisation was made by the Rajiv Gandhi Government. As a result, in the four years from 1985-86 to 1989-90, exports surged forward and the period witnessed a record average annual growth of 17 per cent in dollar terms. Unfortunately exports declined by 9 per cent in 1990-91.

14.1 India's Foreign Trade Policy

Giving the rationale for the new policy, the Commerce Minister noted : For several decades, trade policy in India has been formulated in a system of administrative controls and licenses. As a result, we have a bewildering number and variety of lists, appendices and licences. This system has led to delays, waste, inefficiency and corruption. Human intervention—described as discretion—at every stage, has stifled enterprise and spawned arbitrariness.

The Government, therefore, decided that while all essential imports like POL, fertilizer and edible oil should be protected, all other imports should be linked to exports by enlarging and liberalizing the replenishment licence system. For this purpose, the following major reforms were announced:

Did u know? The then Commerce Minister, Mr. P. Chidambaram, announced a major overhaul of trade policy on July 4, 1991.

Major Trade Reforms

1. Rep will become the principal instrument for export-related imports.
2. All exports will now have a uniform Rep rate of 30 per cent of the f.o.b. value. This was a substantial increase from the present Rep rates which vary between five per cent and 20 per cent of f.o.b. value.
3. The new Rep scheme gave maximum incentive to exporters whose import intensity was low. For example, agricultural exports which earlier had very low replenishment rates of five per cent or 10 per cent will now gain considerably.
4. All supplementary licences shall stand abolished except in the case of the small scale sector and for producers of life-saving drugs/equipment.
5. All additional licences granted to export houses shall stand abolished.
6. All items now listed in the Limited Permissible List OGL items would hereafter be imported through the Rep route.
7. The Exim policy contained a category known as Unlisted OGL. This category stands abolished and all items falling under this category may be imported only through the Rep scheme.
8. Advance licensing had been an alternative to the Rep route for obtaining imports for exporters. It was expected that many exporters would find the Rep route more attractive now. However, for exporters who wish to go through advance licensing, this route would remain open.
9. The goal of the government was to decanalise all items except those that are essential.

Notes

10. In the light of the substantial liberalisation of the trade regime, and also the recent changes in exchange rates (after devaluation), Cash Compensatory Scheme (CCS) was abolished from July 3, 1991.

Assessment of the Trade Policy

Trade Policy (1991) aimed to cut down administrative controls and barriers which acted as obstacles to the free flow of exports and imports. The basic instrument developed by the Policy was the Exim scrip in place of Rep licences. The purpose of this instrument was to permit imports to the extent of 30% on 100 per cent realisation of export proceeds. Obviously, the purpose was to bridge the BOP gap. Trade policy has streamlined various procedures for the grant of advance licences as also permit imports through exim scrips routes.

Since the time of Mudaliar Committee in 1962, the country has been fed on the slogan of export-promotion through import entitlement. Various instruments have been forged there after, but a long term view only underlined the fact that the country failed to check the faster growth of imports than that of exports during the last three decades. Under one pretext or another, the import widow was opened much wider and this continued. There was a strong need to exercise extreme caution in liberalising imports, more so inessential imports.

To conclude, India's trade policy since Independence has been used as part of general economic policy to develop the country and to diversify the economy. Initially it took the form of restricting imports and boosting exports. It also took the form of organising international trade and bilateral and multi-lateral trade agreements. In the later years, trade policy took the form of export promotion through import liberalisation. Formulated by bureaucrats under the influence and guidance of Indian business houses and multinational giants, India's trade policy did have an important influence on the rapid development of the country, but it was basically responsible for leading the country into the classical debt trap.

Let us now analyse the two aspects of India's trade policy—import policy and export policy.

14.2 Export-Import Policy

The import policy in the post-independence period was guided by considerations of a growth-oriented policy which should ultimately lead us to the objective of self-reliance.

Export-Import Policy during First Decade of Planning

The needs of massive programme of industrialisation contemplated in the Second Plan led to the adoption of a liberal import policy in mid-50's. Imports went up sharply both in the private and public sectors. The schemes of modernisation, replacement and expansion undertaken in the private sector and the programmes of the building up of heavy and basic industries in the public sector led to an unprecedented rise in imports. Exports did not expand as planned. Accordingly, India lost all its accumulated sterling balances to pay off its adverse balance. The country also suffered from a serious shortage of foreign exchange—a veritable foreign exchange crisis. This necessitated a reversal of import policy and drastic restrictions were placed on imports.

During the Second Plan period, it was felt that export earnings could not be significantly increased unless industrialisation gathered momentum. This fact was given expression in Second Plan in the following words : "India's export earnings are derived from a few commodities. Three of them, namely, tea, jute and cotton textiles, account for nearly one-half of the quota. These major exports are meeting increasing competition from abroad. This limits the scope for any substantial increase in exports in the short run. While every effort has to be made to promote exports of new items and to develop and diversify the markets for country' s major exports, it has to be recognised that it is only after industrialisation has proceeded some way that increased production at home will be reflected in large export earning.

Mudaliar Committee Recommendations

The Government appointed the Import and Export policy Committee headed by Mr. Mudaliar in 1962 to review Government's trade policy. The Committee felt that developmental and maintenance

Notes

imports were both essential for a growing economy and therefore, urged upon the government to provide facilities for the import of raw materials, components, etc., for all existing industries subject to higher priorities to new industries in (i) power and transport which had proved a serious bottleneck; (ii) 'export-oriented' industries; and (iii) industries producing raw materials and components now imported. Industries depending almost entirely on indigenous raw materials could arrange their own foreign exchange for the import of plant and machinery. The recommendations of the committee were accepted by the Government.

The import policy of restriction of non-essential goods on the one side and liberalisation of imports of essential goods on the other was successful to a large extent—imports were controlled and exports were pushed up. This policy helped to reverse the persistent trade deficit.

Export-oriented Export-Import Policy

Since 1975-76, the Government of India has been following a liberalised import policy with the objective of increasing production, especially export production. There has been an increased emphasis on enhancing maintenance imports in order to promote capacity utilisation. Since the principal purpose of the import policy was to encourage exports, it is characterised as export-oriented import policy.

Export-Import Policy (1985)

Mr. Vishwanath Pratap Singh, the then Commerce Minister, announced the Export-import Policy on the 12th April 1985. For the first time, the Government announced the policy on a three-year basis. The basic aim of the new policy was to facilitate production through easier and quicker access to imported inputs, impart continuity and stability of Exim Policy, strengthen the export production base, facilitate technological upgradation and effect all possible savings in imports.

Import-Export Policy (1990)

The government announced on April 30,1990 a new Import-Export Policy for a 3-year period. The Policy statement made it clear : "Improvement in our Balance of payments position can be achieved not so much through import curtailment as through promotion of exports. "The new policy has, therefore, provided further momentum to the ongoing process of liberalisation with emphasis on strengthening the impulses of industrial and export growth. The salient features of the new policy were :

1. List of items imported under Open General Licence (OGL) were expanded to facilitate easy access to import of items that are not available within the country.
2. The number of capital goods items permitted under OGL was increased from 1,261 to 1,343. This has been the major thrust of liberalisation.
3. Imports of certain raw materials such as petroleum products, fertilizers, oils / oilseeds, feature / video films, newsprint, cereals, phosphoric acid, ammonia etc. were canalised through public sector agencies in view of the essential character of these imports from the point of view of bulk consumption and the requirements of small Actual Users. However, trading houses / star trading houses were also permitted to import canalised items in order to promote exports.
4. A scheme of automatic licensing was introduced under which upto 10 per cent of the value of the previous year's licence can be imported.
5. For Registred Exporters, the concept of net foreign exchange earnings was made a guiding criterion for issue of licences thereunder.
   (a) REP (Replenishment) licensing scheme was expanded and simplified.
   (b) Export services like computer software, overseas management and consultancy service contracts as well as advertising jobs would qualify for import replenishments.
   (c) Under the scheme of registration of Export Houses and Trading Houses, for determining eligibility, the annual average of net foreign exchange earnings in the base period should not be less than ` 5 crores for an Export House and ` 20 crores for a Trading House. These houses would be eligible for additional licences for import of raw materials, components,

Notes

consumables and tools and capital goods allowed under OGL, besides other limited permissible items and canalisd items.

(d) A scheme of Star Trading Houses was introduced for exporters with an average annual net foreign exchange earnings of ` 75 crores in the preceding three licensing years of the base period.

(e) Under the Duty Exemption Scheme, Blanket Advance Licensing was introduced for manufacturer-exporters having a minimum net foreign exchange earnings of ` 10 crores during the preceding 3 years.

(f) The Import-Export Passbook Scheme introduced in January 1986 was withdrawn.

Evaluation of India's Export-Import Policy

The 1985 import policy was broadly welcomed by various Chambers of Commerce and Industry, business and industrial houses and leading industrialists. The policy aimed at restricting unnecessary imports, but permitted imports for encouraging indigenous production and promoting exports. The policy also intended to pursue technological upgradation through imports. The policy was aware of the need to check dumping of goods by multinationals and, therefore, gave support to the indigenous industries by selective restrictions on imports. Another welcome feature of the import policy was the fillip it gave to the small-scale and cottage industries as well as to agricultural exports, all this would help to maximise utilisation of our manpower and agricultural resources. As regards promotion of exports, the import policy contained clear cut measures to expand India's exports. The various measures were direct and positive and a general feeling was that India's import policy was clearly export-oriented.

However, critics noted some developments of a serious nature which would adversely affect our economy. They are :

(i) **Adverse effect on the growth of capital goods industry in India** : The most serious liberalisation has been attempted in the Exim Policy 1985-86 in the Capital Goods List bringing 208 items under the OGL list. Among the additions was microprocessor based equipment, machine tools, spinning machines, jute machinery etc. The impact of this wave of liberalisation is bound to be adverse. Given the limited size of the market and the problems of technology transfer and the procedural bottlenecks created by licensing, the development of capital goods industry which was never a very lucrative proposition for Indian industrialists, was made much more frightening in the wake of liberal imports of customs duty concessions.

(ii) **Import policy likely to hit small-scale industries** : Although the statement of objectives specifically mentioned encouragement of the small-scale sector, but the measures suggested do not match with the professed aims. Rather the Government in the name of modernisation was helping big business to import labour-saving machinery. **Economic and Political Weekly** exposing double talk of the Government mentioned : "the government's pretensions of encouraging the handloom sector by controlling the textile industry are exposed by the fact that the latest in the labour-saving textile machinery, air jet and water jet looms (including shuttle-less looms), have been placed under OGL on the plea of modernisation."

(iii) **Adverse effect on indigenous industry** : The new import policy was trying to over-reach its objectives of liberalisation and under pressure from multi-nationals opened areas in which indigenous industry had adequate capacity. There was certainly far reaching implications of such sweeping relaxations in imports. The Gujarat State Fertilizer Corporation (GSFC) and the Soda Ash Industry have been continuously pleading before the Government to restrict imports of caprolactum and soda ash since it would hit their interests adversely but the powerful multinationals forced the Government to dump these raw materials in India. This posed a problem of survival for the indigenous industry.

(iv) **Technological dumping in the name of technology upgrading** : According to RBI **Report on Currency and Finance (1989-90),** capital goods imports increased from ` 3,168 crores in 1984-85 to ` 8,831 crores in 1989-90 i.e., they have grown at an annual growth rate of 22.8 per cent during the 5 year period. There is, therefore, a relentless drive for unfettered import of capital

goods, design and drawings and technology. This is a dangerous trend from the country's point of view. Criticising this approach, the **Economic and Political Weekly** mentioned : "What is missed in this line of reasoning is that production capacities once built on imported technologies and imported capital goods have to be sustained by imported raw materials, spares and parts. The so-called "inflexible imports" are, therefore, destined to grow constantly and relentlessly." Secondly, experience has also shown that the multinationals are hardly interested in technology transfer. Rather they in the name of technological upgradation, carry on 'technological dumping' of such technologies which have been superseded in the developed countries. This, the critics argue, is far more deleterious than dumping of goods—including capital goods.

From the foregoing analaysis, it becomes evident that opening the door of imports much wider would result in increasing the trade gap. Such indiscriminate liberalisation would create more dependence in terms of foreign exchange and widen the trade gap.

Export-Import Policy (2002-2007)

Union Commerce and Industry Minister Mr. Murasoli Maran announced the EXIM policy for the 5 year period (2002-07) on March 31,2002. The main thrust of the policy was to push India's exports aggressively by undertaking several measures aimed at augmenting exports of farm goods, the small scale sector, textiles, gems and jewellery, electronic hardware etc. Besides these, the policy aimed to reduce transaction cost to trade through a number of measures to bring about procedural simplifications.

The salient features of Exim policy were as under :

I. **Special Economic Zones :** Indian banks were allowed to set up offshore banking units (OBUs) in special Economic zones. These units would act as magnets to attract foreign direct investments. These offshore banking units would be virtually foreign branches of Indian banks, but located in India. OBUs would be exempt from cash reserve ratio (CRR), statutory liquidity ratio (SLR) and would give access to SEZ units and SEZ developers to international finance at international rates. This measure was aimed to make special Economic Zones internationally competitive.

II. **Employment Oriented Measures :** EXIM (2002-07) policy initiated a number of measures which would help employment orientation. Among them were the following :

(a) **Agriculture :** Exim policy removed all quantitative restrictions on all agricultural products except a few sensitive items like jute and onions.

(b) **Cottage sector and handicrafts** :

(i) An amount of ` 5 crores under market access initiative (MAI) were earmarked for promoting cottage sector exports coming under KVIC. The units under handicrafts could also access funds under MAI.

(ii) Under export promotion capital goods (EPCG) scheme, these units would not be required to maintain an average level of exports, while calculating export obligation.

(iii) These units would be entitled to the benefit of Export House status on achieving lower average export performance of ` 5 crore as against ` 15 crores for others; and

(iv) The units in handicraft sector would be entitled to duty-free imports of an enlarged list of items up to 3 per cent of f.o.b value of their exports.

(c) **Small scale industry** : With a view to encouraging further development of centres of economic and export excellence such as Tirpur for hosiery, woollen blankets in Panipat, woollen knitwear in Ludhiana, following benefits would be available to small-scale sector.

1. Common service providers in these areas would be entitled to the facility of Export Promotion Capital Goods (EPCG) Scheme.
2. Entitlement for Export House status at ` 5 crores instead of ` 15 crores for others.

(d) **Textiles :** Duty entitlement passbook (DEPB) rates for all kinds of blended fabrics permitted. Such blended fabrics were to have lower rate as applicable to different constituent fabrics.

(e) **Gems and jewellery :** Rough diamonds import allowed on zero custom duty basis.

Notes

III. Growth-Oriented

(a) Strategic package for status holders : The status holders would be eligible for the following facilities :

(i) 100 per cent retention of foreign exchange in exchange earners foreign currency (EEFC) account.

(b) Neutralising high fuel cost : Fuel costs to be rebated for all export products. This would enhance the cost competitiveness of our export products.

(c) Diversification of markets : The following initiatives have been taken :

Focus LAC (Latin American Countries) was launched in November 1997 in order to accelerate trade with these countries. Our exports to these countries have increased by 40 per cent. To consolidate the gains of these programmes, this was extended upto March 2003.

Focus Africa was launched in April 2002. There is a tremendous potential for trade with sub-Saharan African region. During 2000-01, Indian exports to this region accounted for US $1.8 billion and imports were $1.5 billion.

IV. Duty Neutralisation Instruments

(a) Advance licence : Duty Exemption Entitlement Certificate (DEEC) book was abolished. Redemption on the basis of shipping bills and band realisation certificates.

Withdrawal of advance licence for annual requirement (AAL) as problems were encountered in closure of AAL. The exporters could avail of advance licence for any value.

(b) Duty entitlement pass book (DEPB) : value cap exemption granted on 429 items to continue.

(c) Export promotion capital goods (EPCG) : licences of ` 100 crore or more to have 12 year export obligation period with 5 year moratorium period.

Assessment of EXIM Policy (2002-07)

Mr. Murasoli Maran, the then Minister for Commerce and Industry took a number of initiatives by providing tax concessions, streamlining certain procedures and removing quantitative restrictions.

Another positive feature of the policy was have 'Focus Africa' so that Indian exports to African countries can be developed. This initiative would help Indian exporters to explore this fast growing market which has been neglected earlier.

A big initiative to permit offshore banking units (OBUs) would help to develop foreign branches of Indian banks. The move was intended to provide international finance at international rates. This would lower the cost of credit to our exporters and thus make them more competitive. This initiative, specially directed at Special Economic Zones was another healthy feature of the Exim Policy.

However, critics raised several issues which need consideration. EXIM policy intended to boost the export of agriculture. In this effort, it intended to export wheat and thus reduce the mounting bufferstocks of foodgrains reaching the astonishingly high figure of 58 million tonnes in on January 1, 2002. There are two options before the government—(i) to export these foodgrains and earn foreign exchange and (ii) to use these foodgrains in 'food for work' programme and thus create employment in public works programme. It is really very disappointing that the Food Corporation of India is selling wheat in the international market as cattle feed at throw away prices. The question arises : Why is the quality of wheat procured by FCI poor when the Government continues to raise the support price of wheat for the farmers year after year ? It only speaks volumes about rampant corruption in FCI. The failure of the Central Government to persuade state governments to lift foodgrains from FCI is evident from the fact that as against an allocation of 28.55 million tonnes in 2000-01 in case of rice and wheat, the offtake was merely 11.72 million tonnes which is only 41 per cent of the allocation. This was mainly the consequence of an irrational policy fixing the issue price of foodgrains quite high. The result was that the public preferred to buy foodgrains from the open market. The Government, if it wants to increase the exports of agricultural products, should pay

Notes

more attention toward improving the quality of rice and wheat procured so that it can fetch a good price in the international market.

EXIM Policy has laid great emphasis on Special Economic Zones (SEZs) which is a new incarnation of the Export Promotion Zones (EPZ) and Export-oriented Units (EOUs) promoted earlier. But the experience of the EPZ and EOUs has not been very happy. Together they account for only 12% of total exports. Too many procedural hurdles have prevented them from performing better. It would be very wise if the Special Economic Zones are not saddled with such excessive bureaucratic hurdles and are enabled to capture export markets. It may be noted the Special Economic Zones in China account for over 40 per cent of Chinese exports. India should learn to improve the performance of SEZs.

EXIM Policy made some concessions to help cottage and handicraft sector and small scale units which account for nearly 35 percent of the country's exports. But ironically, the policy did not pay adequate attention to the most important aspect of increasing bank credit to this sector.

Table 1 : Exports and Imports of Gems and Jewellery : India

(US $ million)

	Gross Exports (1)	Imports (2)	Net Exports 3 = 1-2	3 as % of 1
1995-96	5,275	2106	3169	60.1
1999-00	7,550	5346	2114	28.0
2000-01	7384	4838	2546	34.9
2001-02	7306	4623	2683	36.7
2002-03	9030	6063	2967	32.9
2003-04	10,573	7129	3444	32.6
2004-05	13,761	9422	4339	31.5
2005-06	15529	9134	6395	41.2
2006-07	15977	7487	8490	53.1
2007-08	19657	7975	11682	59.4
2008-09	27,955	16,554	11,401	40.8
2009-10	29,000	16,164	13,836	47.7
2010-11	40,791	31,262	9,529	23.4

Source : Computed from the data provided in Economic survey (2003-04) and (2005-06), RBI, Handbook of Statistics on the Indian Economy 2009-10. Economic Survey 2009-10.

The policy allowed import of rough diamond duty free. But if we examine the proportion of net exports of diamonds in total exports of gems and jewellery, it becomes evident that this share has declined from 60.1 percent in 1995-96 and 28 percent 1999-2000, but later on it improved again to 59.4 percent in 2007-08. In 2009-10 it was 47.7 per cent, which again fell to 23.4 percent is 2010-11. We note a decline in this proportion of net export of gem and jewellary which may be attributed to global slowdown. This underlines the fact that mere reduction of import-duty does not provide the much needed elasticity to exports.

To sum up, it may be mentioned that Commerce and Industry Ministry alone cannot create an environment to boost exports. For this purpose, it has to co-ordinate with the Ministry of Power and Transport so that the delays in handling of goods for export can be taken care of. Similarly, the Commerce Ministry has to pursuade the Ministry of Finance to allocate more resources for infrastructure development. Not only that, the Centre and State Governments must co-ordinate to fulfil the objective of increasing exports. This can be done by making our exports more competitive. This requires an improvement of technology in the export sector and the development of an efficient infrastructure.

Notes

14.3 Foreign Trade Policy

Union Commerce and Industry Minister Mr. Kamal Nath announced the Foreign Trade Policy for the 5-year period (2004-09) on 31st August 2004 which aimed at doubling India's percentage share in global merchandise trade from 0.7 per cent in 2003 to 1.5 per cent 2009. During 2003-04, India's merchandise exports were valued at $ 61.8 billion accounting for about 0.7 per cent of world's exports. If this share was to be doubled, it would imply that the country's exports would have to reach $ 195 billion by 2009, assuming a 10 per cent compound annual growth rate in world trade. For this purpose, India's exports should grow at the annual average growth rate of 26 per cent. Besides this, the service sector is also expected to increase its share in export of invisibles to over $ 100 billion. Together, the two sectors are expected to reach the target of $ 300 billion by 2009.

The objective of the Foreign Trade Policy is two-fold :

(i) To double India's percentage share of global merchandise trade from 0.7 per cent in 2003 to 1.5 per cent in 2009; and

(ii) To act as an effective instrument of economic growth by giving a thrust to employment generation, especially in semi-urban and rural areas.

Key strategies to achieve the these objectives are :

1. Unshackling of controls;
2. Creating an atmosphere of trust and transparency;
3. Simplifying procedures and bringing down transaction costs;
4. Adopting fundamental principle that duties and levies should not be exported; and
5. Identifying and nurturing special focus areas to facilitate development of India as a global hub for manufacturing, trading and services.

Special Focus Initiatives : Sectors with significant export prospects coupled with potential for employment generation in semi-urban and rural areas have been identified as thrust sectors. These include agriculture, handicrafts, handlooms, gems and jewellery and leather and footwear sectors.

The threshold limit of designated "Towns of Export Excellence" is reduced from ` 1,000 crores to ` 250 crores in these thrust sectors.

Package for Agriculture : A new scheme called Vishesh Krishi Upaj Yojana (Special Agricultural Produce Scheme) was introduced to boost the exports of fruits, vegetables, flowers, minor forest produce and their value added products. Export of these products shall qualify for duty free credit entitlement equivalent to 5% of FOB value of exports.

Handlooms and Handicrafts : Duty free import of handlooms and handicrafts sector was increased to 5% of FOB value of exports.

Gems and Jewellery : Imports of gold of 18 carat and above shall be allowed under the replenishment scheme.

Export Promotion Scheme : A new scheme to accelerate growth of exports called "Target Plus" has been introduced. Exporters would be entitled to duty free credit based on incremental exports substantially higher than the general export target. For incremental growths of over 20 per cent, 25 per cent and 100 per cent, the duty free credit would be 5 percent, 10 per cent and 15 per cent respectively, of FOB value of incremental exports.

Service Exports : For services export, a "Served from India" scheme as a brand instantly recognized abroad, under which individual service providers earning foreign exchange of ` 10 lakh would be eligible for duty free credit entitlement of 10 per cent of total foreign exchange earned by them.

Duty free Import under EPCG : Duty free import of capital goods under EPCG (Export Promotion Capital Goods) Scheme. Capital good imported under EPCG for agriculture would be permitted to be installed any where in agri export zone.

EOUs : Export Oriented Units (EOUs) shall be exempted from service tax in proportion to their exported goods and services.

Notes

New Status Holder Categorization : A new rationalized scheme of categorization of status holders in Star Export houses has been introduced :

One Star Export House	` 25 crores
Two Star Export House	` 100 crores
Three Star Export House	` 500 crores
Four Star Export House	` 1,500 crores
Five Star Export House	` 5, 000 crores

Star Export Houses would be entitled to a number of privileges including fast-track clearance procedures, exemption from furnishing bank guarantees, eligibility for consideration under target plus scheme etc.

Free Trade and Warehousing Zone

(i) A new scheme to establish Free Trade and Warehousing Zone (FTWZs) was introduced to create trade related infrastructure to facilitate the import and export of goods and services with freedom to carry out trade transaction in free currency. This was aimed at making India into a global trading hub.

(ii) FDI would be permitted up to 100% in the development and establishment of the zones and their infrastructure facilities.

(iii) Each zone would have minimum outlay of ` 100 crores and five lakh *sq.mt*. built up area.

(iv) Units in FTWZs would qualify for all other benefits as applicable for SEZ units.

Import of Second-hand Capital Goods

Import of second-hand capital goods would be permitted without any age restriction.

Bio-technology Parks : Bio-technology parks to be set up which would be granted all facilities of 100 % EOUs.

Assessment of Foreign Trade Policy (2004-09)

Commerce Minsiter Kamal Nath by announcing the new Foreign Trade Policy (2004-09) intended to achieve two objectives simultaneously, that is, to double India's share in world exports from 0.7 per cent in 2003-04 to 1.5 per in 2008-09 as also to give a big thrust to employment generation, especially in semi-urban and rural areas. In that sense, the Foreign Trade Policy is in tune with the objectives laid down in the Common Minimum Programme. A basic feature of the FTP is that instead of emphasizing only removal of quantitative restrictions, it moved away from it and concentrated on initiating measures to promote exports in thrust areas identified by it. The main thrust areas were : Agriculture, handicrafts, handlooms, gems and jewellery and leather and footwear sectors. Since these areas were dominated by small and medium enterprises (SMEs), the thrust provided to SMEs was likely to boost exports as well as generate more employment. In that sense, the policy direction was very meaningful since it reached out to a much larger number of smaller business units and smaller business houses rather than merely concentrating on large five star export houses.

By rationalizing star export houses from one star to five star export houses, it aimed to "bestow status on a large number of hitherto unrecognized small exporters." Moreover, it shall provide an incentive for the small exporter to graduate from low category of star export house to the position of a higher star export house. The incentives will help the smaller entities to rise up on the ladder. This diversification and extension of outreach to a larger number of units is a welcome initiative.

Similarly, the lower threshold of designated towns of excellence from ` 1,000 crores should also be seen as part of this noble effort to include a larger number of towns in export promotion. Mr. Gopal K. Pillai, Director General of Foreign Trade in this connection rightly stated : "Reduction in the cost of developing towns of excellence from ` 1,000 crores to ` 250 crores, as proposed in the policy, is sufficient for improving the amenities in a town engaged exclusively in exports such as knitwear in Tirpur". The main purpose is to enlarge the spread of export centres.

Notes

Since the FTP intends to treble service exports, a number of welcome initiatives have been proposed. To build a brand equity "Served from India" is a unique step to push forward India's image in foreign markets. Secondly, the setting up of Services Export Promotion Council to deal with the problems of services in developing market access as also brand building can go a long way, if pushed forward with zeal and vigour.

The 'Target Plus Scheme' provides incentives on the basis of the performance of the exporter. The simple principle followed is : Higher the performance, higher is the duty-free credit entitlement. Such incentivization does bring about a competitive spirit to improve performance in the export sector by Indian players.

Another vital initiative was to exempt all goods and services exported from service tax. This is in line with the fundamental principle that duties and levies should not be exported. In other words, it improves the competitive strength of the Indian exporter in the international market.

Another initiative taken was to establish Free Trade and Warehousing Zone (FTWZ) to improve infrastructure in the foreign trade sector. The policy permited 100% FDI (Foreign Direct Investment) in the development and establishment of zones and their infrastructural facilities. Some critics have argued that in China, FDI accounts for nearly 50 per cent of China's manufacturing export, whereas in India, it is only 8 per cent. It may be pointed out that FDI can help us to develop world class infrastructure, but if adequate FDI flows are not forthcoming, India should undertake investment in infrastructure on its own strength. Once India is able to prove its credentials in foreign trade, more FDI inflows will start.

Another issue which needed to be paid attention was to reduce the transaction cost, more so when the aim is to enthuse SMEs whose margins are not very high. The exemption from furnishing bank guarantee by exporters with minimum turnover of ` 5 crores, raising the validity of all licences and entitlements to a uniform 24 months and removal of service tax on all goods and services exports are all intended to reduce transaction cost.

Last, but not the least, it may be said that while the policy initiatives are designed with good intentions and are steps in the right direction, the pace of success of FTP will depend on the quality of implementation. Bureaucracy is known for putting spokes in the wheel of implementation the major task of the government is to facilitate the SMEs and other major exporters to achieve the challenging goal set by the new FTP to achieve merchandise export target of $ 195 billion and together with service sector, to earn $ 300 billion in terms of foreign exchange by 2009. It really very courageous of the Commerce and Industry Minister to fix such a high target which requires more than 25 per cent annual average growth rate in exports. Since export growth is also conditioned by exogenous factors operating in the world trade, the achievement of the target may be made more difficult despite our best intentions. But all honour to those who try.

During 2007-08, out exports reached a level of US $ 155 billion which is a creditable achievement. However, correspondingly our imports reached a level of $ 236 billion, widening the trade deficit to an improcedented high level of $ 81 billion which cannot be wiped out by surplus on the invisibles. Consequently, current account balance will become negative with a larger magnitude. Obviously, our foreign trade policy is one-legged since it emphasizes expansion of exports only, but remains oblivious of the tend of imports. Ultimately, India must, reach the stage of positive trade balance, rather than develop an economy with burgeoning trade deficit.

Self-Assessment:

1. Choose the correct options:

(*i*) The Indian Government has set up a committee to recommend the framule for cloud computing services. Who will chair the committee?

(*a*) Azim Premji (*b*) Kris Gopalakrishnan

(*c*) Vineet Nayar (*d*) NR Naryaytana Murthy

Notes

(*ii*) Foreign Direct investment destination by the World Investment Report 2012. Prepared by United National comperence on Trade and Development?

(*a*) UK (*b*) Brazil

(*c*) China (*d*) USA

(*iii*) Which among the following may not be a consequqnce of inflation?

(*a*) Higher speculative Investment (*b*) Equal distribution of Income

(*c*) Fall in Read Income of Salaried People (*d*) Higher production

(*iv*) In the Industrial Policy of 1991 how many industries were reserved only for public sector?

(*a*) 7 (*b*) 8

(*c*) 11 (*d*) 13

14.4 Summary

- India, however, did not have a clear trade policy before Independence, though some type of import restriction—known as discriminating protection—was adopted since 1923 to protect a few domestic industries against foreign competition. It was only after Independence that a trade policy as part of the general economic policy of development was formulated by India.
- On the import side, India has been in a disadvantageous position vis-a-vis advanced countries which are capable of producing and selling almost every commodity at low prices. This meant that India could not develop any industry without protecting it from foreign competition. Import restriction—commonly known as protection—was thus essential to protect domestic industries and to promote industrial development. Since Independence, the Government of India has broadly restricted foreign competition through a judicious use of import licensing, import quotas, import duties and, in extreme cases, even banning import of specific goods. The Mahalanobis strategy of economic development through heavy industries, which India adopted since the Second Plan, called for (a) banning or keeping to the minimum the import of non-essential consumer goods, (b) comprehensive control of various items of imports, (c) liberal import of machinery, equipment and other developmental goods to support heavy-industries based economic growth, and (d) favourable climate for the policy of import substitution.
- During the first phase up to 1951-52, India could have liberalised imports but on account of the restrictions placed by the U.K. on the utilisation of the sterling balances, she had to continue wartime controls. Since our balance of payments with the dollar area was heavily adverse, an effort was made to screen imports from hard currency areas and boost up exports to this area so as to bridge the gap. This also necessitated India to devalue her currency in 1949. By and large, the Import policy continued to be restrictive during this period. Besides this, restrictions were also placed on exports in view of the domestic shortages.
- Trade Policy (1991) aimed to cut down administrative controls and barriers which acted as obstacles to the free flow of exports and imports. The basic instrument developed by the Policy was the Exim scrip in place of Rep licences. The purpose of this instrument was to permit imports to the extent of 30% on 100 per cent realisation of export proceeds. Obviously, the purpose was to bridge the BOP gap. Trade policy has streamlined various procedures for the grant of advance licences as also permit imports through exim scrips routes.
- To conclude, India's trade policy since Independence has been used as part of general economic policy to develop the country and to diversify the economy. Initially it took the form of restricting imports and boosting exports. It also took the form of organising international trade and bilateral and multi-lateral trade agreements. In the later years, trade policy took the form of export promotion through import liberalisation. Formulated by bureaucrats under the influence and guidance of Indian business houses and multinational giants, India's trade policy did have an important influence on the rapid development of the country, but it was basically responsible for leading the country into the classical debt trap.

Notes

14.5 Key-Words

1. Foreign policy : A country's foreign policy, also called the foreign relations policy, consists of self-interest strategies chosen by the state to safeguard its national interests and to achieve its goals within international relations milieu. The approaches are strategically employed to interact with other countries. In recent times, due to the deepening level of globalization and transnational activities, the states will also have to interact with non-state actors
2. Trade policy : Trade policy is a collection of rules and regulations which pertain to trade. Every nation has some form of trade policy in place, with public officials formulating the policy which they think would be most appropriate for their country. The purpose of trade policy is to help a nation's international trade run more smoothly, by setting clear standards and goals which can be understood by potential trading partners. In many regions, groups of nations work together to create mutually beneficial trade policies.

14.6 Review Questions

1. What do you mean by Trade Policy? Discuss the main features of India's trade policy.
2. Write a short note on the Export-Import policy.
3. Discuss foreign policy.

Answers: Self-Assessment

1. (*i*) (*b*) (*ii*) (*c*) (*iii*) (*b*) (*iv*) (*b*)

14.7 Further Readings

1. Krimawati, Wawat. (?) NAFTA: North America Free Trade Agreement. [Accessed 18 May 2009]
2. Vogel, David. (2009) North American Free Trade Agreement. [Accessed 18 May 2009] 2009. North American Free Trade Agreement (NAFTA).
3. United States Department of Agriculture, Foreign Agricultural Service. [Accessed June 8, 2009]

Notes

Unit 15 : India's Balance of Payment

CONTENTS

Objectives
Introduction
15.1 India's Balance of Payments on Current Account
15.2 Balance of Payment Crisis
15.3 Balance of Payment Since the New Economic Reforms of 1991
15.4 Summary
15.5 Key-Words
15.6 Review Questions
15.7 Further Readings

Objectives

After reading this Unit students will be able to:

- Discuss India's Balance of Payments on Current Account.
- Explain the Balance of Payments Crisis.
- Know the Balance of Payments Since the New Economic Reforms of 1991.

Introduction

"The balance of payments of a country is a systematic record of all economic transactions between the 'residents' of a country and the rest of the world. It presents a classified record of all receipts on account of goods exported, services rendered and capital received by 'residents' and payments made by them on account of goods imported and services received from the capital transferred to 'non-residents' or 'foreigners'."

In the previous unit we have discussed the balance of trade, but the trade balance gives only a partial picture of a country's international obligations. In order to have a complete enumeration of international transactions, it is necessary to add to the net trade balance all other payments and receipts—this is the comprehensive balance of payments of a country in relation to the rest of the world.

The balance of payments of India is classified into (a) balance of payments on current account, and (b) balance of payments on capital account. The current account of the balance of payments of India includes three items : (a) visible trade relating to imports and exports; (b) invisible items, viz., receipts and payments for such services as shipping, banking, insurance, travel, etc., and (c) unilateral transfers such as donations. The current account shows whether India has a favourable balance or deficit balance of payments in any given year. The balance of payments on capital account shows the implications of current transactions for the country's international financial position. For instance, the surplus and the deficit of the current account are reflected in the capital account, through changes in the foreign exchange reserves of country, which are an index of the current strength or weakness of a country's international payments position, are also included in the capital account.

15.1 India's Balance of Payments on Current Account

1951-52 to 1955-56—The First Plan Period

During the First Plan period, the balance of payments was affected by the Korean War boom, American recession of 1953 and favourable monsoon at home which helped to boost agricultural and industrial production. (Refer Table 1).

Notes

While India had been experiencing persistent trade deficit, she had generally a surplus in net invisibles; accordingly India's adverse balance of payment during the First Plan was only ` 42 crores. The overall picture during the First Plan was, however, quite satisfactory.

1956-57 to 1960-61—The Second Plan Period

An important feature of the Second Plan period was the heavy deficit in the balance of trade which aggregated to ` 2,339 crores. Earnings on account of invisibles and donations from friendly countries totalled ` 614 crores. Making an allowance for these, the unfavourableness in the balance of payments during the Second Plan period was of the order of ` 1,725 crores. The highly unfavourable balance of payments in the Second Plan was the result of (a) heavy imports of capital goods to develop heavy and basic industries, (b) the failure of agricultural production to rise to meet the growing demand for food and raw materials from a rapidly growing population and expanding industry; (c) the inability of the economy to increase exports; and (d) the necessity of making minimum 'maintenance imports' for a developing economy. As a result, the foreign exchange reserves sharply declined and the country was left with no choice but to think of ways and means to restrict imports and expand exports.

Third Plan and Annual Plans and BOP

From Table 1 it is clear that the balance on current account was unfavourable during the Third Plan. This was mainly because (a) imports were expanding faster under the impact of defence and development and to overcome domestic shortages (import of foodgrains, for example) and (b) exports were extremely sluggish and failed to match imports. The imbalance in the current account of over ` 1,951 crores was financed by loans from foreign countries, PL 480 and PL 665 funds, loans from the World Bank and withdrawals from I.M.F. In spite of all these loans, assistance and withdrawals, there was also some depletion of foreign exchange reserves of the country.

The serious adverse balance of payments which started with the Second Plan continued relentlessly during the Third and the Annual Plans.

It will be observed that the trade deficit during the Annual Plans was quite large. This was because of the heavy imports of foodgrains to overcome famine conditions and internal shortage of foodgrains on the one side and inadequate exports due to economic recession on the other. Besides, devaluation of the rupee was a failure and instead of reducing the trade balance deficit, it further aggravated it. A very interesting development in this period was that net invisibles which used to be positive and which used to reduce the trade deficit, either dwindled or even became negative (for the first time). During this period, heavy amount had to be paid by India in the form of interest payments on loans contracted earlier. This wiped out the surplus on invisible account. Consequently, the influence on net invisibles in reducing the balance of payments deficit was negligible.

1969-70 to l973-74 : The Fourth Plan Period

One of the objectives of the Fourth Plan was self-reliance—i.e., import substitution of certain critical commodities (which are of key importance for the Indian economy) on the one side and export promotion so as to match the rising import bill, on the other. Accordingly, the Government managed to restrict imports and succeeded in expanding exports. On the import side, restriction of imports was made possible through good crops in 1968-69 and 1970-71, and consequent significant reduction of imports of foodgrains. On the export side, vigorous export promotion measures succeeded in boosting exports of traditional as well as non-traditional items.

The abnormal favourableness in the invisibles account in 1973-74 was due to the receipt of ` 1,680 crores from U.S.A. on the disposition of PL 480 and other rupee funds. The trade deficit during the Fourth Plan was ` 1,564 crores and the surplus in net invisibles accounted for ` 1,664 crores. The net result was a surplus in the balance of payments, for the first time, though the surplus was only a nominal amount of ` 100 crores.

1975-76 to 1978-79 : The Fifth Plan Period

During the Fifth Plan, trade balance was affected by two factors : (a) the value of imports was rapidly mounting due to the hike in oil prices, and (b) the value of exports was also rising under the impact

Notes

of promotional measures. These two factors explained the gradual decline in the deficit in the trade balance and the appearance of a surplus in the trade balance in 1976-77. But the persistent upward rise in imports and the inadequate increase in exports due to the relative decline in export prices were responsible for the revival of deficit trade balance in the last two years of the Fifth Plan period. Another outstanding feature of this period was the sharp increase in net invisibles receipts during 1975-76 to 1978-79. Table 1 shows that net invisibles amounting to ` 6,261 crores more than made up the trade balance deficit of ` 3,179 crores and thus India was able to have huge surplus balance of payments of ` 3,082 crores. For the first time since planning started, India was in a comfortable position in its external account.

Notes

The main factors responsible for the increase in invisible receipts were : (i) stringent measures taken against smuggling and illegal payment transactions; (ii) the relative stability in the external value of the rupee at a time when major international currencies were experiencing sizeable fluctuations; (iii) increase in earnings from tourists; (iv) the growth of earnings from technical, consultancy and contracting services; and (v) increase in the number of Indian nationals going abroad for employment and larger remittances sent by them to India.

The Sixth and the Seventh Plan Period

There has been a sea change in the balance of payments position since 1979-80. As against the surplus balance of payments experienced by the country during the whole of the Fifth Plan, India started experiencing adverse balance of payments from 1979-80 onwards. For one thing, trade deficit began to widen from 1978-79. The trade deficit which was more than offset by the flow of funds under net invisibles during the Fifth Plan period, could not be so offset since 1979-80. The current balance of payments became adverse to the tune of ` 11,384 crores during the Sixth Plan. Apart from net external assistance, India had to meet this colossal deficit in the current account through withdrawals of SDRs and borrowing from IMF under the extended facility arrangement. Besides, India used part of its accumulated foreign exchange reserves to meet its deficit in the balance of payments.

During 1985-86 and 1989-90, the total trade deficit amounted to ` 54,204 crores for the Seventh Plan. Making an adjustment for the positive balance on invisible account, the deficit in balance of payment on current account was ` 41,047 crores. The highly adverse balance of payments position was the cause for serious concern.

1990-91 and Thereafter

For the first time during the last 40 years, net invisibles became negative to the tune of ` 435 crores in 1990-91. This was largely the consequence of a net outflow of investment income of the order of ` 6,732 crores in 1990-91 as against ` 4,875 crores in 1989-90—as increase by 38 per cent. Thus, the cushion available through net invisibles to partly neutralise the trade deficit was removed.

During the Eighth Plan (1992-93 to 1996-97), trade deficit has been mounting, by 1996-97, it has reached a record level of ` 52,561 crores from that of ` 16,934 crores in 1990-91—a threefold increase. For the Eighth Plan period, invisibles neutralised the trade deficit to the extent of about 58 per cent—a really commendable achievement. Despite this, the balance of payments has shown continuously a deficit in all the years.

During 2001-02, although trade deficit was 54,955 crores, but the heavy receipts on account of invisibles amounting to ` 71,381 crores not only wiped out the trade deficit, they also created a surplus in current account balance of the order of ` 16,926 crores. Taking the entire Ninth Plan period (1997-98 to 2001 -02), trade deficit was wiped out to the extent of 82 per cent by invisible account surplus. Consequently, the total deficit in current account balance was of the order of the ` 53,175 crores for the Ninth Plan.

Notes

Table 1: India's Balance of Payments on Current Account (1950-51 to 2010-11)

(` crores)

Year	Trade Deficit	Net Invisibles	Balance of 3 Payments	as % of 2
(1)	(2)	(3)	(4)	(5)
First Plan	—542	+ 500	—42	92.2
Second Plan	—2,339	+ 614	—1,725	26.5
Third Plan	—2,382	+ 431	—1,951	81.1
Annual Plans	—2,067	+ 52	—2,015	2.5
Fourth Plan	—1,564	+ 1,664	+ 100	106.4
Fifth Plan	—3,179	+ 6,221	+ 3,082	195.7
1979—80	—3,374	+ 3,140	—234	93.1
Sixth Plan				
Total (1980—85)	**—30,456**	**+ 19,072**	**—11,384**	**62.6**
Seventh Plan				
Total (1985—90)	**—54,204**	**+ 13,157**	**—41,047**	**24.3**
1990—91	—16,934	—433	—17,367	—2.6
1991—92	—6,494	+ 4,259	—2,235	—65.6
Eighth Plan				
1992—93	—17,239	+ 4,475	—12,764	26.0
1993—94	—12,723	+ 9,089	—3,634	71.4
1994—95	—28,420	+ 17,835	—10,585	62.8
1995—96	—38,061	+ 18,415	—19,646	48.5
1996—97	—52,561	+ 36,279	—16,283	69.9
Total 1992—97	**149,004**	**+ 86,090**	**—62,914**	**57.7**
Ninth Plan				
1997—98	—57,805	+ 36,922	—20,883	63.9
1998—99	—55,478	+ 38,689	—16,789	69.7
1999—2000	—77,359	+ 57,028	—20,331	73.7
2000—01	—56,737	+ 45,139	—11,598	79.5
2001—02	—54,955	+ 71,381	+ 16,426	129.9
Total 1997—02	**302,334**	**+ 249,159**	**—53,175**	**82.4**
2002—03	—51,697	+ 82,357	+ 30,660	159.3
2003—04	—63,386	+ 127,369	+ 63,983	220.9
2004—05	—151,765	+ 139,591	—12,174	92.0
2005—06	—229,664	+ 185,927	—43,737	80.9
2006—07	—279962	+ 235579	—44383	87.1
Total 2002—07	**— 776474**	**+ 770823**	**—5651**	**99.3**
2007—08	—3,67,664	+ 3,04,185	—63,479	82.7
2008—09	—5,47,452	+ 4,19,821	—1,27,631	76.7
2009—10	—5,60,746	+ 3,80,120	—1,80,626	67.8
2010—11	—595028	+ 392494	—202532	66.0

Notes

During the first two years of the Tenth Plan, in 2002-03 again our current account balance was positive to the extent of ` 30,660 covers and during 2003-04, it was of the order of ` 63,983 crores. But this was the consequent of a heavy surplus on invisibles account which not only wiped out the trade deficit, but yieled a net positive balance an current account. India has the unique distiction that though during the 3-year period 2001-02 to 2003-04, our trade balance showed a massive deficit, a big inflow of net invisibles, resulted in a positive balance on current account

However, during 2004-05, there was a huge trade deficit of the order of ` 1,51,765 crores on account of an unprecedented increase in our imports, although our exports also showed a big jump. There is no doubt that our invisibles showed a record positive balance of ` 1,39,591 crores in 2004-05, but this could wipe out the trade deficit only to the extent of 92 percent, Consequently, a current count deficit of ` 12,174 crores was witnessed in 2004-05. This is an unhealthy development, but since the same reckless policy of import liberalisation is being pursued later also, the situation worsened further and current account deficit increased to the extent of ` 43,737 crores in 2004-05 and ` 1,31,614 crores in 2008-09. However, taking the Tenth Plan period (2002-03 to 2006-07) as whole, the total current account deficit was of the order of ` 5,651 crores. The trade deficit in the Tenth Plan was wiped out by the surplus from invisibles to the extent of 99.3%.

However situation worsened in 2007-08, 2008-09 and 2009-10 as we find net invisibles fell short of trade deficit, resulting in heavy deficit of balance of payment to the tune of ` 6,34,79 crores 2007-08, ` 1,27,631 crores in 2008-09 ` 1,80,626 crore in 2009-10 and ` 202532 in 2010-11.

15.2 Balance of Payment Crisis

Basic aim of the 1985 Export—Import Policy was

(a) to facilitate production through easier and quicker access to imported inputs;

(b) to strengthen export production base; and

(c) to facilitate technological upgradation.

Although the Government has been maintaining that the policy is neither liberal nor restrictive, but the fact of the matter is that the policy led to a wave of indiscriminate liberalisation of imports.

On the other hand import of quite a large number of capital goods were brought under OGL. These 208 items included micro-processor based equipment, machine tools, spinning machines, jute machinery. In this wave of liberalisation, even in areas where indigenous machinery was produced by BHEL, imports were allowed. While the MMTC and Department of Electronics were not in favour of this indiscriminate liberalisation of imports, the powerful local and multi-national lobbies were able to persuade the government to permit liberalisation even in areas where an independent self-reliant indigenous sector was emerging. All this was done in the name of hi-tech and upgration of technology. But as the then Prime Minister Mr. Rajiv Gandhi himself conceded in one of his interviews, this triggered off what may be described as ''screw driver industrialisation."

Obviously, import liberalisation measures resulted in the emergence of the huge deficit in the balance of trade. The finance ministry, therefore, started working out proposals to curtail imports of machinery and equipment. Similarly, the introduction of MODVAT was also aimed at weaning away Indian industry from dependence on imported components to increased use of indigenous products. In other words, the policy was imperceptibly reversed toward self-reliance and the Government tacitly accepted its mistake in opening the import-window rather too wide.

In the name of technological upgradation, there was, therefore, an unfettered drive for import of capital goods, designs and drawings. All studies on technology transfer by multi-nationals indicate that in the name of technological upgradation, the multinationals carry on 'technological dumping' of such technologies which have been superseded in developed countries. Consequently, second-hand machinery is dumped in the name of import of capital goods. It is really this area which led to the growth of foreign dominance in collusion with Indian big business playing the role of the underpinning of the world economy.

The upshot of the entire analysis is that the crisis in the balance of trade and consequently its adverse impact on the balance of payments was the result of the policy of indiscriminate import liberalisation

Notes

pursued underpressure from World Bank / IMF lobbies. Another disturbing feature of the situation was that export promotion has not been commensurate with the increase of imports.

Balance of Payment in the Seventh Plan and Thereafter

During the Seventh Plan (1985-86 to 1989-90), trade deficit of the order of ` 54,204 crores emerged. Net favourable balance in the invisible account was of the order of ` 13,157 crores and thus net balance of payment on current account was ` 41,047 crores. Economists identified the following factors :

Firstly, despite an encouraging rate of growth of exports, the pressure on the balance of payments has increased. During the Seventh Plan, the annual rate of growth of exports was of the order of 18.7 per cent per annum, but the rate of growth of imports was of the order of 16.8 per cent per annum. Since we started with a large volume of imports, even a smaller percentage growth of imports was able to offset a larger growth rate of exports and thus the deficit in balance of trade in absolute terms became higher.

Secondly, a major factor responsible for larger inflow of imports was the policy of import liberalisation.

Thirdly, there has been an increase in import-intensity due to the pattern of industrial development promoted during the Seventh Plan which catered to the demands thrown up by the upper income groups of the population. The shifts in income distribution in favour of the neo-rich classes resulted in higher demand for consumer durables, mention may be made of colour TVs, VCRs, air conditioners, refrigerators, motor cycles, cars, and other gadgetry. All these items of elitist consumption required assembly of kits, machinery and components imported from abroad. Thus luxury-consumption-led growth during the eighties could be appropriately described as import-intensive industrialisation. During 1980's as against the overall industrial growth of 7.7 per cent per annum, the growth rate of consumer durables segment was of the order of 12.4 per cent per annum.

Lastly, the relative steep depreciation of the rupee vis-a-vis other currencies also led to an increase in the value of imports. From ` 12.82 per dollar at the end of 1987, the rate of exchange depreciated to ` 18.05 at the end of 1989 and was around ` 31.36 per dollar in April 1993.

At the outset, it should be realised that the problem of adverse balance of payments of India is essentially due to the huge trade deficit which, in turn, is partly the result of persistently rising imports and partly due to slowly rising exports. The ultimate solution has to be found in restricting imports to the unavoidable minimum and promoting exports to the maximum.

Professor Sukhmoy Chakravarty in his work **"Development Planning—the Indian Experience (1987)"** questioning the policy of liberal imports wrote : "In my judgement, India's balance of payments is likely to come under pressure unless we carry out a policy of import substitution in certain crucial sectors. These sectors include energy, edible oils and nitrogenous fertilizers. In all these sectors, except fertilizers, India is getting increasingly dependent on imports resulting in a volatile balance of payments situation."

Rangarajan Panel for Correcting BOP

Dr. C. Rangarajan, former Governor, Reserve Bank of India who headed the high level committee on balance of payments submitted its report on June 4, 1993. The Committee made the following findings and recommendations :

1. The Committee stressed the fact that a realistic exchange rate and a gradual relaxation of restrictions on current account transactions have to go hand in hand.
2. The Committee suggested that the current account deficit of 1.6 per cent of GDP should be treated as ceiling rather than as target.
3. A number of recommendations were made regarding foreign borrowings, foreign investment and external debt management. Very important among them were :
   (a) The Government must exercise caution against extending concessions or facilities to foreign investors, which are more favourable than what are offered to domestic investors and also against enhancing external debt to supplement equity.

Notes

(b) A deliberate policy of prioritizing the use to which external debt is to be put should be pursued and no approval should be accorded for any commercial loan with a maturity of less than five years for the present.

(c) The Committee was of the view that efforts should be made to replace debt flows with equity flows. However, it recognised that direct foreign investment would contain both debt and equity, and the system of approvals is applicable to all external debt. Therefore, as an operational guideline, the approval of debt linked to equity should be limited to ratio of 1 : 2.

4. The minimum foreign exchange reserves target should be fixed in such a way that the reserves are generally in a position to accommodate imports of three months.

A careful perusal of the recommendations of Rangarajan Panel on balance of payments reveals that it aimed to halt the process of indiscriminate permissions in the name of foreign investments in any branch of economic activity. The Committee, therefore, cautioned against extending concessions or facilities to foreign investors which are more favourable than what are offered to domestic investors. Similarly, the Committee has insisted that there should be a policy of prioritizing the use to which external debt should be put. The Report of Rangarajan Committee was a timely warning to manage our external debt and thus salvage our economy.

15.3 Balance of Payment Since the New Economic Reforms of 1991

New economic reforms were initiated in 1991 and an effort was made to step up exports so that a major part of the import bill is paid for by exports. Secondly, with a view to bring about technological upgrdation, imports were liberalised. Along with this, in place of debt-creating inflows of capital, non-debt creating inflows such as foreign direct investment as well as portfolio investment were encouraged. The result of all these measures has been summarized in Table 2.

Data provided in Table 2 rveal that the most notable feature of the changing scenario in the balance of payments situation is that there has been a sharp increase in the coverage of imports by export earnings. In 1990-91, export earnings accounted for merely 66.2% of import bill, and this ratio sharply improved to 84.8% in1993-94. **Economic Survey (1994-95),** therefore, asserted : "The recent developments in India's external sector reflect a shift from a foreign-exchange constrained control regime to a more open market driven and liberalised economy. This has been facilitated by the structural change in the country' s balance of payments which has occured during the last few years. The most notable feature of this change has been the sharp increase in the coverage of imports by export earnings... during the last 3 years export earnings have, on an average, accounted for nearly 90 per cent of the value of imports". This marked improvement in the export-import ratio combined with an improvement in the invisibles account, has resulted in a sharp reduction in the current account deficit, which had come down from unsustainable levels of more than 3.2 percent of GDP to less than half a percent by 2003-04, but by the year 2007-08 it again surged to 1.5 percent GDP. In the meanwhile in few years even current account deficit turned to be surplus. This has been made possible due to rising export-import ratio till 2002-03 and later it started dipping again and came down as low as 60.6 percent in 2009-10. In 2010-11 it improved to 65.7 percent.

Table 2 also indicates that dependence on external assistance and external commercial borrowing has come down markedly. The ratio of external assistance to total capital inflow which had risen to about 27 per cent in 1990-91 came down to 19 per cent in 1993-94, but has risen again to 30 per cent in 1995-96 but continuously declined thereafter to reach a low level of 3.8 per cent in 2006-07. Similarly, external commercial borrowing which accounted for about 26 per cent of the total capital inflows in 1990-91 has again increased to 42 per cent in 1995-96 and further risen to 50.6 in 2000-01. But since rates of interest in the world markets have sharply gone down, this has resulted in a decline in debt service ratio. Table 2 reveals that debt service ratio which was 35.3 per cent in 1990-91 has also declined to 13.6 per cent in 2001-02. It has further declined to 6.1 per cent in 2004-05 but was 8.3 percent in 2010-11. The Government has, therefore, claimed that the economy has thus moved to a more stable and sustainable balance of payments in the nineties.

Another healthy feature of the changing scenario is that foreign reserves have more than doubled during 1993-94, from US $ 6.4 billion at the end of March 1993 to US $ 15.1 billion at the end of March

Notes

1994. The large build-up in foreign exchange assets has been made possible by large inflows of private foreign investments and Non-resident deposits. The foreign currency reserves have been further augmented to reach a level of $ 24.9 billion at the end of June 1997 and still further to $ 76.1 billion during 2002-03, and they shot up to $ 302.34 billion in June 2008. In the year 2008-09, however we witness a decline in foreign exchange reserves to $ 241.42 billion due to large scale outflow of foreign exchange by foreign institutional investors (FIIs). We again find an improved situation, as foreign exchange reserves reached $ 305 billion in 2010-11. The continued strength of these reserves has saved the country from the impending balance of payments crisis which was looming large in 1991.

A point which needs serious consideration is : Is the escalation in these reserves a consequence of an improvement in the current account or the result of excessive borrowing or external assistance by bilateral or multilateral donors ? The answer obviously is : The sharp increase in foreign exchange reserves is the consequence of excessive borrowing and large inflows of external assistance. The Government has been trying to camouflage the situation by saying the non-debt creating assistance has been used to tide over the current crisis. But the distinction between debt and non-debt inflows does not reduce the burden of foreign exchange outflows. In case of debt, interest and amoritization payments constitute outflows and in the case of non-debt creating assistance, it is royalties and dividend outflows that lead to foreign exchange outgo. Both situations impose burdens on the country. The difference is only in form and not in substance.

There is no doubt that both international and domestic factors have contributed to the deterioration in the balance of payments in 1997-98 and this is reflected by the increase in current account deficit to 1.4 per cent of GDP and trade deficit rising to 4.9 per cent of GDP in 2004-05. The situation has deteriorated further and the trade deficit as per data available form DGCI&S is of the order of US $ 9.2 billion in 1998-99. This is because export (in US dollar terms) declined to US $ 34.3 billion in 1998-99 as against US $ 35.6 billion in 1997-98. The trade deficit has reached an unprecedented level of US $ 7.9 billion in 1998-99. Obviously, this is likely to be 3.2 per cent of GDP. To describe the "BOP situation as manageable" as the Economic Survey (1998-99) does, is to conceal the hard reality that the fundamentals of the economy are not sound and that all measures of export promotion have not produced the desired effect. To meet this deficit by a larger inflow from Resurgent India Bonds of the order of US $ 4.2 billion during 1998-99 from NRIs or larger inflow offoreign direct investment and external commercial borrowing only indicates the adoption of the dependency syndrome by. international players. The internal resilience of the economy is still weak and the economy has to be strengthened. This is evident from the fact that the Rupee depreciated against the US dollar by about 7.1 per cent from ` 38.50 per US dollar in March 1998 to ` 45.68 per US dollar in 2000-0l. The situation has further worsened to ` 47.49 per US dollar in April 2000. It would be, therefore, more prudent to adopt a cautious approach in admitting large inflows of external commercial borrowing, portfolio investment by foreigners and also larger contributions from NRIs in the form of bonds.

Table 2 : Changing Scenario of Balance of Payments (Ratio of Selected Items)

	1990 -91	1995 -96	1997 -98	2000 -01	2001 -02	2002 -03	2005 -06	2006 -07	2007 -08	2008 -09	2009 -10	2010 -11
1. Exports as % of imports	66.2	74.0	69.7	78.5	79.5	83.4	67.0	67.0	66.35	61.4	60.6	65.7
2. Current account balance as % of GDP	– 3.2	– 1.8	– 1.4	– 0.6	0.7	1.2	– 1.2	– 1.1	– 1.3	– 2.5	– 3.1	– 2.9
3. ECB / TC (%)	26.8	42.0	42.6	50.6	– 19.0	– 15.9	10.1	34.8	20.2	92.8	5.7	3.1
4. NRI deposits / TC *(%)*	18.3	37.1	12.0	27.2	33.0	28.0	11.2	9.3	0.16	59.2	5.5	5.4

Notes

5. External assistance /TC (%)	26.2	29.7	9.7	4.8	13.4	– 29.4	6.8	3.8	1.9	36.5	4.5	8.3
6. Import cover of FER (No. of months)	2.5	6.0	6.9	8.8	11.5	14.2	11.6	12.5	15.0	9.8	11.2	9.6

Notes :

1. TC : Total Capital flows (net)
2. FER: Foreign exchange reserves
3. FCB : External Commercial Borrowings
4. As total capital outflows are netted after taking into account some capital outflows, the ratio against items 3, 4 and 5, in some years, add up to more than 100 per cent.

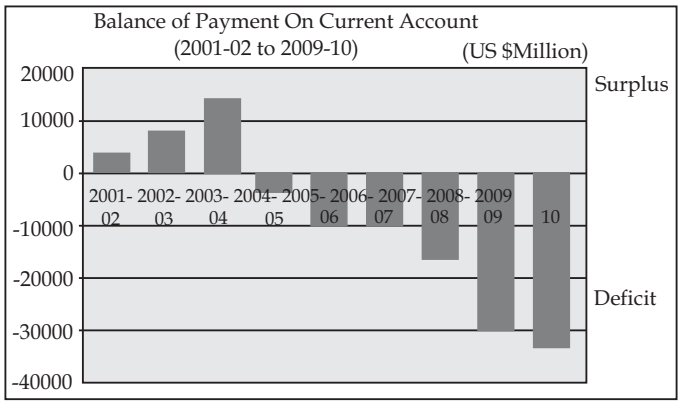
Source : Government of India, Economic Survey (2009-2010), RBI, Handbook of Statistics on the Indian Economy (2010-11).

Table 3 : Balance of Payments 2001-2002 to 2008-09 : Key Indicators

	2001-02	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
1. Exports (f.o.b)	44,703	66,285	85,206	105,152	1,28,888	1,66,162	1,89,001	1,82,235	2,50,468
2. Imports (c.i.f)	56,277	80,003	118,908	157,056	1,90,670	2,57,629	3,07,651	3,00,609	3,30,935
3. Trade Balance	**–11,574**	**-13,718**	**-33,718**	**-51,904**	**-61,782**	**-91.467**	**-1,18,650**	**-1,18,374**	**–130467**
4. Invisibles (net)	14,974	27,801	31,232	42,002	52,217	75,731	89,923	79,991	86,186
a. Services	3,324	10,144	15,426	23,170	29,469	38,853	49,631	35726	47,664
b. Income	-4,206	-4,505	-4,979	-5,855	-7331	-5,068	-4,507	-8040	–14863
c. Private transfers	15,398	21,608	20,525	24,687	30,079	41,995	44,798	52305	53,368
5. Current Account Balance	**3,400**	**14,083**	**-2,470**	**-9,902**	**-9,565**	**-15,757**	**-28,728**	**-38383**	**–44,281**
6. Capital Account	8,551	16,736	28,022	25,470	45,203	1,06,585	67,685	53,397	59,747
A. Foreign Investment	6,686	13,744	13,000	15,528	14,753	43,326	3,467	51167	37,434
B. External assistance, net	1,204	-2,754	2,027	1,766	1,787	2,119	2,639	2893	4,941
C. Commercial borrowings, Net	-1,588	-2,928	5,426	2,759	16,443	22,640	6,648	3,339	11,599
D. Rupee debt service	-519	-376	*-417*	-572	-162	-122	-100	-97	–69
E. NRI deposits, net	**2,654**	**3,642**	**-964**	**2,789**	**4,321**	**178**	**4,289**	**+3792**	**3239**
F. Other Capital	**-1,640**	**4,076**	**7,259**	**-3,183**	**-5,961**	**10,969**	**-3,990**	**-13016**	**–10440**

Notes

7. Overall Balance	**11,757**	**31,421**	**26,159**	**15,052**	**36,606**	**92,164**	**-20,080**	**-13441**	**13,050**
8. F.E. Reserve Use (Increase - /Decrease) As percent of GDP	**-11,757**	**-31,421**	**-26,159**	**-15,052**	**-36,606**	**-92,164**	**20,080**	**+13441**	**13,050**
Exports	9.4	11.0	12.2	13.0	13.84	13.5	15.6	14.4	15.9
Imports	11.8	13.3	17.1	19.4	20.05	21.0	25.4	23.1	24.2
Trade Balance	-2.4	-2.3	-4.8	-6.4	-6.8	-7.4	-9.8	8.7	8.3
Invisible Balance	3.1	4.6	4.5	5.2	5.7	6.2	7.4	7.0	5.5
Current Account Balance	0.7	2.3	-0.4	-1.2	-1.1	-1.3	-2.4	-3.1	–2.8



During 2006-07 and 2007-08, there was an appreciation in the exchange rate of the Rupee vis-a-vis the US dollar. The exchange rate has declined from ` 44.27 in 2005-06 to ` 42.25 in 2006-07 and has further declined to ` 39.44 per US dollar in November 2007. This was also one of the reasons causing increasing trade deficit during 2007-08. However even depreciation of Indian rupees could not bring any relief in trade deficit during the year 2008-09. Year 2009-10 saw marginal fall in trade defict. But in 2010-11 again trade deficit increased to $ 130.5 billion.

The exports of the country must grow faster if the country wants to save itself from the balance of payments crisis. At the same time, a policy of selective import liberalisation in priority areas would help to strengthen the fundamentals of the economy.

Highlighting the changed situation in the current account balance, **Economic Survey (2005-06)** opined: "The year 2004-05 marked a significant departure in the structural composition of India's balance of payments (BOP), with the current account, after three consecutive years of surplus, turning into a deficit. (Refer table 4). In a significant transformation, the current account deficit, observed for 24 years since 1977-78, had started shrinking from 1999-00. The contraction gave way to a surplus in 2001-02, which continued until 2003-04. However, from a surplus of US $ 14.1 billion in 2003-04, the current account turned into a deficit of US $ 1.47 billion in 2004-05 and further to adeficit of US $ 9.2 billion in 2005-06. The deficit was caused by a burgeoning excess of merchandise imports over exports, which was left uncompensated by the net surplus in invisibles. While the magnitude of deficit is one of highest in recent times, it underscored the rising investment demand in the economy, As a proportion of GDP, the turnaround in the current balance was from a surplus equivalent of 2.3 per cent in 2003-04 to a deficit of 0.4 per cent in 2004-05. For 2005-06 the current account deficit has shot up to US $ 9.9 billion. The situation in 2006-07 also indicates a current account deficit of the order of $ 9.766 billion. Situation worsened and current account deficit reached at $ 15.7 billion in 2007-08. Situation

Notes

worsened even more during 2008-09, when current account deficit shooted up to $ 28.7 billion, as even much larger invisibles (net) receipt of $ 89.9 billion was not able to fill the huge trade deficit of $ 118.6 billion. Defict in current account further shooted up to $ 38.4 billion in 2009-10 and $ 44.3 in 2010-11. Since it is customary to look upon the Chinese experience as a role model, it may be pointed out that China had a current account surplus of 3.8 per cent of GDP in 1997 and has further improved this surplus to 6.1 per cent of GDP in 2005.

Invisibles and Balance of Payments

India has achieved commendable success in its receipts from invisibles. As a consequence, surplus from invisibles not only wiped out deficit in balance of trade, but also created a positive balance on current account. For instance, in 2003-04, trade deficit was of the order $ 13.7 billion, but the surplus from invisibles shot up to $ 27.8 billion. As a result, the balance of payment on current account became positive to the extent of $ 14.1 billion.

It would be appropriate to study the components of invisible items so as to understand the importance of various items. Table 4 provides data from 2000-01 to 2010-11. It may be observed that on the side of receipts, among the services, the most important contribution is that of software services. But transfers in form of remittance from Indians abroad provide the highest contribution to receipts. Besides these two items, moderate contribution is also made by travel, transportation, investment income and miscellaneous items. *Economic Survey (2004-05)* in this connection mentions : "The main driver behind the current account surpluses, buoyant invisible flows, particularly private transfers comprising remittances, along with software services exports, have been instrumental in creating and sustaining current account surpluses for India." As a consequence, invibles balance as a proportion of GDP increased from 3.1 percent 2001-02 to 4.5 percent in 2004-05. This situation further improved to 5.3 % of GDP in 2005-06 and 7.0 percent in 2009-10 but it declined to only 5.5 per cent in 2010-11. This is a healthy development.

On the payments side, two items are prominent –Miscellaneous services and investment income. These items accounted for over 73 percent of payments in 2003-04. In these two items, India shows a net deficit in invisibles. There is a need for exercising caution in this regard, more especially in continuous, unrestricted and sharp increase in foreign investment which generates a reverse flow in the form of investment income.

If we study the net balance on invisibles in 2010-11, services accounted for 55.3 percent, transfers accounted for 61.9 percent and investment income showed a net deficit of 17.2 percent.

It is vitally necessary to exercise caution regarding the warning signals in 2004-05. During 2004-05, the trade deficit has shot up to $ 36.63 billion, while the invisibles surplus was $ 31.23 billion, thus a deficit in current account has appeared again in 2004-05. The jubilation about the emergence of surplus in current account surplus during 2002-03 and 2003-04 dried up and India was once again back to its proverbial current account deficit. While the Commerce and Industry Minister has been feeling proud of the achievement in high growth rates in exports, there was a total negligence on his part to realize that the ground under his feet was being cut by a much sharper increase in imports. The situation has worsened between 2005-06 and 2010-11 and current account defict shooted up to $ 44.3 billion by 2010-11.

Much of the relief in current account of balance of payment has been brought by net software exports, which has increase from mere $ 355 million in 1997-98 to $ 43,224 million in 2010-11, but this trend may taper off as China makes an inroad in the world software market. Similarly, remittances from Indians may also grow at a lesser rate in future since they are reaching peak levels.

The purpose is not to paint a gloomy picture, but draw attention to the emerging dangers in the external sector. The country has, therefore, to be vigilant about foreign payments account, as it has been having only a one-legged policy in this area of boosting exports.

Notes

Table 4 : Analysis of invisibles Account

Net Balance on Various Items **(US $ million)**

	2000-01	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
A. Services	1,692	10,144	15,426	23,170	29,469	38,853	49,631	35,726	47,664
	(17.3)	(36.5)	(49.4)	(55.2)	(56.4)	(51.3)	(55.2)	(44.7)	(55.3)
1. Travel	693	1,435	1,417	1,215	2,439	2,091	1,469	2,517	4,043
	(7.08)	(5.16)	(4.54)	(2.89)	(4.67)	(2.76)	(1.6)	(3.1)	(4.7)
2. Transportation	-512	879	144	-2,120	-94	-1,500	-1,534	-757	397
	(-5.2)	(3.2)	(0.5)	(-5.0)	(-0.2)	(-2.0)	(-1.7)	(-1.0)	(.5)
3. Software Services	5,750	12,324	16,900	22,262	26,721	37,712	49,812	33,966*	43,224*
	(58.7)	(44.3)	(54.1)	(53.0)	(51.2)	(49.8)	(55.4)	(42.5)	(50.1)
4. Miscellaneous	-3,239	-4,491	-3,035	1,707	403	550	-115		
	(-33.1)	(-16.2)	(-9.7)	(4.1)	(0.8)	(0.7)	(-0.1)	(-18.1)	
B. Transfers	13,106	22,162	20,785	24,687	30,079	51,945	44,799	52,305	53,385
	(133.8)	(79.7)	(66.6)	(58.8)	(57.6)	(68.6)	(49.8)	(65.4)	(61.9)
C. Income	-5,004	-4,505	-4,979	-5,855	-7,331	-5,067	-4,507	-8,040	–14,862
	(-51.1)	(-16.2)	(-15.9)	(-13.9)	(-14.0)	(-6.7)	(-5.0)	(-10.0)	(–17.2)
Total (A+B+C)	9,794	27,801	31,232	42,002	52,217	75,731	89,923	79,991	86,186
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)

Source : Compiled and computed from RBI Handbook of Statistics on the Indian Economy (2010-11), *Economic Survey 2010-11.*

Note : *includes miscellaneous

Self-Assessment:

1. **Choose the correct options:**

(*i*) What is the difference between GNP and GDP?

(*a*) Net income for factors of production from abroad

(*b*) Domestic transfers of income

(*c*) International transfers in the capital account

(*d*) Capital depreciation

(*e*) Indirect business taxes

(*ii*) If imports and exports are insignificant, then national income accounting shows that

(*a*) net financial investment from foreign countries is negative.

(*b*) the financial account is positive.

(*c*) net financial investment from foreign countries is positive.

(*d*) the financial account is negative.

(*e*) national saving equals aggregate investment expenditure.

(*iii*) Which of the following is NOT recorded in the balance of payments?

(*a*) Official international reserves (*b*) Current account

(*c*) Future account (*d*) Capital account

(*e*) Financial account

Notes

(*iv*) A purchase of foreign reserves by a country's central bank would be reflected as

(*a*) a credit in the capital account and a debit in the capital account.

(*b*) an entry in a separate account not in the balance of payments.

(*c*) a credit in the current account and a debit in the financial account.

(*d*) a credit in the financial account and a debit in the financial account.

(*e*) a debit in the current account and a credit in the financial account.

(*v*) What does the term "balance of payments deficit" refer to?

(*a*) A decrease in the financial account.

(*b*) A negative statistical discrepancy.

(*c*) A decrease in official international reserves.

(*d*) A positive statistical discrepancy.

(*e*) An increase in official international reserves.

(*vi*) What is the official settlements balance?

(*a*) Another name for the capital account.

(*b*) One of the accounts in the balance of payments.

(*c*) The balance of official transactions between the U.S. Treasury and the Bank of England.

(*d*) The balance of official transactions between the U.S. Treasury and the Federal Reserve System.

(*e*) Everything in the balance of payments except for official international reserves.

15.4 Summary

- The balance of payments of India is classified into (a) balance of payments on current account, and (b) balance of payments on capital account. The current account of the balance of payments of India includes three items : (a) visible trade relating to imports and exports; (b) invisible items, viz., receipts and payments for such services as shipping, banking, insurance, travel, etc., and (c) unilateral transfers such as donations. The current account shows whether India has a favourable balance or deficit balance of payments in any given year. The balance of payments on capital account shows the implications of current transactions for the country's international financial position. For instance, the surplus and the deficit of the current account are reflected in the capital account, through changes in the foreign exchange reserves of country, which are an index of the current strength or weakness of a country's international payments position, are also included in the capital account.
- Although the Government has been maintaining that the policy is neither liberal nor restrictive, but the fact of the matter is that the policy led to a wave of indiscriminate liberalisation of imports.
- On the other hand import of quite a large number of capital goods were brought under OGL. These 208 items included micro-processor based equipment, machine tools, spinning machines, jute machinery. In this wave of liberalisation, even in areas where indigenous machinery was produced by BHEL, imports were allowed. While the MMTC and Department of Electronics were not in favour of this indiscriminate liberalisation of imports, the powerful local and multi-national lobbies were able to persuade the government to permit liberalisation even in areas where an independent self-reliant indigenous sector was emerging. All this was done in the name of hi-tech and upgration of technology. But as the then Prime Minister Mr. Rajiv Gandhi himself conceded in one of his interviews, this triggered off what may be described as ''screw driver industrialisation."
- New economic reforms were initiated in 1991 and an effort was made to step up exports so that a major part of the import bill is paid for by exports. Secondly, with a view to bring about technological upgrdation, imports were liberalised. Along with this, in place of debt-creating

Notes

inflows of capital, non-debt creating inflows such as foreign direct investment as well as portfolio investment were encouraged.

- There is no doubt that both international and domestic factors have contributed to the deterioration in the balance of payments in 1997-98 and this is reflected by the increase in current account deficit to 1.4 per cent of GDP and trade deficit rising to 4.9 per cent of GDP in 2004-05. The situation has deteriorated further and the trade deficit as per data available form DGCI&S is of the order of US $ 9.2 billion in 1998-99. This is because export (in US dollar terms) declined to US $ 34.3 billion in 1998-99 as against US $ 35.6 billion in 1997-98. The trade deficit has reached an unprecedented level of US $ 7.9 billion in 1998-99.
- India has achieved commendable success in its receipts from invisibles. As a consequence, surplus from invisibles not only wiped out deficit in balance of trade, but also created a positive balance on current account. For instance, in 2003-04, trade deficit was of the order $ 13.7 billion, but the surplus from invisibles shot up to $ 27.8 billion. As a result, the balance of payment on current account became positive to the extent of $ 14.1 billion.

15.5 Key-Words

1. Development planning : Personal development planning is the process of creating an action plan based on awareness, values, reflection, goal-setting and planning for personal development within the context of a career, education, relationship or for self-improvement.
2. Balance of payments deficit : An imbalance in a nation's balance of payments in which payments made by the country exceed payments received by the country. This is also termed an unfavorable balance of payments. It's considered unfavorable because more currency is flowing out of the country than is flowing in. Such an unequal flow of currency will reduce the supply of money in the nation and subsequently cause an increase in the exchange rate relative to the currencies of other nations. This then has implications for inflation, unemployment, production, and other facets of the domestic economy. A balance of trade deficit is often the source of a balance of payments deficit, but other payments can turn a balance of trade deficit into a balance of payments surplus.

15.6 Review Questions

1. Discuss the balance of payments on current account.
2. Write a short note on the balance of payment crisis.

Answers: Self-Assessment

1. (*i*) (*a*) (*ii*) (*e*) (*iii*) (*c*)
   (*iv*) (*d*) (*v*) (*c*) (*vi*) (*e*)

15.7 Further Readings

1. Krimawati, Wawat. (?) NAFTA: North America Free Trade Agreement. [Accessed 18 May 2009]
2. Vogel, David. (2009) North American Free Trade Agreement. [Accessed 18 May 2009] 2009. North American Free Trade Agreement (NAFTA).
3. United States Department of Agriculture, Foreign Agricultural Service. [Accessed June 8, 2009]