LOVELY PROFESSIONAL UNIVERSITY

INTERNATIONAL BUSINESS

Edited By

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SYLLABUS

International Business

Objectives: The objective of the course is to; enable the students in building strong foundation in concepts of international trade and business; help the students in understanding social, cultural and economic factors that lead to trade between countries.

Sr. No.	Description
1.	**International Business:** Evolution, nature, influences and goals of international business, problems of international business.
2.	Theories of international trade.
3.	**International Business Environment:** Introduction, social and cultural environment, technological environment, economic environment and political environment.
4.	Modes of entering international business.
5.	**Foreign Direct Investment:** Meaning, international investment theories, factors influencing FDI, costs and benefits associated, trends in FDI, FDI in India.
6.	**Globalisation:** Emerging global economy, drivers of globalisation, globalisation of markets, policy issues, globalisation and India.
7.	**World Trade Organisation:** GATT, establishment of WTO, the Uruguay rounds package, WTO and anti-dumping measures, India and WTO.
8.	**Multinational Corporations:** Definition, factors that contributed for the growth of MNCs, advantages and disadvantages, control over MNCs, organisation structure, MNCs in india.
9.	**Conflicts and Negotiations in International Business:** introduction, factors causing conflicts, conflict between host and transnational company.
10.	International trade policies, trade blocks, international finance and foreign exchange.
11.	E-business vis-à-vis international business.

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Unit 1: Introduction to International Business

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Introduction

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Objectives

After studying this unit, you should be able to:

- Know how the concept of international business evolved
- State the nature of international business
- Describe the influences and goals of international business
- Identify the problems of international business

Introduction

International business is all commercial transactions private and governmental between two or more countries. Private companies undertake such transactions for profits; governments may or may not do the same in their transactions. These transactions include sales, investments and transportation.

Study of international business has become important because (i) It comprises a large and growing portion of the world's total business. (ii) All companies are affected by global events and competition, whether large or small, since most sell output to and secure raw materials and supplies from foreign countries. Many companies also compete against products and services that come from outside India.

The company's external environment conditions such as physical, societal and competitive affect the way business functions such as marketing, manufacturing and supply chain management are carried out. When a company operates internationally, foreign conditions are added to domestic ones making the external environment more diverse and complex.

1.1 Global, Multinational and Transnational Company

Each term is distinct and has a specific meaning which defines the scope and degree of interaction with their operations outside of their "home" country.

Notes

- Multinational companies have investment in other countries, but do not have coordinated product offerings in each country. More focused on adapting their products and service to each individual local market. A Multinational Corporation (MNC) or Multinational Enterprise (MNE) is a corporation enterprise that manages production or delivers services in more than one country. It can also be referred to as an international corporation. They play an important role in globalization.

Example: Toyota, Honda, Budweiser, Kia, McDonalds, Pepsi, KFC, Adidas, Nike, Puma, Umbro, Nissan, Renault, Citroen

- Global companies have invested and are present in many countries. They market their products through the use of the same coordinated image/brand in all markets. Generally one corporate office that is responsible for global strategy. Emphasis on volume, cost management and efficiency.

Example: Some examples of global companies are: Seagate, McDonald's boots, pizza hut, Burger king, Thornton's asda, Tesco, etc.

- Transnational companies are much more complex organizations. They have invested in foreign operations, have a central corporate facility but give decision-making, R&D and marketing powers to each individual foreign market.

Example: An example of a TNC is Nestlé who employ senior executives from many countries and try to make decisions from a global perspective rather than from one centralised headquarters. However, the terms TNC and MNC are often used interchangeably.

1.2 Evolution of International Business

The analytical framework of international business is build around the activities of Multinational Enterprises (MNEs) enunciated by the process of internationalisation. The FDI on the part of an MNE attempts to overcome the obstructions to trade in foreign countries. The strategies relating to the functional areas, such as production, marketing, finance and price policies, are adopted by the MNEs in such a manner that an amicable relationship between home and host nations is created.

Caution Foreign direct investment can be distinguished from the other forms of international business, such as exporting, licencing, joint ventures and management contracts. Basically, it reacts to the restrictions in foreign trade, licensing, etc. and its growth at the global level has taken place mainly due to the imperfections in the world markets and protective trade policies pursued by different countries for the sake of protecting their economies.

The ways in which the MNEs have provided challenges to the imperfections and restraints in the world markets from an important part of the conceptual methods underlying the expanding role of international business.

Before the emergence of the MNEs, foreign trade and international business were regarded as synonymous, and international trade doctrines based on labour cost differentials and free trade guided the international transactions among different trading partners. The multinationals undertook FDI abroad, and their innovative efforts in technological development and

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management techniques, in a way, refuted the traditional trade theories. Several FDI theories have been developed in support of international business for the improvement and welfare of world economies.

The fast growth of international business has also been conducive to foster close international economic relations among different countries of the world. Now, the world economy is not only interdependent but also inter-linked, and any kind of R&D taking place in any part of the world has its impact on the entire global economy.

The multinationals are to keep a constant surveillance on the fluctuating foreign exchange rates and inflation as these have a direct bearing on the profitability of international operations. The socio-cultural, political and economic environments of host countries also affect the investment decisions of foreign investors.

The business across the borders of the countries had been carried on since times immemorial. But, the business had been limited to the international trade until the recent past. The post-World War II period witnessed an unexpected expansion of national companies into international or multinational companies. The post 1990's period has given greater fillip to international business.

In fact, the term international business was not in existence before two decades. The term international business has emerged from the term 'international marketing', which, in turn, emerged from the term 'export marketing'.

International Trade to International Marketing: Originally, the producers used to export their products to the nearby countries and gradually extended the exports to far-off countries. Gradually, the companies extended the operations beyond trade. For example, India used to export raw cotton, raw jute and iron ore during the early 1900s. The massive industrialization in the country enabled us to export jute products, cotton garments and steel during 1960s.

India, during 1980s could create markets for its products, in addition to mere exporting. The export marketing efforts include creation of demand for Indian products like textiles, electronics, leather products, tea, coffee, etc., arranging for appropriate distribution channels, attractive package, product development, pricing, etc. This process is true not only with India, but also with almost all developed and developing economies.

International Marketing to International Business: The multinational companies which were producing the products in their home countries and marketing them in various foreign countries before 1980s, started locating their plants and other manufacturing facilities in foreign/host countries. Later, they started producing in one foreign country and marketing in other foreign countries. For example, Unilever established its subsidiary company in India, i.e. Hindustan Liver Limited (HLL), HLL produces its products in India and markets them in Bangladesh, Sri Lanka, Nepal, etc. Thus, the scope of the international trade is expanded into international marketing and international marketing is expanded into international business.

The 1990s and the new millennium clearly indicate rapid internationalization and globalization. The entire globe is passing at a dramatic pace through the transition period. Conducting and managing international business operations is a crucial venture due to variations in political, social, cultural and economic factors, from one country to another country. For example, most of the African consumers prefer high quality and high priced products due to their higher ability to buy. Therefore, the international businessman should produce and export less costly products to most of the African countries and vice versa to most of the European and North American countries. High priced Palmolive soaps are exported and marketed in developing countries like Ethiopia, Pakistan, Kenya, India, Cambodia, etc.

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- International business houses need accurate information to make an appropriate decision. Europe was the most opportunistic market for leather goods and particularly for shoes. Bata based on the accurate data could make appropriate decision to enter various European countries.
- International business houses need not only accurate but timely information. Coca-Cola could enter the European market based on the timely information, whereas Pepsi entered later. Another example is the timely entrance of Indian Software companies also made timely decision in the case of Europe.
- The size of the international business should be large in order to have impact on the foreign economies. Most of the multinational companies are significantly large in size. In fact, the capital of some of the MNCs is more than our annual budget and GDPs of the some of the African countries.
- Most of the international business houses segment their markets based on the geographic market segmentation. Daewoo segmented its market as North America, Europe, Africa, India sub-continent and Pacific market.
- International markets present more potentials than the domestic markets. This is due to the fact that international markets are wide in scope, varied in consumer tastes, preferences and purchasing abilities, size of the population, etc. For example, the IBM's sales are more in foreign countries than in USA. Similarly, Coca-Cola sales, Procter and Gamble's sales and Satyam Computer's Sales are more in foreign countries than in their respective home countries.

Caselet

Carpet Industry in India

In this era of globalisation, every company and every industry wants to go global. India also wants to sell carpets to the foreign markets. This can only be done through exports when the profits in the exports increase we go in for International Marketing, which lead to international trade and international business. How it happens? This happens only when our company becomes international, multinational and transnational.

The carpet industry at present is passing through international marketing stage.

The carpets that are exported follow the concept of Ethnocentricity. In order to make the carpet industry an MNC the export of carpets have to increase to more than $ 100 million turnover per annum. This can only happen in case this industry is properly organised and given more incentives by the Government being a labour intensive industry.

The question of its becoming transnational cannot arise unless this industry falls in the hands of MNC itself and a large number of carpet weavers are trained on a large scale through Carpet Management Schools which is a far of dream. However, effort should be made to give more incentives to the carpet weavers so that the child labour in this industry is completely abolished and the objection of the importers on the use of child labour is removed.

Source: P. K. Vasudeva, *International Marketing,* 3rd Edition, Excel Books

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Self Assessment

Fill in the blanks:

1. ..... are responsible for the popularity of FDI.
2. With the growth of international business, the world has not only become independent but also .....
3. ..... environments of host countries influence the investment decision of foreign firms.

1.3 Nature of International Business

The study of international business focuses on the particular problems and opportunities that emerge because a firm is operating in more than one country. In a very real sense, international business involves the broadest and most generalised study of the field of business, adapted to a fairly unique across the border environment. Many of the parameters and environmental variables that are very important in international business are either largely irrelevant to domestic business or are so reduced in range and complexity as to be of greatly diminished significance.

Example: Foreign legal systems, foreign exchange markets, cultural differences, and different rates of inflation.

Thus, it might be said that domestic business is a special limited case of international business.

The distinguishing feature of international business is that international firms operate in environments that are highly uncertain and where the rules of the game are often ambiguous, contradictory, and subject to rapid change, as compared to the domestic environment. In fact, conducting international business is really not like playing a whole new ball game, however, it is like playing in a different ball park, where international managers have to learn the factors unique to the playing field. Managers who are astute in identifying new ways of doing business that satisfy the changing priorities of foreign governments have an obvious and major competitive advantage over their competitors who cannot or will not adapt to these changing priorities.

The guiding principles of a firm engaged in (or commencing) international business activities should incorporate a global perspective. A firm's guiding principles can be defined in terms of three board categories products offered/market served, capabilities, and results. However, their perspective of the international business is critical to understand the full meaning of international business. That is, the firm's senior management should explicitly define the firm's guiding principles in terms of an international mandate rather than allow the firm's guiding principles in terms as an incidental adjunct to its domestic activities. Incorporating an international outlook into the firm's basic statement of purpose will help focus the attention of managers (at all levels of the organisation) on the opportunities (and hazards) outside the domestic economy.

It must be stressed that the impacts of the dynamic factors unique to the playing field for international business are felt in all relevant stages of evolving and implementing business plans. The first broad stage of the process is to formulate corporate guiding principles. As outlined below the first step in formulating and implementing a set of business plans is to define the firm's guiding principles in the market place. The guiding principles should, among other things, provide a long-term view of what the firm is striving to become and provide direction to divisional and subsidiary managers vehicle, some firms use "the decision circle" which is simply an interrelated set of strategic choices forced upon any firm faced with the internationalisation of its markets. These choices have to do with marketing, sourcing, labor,

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management, ownership, finance, law, control, and public affairs. Here the first two marketing and sourcing-constitute the basic strategies that encompass a firm's initial considerations. Essentially, management is answering two questions: to whom are we going to sell what, and from where and how will we supply that market? We then have a series of input strategies – labor, management, ownership, and financial. They are in their efforts to develop their own business plans. As an obligation addressed essentially to the query, with what resources are we going to implement the basic strategies? That is, where will we find the right people, willingness to carry the risk, and the necessary funds? A second set of strategies legal and control respond to the problem of how the firm is to structure itself of implement the basic strategies, given the resources it can muster. A final strategic area, public affairs, is shown as a basic strategy simply because it places a restraint on all other strategy choices.

Each strategy area contains a number of subsidiary strategy options. The decision process that normally starts in the marketing strategy area is an iterative one. As the decision maker proceeds around the decision circle, previous selected strategies must be readjusted. Only a portion of the possible feedback adjustment loops is shown here.

Although these strategy areas are shown separately but they obviously do not stand-alone. There must be constant reiteration as one moves around the decision circle. The sourcing obviously influences marketing strategy, as well as the reverse. The target market may enjoy certain preferential relationships with other markets. That is, everything influences everything else. Inasmuch as the number of options a firm faces is multiplied as it moves into international market, decision-making becomes increasingly complex the deeper the firm becomes involved internationally. One is dealing with multiple currency, legal, marketing, economic, political, and cultural systems. Geographic and demographic factors differ widely. In fact, as one moves geographically, virtually everything becomes a variable: there are few fixed factors.

For our purposes here, a strategy is defined as an element in a consciously devised overall plan of corporate development that, once made and implemented, is difficult (i.e. costly) to change in the short run. By way of contrast, an operational or tactical decision is one that sets up little or no institutionalised resistance to making a different decision in the near future. Some theorists have differentiated among strategic, tactical, and operational, with the first being defined as those decisions, that imply multi-year commitments; a tactical decision, one that can be shifted in roughly a year's time; an operational decision, one subject to change in less than a year. In the international context, we suggest that the tactical decision, as the phrase is used here, is elevated to the strategic level because of the rigidities in the international environment not present in the purely domestic for example, work force planning and overall distribution decisions. Changes may be implemented domestically in a few months, but if one is operating internationally, law, contract, and custom may intervene to render change difficult unless implemented over several years.

Task Analyse Tata Motor's domestic strategy vis-à-vis its international marketing strategy.

Self Assessment

State whether the following statements are true or false:

4. Domestic business is a special limited case of international business.
5. The first step in formulating and implementing a set of international business plans is to define the firm's guiding principles in the market place.

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6. The demographic and geographic factors of a home and host country are significantly similar.
7. In international business, tactical decisions should be treated as strategic.
8. Public affairs place a restraint on all other strategic choices of an international firm.

1.4 Influences and Goals of International Business

Companies engage in international business to:

- ***Expand Sales:*** Companies' sales are dependent on (a) the consumers' interest in their products or service and (b) the consumers' willingness and ability to buy them. The number of people and the extent of their purchasing powers are higher for the world as a whole than for a single country. Hence companies increase the potential market for their sales by pursuing global markets. Thus, higher sales means higher profits because of economies of scale. So, increased sales are a major motive for a company's expansion into international business.
- ***Acquire Resources:*** Manufacturers and distributors also look for foreign capital, technologies and information that they can use at home, to reduce their costs. Sometimes, a company operates abroad to acquire something not readily available in the home country so as to improve its product quality and differentiate itself from competitors, potentially increasing market share and profits.
- ***Minimise Risk:*** Companies seek out foreign markets to minimise swings in sales and profits arising out of business cycle recessions and expansions which occur differently in different countries.

Example: Sales decrease or grow more slowly in a country that is in recession and increase or grow more rapidly in one that is expanding rapidly in one that is expanding economically.

Many companies enter into international business for defensive reasons e.g. to counter advantages competitors might gain in foreign markets that in turn, can hurt them in the domestic market.

The company forms its strategies and the means to implement them after examining the external environment. The company faces different external environment in each country where it operates.

Understanding a Company's Physical and Social Environments

To operate within a company's external environment, its mangers should have in addition to knowledge of business operations, a working knowledge of basic social sciences, political sciences, law, anthropology, sociology, psychology, economies and geography.

Politics helps shape business worldwide because political leaders control shaping of international business. Political disputes can disrupt trade and investments; even small conflicts have far-reaching effects.

Domestic law includes regulations in both the home and host countries on matters such as taxation, employment and foreign exchange transactions.

Example: Japanese law determines how Lucas film revenues from Japanese screenings are taxed and how they can be exchanged from yen to US dollars. US law in turn, determines how and when the losses or earnings from Japan are treated for tax purposes in the US.

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International law in the form of legal agreements between two countries governs how the earnings are taxed by both. International law may also determine how and whether companies can operate in certain locales.

The related sciences of anthropology, sociology, and psychology describe, in part, peoples' social and mental developments, behaviour and interpersonal activities. Managers of international companies can better understand societal values, attitudes and beliefs concerning themselves and others. The understanding enables to function better in different countries.

Caution Economics explains among others, why countries exchange goods and services with each other, why capital and people travel among countries in the course of business and why one country's currency has a certain value compared to another's.

By studying economics, managers can better understand why, where and when one country can produce goods or services less expensively than another can. In addition, managers can obtain the analytical tools needed to determine the impact of an international company on the economies of the host and home countries and the effect of a country's policies and conditions on the company.

By knowing geography, managers can better determine the location, quantity, quality and availability of the world's resources and the best way to exploit them. Geographical barriers such as high mountains, vast deserts and the jungles affect communications and distribution channels for companies in many countries. The probability of natural disasters and adverse climatic conditions such as hurricanes, floods or freezing weather makes it riskier to invest in some areas than in others.

Competitive Environment

The competitive environment varies by industry, company and country and accordingly lay down international strategies.

Example: Companies in industries with homogenous products such as copper tubing compete more on price, than companies in industries that compete more on differentiated and innovative products such as branded toothpaste or state-of-the-art computer chips. Strategies for the former are focused on cost savings such as developing better equipment and operating methods, producing on a large scale to spread costs over more units and location to have cheap labour and materials.

Companies within the same industry also differ in their competitive strategies.

Example: Honda's greater concern about reducing automobile costs than BMW helps explain why the former has recently moved much of its automobile production to China to take advantage of lower labour costs while the latter has not. Still another competitive factor is the size of the company and the resources it has, compared to its competitors.

The competitive environment also varies in other ways among countries. For example, the domestic market in the US is much larger than the one in Sweden. Swedish producers have to depend more on foreign sales to spread fixed costs of product development and production than US producers.

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Case Study

Indian Companies on a Global Stage

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

The AV Birla group's takeover of the U.S. based aluminium products manufacturer, Novelis for a consideration of approximately $6 billion came within two weeks after the Tatas inked their deal with the U.K. based steel producer Corus. That two of India's most admired business groups should move decisively ahead with their global growth strategies at roughly the same time might be a coincidence. But there are important similarities.

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

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

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

Many Similarities

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

Both acquisitions have not evoked any nationalist opposition from politicians of the host countries. Their trade unions too have not opposed the sales. All these are very different from the stormy reception Lakshmi Mittal faced initially while taking over the European

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steel major, Arcelor. Senior politicians from France and Luxembourg had initially rallied against the takeover.

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

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

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

It's just the beginning

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

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

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

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

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

Questions

1. How have the India MNCs fared at the international arena?
2. Do you think that the local Indian companies have what it takes to succeed in the international market?

Source: *The Hindu*, 13th Jan 2009.

Notes

Self Assessment

Fill in the blanks:

9. The purchasing power is ..... for the world as a whole as compared to a single country.
10. A company has entered into an international market for ..... reasons if it is looking to counter advantages that a competitor might gain in foreign market.
11. ..... includes regulations in both the home and host countries on issues such as taxation, employment and foreign exchange transactions.
12. ..... explains why countries exchange goods and services with each other.

1.5 Problems of International Business

What make international business strategy different from the domestic are the differences in the marketing environment. The important special problems in international marketing are given below:

1. ***Political and Legal Differences:*** The political and legal environment of foreign markets is different from that of the domestic. The complexity generally increases as the number of countries in which a company does business increases. It should also be noted that the political and legal environment is not the same in all provinces of many home markets.

Example: The political and legal environment is not exactly the same in all the states of India.

2. ***Cultural Differences:*** The cultural differences, is one of the most difficult problems in international marketing. Many domestic markets, however, are also not free from cultural diversity.
3. ***Economic Differences:*** The economic environment may vary from country to country.
4. ***Differences in the Currency Unit:*** The currency unit varies from nation to nation. This may sometimes cause problems of currency convertibility, besides the problems of exchange rate fluctuations. The monetary system and regulations may also vary.
5. ***Differences in the Language:*** An international marketer often encounters problems arising out of the differences in the language. Even when the same language is used in different countries, the same words of terms may have different meanings. The language problem, however, is not something peculiar to the international marketing.

Example: The multiplicity of languages in India.

6. ***Differences in the Marketing Infrastructure:*** The availability and nature of the marketing facilities available in different countries may vary widely. For example, an advertising medium very effective in one market may not be available or may be underdeveloped in another market.
7. ***Trade Restrictions:*** A trade restriction, particularly import controls, is a very important problem, which an international marketer faces.
8. ***High Costs of Distance:*** When the markets are far removed by distance, the transport cost becomes high and the time required for affecting the delivery tends to become longer. Distance tends to increase certain other costs also.

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9. ***Differences in Trade Practices:*** Trade practices and customs may differ between two countries.

Task Identify the difficulties that foreign companies face while setting up their business in India.

Self Assessment

State whether the following statements are true or false:

13. Usually it can be seen that the complexity decreases as the number of countries in which a company does business increases.
14. The economic environment of one country is different from that of another country.
15. Import controls can create problems for an international marketer.

1.6 Summary

- The analytical framework of international business is built around the activities of the MNEs explained by the process of internalisation.
- Before the emergence of the multinationals, foreign trade and international business were synonymous. International trade doctrines based upon labour cost differentials and free trade guided the international transactions.
- Innovative efforts of the MNEs, in technological development and management styles superseded the international trade theories.
- The theorists began to develop the FDI approaches in support of international business for the improvement and welfare of the world economies.
- International companies operate in environments that are highly uncertain and where the rules of the game are often ambiguous, contradictory, and subject to rapid change, as compared to the domestic environment.
- A company engages in international business to expand sales, acquire resources and minimise risks associated with doing business only in one country.
- Many problems can arise in course of international business. Some prominent problems include political differences, cultural differences, economic differences, differences in currency, language and marketing infrastructure.
- The trade restrictions and differences in trade practices also pose problems for a company looking to expand itself in international market.

1.7 Keywords

Competitive Environment: The immediate competitive context in which an organisation or enterprise operates.

Foreign Direct Investment: Investment by a company in a country other than that in which the company is based.

International Business: The exchange of goods and services among individuals and businesses in multiple countries.

Notes

Multinational Enterprise (MNE): A firm that owns operations in more than one country.

Social Environment: The environment developed by humans as contrasted with the natural environment; society as a whole, esp. in its relation to the individual.

Trade Restriction: It is an artificial restriction on the trade of goods between two countries.

1.8 Review Questions

1. Describe how international business evolved.
2. International business environment is very uncertain, then why do companies want to engage in international business?
3. What do firms mean by a "decision circle"? How does it help?
4. Explain how venturing into international business can minimise risk for a company.
5. Would you advise a company with minimum R&D to venture into international business just to expand sales? Why or why not?
6. Is it important to study the physical environment of a country before setting up a business over there? Justify your answer.
7. "The understanding of economics enables a company to function better in different countries." Substantiate
8. How do geographic and competitive environments pose problems for an international company?
9. Discuss the special problems that an international company faces in different host countries.
10. "Cultural differences, is one of the most difficult problems in international marketing." Comment.

Answers: Self Assessment

1.	Multinational enterprises	2.	Interlinked
3.	Socio-cultural, political and economic	4.	True
5.	True	6.	False
7.	True	8.	True
9.	Higher	10.	Defensive
11.	Domestic law	12.	Economics
13.	False	14.	True
15.	True		

1.9 Further Readings

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Unit 2: Classical International Trade Theories

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Objectives

After studying this unit, you should be able to:

- Discuss various classical internal trade theories
- Describe the implications of classical trade theories
- Identify the criticisms of classical trade theories

Introduction

International trade plays an important role in the formulation of the world economy. One should know how monetary systems work because they relate directly to the ability of overseas customers to buy from an international marketer. One should also be aware of how various governments and international organisations seek to regulate international trade because this affects how and where one's goods may be exported.

Why do nations trade? A nation trades because it expects to gain something from its partner. One may ask whether trade is like a zero-sum game, in the sense that one must lose so that another will gain. The answer is no, because though one does not mind gaining benefits at someone else's expense but no one wants to engage in a transaction that includes a high risk of loss. For trade to take place both nations must anticipate gain from it. In other words, international trade is a positive sum game. There are basically two sets of theories of International Trade: The Classical Trade Theories, explaining how inter-country trade takes place; and theories

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of International Trade, explaining inter-country investment in manufacturing and service activities and the management of these activities. In this unit, we will cover the classical trade theories.

2.1 Theory of Mercantilism (1500-1700)

Mercantilism became popular in the late seventeenth and early eighteenth centuries in Western Europe and was based on the notion that governments (not individuals who were deemed untrustworthy) should become involved in the transfer of goods between nations in order to increase the wealth of each national entity. Wealth was defined, however, as an accumulation of previous metals, especially gold.

Consequently, the aims of the governments were to facilitate and support all exports while limiting imports, which was accomplished through the conduct of trader by government monopolies and intervention in the market through the subsidization of domestic exporting industries and the allocation of trading rights. Additionally, nations imposed duties or quotas upon imports to limit their volume. During this period colonies were acquired to provide sources of raw materials or precious metals. Trade opportunities with the colonies were exploited, and local manufacturing was repressed in those offshore locations. The colonials were often required to buy their goods from their mother countries.

The concept of mercantilism incorporates two fallacies. The first was the incorrect belief that old or precious metals have intrinsic value, when actually they cannot be used for either production or consumption. Thus, nations subscribing the mercantilism notion exchanged the products of their manufacturing or agricultural capacity for this non-productive wealth. The second fallacy is that the theory of mercantilism ignores the concept of production efficiency through specialisation. Instead of emphasizing cost-effective production of goods, mercantilism emphasises sheet amassing of wealth with acquisition of power.

Neo-mercantilism corrected the first fallacy by looking at the overall favourable or unfavourable balance of trade in all commodities, that is, nations attempted to have a positive balance of trade in all goods produced so that all exports exceeded imports. The term "balance of trade" continues in popular use today as nations attempt to correct their trade deficit positions by increasing exports or reducing imports so that outflow of goods balances the inflow.

The second fallacy, a disregard for the concept of efficient production, was addressed in subsequent theories, notably the classical theory of trade, which rests on the doctrine of comparative advantage.

Caselet

BRICS

BRICS is the title of an association of leading emerging economies, arising out of the inclusion of South Africa into the BRIC group in 2010. As of 2012, the group's five members are Brazil, Russia, India, China and South Africa. With the possible exception of Russia, the BRICS members are all developing or newly industrialised countries, but they are distinguished by their large, fast-growing economies and significant influence on regional and global affairs. As of 2012, the five BRICS countries represent almost 3 billion people, with a combined nominal GDP of US$13.7 trillion, and an estimated US$4 trillion in combined foreign reserves. Presently, India holds the chair of the BRICS group.

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President of the People's Republic of China Hu Jintao has described the BRICS countries as defenders and promoters of developing countries and a force for world peace. However, some analysts have highlighted potential divisions and weaknesses in the grouping, such as India and China's disagreements over Tibetan and border issues, the failure of the BRICS to establish a World Bank-analogue development agency, and disputes between the members over UN Security Council reform.

The foreign ministers of the initial four BRIC states (Brazil, Russia, India, and China) met in New York City in September 2006, beginning a series of high-level meetings. A full-scale diplomatic meeting was held in Yekaterinburg, Russia, on May 16, 2008.

First BRIC Summit

The BRIC grouping's first formal summit commenced in Yekaterinburg on June 16, 2009, with Luiz Inácio Lula da Silva, Dmitry Medvedev, Manmohan Singh, and Hu Jintao, the respective leaders of Brazil, Russia, India and China, all attending. The summit's focus was on means of improving the global economic situation and reforming financial institutions, and discussed how the four countries could better co-operate in the future. There was further discussion of ways that developing countries such as the BRIC members, could become more involved in global affairs.

In the aftermath of the Yekaterinburg summit, the BRIC nations announced the need for a new global reserve currency, which would have to be 'diversified, stable and predictable'. Although the statement that was released did not directly criticise the perceived 'dominance' of the US dollar - something which Russia had attacked in the past - it did spark a fall in the value of the dollar against other major currencies.

Entry of South Africa

In 2010, South Africa began efforts to join the BRIC grouping, and the process for its formal admission began in August of that year. South Africa officially became a member nation on December 24, 2010, after being formally invited by the BRIC countries to join the group. The group was renamed BRICS - with the "S" standing for South Africa - to reflect the group's expanded membership. In April 2011, South African President Jacob Zuma attended the 2011 BRICS summit in Sanya, China, as a full member.

Developments

The BRICS Forum, an independent international organisation encouraging commercial, political and cultural cooperation between the BRICS nations, was formed in 2011. In June 2012, the BRICS nations pledged $75 billion to boost the International Monetary Fund's lending power. However, this loan is conditional on IMF voting reforms.

Self Assessment

Fill in the blanks:

1. During Mercantilism, ... was defined as an accumulation of previous metals, especially gold.
2. All nations attempt to correct their trade deficit positions by increasing exports or reducing imports so that outflow of goods balances the inflow. This is referred to as .....

Multiple Choice Questions:

3. What is the basis of Classical Economic theory?
   a. Economic theory of free trade and enterprise

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b. Economic theory of absolute advantage

c. Economic theory of comparative advantage

d. Mercantilism.

4. All these put forward the Classical Economic Theory, except

a. Ricardo

b. Adam Smith

c. Thomas Malthus

d. Rostow.

2.2 Theory of Economic Development

The trade structure is also sought to be explained in terms of scale economies. According to this theory, there is a relationship between the size of the internal market and average unit cost of production and export competitiveness. A firm operating in a country where the domestic market is large will be able to reach a high output level thereby reaping the advantage of large-scale production. The lower cost of production will increase its competitiveness enabling the firm to make an easy entry to the export market. While prima-facie this logic appears to be valid, this hypothesis cannot be generalized because it is possible that the pull of the domestic market will be so strong that the export would not be promoted, as is the case with India in certain products.

Self Assessment

State whether the following statements are true or false:

5. Theory of Economic Development advocated that there is a relationship between the size of the internal market and average unit cost of production and export competitiveness.

6. The higher cost of production will increase its competitiveness enabling the firm to make an easy entry to the export market.

2.3 Rostow's Stages of Economic Growth Theory

A more recent and applicable theory of economic development was provided in the 1960s by Walter W. Rostow, who attempted to outline the various stages of a nation's economic growth and based his theory on the notion that shifts in economic development coincided with abrupt changes within the nations themselves. He identified five different economic stages for a country – traditional society, preconditions for take off, take off the drive to maturity, and the age of high mass consumption.

Stage 1: Traditional Society

Rostow saw traditional society as a static economy, which he likened to the pre-1700s attitudes and technology experienced by the world's current economically developed countries. He believed that the turning point for these countries came with the work of Sir Isaac Newton, when people began to believe that the world was subject to a set of physical laws but was malleable within these laws. In other words, people could effect change within the system of descriptive laws as developed by Newton.

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Stage 2: Preconditions for takeoff

Rostow identified the preconditions for economic takeoff as growth or radical changes in three specific, non-industrial sectors that provided the basis for economic development:

1. Increased investment in transportation, which enlarged prospective markets and increased product specialisation capacity.
2. Agricultural developments providing for the feeding and nourishing of larger, primarily urban, population.
3. An expansion of imports into the country.

These preconditioning changes were to be experienced in concert with an increasing national emphasis on education and entrepreneurship.

Stage 3: Takeoff

The takeoff stage of growth occurs, according to Rostow, over a period of twenty to thirty years and is marked by major transformations that stimulate the economy. These transformations could include widespread technological developments, the effective functioning of an efficient distribution system, and even political revolutions. During this period barriers to growth are eliminated within the country and indeed the concept of economic growth as a national objective becomes the norms. To achieve the takeoff, however, Rostow believes that three conditions must be met:

1. Net investment as a percentage of net national products must increase sharply.
2. At least one substantial manufacturing sector must grow rapidly. This rapid growth and larger output trickles down as growth in ancillary and supplier industries.
3. A supportive framework for growth must emerge on political, social and institutional fronts. For example, banks, capital markets, and tax systems should develop and entrepreneurship should be considered a norm.

Stage 4: The Drive to Maturity

Within Rostow's scheme, this stage is characterised as one where growth becomes self-sustaining and a widespread expectation within the country. During this period, Rostow believes that the labour pool becomes more skilled and more urban and that technology reaches heights of advancement.

Stage 5: The Age of Mass Consumption

The last stage of development, as Rostow sees it, is an age of mass consumption when there is a shift to consumer durables in all sectors and when the populace achieves a high standard of living as evidenced through the ownership of such sophisticated goods as automobiles, televisions and appliances.

Since its introduction in the 1960s, Rostow's framework has been criticized as being overly ambitious in attempting to describe the economic paths of many nations. Also, history has not proved the framework to be true.

Example: Many lesser-developed countries exhibit dualism that is, state of the art technology is used in certain industries and primitive production methods are retained in

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others. Similarly, empirical data has shown that there is no twenty-to-thirty year growth period. Such countries as the United Kingdom, Germany, Sweden, and Japan are more characterised by slow, steady growth patterns than by abrupt takeoff periods.

Self Assessment

Match the following Rostow's stages of economic growth to their characteristics:

Set A

7. Stage 1
8. Stage 2
9. Stage 3
10. Stage 4
11. Stage 5

Set B

a. Preconditions for take-off
b. Take-off
c. Drive to maturity
d. Age of mass consumption
e. Traditional society

2.4 Theory of Absolute Advantage

Here, we will discuss the principles of absolute and relative advantage.

2.4.1 Principle of Absolute Advantage

Adam Smith was the first economist to investigate formally the rationale behind foreign trade. In his book, *Wealth of Nations*, Smith used the principle of absolute advantage as the justification for international trade. According to this principle, a country should export a commodity that can be used at a lower cost than can other nations. Conversely, it should import commodity that can only be produced at a higher cost than can other nations.

Example: Consider, for example, a situation in which two nations are each producing two products following Table provides hypothetical production figures for the United States and Japan based on two products – the computer and automobile. The United States can produce 20 computers or 10 automobiles or some combination of both. In contrast, Japan is able to produce only half as many computers (Japan produces 10 for every 20 computers that United States produces). The disparity might be the result of better skills by American workers in making this product. Therefore, the United States has an absolute advantage in computers. But the situation is reversed for automobiles because the United States makes 10 cars for every 20 units manufactured in Japan. In this instance, Japan has an absolute advantage.

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Table 2.1: Possible Physical Output

Case	Product	United States	Japan
Case 1	Computer Automobiles	20 10	10 20
Case 2	Computer Automobile	20 30	10 20
Case 3	Computer Automobile	20 40	10 20

An analogy may help demonstrate the value of the principle of absolute advantage. A doctor is absolutely better than a mechanic in performing surgery is whereas the mechanic is absolutely superior in repair cars. It would be impracticable for the doctor to practice medicine as well as to repair the cars when repairs are needed. Similar case is with mechanic because he cannot even attempt to practice medicine or surgery. Thus, for practicality each person should concentrate on and specialize in the craft that person has mastered. Similarly, it would not be practical for consumers to attempt to produce all the things they desire to consume. One should practice what one does well and leave the production of other things to people who produce them well.

2.4.2 Principle of Relative Advantage

One problem with the principle of absolute advantage is that it fails to explain whether trade will take place if one nation has absolute advantage for all products under consideration. Case 2 of Table shows this situation.

Caution Note that only difference between Case 1 and Case 2 is that United States is capable of making 30 automobiles instead of 10 in Case 1. In the second instance, the United States has absolute advantage for both the products resulting in absolute disadvantage for Japan for both. The efficiency of the United States enables it to produce more of both products at lower costs.

At first glance it may appear that United States has nothing to gain from trading with Japan. But 19th Century British Economist David Ricardo fully appreciates the relative cost as a basis for trade and he argues that absolute production costs are irrelevant. More meaningful are relative production costs, which determine whether trade should take place and what items to export or import. According to Ricardo's Principle of Relative (or Comparative) Advantage, a country may be better than another countries in producing many products but should only produce what it produces the best. Essentially it should either concentrate on a product with the greatest comparative advantage or a product with the least comparative disadvantage. Conversely, it should import either a product for which it has the greatest comparative disadvantage or one for which it has the least comparative advantage.

Consider again the analogy of the doctor and the mechanic. The doctor may take up automobile repair as a hobby. It is even possible, though not probable that the doctor may eventually be able to repair an automobile faster and better than the mechanic. In such an instance the doctor would have absolute advantage in both the practice of medicine and automobile repair whereas the mechanic would have an absolute disadvantage for both the activities. This situation does not mean that the doctor would better of repairing automobiles as well as performing surgery because of relative advantages involved. When compared to mechanic, the doctor may be superior in surgery but only slightly better in automobile repair. Hence the doctor should concentrate only on surgery. When a doctor has automobile problems, only the mechanic should make the repairs because the doctor has slight relative advantage in the skill thereby doctor is using time more productively while maximizing the income.

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In 1776, Adam Smith noted that, if a country could produce a good cheaper than other countries, it had an absolute advantage in the production of that good; he then argued that, in order to maximize national income, countries should produce and export surpluses of what they have absolute advantage in, and buy whatever else they need from the rest of the world. In this way, be theorized, specialization, and hence efficiency, would be encouraged as a result of the increased competition and scale economies. Of course, the question that was left unanswered was, "what if a country had absolute advantage in all products; or even worse, in no products at all?" the theory would imply that the former country need not trade, while the latter could not trade!

Forty years later, David Ricardo unambiguously answered the question with what has become one of the most important ideas in all of economics: He showed that both countries should, and indeed, will trade in order to increase their national welfare, as long as each has a comparative advantage in the production of one good versus another. In other words, incentives for trade would exist even when one country has absolute cost advantage in everything or another country has the absolute cost advantage in nothing. The key, he noted, was that a country should have the ability to produce one good, relative to another good, that is different from another county's try's relative ability to produce the same two goods. The best way to see this argument before we see the intuitive reasoning behind this powerful idea is through an example.

Task Take another hypothetical example and explain the concept of absolute advantage.

Self Assessment

Fill in the blanks:

12. According to Absolute advantage principle, a country should ..... a commodity that can be used at a lower cost than can other nations.
13. According to ..... advantage principle, a country may be better than other countries in producing many products but should only produce what it produces the best.

2.5 Theory of Comparative Advantage

This question was considered by David Ricardo, who developed the important concept of comparative advantage in considering a nation's relative production efficiencies as they apply to international trade. In Ricardo's view, the exporting country should look at the relative efficiencies of production for both commodities and make only those goods it could produce most efficiently.

Example: Suppose, for example, in our illustration that Greece developed an efficient manufacturing capacity so that martini glasses could be produced by machine rather than being hand-blown. In fact, since the development of the productive capacity and capital plants were newer than those in Sweden, Greece could produce 100 crates of martini glasses using only 200 resource units as opposed to the 300 units required by Sweden. Thus, Greece's comparative costs would fall below that of Sweden for both products and its comparative advantage vis-à-vis those products would be higher. Therefore, the resource units required to produce olives and glasses would now be:

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Table 2.2: Comparative Advantage

Country	Olives (500 crates)	Martini Glasses (100 crates)
Greece	100 units	200 units
Sweden	600 units	300 units

Logically, Greece should be the producer of both olives and martini glasses, and Sweden's capital and labour used in making these happy-hour supplies should be directed to Greece, so that maximum production efficiencies are achieved. Neither capital nor labour is entirely mobile, however, so each country should specialize – Greece in olives at 100 resources units per 500 crates and Sweden in glass production at 300 resource units per 100 crates. Greece is still better off at maximising its efficiencies in olive production. By doing so, it produces twice as many goods for export with the same amount of resources than if it allocated production level.

While Sweden's production costs for glasses are still higher than those of Greece at 300 units the resources of Sweden are better allocated to this production than to expensive olive growing. In this way, Sweden minimizes its inefficiencies and Greece maximizes its efficiencies. The point is not that a country should produce all the goods it can more cheaply, but only those it can make cheapest. Such trading activity leads to maximum resource efficiency.

The concepts of absolute advantage and comparative advantage were used in a subsequent theory development by John Stuart Mill who looked at the question of determining the value of export goods and developed the concept of terms of trade. Under this concept, export value is determined according to how much of a domestic commodity each country must exchange to obtain an equivalent amount of an imported commodity. Thus, the value of the product to be obtained in the exchange was stated in terms of the amount of products produced domestically that would be given up in exchange. For example, Sweden's terms with Greece would be exporting of 100 crates of glasses for an equivalent 500 crates of olives.

Case Study

Core Complexities

Raj Abrader Singh, the 55-year-old CEO of the ₹353 crore Bharat Synthetics, was taken aback at the tone of the letter he had just received from his creditors. Expressing concern at the lack of seriousness in initiating a turnaround strategy, and the inordinate delays in the repayment of loans, it said that Singh should now make way for a new CEO. "In the considered view of the consortium of lenders," it said, "only a professional manager can steer Bharat Synthetics towards growth." The news was worrisome. Clearly, the letter was a vote of no confidence in Singh's ability to lead a 35-year-old company in a highly competitive marketplace.

"Damn liberalisation!" swore Singh. "Why did it have to rock by cozy world?" The economy had opened up all right, but, to his dismay, it had left Bharat Synthetics in limbo. Or had it? "Perhaps I did not read the signals right," he said to himself. After all, economic liberalisation had also created a world of opportunities that many entrepreneurs had grabbed quickly. He wondered if he had done anything wrong by refraining from diversification. Recalling the time, only four years ago, when Bharat Synthetics was perceived as a good investment opportunity, Singh was troubled at the way the tide had changed.

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Later, at a luncheon meeting with Abhinav Paul, 54, executive director of the management consultancy firm, Quotient, Singh ruminated. "It does not make any sense," he told Paul, who was a childhood friend. "I have been practising for years all that management consultants have been preaching. Core competence. No unrelated diversification. I was doing well without these fancy buzzwords. I have stuck to man-made fibres throughout my career. Why, then, am I in this mess? And look at my competitors. They did everything that went against present business wisdom. They diversified into unrelated areas – one of them even set up a cement plant – without giving a damn about core competence. Another ventured into financial services and hoteliering. Still, they seem to prosper."

"Interesting," said Paul. 'You know, although we have never discussed business, I have been tracking Bharat Synthetics' progress. Its predicament is typical of what has been happening to many commodity businesses since the economy opened up. Costs, you must understand, are driven by two factors: economies of scale and technology. Bharat Synthetics' products are out-priced and no longer competitive. I am aware that after record profits of ₹ 34 crore in 1994-95, Bharat Synthetics' today has accumulated losses of ₹ 27 crore, and is unable to service its total debt of ₹ 60 crore. You have a big crisis on hand. But we could find a way out of the mess. Why did you think of man-made fibres in the first place? Did you have any expertise?'

'We took the plunge into rayon filament yarn simply because we had a licence to make the product," said Singh. "In those days, if you remember, the choice of business was determined by official approvals – not market needs. You needed a licence to be competitive. Of course, being a cellulose derivative, rayon was a perfect substitute for cotton. So, its manufacture made good business sense. It was also a sellers' market. We could sell everything we produced. So, we set up a plant in 1963 at Surat, to make rayon yarn. Profits posed no problem, since pricing was done on a cost-plus basis.'

"I was also keen on improving the quality of our products. So, in 1966, we collaborated with a Japanese company. We also began trading in finer deniers of rayon filament yarn, which are used in the manufacture of chiffon and georgette. A decade later, we commissioned a nylon filament yarn plant in collaboration with an Italian company. Simultaneously, we went into the manufacture of Polyester Filament Yarn (PFY). And, in 1984, we started making nylon cord – which is consumed by the tyre industry – in collaboration with a Japanese firm. Today, we have four product categories: rayon yarn, which has a capacity of 4,500 tonnes per annum (tpa); nylon yarn (2500 tpa); nylon cord (4000 tpa); and PFY (15000 tpa). And we have been operating at full capacity for years."

"Frankly, those capacities look minuscule," said Paul, "in relation to global scales of 100,000 plus tpa. And India is gradually becoming a global market. In fact, you are incurring losses despite optimum capacity utilisation. This is a clear indication of poor economies of scale. Was there any synergy among the four products?" "No," replied Singh. "It was the availability of a licence that influenced the choice of products. Each product-line is characterised by its own value chain. Except rayon, all others are derived from naphtha. So, a common feedstock was the only link between the products. Which meant that synergy lay in backward integration up to the feedstock."

"You mentioned poor economies of scale," continued Singh. "That, precisely, is the root of our problems. The government did not permit large capacities when we started because of apprehensions of creating monopolies. Capacities and market shares were fragmented across small players. There are 30 players in the industry today. Scale did not matter for decades because we had large tariff barriers. The import duty on PFY, for instance, was 150 per cent. But with liberalisation, the duty has fallen to 32 per cent today. I don't see any reason why a customer should buy from Bharat Synthetics."

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"But why didn't you augment capacity even after the licence-permit era ended?" asked Paul. "After all, most of your competitors have gone in for capacities over 50,000 tpa. For instance, Vimoline Industries has not only set up a 200,000 tpa capacity, it has also integrated backwards, right up to the primary feedstock."

"A valid point," conceded Singh. "You know, Bharat Synthetics was doing well till the mid-1990s, with operating margins of up to 40 per cent. We were declaring dividends of between 20 and 25 per cent for years, and Bharat Synthetics carried a premium. Our credibility with bankers was high. We rode the textile boom all through the 1980s. We thought the good times would last. We were in no mood to see the flipside."

"The classic trap of success," said Paul.

"On hindsight. Yes," said Singh. "It was only in 1995 – when profits began to decline – that we thought of expanding polyester capacity. Paradoxically, it triggered off a spiral from which we have not recovered as yet. Since the primary market was languishing, we decided on a rights issue of ₹ 70 crore in mid-1995 to fund capacity expansion in PFY, and backward integration into polyester chips. But the rights issue flopped. All major shareholders, including our collaborators, renounced their entitlements. The trouble was that we had already taken a bridge loan of ₹ 40 crore from financial institutions. As the original promoter, I was forced to subscribe to more than 80 per cent of the issue, increasing my stake from 12 to 34 per cent. Unfortunately, the proceeds of the issue were frozen following a court order. Unsure of getting their money back, the institutions had taken the matter to court. Sooner than we realised, we got into working capital problems. And while servicing the debt, our business priorities went haywire. One example: although we imported the plant and machinery, it could not be commissioned for two years for lack of funds."

"It is a typical trap that most companies get into," said Paul. "I have seen how companies get trapped when cash flows go haywire. The choice of the product is decided by the availability of working capital. You end up making something that costs less to produce but is not the most profitable product. You are compelled to source cheaper raw materials, affecting quality and revenues. Exigency becomes all. I don't know if you have also been facing that situation at Bharat Synthetics."

"That is just the paradox at Bharat Synthetics," said Singh. "But the fact is that, despite a range of businesses, we're a small player in each of them. And none of these businesses is sustainable in the long run because of scale and technology. Take nylon tyre cord. It does not have a future because most tyre manufacturers are now switching to radials that do not use nylon cord. As far as polyester is concerned, there is a glut in India. And our scale is not large enough to warrant a full-fledged business unit. Nylon is threatened by a substitute: polypropylene fibre yarn. And although rayon is the only substitute for cotton, the rate of growth in demand has been a measly 4 per cent per annum. Unfortunately, there are simply no buyers around."

"The threat is obvious: technology is changing the rules of the game. Without large-scale economies, you are extremely vulnerable. Your immediate priority is to prevent bleeding. Do you have an action plan?" asked Paul. "On the operations front, yes," replied Singh. 'It centres around diversifying the client base and enlarging the end uses of our products. We have developed – and successfully test-marketed – several types of industrial products. Flame-retardant polyester, in particular, has a big demand. Bharat Synthetics has also developed adhesive-activated polyester industrial yarn, which is used in rubberised goods. We are also making fancy yarn by combining various types of filament yarns. All these products have improved our cash flow substantially.'

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"To cut costs, we are recycling solid waste from the nylon tyre-cord and the polyester plants to produce chips and industrial yarn. But none of these initiatives can solve the fundamental problem. The Return On Capital Employed (ROCE) in our business is a measly 3 per cent. There are two redeeming features, though. We have fixed assets worth ₹130 crore. And we have a locational advantage. Surat has one of the largest concentrations of power looms, and one of the largest segments of synthetic yarn users. We are close to the customer."

"Close to the customer," repeated Paul. "That is interesting. How about the long-term?" "Well, there are several options," said Singh. "In order to generate some quick resources, we will be selling off some unproductive assets like our corporate office in Mumbai. We are also negotiating with some firms for the sale of some of our existing businesses. In fact, that is what the consortium of lenders has proposed. Of course, once we clear our debt, newer options will open up. One option: forward integration, from polyester into textiles and finished products. Another: a joint venture with our technology partner to produce and market polyester yarn. We are also open to the idea of entering into non-textile-related businesses like chemicals and engineering. Bharat Synthetics is also considering a proposal to become a contract manufacturer for a larger player like Vimoline, which is already operating at full capacity."

"It is noteworthy that the ROCE is less than the average cost of fresh capital," continued Singh. "So, we might be better off selling the business and investing in risk-free financial instruments than in remaining in a business which does not have inherent long-term strengths."

"You spoke of Bharat Synthetics being close to the customer," said Paul. "There could be a clue there. You also spoke earlier about how you stuck to what you believed was your core competence. Tell me, what do you understand by core competence?" Core competence," said Singh "is a process by which you have an edge over the competitor, and which you do well, along with the customer, to create superior value. Bharat Synthetics' strength is product quality. And customer loyalty. Most powerlooms in Surat preferred to deal with us than with our competitors. Liberalisation changed those equations. We are no longer cost competitive."

"Frankly," said Paul, "I don't think you have a clear understanding of the concept of core competence. India is acknowledged to be one of the few countries in the world possessing a natural advantage in processing cotton and cellulose derivatives. That was a start up advantage. But did you build on it? Did you make any attempt to identify the skills that could set you apart from competition? You accessed newer technologies, but did you leverage them fully? Did you strengthen your locational advantages? Did you ever find out where the Indian synthetics market was heading? You have been in the synthetics business for 35 years. How could you not anticipate its future? If you had done that exercise, you would not be in this situation today."

Questions

1. Is there any hope for Bharat Synthetics? Are their problems results of circumstances alone? Or is it all its own doing? Do its business portfolio and product range needs a fresh look?
2. What is the impact of Bharat synthetics products in relation to Theory of Comparative Advantage?

Source: International Trade: Text and Cases, P. K. Vasudeva, Excel Books, New Delhi

Self Assessment

Notes

State whether the following statements are true or false:

14. As per Ricardo, the exporting country should make only those goods it could produce most efficiently.

15. According to Stuart Mill, the value of the product to be obtained in the exchange was stated in terms of the amount of products produced domestically that would be given up in exchange.

2.6 Factor Endowment Theory

The Eli Heckscher and Bertil Ohlin theory of factor endowment addressed the question of the basis of cost differentials in the production of trading nations. They posited that each country allocates its production according to the relative allocates its production according to the relative proportions of all its production factor endowments – land, labour and capital on a basic level, and, on a more complex level, such factors as management and technological skills, specialised production facilities, and established distribution networks.

Thus, the range of products made or grown for export would depend on the relative availability of different factors in each country.

Example: Agricultural production or cattle grazing would be emphasised in such countries as Canada, and Australia, which are generously endowed with land. Conversely, in small land mass countries with high populations, export products would center or labour-intensive articles. Similarly, rich nations might center their export base on capital-intensive production.

In this way, countries would be expected to produce goods that require large amounts of the factors they hold in relative abundance. Because of the availability and low costs of these factors, each country should also be able to sell its products on foreign markets at less than international price levels. Although this theory holds in general, it does not explain export production that arises from taste differences rather than factor differentials. Some of these situations can be seen in sales of luxury-imported goods, such as Italian leather products, deluxe automobiles and French wine, which are values for their quality, prestige, or panache. Like Classical theory, the Heckscher-Ohlin theory does not account for transportation costs in its computation, nor does it account for differences among nations in the availability of technology.

Economist Paul Samuelson extended the factor endowment theory to look at the effect of trade upon national welfare and the prices of production factors: Samuelson posited that the effect of free trade among nations would be to increase overall welfare by equalizing not only the prices of the goods exchanged in trade, but also of all involved factors. Thus, according to his theory, the returns generated by use of the factors would be the same in all countries.

In 1933, drawing upon the work of Eli Heckscher, Bertil Ohlin took the Ricardo model a significant step further, by linking the source of a country's comparative advantage to the endowment of its factors of production. This theory, known as the Heckscher-Ohlin model of international trade (or simply, the H-O model) is probably the most widely accepted form of the comparative advantage theory today.

The H-O model focused on two assumptions: (1) Goods differ in how much they use of certain types of factors of production – that is, different goods have different factor intensities; for instance, the manufacture of textiles is labour intensive, while the manufacture of semiconductor is capital intensive. (2) Countries differ with respect to their factor endowments; for instance, one might reasonably argue that India has an abundant supply of labour relative to capital,

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while the reverse is true of the US. Further, H-O assumed (as Ricardo did) that markets are perfectly competitive and factors are perfectly mobile, but it relaxed the assumption of constant returns to scale in order to allow for decreasing returns to scale. Putting these assumptions together, the main proposition of the H-O model is the following: *A country exports those goods that use intensively its relatively abundant factor of production*. That is, countries export those goods that they are best suited to produce, given their factor endowments.

Using the examples above, H-O would argue that a country such as India would export labour-intensive goods (and import capital-intensive goods), while a country such as the US would export capital-intensive goods (and import labour-intensive goods).

As with Ricardo's theory of comparative advantage, there are some potential weaknesses underlying the theory: (1) Endowments are supposed to be given, when they can often be created (for example, through innovation); in other words, H-O assumes a static supply of factor endowments. (2) If some countries kept to their static endowment-determined advantages, they might be stuck with a second-rate economy in the long run. (3) In an empirical insight that later came to be known as the "Leontief Paradox," economist Wassily Leontief found that, contrary to predictions suggested by the H-O model, US exports were less capital intensive than US imports. All these shortcomings led economists to a number of other, more realistic approaches to modeling international trade. However, the central insight of H-O regarding the link between factor endowments and factor intensity remains widely accepted.

Self Assessment

Fill in the blanks:

16. According to Hecksher-Ohlin Theory, the range of products made or grown for export would depend on the relative availability of ..... in each country.
17. According to his ..... theory, the returns generated by use of the factors would be the same in all countries.

2.7 Implications

Both the Ricardian and the H-O theories have some powerful implications. These implications, paradoxically, lead to equally powerful incentives – and in some cases, commonly used arguments to justify demands for protection from the forces of free trade.

Caution The first major implication of free trade is *factor price equalization*: International trade will be tending to equalize factor prices across countries that trade.

The reason is simple. The more trade that occurs in a particular good from a country, the greater the demand for the factors used intensively in the production of that good and the less the demand for the other factor. As a result, the price of one of the factors will be driven up and the other driven down. The exact opposite will happen in the other country. As a consequence, factor prices will be driven toward equalization in the two countries. For example, in the country that exports labour-intensive goods, the relative wages of labour will rise. Similarly, international trade will tend to drive the costs of capital closer together in the countries that trade.

Caution The second major implication has come to be known as the Ryczynski Theorem.

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An increase in the endowment of one of the factors will reduce the production of goods that intensively use the other factor.

Example: If the US is capital rich, and innovation increases the productivity of capital, then labour-intensive industries in the US will get hurt.

Again, the reason is simple. With an increase in its capital endowment, the US can now produce and export more capital-intensive goods; this would lower the demand for labour, since resources will move away from the labour-intensive sectors of the economy (and, by definition, the capital-intensive sectors use relatively less labour). Indeed, in developing countries that specialize in labour-intensive goods, the reverse implication is even more surprising: An increase in the productivity of labour – for example, through better education and training or better provision of health care—will hurt capital-intensive sectors in those economies!

If these two implications are true, then we are likely to observe demand for protection from the effects of free trade from precisely those sectors in the economy that are hurt. Thus, demands for protection are likely to come from segments that represent labour in capital-intensive economies, and segments that represent capital in labour-intensive economies. This may explain why, in countries such as the US, labour unions often strongly oppose agreements such as NAFTA. It may also explain why developing countries tend to be the ones that usually have stricter controls on cross-border capital flows. But this suggests another important corollary to the factor price equalization and Rybezynski theorems: *Demands for protection are most likely to arise from the less efficient sectors in an economy*.

This takes us to another implication of comparative – advantage theories, an implication that has come to be known as the *Stolper Samuelson Theorem:* Any protection – for example, a tariff – will increase the income of factors of production used intensively in the good that receives protection; in the process, the relative income of the factor of production used in the other good will fall. For example, in countries such as the US, there will be cries for – and hence the incentive for – protection from labour – intensive sectors; such policies will prop up incomes in those sectors, but in the process they will hurt the capital-intensive sectors and, hence, capital. The reverse will be true in labour-intensive economies such as the developing countries. Efforts at protecting capital (for example capital controls) would actually end up hurting labour in those economies.

There are three main insights to take away from this discussion. One, the incentives (and some might argue, the logic) for protection is inherent in arguments for free trade. Two, demands for protection will usually arise from the less efficient sectors in an economy. Three, protection will usually end up hurting the more efficient sectors in an economy.

As with many other arguments in economics, the logic for free trade is a conditional one. It simply says that, if a nation wants to increase its economic efficiency, then the avenue for doing so is by focusing on its comparative advantage and trading with other nations. But policymakers also often worry about no efficiency aspects of free trade, in particular, aspects such as distributional (or "equity") considerations, short-term unemployment, preservation of a "way of life", and so forth. But the question that they, and the MNEs that benefit from such protection – then have to confront is whether global economic competition makes loss of jobs (and attendant ways of life) inevitable, and if so, whether it is better to recognize and manage the inevitable transitions and dislocations that are bound to occur sooner or later.

Task Find out more about the Stolper Samuelson Theorem. How is this theorem different from the Ricardian theories?

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Self Assessment

State whether the following statements are true or false:

18. Ryczynski Theorem states that an increase in the endowment of one of the factors will increase the production of goods that intensively use the other factor.

19. It can be induced from Stopler Samuelson theorem that the efforts at protecting capital would actually end up hurting labour in those economies.

2.8 Analysis

Although these more recent theories seem to go far in explaining why nations trade, they have nonetheless come under criticism as being only partial explanations for the exchange of goods and services between nations. Some of these criticisms are that:

1. The theories assume that nations trade, when in reality trade between nations is initiated and conducted by individuals or individual firms within those nations.

2. Traditional theory also assumes perfect competition and perfect information among trading partners.

3. They are limited in looking at either the transfer of goods or of direct investments. No theories explain the comprehensive dynamic flow of trade in goods, services and financial flows.

4. They do not recognise the importance of technology and expertise in the areas of marketing and management.

Consequently, some scholars have looked separately at the reasons why firms enter into trade or foreign investment. One of these theories is the international product life cycle, which looks at the path a product takes as it departs domestic shores and enters foreign markets.

Self Assessment

Fill in the blanks:

20. The Traditional theory assumes that there is ..... competition among trading partners.

21. The Classical theories do not recognise the importance of technology and expertise in the areas of ..... and .....

2.9 Summary

- More meaningful are relative production costs, which determine whether trade should take place and what items to export or import.
- According to Ricardo's Principle of Relative (or Comparative) Advantage, a country may be better than another countries in producing many products but should only produce what it produces the best.
- The Ricardian Model of Comparative Cost is based on only on production. Manufacturing centres can move from the developed to the developing countries, which have low labour cost.
- Several studies have investigated the validity of the classical trade theories. There are several classical trade theories like the Adam Smith Theory, Classical Economic Theory,

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Theory of Mercantilism, Absolute and Comparative advantage theories, Factor Endowment Theory, etc.

- The studies conducted by Leontief revealed that the United States actually exports labour intensive goods and imports capital-intensive products.
- One limitation of classical trade theory is that the factors of production are assumed to remain constant for each country because of the assumed mobility of such resources between countries. Labour, as a factor is relatively immobile.
- Immigration laws in most countries severely limit the freedom of movement of labour between the countries. As a result, production cost and product prices are completely equalised across countries.
- The most serious shortcoming of classical trade theory is that they ignore the marketing aspect of trade.

2.10 Keywords

Classical Economic Theory: The theory claims that leaving individuals to make free choices in a free market results in the best allocation of scarce resources within an economy and the optimal level of satisfaction for individuals

Factor Endowment Theory: A trade theory which holds that nations will produce and export products that use large amounts of production factors that they have in abundance and will import products requiring a large amount of production factors that they lack.

Factor Price Equalization: It is an economic theory, which states that the relative prices for two identical factors of production in the same market will eventually equal each other because of competition.

International Trade: It refers to the exchange of capital, goods, and services across international borders or territories.

Mercantilism: It is a body of economics thought popular during the mid 16th and late 17th centuries that held that money was wealth, accumulation of gold and silver was the key to prosperity, and one nation's gain was another's loss.

Neomercantilism: It is a term used to describe a policy regime which encourages exports, discourages imports, controls capital movement and centralizes currency decisions in the hands of a central government.

Principle of Absolute Advantage: A country has an absolute advantage over it trading partners if it is able to produce more of a good or service with the same amount of resources or the same amount of a good or service with fewer resources.

Principle of Comparative Advantage: A country has a comparative advantage in the production of a good or service that it produces at a lower opportunity cost than its trading partners.

2.11 Review Questions

1. State the fallacies of Mercantilism. How did Neo Mercantilism overcome the fallacies of Mercantilism?
2. Describe the basic premise of Adam Smith's theory.
3. Discuss the Classical Economic Theory. Give examples to explain the concept.
4. Describe the five economic stages of a country as told by Rostow.

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5. Is absolute advantage as the justification for international trade? Validate your answer.
6. Explain the difference between Absolute Advantage and Comparative Advantage. How has the theory of Absolute Advantage been evolved?
7. Differentiate between absolute and relative advantage giving a suitable example.
8. As per Ricardo, "the exporting country should look at the relative efficiencies of production for both commodities and make only those goods it could produce most efficiently". Do you agree with his view? Why or why not?
9. Describe the basic premise of Factor Endowment theory. How is it different from the premise of Ricardian theory?
10. Discuss the implications of Trade Theories on the present day economic scenario in the international trade.
11. Describe the "Stolper Samuelson Theorem".
12. On what grounds can the classical theories be criticised?

Answers: Self Assessment

1.	Wealth	2.	Balance of trade
3.	(d)	4.	(d)
5.	True	6.	False
7.	(e)	8.	(a)
9.	(b)	10.	(c)
11.	(d)	12.	Export
13.	Relative	14.	True
15.	True	16.	Different factors
17.	Samuelson's	18.	False
19.	True	20.	Perfect
21.	Marketing, management		

2.12 Further Readings

Books

Adhikary, Manab, *Global Business Management*, New Delhi: Macmillan

Bhattacharya B., *Going International Response Strategies for Indian Sector*, New Delhi: Wheeler Publishing Co.

Black and Sundaram, *International Business Environment*, New Delhi: Prentice Hall of India

Vasudeva, P. K. (2010), *International Trade: Text and Cases*, New Delhi: Excel Books

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Online links

http://cis01.central.ucv.ro/iba/files/int_ec2.pdf

http://dibartolomeo.comunite.it/courses/ieric/L1.pdf

http://www.preservearticles.com/201012291891/comparison-between-classical-theory-and-modern-theory-of-international-trade.html

http://121.52.153.179/JOURNAL/Vol4-No1/S-Rahim.pdf

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Unit 3: Modern Theories of International Trade

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Objectives

After studying this unit, you should be able to:

- Describe the basic premise of Human Capital Theory and Identical Preferences Theory
- Discuss the main points of the Strategic Trade Theory
- Realise the concept behind the Modern Investment Theory
- State the characteristics of stages of international product life cycle
- Assess the validity and limitation of international trade theories.

Introduction

After having learnt the classical trade theories in the previous unit, you will learn the modern theories of international trade in this unit. The year 1993 witnessed two landmark events in the recent history of international trade: the passage of the North American Free Trade Agreement (NAFTA) by the US, Canada, and Mexico, and the conclusion (although not yet ratification) of the seven-year "Uruguay Round" of negotiations of the General Agreement on Tariffs and Trade (GATT). Despite general consensus that these agreements would benefit the world economy in general and MNEs in particular, passage of both agreements was preceded by acrimonious debate in the media, by makers of public policy, and in academic realms. While many CEOs and MNEs welcomed both NAFTA and GATT, many labour unions, consumer groups, and environmentalists were strongly opposed to their passage.

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This unit also looks at a phenomenon that has grown in both its application and its intensity during the past decade, namely, "strategic trade," and what drives governments and industries to try to "manage" their trading relationships with other countries.

3.1 Human Capital Approach Theory

This theory, which is also sometimes known as Skills Theory of International Trade, has been advocated by a number of economists, especially Becker, Kennen and Kessing. Whereas the Factor Proportions Theory considers labour as a homogenous factor, however, it is not so in the real world. In fact, for export of manufactured goods, the skill level of labour is very important determinant. Labour can be basically divided into skilled and unskilled labour. On the basis of empirical testing Kessing concluded that patterns of international trade and location were predetermined for a broad group of manufacturers by the relative abundance of skilled and unskilled labour. For example, a developing country like India has more abundant supply of unskilled labour will specialize and export those goods, which are relatively, more intensive in unskilled labour. Imports, on the other hand, will consist of those goods which are hi-tech or which is more skill intensive.

Self Assessment

State whether the following statements are true or false:

1. In real world, labour is a homogenous factor.
2. As per Human Capital Theory, the export or import will depend on the availability of skilled or unskilled labour.

3.2 Identical Preferences Theory

This theory is based on the role of demand as an explanatory variable used by Linder. A domestic industry can flourish and reach commercially optimal level of production if the domestic demand is large enough. It is also found that countries at similar levels of economic development have similar demand characteristics. It is, therefore, postulated that trade opportunities are more among counties at similar stage of development with similar demand structure.

Example: USA and Japan are highly industrialized; both have similar demand characteristics viz. computers, software, air-conditioners, internet, fashion garments etc. Firms in both the countries are highly export competitive because they have already grown big by first catering to the domestic demand that is why the trade between the USA and Japan is so substantial. This theory explains how an industrialized country grows rapidly in its economic growth.

The theory also assumed that each country had as its objective full production efficiency. It neglected such other motives as traditional employment and production history, self-sufficiency or political objectives.

In addition, the theory is overly simplistic in that it deals only with two commodities and two countries. In reality, given the full range of production by many countries and interplay of many motives and factors, the trade situation is actually an ongoing dynamic process in which there is interplay of forces and products. The largest area of weakness in classical theory is that while we considered all resource units used in production, the only costs considered by classical economists were those associated with labour. The theorists did not account for other resources used in the production of commodity or manufactured goods for export such as transportation

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cost, the use of land, and capital. This failing was addressed by subsequent trade theories, which in modern theories include all factors of production in looking at theories of comparative advantage.

Task Identify the countries that have similar demand and consumption patterns. What are the similarities between these countries?

Self Assessment

Fill in the blanks:

3. The Identical Preference theory assumes that each country had as its objective .....
4. The Identical Preference theory is too simplistic in that it deals only with two commodities and two .....

3.3 Strategic Trade Theory

With the dramatic growth in trade in the last few decades, and the growth in the role of MNEs in international trade, there has been a resurgence of interest in taking a fresh look at theories of international trade. In the last two decades, a new set of models has come into being, using the perspectives of game theory and theories of industrial organisation. While there is no one overarching model, this broad collection of theories and ideas has come to be known as "strategic trade theories".

Caution Most of the models of strategic trade are motivated by the attempt to relax (and explore systematically the implications of) the seemingly restrictive assumptions of the Ricardian and H-O models, such as those relating to perfectly competitive markets, constant or decreasing returns to scale, product homogeneity, per factor mobility, no externalities or spillover effects, and so forth.

In the process of doing so a fresh new set of insights relating to international trade and trade policy has emerged.

The essence of almost all the new models of trade is the recognition that industries are characterized by any or all of the following features: scale, economies (both dynamic and static), product differentiation, imperfect competition, externalities and spillover and, in cases, irreversible investments. Some of the main insights from this literature are as follows:

1. ***Increasing returns to scale*** provide a justification for trade for reasons other than comparative advantage, since firms will have the incentive to produce and export in order to lower costs by attaining greater scale economies; an example of a industry where this is an important issue is the commercial airframes industry.
2. ***Product differentiation*** can result in intra industry trade, since, within the same industry, the same product can have different brand identities; for example, the US will export certain types of automobiles (Ford Escort) and it will import other types of automobiles (BMWs).
3. ***Imperfect competition*** creates rents, and trade policy could shift rents from the foreign country to the home country. For example, the imposition of quotas will increase domestic

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prices and thus can create rents for foreign producers; the home-country government may try to counterbalance it with a subsidy to domestic producers, so as to put price pressure on foreign producers.

4. ***Externalities and spillover effects*** (particularly in innovation and R & D) may sometimes provide a justification for industry protection for reasons other than industry infancy or national security.

Example: If the process innovations commodity chip production can create spillovers in the manufacture of specialized chips, then the government may have an incentive to protect the manufacture of commodity chips.

5. ***Irreversible investments*** induce an asymmetry between entry and exit costs, and can therefore lead to "hysteretic" responses to price or quantity shifts.

Example: Firms in the US earth-moving equipment industry (like the Caterpillar Tractor Company) lost substantial market share in the early 1980 when the US dollar appreciated 35% in real terms against the Japanese yen. Yen firms could not exit markets because the costs of reentry (like, rebuilding distribution networks) would be prohibitive. Thus, they had to stay on many markets despite the fact that they were incurring losses.

As with conventional trade models, models of imperfect competition in international trade predict an increase in domestic producer surplus (and a decrease in domestic consumer surplus) as a result of price or quantity restrictions. However, the literature is eclectic on the impact of protection on foreign producer surplus. We may argue, for instance, that when domestic and foreign goods are substitutes, both price and quantity restrictions should, in general, increase the welfare of foreign producers. The reasoning is that trade restraints alter the nature of interaction between firms in a collusive directions, and thereby raise equilibrium prices and profits for all firms – that is, trade restrictions result in a collusion that the firms themselves were not able to achieve, since they impede the ability of firms to compete effectively.

The insights developed in the literature on strategic trade have been quite influential in shaping the evolution and application of US trade laws against its foreign competitors, particularly during the 1980s. Policymakers, increasingly use these arguments to justify imposition of barriers to international trade. However, GATT has also come to grips with many of these insights, and the Uruguay round concluded in 1994 marks a significant step in multilateral attempts to combat many of these incentives to imposition of trade barriers.

Self Assessment

Fill in the blanks:

5. Product ..... can result in intra industry trade.

6. ..... is an effect of a purchase or use decision by one set of parties on others who did not have a choice and whose interests were not taken into account.

3.4 Modern Investment Theory

Other theories explain investing overseas by firms, as a response to the availability of opportunities not shared by their competitors, that is, to take advantage of imperfections in markets and only enter foreign spheres of production when their comparative advantages outweigh the costs of going overseas. These advantages may be production, brand awareness, product identification, economies of scale, or access to favourable capital markets. These firms

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may make horizontal investments, producing the same goods abroad as they do at home, or they make vertical investments, in order to take advantage of sources of supplies or inputs.

Going a step further, some believe that firms within an oligopoly enter foreign markets merely as a competitive response to the actions of an industry leader and to equalize relative advantages. Oligopolies are those market situations in which there are few sellers of a product that is usually mass merchandised.

Example: In oligopolistic situations, no firm can profit by cutting prices because competitors quickly respond in kind. Consequently, prices for oligopolistic products are practically identical, and are set through industry agreement (either openly or tacitly).

Thus, firms within an oligopoly must be keenly aware of the actions, market reach, and activities of their competitors. Unless their response to the actions of competitors is following the leader, they will yield precious competitive edges to their competitors. Therefore, it follows that when a market leader in an oligopoly establishes a foreign production facility abroad, its competitors rush to follow suit.

Thus, the impetus for a firm to go abroad may come from a wish to expand for internal reasons-to use existing competitive advantages in additional spheres of operations, to take advantage of technology, or to use raw materials available in other locations. Alternatively, the motive might arise from external forces, such as competitive actions, customer requests or government incentives. The final determinant however, is based in a cost benefit analysis. The firm will move abroad if it can use its own particular advantages to provide benefits that outweigh the costs of exporting or production abroad and provide a profit.

Task Identify the major firms within oligopolies operating around the globe.

Self Assessment

State whether the following statements are true or false:

7. Firms within an oligopoly must be keenly aware of the actions, market reach, and activities of their competitors.
8. The final determinant of whether a firm wants to move abroad is based in a cost benefit analysis.

3.5 International Product Life Cycle Theory

The international product life cycle theory puts forth a different explanation for the fundamental motivations for trade between and among nations. It relies primarily on the traditional marketing theory regarding the development progress, and life span of products in markets. This theory looks at the potential export possibilities of a product in four discrete stages in its life cycle.

Caution The international product life cycle theory has been found to hold primarily for such products as consumer durables, synthetic fabrics, and electronic equipment, that is, those products that have long lives in terms of the time span from innovation to eventual

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high consumer demand. The theory does not hold for products with a rapid time span of innovation, development, and obsolescence.

The theory holds less often these days because of the growth of multinational global enterprises that often introduce products simultaneously in several markets of the world. Similarly, multinational firms no longer necessarily first introduce a product at home. Instead, they might launch an innovation from a foreign source in the domestic markets to test production methods and the market itself, without incurring the high initial production costs of domestic environment.

According to these theories, the commodity composition of trade can explained in terms of relative research efforts and the consequent technological gaps between the trading partners. A number of economists especially Vernon has contributed to the development of this theory. It is argued that the industrialized countries commit more resources to research and development efforts and as a result develop new products. In the initial stage of manufacture these countries will be monopolists and will enjoy easy access to foreign market. This can explain the trade between the developed and the developing countries as well as trade among the industrialized countries themselves. Subsequently, a process of limitation will start and other countries will start manufacturing the same product. The initial comparative advantage will then disappear and the manufacturing centres can move from the developed to the developing countries, which have low labour cost. Many developing countries like India have turned into exporters of textiles being low labour intensity skills from being net importers some years ago.

The international product life cycle theory puts forth a different explanation for the fundamental motivations for trade between and among nations. It relies primarily on the traditional marketing theory regarding the development, progress and life span of products in market.

The international product life cycle (IPLC) theory developed and verified by economists to explain trade in a context of comparative advantage describes the diffusion process of an innovation across national boundaries. The life cycle begins when a developed country having a new product to satisfy consumer needs wants to exploit its technological breakthrough by selling abroad. Other advanced nations soon start up their own production facilities and before long LDCs do the same? Efficiency/comparative advantage shifts from developed countries to the developing nations. Finally, advanced nations that are no longer cost-effective, import products from their former customers.

IPLC theory has the potential to be a valuable framework for marketing planning on a multinational basis.

Caselet

Apple – from the iPod to the iPad - Product Life Cycles and Growth Potential

The Apple product life cycles indicates just how big the iPhone and the iPad will be over the next few years. It took the iPod five years to break the thirty million units per annum mark. The iPhone got there in four and the iPad will make it in year two of launch. As for the Sony Walkman it never made it, it took over ten years to top out, the iPod topped out within eight years of launch. Apple product Life Cycles are moving faster and higher sooner than ever before.

iPod sales may have peaked in 2008 at just under 55 million units and may fall to around 45 million units this year but the iPhone is set to sell just under 70 million units and the iPad is chasing fast behind. It all adds up to an exciting phase of growth for Apple over the next four years with revenues set to rise over $100 billion in 2011.

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Students of corporate strategy and business theory are familiar with the concept of the Product Life Cycle. Generally the life cycle is perceived to have four specific stages, introduction, growth, maturity and decline generally plotted with volumes a function of time.

In the introduction phase, costs are high, sales volumes are slow, there may be little or no competition and customers have to be stimulated to action. Profits are limited and the product is cash extensive as marketing costs are substantial. Key customers tend to be innovators and early adopters.

In the growth phase, unit costs are reduced as volumes increase, advertising is amortised over greater volume, market awareness increases beyond the early adopters, to the "early majority", competition increases with more competitors entering the market and price levels may begin to fall. Profits increase but the product remains cash extensive as greater investment in marketing or working capital is required.

In the maturity stage, costs are lowered further as volumes have increased, the market becomes more competitive and alternative products begin to date the initial product offering. The product remains profitable and begins to generate cash. The innovators, early adopters and early majority are joined by the "late majority".

In the saturation and decline phase, sales volumes decline, profits margins are maintained and the product becomes remains cash generative. The laggards and luddites still do not enter the market.

Either way for Apple, four years of strong growth are evident from products already in the line up, both the iPhone and the iPad are set to hit the one hundred million units per annum mark in 2012 and 2014. Despite the march of the Androids, the Apple growth story will continue.

Source: http://jkaonline.typepad.com/

Stages and Characteristics

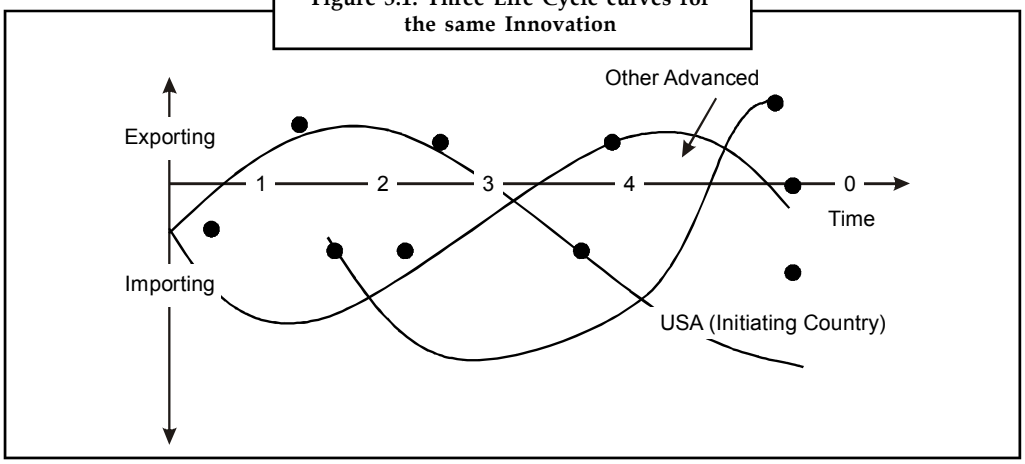
There are five distinctive stages in IPLC. The Table 3.1 shows the major characteristics of the IPLC stages with the US as the developer of the innovation in question. The Figure 3.1 shows that three life cycle curves for the same innovation: one for the initiating country (US), one for other advanced nations and one for LDCs. For each curve net export results when the curve is above the horizontal line; if under the horizontal line net import results for the particular country. As the innovation moves through times, directions of all three curves change. Time is relative because the time needed for cycle to be completed varies from one kind of product to another. In addition, the time interval also varies from one stage to the next.

Table 3.1: Major Characteristics of the IPLC Stages

Stage	Import/Export	Target Market	Competitors	Production Costs
(0) local innovation	None	USA	Few: local firms	Initially high
(1) Overseas innovation	Increasing export	USA & advanced nations	Few: local firms	Decline owing to economies of scale
(2) Maturity	Stable export	Advanced nation & LDCs	Advanced nations	Stable
(3) Worldwide imitation	Declining export	LDCs	Advanced nations	Increase owing to lower economies of scale
(4) Reversal	Increasing export	USA	Advanced nations & LDCs	Increase owing to comparative disadvantage

Notes

Figure 3.1: Three Life Cycle curves for the same Innovation



Stage 0 – Local Innovation: Stage 0 depicted as time 0 on the left of the vertical importing/ exporting axis, representing a regular and highly familiar product life cycle in operation within its original market. Innovations are most likely to occur in highly developed countries because consumers in such countries are affluent and have relatively unlimited want. From the supply side, the firms in advanced nations have both the technological know-how and abundant capital to develop new products.

Stage 1 – Overseas Innovation: As soon as the new product is well developed, its original market well cultivated, and local demand adequately supplied, the innovating firm will look to overseas market in order to expand its sales and profits. Thus this stage is known as "Pioneering or International Introduction" stage. The technological gap is first noticed in other advanced nations because of their similar needs and high-income levels.

Did u know? Not surprisingly, English-speaking countries such as the United Kingdom, Canada and Australia account for half of the sales of US innovations when such products are first introduced overseas.

Countries with similar cultures and economic conditions are often perceived by the exporters as posing less risk and thus are approached first before proceeding to less familiar territory.

Competition in this stage usually comes from US firms, since firms in other countries may not have much knowledge about the innovation. Production cost tends to be decreasing at this stage because by this time the innovating firm will normally have improved the production process. Supported by overseas sales aggregate production costs tend to decline further because of increased economies of scale. A low introductory price is usually not necessary because of the technological breakthrough; a low price is not desirable because of the heavy and costly marketing effort needed in order to educate consumers in other countries about the new product.

Stage 2 – Maturity: Growing demand in advanced nations provides an impetus for firms there to commit themselves to starting local production, often with the help of their governments' protective measures to preserve infant industries. Thus, these firms can survive and thrive in spite of the relative inefficiency.

Development of the competition does not mean that the initiating country's export level will immediately suffer. The innovating firms' sales and export volumes are kept stable because LDCs are now beginning to generate a need for the product. Introduction about the product in LDCs helps offset any reduction in export sales to advanced countries.

Notes

Stage 3 – Worldwide Imitation: This stage means tough times for the innovating nations because of its continuous decline in exports. There is no more new demand anywhere to cultivate. The decline will inevitably affect the US innovating firms' economies of scale and its production costs thus begin to rise again. Consequently, firms in other advanced nations use their lower prices (coupled with product differentiation techniques) to gain more consumer acceptance abroad at the expense of the US firm. As the product becomes more and more widely disseminated, imitation picks up at a faster pace. Towards the end of this stage US export dwindles almost to nothing and any US production still remaining is basically for local consumption.

Example: The US automobile industry is a good example of this phenomenon. There are about 30 different companies selling cars in United States with several on the rise. Of these, only three are US firms with the rest being from Western Europe, Japan, South Korea, Taiwan, Mexico, Brazil and Malaysia.

Stage 4 – Reversal: Not only must all good things end, but misfortune frequently accompanies the end of a favourable situation. The major functional characteristics of this stage are product standardisation and comparative disadvantage. The innovating country's comparative advantage has disappeared, and what is left is comparative disadvantage. This disadvantage is brought about because the product is no longer capital-intensive or technology-intensive but instead has become labour intensive – a strong advantage possessed by LDCs. Thus, LDCs – the last innovators – establish sufficient productive facilities to satisfy their own domestic needs as well as to produce for the biggest market in the world, the United States.

Self Assessment

Match the following sets:

Set A

9. Stage 0 of International Product Lifecycle
10. Stage 1
11. Stage 2
12. Stage 3
13. Stage 4

Set B

a. Overseas innovation
b. Maturity
c. Reversal
d. Worldwide imitation
e. Local innovation

3.6 Critical Evaluation of International Trade Theories

We will study this under two heads: validity and limitations.

3.6.1 The Validity

Several studies have investigated the validity of the classical trade theories. The evidence collected by MacDougall shortly after the World War II showed that comparative cost was useful in explaining trade patterns. Other studies using different data and time periods have yielded results similar to MacDougall. There is, thus, a support for the claim that relative labour productivity determines trade patterns.

Notes

These positive results were later questioned. The studies conducted by Leontief revealed that the United States actually exports labour intensive goods and imports capital-intensive products. These paradoxical findings are now called Leontief Paradox. Thus, the findings are ambiguous indicating that in its simplest form the Heckscher-Ohlin Theory is not supported by evidence.

In theory, the more different two countries are the more they stand to gain by trading with each other. There is no reason why a country should want to trade with another that is a mirror image of itself.

3.6.2 Limitations

Trade Theories provide logical explanations about why nation trade with one another but such theories are limited by their underlying assumptions. Most of the world's trade rules are based on traditional models that assume: (1) Trade is Bilateral, (2) Trade involves products originating primarily in the exporting country, (3) the exporting country has a comparative advantage and (4) competition primarily focuses on the importing country's market. However, today the reality is quite different. Firstly, trade is a multilateral process. Secondly, trade is often based on products assembled from components that are produced in various countries. Thirdly, it is not easy to determine a country's comparative advantage as evidenced by the countries that often export and import the same product. Finally, competition usually extends beyond the importing country to include the exporting country and third countries.

In all fairness, virtually all theories acquire assumptions in order to provide a focus for investigation while holding extraneous variables constant. But controlling the effect of extraneous variables act to limit a theory's practicality and generalisation.

One limitation of classical trade theory is that the factors of production are assumed to remain constant for each country because of the assumed mobility of such resources between countries. This assumption is especially true in case of land, since physical transfer and ownership of land can only be complete by war or purchase (US seizure of California from Mexico and purchase of Alaska from Russia). At present, such means to gain land are less and less likely.

Labour, as a factor is relatively immobile. Immigration laws in most countries severely limit the freedom of movement of labour between the countries. In China, labour is not even able to select a city of their choice. Still labour moves across borders. Western European nations allow their citizens to pass across borders rather freely. For Asian countries, most of them are so well endowed with cheap and abundant labour that such countries as South Korea, Thailand and India send labour to work in Saudi Arabia and other developed countries.

Production factors are considered now more mobile than previously assumed but their mobility is still considered restricted. As a result, production cost and product prices are completely equalised across countries. The small amount of mobility that does exist serves to narrow the price/cost differentials.

The most serious shortcoming of classical trade theory is that they ignore the marketing aspect of trade. These theories are primarily concerned with commodities rather than with manufactured goods or value-added products. It is assumed that all suppliers have identical products with similar physical attributes and quality. This habit of assuming product homogeneity is not likely to be made among that familiar with marketing.

Notes

Self Assessment

State whether the following statements are true or false:

14. One limitation of classical trade theory is that the factors of production are assumed to change for each country because of the assumed mobility of such resources between countries.
15. Labour is the most mobile factor of production.
16. As the world economy is opening up, factors of production are becoming more mobile.

3.7 Summary

- The Human Capital Theory concludes that patterns of international trade and location were predetermined for a broad group of manufacturers by the relative abundance of skilled and unskilled labour.
- As per Identical Preference Theory, a domestic industry can flourish and reach commercially optimal level of production if the domestic demand is large enough.
- Strategic trade theory describes the policy certain countries adopt in order to affect the outcome of strategic interactions between firms in an international oligopoly, an industry dominated by a small number of firms.
- As with conventional trade models, models of imperfect competition in international trade predict an increase in domestic producer surplus (and a decrease in domestic consumer surplus) as a result of price or quantity restrictions.
- Some economists believe that firms within an oligopoly enter foreign markets merely as a competitive response to the actions of an industry leader and to equalize relative advantages.
- The international product life cycle theory puts forth a different explanation for the fundamental motivations for trade between and among nations.
- The international product life cycle theory puts forth a different explanation for the fundamental motivations for trade between and among nations.
- Production factors are considered now more mobile than previously assumed but their mobility is still considered restricted.

3.8 Keywords

Imperfect Competition: Real world competition that is less effective in lowering price levels nearer to the cost levels than the theoretical perfect competition.

Increased Returns to Scale: Reduction in cost per unit resulting from increased production, realized through operational efficiencies.

International Product Lifecycle Theory: A model which suggest that products go through a cycle whereby high income, mass consumption countries go through a cycle of exporting, loss of exports to final importers of products.

Net Exports: The value of a country's total exports minus the value of its total imports.

Oligopoly: A state of limited competition, in which a market is shared by a small number of producers or sellers.

Self-sufficiency: Able to provide for oneself without the help of others

Notes

Skill: It is a measure of a worker's expertise, specialisation, wages, and supervisory capacity.

Strategic Trade Theory: It describes the policy certain countries adopt in order to affect the outcome of strategic interactions between firms in an international oligopoly, an industry dominated by a small number of firms.

3.9 Review Questions

1. Describe the basic premise of the Human Capital Theory.
2. "Identical Preference Theory doesn't work because it ignores an important concept of self-sufficiency." Do you agree? Why or why not?
3. Discuss the Strategic Trade Theory in detail.
4. Identify the feature of models of imperfect competition.
5. "Oligopolies are those market situations in which there are few sellers of a product that is usually mass merchandised." How does this connect with the Modern Trade Theory?
6. Describe the relevance of a product life cycle. Use inferences from the International Product Lifecycle Theory.
7. Why does the International Product Lifecycle Theory hold more relevance these days?
8. Discuss the stages in the International Product Lifecycle.
9. "Trade Theories provide logical explanations about why nation trade with one another but such theories are limited by their underlying assumptions." Substantiate.
10. "The most serious shortcoming of classical trade theory is that they ignore the marketing aspect of trade." What do you mean by this statement?

Answers: Self Assessment

1.	False	2.	True
3.	Full production efficiency	4.	Countries
5.	Differentiation	6.	Externality
7.	True	8.	True
9.	(e)	10.	(a)
11.	(b)	12.	(d)
13.	(c)	14.	False
15.	False	16.	True

3.10 Further Readings

Books

Vasudeva, P. K. (2010) *International Marketing*, New Delhi: Excel Books

Black and Sundaram, *International Business Environment*, New Delhi: Prentice Hall of India

Gosh, Biswanath, *Economic Environment of Business*, New Delhi: South Asia Book

Notes

Bhalla, V. K. and Ramu, S. S, *International Business Environment & Management*, New Delhi: Anmol Publication Pvt. Ltd

Online links

http://www.rulemic.com/

http://www.witiger.com/internationalbusiness/tradetheories.htm

http://www.edcon-edwards.com/VERNON

http://www.provenmodels.com/583/international-product-life-cycle/vernon

Unit 4: International Business Environment

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Objectives

After studying this unit, you should be able to:

- Discuss the international socio-cultural framework
- Evaluate the role of technological developments
- Examine the relevant aspects of the international economic environment
- Assess the importance of international political environment

Notes

Introduction

Environmental factors are external effects that cannot be managed. Because environmental factors cannot be managed they must be anticipated and analyzed. The ability to predict or "guess" the future state of the environment enables the marketer to position the firm defensively against environmental threats or to seize opportunities that are created by the environment.

Before entering into international market, a company must analyse the international marketing environment very carefully because the future of the company depends on this analysis only. However, you must note that this analysis should not be done at the beginning but throughout the life of the business as the international marketing environment changes really fast. A company needs to analyse the political, legal and regulatory, socio-cultural, economic, and technological environment in order to understand the international marketing environment.

4.1 Social and Cultural Environment

Though society and culture do not appear to be a part of business situations, yet they are actually key elements in showing how business activities will be conducted, what goods will be produced, and through what means they will be sold to establishing industrial and management patterns and determining the success or failure of a local subsidiary or affiliate.

Let us learn various aspects of international socio-cultural environment, discussed in the subsequent subsections.

4.1.1 Elements of Culture

There are too many human variables and different types of international business functions for an exhaustive discussion about culture. The main elements of culture are:

- ***Attitudes and Beliefs:*** The set of attitudes and beliefs of a culture will influence nearly all aspects of human behaviour, providing guidelines and organisation to a society and its individuals.

Example: In contrast to American individualism, Japanese are group-oriented. Japanese do not like to be alone or to do things differently from others. They stick together: eating, working, or traveling in a group. Following others and being part of a group gives them a kind of care freeness and joy. Why are Japanese group-oriented? The reasons originate from their geography, history, and culture.

Arab Countries are attempting to strike a balance between the individuals rights and privileges and the individuals obligations toward the family and the community. This balance is germane to this discussion because the path chosen may affect the state's role and efficiency in Human Resources. The extent to which MENA countries can capitalize on their Traditional support for family security (for example, through waqf) may help determine the degree to which state may concentrate financing for issues in which it may have a comparative advantage.

- ***Attitudes towards Time:*** Everywhere in the world people use time to communicate with each other. In international business, attitudes towards time are displayed in behaviour regarding punctuality, responses to business communication, responses to deadlines, and the amount of time that is spent waiting in an outer office for an appointment.

Notes

Example: An interesting phenomenon related to the Spanish people's attitude toward time is something that we have come to dub "The Manana Complex" (Manana meaning 'tomorrow' in the Spanish language). "Why do something now when it can be done tomorrow?" Or "What's the rush? Things will be completed eventually" seems to be the philosophy and way of life for many Spanish people.

- ***Attitude towards Work and Leisure:*** People's attitudes towards work and leisure are indicative of their views towards wealth and material gains. These attitudes affect the types, qualities and numbers of individuals who pursue entrepreneurial and management careers as well.

Example: Time spent in the home and with other household members (Kelly, 1997, p.132), and research has uncovered both the familial and personal importance of leisure in daily life

- ***Attitude towards Achievement:*** In some cultures, particularly those with high stratified and hierarchical societies, there is a tendency to avoid personal responsibility and to work according to precise instructions received from supervisors that are followed by the latter. In many industrial societies, personal responsibility and the ability to take risks for potential gain are considered valuable instruments in achieving higher goals.

Example: For example, McCoach and Siegle (2001) compared 122 gifted achievers with 56 gifted underachievers in 28 different high schools. The results of an analysis suggested that gifted underachievers differed from achievers on four factors: attitudes toward teachers, attitudes toward school, goal valuation, and motivation/self-regulation.

- ***Attitudes towards Change:*** The international manager must understand what aspects of a culture will resist change and how the areas of resistance differ among cultures, how the process of change takes place in different cultures and how long it will take to implement change.

Example: For example, Perlman and Takacs (1990) argued that there is a big similarity between the stages that an individual goes through dealing with death described by Kubler-Ross (1969) and the stages they identified that individuals go through when they experience organizational change. More specifically, they noted that there are many emotional states that a person can experience during change processes, which are equilibrium, denial, danger, bargaining, chaos, depression, resignation, openness, readiness and re-emergence.

- ***Attitude towards Job:*** The type of job that is considered most desirable or prestigious varies greatly according to different cultures. Thus, while medical and legal professions are considered extremely prestigious in the United States, civil service is considered the most prestigious occupation in several developing countries including India.

Example: Gardner & Korth (1998) sought to understand if attitudes toward group work varied according to individual learning style preference. They found that there were a large number of statistically significant differences; in other words, student attitudes about group work and preferred instructional methods seemed to vary systematically with their individual learning style.

Notes

Case Study

Two Women Say they were denied Jobs Over Hijabs

Two Muslim women said they were denied jobs at a McDonald's restaurant in Dearborn because they wore Islamic headscarves, according to a discrimination lawsuit filed today in Wayne County Circuit Court.

Toi Whitfield, 20, of Detroit, and Quiana Pugh, 25, of Dearborn, said they applied for jobs at the McDonald's on Ford Road in the eastern section of Dearborn, but were told by the store manager "you're not going to work here if you don't remove" the headscarf, known as hijab. According to the women, he also said he couldn't "really hire you due to your scarf."

A spokeswoman for McDonald's did not immediately comment on the lawsuit, but said a statement would be coming soon.

The Dearborn restaurant happens to be one of only two stores in the U.S. that sells Chicken McNuggets that are halal, the Muslim equivalent of kosher.

Dawud Walid, head of the Michigan branch of the Council on American Islamic Relations, said that it's upsetting that a restaurant with such a large Muslim customer base would discriminate against Muslim women employees.

"They'll take Muslim dollars, but won't hire Muslim female employees," Walid said.

The case was filed in Detroit against the store manager, a management company, and McDonald's. It alleges the restaurant violated a state civil rights law.

The store is located in an area with one of the largest Arab-American and Muslim communities in the U.S. Walid said the two Muslim women were African-Americans born in the United States.

Question

1. Analyse the case and Discuss the case facts.

Source: http://dawudwalid.wordpress.com

4.1.2 Cultural Dimension

The influences of the religious, family, educational and social systems of a society on the business system comprise the cultural dimension of our picture. Because cultural attitudes vary so much among countries, it is harder to find general patterns here than for the economic dimension.

Did u know? The French and the Germans, though their economic levels are similar, are culturally quite different.

Thus, to determine the cultural aspects of markets, we must, in large measure, analyse each society by itself without the benefit of guiding generalisations.

There are, however, a few common threads that run through the cultures of groups of countries. Religion is one, for, a few major religions have spread over large areas. In northern Europe and the Anglo-Saxon countries (the United States, Canada, and Australia), the Protestant influence has generally been dominant, though other religions existing alongside have moderated its importance.

Notes

Religions are a major determinant of the moral and ethical standards that play a large part in the business process. It is difficult, however, to develop any generalisations about their nature in each region. The basic codes of religions—the entire Bible, the Kuran, etc.— exhort their followers to be honest, truthful and otherwise to act in a "good" manner. In practice, however, all business systems are characterised to varying degrees by false claims, dishonesty and other moral shortcomings. So the specific character of each society must be analysed as a distinct entity in this regard.

Family systems fall into three general categories. One, especially prevalent in Moslem areas, traditionally places the wife in a subordinate and secluded role, with few rights and little control over the affairs of the family. This general pattern still prevails over much of the Middle-east, though in many Muslim countries, like Turkey and Pakistan, women have achieved a high degree of emancipation. A second pattern is particularly common in Latin America. The wife is still definitely a junior member of the partnership, the husband having the final authority in all but minor matters. The third type of relationship is found in varying forms throughout most of Europe and the Anglo-Saxon countries. The basic code in this pattern is equality, though there are many variations in actual practice. In other respects, cultural attitudes related to the family system differ widely among countries. Such matters as the way in which the sexes attract each other bear both on products sold and advertising methods, and they are subject to a host of local codes.

So far as educational systems are concerned, the obvious marketing factors are the literacy rate and the general level of education, both of which generally run parallel to the pattern of economic development. There are also differences in educational methods common to large areas.

Task Find out the cultural differences among India, France, Indonesia, Japan and Canada. Also try to find out a few similarities.

4.1.3 Marketing in Cross-cultural Context

In understanding, analyzing and predicting consumer behaviour for marketing management purposes, the role of culture has always been given a prominent role in consumer behaviour studies, which in turn are expected to facilitate the effectiveness of marketing management efforts. In the post-Second World War years, with the adoption of marketing concepts, marketers started imparting greater consumer orientation to their marketing efforts. In recent years, the marketing discipline has been going through a number of major paradigm shifts. The traditional transaction-oriented marketing is being replaced by relationship marketing. In recent times, segmentation marketing with emphasis on viable segments as target markets is progressively replaced by micro marketing facilitated by the advances in the information, communication and production technologies.

Though all people have much in common as human is, there still are many differences in cultures as we move from nation to nation. Culture is adaptive, and marketing strategies based on the values of society must also be adaptive. When cultural changes occur, trends develop and provide marketing opportunities to those who spot the changes before their competitors do. As culture evolves, marketers may associate product or brand benefits with new values, or they may have to change the product if that value is no longer gratifying in society.

With so much diversity present among the members of just one nation, it is easy to appreciate that numerous larger differences may exist between citizens of different nations having different cultures, values, beliefs, and languages. If international marketers are to satisfy the needs of consumers in potentially very distinct markets effectively, they must understand the relevant similarities and differences that exist between the peoples of the countries they decide to target.

Notes

When consumers make purchase decisions, they seem to take into consideration the countries of origin of the brands that they are assessing. Consumers frequently have specific attitudes or even preferences for products made in particular countries. This country of origin influence how consumers rate quality and sometimes, which brands they will ultimately select.

As increasing numbers of consumers from all over the world come in contact with the material goods and lifestyle of people living in other countries and as the number of middle-class consumers grows in developing countries, marketers are eager to locate these new customers and to offer them their products. The rapidly expanding middle classes in countries of Asia, South America, and Eastern Europe possess relatively substantial buying power because their incomes are largely discretionary.

Consumer behaviour has emerged as a sub-field of marketing discipline. Initially, consumer behaviour research mainly focused on the Behavioural aspects of consumers of the majority culture, and that too was limited to domestic country context. Historically, this was the case in the USA, the home of marketing discipline. However the marketing phenomenon spread to other parts of the world, either through increasing international trade or through the expanding operations of multinational corporations worldwide. This often led to comparisons between the behaviors of foreign consumers with those of the USA, and thus the initial research efforts into cross-cultural marketing came into existence. Thus, when Americans venture abroad, they experience what anthropologists call culture shock, that is, a series of psychological jolts when they encounter new customs, value systems, attitudes, and work habits; the shock reduces their effectiveness in foreign commercial environments. Therefore, it is crucial to effective operations that the manager be well schooled in the host culture. A lack of understanding of the host culture will lead the manager to think and act as he would in his home culture. Such a self-reference criterion, that is, the unconscious reference to one's own cultural values- has been termed the root cause of most international business problems abroad. The goal should be to eliminate this cultural myopia.

Culture is specific to a context. Different countries have different cultures; hence, consumer behaviour also differs in different countries. This aspect is particularly important to multinational corporations, which enter different markets to cater to the diverse cultural needs of consumers. The differences in perception among consumers with regard to products (and, perhaps, even brands) are based on need, usage and importance.

Example: In the US, products like cola, burgers, peanuts, popcorn and ketchup are a popular part of the culture.

The theme of cultural influences in a given country has two variations. Cross-cultural influences are norms and values of consumers in foreign markets that influence strategies of multinational organisations marketing their products and services abroad. The second variation refers to sub-cultural influences that concern differences in values among different groups within a country that distinguish them from society as a whole.

In its international operations, Levi Strauss closely follows both cross-cultural and sub-cultural trends. The basic principle it follows is "think globally but act locally." The company recognises that tastes in fashion, music and technology etc. are becoming increasingly similar across most countries of the world because of International reach of media such as MTV, Internet and greater facilities for travel. There seems to be increasing influence of American culture on consumption vales as more and more consumers are shifting their preferences for American goods.

Example: Multinational corporations such as Proctor & Gamble, Pepsi, Coca Cola, IBM, Gillette, Johnson and Johnson, Kellogg's, Colgate-Palmolive, Nestle, Canon, Epson, Honda, Suzuki and many others earn large revenues abroad.

Notes

As more foreign markets emerge and offer opportunities for growth, marketing in foreign countries is likely to increase in importance. Marketing across cultural boundaries is a difficult and challenging task because cultures may differ in demographics, languages, values and non-verbal communications.

Cross-cultural analysis helps marketers determine to what extent the consumers of two or more nations are similar or different. The greater the similarity between consumers, the more feasible it is to use relatively similar strategies in each country. In case the cross-cultural analysis reveals that there are wide cultural differences, then a highly individualized marketing strategy may be indicated for each country.

A study reported by Rosabeth Moss Kanter of almost 12,000 managers around the world ("Transcending Business Boundaries: 12,000 World managers View Change," *Harvard Business Review* 69, May-June 1991) found that although in every country, culture and corporation changes were occurring, there is still no common culture of management. In fact, the views of managers tend to relate more to their own country's culture and less to its geographic location.

Caution Some experts argue that marketing strategies, particularly advertising, should be standardized because this can result in substantial cost savings. The differences in cultural values across countries make it difficult and a risky proposition. An ad for a beauty care product showing a model wearing a short dress with very low neckline may be appealing in most Western cultures but would be probably banned in most Muslim cultures.

Marketers often make the strategic error of assuming that since domestic consumers like a product, consumers in other countries would naturally like it. Such a view is often referred to as a "culturally myopic view." Companies have generally been successful in marketing abroad by recognizing local differences in consumer needs and customs. To accomplish this, such companies had to learn cross-cultural acculturation, which means thoroughly orienting themselves to the values, beliefs, customs, language and demographics of the new country. They developed strategies to encourage members of the society to modify attitudes and possibly alter their behaviors.

Notes **McDonald's Case**

McDonald's had a policy of adopting uniformity across International markets. After facing problems, now it adopts products appropriate for particular cultures. When McDonald's entered India, it had to make the most dramatic changes. Eighty per cent of the Indian population is Hindu and they don't eat beef so there is no Big Mac (which contains beef). In its place there is Big Maharaja, which contains mutton. Many Hindus and almost all Jains are strictly vegetarian and for this segment McDonald's offers Vegetable Burgers. McDonald's also claims that only vegetable oils are used. The menu also does not contain any product containing pork because a sizable population in India is Muslim and considers it unclean.

What multinational advertisers are finding is that it is very difficult to assume anything when it comes to cultures. While many believe that the world is getting smaller and that cultural diversity will decline as is suggested by the adoption of Western fashions in many Asian countries, there are others who are finding that differences between cultures remain firm. For example, some of the European countries with similar values and purchasing behaviors were banded together in a common market. This has not met expectations due to stereotypes, history and schooling.

Notes

Eighty percent of Indians are Hindu who don't eat beef so there will be no Big Macs in India, Instead, the menu will feature the Maharaja Mac—"two all mutton patties, special sauce, lettuce, cheese, pickles, onions on a sesame-seed bun." For the strictest Hindus who eat no meat, McDonald's will offer deep-fried rice patties flavored with peas, carrots, red pepper, beans, onions, coriander, and other spices.

The critical decision is whether utilizing a standardized marketing strategy, in any given market, will result in a greater return on investment than would an individualized campaign. Thus, the consumer response to the standardized campaign and to potential individualized campaigns must be considered in addition to the cost of each approach.

As the international trade barriers break down under the World Trade Organization regime, International marketing is replacing the dominance of domestic marketing. The International marketing possibilities are also greatly facilitated by the globalization, privatization and liberalization forces sweeping the world economies. In addition to these, emerging trends in the marketing discipline, the dominant cultural paradigm in marketing has shifted from dominance of majority culture to multicultural and/or cross-cultural marketing. For both domestic marketing and International marketing, marketers all over the world are being forced to recognize the fact of cultural diversity of marketplaces and how to make their marketing efforts effective in such culturally diverse contexts.

More and more companies have adopted a International outlook in which the world becomes their market.

Example: Numerous major corporations, such as Coca-Cola, IBM, Pfizer and Gillette, receive over half of their earnings from foreign operations, while many others also have significant international markets.

Such situations require the marketer's appreciation both of cultural differences among international markets and of their influence on consumer behavior.

There is growing evidence that increasing integration across cultures both within a country and across countries is creating an emerging common consumption culture. Such a consumption culture is exhibiting greater commonalities, especially among the middle-class segment, across all cultural groups. These developments call for greater integration of cross-cultural marketing and multicultural marketing research streams. By integrating these fields of research, greater synergy can be achieved to benefit the development of more relevant research for the benefit of marketing practice, both at the domestic and international levels.

Globalization has increased the mobility of individuals across national borders, ensuring that populations become more heterogeneous and culturally diverse. The advanced societies are becoming more multicultural and culturally diverse and marketing theory and practice needs to e developed to accommodate these changes.

The main issue that marketers have to address is whether ethnic minorities have different wants and needs from the majority population and thus whether special marketing strategies are required to effectively target them. If individuals from minority groups lose their ethnic identity by adopting the behaviour of the indigenous population over time, a process of acculturation occurs. High levels of acculturation enable minorities to become assimilated whereby individuals become completely integrated into the host culture. If ethnic minorities adopt the assimilation list pattern of behaviour, marketers could safely assume that minority groups require no special targeting and that the same marketing strategies would work equally as well with minority populations as those designed for the indigenous population. But it is not so in real life, minorities they have their own tastes and preferences and thereby making the jobs of marketer very challenging.

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Another aspect is geographical concentration of ethnic populations that is evident in many multicultural societies suggests that specific segments of the ethnic minority population should be fairly easy to target. For this reason community-based marketing strategies are thought to be the key to marketing to ethnic minorities.

For some international marketers, acculturation is a dual process: first, marketers must learn everything that is relevant to the product and product category in the society in which they plan to market, and then they must persuade the members of that society to break with their traditional ways of doing things to adopt the new product. The more similar a foreign target market is to a marketer's home market, the easier is the process of acculturation. Conversely, the more different a foreign target market, the more difficult the process of acculturation.

Some of the problems involved in multi-cultural analysis include differences in language, race, ethnicity, consumption patterns, needs, product usage, economic and social conditions, marketing conditions and market research opportunities. There is an urgent need for more systematic and conceptual cross-cultural analyses of the psychological, social and cultural characteristics concerning the consumption habits of foreign consumers. Such analyses would identify increased marketing opportunities that would benefit both international marketers and their targeted consumers.

Case Study

Cultural Differences at ABB

Asia Brown Boveri (ABB) is a quintessential global enterprise. Formed out of the merger of two engineering companies, one Swiss and the other Swedish, ABB has worldwide revenues of over $35 billions, 250,000 employees, and activities in 140 countries. Percy Barnevik, the company's CEO, notes that ABB is a company with no geographical centre, no national axe to grind:

Are we a Swiss company? Our headquarters are in Zurich, but only 100 professionals work at headquarters. Are we a Swedish company? I am the CEO, and I was born and educated in Sweden. But our headquarter is not in Sweden, and only two of the eight members of our board of directors are Swedes. Perhaps we are an American company. We report our financial results in US dollars, and English is ABB's official language. We conduct all high-level meetings in English. My point is that ABB is none of these things – and all of these things. We are not homeless. We are a company with many homes.

In this company with many homes, Barnevik stresses the advantage of building a culturally diverse cadre of global managers. In particular, Barnevik believes that such a management group can improve the quality of managerial decision making. To quote:

"If you have 50 business areas and five managers on each business area team, that is 250 people from different parts of the world, people who meet regularly in different places, bring their national perspectives to bear on tough problems and begin to understand how things are done elsewhere. I experience this every three weeks in our executive committee. When we sit together as Germans, Swiss, Americans and Swedes, with many of us living, working and travelling in different places, the insights can be remarkable."

Barnevik also stresses the need to acknowledge cultural differences without becoming paralysed by them – to work with those differences. Again, Barnevik states the point clearly:

"We have done some surveys (at ABB) … and we find interesting differences in perception. For example, a Swede may think a Swiss is not completely frank and open, that he does not

Contd...

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know exactly where he stands. That is a cultural phenomenon. Swiss culture shuns disagreement. A Swiss might say, "Let's come back to that point later, let me review it with my colleagues." A Swede would prefer to confront the issues directly. How do we undo hundreds of years of upbringing and education? We do not understand (of cultural differences)."

Thus, Barnevik's argument is that a culturally diverse set of managers can be a source of strength. According to Barnevik, managers should not try to eradicate these differences and establish a uniform managerial culture. Rather, they should seek to understand these cultural difference, to empathise with the views of people from different cultures, and to make accommodations for such differences.

Questions

1. How can ABB's culturally diverse management team be a source of competitive strength?
2. What barriers are likely to stand in the way of Percy Barnevik's attempt to make his culturally diverse management team a source of competitive strength?
3. What do you thing Barnevik means by the need to acknowledge cultural differences without becoming paralysed by them – to work with those differences? What does working with cultural differences at a global company such as ABB actually mean?
4. How can ABB increase the cross cultural literacy of its management cadre?

Source: Raj Agrawal, *International Trade*, First Edition, Excel Books, New Delhi, 2001.

Self Assessment

State whether the following statements are true or false:

1. Attitudes and beliefs are but time is not an element of culture that concerns the international marketer.
2. The basic pattern of the family relationships in the Latin American countries is based on equality.
3. Region and religion, both are important determinants of cultural values.
4. Host country's ethic minorities' needs and wants should also be analysed by a foreign company.
5. Sub-cultural influences concern differences in values among different groups within a country that distinguish them from society as a whole.

4.2 Technological Environment

Pervasive are diversified in scope, technological changes affect many parts of societies. These effects occur primarily through new products, processes, and materials. The technological segment includes the institutions and activities involved with creating new knowledge and translating that knowledge into new outputs, products, processes and materials. Given the rapid pace of technological change, it is vital that firms carefully study different elements in the technological segment. The marketers need to identify the speed with which substitute technologies are likely to emerge and the timing of any major technological changes. Some new technologies that have helped international marketers are discussed in the following subsections.

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4.2.1 Internet

A technology with important implications for business in the Internet sometimes referred to as "the information superhighway." The Internet is a global web of more than 25,000 computer networks. It provides a quick, inexpensive means of global communication (i.e. with strategic alliance partners) and access to information.

Example: GE engineers often use the Internet to communicate with their counterparts when doing development work for other companies. The Internet provides access to experts on such topics as chemical engineering and semi-conductor manufacturing, to the library of Congress, and even to satellite photographs.

4.2.2 Modems

Modems are important for connecting personal computers to phone lines that help gain access to the Internet. The technology in the manufacture of modems has advanced rapidly. Their speed may only be curtailed by the limits of conventional phone lines. Encyclopedia Britannica Inc. is using the Internet to revive its business.

Example: The firms now offer a free search engine with sites screened by its editors. As Encyclopedia Britannica's actions demonstrate, the Internet can allow a firm to be both flexible and innovative with its product introductions.

4.2.3 High Speed Digital Stream

To obtain technology to deliver a high-speed digital stream that can be viewed as movies, Web sites or advertising on televisions with its equipment.

Did u know? Oracle Corporation, through its unit Network Computer, Inc., is developing a rival design for a cable box, which was given a significant boost by support from Intel.

4.2.4 Satellite Imaging

Another new technology that is gaining rapid popularity is satellite imaging. Several aerospace companies have invested up to $1 billion in corporate earth imaging systems.

Example: Space Imaging, Inc., a joint venture for Lockheed Martin, E-systems, Mitsubishi Corporation, and Eastman Kodak Company, is a $500 million venture that provides from an advanced satellite. Many expect this technology to compete in the global information trade industry and some anticipate that it will create a revolution. There are a number of uses for this technology.

Self Assessment

Fill in the blanks:

6. ..... are instruments that connect computers to the phones that help access the internet.
7. ..... is sometimes referred to as 'the information super highway'.

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4.3 Economic Environment

Perhaps the most important characteristic of the international market environment is the economic dimension. With money, all things (well, almost all!!) are possible. Without money, many things are impossible for the marketer. Luxury products, for example, cannot be sold to low-income consumers. Hypermarkets for food, furniture, or durables require a large base of consumers with the ability to make large purchases of goods and the ability to drive away with those purchases. Sophisticated industrial products require sophisticated industries as buyers. Let us learn more about economic environment, discussed in the following sub-sections:

4.3.1 Economic Systems

There are three types of economic systems: capitalist, socialist, and mixed. This classification is based on the dominant method of resource allocation: *market allocation, command or central plan allocation, and mixed allocation, respectively.*

Market Allocation

A market allocation system is one that relies on consumers to allocate resources. Consumers "write" the economic plan by deciding what will be produced by whom. The role of the state in a market economy is to promote competition and ensure consumer protection.

Example: The United States, most Western European countries, and Japan – the triad countries that account for three quarters of gross world product – are predominantly market economy.

Command Allocation

In a command allocation system, the state has broad powers to serve the public interest. These include deciding which products to make and how to make them. Consumers are free to spend their money on what is available, but state planners make decisions about what is produced and, therefore, what is available. Because demand exceeds supply, the elements of the marketing mix are not used as strategic variables.

Mixed System

There are, in reality, no pure market or command allocation systems among the world's economies. All market systems have a command sector and all command systems have a market sector; in other words, they are "mixed". In a market economy, the command allocation sector is the proportion of Gross Domestic Product (GDP).

4.3.2 The International Economic System

Several factors have contributed to the growth of the international economy post World War II. The principal forces have been the development of economic blocs like the European Union (EU) and then the "economic pillars"– the World Bank (or International Bank for Reconstruction and Development to give its full name), the International Monetary Fund (IMF) and the evolution of the World Trade Organisation from the original General Agreement on Tariffs and Trade (GATT).

Until 1969 the world economy traded on a gold and foreign exchange base. This affected liquidity drastically. After 1969 liquidity was eased by the agreement that member nations to the IMF

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accept the Special Drawing Rights (SDR) in settling reserve transactions. Now an international reserve facility is available. Recently, the World Bank has taken a very active role in the reconstruction and development of developing country economies, a point which will be expanded on later.

Until the General Agreement on Tariffs and Trade (GATT) after World War II, the world trading system had been restricted by discriminating trade practices. GATT had the intention of producing a set of rules and principles to liberalise trade. The Most Favoured Nation (MFN) concept, whereby each country agrees to extend to all countries the most favourable terms that it negotiates with any country, helped reduce barriers. The "round" of talks began with Kennedy in the 60s and Tokyo of the 70s. The latest round, Uruguay, was recently concluded in April 1994 and ratified by most countries in early 1995. Despite these trade agreements, non-tariff barriers like exclusion deals, standards and administrative delays are more difficult to deal with. A similar system exists with the European Union, – the Lomè convention. Under this deal, African and Caribbean countries enjoy favoured status with EU member countries.

No doubt a great impetus to global trade was brought about by the development of economic blocs, and, conversely, by the collapse of others. Blocs like the European Union (EU), ASEAN, the North American Free Trade Agreement (NAFTA) with the USA, Canada and Mexico has created market opportunities and challenges. New countries are trying to join these blocs all the time, because of the economic, social and other advantages they bring. Similarly, the collapse of the old communist blocs have given rise to opportunities for organisations as they strive to get into the new market based economies rising from the ruins. This is certainly the case with the former Soviet bloc.

4.3.3 Income and Purchasing Power Parity around the Globe

When a company charts a plan for global market expansion, it often finds that, for most products, income is the single most valuable economic variable. After all, a market can be defined as a group of people willing and able to buy a particular product.

Ideally, GNP and other measures of national income converted to U.S. dollars should be calculated on the basis of purchasing power parities (i.e. what the currency will buy in the country of issue) or through direct comparisons of actual prices for a given product. This would provide an actual comparison of the standards of living in the countries of the world.

Did u know? The top 10 nations ranked as per purchasing parity are: (In Order) USA, China, India, Japan, Germany, Russia, Brazil, UK, France and Italy.

4.3.4 Key Economic Issues that Influence International Business

The key economic issues that influence international business are discussed below:

Inflation

Inflation is the pervasive and sustained rise in the aggregate level of prices measured by an index of the cost of various goods and services. Inflation results when aggregate demand grows faster than aggregate supply- essentially, too many people are trying to buy too few goods, thereby creating demand that pushes prices up faster than incomes grow. Consider the impact of inflation on the cost of living. Rising prices make it more difficult for consumers to buy products unless their incomes rise at the same or faster pace. Sometimes it is practically impossible. Either alone or together, these measures slow or stop economic growth.

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Unemployment

The unemployment rate is the number of unemployed workers divided by the total civilian labor force, which includes both the unemployed and those with jobs. In practice, measuring the number of unemployed workers actually seeking work in various countries is difficult given the lack of a standard measurement method. Generally, people out of work and unable to find jobs depress economic growth, create social pressure, and provoke political uncertainty.

Debt

Debt, the sum total of government's financial obligations, measures the state's borrowing from its population, from foreign organizations, from foreign governments, and from international institutions. More recently, many countries have borrowed from international lenders to finance their movement to freer markets, a process of economic transition. Many countries that began with this ambition but that eventually failed then increasingly had to rely on foreign debt.

Income Distribution

GNI or PPP, even weighted by the size of the population, can misestimate the relative wealth of a nation's citizens. Uneven income distribution is not a problem of poorer nations. There is a strong relationship between skewed income distributions and the split between those who live in urban settings versus those who live in rural areas.

Poverty

A related but separate issue concerns poverty- the state of having little or no money, few or no material possessions, and little or no resources to enjoy a reasonable standard of life. In many parts of the world, workers and consumers struggle for food, shelter, clothing, and clean water, health services, to say nothing of safety, security, and education. Failure results in suffering, malnutrition, mental illness, death epidemics, famine, and war.

The Balance of Payments

The Balance of Payments (BOP), officially known as the statement of International Transactions, records a country's international transactions that take place between companies, governments, or individuals. Managers use the BOP as a comprehensive indicator of a country's economic stability.

Self Assessment

Fill in the Blanks:

8. Countries where the government decides the market prices are called ..... economies.
9. A ..... is defined as a group of people willing to buy a particular product.
10. India holds the ..... place in the rankings based on purchasing power parity.
11. ..... is a state of having little or no money, few or no material possessions little or no resources to enjoy a reasonable standard of life.

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4.4 Political Environment

Majority of the MNCs have to face complex political environmental problems because they must cope with the politics of more than one nation. That complexity forces MNCs to consider three types of political environment: foreign, domestic and international.

The developing countries and the less Developed Countries (LDCs) often view foreign firms and foreign capital investment with distrust and even resentment, owing primarily to a concern over potential foreign exploitation of local natural resources. Dependency Theory explains why Latin American countries are reluctant to welcome foreign-based MNCs. According to this theory, the ongoing economic, political and social transformations have made it necessary for Latin America to rely on the capitalistic system. Let us know some more about political environment, discussed in following subsections.

4.4.1 Political Systems

In order to appraise the political environment of a country, the knowledge of the form of government of that country is essential. Basically, the government can be classified into two categories – parliamentary (open) or absolutist (closed). In the parliamentary form of government, the citizens are supposed to be consulted from time to time for learning about their opinions and preferences. In this type of government the policies are thus intended to reflect the desire of the majority segment of society. Most of the industrialised nations and democratic countries can be classified as parliamentary.

The absolutist governments include monarchies and dictatorships. In the absolutist system, the ruling regime dictates government policies without considering citizens' needs or opinions. The United Kingdom is a good example of a constitutional hereditary monarchy. Despite the monarch, the government is still classified as parliamentary.

Political system of many countries does not fall neatly into these two categories. Some monarchies and dictatorships like Saudi Arabia and North Korea have parliamentary elections. The erstwhile Soviet Union had elections and mandatory voting but was not classified as parliamentary because the ruling party never allowed any alternative on the ballot. Countries such as the Philippines under Marcos and Nicaragua under Somoza held elections but the results were suspect because of the government's involvement in fraud.

At the international political level, the governments can be classified in a number of ways. However, the best way to classify the government is through the political parties. The classification could be based on four types of governments (i) Two party, (ii) Multiple party, (iii) Single party, and (iv) Dominated by one party.

In a two party system, there are mainly two parties that control the government, turn by turn, which-so-ever in a majority and the other parties are also allowed to support any one of the two parties.

Example: The classic examples are the United States and the United Kingdom. Both the parties have different philosophies, which change the government policy when one of the parties is elected to form the government.

In a multi party system, there are a large number of parties, however, none of them are strong enough to gain control of the government. There have been cases when the larger parties, in spite of having a thin majority, cannot control the government because it needs support from other parties. The government, in this case, can only be formed through coalition of like-minded parties each one of which would like to protect its own interest. The coalition government largely depends upon the cooperation of its allies. There have been instances when the

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governments have fallen because one of the parties in the coalition government withdrew its support. A change in a few votes may be sufficient to bring the coalition government down. In such cases fresh elections are called for.

In a single party system, there may be a number of parties functioning in a country, however, one party has so much of majority that there is very little opportunity for others to elect representatives to govern the country.

Example: India is again a classic example of single party rule after independence and after the formulation of the constitution in 1952. It was the Indian National Congress that ruled the country, being the single largest party, till 1982.

In a dominated one party system, the dominant party does not allow any opposition resulting in no alternative for the people. In contrast, a single party system does allow some opposition parties. The former Soviet Union, Cuba and Libya are good examples of dominated one party system. Such a system tends to easily transform itself into dictatorship.

Democratic political system is a pre requisite for political stability also. India, the largest democracy in the world, possesses a sound political infrastructure and political institutions that have withstood many crises over the years.

4.4.2 Political Risks Defined

Political risk, sometimes called "sovereign risk," has several elements. First, it is found whenever a government prevents a private sector debtor from repaying its obligations. Second, it occurs when the foreign government is itself a debtor and defaults on its own obligations due to its own volition. Third, political risk is present when a government repossesses the assets of a private entity (sometimes referred to as "confiscation," or "expropriation"). Other examples of political risks include imposition of new controls (such as trade restrictions, exchange limitations or monetary controls), and war, revolution or insurrection. Ultimately, the exact definition of "political risk" will be listed in any insurance or guarantee documentation.

Interestingly, political risk is not limited to foreign countries.

Example: The United States froze Iranian financial assets during the hostage crisis in Iran. This may have been considered a confiscation by the U.S. Government of Iranian assets.

However, despite domestic political risk threats such as this, most businesses are much more concerned about political risks initiated by foreign governments.

In theory, whenever a business suffers a loss due to the occurrence of a political risk, it can receive compensation from that foreign government. However, most countries have adopted the idea of "sovereign immunity." This doctrine asserts that a government is not liable for its actions in court either in that nation or broad, unless the government submits voluntarily to any such lawsuit. It is easy to understand why not many business executives are eager to discover the limits of this legal doctrine. Therefore, most companies prefer to avoid political risks when possible by insuring against that class of risk.

4.4.3 Political Risk Analysis

There are a number of political risks which are to be faced by international marketers. The risks, which the marketers face from the host government, are:

Confiscation is the process of a government's taking ownership of a property without compensation.

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Example: The Chinese government seized American property after the Chinese communists took power in 1949.

Expropriation differs from confiscation in that there is some compensation though not necessarily just compensation. More often than not, a company whose property is being expropriated agrees to sell its operations – not by choice but rather because of some explicit or implied coercion.

Nationalisation involves government ownership and it is the government that operates the business being taken over.

Example: Myanmar's foreign trade is completely nationalised.

In ***domestication***, foreign companies relinquish control and ownership either completely or partially to the nationals. The result is that private entities are allowed to operate the confiscated or expropriated properties.

Example: The French government, after finding out that the state was not sufficiently proficient to run the banking business, developed a plan to sell 36 French banks.

Task Find out about the different political form in China, Mexico and Australia. Also write a note on political risks associated with international business in these countries.

4.4.4 Indicators of Political Instability

To assess a potential marketing environment, a company should identify and, evaluate the relevant indicators of political difficulty. Potential sources of political complication include social unrest, the attitudes of nationals, and the policies of the host government.

Social Unrest

Social disorder is caused by such underlying conditions as economic hardship, internal dissension and insurgency, and ideological, religious, racial, and cultural differences.

Example: Lebanon has experienced conflict among the Christians, Muslims, and other religious groups. The Hindu-Muslim conflict in India continues unabated.

A company may not be directly involved in local disputes, but its business can still be severely disrupted by such conflicts.

The breakup of the Soviet Union should not come as a surprise. Human nature involves monastery (the urge to stand alone) as well as systems (the urge to stand together), and the two concepts provide alternative ways of utilizing resources to meet a society's needs. Monastery encourages competition, but systems emphasize cooperation. As explained by Alderson, "a cooperative society tends to be a closed society. Closure is essential if the group is in some sense to act as one." Not surprisingly China, although wanting to modernize its economy, does not fully embrace an open economy, which is likely to encourage dissension among the various groups. For the sake of its own survival, a cooperative society may have to obstruct the dissemination of new ideas and neutralize an external group that poses a threat. China apparent has learned a lesson from the Soviet Union's experience.

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Attitudes of Nationals

An assessment of the political climate is not complete without an investigation of the attitudes of the citizens and government of the host country. The nationals' attitude toward foreign enterprises and citizens can be quite inhospitable. Nationals are often concerned with foreigners' intentions in regard to exploitation and colonialism, and these concerns are often linked to concerns over foreign governments' actions that may be seen as improper. Such attitudes may arise out of local socialist or nationalist philosophies, which may be in conflict with the policy of the company's home country government.

Policies of the Host Government

Unlike citizens' inherent hostility, a government's attitude toward foreigners is often relatively short-lived. The mood can change either with time or change in leadership, and it can change for either the better or the worse. The impact of a change in mood can be quite dramatic, especially in the short run. Government policy formulation can affect business operations either internally or externally. The effect is internal when the policy regulates the firm's operations within the home country. The effect is external when the policy regulates the firm's activities in another county.

Trouble in Paradise

The biggest threat that India is facing today is the slow economic growth because of two great factors. First, terrorism from across the border in Jammu and Kashmir and other parts of the country which is dissuading the MNCs for foreign direct investment in the country and second, poor labour legislation. Unless higher and fire system in the labour legislation is brought, foreign companies will not like to come to India for investments.

The greatest risk that any foreign company faces today is the instability of a government due to terrorism in the country. Though the government is stable in the country and is running smoothly and efficiently, however, the threat of terrorism is making the MNCs to avoid investing in a big way. It is, therefore, essential that terrorism is curbed at all levels for which the government must go all out to ensure the safety and integrity of the people and the property of the country.

India, after 1990, opened its economy to international institutions through modernisation, privatisation and globalisation. There is hope now that the economic growth of the country will touch 6.5 % of GDP as envisaged by the Reserve Bank of India Annual Report for the year 2003-04.

Source: International marketing- 3rd edition, P. K. Vasudeva, Excel Books

Self Assessment

Match the following:

	Set A		Set B
12.	Confiscation	a.	It is process of a government's taking ownership of a property without compensation.
13.	Expropriation	b.	It involves government ownership and it is the government that operates the business being taken over.
14.	Nationalisation	c.	In this, the foreign companies give up control and ownership either completely or partially to the nationals.
15.	Domestication	d.	It is process of a government's taking ownership of a property with some compensation.

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4.5 Summary

- Culture is a system of values and norms that are shared among a group of people and that when taken together constitute a design for living.
- The socio-cultural fabric is an important environmental factor that should be analysed while formulating business strategies. The cost of ignoring the customs, traditions, taboos, tastes and preferences, etc., of people could be very high.
- Society and culture influence every aspect of overseas business of an MNC and successful MNC operations – whether it is marketing, finance, production, or personnel – have to be acutely aware of the predominant attitudes, feelings and opinions in the local environment.
- Given the rapid pace of technological change, it is vital that firms carefully study different elements in the technological segment.
- The major challenges facing the international marketers today are coping with change, understanding complexity of the changing markets, dealing with competition and performing social responsibilities.
- Majority of the MNCs have to face complex political environmental problems because they must cope with the politics of more than one nation. In order to analyse the political scenario of the nations the companies must know the type of political system that exists in that nation.
- As there is a multiplicity of political environment, there are various legal environments: domestic, foreign and international.
- The most important characteristic of the international market environment is the economic dimension. It includes the analysis of the world economic systems, development status of the countries, the purchasing power across nations and income of the population.

4.6 Keywords

Absolutist Government: In this, the ruling government dictates the policies without considering citizens' opinions.

Confiscation: Confiscation is the process of a government's taking ownership of a property without compensation.

Counterfeiting: To make a copy of, usually with the intent to defraud.

Culture: Culture is, the thought and behaviour patterns that member of a society learns through language and other forms of symbolic interaction their customs, habits, beliefs and values, the common viewpoints, which bind them together as a social entity.

Gross National Product: It is the total value of all final goods and services produced within a nation in a particular year.

Parliamentary Government: In this, the citizens are consulted from time to time to know their opinions.

Purchasing Power Parity: It states that the exchange rate between one currency and another is in equilibrium when their domestic purchasing powers at that rate of exchange are equivalent.

Religion: Religion is one of the important social institutions influencing business. A few religions have spread over large areas in the world.

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4.7 Review Questions

1. "Though society and culture do not appear to be a part of business situations, yet they are actually key elements in showing how business activities will be conducted". Discuss.
2. Discuss the famous McDonald's case where the multinational company failed to understand the culture of India and thus failed initially, before bouncing back.
3. How relevant is the political environment in international business? Enumerate different types of political systems that exist around the globe.
4. Describe the different types of economic systems. Explain with suitable examples.
5. "The development of new technologies helped international business". Do you agree? Justify your answer.
6. Can the emerging technologies pose a challenge for an international marketer? Give valid arguments to support your answer.
7. Discuss the various key economic issues that influence international business.
8. Describe the various indicators of political instability.
9. You are a marketing manager of a textile company that is looking to venture into international business. The country you want to target first is the UK. You want to start by exporting to UK. What environmental factors would you keep in mind and how would you analyse the business environment of the UK?
10. Why is it difficult for a marketer to position products in a culturally diverse nation like India?
11. Is the economic environment same all across the globe or it differs? Give valid arguments to support your answer.
12. How does the technological environment of India differ from that of Japan?

Answers: Self Assessment

1.	False	2.	False
3.	True	4.	True
5.	True	6.	Modem
7.	Internet	8.	Mixed
9.	Market	10.	4th
11.	Poverty	12.	(a)
13.	(d)	14.	(b)
15.	(c)		

4.8 Further Readings

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Unit 5: Modes of Entering International Business

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Objectives

After studying this unit, you should be able to:

- Discuss the Strategic Decisions an International Business makes while Entering Foreign Markets
- State the Benefits and Limitations
- Explain the concept of Joint Ventures
- Describe Strategic Alliances
- Discuss about Franchising
- Describe the concept of Direct Investment
- Explain Contract Manufacturing
- Identify the Methods of Exporting

Introduction

The market for a number of products tends to saturate or decline in the advanced countries. This often happens when the market potential has been almost fully tapped. In the United States, for example, the number of several consumer durables like cars, TVs etc. is almost equal to the total number of household. Further the technological advances have increased the size of the optimum scale of operation substantially in many industries making it necessary to have foreign market, in addition to domestic market to take advantage of scale economies. Again when the domestic market is very small, internationalization is the only way to achieve significant growth. For

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example Nestle derives only about 2 per cent of its total sales from its home market Switzerland. Similarly with only 8 per cent of the total sales coming from the home market, Holland, many different national subsidiaries of the Philips have contributed much larger share of the total revenues than the parent company. In order to overcome this problem and gain other advantages such as growth opportunity, increase profits, global recognition and spin off benefits, businesses enter the international markets.

5.1 Different Entry Modes

Mergers and acquisitions (M&A) and corporate restructuring are a big part of the corporate finance world. Every day, Wall Street investment bankers arrange M&A transactions, which bring separate companies together to form larger ones. When they're not creating big companies from smaller ones, corporate finance deals do the reverse and break up companies through spinoffs, carve-outs or tracking stocks.

One plus one makes three: this equation is the special alchemy of a merger or an acquisition. The key principle behind buying a company is to create shareholder value over and above that of the sum of the two companies. Two companies together are more valuable than two separate companies - at least, that's the reasoning behind M&A.

This rationale is particularly alluring to companies when times are tough. Strong companies will act to buy other companies to create a more competitive, cost-efficient company. The companies will come together hoping to gain a greater market share or to achieve greater efficiency. Because of these potential benefits, target companies will often agree to be purchased when they know they cannot survive alone.

5.1.1 Types of Merger

From the perspective of business structures, there is a whole host of different mergers. Here are a few types, distinguished by the relationship between the two companies that are merging:

- ***Horizontal merger:*** Two companies that are in direct competition and share the same product lines and markets.
- ***Vertical merger:*** A customer and company or a supplier and company. Think of a cone supplier merging with an ice cream maker.
- ***Market-extension merger:*** Two companies that sell the same products in different markets.
- ***Product-extension merger:*** Two companies selling different but related products in the same market.
- ***Conglomeration:*** Two companies that have no common business areas.

  There are two types of mergers that are distinguished by how the merger is financed. Each has certain implications for the companies involved and for investors:

  - *Purchase Mergers:* As the name suggests, this kind of merger occurs when one company purchases another. The purchase is made with cash or through the issue of some kind of debt instrument; the sale is taxable.

    Acquiring companies often prefer this type of merger because it can provide them with a tax benefit. Acquired assets can be written-up to the actual purchase price, and the difference between the book value and the purchase price of the assets can depreciate annually, reducing taxes payable by the acquiring company. We will discuss this further in part four of this tutorial.

Notes

- *Consolidation Mergers:* With this merger, a brand new company is formed and both companies are bought and combined under the new entity. The tax terms are the same as those of a purchase merger.

5.1.2 Acquisitions

As you can see, an acquisition may be only slightly different from a merger. In fact, it may be different in name only. Like mergers, acquisitions are actions through which companies seek economies of scale, efficiencies and enhanced market visibility. Unlike all mergers, all acquisitions involve one firm purchasing another - there is no exchange of stock or consolidation as a new company. Acquisitions are often congenial, and all parties feel satisfied with the deal. Other times, acquisitions are more hostile.

In an acquisition, as in some of the merger deals we discuss above, a company can buy another company with cash, stock or a combination of the two. Another possibility, which is common in smaller deals, is for one company to acquire all the assets of another company. Company X buys all of Company Y's assets for cash, which means that Company Y will have only cash (and debt, if they had debt before). Of course, Company Y becomes merely a shell and will eventually liquidate or enter another area of business.

Another type of acquisition is a reverse merger, a deal that enables a private company to get publicly-listed in a relatively short time period. A reverse merger occurs when a private company that has strong prospects and is eager to raise financing buys a publicly-listed shell company, usually one with no business and limited assets. The private company reverse merges into the public company, and together they become an entirely new public corporation with tradable shares.

Regardless of their category or structure, all mergers and acquisitions have one common goal: they are all meant to create synergy that makes the value of the combined companies greater than the sum of the two parts. The success of a merger or acquisition depends on whether this synergy is achieved.

5.1.3 Difference between Mergers & Acquisitions

Merger and acquisition is often known to be a single terminology defined as a process of combining two or more companies together. The fact remains that the so-called single terminologies are different terms used under different situations. Though there is a thin line difference between the two but the impact of the kind of completely different in both the cases.

Merger is considered to be a process when two or more companies come together to expand their business operations. In such a case the deal gets finalized on friendly terms and both the companies share equal profits in the newly created entity.

When one company takes over the other and rules all its business operations, it is known as acquisitions. In this process of restructuring, one company overpowers the other company and the decision is mainly taken during downturns in economy or during declining profit margins. Among the two, the one that is financially stronger and bigger in all ways establishes it power. The combined operations then run under the name of the powerful entity who also takes over the existing stocks of the other company.

Another difference is, in an acquisition usually two companies of different sizes come together to combat the challenges of downturn and in a merger two companies of same size combine to increase their strength and financial gains along with breaking the trade barriers. A deal in case of an acquisition is often done in an unfriendly manner, it is more or less a forceful or a helpless association where the powerful company either swallows the operation or a company in loss is

forced to sell its entity. In case of a merger there is a friendly association where both the partners hold the same percentage of ownership and equal profit share.

5.1.4 Licensing

There is no nationally recognized license specifically for merger and acquisition ("M&A") or business broker services. Accordingly, most practitioners have relied upon state real estate broker licenses for their transaction activities. Most states require a realty license to sell a business property, and some states stipulate that a broker must hold a realty license to sell a business. Therefore, over time, the real estate broker license became the defacto license for this niche service.

Reliance upon a real estate license, alone, has been problematic for some dealmakers for certain transactions. For instance, there are cases where a business broker sells a business that has locations or stores in multiple states where the broker may not be licensed. In those instances, they would either co-broker or forgo the fee for those properties. Additional confusion arose when a buyer was located from a different state from which the seller and broker were located. Issues like these were handled on a case-by-case basis between the principals involved and their attorneys, and in some cases the courts.

Another area of concern arose when the buyer purchased the stock of the small business versus the assets. Was this a sale of securities or not? Section 15(a)(1) of the Securities Exchange Act of 1934 makes it unlawful for any person or entity to "effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless such person or entity is registered as a broker or dealer with the Securities and Exchange Commission ("SEC"). Section 3(a)(4)(A) defines a broker as any person engaged in the business of effecting transactions in securities for the account of others. State securities boards have adopted similar rules.

The SEC has issued several no-action letters regarding the registration requirements for people or entities that act as business brokers or finders. It is beyond the scope of this article to delve into each of these letters; however, this patchwork of no-action letters has formed the guidance for determining whether a small business stock sale qualifies as a security, thereby requiring registration for the professional and firm involved.

Caselet

BDP International Enters India

Reports have it that the US-based BDP International has launched a joint venture in India with a local company, Unique Global Logistics, having strong expertise in the energy sector, including oil and gas. The joint venture company, BOP Global Logistics (India), will target the country's expanding chemicals, life sciences, healthcare, retail, telecom and manufacturing sectors, it is learnt. Chemicals, it might be noted, accounts for 13-14 per cent of India's exports and 8-9 per cent of imports. BDP, an acknowledged leader in the chemical sector and active in more than 120 countries, has also announced the Indian launch of its new technology, which is a vendor management tool that provides logistics managers with visibility of each stage of an international purchase. Meanwhile, GAC Marine Logistics has opened an office in Chennai to house its fast growing dedicated customer service team. The office, launched a few months ago, proved to be inadequate to handle the growing business, particularly the international client portfolio and to provide round-the-clock service.

Source: thehindubusinessline.com

Notes

Self Assessment

State whether the following statements are true or false:

1. The choice of the nation which a businessman wants to enter would probably depend on immediate short-term benefits.
2. It is difficult to do business in a country where there are no strict legal standards for product and environment safety.
3. Economic and political risks are not independent of each other, but they influence each other.
4. One of the first mover advantages is to ride the experience curve ahead of the rivals and capture demand by creating a solid brand name.
5. Whenever a firm wants to enter an international market, it should be on a high scale with high impact on the host country.
6. Pioneering costs arise when an international firm, in attempt to gain the first mover advantage, spends considerable time to learn the systems of the host country.

5.1.5 Joint Ventures

A joint venture is a strategic alliance where two or more parties, usually businesses, form a partnership to share markets, intellectual property, assets, knowledge, and, of course, profits. A joint venture differs from a merger in the sense that there is no transfer of ownership in the deal.

Example: Fuji-Xerox was set up as a joint venture between Xerox and Fuji Photo.

Establishing a joint venture with a foreign firm has long been popular mode for entering a new market. The most typical joint venture is a 50/50 venture, in which there are two parties, each of which holds a 50 percent ownership stake and contributes a team of mangers to share operating control.

It can also occur between two small businesses that believe partnering will help them successfully fight their bigger competitors.

While forming a joint venture, a company should keep in mind the following:

- Before a company forms a joint venture, they will need to look for partners to join them.
- When a company has its partner(s) chosen, agree on the terms of partnership such as who takes on what tasks, what they both earn from the business, solutions to conflicts that may arise, including if one, both, or all of them want to exit the business.
- Every partner will have to agree on the type of structure that the business is to have.

Task Discuss about any two joint ventures that involves an Indian company and a foreign company.

Notes

Self Assessment

Fill in the blanks:

7. Large companies enter into ..... with smaller companies to acquire intellectual property and resources, which are otherwise hard to get.
8. Xerox has formed a joint venture with .....

5.1.6 Strategic Alliances

A strategic alliance is when two or more businesses join together for a set period of time. The businesses, usually, are not in direct competition, but have similar products or services that are directed toward the same target audience.

In the new economy, strategic alliances enable business to gain competitive advantage through access to a partner's resources, including markets, technologies, capital and people.

Teaming up with others adds complementary resources and capabilities, enabling participants to grow and expand more quickly and efficiently. The goal of alliances is to minimize risk while maximizing your leverage and profit. Alliances are often confused with mergers, acquisitions, and outsourcing.

Self Assessment

Fill in the Blanks

9. ..... are formed by two or more, in most cases, indirect competitors, for a set period of time.
10. The goal of alliances is to minimize risk while maximizing the ..... and profit.

5.1.7 Franchising

Franchising is basically a specialized form of licensing in which the franchiser not only sells intangible property to the franchisee, but also insists that the franchisee agree to abide by strict rules as how it does business. The franchiser will also often assist the franchisee to run the business on an ongoing basis.

While licensing works well for manufacturers, franchising is often suited to the global expansion efforts of service and retailing.

Example: McDonald's, Tricon Global Restaurants (the parent of Pizza Hut, Kentucky Fried Chicken, and Taco Bell), and Hilton Hotels have all used franchising to build a presence in foreign markets.

Different Types of Franchising

Product Franchise

With this the manufacturer uses the franchise agreement to determine how the product is distributed by the person buying the franchise.

Notes

Manufacturing Franchise

The franchisee is permitted to manufacture the products under license and sell them using the originator's trademark and name.

Business Franchise Venture

The franchisee purchases and distributes the products for the franchise owner. A client base is provided by the product owner for the franchisee to maintain.

A Business Format Franchise

This opportunity is very popular, and involves providing the franchisee a proven business model using a recognized product and brand. Training is provided by the franchise owner and assistance in setting up the business. Supplies are purchased from the franchisor and the franchisee pays a royalty fee.

Social Franchising

In recent years, the idea of franchising has been picked up by the social enterprise sector, which hopes to simplify and expedite the process of setting up new businesses. A number of business ideas, such as soap making, whole food retailing, aquarium maintenance, and hotel operation, have been identified as suitable for adoption by social firms employing disabled and disadvantaged people.

Social franchising also refers to a technique used by governments and aid donors to provide essential clinical health services in the developing world.

Event Franchising

Event franchising is the duplication of public events in other geographical areas, while retaining the original brand (logo), mission, concept and format of the event.

Benefits of Franchising

There are several benefits of franchising. The major benefits include:

Branding

The first thing Franchises offer franchisees is a strategic identity that is not only effective, it has cumulative market impact. Corporate Brand Identities are proven.

Did u know? Mega-brands like McDonald's and Dunkin' Donuts have literally spent millions on their brandings and logos and the franchisee gets to take full advantage.

Advertising

Advertising can be one of the biggest expenses for any new business and for good reason. You can't survive without effective advertising and effective advertising is expensive.

Notes

Name Recognition

People today want guarantees like never before and name/menu/brand recognition gives them that assurance. You get to take advantage of the fact that a family from out-of-state, for instance, who has previously enjoyed your franchise's products and services, will think nothing of visiting your facility because of their past positive experiences.

Reputation

The reputation of the franchise is important enough, it is what breeds positive expectations that keep patrons loyal, but this benefit coupled with a built-in umbrella of legal protection is an incredible bonus and one you cannot get as an independent.

Support

Franchisors want you to be successful and they make themselves available every step of the way. After all, they want to keep selling franchises and high success ratios keep potential franchisees coming.

Limitations

The disadvantages/limitations of franchises are:

Loss/Lack of Control

Independent franchises often have to follow the guidelines set forth by the franchise including what kinds of tables to use, wallpapers and more. If you don't want to give up that control, this won't be the business for you.

Less Long-term Profits

Franchises are a big business but making it rich isn't always there. You'll earn a decent income but nothing like Microsoft or any other Fortune 500 company.

Hard to Sell

When you have a franchise, it's harder to get out from underneath it especially if it seems the parent company is having problems.

Possibility of Parent Company Going Out of Business

It doesn't matter if your business is doing well or not; if the parent company goes under, so will you. Make sure you choose a company that's been doing well, both in good times and in bad.

Possibility of Getting a Bad Name

When a franchise fails to do well, you could be indirectly affected by it. Your reputation will be tarnished just because of the name.

Notes

Self Assessment

Multiple choice questions:

11. In……., there is usually a sale of intangible assets to the new business.

    (a) Licensing (b) Joint venture

    (c) Franchising (d) Strategic alliance

12. In……franchise, the manufacturer uses the franchise agreement to determine how the product is distributed by the person buying the franchise.

    (a) Business (b) Manufacturing

    (c) Social (d) Product

5.1.8 Contract Manufacturing

Contract manufacturing is a process that established a working agreement between two companies. As part of the agreement, one company will custom produce parts or other materials on behalf of their client. In most cases, the manufacturer will also handle the ordering and shipment processes for the client. As a result, the client does not have to maintain manufacturing facilities, purchase raw materials, or hire labor in order to produce the finished goods.

The basic working model used by contract manufacturers translates well into many different industries. Since the process is essentially outsourcing production to a partner who will privately brand the end product, there are a number of different business ventures that can make use of a contract manufacturing arrangement. There are a number of examples of pharmaceutical contract manufacturing currently functioning today, as well as similar arrangements in food manufacturing, the creation of computer components and other forms of electronic contract manufacturing. Even industries like personal care and hygiene products, automotive parts, and medical supplies are often created under the terms of a contract manufacture agreement.

Benefits and Limitations of Contract Manufacturing

When working with contract manufacturing there are advantages and disadvantages. The advantages are lower costs, flexibility, access to outside expertise in selling the product, and lower capital requirements, since there is no need to produce anything. Contract manufacturing works if the company gets involved with the right company. If the company were to get involved in the wrong company, the whole process will not work. Or, the company engaging in the contract with the manufacturer may assume too much or make the wrong assumptions. For one thing, it is hard to track prices when the market changes, because the emphasis may be placed on the wrong company. Another problem that can occur is the company may need to deal with suppliers for the products they are selling. However, the supplier may only want to do deal with the original manufacturer. This may limit the company from obtaining supplies.

In order to gain the benefits of using contract manufacturing, it is best to take a strategic approach. Here are the areas you can focus on that will help you better prepare manage contract manufacturing:

Timing and reason: In order for contract manufacturing to work, the timing has to be right. Is it the right time to get involved in contract manufacturing? What is the reason for getting involved with contract manufacturing? Did you analyze your position and see the need to get into outsourcing? Does the company you want to get involved with offer a product that is well received?

Notes

Right mindset: In order to enter into a contract manufacturing deal, the company that wants to get involved must have the right mindset. They may want to look at the deal as if it is really an in-house arrangement. The basic precise here is the company wants to have a certain amount of control with the product. They want products that are known to sell and can be predicted as to what areas or territories the products will sell well at, so as to engage in affective marketing.

Effective organization: To handle contract manufacturing, the business has to be developed and be effective in selling the product that he is contracted to sell. This is very important or the whole process will not work. There has to be stability in place along with the ability to keep grow and expand as the need arises.

Self Assessment

Fill in the blanks:

13. In case of ..... the businessman does not have to hire a facility or labour in order to get finished goods.
14. Contract manufacturing works only if the company gets involved with the ..... company.

5.2 Exporting

The term "export" is derived from the conceptual meaning as to ship the goods and services out of the port of a country. The seller of such goods and services is referred to as an "exporter" who is based in the country of export whereas the overseas based buyer is referred to as an "importer". In International Trade, "exports" refers to selling goods and services produced in home country to other markets.

There are a number of factors were important in contributing to successful exporting:

- commitment of the firms' management
- an exporting approach in the firm which emphasised the importance of augmenting and maintaining skills
- a good marketing information and communication system
- sufficient production capacity and capability, product superiority and competitive pricing
- effective market research to reduce the psychic distance between the home country and target country market given that it is knowledge that generates business opportunities and drives the international process
- an effective national export policy which provides support at an individual firm level, and emphasises the need for knowledge-based programmes which prioritise market information about foreign market opportunities.

Selection of Exporting Method

The choice of the specific individual markets for exporting was discussed in the first section of this book, but it is important to re-emphasise that the more subjective factors, such as a senior executive's existing formal or informal links, particular knowledge of culture or language and perceived attractiveness of markets, may well influence an individual firm's decision.

Once individual markets have been selected and the responsibilities for exporting have been allocated, the decision needs to be taken about precisely how the firm should be represented in the new market.

Notes

Caution Clearly the nature, size and structure of the market will be significant in determining the method adopted.

In a large market, particularly if a high level of market knowledge and customer contact is needed, it may be necessary to have a member of the firm's staff resident in or close to the market. This cannot be justified if the market is small or levels of customer contact need not be so high. Alternatively a home-based sales force may be used to make periodic sales trips in conjunction with follow-up communications by telephone, fax and e-mail.

Many other factors will affect the cost/benefit analysis of maintaining the company's own staff in foreign markets, such as whether the market is likely to be attractive in the long term as well as the short term and whether the high cost of installing a member of the firm's own staff will be offset by the improvements in the quality of contacts, market expertise and communications. The alternative, and usually the first stage in exporting, is to appoint an agent or distributor.

Agents

Agents provide the most common form of low cost direct involvement in foreign markets and are independent individuals or firms who are contracted to act on behalf of exporters to obtain orders on a commission basis. They typically represent a number of manufacturers and will handle non-competitive ranges. As part of their contract they would be expected to agree sales targets and contribute substantially to the preparation of forecasts, development of strategies and tactics using their knowledge of the local market.

The selection of suitable agents or distributors can be a problematic process. The selection criteria might include:

- The financial strength of the agents.
- Their contacts with potential customers.
- The nature and extent of their responsibilities to other organisations.
- Their premises, equipment and resources, including sales representatives.

Clearly, the nature of the agreement between the firm and its agent is crucial in ensuring the success of the arrangement, particularly in terms of clarifying what is expected of each parry, setting out the basis for the relationships that will be built up and ensuring that adequate feedback on the market and product development is provided. There are various sources for finding a suitable agent at low cost to the exporter:

- Asking potential customers to suggest a suitable agent.
- Obtaining recommendations from institutions such as trade associations, chambers of commerce and government trade departments.
- Using commercial agencies.
- Using agents for non-competing products.
- Poaching a competitor's agent.
- Advertising in suitable trade papers.

Notes

Distributors

Agents do not take ownership of the goods but work instead on commission, sometimes as low as 2-3 per cent on large volume and orders. Distributors buy the product from the manufacturer and so take the market risk on unsold products as well as the profit. For this reason, they usually expect to take a higher percentage to cover their costs and risk.

Distributors usually seek exclusive rights for a specific sales territory and generally represent the manufacturer in all aspects of sales and servicing in that area. The exclusivity, therefore, is in return for the substantial capital investment that may be required in handling and selling the products. The capital investment can be particularly high if the product requires special handling equipment or transport and storage equipment in the case of perishable goods, chemicals, materials or components.

The issue of agreeing territories is becoming increasingly important, as in many markets, distributors are becoming fewer in number, larger in size and sometimes more specialised in their activity. The trend to regionalisation is leading distributors increasingly to extend their territories through organic growth, mergers and acquisitions. Also within regional trading blocs competition laws are used to avoid exclusive distribution being set up for individual territories.

Example: The car industry in the EU was allowed to retain exclusive distribution until Block Exemption was removed in 2002.

Direct Marketing

Direct marketing is concerned with marketing and selling activities which do not depend for success on direct face-to-face contact and include mail order, telephone marketing, television marketing, media marketing, direct mail and electronic commerce using the Internet. There is considerable growth in all these areas largely encouraged by the development of information and communication technology, the changing lifestyles and purchasing behaviour of consumers and the increasing cost of more traditional methods of entering new markets. The critical success factors for direct marketing are in the standardisation of the product coupled with the personalisation of the communication. Whilst technical data about the product might be available in one language, often English, the recipients of the direct marketing in international markets expect to receive accurate communications in their domestic language. International direct marketing, therefore, poses considerable challenges, such as the need to build and maintain up-to-date databases, use sophisticated multilingual data processing and personalisation software programs, develop reliable credit control and secure payment systems.

However, it also offers advantages, Whereas American firms have had trouble breaking into the Japanese market, catalogue firms have been highly successful as they are positioned as good value for money for well-known clothing brands compared to Japanese catalogues which are priced higher for similar quality items.

Direct marketing techniques can also be used to support traditional methods of marketing by providing sales leads, maintaining contact or simply providing improved customer service through international call centres. Where multiple channels are used for market entry, especially e-commerce, it is the integration of channels through Customer Relationship Management that is essential to ensure customer satisfaction.

Notes

Case Study

Toshiba's Corporate Strategy

Toshiba firmly believes that a single company cannot dominate any technology or business by itself. Toshiba's approach is to develop relationships with different partners for different technologies. Strategic alliances form a key element of Toshiba's corporate strategy. They helped the company to become one of the leading players in the global electronics industry.

In early 1990s Toshiba signed a co-production agreement for light bulb filaments with GE. Jack Welch, the legendary former CEO of GE, was a Toshiba's admirer. According to him, a phone call to Japan was enough to sort out problems if and when they arise, in no time.

Since then, Toshiba formed various partnerships, technology licensing agreements and joint ventures. Toshiba's alliance partners include Apple Computers, Ericsson, GE, IBM, Microsoft, Motorola, National Semi Conductor, Samsung, Siemens, Sun Microsystems and Thomson.

Toshiba formed an alliance with Apple Computer to develop multimedia computer products. Apple's strength lay in software technology, while Toshiba contributed its manufacturing expertise. Toshiba created a similar tie-up with Microsoft for hand held computer systems.

In semiconductors, Toshiba, IBM and Siemens came together to pool different types of skills. Toshiba was strong in etching, IBM in lithography and Siemens in engineering. The understanding among the partners was limited to research. For commercial production and marketing the partners decided to be on their own.

In flash memory, Toshiba formed alliances with IBM and National Semi Conductor.

Toshiba's alliance with Motorola has helped it become a world leader in the production of memory chips.

The tie-up with IBM has enabled Toshiba to become a world's largest supplier of color flat panel displays for notebooks.

Toshiba believes in a flexible approach because some tension is natural in business partnerships, some of which may also sour over time. Toshiba executives believe that the relationship between the company and its partner should be like friends, not like that of a married couple. Toshiba senior management is often directly involved in the management of strategic alliances. This helps in building personal equations and resolving conflicts.

Question

Critically evaluate Toshiba's strategy and measure the results.

Source: 1000ventures.com

Self Assessment

State whether the following statements are true or false:

15. Distributors buy the product from the manufacturer and so take the market risk on unsold products as well as the profit.
16. Direct marketing is nothing but face-to-face marketing.

Notes

5.3 Summary

- The three basic strategic decisions that make a firm contemplating foreign expansion are: (a) which markets to enter, (b) when to enter those markets, and (c) on what scale.
- A joint venture is a strategic alliance where two or more parties, usually businesses, form a partnership to share markets, intellectual property, assets, knowledge, and, of course, profits.
- A strategic alliance is when two or more businesses join together for a set period of time.
- The businesses in strategic alliance, usually, are not in direct competition, but have similar products or services that are directed toward the same target audience.
- Franchising is basically a specialized form of licensing in which the franchiser not only sells intangible property normally a trademark to the franchisee, but also insists that the franchisee agree to abide by strict rules as how it does business.
- The franchiser will also often assist the franchisee to run the business on an ongoing basis.
- Through Foreign Direct Investment a firm invests directly in facilities to produce and/or market a product in a foreign country.
- FDI takes on two main forms; the first is a green field investment, which involves the establishment of a wholly new operation in a foreign country.
- Contract manufacturing is a process that established a working agreement between two companies. As part of the agreement, one company will custom produce parts or other materials on behalf of their client.
- In most cases, the manufacturer will also handle the ordering and shipment processes for the client.
- The term "export" is derived from the conceptual meaning as to ship the goods and services out of the port of a country. The seller of such goods and services is referred to as an "exporter" who is based in the country of export whereas the overseas based buyer is referred to as an "importer".

5.4 Keywords

Contract manufacturing: It is a process that established a working agreement between two companies.

Direct investment: In this a firm invests directly in facilities to produce and/or market a product in a foreign country.

Direct marketing: The business of selling products or services directly to the public, e.g., by mail order or telephone selling, rather than through retailers.

Exports: It refers to selling goods and services produced in home country to other markets.

Export agent: An intermediary who acts on behalf of a company to open up or develop a market in a foreign country.

Franchising: A specialized form of licensing in which the franchiser not only sells intangible property normally to the franchisee, but also insists that the franchisee agree to abide by strict rules as how it does business.

Joint ventures: A contractual agreement joining together two or more parties for the purpose of executing a particular business undertaking.

Notes

Strategic alliances: An arrangement between two companies who have decided to share resources in a specific project.

5.5 Review Questions

1. Discuss the strategic decision that a business has to make before entering into the international markets.
2. What points should be kept in mind while entering into joint venture? What are the limitations of a joint venture?
3. "Strategic alliances help the businesses to gain competitive advantage". Substantiate.
4. Describe the term 'franchising'. Discuss the pros and cons of this mode of market entry.
5. State the benefits of a direct investment. Are there any disadvantages of direct investment?
6. Describe contract manufacturing. Why is it becoming popular these days?
7. Discuss the benefits of exporting.
8. If you were a manager of a firm that manufactures shoes, which of these options would you choose to venture into international business and why? A- Exporting, B- Contract Manufacturing.
9. State the benefits of franchising over joint venture.
10. Explain, with examples, the concept of strategic alliance.
11. Is exporting a safer option than FDI or contract manufacturing? Justify your answer.
12. Take example of any joint venture between an Indian and a foreign company and state its advantages for both.

Answers: Self Assessment

1.	False	2.	False
3.	True	4.	True
5.	False	6.	True
7.	Joint Venture	8.	Fuji Photo
9.	Strategic Alliance	10.	Leverage
11.	(c)	12.	(d)
13.	Contract Manufacturing	14.	Right
15.	True	16.	False

5.6 Further Readings

Books

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Unit 6: Foreign Direct Investment

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Objectives

After studying this unit, you should be able to:

- Define foreign direct investment (FDI)
- Discuss the international investment theories
- State the factors that influence FDI
- Identify the costs and benefits associated with FDI
- Discuss the trends in FDI in India and the world

Notes

Introduction

Through Foreign Direct Investment a firm invests directly in facilities to produce and/or market a product in a foreign country.

Example: In the early 1980's Honda, a Japanese automobile company, built an assembly plant in Ohio and began to produce cars for the North American market. These cars were substitutes for imports from Japan. Once a firm undertakes FDI, it becomes a Multinational Enterprise (The meaning of Multinational being "more than one country").

FDI takes on two main forms; the first is a green field investment, which involves the establishment of a wholly new operation in a foreign country. The second involves acquiring or merging with an existing firm in a foreign country. Acquisition can be a minority (where the foreign firm takes a 10 percent to 49 percent interest in the company's Share Capital and voting rights), or majority (foreign interest of 10 percent to 99 percent) or full outright stake (foreign interest of 100 percent).

There is an important distinction between FDI and Foreign Portfolio Investment (FPI). Foreign portfolio investment is investment by individuals, firms or public bodies (e.g. National and local Govts) in foreign financial instruments, (e.g. Government bonds, foreign stocks). FDI does not involve taking a significant equity stake in a foreign business entity. FPI is determined by different facts than FDI. FPI provides great opportunities for business and individuals to build a truly diversified portfolio of international investments in financial assets, which lowers risk.

6.1 Meaning of FDI

Foreign Direct Investment (FDI) is defined as an investment made by an investor of one country to acquire an asset in another country with the intent to manage that asset (IMF, 1993). The IMF definition of FDI includes as many as following elements: equity, capital, reinvested earning of foreign companies, inter-company debt transactions including short-term and long term loans, overseas commercial borrowings, non-cash acquisition of equity, investment made by foreign venture capital investors, earnings data of indirectly-held FDI enterprises, control premium, non-competition fee and so on.

Foreign investment and technology play an important role in the economic development of a nation and have been exploited by a number of developing countries.

Example: The economic health of transition countries in Eastern Europe, Russia, and Central Asia is smoother due to FDI.

Even communist countries like China have welcomed foreign investment to improve their economies.

Governments of developing nations are attracting FDI along with the technology and management skills that accompany it. To attract multinational companies, governments are offering tax holidays, import duty exemption, subsidised land and power and many other incentives. FDI are supposed to bring many benefits to the economy. They contribute to GDP, capital formation, balance of payment and generate employment.

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Definition of FDI by U.S. Department of Commerce

Since 2000, FDI has supported more than five million jobs at 30 percent higher wages

The U.S. Department of Commerce's Economics and Statistics Administration (ESA) today reported that foreign direct investment (FDI) in the United States over the past decade has supported more than five million U.S. jobs that, on average, paid 30 percent more than other jobs. The findings, presented in a new ESA report entitled "Foreign Direct Investment in the United States," point the way toward policies that could expand the number of foreign partners investing in the United States and, in so doing, create more high-paying U.S. jobs.

Total FDI has exceeded $1.7 trillion over the past decade. The manufacturing sector relies heavily on FDI, where close to two million FDI-supported jobs reside. In 2010, $78 billion, or 41 percent of total FDI, was spent on the manufacturing sector.

"Foreign direct investment in the United States is a critical dimension of our economy and one that holds great growth potential for high-paying American jobs," Acting Commerce Deputy Secretary Rebecca Blank said. "By expanding the number of countries that bring business operations to the United States and encouraging further domestic business expansion, we can leverage foreign investment as a powerful engine for U.S. economic growth and job creation."

In 2010, the majority of FDI came from only eight countries: Switzerland, the United Kingdom, Japan, France, Germany, Luxembourg, the Netherlands and Canada. A temporary surge of FDI recorded in 2007 suggests there is untapped potential for increasing total foreign investment in the United States by expanding the number of countries that operate here.

According to the International Monetary Fund, foreign direct investment, commonly known as FDI, "... refers to an investment made to acquire lasting or long-term interest in enterprises operating outside of the economy of the investor." The investment is direct because the investor, which could be a foreign person, company or group of entities, is seeking to control, manage, or have significant influence over the foreign enterprise.

FDI is a major source of external finance which means that countries with limited amounts of capital can receive finance beyond national borders from wealthier countries. Exports and FDI have been the two key ingredients in China's rapid economic growth. According to the World Bank, FDI and small business growth are the two critical elements in developing the private sector in lower-income economies and reducing poverty.

The US and FDI

Because the US is the world's largest economy, it is a target for foreign investment AND a large investor. America's companies invest in companies and projects all over the world. Even though the US economy has been in recession, the US is still a relatively safe haven for investment. Enterprises from other countries invested $260.4 billion dollars in the US in 2008 according to the Department of Commerce. However, the US is not immune to global economic trends, FDI for the first quarter of 2009 was 42% lower than the same period in 2008.

US Policy and FDI

The US tends to be open to foreign investment from other countries. In the 1970s and 1980s, there were short-lived fears that the Japanese were buying America based on the strength of the Japanese economy and the purchase of American landmarks such as Rockefeller Center in New York City by Japanese companies. At the height of the spike in oil prices in 2007 and 2008, some wondered if Russia and the oil-rich nations of the Middle East would "buy America."

There are strategic sectors which the US Government does protect from foreign buyers. In 2006, DP World, a company based in Dubai, United Arab Emirates, bought the UK-based firm managing many of the major seaports in the United States. Once the sale went through, a company from an

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Arab state, albeit a modern state, would be responsible for port security in major American ports. The Bush Administration approved the sale. Senator Charles Schumer of New York led Congress to try to block the transfer because many in Congress felt that port security should not be in the hands of DP World. With a growing controversy, DP World ultimately sold their US port assets to AIG's Global Investment Group.

On the other side, the US Government encourages American companies to invest overseas and establish new markets to help create jobs back home in America. US investment is generally welcome because countries seek capital and new jobs. In rare circumstances, a country will reject a foreign investment for fears of economic imperialism or undue influence. Foreign investment becomes a more contentious issue when American jobs are outsourced to international locations. Outsourcing of jobs was an issue in the 2004 and 2008 Presidential Elections.

Caselet

Petrol Price Rise Offers FDI hope to Retail Chains

The recent decision by state-owned oil marketing companies to increase petrol prices steeply has raised hopes of retail chains, which expects the government will now initiate steps to take the long-pending decision on allowing foreign direct investment (FDI) in multi-brand retail.

The oil companies raised petrol prices by ₹7.50 in May, 2012, a tough but unpopular decision which many see as a strong signal from the government that it's now stepping on the reform pedal.

Many of the retail chains, which have been on a silent mode for months, sent out feelers on Thursday that all was not lost on the FDI front. In another indication that things could be moving, India head of French retail chain Carrefour SA, Jean Noel Bironneau met Commerce and Industry Minister Anand Sharma on Thursday. Carrefour is one of the chains waiting for the government's decision on FDI in multi-brand retail.

It is learnt that the Centre had not held any concrete dialogue with the 'stakeholders' except for state governments over the past six months since the Cabinet decision to allow 51 per cent FDI in multi-brand retail was kept in abeyance.

Although there was a general expectation that the retail FDI talks would be revived after the Assembly elections held across five states earlier this year, nothing moved on that front. However, the petrol price hike is being seen by many as the government stepping up the reform measures.

Source: Business Standard/May, 2012

Self Assessment

State whether the following statements are true or false:

1. FDI includes inter-company debt transactions.
2. FDI contribute to the GDP and economic growth of the host country.

6.2 International Investment Theories

We have already discussed some international investment theories in unit 3. In this unit, we will discuss some more international investment theories.

Notes

6.2.1 Monopolistic Advantage Theory

Stefan Hymer saw the role of firm-specific advantages as a way of marrying the study of direct foreign investment with classic models of imperfect competition in product markets. He argued that a direct foreign investor possesses some kind of proprietary or monopolistic advantage not available to local firms.

These advantages must be economies of scale, superior technology, or superior knowledge in marketing, management, or finance. Foreign direct investment took place because of the product and factor market imperfections.

The direct investor is a monopolist or, more often, an oligopolist in product markets. Humer implied that governments should be ready to impose controls on it.

6.2.2 Product and Factor Market Imperfection

Caves (1971) expanded Hymer's theory and hypothesized that the ability of firms to differentiate their products - particularly high income consumer goods and services - may be key ownership advantages of firms leading to foreign production.

The consumers would prefer to similar locally made goods and thus would give the firm some control over the selling price and an advantage over indigenous firms. To support these contentions, Caves noted that companies investing overseas were in industries that typically engaged in heavy product research and marketing effort.

6.2.3 Cross Investment Theory

E. M. Graham noted a tendency for cross investment by European and American firms in certain oligopolistic industries; that is, European firms tended to invest in the United States when American companies had gone to Europe.

He postulated that such investments would permit the American subsidiaries of European firms to retaliate in the home market of U.S. companies if the European subsidiaries of these companies initiated some aggressive tactic, such as price cutting, in the European market.

6.2.4 The Internalization Theory

It is an extension of the market imperfection theory. By investing in a foreign subsidiary rather than licensing, the company is able to send the knowledge across borders while maintaining it within the firm, where it presumably yields a better return on the investment made to produce it.

Task **Other International Investment Theories**

Other theories relate to financial factors. Robert Aliber believes the imperfections in the foreign exchange markets may be responsible for foreign investment. He explained this in terms of the ability of firms from countries with strong currencies to borrow or raise capital in domestic or foreign markets with weak currencies, which, in turn, enabled them to capitalize their expected income streams at different rates of interest.

Structural imperfections in the foreign exchange market allow firms to make foreign exchange gains through the purchase or sales of assets in an undervalued or overvalued currency.

Contd...

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One other financially based theory (portfolio theory) was put by Rugman, Agmon and Lessard. These researchers argued that international operations allow for a diversification of risk and therefore tend to maximize the expected return on investment.

Rugman and Lessard have further argued that the location of the foreign direct investment would be a function of both the firm's perception of the uncertainties involved and the geographical distribution of its existing assets.

Self Assessment

Match the following:

Set A	Set B
3. Monopolistic Advantage Theory	a. It is an extension of market imperfection theory
4. Product and Factor Market Imperfection	b. It has been advocated by EM Graham
5. Cross Investment Theory	c. It hypothesises that the ability of firms to differentiate their products - particularly high income consumer goods and services
6. The Internalization Theory	d. It has been advocated by Stefan Hymer

6.3 Various Routes of FDI

FDI Approvals in India are carried out by agencies like the Reserve Bank of India and the Foreign Investment Promotion Board. FDI Approval in India is done quickly by the concerned agencies in order to bring in huge amounts of foreign direct investment into the country.

6.3.1 Foreign Direct Investment in India

Major economic reforms were undertaken in India in the early 1990s.

This led to the liberalization and deregulation of the Indian economy and also opened the country's markets to Foreign Direct Investment (FDI).

In India, foreign direct investments are allowed through collaborations that are of financial nature, joint venture collaborations, through preferential allotments, and also through Euro issues.

6.3.2 Various Routes of FDI Approval in India

The proposals for foreign direct investment in India get their approval through two routes that are the Reserve Bank of India and the Foreign Investment Promotion Board. Automatic approval is given by the Reserve Bank of India to the proposals for foreign direct investment in India. The Reserve Bank of India gives approval within the time period of two weeks. It gives approval to the proposals for foreign direct investment in India that involve FDI up to 74% in the nine categories that are included in List four, FDI up to 50% in the three categories that are included in List two, and FDI up to 51% in the forty eight industries that are included in List 3.

FDI Approval in India is also done by the Foreign Investment Promotion Board (FIPB), which processes cases of non- automatic approval. The time taken by Foreign Investment Promotion Board for approving the proposals for foreign direct investment in India is between four to six weeks. The approach of FIPB is liberal as a result of which it accepts most of the proposals and rejects very few.

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6.3.3 FDI Approval in India and Economic Growth

FDI approvals in India have grown significantly in recent years. Significant FDI approvals have taken place in telecom, real estate, banking and insurance sectors. Several other sectors have also benefited from FDI approvals in India. FDI approvals have played a major role in the economic growth of India in recent years.

The Government of India has recently undertaken a comprehensive review of the FDI policy and associated procedures. As a result, a number of rationalisation measures have been undertaken which, inter alia include, dispensing with the need of multiple approvals from Government and/or regulatory agencies that exist in certain sectors, extending the automatic route to more sectors, and allowing FDI in new sectors. The latest changes in the FDI policy were notified vide Press Note 4 (2006 Series).

As per the extant policy, FDI up to 100% is allowed, under the automatic route, in most sectors/activities. FDI under the automatic route does not require prior approval either by the Government of India or the Reserve Bank of India (RBI). Investors are only required to notify the concerned Regional Office of RBI within 30 days of receipt of inward remittances and file required documents with that office within 30 days of issue of shares to foreign investors.

6.3.4 Routes for Foreign Direct Investment (FDI)

Automatic Route

FDI up to 100% is allowed under the automatic route in all activities/sectors except the following which require approval of the government:

- Activities/items that require an Industrial License
- Proposals in which the foreign collaborator has an existing venture/tie up in India in the same field
- Proposals for acquisition of shares in an existing Indian company in some cases
- All proposals falling outside notified sectoral policy/caps or under sectors in which FDI is not permitted

Government Approval Route

All activities which are not covered under the automatic route, require prior Government approval. Areas/sectors/activities hitherto not open to FDI/NRI investment shall continue to be so unless otherwise notified by Government.

6.3.5 Government Route of FIPB

The **Foreign Investment Promotion Board (FIPB)** is a national agency of Government of India, with the remit to consider and recommend foreign direct investment (FDI) which does not come under the automatic route. It provides a single window clearance for proposals on FDI in India.

Members

FIPB comprises Secretaries of different ministries with Secretary, Department of Economic Affairs, Ministry of Finance being the chairman.

- Secretary, Department of Economic Affairs - Chairman
- Secretary, Department of Industrial Policy & Promotion - Member

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- Secretary, Department of Commerce - Member
- Secretary, (Economic Relation), Ministry of External Affairs - Member

The Board is empowered to co-opt Secretaries to the Government of India and other top officials of financial institutions, banks and professional experts of industry and commerce, as required.

Process

In a significant move aimed at expediting flow of foreign investment into the country, the Union Cabinet liberalized the FDI policy further by allowing the FIPB to clear proposals from overseas entities worth up to ₹ 1,200 crore, against the existing limit of ₹ 600 crore.

Recommendations of FIPB for proposals up to ₹ 1,200 crore are approved by Minister of Finance. While recommendations for proposals of more than ₹ 1,200 crore need to be approved by Cabinet Committee on Economic Affairs.

Aircel-Maxis Deal Controversy

Former Minister of Law and Justice and a well known 2G spectrum scam petitioner Dr. Subramanian Swamy alleged that in 2006, a company controlled by then Minister of Finance P Chidambaram's son Karti got five per cent stake in Sivasankaran's Aircel to get part of ₹ 4,000 crore that the Maxis Communications paid for 74 per cent stake in Aircel. He alleged that Mr. Chidambaram with held the FIPB clearance to the deal till his son got the five per cent shares in Siva's company. Subsequently the issue was raised on multiple times in Parliament of India by the opposition which demanded resignation of Mr. P Chidambaram. He and the government denied all the allegations. However, according to The Pioneer and India Today reports, documents show that approval to the FDI proposal was indeed delayed about 7 months by P Chidambaram.

6.4 Factors Influencing FDI

Liberalization is not the sole reason to attract FDI. There are many other determinant of FDI, India may lagging there. As at Kearney's FDI Confidence Audit: India, February 2001 said "India gain's in attractiveness because of its market size and its potential is diminished by negative assessment of its regulatory environment." Other important determinants are rule of law, competitive wages, labour skill, infrastructure and well developed financial institutions. Determinants of FDI can be better understood by the Porter's diamond model of international competitiveness, which has identified four major determinants:

1. ***Factor Condition:*** A nation may have comparative advantage over others because of certain factors of production. Organizations will shift their production base to those countries where the critical factors of production of their industry specific are economical. India's human resources are of proven quantity as well as more economical in comparison to the US and Europe leading many countries to establish their manufacturing units here. India has the largest pool of English speaking people in Asia causing MNCs to shift their BPO, to India. India has also proven its competitive edge in R&D and Software Development, it is the reason that almost all the major software companies of the world have invested in India in software development and more and more companies like GE, NOKIA are establishing their Research center in India. But India doesn't have proved its advantage in basic research. In basic research it is the USA who has established its reputation, hence most of companies established there basic research set up in USA.

Example: Honda a Japanese company having a Core Competency in Engine technology has its research center in Engine technology in USA.

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Most of the Software companies established their Application software research center in USA and Customized Research Center in India. Italy have established its comparative advantage in terms of Industrial Design the result is that job of industrial design goes to Italy from all over world.

Example: TATA took the help of Italian firm in designing TATA Indica.

Other factors of production like availability of capital, raw material and technology also plays a decisive role. It is because of the availability of raw material that South Korean's POSCO has invested in India. Availability of capital has made the US a haven for foreign investment.

2. ***Demand Condition:*** This is also a significant factor in deciding the level of FDI. Higher the demand higher will the FDI. China and India are hot destinations of FDI because of their aggregate demand. In terms of PPP they are in top five countries of the world. Event the companies like P&G who don't believe in the customization of product for low income group is investing in R&D for the sake of customization of product for low income group. Most of MNCs whether it is Electronics, FMCG, Automobiles, White Goods, etc. are investing in India and China and are investing in R&D in developing product for the local people only because huge demand in these countries specially in the low income and middle income group.

Example: It is level of demand only that Retail Giant Wal-Mart is very much keen to invest in India.

3. ***Related and Supported Industry:*** MNCs prefer to go to the destination where there is well developed supported industry (ancillaries units) for the specific industry. Infrastructure play a critical role in a selection of site. It is well said that take care of roads and electricity investment will take care of itself. Well developed ancillaries units facilitate the FDI. As now organization don't have to invest in ancillaries. Not only ancillaries but other supported industry as the availability of well developed financial market, distribution network, etc. also plays role.

4. ***Rivalry and Firm Strategy:*** The Competitive environment in a nation also plays a critical role. Organizations like to invest in countries where there is no stiff competition.

Did u know? Pepsi invested in India when the Indian policies were not so liberal, consenting to many Indian conditions imposed on Pepsi. It did so only because here it wouldn't have to face competition from its arch rival Coca Cola.

Level of rivalry also decides the FDI. If all the above mentioned reasons are favorable to attract FDI even after that ultimately it is the Firms strategy which decides that whether it will invest in a most attractive destination or not. Few organizations are very aggressive in grabbing overseas investment opportunity on the other hand few are reluctant and follow a policy of wait and watch.

Task Give examples to show how demand and supply conditions in a country affect level of FDI in a country.

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Self Assessment

State whether the following statements are true or false:

7. A new software firm would prefer to set up its Application software research centre in a developing country like India.
8. China and India are likely to receive high FDI in future as they have high purchasing power parity.
9. Infrastructure of a country plays a critical role in a selection of site of a company.
10. Organizations like to invest in countries where there is a stiff competition.

6.5 Costs and Benefits Associated with FDI

Costs and benefits associated with FDI can be discussed from two point-of-views: host country's point-of-view and home country's point-of-view.

6.5.1 Benefits to the Host Country

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

Resource-transfer Effects

FDI can make a positive contribution to a host economy by supplying capital, technology, and management resources that would otherwise not be available and thus boost that country's economic growth rate.

Many MNEs, by virtue of their large size and financial strength, have access to financial resources not available to host-country firms. These funds may be available from internal company resources, or because of their reputation, large MNEs may find it easier to borrow money from capital markets that host-country firms would.

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

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

Employment Effects

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

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Example: When Toyota opened a new auto plant in France in 1997, estimates suggested the plant would create 2,000 direct jobs and perhaps another 2,000 jobs in support industries.

Balance-of-Payments Effect

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

Second, if the FDI is a substitute for imports of goods or services, it can improve the current account of the host country's balance of payments.

Example: Much of the FDI by Japanese automobile companies in the United States and United Kingdom, for example can be seen as substituting for imports from Japan.

A third potential benefit to the host country's balance-of –payments position arises when the MNE uses a foreign subsidiary to export goods and services to other countries.

Effect on Competition and Economic Growth

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

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

6.5.2 Costs of FDI to Host Countries

Three costs of FDI concern host countries: (i) possible adverse effects on competition within the host nation, (ii) adverse effects on the balance of payments, and (iii) the perceived loss of national sovereignty and autonomy.

Possible Adverse Effects on Competition within the Host Nation

Host governments worry that the subsidiaries of foreign MNEs may have greater economic power than indigenous competitors. It is a part of a larger international organization, the foreign MNE may be able to draw on funds generated elsewhere to subsidize its costs in the host market, which could drive indigenous companies out of business and allow the firm to monopolize the market. This concern tends to be greater in countries that have few large firms of their own (generally less developed countries). It tends to be relatively minor concern in most advanced industrialized nations.

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Adverse Effects on the Balance of Payments

There are two main areas of concern with regard to the balance of payments. First, the initial capital inflow that comes with FDI must be the subsequent outflow of earnings from the foreign subsidiary to its parent company. Such outflows show up as a debit on the capital account. Some governments have responded to such outflows by restricting the amount of earnings that can be repatriated to a foreign subsidiary's home country.

A second concern arises when a foreign subsidiary imports a substantial number of its inputs from abroad, which results in a debit on the current account of the host country's balance of payments.

Perceived Loss of National Sovereignty and Autonomy

Many host governments worry that FDI is accompanied by some loss of economic independence. The concern is that key decisions that can affect the host country's economy will be made by a foreign parent that has no real commitment to the host country and over which the host country's government has no real control.

6.5.3 Benefits and Costs of FDI to Home Countries

FDI also produces costs and benefits to the home (or source) country.

Benefits of FDI to the Home Country

The benefits of FDI to the home country arise from three sources. First, the capital account of the home country's balance-of-payments benefits from the inward flow of foreign earnings FDI can also benefit the current account of the home country's balance of payments if the foreign subsidiary created demands for home country exports of capital equipment, intermediate goods, complementary products, and the like.

Second, benefits to the home country from outward FDI arise from employment effects. As with the balance of payments, positive employment effects arise when the foreign subsidiary creates demand for home-country exports of capital equipment, intermediate goods, complementary products, and the like.

Example: Toyota's investment in auto assembly operations in Europe has benefited both the Japanese balance-of-payments position and employment in Japan because Toyota imports some component parts for its European-based auto assembly operations directly from Japan.

Third, benefits arise when the home-country MNE learns valuable skills from its exposure to foreign markets that can be transferred back to home country. This amounts to a reverse resource-transfer effect. Through its exposure to a foreign market, an MNE can learn about superior management techniques and superior products and process techniques. These resources can then be transferred back to the home country, contributing to the home country's economic growth rate.

Costs of FDI to the Home Country

Against these benefits there are apparent costs of FDI for the home (source) country. The most important concerns center around the balance-of-payments and employment effects of outward FDI. The home country's balance of payments may suffer in three ways. First, the capital account of the balance of the payments suffers from the initial capital outflow required to finance the

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FDI. This effect, however, is usually more than offset by the subsequent inflow of foreign earnings. Second, the current account of the balance of payments suffers if the purpose of the foreign investment is to serve the home market from a low-cost production location. Third, the current account of the balance of payments suffers if the FDI is a substitute for direct exports.

With regard to employment effects, the most serious concerns arise when FDI is seen as a substitute for domestic production.

Self Assessment

Fill in the blanks:

11. Technology can be incorporated in a production process or it can be incorporated in a .....
12. Increased ..... tends to stimulate capital investments by firms in plant, equipment, and R&D.
13. With regard to employment effects, the most serious concerns arise when FDI is seen as a substitute for ..... in the home country.

6.6 Trends in FDI

Indian has been attracting foreign direct investment for a long period. The sectors like telecommunication, construction activities and computer software and hardware have been the major sectors for FDI inflows in India.

According to AT Kearney report India sits in 3rd place on the FDI Confidence Index globally. European and North American investors place it 3rd, while Asia-Pacific investors' rank it 4th. India is the top location for nonfinancial services investment, and also scores highly in heavy industries, light industries and financial services. Even during economic crisis looming largely on other economies, FDI inflows to India soared from US$25.1billion in 2007 to US$41.6billion in 2008.

Multinationals are managing to counter FDI restrictions and supply chain challenges at the most possible way showing path to others who are hesitant to enter into Indian market. For instance, Wal-Mart has taken steps to develop supply chains, procure 30-35 per cent local produce, making changes to its stock policy by reducing inventories etc. Similarly, Auto majors are pumping money in the sector. Ford planned to invest US $500mn in its Chennai plant, Nissan-Renault planning to manufacture ultra-low-cost car with its local partner Bajaj Auto, French tyre maker Michelin's to invest US$874mn in its first Indian manufacturing facility. All these developments are helping in getting FDI inflows into the country.

The measures introduced by the government to liberalize provisions relating to FDI in 1991 lure investors from every corner of the world. As a result FDI inflows during 1991-92 to March 2010 in India increased manifold as compared to during mid-1948 to March 1990. As per the fact sheet on FDI, there was ₹ 6,303.36 billion FDI equity inflows between the period of August 1991 to January 2011.

The FDI inflows in India during mid-1948 were ₹ 2.56 billion. It is almost double in March 1964 and increases further to ₹ 9.16 billion. India received a cumulative FDI inflow of ₹ 53.84 billion during mid-1948 to march 1990 as compared to ₹ 1,418.64 billion during August 1991 to march 2010.

An annual FDI inflow indicates that FDI went up from around negligible amounts in 1991-92 to around US$9 billion in 2006-07. It then hiked to around US$22 billion in 2007-08, rising to around US$37 billion by 2009-10.

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Table 6.1: FDI Flow in India (in Crores)

Years	FDI inflows in India
1991-92	409
1992-93	1094
1993-94	2018
1994-95	4312
1995-96	6916
1996-97	9654
1997-98	13548
1998-99	12343
1999-00	10311
2000-01	10368
2001-02	18486
2002-03	13711
2003-04	11789
2004-05	14653
2005-06	24613
2006-07	70630
2007-08	98664
2008-09	123025

Source: Various issues of SIA Bulletin.

Even if we examine quarterly figures, we find that FDI flows that rose from US$6.9 billion in the second quarter of 2009 to a peak of US$8.2 billion in the third quarter of that year, have since stayed in the 5-6 billion range for all but one quarter, namely January-March 2011. In fact, if we consider the 16 quarters ending Jan-March 2011, there have been only two in which FDI inflows stood at between US$6-7 billion and four when it exceeded US$7 billion.

It is now clear that FDI was related to the recessionary conditions in the western economies. The recent flattening of monthly FDI flows is a sign more of recovery in the western economies than any loss of long term interest in the Indian economy. The monthly figure only shows that the incremental FDI is going back to the pre-recession years rather than indicating decline of FDI into India.

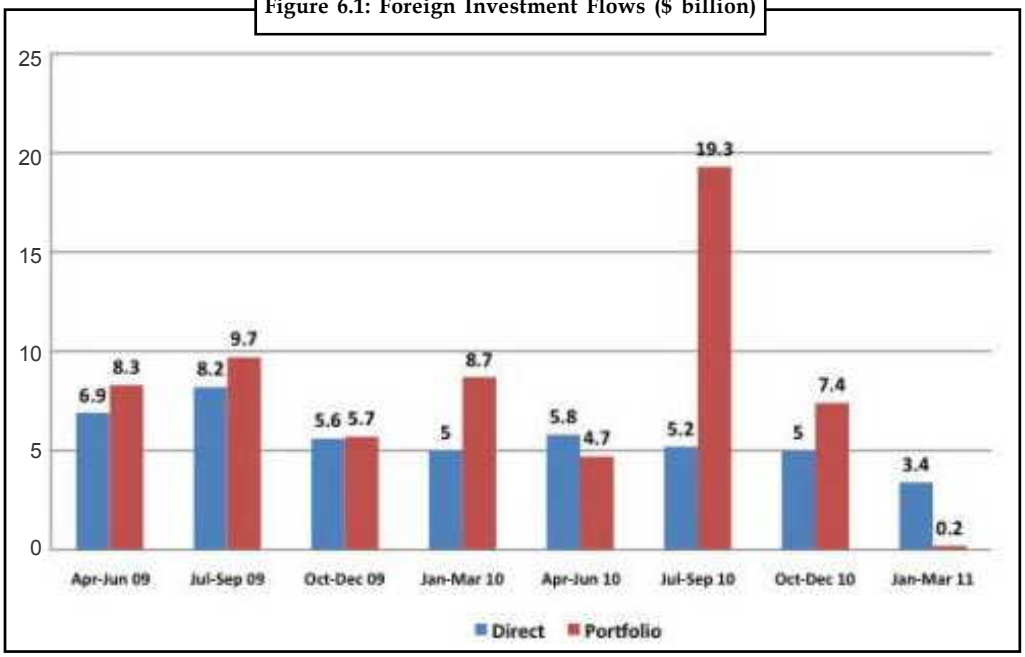
In fact when foreign direct investment into India had "tumbled 32 per cent to just US$3.4 billion", as mentioned in financial times during January to March 2011 that it emerged that net FDI flows in the month of April alone amounted to US$3.1 billion.

Also, FDI is all about long term investment. Companies have already invested in to India and are unlikely to move elsewhere. Unless any dramatic negative changes in policy, FDI will continue to inch upwards.

Recent trends have also shown that FDI inflow changes are mainly due to portfolio investment, which displayed a degree of volatility.

Notes

Figure 6.1: Foreign Investment Flows ($ billion)



Source of FDI: The list of investing countries to India reached to maximum number of 120 in 2008 as compared to 15 in 1991. Although, India is receiving FDI inflows from a number of sources but large percentage of FDI inflows is vested with few major countries.

Mauritius is the major investing country in India during 1991-2008. Nearly 40per cent of FDI inflows came from Mauritius alone. The other major investing countries are USA, Singapore, UK, Netherlands, Japan, Germany, Cypress, France and Switzerland. An analysis of last eighteen years of FDI inflows in the country shows that nearly 66per cent of FDI inflows came from only five countries viz. Mauritius, USA, Singapore, UK, and Netherlands.

Mauritius and United states are the two major countries holding first and the second position in the investor's list of FDI in India. While comparing the investment made by both countries, one interesting fact comes up which shows that there is huge difference in the volume of FDI received from Mauritius and the US. It is found that FDI inflows from Mauritius are more than double from that of US.

Top 10 FDI investing countries in India are Mauritius, Singapore, United States, UK, Netherlands, Japan, Cyprus, Germany, France and UAE.

Notes

Table 6.2: Share of Top Investing Countries FDI Equity Inflows

Amount Rupees in crores (US$ in millior

Ranks	Country	2009-10 (April-March)	2010-11 (April-March)	2011-12 (for April 2011)	Cumulative Inflows (April '00 - April '11)	%age to total Inflows (in terms of US $)
1.	MAURITIUS	49,633 (10,376)	31,855 (6,987)	4,332 (976)	247,092 (55,203)	42 %
2.	SINGAPORE	11,295 (2,379)	7,730 (1,705)	5,214 (1,175)	58,090 (13,070)	10 %
3.	U.S.A.	9,230 (1,943)	5,353 (1,170)	356 (80)	42,898 (9,529)	7 %
4.	U.K.	3,094 (657)	3,434 (755)	19 (4)	29,451 (6,643)	5 %
5.	NETHERLANDS	4,283 (899)	5,501 (1,213)	172 (39)	25,799 (5,739)	4 %
6.	JAPAN	5,670 (1,183)	7,063 (1,562)	1,043 (235)	25,001 (5,511)	4 %
7.	CYPRUS	7,728 (1,627)	4,171 (913)	754 (170)	22,702 (4,982)	4 %
8.	GERMANY	2,980 (626)	908 (200)	231 (52)	13,607 (3,051)	2 %
9	FRANCE	1,437 (303)	3,349 (734)	977 (220)	11,244 (2,484)	2 %
10.	U.A.E.	3,017 (629)	1,569 (341)	91 (21)	8,683 (1,910)	1 %
TOTAL FDI INFLOWS *		123,120 (25,834)	88,520 (19,427)	13,846 (3,121)	594,569 (132,837)	-

Note: *(i) *Includes inflows under NRI Schemes of RBI.*
(ii) Cumulative country-wise FDI equity inflows (from April 2000 to April 2011) – Annex-'A'.
(iii) %age worked out in US$ terms & FDI inflows received through FIPB/SIA+ RBI's Automatic Route+ acquisiti existing shares only.

FDI-sectoral analysis: FDI inflows are welcomed currently in 63 sectors as compared to 16 sectors in 1991. The sectors receiving the largest share of FDI inflows up to 2010 were the service sector and computer software and hardware sectors, each accounting for 22.14 per cent and 9.48 per cent respectively. There were followed by the telecom, real estate, construction and automobile sectors. The top sectors attracting FDI into India via M&A activity were manufacturing, information; and professional, scientific and technical services.

- Infrastructure sector received 28.62% of total FDI inflows from 1991-2008
- Services sector received 19.34% of total FDI inflows from 1991-2008.
- Trading sector received 1.67% of total FDI inflows from 1991-2008.
- Consultancy Sector received 1.14% of total inflows from 2000-2008
- Education sector received US $308.28 million of FDI inflows from 2004-2008.
- Housing and Real Estate Sector accounts for 5.78% of total FDI inflows during 2000-2008.
- Construction Activities Sector received 6.15% of the total inflows during 2000 to Dec. 2008.
- Automobile Industry received US $3.2 billion of total FDI inflows to the country during 2000 to 2008.
- Computer Software and Hardware sector received US $8.9 billion of total FDI inflows during 2000 to Dec. 2007.
- Telecommunications Sector received an inflow of US $8.2 billion during 1991 to 2008.

Notes

Table 6.3: Sector Specific FDI Inflow

Amount inRs. crores (US$ in million)

Ranks	Sector	2009-10 (April-March)	2010-11 (April-March)	2011-12 (for April 2011)	Cumulative Inflows (April '00 - April '11)	% age to total Inflows (In terms of US$)
1.	SERVICES SECTOR (financial & non-financial)	20,776 (4,353)	15,539 (3,403)	2,922 (658)	123,706 (27,668)	21 %
2.	COMPUTER SOFTWARE & HARDWARE	4,351 (919)	3,571 (784)	425 (96)	48,135 (10,821)	8 %
3.	TELECOMMUNICATIONS (radio paging, cellular mobile, basic telephone services)	12,338 (2,554)	7,546 (1,665)	205 (46)	48,313 (10,611)	8 %
4.	HOUSING & REAL ESTATE	13,586 (2,844)	5,149 (1,127)	167 (38)	43,288 (9,655)	7 %
5.	CONSTRUCTION ACTIVITIES (including roads & highways)	13,516 (2,862)	5,077 (1,125)	1,381 (311)	42,160 (9,491)	7 %
6.	AUTOMOBILE INDUSTRY	5,754 (1,208)	6,008 (1,331)	1,182 (266)	28,037 (6,199)	5 %
7.	POWER	6,908 (1,437)	5,709 (1,252)	1,136 (256)	27,848 (6,156)	5 %
8.	METALLURGICAL INDUSTRIES	1,935 (407)	5,055 (1,105)	229 (52)	18,724 (4,286)	3 %
9.	PETROLEUM & NATURAL GAS	1,328 (272)	2,621 (574)	28 (6)	13,763 (3,159)	2 %
10.	CHEMICALS (other than fertilizers)	1,707 (362)	1,810 (398)	152 (34)	13,234 (2,927)	2 %

Table 6.4: Sector Specific FDI Policy

Sr. No.	Sector/Activity	FDI cap/Equity	Entry/Route
1.	Hotel & Tourism	100%	Automatic
2.	NBFC	49%	Automatic
3.	Insurance	26%	Automatic
4.	***Telecommunication:*** cellular, value added services ISPs with gateways, radio-paging Electronic Mail & Voice Mail	 49% 74% 100%	Automatic Above 49% need Govt. licence
5.	***Trading companies:*** primarily export activities bulk imports, cash and carry wholesale trading	 51% 100%	 Automatic Automatic
6.	Power(other than atomic reactor power plants)	100%	Automatic
7.	Drugs & Pharmaceuticals	100%	Automatic
8.	Roads, Highways, Ports and Harbors	100%	Automatic
9.	Pollution Control and Management	100%	Automatic
10	Call Centers	100%	Automatic

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Notes

11.	BPO	100%	Automatic
12.	***For NRI's and OCB's:*** i. 34 High Priority Industry Groups ii. Export Trading Companies iii. Hotels and Tourism-related Projects iv. Hospitals, Diagnostic	100%	Automatic

Task Find out the following FDI related statistics for the year 2011:

- The total amount of FDI
- Which country made maximum FDI?
- Which country received maximum FDI?
- Which sector received maximum FDI in India?

FDI in India

Multinational companies are a part of the Indian economy since the British period either as a wholly owned subsidiary or as a joint venture. They played a critical role in the development of the automobile industry, two wheeler industry, mining, petroleum, FMCG, etc. But after independence, because of government policies some like Coca Cola, IBM, etc., left the country.

Flow of substantial foreign investment began in India in the 1980s. At that time Suzuki entered India with a joint venture with the Indian Government. The then Prime Minister Rajiv Gandhi initiated the reforms and allowed FDI in certain cases and because of these liberal policies Pepsi was able to entered India.

Case Study

Foreign Direct Investment in India's Single and Multi-brand Retail

As India has liberalized its single brand retail industry to permit 100 percent foreign investment, we take a look at the regulatory issues and legal structures pertinent to establishing operations in this new dynamic market. That India should be well on the radar for foreign retailers was recently supported by A.T. Kearney, whose 2011 Global Retail Development Index ranks the nation as fourth globally.

India's retail industry is estimated to be worth approximately US$411.28 billion and is still growing, expected to reach US$804.06 billion in 2015. As part of the economic liberalization process set in place by the Industrial Policy of 1991, the Indian government has opened the retail sector to FDI slowly through a series of steps:

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Notes

1995

- World Trade Organization's General Agreement on Trade in Services, which includes both wholesale and retailing services, came into effect

1997

- FDI in cash and carry (wholesale) with 100 percent rights allowed under the government approval route

2006

- FDI in cash and carry (wholesale) brought under the automatic route
- Up to 51 percent investment in a single-brand retail outlet permitted, subject to Press Note 3 (2006 Series)

2011

- 100 percent FDI in single-brand retail permitted

The Indian government removed the 51 percent cap on FDI into single-brand retail outlets in December 2011, and opened the market fully to foreign investors by permitting 100 percent foreign investment in this area.

It has also made some, albeit limited, progress in allowing multi-brand retailing, which has so far been prohibited in India. At present, this is restricted to 49 percent foreign equity participation. The specter of large supermarket brands displacing traditional Indian mom-and-pop stores is a hot political issue in India, and the progress and development of the newly liberalized single-brand retail industry will be watched with some keen eyes as concerns further possible liberalization in the multi-brand sector.

In this article, we discuss the policy developments for FDI in these two retail categories, with a focus on the details of the multi-brand retail FDI discussion paper and related policy developments.

FDI in "single-brand" retail

While the precise meaning of single-brand retail has not been clearly defined in any Indian government circular or notification, single-brand retail generally refers to the selling of goods under a single brand name.

Up to 100 percent FDI is permissible in single-brand retail, subject to the Foreign Investment Promotion Board (FIPB) sanctions and conditions mentioned in Press Note 3[8]. These conditions stipulate that:

1. Only single-brand products are sold (i.e. sale of multi-brand goods is not allowed, even if produced by the same manufacturer)
2. Products are sold under the same brand internationally
3. Single-brand products include only those identified during manufacturing
4. Any additional product categories to be sold under single-brand retail must first receive additional government approval

FDI in single-brand retail implies that a retail store with foreign investment can only sell one brand. For example, if Adidas were to obtain permission to retail its flagship brand in India, those retail outlets could only sell products under the Adidas brand. For Adidas to sell products under the Reebok brand, which it owns, separate government permission is required and (if permission is granted) Reebok products must then be sold in separate retail outlets.

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FDI in "multi-brand" retail

While the government of India has also not clearly defined the term "multi-brand retail," FDI in multi-brand retail generally refers to selling multiple brands under one roof. Currently, this sector is limited to a maximum of 49 percent foreign equity participation.

In July 2010, the Department of Industrial Policy and Promotion (DIPP) and the Ministry of Commerce circulated a discussion paper on allowing FDI in multi-brand retail. The Committee of Secretaries, led by Cabinet Secretary Ajit Seth, recommended opening the retail sector for FDI with a 51 percent cap on FDI, minimum investment of US$100 million and a mandatory 50 percent capital reinvestment into backend operations. Notably, the paper does not put forward any upper limit on FDI in multi-brand retail.

Immediately following the release of this discussion paper, the shares of a number of retail companies in India grew; domestic retail giant, Pantaloon Retail gained 7 percent on the same day, while Shoppers Stop, an Indian department store chain and emerging retailer, gained 2.9 percent.

The long-awaited scheme has been sent to the Cabinet for approval, but no decision has yet been made. There appears to be a broad consensus within the Committee of Secretaries that a 51 percent cap on FDI in multi-brand retail is acceptable. Meanwhile the Department of Consumer Affairs has supported the case for a 49 percent cap and the Small and Medium Enterprises Ministry has said the government should limit FDI in multi-brand retail to 18 percent. In terms of location, the proposed scheme allows investment in towns with populations of at least 10 lakh (1 million), while retailers with large space requirements may also be allowed to open shop within a 10 kilometer radius of such cities.

Our view is that while we do expect further liberalization towards foreign investment in the multi-brand sector, this is highly unlikely to be gazetted until after the next elections, due to be completed towards the end of 2012. Any additional liberalization of this market will therefore depend on the political make-up of the next government.

Government "safety valves" on FDI

There is concern about the competition presented to domestic competitors and the monopolization of the domestic market by large international retail giants. The Indian government feels that FDI in multi-brand retailing must be dealt with cautiously, given the large potential scale and social impact.

As such, the government is considering safety valves for calibrating FDI in the sector. For example:

- A stipulated percentage of FDI in the sector could be required to be spent on building back-end infrastructure, logistics or agro-processing units in order to ensure that the foreign investors make a genuine contribution to the development of infrastructure and logistics.
- At least 50 percent of the jobs in the retail outlet could be reserved for rural youth and a certain amount of farm produce could be required to be procured from poor farmers.
- A minimum percentage of manufactured products could be required to be sourced from the SME sector in India.
- To ensure that the public distribution system and the Indian food security system, is not weakened, the government may reserve the right to procure a certain amount of food grains.

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- To protect the interest of small retailers, an exclusive regulatory framework to ensure that the retailing giants do not resort to predatory pricing or acquire monopolistic tendencies.

Benefits of FDI in multi-brand retail

Soaring inflation is one of the driving motives behind this move towards multi-brand retail. Allowing international retailers such as Wal-Mart and Carrefour, which have already set up wholesale operations in the country, to set up multi-brand retails stores will assist in keeping food and commodity prices under control. Moreover, industry experts feel allowing FDI will cut waste, as big players will build backend infrastructure. FDI in multi-brand retail would also help narrow the current account deficit.

Additional benefits include moving away from an industry focus on intermediaries and job creation.

Moving away from intermediary-only benefits

There is broad agreement on the need to improve efficiencies in the household trade of consumer goods. Competent management practices and economies of scale, joined with the acceptance of global best practices and modern technology, could immensely recover systemic competence.

Like their foreign counterparts, Indian customers are entitled to receive quality products, produced, processed and handled under a hygienic environment through professionally-managed outlets. Speculative apprehensions that small retailers will be adversely affected are not reason enough to deny millions of consumers access to products that meet global standards.

Furthermore, today's intermediaries amid producers and customers add no value to the products, adding hugely to final costs instead. By the time products filter through various intermediaries and into the marketplace, they lose freshness and quality, and often go to waste. However, intermediaries garner huge profits by distributing these losses between producers and customers by buying products at low prices from producers, but selling at extremely marked-up prices to consumers. In an unbalanced system that incorporates multiple intermediaries simply for logistics, only intermediaries benefit.

With organized retail, every intermediate step – procurement, processing, transport and delivery – adds value to the product. This happens because it uses international best practices and modern technology, ensuring maximum efficiency and minimum waste. Organized retail enables on-site processing, scientific handling and quick transport through cold storage chains to the final consumer. Once modern retailers introduce an organized model, other vendors, including small retailers, would mechanically copy this model to improve efficiencies, boost margins and stay in business. Organized retail would thereby bring more stability to prices, unlike the present system where hoarding and artificial shortages by profiteering intermediaries push up product prices.

Job creation

Despite predictions from some analysts that millions of jobs would be lost due to FDI in retail, it may in fact be the other way around. With the entry of branded retailers, the market will increase, creating additional employment in retail and other tertiary sectors. Given their professional approach, organized retailers will allot some quantity of resources towards the training and development of the resources they employ.

This effect of branded retailing can already be seen with the Bharti-Wal-Mart collaboration, which has joined forces with state governments to open training and development centers

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in Amritsar, Delhi and Bangalore, preparing local youth for jobs in retail. Training is entirely free and more than 5,600 local youth have already been trained. Retail jobs don't require higher education or highly specialized abilities.

No threat to kiranas (mom-and-pop stores)

The Indian retail industry is generally divided into organized and unorganized retailing:

Organized retailing

Organized retailing refers to trading activities undertaken by licensed retailers, those who have registered for sales tax, income tax, etc. These include corporate-backed hypermarkets and retail chains, and also privately-owned large retail businesses.

Unorganized retailing

Unorganized retailing refers to the traditional forms of low-cost retailing, for example, local kirana shops, owner-operated general stores, paan/beedi shops, convenience stores, hand cart and street vendors, etc.

The question of whether or not organized and unorganized retailing can peacefully co-exist is a primary concern. While the Indian retail sector is still heavily weighted towards unorganized retailers, which occupy 97 percent of the market, organized retail is growing quickly. But with a mere 7 percent of the market, organized retailers are unlikely to drive kiranas (local grocery stores) out of business. Indian retailers simply lack the deep pockets and in-depth field expertise required to be on a par with global models. However, the presence of foreign retailers through joint ventures and other means could speed up the process of transforming India's retail trade. Considering that small stores offer customers quick doorstep delivery and even credit extensions – conveniences that no organized retailer in India has so far matched – local, unorganized retailers will likely retain a sizeable market share.

The example of China demonstrates clearly that increased FDI in retailing does not necessitate the complete closure of local retailers. China first allowed FDI in retail in 1992, capping it at 26 percent, while India capped FDI in single-brand retail at 26 percent. Only in 2004 did China finally permit 100 percent FDI and local Chinese grocery stores have since grown from 1.9 million to more than 2.5 million. Organized retail has just 20 percent market penetration in China, despite a 20 year lapse since the initial introduction of FDI.

According to the proposed state regulations, the minimum FDI would be US$100 million and retail stores would only be allowed in cities with more than one million people. Front-end operations would be allowed only in states that agree to authorize FDI in multi-brand retail. It will also be mandatory for retailers to source at least 30 percent of the value of manufactured goods, barring food products, from small and medium-sized, local enterprises.

Such terms will serve as ample safeguards for small retailers. Farmers and small producers will benefit in the long run from better prices for their products and produce, while consumers receive higher quality products at lower prices, along with better service.

The advantages outweigh the disadvantages of allowing unrestrained FDI in the retail sector, as successful experiments in countries like Thailand and China demonstrate. In both countries, the issue of allowing FDI in the retail sector was first met with incessant protests, but allowing such FDI led to GDP growth and a rise in the level of employment.

Moreover, in the fierce battle between the advocates and opponents of unrestrained FDI flows in the Indian retail sector, the impact of the consumer on the outcome of these policy

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changes has been largely disregarded. Consumers will ultimately respond to the incentives of convenience, price, variety and service. Thus, the interests of those in the unorganized retail sector will not be gravely undermined; rather, the choice to visit a mega shopping complex or a small retailer/sabjimandi is purely left to the consumer, whose tastes are complex and constantly changing.

Questions

1. How will FDI in retail help the Indian organised retail?
2. Will FDI in organised retail affect the unorganized retails sector in India?

Source: India Briefing/February, 2012

Self Assessment

Fill in the blanks:

14. The ..... of FDI refers to the amount of FDI undertaken over a given time period (normally a year).
15. The ..... of FDI refers to the total accumulation of foreign owned assets at a given time.
16. In India, FDI was opened in the true sense in the year ..... post liberalisation.

6.7 Summary

- Foreign direct investment occurs when a firm invests directly in facilities to produce a product in a foreign country. It also occurs when a firm buys an existing enterprise in a foreign country.
- Liberalization is not the sole reason to attract FDI. There are many other determinant of FDI, India may lagging there like demand conditions, factor conditions, supporting industries and firm strategy.
- The benefits of FDI to a host country arise from resource-transfer effects, employment effects, balance of payments effects, and its ability to promote competition.
- The costs of FDI to a host country include adverse effects on competition and balance of payments and a perceived loss of national sovereignty.
- The benefits of FDI to the home (source) country include improvement in the balance of payments as a result of the inward flow of foreign earnings, positive employment effects when the foreign subsidiary creates demand for home country exports and benefits from a reverse resource-transfer effect. A reverse resource-transfer effect arises when the foreign subsidiary learns valuable skills abroad that can be transferred back to the home country.
- The costs of FDI to the home country include adverse balance-of-payments effects that arise from the initial capital outflow and from the export substitution effects of FDI. Costs also arise when FDI exports jobs abroad.
- Governments of developing nations are attracting FDI along with the technology and management skills that accompany it. To attract multinational companies, governments are offering tax holidays, import duty exemption, subsidised land and power and many other incentives.

Notes

- Multinational companies are a part of the Indian economy since the British period either as a wholly owned subsidiary or as a joint venture. They played a critical role in the development of the automobile industry, two wheeler industry, mining, petroleum, FMCG, etc.
- The automatic route for FDI and/or technology collaboration is not available to those who have or had any previous joint venture or technology transfer/trademark agreement in the same or allied field in India.

6.8 Keywords

Balance of payments: The difference between the payments made to foreign nations and the receipts from foreign nations in a given period.

Current account deficit: It is when a country's government, businesses and individuals imports more goods, services and capital than it exports.

Flow of FDI: It refers to the amount of FDI undertaken over a given time period (normally a year).

***FDI*:** Investment made by an investor of one country to acquire an asset in another country.

GDP: The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis.

Liberalisation: The removal of or reduction in the trade practices that thwart free flow of goods and services from one nation to another.

Portfolio investment: The purchasing of assets in the stock market of another country.

Stock of FDI: It refers to the total accumulation of foreign owned assets at a given time.

6.9 Review Questions

1. Describe the concept of FDI.
2. Discuss the Internalisation Theory and its implications.
3. "Liberalization is not the sole reason to attract FDI." Do you agree? Why or why not?
4. Explain Porter's Diamond in context of FDI.
5. Discuss the factors that determine the inflow of FDI in a country.
6. "The objective of the country as a whole was the attainment as far as possible, of national sufficiency. International trade was certainly to be included but we were anxious to avoid being drawn into the whirlpool of economic imperialism." What do you mean by the statement?
7. How can FDI make positive contributions to the host and the home country?
8. "FDI is accompanied by some loss of economic independence." Explain
9. Do you think that FDI holds the key to growth of certain sectors of developing and under-developed countries like India? Give reasons to explain your answer.
10. Critically analyse the FDI policies of the Indian Government before 1991.
11. Evaluate the inflow of FDI in India in recent years.

Notes

Answers: Self Assessment

1.	True	2.	True
3.	(d)	4.	(c)
5.	(b)	6.	(a)
7.	False	8.	True
9.	True	10.	False
11.	Product	12.	Competition
13.	Domestic production	14.	Flow
15.	Stock	16.	1991

6.10 Further Readings

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Unit 7: Globalisation

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Objectives

After studying this unit, you should be able to:

- Realise the trends in the emerging global economy
- Identify the drivers of globalisation
- Describe the concept of 'globalisation of markets'
- Discuss the policy issues in globalisation
- Know the extent of globalisation in India

Introduction

A fundamental shift is occurring in the World economy. We are rapidly moving from a world in which national economies were relatively self contained entities, isolated from each other by barriers to cross border trade and investment; by distance, time zones, and language and by national differences in Govt., regulation, culture and business systems –And we are moving towards a world in which barriers to cross- border trade and investment are tumbling, perceived distance is shrinking due to advances in transportation and telecommunication technology, material culture is starting to look similar the world over and national economies are merging into an inter dependent global economic system. The process by which this is happening is currently reported as globalisation.

International Monetary Fund defines Globalisation as "*the growing interdependence of countries worldwide through increasing volume and variety of cross border transactions in goods and services and of international capital flows and also through the more rapid and wide spread diffusion of technology*".

Charles U.L. Hill defines globalisation as "*The shift towards a more integrated and interdependent World Economy. Globalisation has two main components-the globalisation of markets and Globalisation of production.*"

Interdependence and integration of individual countries of the World may be called as Globalisation. Thus, globalisation integrates not only economies but also societies.

Notes

7.1 Emerging Global Economy

The decades of the 1980s and 1990s brought transitions in the political, economic, technological, and environmental arenas. Some of these changes continue to reshape our work and non-work lives, much as the early Industrial Revolution did during the mid-1800s. This revolution is fuelling increased globalisation.

Globalisation has made a big world smaller. Globalisation affects trade, finance, production, communications, and technological change. When we look at the world map, we need to think about how this global community of people and nations is being systematically drawn closer together.

Example: At Distributed Service Systems, a small full-service computer company located in Reading, Pennsylvania, a technical consultant sits at a terminal and solves assembly line production problems at Carpenter Technology steel plants in India, China, Mexico, and Taiwan. At the same time, a major U.S. global manufacturer in Green Bay, Wisconsin, has a small staff of foreign currency traders working twenty-four hours a day to manage the firm's global financial needs and resources.

Since 1980, world exports (goods leaving a country) have increased 194 per cent, and U.S. imports (goods coming into the country) have more than tripled. In 1980, total U.S. trade equalled 9 per cent of Gross Domestic Product (GDP), and Gross National Product (GNP), both of which measure the annual output of goods and services; in 2004, it amounted to 26 per cent. Nations have found it cheaper and more efficient to trade more with each other than to produce all their products at home.

The last quarter of century has seen rapid changes in the global economy. Barriers to the free flow of goods, services, and capital have been coming down. The volume of cross-border trade and investment has been growing more rapidly than global output, indicating that national economies are becoming more closely integrated into a single, interdependent, global economic system.

The move toward a global economy has been further strengthened by the widespread adoption of liberal economic policies by countries that for two generations or more were firmly opposed to them. Country after country, we are seeing state-owned businesses privatized, widespread deregulation, markets being opened to more competition, and increased commitment to removing barriers to cross-border trade and investment.

Did u know? This suggests that over the next few decades, countries such as the Czech Republic, Poland, Brazil, China, and South Africa may build powerful market-oriented economies.

In short, current trends indicate that the world is moving rapidly toward an economic system that is more favourable for the practice of international business.

Greater globalisation brings with it risks of its own. This was starkly demonstrated in 1997 and 1998 when a financial crisis in Thailand spread first to other East Asian nations and then in 1998 to Russia and Brazil. Ultimately, the crisis threatened to plunge the economies of the developed world, including the United States into a recession.

BRICS

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BRICS is the title of an association of leading emerging economies, arising out of the inclusion of South Africa into the BRIC group in 2010. As of 2012, the group's five members are Brazil, Russia, India, China and South Africa. With the possible exception of Russia, the BRICS members are all developing or newly industrialised countries, but they are distinguished by their large, fast-growing economies and significant influence on regional and global affairs. As of 2012, the five BRICS countries represent almost 3 billion people, with a combined nominal GDP of US$13.7 trillion, and an estimated US$4 trillion in combined foreign reserves. Presently, India holds the chair of the BRICS group.

President of the People's Republic of China Hu Jintao has described the BRICS countries as defenders and promoters of developing countries and a force for world peace. However, some analysts have highlighted potential divisions and weaknesses in the grouping, such as India and China's disagreements over Tibetan and border issues, the failure of the BRICS to establish a World Bank-analogue development agency, and disputes between the members over UN Security Council reform.

The grouping has held annual summits since 2009, with member countries taking turns to host. Prior to South Africa's admission, two BRIC summits were held, in 2009 and 2010. The first five-member BRICS summit was held in 2011. The most recent summit took place in New Delhi, India, on March 29, 2012.

Table 7.1

Summit	Participants	Date	Host Country	Host Leader	Location
1st	BRIC	June 16, 2009	Russia	Dmitry Medvedev	Yekaterinburg
2nd	BRIC	April 16, 2010	Brazil	Luiz Inácio Lula da Silva	Brasília
3rd	BRICS	April 14, 2011	China	Hu Jintao	Sanya
4th	BRICS	March 29, 2012	India	Manmohan Singh	New Delhi
5th	BRICS	*2013*	South Africa	Jacob Zuma	*TBA*

Caselet

Hello Bangladesh

Bharti Airtel has been trying to expand its footprint overseas for the past couple of years. Bharti is planning to pick 70% stake in Warid Telecom, the fourth largest telecom operator of Bangladesh. Abu Dhabi group will hold 30% stake. Bharti will invest over $ 1 Billion in the Bangladeshi Telecom market in the coming years. Warid has operations in Uganda, Pakistan and Congo. Bharti will be the first Indian operator to enter the Bangladeshi market. In Bangladesh, it will compete against the state - run Teletalk, the Bangladesh-Singapore JV Citycell, Grameenphone (Bangladesh - Norway JV) and AKTEL (Japan Malaysia JV).

Bharti is already operating in overseas market such as Sechelles, Srilanka, and Channel Islands. The Dropping ARPU (Average Revenue Per User) forced it to further expands its footprint in new markets.

Indian Telecom market is very competitive as 13 players are competing for the share in pie and price put is the most common strategy among the player. Telecom companies are searching opportunity overseas. There are three major geographies that hold opportunity

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for ambitious Indian telecom companies - The Middle East, Africa, and South East Asia. In India, EBIDTA is high but ARPU is very low as low as ' 200. Compare this with ARPU of as high as ' 2,000 in some of other markets and it makes obvious sense for a low cost player to foray there.

The Subscriber base in Bangladesh is growing rapidly. It has increased from 2 Lakh in 2001 to more than 50 Million in 2009. The population of Bangladesh is 150 million and telecom density is very low. The subscriber base is expected to increase to 70 million by 2011. Joint Venture or Acquisition is the most viable route for overseas investment in Telecom sector. This move provides an operator with scale to negotiate with infrastructure vendors.

Indian telecom companies are considered to be most cost efficient telecom operators of the world. They have an expertise in cutting cost and offering services at lower tariffs than anywhere in the world. Applying the Low – Cost Model to higher APRUs market will maximize the returns. Bharti can leverage on the economies of scale it is operating in Indian Market. Bharti is very good at rolling out networks fast and effortlessly and have got some unique contracts and relationships that they can leverage internationally. For instance, Bharti has tied up with IBM (on the IP front) Nokia and Ericsson (for Networks).

There are many first to Indian Telecom Companies as India is the first country in the world to outsource the IT network, India is the first to start infrastructure sharing, Indian telecom players were the first to hive off their towers into separate companies. Such innovative strategies will help Bharti fight it out in the Bangladesh telecom market.

Source: *Business Environment: Text and Cases*, Dr. Vivel Mittal, Excel Books, New Delhi

Self Assessment

Fill in the blanks:

1. ..... revolution fuelled globalisation.
2. Globalisation integrates not only economies but also .....

7.2 Drivers of Globalisation

Two macro factors seem to underlie the trend toward greater globalisation. The first is the decline in barriers to the free flow of goods, services, and capital that has occurred since the end of World War II. The second factor is technological change, particularly the dramatic developments in recent years in communication, information processing, and transportation technologies.

***Declining trade and investment barriers*:** During the 1920s and 30s, many of the nation-states of the world erected formidable barriers to international trade and foreign direct investment. International trade occurs when a firm exports goods or services to consumers in another country. Foreign direct investment occurs when a firm invests resources in business activities outside its home country. Many of the barriers to international trade took the form of high tariffs on imports of manufactured goods. The typical aim of such tariffs was to protect domestic industries from foreign competition.

Having learnt from this experience, the advanced industrial nations of the West committed themselves after World War II to removing barriers to the free flow of goods, services and capital between nations. This goal was enshrined in the treaty known as the General Agreement on Tariffs and Trade (GATT). It started out in 1947 as a set of rules to ensure non-discrimination, transparent procedures, the settlement of disputes and the participation of the lesser-developed countries in international trade.

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The latest GATT negotiations, called the Uruguay Round, were initiated in 1987. Even though tariffs still were addressed in these negotiations, their importance has been greatly diminished due to the success of earlier agreements. The main thrust of negotiations had become the sharpening of dispute-settlement rules and the integration of the trade and investment areas that were outside of the GATT. After many years of often-contentious negotiations, a new accord was finally ratified in early 1995. The GATT was supplanted by a new institution, the World Trade Organisation (WTO), which now administers international trade and investment accords.

***The role of technological change*:** Microprocessors and Telecommunications: Perhaps the single most important innovation has been development of the microprocessor, which enabled the explosive growth of high-power, low-cost computing, vastly increasing the amount of information that can be processed by individuals and firms. The microprocessor also underlies many recent advances in telecommunications technology.

The Internet and the World Wide Web: The phenomenal growth of the Internet and the associated World Wide Web is the latest expression of this development.

Transportation technology: In addition to developments in communication technology, several major innovations in transportation technology have occurred since World War II. In economic terms, the most important are probably the development of commercial jet aircraft and super freighters and the introduction of containerization, which simplifies transshipment from one mode of transport to another. The advent of commercial jet travel, by reducing the time needed to get from one location to another, has effectively shrunk the globe.

Did u know? In terms of travel time, New York is now closer to Tokyo than it was to Philadelphia in the colonial days.

Self Assessment

State whether the following statements are true or false:

3. Foreign direct investment occurs when a firm invests resources in business activities outside its home country.
4. The fast changes in technology have helped in rapid globalisation.
5. World Trade Organisation now administers international trade and investment accords.

7.3 Globalisation of Markets

The globalisation of markets refers to the merging of historically distinct and separate national markets into one huge global marketplace. Falling barriers to cross-border trade have made it easier to sell internationally. It has been argued for some time that the tastes and preferences of consumers in different nations are beginning to converge on some global norm, thereby helping to create a global market.

Example: Consumer products such as Citicorp credit cards, Coca-Cola soft drinks, Sony play station, and Mc Donald's hamburgers are frequently held up as prototypical example of this trend; they are also facilitators of it. By offering a standardized product worldwide, they help to create a global market.

Despite the global prevalence of Citicorp credit cards and McDonald's hamburgers, it is important not to push too far the view that national markets are giving way to the global market. Very significant differences still exist between national markets along many relevant dimensions,

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including consumer tastes and preferences, distribution channels, culturally embedded value systems and the like. For example, automobile companies will promote different car models depending on a range of factors such as local fuel costs, income levels, traffic congestion, and cultural values.

The most global markets are not markets for consumer products – where national differences in tastes and preferences are still often important enough to act as a brake on globalisation – but markets for industrial goods and materials that serve a universal need the world over. These include the markets for commodities such as aluminum, oil and wheat; the markets for industrial products such as microprocessors, computer memory chips and commercial jet aircraft.

In many global markets, the same firms frequently confront each other as competitors in nation after nation.

Example: Coca-Cola's rivalry with Pepsi is a global one, as are the rivalries between Ford and Toyota, Boeing and Airbus, Caterpillar and Komatsu.

If one firm moves into a nation that is not currently served by its rivals, those rivals are sure to follow to prevent their competitor from gaining an advantage.

Task Name a few Indian companies that have found a stable market in foreign countries. Try to find out the details of their international business with regards to its product portfolio, revenue, major clients and reputation in foreign markets.

Transition from Domestic to International to Global Markets

After a company decides to go international, it must decide the degree of marketing involvement and commitment it is prepared to make. Generally, a domestic company enters emerge as an international company through the following stages:

1. ***No direct foreign marketing:*** A company in this stage does not actively cultivate customers outside national boundaries; however, this company's products may reach foreign marketing. Sales may be made to trading companies as well as foreign customers who come directly to the firm. Or products may reach foreign markets via domestic wholesalers or distributors who sell aboard without explicit encouragement or even knowledge of the producer. As companies develop websites on the Internet, many receive orders from international web surfers.

2. ***Infrequent foreign marketing:*** Temporary surpluses caused by variations in production levels or demand may result in infrequent marketing overseas. The surpluses are characterized by their temporary nature; therefore, sales to foreign markets are made as goods are available, with little or no intention of maintaining continuous market representation.

3. ***Regular foreign marketing:*** At this level, the firm has permanent productive capacity devoted to the production of goods to be marketed in foreign markets. A firm may employ foreign or domestic overseas middlemen to it may have its own sales force or sales subsidiaries in important foreign markets. The primary focus of operations and production is to service domestic market needs. However, as overseas demand grows, production is allocated for foreign markets.

4. ***International marketing:*** Companies in this stage are fully committed and involved in international marketing activities. Such companies seek markets all over the world and

sell products that are a result of planned production for markets in various countries. This generally entails not only the marketing but also the production of goods outside the home market. At this point, a company becomes an international or multinational marketing firm.

5. ***Global marketing:*** At the global marketing level, the most profound change is the orientation of the company toward markets and associated planning activities. At this stage, companies treat the world, including their home market, as one market. Market segmentation decisions are no longer focused on national borders. Instead, market segments are defined by income levels, usage patterns, or other factors that often span countries and regions. Often, this transition from international marketing to global marketing is catalyzed by a company's crossing the threshold of more than half its sales revenues coming from aboard.

Example: Coca Cola.

Self Assessment

Fill in the blanks:

6. Globalisation of ..... refers to the merging of historically distinct and separate national markets into one huge global marketplace.
7. The differences in taste and preferences in different markets indicate the differences in ..... in different countries.
8. At ..... level, the firm has permanent productive capacity devoted to the production of goods to be marketed in foreign markets.
9. Income levels and usage patterns are used as basis for market .....

7.4 Policy Issues

The key problems of the major institutions of global governance is that of unilateralism led by hegemons and lack of democracy in the workings and operations of these institutions - voting and representation is heavily skewed towards the hegemons. Secondly, these institutions have continued to foster policies in the old spirit and using the same methods, without taking into account the dynamising impact of the logic of globalisation which has implication for time and space compression and mobility of capital and markets.

These processes have further intensified the poverty in the global south and increased income inequalities in the global North. In particular, there has been so much arbitrariness in the operation of the World Bank and IMF and so much teleguiding of the activities of the UN and its agencies - the result of which is the Gulf crisis. All these organisations and agencies need reform in their Charters and Conventions to bring them up to date with the demands of current thinking and the democracy current gripping the world. In particular, the WTO has in many ways made it impossible for smaller countries to have leverage for their internal development with its clause on the principle of "Reciprocity". Its pronouncement on Agricultural development and indeed Third World Development has been most pernicious since the Doha Rounds, over which the major economic powers have foot dragged.

Over the years, the roles and responsibilities of international organisations have been affected seriously by national, regional and global events, as well as the defining and changing features of globalisation. On the one hand, their roles in international affairs first, after the Second World War in the 1940s and secondly after the cold war in the 1990s have increased significantly as

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globalisation and governance issues raise the bar for global problems and challenges. They however, would be best described at this time as anachronisms, organs that are more or less in danger of living out their relevance.

Presently, international organisations, particularly the multilateral organisation s, such as the United Nations Organisation, the World Bank, the International Monetary Fund and the World Trade Organisation, among others, carry with them fundamental structural deformities. They, thus face compelling operational challenges.

Caution These challenges are essentially derived from some of the following:

- *At inauguration*: The global circumstances which gave birth to the constitutive rules and consequently gave international institutions their structure of operations have changed significantly particularly since the end of the Cold War. The extant structures, therefore cannot serve effectively the present global system of organisation. At the minimum, the structures would have to be reviewed and revised to take into cognizance, the present configurations of national and regional balances and imbalances.
- *Democratic Deficits*: Engagements within international organisations can hardly be described as democratic, as issues bordering on the transparency in the decision making processes are constant. Developing countries are hard pressed to pursue their positions conclusively, as they lack the resources/capacity to do so at the expense of dominant states, which have the capacity. In the United Nations for example, the presence of a permanent Security Council with veto powers to vet decisions at the General Assembly, constitute a block of the "almighty" in an assembly of equal states. The UN operates like a huge bureaucracy, affecting its response and carrying capacity, and ultimately its output. There is disproportionate structuring of the UN such that the carrying capacity of some of its agencies, groups and individuals is more than that of others. Indeed, some offices end up carrying out the responsibility and schedule of other agencies or departments. The efficiency of the UN system is measured more by paper work than operation and real work. Proposed reforms of such should not be delayed, but pursued to their logical conclusions.
- *Global response to regional problems*: The response of international organisations to developing regions like Africa and their most pressing problems has in many cases not been adequate, and most times, it is untimely. *Early warning signals are either disregarded or totally ignored in a somewhat mindless manner.* The way and manner international organisations such as the IMF, World Bank and even the United Nations address national or regional problems in some of the continents are more of a wait-for-something-to-happen-before-we-move engagement. International mechanisms for protecting basic human rights, or even preventing wide-scale atrocities, are weak and inadequate and used sometimes arbitrary (i.e. the haste to save Kuwaitis under Iraqi occupation and the lack of enthusiasm to prevent the Rwandan Genocide or the lukewarm approach to Darfur). Therefore, what is needed, are responsive global governance institutions that meet the needs of everyone in a balance between the rights of the citizens, sovereignty of states and legitimacy of mandate.
- *Legitimacy issues*: Legitimacy is mostly linked to perception, and the issue of legitimacy is at the heart of the challenge facing many international organisations. Their failure to rise to meet certain global challenges, particularly in distraught humanitarian cases (for example Rwanda and Darfur), leads to constant suspicion and calls, questioning the very basis of their existence and their corporate legitimacy.

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- *Issues of accountability and transparency*: The case of accountability is worsened by the perceived lack of transparency in international organisations. This is made important as they assume more and more global tasks and responsibilities that go beyond the mission for which they were originally created. They thus have a greater impact on the lives of peoples and states, in ways that were not possible 20 years ago. They however, are hardly accountable to any independent institution acting on behalf of the generality of nations they represent or on whose behalf they act.
- *Enforcement of Mandates*: Enforcement powers of international organisations are severely limited, as their mandates are subject to the availability of resources to be provided by the patronizing or member states as well as their authorization. The concentration of powers in centralized distant bureaucracies with little sympathy for local cultural norms has the potential to counteract the concept of "division of powers" and the benefits of adapting methods of government to localities.

International organisations are generally prone to the duplication of projects and mission objectives. This can lead to an over concentration efforts on a single subject or agenda, at the expense of other critical areas. Environment problems are an instance of this. Perhaps more important is the fact that the current relentless push for some form of uniformity under the rubric of an imposed single market. This in turn has created a situation wherein there is increasing political, social and cultural fragmentation. In essence the world is today witnessing factionalization which in turn breeds complex frictions. From all indications, the Doha process of the WTO is more or less comatose, the IMF and the World Bank cannot be said to be at their imperial best and may become irrelevant once the Asian powers consolidate their growth and grip. Current prognosis suggests that only the United Nations might maintain any form of serious strategic relevance.

Globalisation is not based on any ethical or moral guidelines. Most of the rules and regulations guiding the global processes have been made by the developed or the heavily developed countries. They have the resources as well as control the international institutions or mechanisms of globalisation. Developing countries are therefore kowtowed into globalisation without choices.

Globalisation's Free Trade and its concomitants as promoted through international organisations like the WTO, work to the disadvantage of developing market economies. Free Trade seeks the removal of protective measures and tariffs, put in place by developing economies to protect indigenous entrepreneurs, who are not likely to survive the influx of heavily subsidised products from developed nations if they remove protective measures.

Globalisation's features have exposed inherent weaknesses by internationalising crime and battlefields. Resources used to process globalisation may also be deployed to perpetrate crimes. Ideological conflict agendas are being reinterpreted to include anywhere and everywhere. For instance, terrorists battling America, have no compulsion bombing American Embassies in Kenya and Tanzania, developing countries without the resources to deal with global terrorism.

Globalisation has facilitated an increasing growth trend for urbane centres. The attendant pressure on the existing inadequate recreational and development infrastructures adds to the environmental security and heightens the challenges to the provision of water and energy resources to the growing population. The consequence is a natural increase on violent crimes, conflicts hotspots and dysfunctional cities. These problems are magnified when the developed centres lure away professionals from poor nations to the richer nations. Globalisation facilitates this by the inequality that is accentuated in remunerations and incomes for professionals.

Globalisation promotes competitions, sometimes violent competitions and conflicts, among nations, thereby putting in place motives for regional insecurities. It also promotes emergence of global oligopolies as typified by the rash of Mergers and Acquisitions (M&A) especially in banking and extractive industries.

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Globalisation also facilitated the rise of international media houses, which monitor global events and transmit them live into people's living rooms. Much as they can use this power to drive international development processes, majority of the global media, however, chose to broadcast information that are stereotypical and tend to stigmatize peoples and their cultures.

Globalisation has transformed many countries into cultural hybrids; typified by the McDonaldisation of the world. People, especially young people, are becoming more confused in terms of their identity. And the international media is fast creating illusions of better lives in other regions. Young people are encouraged by the visions they see, to live anywhere else but home. Most times, they are willing to disregard the humiliation, hostility and unsavouriness of their host country. The import is that, another round of slavery has begun. This time, the African is actually begging to be enslaved.

Globalisation has also added to the "cultural confusion" identity crises by endorsing the superiority of one cultural origin over another. More people are seeking to have their children in Europe and America. These so-called global citizens will emerge in the world without any serious heritage, without any anchor.

Task Find out the various policy issues that India faces in its quest for globalisation.

Self Assessment

State whether the following statements are true or false:

10. WTO has in many ways made it possible for smaller countries to have leverage for their internal development with its clause on the "principle of reciprocity".
11. The efficiency of the UN system is measured more by paper work than operation and real work.
12. International organisations are generally prone to the duplication of projects and mission objectives.

7.5 Globalisation in India

The process of globalisation has been an integral part of the recent economic progress made by India. Globalisation has played a major role in export-led growth, leading to the enlargement of the job market in India.

One of the major forces of globalisation in India has been in the growth of outsourced IT and business process outsourcing (BPO) services. The last few years have seen an increase in the number of skilled professionals in India employed by both local and foreign companies to service customers in the US and Europe in particular. Taking advantage of India's lower cost but educated and English-speaking work force, and utilizing global communications technologies such as voice-over IP (VOIP), email and the internet, international enterprises have been able to lower their cost base by establishing outsourced knowledge-worker operations in India.

India opened up the economy in the early nineties following a major crisis that led by a foreign exchange crunch that dragged the economy close to defaulting on loans. The response was a slew of Domestic and external sector policy measures partly prompted by the immediate needs and partly by the demand of the multilateral organisations. The new policy regime radically pushed forward in favour of a more open and market oriented economy.

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Major measures initiated as a part of the liberalisation and globalisation strategy in the early nineties included scrapping of the industrial licensing regime, reduction in the number of areas reserved for the public sector, amendment of the monopolies and the restrictive trade practices act, start of the privatisation programme, reduction in tariff rates and change over to market determined exchange rates.

Over the years there has been a steady liberalisation of the current account transactions, more and more sectors opened up for foreign direct investments and portfolio investments facilitating entry of foreign investors in telecom, roads, ports, airports, insurance and other major sectors.

As a new Indian middle class has developed around the wealth that the IT and BPO industries have brought to the country, a new consumer base has developed. International companies are also expanding their operations in India to service this massive growth opportunity.

Example: International companies that have done well in India in the recent years include Pepsi, Coca-Cola, McDonald's, and Kentucky Fried Chicken, whose products have been well accepted by Indians at large.

Globalisation in India has been advantageous for companies that have ventured in the Indian market. By simply increasing their base of operations, expanding their workforce with minimal investments, and providing services to a broad range of consumers, large companies entering the Indian market have opened up many profitable opportunities.

Indian companies are rapidly gaining confidence and are themselves now major players in globalisation through international expansion. From steel to movies, from cars to IT, Indian companies are setting themselves up as powerhouses of tomorrow's global economy.

Case Study

Dealing with Globalisation

With the Cup of Coffee in his hand and fear in his eyes Mr. Choksy was listening to the budget speech of Mr. Manmohan Singh, the Finance Minister of the then Congress Government. He was afraid that will happen in this Globalized and Liberalized economy. He has only heard of cutthroat competition in USA and Europe and has never witnessed the same. He was worried about the future of his company.

Mr Mohan Choksy is a son of Gujrati Trader. In 1976, after finishing his Graduation in Pharmaceuticals he decided to establish a pharmaceutical company. His father lended him money and land.

That was the era of License and Permit. The Mantra of successful business is to acquire a permit and license. Patent law was very liberal in India. Companies do not get the patent for the product rather they get the patent for the process. Thus, same drug can be manufactured and marketed by many companies if they just change their manufacturing process. Internationally, Pharmaceutical industry is research intensive industry but in India, it was an Marketing intensive industry as company can manufacture any drug of their choice by altering the process. In off- patent drugs even that is not required.

Because of License and Permit, there is always a scarcity of Drugs. Economy is closed and thus, there is no fear from MNCs.

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Thus, environment is very conducive for pharmaceutical industry. The critical success factors are product knowledge, Money, Marketing and above all, political contacts and Mr. Mohan Choksy has inherited all of the above except one which he has acquired.

Mr. Mohan Choksy launched the firm in 1978 named "Morphene" in Bododra. After studying the market Mr. Mohan launched few general Antibiotics, Pain Killers, and drugs for seasonal diseases like Paracetamol etc. He also launched a full range of products for Respiratory disease as he found it a more lucrative market.

Mr Mohan Choksy appointed a very aggressive National Sales Manager Mr. Mohit Dalal. Mr Mohit started his carreer as a Medical Representative (MR) in a Rival firm and within a span of 10 years, he became GM sales. He knows all the tits and bits of the pharmaceutical sales. He knew very well how to allure doctors and find a place in the "Prescription". By 1985, Morphene acquired 15% share in Respiratory Diseases and have a more than 10% share in all the drugs it was selling.

By 1985, competition became very stiff. New companies emerged. Because of process patent, any new company could launch any drug. Mr. Mohan Choksy thought of investing in fundamental research but it was very expensive and because of Process Patent. Mr. Mohan couldn't get the Patent so he dropped the idea. In 1987, he was going to France with his wife on a holiday. In the flight he met Mr. Becker who was a CEO of MNC pharma company named "Novamin". In a discussion Mr. Becker told him that his company is in search of Pharmaceutical manufacturer who can manufacture the off patent drugs for Novamin at low cost. Mr. Becker told him that in Europe they had limited manufacturing capacity and they wanted to use it only for patented drug. He further told that in Europe, the production cost is high and in off patent drug, the margins are very low so they are looking for low manufacturing base. Mr. Mohan saw an opportunity in it. After returning from holiday, Mr. Mohan contacted Mr. Beceker. Mr. Mohan increased the capacity of his plant. He started producing on economies of scale as now he was selling the same molecule under a brand in India and as a molecule to Novamin. By 1989, Morphene was exporting almost 25% of its production. Everything was going very smoothly but in 1991, the economy was liberalized. Being a signatory of GATT, soon India needed to follow the International Patent norms under which the Product is Patented and there was no scope for reverse engineering.

Mr. Mohan has to prepare his company for the future. He thought of two strategies:

1. To make the company attractive and sell it to some MNCs which are supposed to come in near future and may be interested in some strong local player to have a strong foothold in the country.
2. To invest in R&D and compete with MNCs.

Mr. Mohan was not comfortable with the first option and for him second option was not feasible for his small company with a turnover of ₹ 120 crore.

He lived in this dilemma for the next three years and followed the same business model and by 1994, his turnover reached 160 crores. By 1994, things were changing very fast. His company being a Zero Debt company had enough cash reserves (20 crore) and being a Zero Debt Company and a good profitability ratio (15%), banks were ready to provide liberal loans.

Mr. Mohit Dalal, the Marketing Manager of the company looks after the Domestic and International Marketing of the Firm. In 1992, Mr. Mohan had sent Mr. Dalal to Kellogs to attend the one year Executive Management Programme. After coming from Kellog, Mr. Dalal was continuously trying to foray into the international market.

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In April 1995, Mr. Mohit Dalal gave a ring to Mr. Mohan from USA. He congratulated Mr. Mohan and said that it was time for celebration as there were two good news for Morphene, one is that it had fetched a order of supplying a bulk drug to a MNC worth ' 100 crore per annum for coming five years. That will not only double the turnover of the company but will also open the avenues for new orders. Mr. Dalal further said that WTO agreement will be applicable from 1995 and by 2000, new Patent Law will be applicable in India.

Mr. Mohan was very happy with the order but couldn't understand what is good about the new Patent Law, infact he was worried for the same for last five years. Mr. Mohan congratulated Mr. Mohit and asked him to return to India.

As Mr. Dalal returned, Mr. Mohan asked to meet him. Mr Mohan Choksy shared his doubt with Mr. Mohit Dalal. Mr. Mohit Dalal said that world is Globalizing and "it is not only we but more than 150 nations have signed the WTO Agreement. If our market is open for foreign companies, then foreign market is also open for us". He further added that "Globalisation is an opportunity for Morphene and not a threat". Mr. Mohan Choksy was listening to Mr. Dalal and asked with a silver line in his eyes that how it is an opportunity. Mr. Dalal described that "instead of becoming competitor to MNCs we will become complimentary to MNCs". In the scenario, he said:

1. "MNCs are coming to India and they require manufacturing base and the state of the art manufacturing capacity, we can supply bulk drugs to them.
2. We are already supplying to USA and if those companies comes to India, they will come to them naturally .
3. If we collaborate with these MNCs, they will also transfer new technology, manufacturing processes and international practices to get the product of their desired quality. This will help us in getting more export orders.
4. In the present scenario, it will be easy for us to get international client for bulk drug supplies as other economies have to also liberalize their import procedures.
5. Each year, more than 1000 new drugs get off patent. We will not supplies these drugs to international market rather we will also launch them under our brand. Our competitive advantage will be the cost structure as we will be operating on the economies of scale because of our bulk drug supplies.
6. Our biggest advantage is our Marketing. MNCs may have an advantage on the patented drugs but they cannot compete with us in our land on the off patented drugs. They can't give the margins which we can give to retailers, they can't even think of incentives which we can provide to the doctors. They cannot penetrate in the rural areas. Their sales cost is very high".

He further added that "we have just received an order of ` 100 crore per annum. In the current scenario, we may get many such orders. We have to restructure the organisation for the new environment and we have to design our plant to the international scales and Quality standards". With optimism in his eye, Mr. Mohan gave a ring to his GM Production and GM Finance to work out on the cost structure and financing of restructuring.

Questions

1. In the above case, Discuss the impact of Globalisation on the decisions of Morphene.
2. Discuss how Globalisation is an opportunity for Morphene.

Source: Business Environment: Text and Cases, Dr. Vivel Mittal, Excel Books, New Delhi

Notes

Self Assessment

Fill in the blanks:

13. India opened up the economy in the early .....
14. India's liberalisation policy was followed by a major ..... crunch.
15. One of the major flag bearers of India's globalistaion drive is .....sector.

7.6 Summary

- Business is increasingly becoming international or global in its competitive environment, orientation and strategic intent because of the facts like the competition, liberalisation, globalisation, etc.
- The prolonged recession before the World War II in the West, led to an international consensus after the World War II in the west, led to an international consensus after the World War II that a different approach towards international trade is needed.
- The efforts of the IMF, the World Bank and the WTO along with the efforts of individual countries led to globalisation of business. In fact, the term 'International Business' has emerged from 'International Marketing', which in turn, emerged from the term 'export-marketing'.
- The meaning of globalisation varies according to how one approaches the subject and even how one feels about it. Definitions will also vary according to the social actor defining it (e.g., worker, employer, government official), on the adopted perspective (e.g., historical, economic, legal, sociological, etc.) and on the ideological orientation of the people or institutions who use the term. Because the definition of globalisation is not settled, defining the term is itself a subject of some debate.
- In simple words, globalisation means moving towards an interdependent global economy.
- There are multiple reasons why companies go global like: (i) Profit advantage, (ii) domestic demand constraints, (iii) competition, (iv) government policies, (v) availability of resources, etc.
- With technological developments and relaxation on rules and regulations on international business most of the companies are entering into global market.
- Globalisation of market and production has become major driving force behind globalisation.
- Corporations are today changing their strategies and are reorganizing their functions to cope up with the changed scenario. Whether, it is their production process or location, product strategy, marketing, finance, HR policies, etc.

7.7 Keywords

Globalisation: Growing interdependence of countries.

Globalisation of markets: It refers to the merging of historically distinct and separate national markets into one huge global marketplace.

Global Company: A company which takes the whole world as a single market and it standardises operations and its product worldwide in one or more of the firm's functional areas.

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International marketing: It refers to marketing carried out by companies overseas or across national borderlines.

Mandate: An official order or commission to do something.

Outsourcing: Any task, operation, job or process that could be performed by employees within an organisation, but is instead contracted to a third party for a significant period of time.

Principle of reciprocity: It states that favours, benefits, or penalties that are granted by one state to the citizens or legal entities of another, should be returned in kind.

World Wide Web: A widely used information system on the Internet that provides facilities for documents to be connected to other documents by hypertext links, enabling the user to search for information by moving from one document to another.

7.8 Review Questions

1. Explain the term 'Globalisation'. Why do companies engage in international business?
2. Discuss the forces driving companies towards international business.
3. Explain the concept of 'Globalisation of market'.
4. 'Think global, act local' how far this argument true? Explain.
5. 'The world is flat' - Friedman. Explain this concept in your own words.
6. Write briefly on 'Globalisation and India'.
7. Discuss the role of globalisation in development of Indian business.
8. Mention any four major trends in the changing scenario of Indian business.
9. Explain the policy issues involved in globalisation.
10. "Very significant differences still exist between national markets along many relevant dimensions". Substantiate.

Answers: Self Assessment

1.	Industrial	2.	Socities
3.	True	4.	True
5.	True	6.	Markets
7.	Consumer behaviour	8.	Regular foreign marketing
9.	Segmentation	10.	False
11.	True	12.	True
13.	1990s	14.	Foreign exchange
15.	BPO/Outsourced IT		

Notes

7.9 Further Readings

Books

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Unit 8: World Trade Organisation

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Objectives

After studying this unit, you should be able to:

- Identify the idea behind introducing GATT
- Discuss the Uruguay Rounds package
- Describe the motive behind establishment of WTO
- Realise WTOs anti-dumping measures
- Evaluate WTOs impact on India

Introduction

World Trade Organisation (WTO) is a regulatory body that deals with the rules of trade between nations at a global or near-global level.

There are a number of ways, in which you can look at the WTO. It's an organisation for liberalizing trade. It's a forum for governments to negotiate trade agreements. It's a place for them to settle trade disputes. It operates a system of trade rules.

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At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations. These documents provide the legal ground-rules for international commerce. They are essentially contracts, binding governments to keep their trade policies within agreed limits. Although negotiated and signed by governments, the goal is to help producers of goods and services, exporters, and importers conduct their business, while allowing governments to meet social and environmental objectives.

8.1 General Agreement on Trade and Tariff (GATT)

GATT is a multilateral treaty among the member countries that lays down certain agreed rules for conducting international trade. The member countries contribute together to four-fifth of the total world trade.

Did u know? It is interesting to note that underdeveloped countries form a sizable majority in GATT.

The basic aim of GATT is to liberalise world trade negotiations among members countries and, for the last forty seven years, it has been concerned with negotiations on the reduction, even the elimination of trade barriers — tariff and non-tariff — between countries and improving trade relations so that the international trade flows freely and swiftly. It also provides a forum to member countries to discuss their trade problems and negotiate to enlarge their trading opportunities.

There have been a total of eight GATT Rounds since its inception in 1947. The details of these rounds are briefly given in Table 8.1.

Table 8.1: GATT Trade Rounds

Year		Subjects Covered	Participating countries
1947	Geneva	Tariffs	23
1949	Annecy	Tariffs	13
1951	Torquay	Tariffs	38
1956	Geneva	Tariffs	26
1960-61	Geneva (Dillon Round)	Tariffs	26
1964-67	Geneva (Kennedy Round)	Tariffs and Anti-dumping measures	62
1973-79	Geneva (Tokyo Round)	Tariffs, Non-tariff measures and "Framework" agreements	102
1986-93	Geneva (Uruguay Round)	Tariffs, Non-tariff measures, Rules, Services, Intellectual property rights, Dispute settlement, Textiles and Clothing, Agriculture, Establishment of the WTO, etc.	123

First Round

The first round of tariff negotiations, the Geneva Round, held in 1947 in Geneva from 10th April to 30th October 1947, was a part of the establishment of the GATT. Just before the end of the first session of the Preparatory Committee, it was decided that the members of the Preparatory Committee should hold negotiations, at the second session to be held at Geneva in 1947, aimed at substantial reduction of tariffs and other barriers to trade on a mutually advantageous basis. The concessions exchanged in the negotiations took the form of:

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i. The complete elimination of certain duties and preferences,

ii. The reduction of duty preference,

iii. The binding of duties at existing levels, and

iv. The binding of duty free treatment.

The participating countries completed 133 sets of bilateral negotiations covering two-thirds of import trade of the countries concerned.

Second Round

The second conference for the negotiations was held at Annecy in 1949 with the aim:

i. To facilitate the extension of GATT to countries which could not participate in the Geneva conference,

ii. To add nine more countries to increase the strength to 32.

Caution World trade, affected by concessions, increased from 66% to 80% and 147 sets of bilateral negotiations covering over 500 items were completed. In all, 5000 concessions were negotiated at Annecy.

Third Round

This Round was known as the Torquay Round, 1951, and the participants who attended this Round were 38 in number. The main issues that were discussed during this round are given below:

i. About 8700 concessions were negotiated in Torquay.

ii. Tariff rates were considered and it was found that they had entered the Torquay negotiations at disadvantage.

iii. The conference was not successful as only 147 out of the accepted 400 agreements could be concluded.

iv. The success of this conference lay more in the widening of the membership of GATT than in the reduction of tariff.

Fourth Round

The Fourth Round, known as the Geneva Round 1956, was attended by 26 countries. The following was the outcome of the talks:

i. Except the US which went almost by the limits of her negotiating power and granted concessions on imports valued at about $ 900 million and obtained concessions with exports valued at about $400 million, no other country felt satisfied.

ii. Several countries withdrew from the negotiations owing to inadequate leeway.

iii. The representatives of European countries returned home with a sense of frustration.

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Fifth Round

It was known as the Dillon Round, Geneva, 1960-61, and was attended by 26 countries. Three factors had a strong bearing on the decision to hold a tariff negotiating conference in the 1960-61 period.

i. It related to the step by step progress being made by the European Economic Community towards the establishment of a full customs union comprising the six member states of the community and more particularly those favouring gradual alignment starting in 1961 of the national customs tariffs of Benelux, France, the Federal Republic of Germany and Italy to the new common tariff.

ii. It was decided to hold a further general round of tariff negotiations especially as these would give an opportunity to negotiate with EEC on its new common tariff.

iii. The US government had obtained authority in the Trade Agreement Extension Act of 1958 to participate in multilateral tariff negotiations during the four years ending 30 June 1962. If advantage was to be taken of this limited authority, the tariff conference had to be held in the 1960-61 period.

A bilateral tariff agreement between UK and the EEC was announced on 17 May 1962. Agreement included reducing tariffs on a wide variety of industrial goods by one tariff.

Sixth Round

This Round was known as the Kennedy Round, 1964-67, and was attended by 62 participants. The following decisions were taken after three years of long discussions:

i. The President got unprecedented powers to reduce, on a reciprocal basis, almost the entire range of US tariff by 50%, spread over five years.

ii. Negotiations permitted the broadcast of possible tariff reductions; increased access to world markets for agricultural products; and the granting of concessions to the developing countries on a non-reciprocal basis, for products of special interest to the US.

iii. The participants in the negotiations made tariff reductions together account for almost 75% of total world trade and the concessions granted by them represent a volume of trade valued at slightly more than $ 40,000 million.

iv. ***In the field of non-tariffs:***

   a. The agreement relating principally to chemicals should, inter alia, result in the abolition of the American selling price system of valuation applied to imports of certain chemical products under which the US did not empower the President to negotiate on this matter.

   b. On anti-dumping code, as per Article VI of the GATT, a Committee on Anti-Dumping Practice was established on 1 July 1968, where the signatory countries could consult on matters relating to the administration of anti-dumping systems.

v. ***Agriculture Round:*** The negotiations on grains resulted in agreement on basic minimum and maximum prices for varieties of wheat of major importance in international trade and on the provisions to developing countries of 4.5 million metric tons of grains annually, initially for a three-year period.

vi. The tariff concessions negotiated in this round were to be implemented in stages. The countries could either make the total reduction in tariffs in five equal annual installments, first on 1st Jan 1968; or make 2/5th of the total reduction by 1st July 1968, and subsequent

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reductions by 1st Jan. 1970, 1971 and 1972. There was nothing to prevent countries from making their tariff cuts earlier than the dates provided for if they so wished.

Seventh Round

This Round was known as the Tokyo Round, 1973-79, and was attended by 102 participants. The following decisions were taken during this Round:

i. This round presented an opportunity to review and improve the working of some of the fundamental provisions of GATT, notably Article I, the most favoured nation (MFN) clause.

ii. This agreement marks a turning point in international trade relations by recognising tariff and non-tariff preferential treatment in favour of and among developing countries as a permanent legal feature of the world-trading feature.

iii. It codifies practices and procedures regarding the use of trade measures by governments to safeguard their external financial position and their balance of payments (BoPs).

iv. ***Safeguard Action:*** The agreement concerns the de-recognition from other GATT provisions which are accorded to developing countries under Article XVIII of the GATT, giving them greater flexibility in applying trade measures to meet their essential development needs.

v. Understanding on notification, consultation, dispute settlement and surveillance in GATT.

vi. ***Tariffs:*** In the second half of 1979, two protocols embodying results of the Tokyo Round tariff negotiations were opened for acceptance by governments. By annexing to the Protocols, their schedules of concessions and by accepting the Protocols, governments made their tariff cutting commitments legally binding within the GATT.

vii. The nine industrialised markets MFN tariffs facing developing countries exports of manufactured products will be reduced by 27% based on the weighted average tariff, and by 38 per cent based on the simple average tariff.

viii. ***Non-tariff Measures:***

a. *Subsidies and Countervailing Duties*: Production export subsidies have, in recent years, had, growing and distorting influence on international trade, often protecting inefficient production at the expense of competitive industries; the use of countervailing duties has grown proportionately and increasing protectionist pressures has encouraged resort to both measures.

b. *Technical Barriers to Trade*: The agreement on Technical Barriers to Trade (also known as Standards Code) aims to ensure that when governments or other bodies adopt technical regulations of standards, for reason of safety, health, consumer or environmental protection or other purposes, these regulations or standards and the testing and certification schemes related to them, should not create unnecessary obstacles to trade.

c. *Import Licensing Procedures*: The Agreement on Import Licensing Procedures recognises that procedures can have acceptable uses, also that inappropriate use may hamper international trade; it aims at ensuring that they do not in themselves act as restrictions on imports.

d. *Government Procurement*: The Agreement on Government Procurement aims to secure greater international competition in the government procurement market. Increased competition, besides benefiting exporters should also make more effective use of taxpayers' money in government purchases of goods.

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e. *Customs Valuation*: The agreement on the implementation of Article II of the GATT (known as Customs Valuation Code) is intended to provide a fair, uniform and natural system for the valuation of goods for customs purposes.

f. *Revised GATT Anti-Dumping Code*: The revised version of the Anti-Dumping Code brings certain of its provisions, notably those concerning determination of injury, price undertakings between exporters and the importers, imposition and collection of anti-dumping duties, into line with the relevant provisions of the code on subsidies and countervailing duties.

The Eighth Round-the Uruguay Round- is discussed in the next section.

Self Assessment

Match the following sets:

	Set A		Set B
1.	Fourth GATT Round	a.	Dillon Round
2.	Fifth Round	b.	Geneva Round
3.	Sixth Round	c.	Kennedy Round
4.	Seventh Round	d.	Tokyo Round

8.2 Uruguay Round Package

The Eighth Round of GATT was known as Uruguay Round, 1986-93, and 123 countries participated in this Round. After seven years of protracted negotiations of the eighth round of talks the decisions have been as under.

The Uruguay Round was the eighth of the rounds of negotiations to be held under the auspices of the General Agreement on Tariffs and Trade (GATT). The Round got its name from the Ministerial Conference launching the negotiations in September 1986, which was held in Punta del Este, Uruguay. The negotiations were to have been completed in four years, but because of the crises and deadlocks that developed from time to time, they dragged on for over seven years. They were formally concluded at the Ministerial Meeting held in April 1994 in Marrakesh, Morocco. The Final Act embodying its results came into force on 1st January 1995.

8.2.1 Factors Influencing the Launching

Broadly speaking, three developments made some GATT member countries feel that there was a need to hold a new round of negotiations.

First, it had become evident that, although as a result of the adoption of associate agreements the rules of GATT in a number of areas had been strengthened, its rules were not being applied in two important trade sectors, viz. agriculture and textiles. In the agricultural sector, most developed countries had taken advantage of the loophole to establish policies that were not always consistent with GATT principles. In the textile sector, a number of these countries imposed restrictions on imports, particularly from developing countries. They did this under the so-called Multi-Fibre Arrangement (the Arrangement Regarding International Trade in Textiles or MFA), which provided a legal cover for derogation from GATT rules against the use of quantitative restrictions. Arrangements like the voluntary export restraints (VERs) proliferated, under which some developed countries restricted competitive imports of certain products. These measures had come to be called "grey area measures" as there were doubts about their consistency with GATT principles and rules.

Second, by about the same time, it had become evident that trade in services had grown into an important component of international trade. The rules of GATT applied to trade in goods and there were no international rules on measures taken by countries to protect their service industries. Opinion was growing therefore, that both for the efficient development of the service industries in different countries and to develop trade in services, it was necessary to bring this trade under international discipline.

Third, industries and trading organisations were complaining that because of differing national standards for the protection of intellectual property rights, such as patents and trademarks, and ineffective enforcement by governments of the national rules providing for such rights, trade in counterfeit goods was on the increase. The absence of adequate protection was also considered a deterrent to foreign investment in the production of patented goods and a reason for the reluctance of industries in developed countries to sell or license technology to industries in developing countries.

8.2.2 Positive Factors Influencing the Negotiations

The Uruguay Round negotiations lasted, as noted earlier, over seven years. The reasons for the crisis that occurred from time to time are now of historical interest. It would be sufficient to note for the purpose of this Guide that, in the Round's last phase and especially during its last two years, the deadlock among the major players (particularly the United States of America and the European Union) on certain crucial elements in the areas of agriculture and trade in services delayed the successful conclusion of the Round.

Caution On the other hand, certain developments elsewhere had a positive impact on both the negotiating process and its final results. These were:

- A shift in the trade policies of developing countries from import substitution to policies encouraging export-oriented growth;
- The breakdown of communism and the end of the cold war; and
- The adoption of market-oriented reforms.

In many ways, the launching of the negotiations coincided with the decision of a number of developing countries to reoriented their trade and economic policies away from import substitution to export-oriented growth. The measures they were taking to reduce tariffs, to liberalise their import control system and to open their doors to foreign investment were consistent with GATT principles, its philosophy and approach. Though these measures were unilateral and were not influenced by the launching of negotiations, they enabled developing countries, including those that were initially sceptical, to take a more constructive attitude to the issues being discussed and to agree to integrate themselves more fully into the legal system that was being formulated. This shift in trade policies and the adoption of market-oriented reforms also led a number of developing countries to seek GATT membership. Simultaneously, with the breakdown of communism, policies favouring privatisation and market-oriented reform in the countries that are now called transitional economies prompted most of them to apply for GATT membership.

8.2.3 Brief Description of the Results

As multilateral negotiations generally involve compromises, the results do not always meet the expectations of individual countries. It is often said that no country leaves the negotiating table as a winner or as a loser. On the whole, however, the negotiations have brought about positive outcomes.

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In particular they have resulted in:

- An improved framework of multilateral rules governing international trade; and
- Further improvements in access to foreign markets for both goods and services.

One of the other achievements of the Round is the establishment of the World Trade Organisation (WTO). GATT has ceased to be a separate institution and has become part of WTO. The organisation is responsible for overseeing the implementation of the multilateral rules. The improved mechanism that has been adopted for consultations among member countries when differences arise and for the settlement of disputes is expected to reduce trade friction. The organisation also provides a continuing forum for negotiations among its member countries on further trade liberalisation and for the elaboration of rules in other areas with an impact on international trade.

8.2.4 Improved Framework of Rules

The improved rules governing international trade are contained in three main legal instruments:

- General Agreement on Tariffs and Trade (GATT) and its associate agreements. These apply to trade in goods.
- General Agreement on Trade in Services (GATS), which applies to trade in services.
- Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

Task Write a report on the Uruguay Round agreement on agriculture. Highlight the main points and the loopholes, if any.

Self Assessment

State whether the following statements are true or false:

5. The Uruguay Round got its name from the Ministerial Conference launching the negotiations in September 1986, which was held in Punta del Este, Uruguay.
6. The rules of GATT applied to trade in goods and services.
7. As one of the results of this Round, GATT became a part of WTO.

8.3 Establishment of WTO

The World Trade Organisation (WTO) was established on 1st January 1995. Governments had concluded the Uruguay Round negotiations on 15th December 1993 and ministers had given their political backing to the results by signing the Final Act at a meeting in Marrakech, Morocco, in April 1994. The 'Marrakech Declaration' of 15th April 1994, affirmed that the results of the Uruguay Round would strengthen the world economy and lead to more trade, investment, employment and income growth throughout the world.

Did u know? The WTO is the embodiment of the Uruguay Round results and the successor to the General Agreement on Tariffs and Trade (GATT). The WTO has a larger membership than GATT (155 by the end of March 2012). India is one of the founder members of the WTO.

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8.3.1 Trade without Discrimination

The main principle that guided the erstwhile GATT and directs the present incumbent, WTO, is to promote trade without discrimination. For almost 50 years, key provisions of GATT outlawed discrimination among members and between imported and domestically produced merchandise. According to Article I, the famous "most favoured nation" (MFN) clause, members are bound to grant to the products of other members treatment no less favourable than that accorded to the products of any other country. A second form of non-discrimination known as "national treatment" requires that once goods have entered a market, they must be treated no less favourably than the equivalent domestically produced goods. This is Article III of the GATT. Apart from the revised GATT (known as "GATT 1994"), several other WTO agreements contain important provisions relating to MFN and the national treatment. Intellectual property protection by WTO members provides for MFN and national treatment. The General Agreement on Trade in Services (GATS) requires members to offer MFN treatment to services and service suppliers of other members pre-shipment inspection; trade related investment measures and the application of sanitary and phytosanitary measures.

Caution WTO, contrary to popular belief, is not a "free trade" institution. It permits tariffs and other forms of protection but only in limited circumstances. It is a system of rules dedicated to open, fair and undistorted competition.

Caselet

WTO and Inequalities

Multilateral trade has not yielded the desired results in respect of least developing countries (LDCs) and the developing countries due to years of economic exploitation suffered by them. One important objective of the WTO is to reduce inequalities by giving smaller countries more voice.

Unfortunately, these countries are still at the receiving end, despite various ministerial meetings, starting with the 1986 Uruguay Round to the latest Doha meet. It is time LDCs and developing countries got more favourable treatment from the advanced nations. In fact, developed countries should realise that, by doing so, they are not conferring any favour on LDCs, but rather mitigating the hardships being inflicted upon them.

The so-called developed countries expect other countries to come to the discussion table with an assurance that they will reduce their subsidies. Why cannot the developed countries come forward to do the same in the interest of poor countries, which constitute the majority membership in the WTO?

The irony is, majority makes no authority in WTO deliberations as LDCs and developing countries are not in a position to assert their position diplomatically or get issues focused in their favour.

The ensuing seventh ministerial meeting should be a trend-setter in helping LDCs and developing countries and, in the process, paving the way for early conclusion of the Doha Round.

It is the change of mind-set that is most important in resolving issues for the benefit of the poorer sections. From the BRIC group, China and India must take the lead and impress

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upon developed countries the urgent need to address and ameliorate the conditions of the poor in the developing countries.

Source: thehindubusinessline.com

8.3.2 Objectives of WTO

In its preamble, the agreement establishing the World Trade Organisation reiterates the objectives of GATT. These are: raising standards of living and incomes, ensuring full employment, expanding production and trade and optimal use of the world's resources. The preamble extends these objectives to services and makes them more precise.

- It introduces the idea of "sustainable development" in relation to the optimal use of the world's resources, and the need to protect and preserve the environment in a manner consistent with various levels of national economic development.
- It recognises that there is a need for positive efforts to ensure that developing countries, and especially the least developed among them, secure a better share of the growth in international trade.

8.3.3 Functions of WTO

The agreement establishing WTO provides that it should perform the following four functions:

- First, it shall facilitate the implementation, administration and operation of the Uruguay Round legal instruments and of any new agreements that may be negotiated in the future.
- Second, it shall 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.
- Third, it shall be responsible for the settlement of differences and disputes among its member countries.
- Fourth, it shall be responsible for carrying out periodic reviews of the trade policies of its member countries.

Notes **Most Favoured Nations Status**

According to WTO, all the signatory countries are given the most favoured nations (MFN) status so that these countries have market access to each others, trading areas. India has already given a most favoured nation status to Pakistan; however, Pakistan has not so far reciprocated. India, in any case, is not going to suffer because of the acrimonious attitude of Pakistan.

8.3.4 The WTO Structure

Its highest authority – the Ministerial Conference — dominates the structure of the WTO. This body is composed of representatives of all WTO members. It meets at least every two years and is empowered to make decisions on all matters under any of the multilateral trade agreements.

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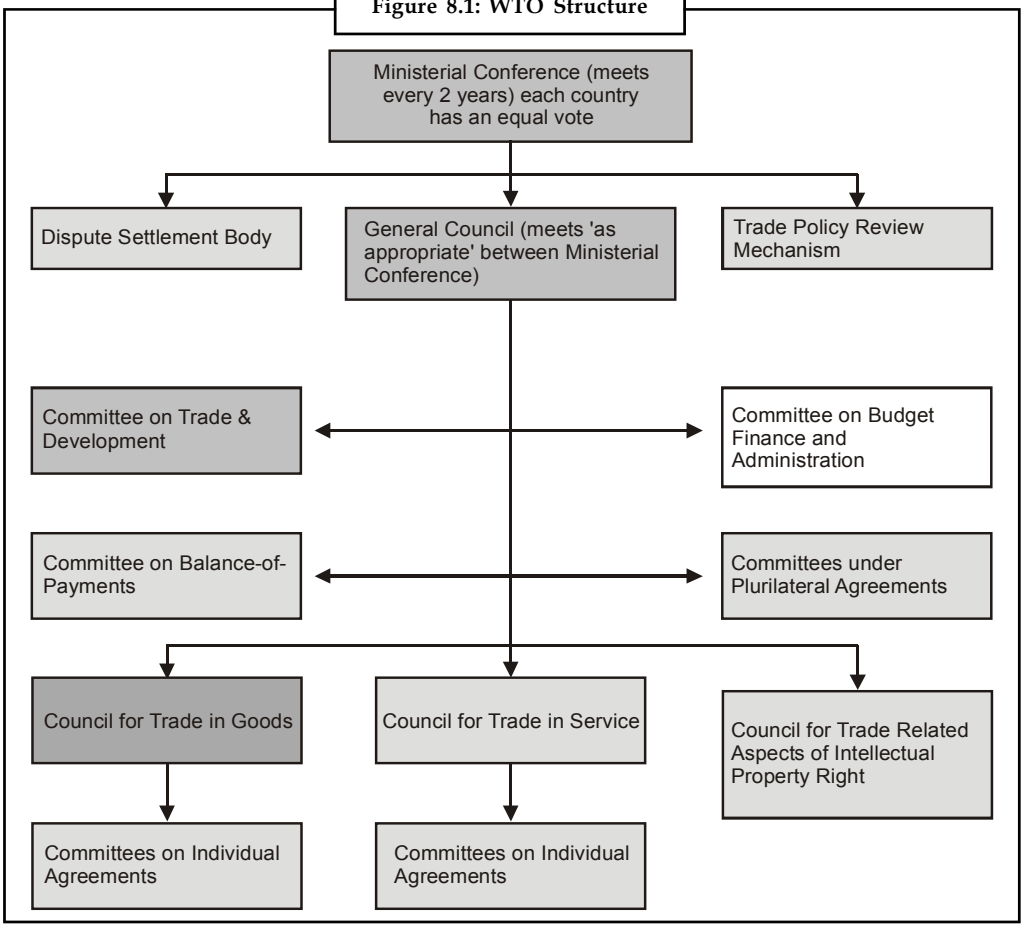
Figure 8.1: WTO Structure



Source: WTO Secretariat, Geneva 1996

The day-to-day work of the WTO is entrusted to a number of subsidiary bodies, principally, the General Council, also composed of all WTO members, which is required to report to the Ministerial Conference. The General Council also convenes in two particular forms – as the Dispute Settlement Body and the Trade Policy Review Body. The former overseas the dispute settlement procedure and the latter conducts regular reviews of trade policies of individual WTO members.

The General Council delegates responsibility to three other bodies, namely the Councils for Trade in Goods, Trade in Services and Trade-Related Aspects of Intellectual Property Rights (TRIPS). The Council of Goods overseas the implementation and functioning of all the agreements covering trade in goods, though many such agreements have their own specific overseeing bodies. The latter two Councils have responsibility for their respective WTO agreements and may establish their own subsidiary bodies as necessary.

The Ministerial Conference reports to the General Council which delegates responsibility to three other bodies as mentioned above. The Committee on Trade and Development is concerned with issues relating to the developing countries and especially to the "least developed" among them. The Committee on Balance of Payments is responsible for consultations among WTO members and countries which resort to trade and restrictive measures in order to cope with their balance of payments difficulties. Finally, a Committee on Budget, Finance and Administration deals with issues relating to WTO's financing and budget. Each of the plurilateral agreements of the WTO – those on civil aircraft, government procurement, dairy products and

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bovine meat – establish their own management bodies which are required to report to the General Council.

8.3.5 The WTO Secretariat and Budget

The WTO Secretariat is located in Geneva. It has 155 members and is headed by its Director General, Supachai Panitchpakdi, and four deputy directors. Its responsibilities include the servicing of WTO delegate bodies with respect to negotiations and the implementation of agreements. It has a particular responsibility to provide technical support to developing countries, and especially the least developed countries. WTO economists and statisticians provide trade performance and trade policy analyses while its legal staff assists in the resolution of trade disputes involving the interpretation of WTO rules and precedents. Other secretariat work is concerned with accession negotiations for new members and providing advice to governments considering membership.

Caution The WTO budget is around US $202 million (196 million Swiss Francs) with individual contributions calculated based on shares in the total trade conducted by WTO members. Part of the WTO budget also goes to the International Trade Centre.

8.3.6 Norms for Joining WTO

Most WTO members were previously GATT members who signed the Final Act of the Uruguay Round and concluded their market access negotiations on goods and services by the Marrakech meeting in 1994. A few countries which joined the GATT later, in 1994, signed the Final Act and concluded negotiations on their goods and services schedules, and became WTO members. Other countries that had participated in the Uruguay Round negotiations concluded their domestic ratification procedures only during the course of 1995 and became members thereafter.

Aside from these arrangements, which relate to "original" WTO membership, any other state or customs territory having full autonomy in the conduct of its trade policies may accede to the WTO on terms agreed with WTO members.

In the first stage of the accession procedures, the applicant government is required to provide the WTO with a memorandum covering all aspects of its trade and economic policies having a bearing on WTO agreements. This memorandum becomes the basis for a detailed examination of the accession request in a working party.

Alongside the working party's efforts, the applicant government engages in bilateral negotiations with interested members' governments to establish its concessions and commitments on goods and its commitments on services. This bilateral process, among other things, determines the specific benefits for WTO members in permitting the applicant to accede. Once both, the examination of the applicant's trade regime and market access negotiations, are complete the working party draws up basic terms of accession.

Finally, the results of the working party's deliberations contained in its report, a draft protocol of accession, and the agreed schedules resulting from the bilateral negotiations are presented to the General Council or the Ministerial Conference for adoption. If a two-thirds majority of WTO members vote in favour, the applicant is free to sign the protocol and to accede to the Organisation; when necessary, after ratification in its national parliament or legislature.

The General Council convenes, as appropriate, to discharge the responsibilities of the Dispute Settlement Understanding as well as of the Trade Policy Review Body. These bodies may have their own chairman and establish rules of procedure, as they feel necessary, for the fulfilment of these responsibilities.

Notes

The bodies provided under the plurilateral trade agreements carry out the functions assigned to them under those agreements and operate within the institutional framework of the WTO. These bodies keep the General Council informed of their activities on a regular basis.

Self Assessment

Fill in the blanks:

8. World Trade Organisation was established on .....
9. ..... requires that once goods have entered a market, they must be treated no less favourably than the equivalent domestically produced goods.
10. ..... is the highest authority at WTO and dominates the structure of WTO.
11. Countries that were previously GATT members became WTO members by signing the ..... and concluding their market access negotiations on goods and services by the Marrakech meeting in 1994.

8.4 WTO and Anti-Dumping Measures

Article VI of the GATT provides for the right of contracting parties to apply anti-dumping measures, i.e. measures against imports of a product at an export price below its "normal value" (usually the price of the product in the domestic market of the exporting country) if such dumped imports cause injury to a domestic industry in the territory of the importing contracting party. More detailed rules governing the application of such measures are currently provided in an Anti-Dumping Agreement concluded at the end of the Tokyo Round. Negotiations in the Uruguay Round have resulted in a revision of this agreement, which addresses many areas in which the current agreement lacks precision and detail.

In particular, the revised agreement provides for greater clarity and more detailed rules in relation to the method of determining that a product is dumped, the criteria to be taken into account in a determination that dumped imports cause injury to a domestic industry, the procedures to be followed in initiating and conducting anti-dumping investigations, and the implementation and duration of anti-dumping measures. In addition, the new agreement clarifies the role of dispute settlement panels in disputes relating to anti-dumping actions taken by domestic authorities.

On the methodology for determining that a product is exported at a dumped price, the new agreement adds relatively specific provisions on such issues as criteria for allocating costs when the export price is compared with a "constructed' normal value and rules to ensure that a fair comparison is made between the export price and the normal value of a product so as not to arbitrarily create or inflate margins of dumping.

The agreement strengthens the requirement for the importing country to establish a clear causal relationship between dumped imports on the industry concerned and must include an evaluation of all relevant economic factors bearing on the state of the industry concerned. The agreement confirms the existing interpretation of the term "domestic industry". Subject to a few exceptions, "domestic industry" refers to the domestic producers, as a whole, of like products or to those of them whose collective output of the products constitutes a major proportion of the total domestic production of those products.

Clear-cut procedures have been established on how anti-dumping cases are to be initiated and how such investigations are to be conducted. Conditions for ensuring that all interested parties are given an opportunity to present evidence are set out. Provisions on the application of provisional measures, the use of price undertakings in anti-dumping cases, and on the duration

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of anti-dumping measures have been strengthened. Thus, a significant improvement over the existing agreement consists of the addition of a new provision under which anti-dumping measures shall expire five years after the date of imposition, unless a determination is made that, in the event of termination of the measures, dumping and injury would be likely to continue or recur.

A new provision requires the immediate termination of an anti-dumping investigation in cases where the authorities determine that the margin of dumping is de minimus (which is defined as less than 2 per cent, expressed as a percentage of the export price of the product) or that the volume of dumped imports is negligible (generally when the volume of dumped imports from an individual country accounts for less than 3 per cent of the imports of the product in question into the importing country).

The agreement calls for prompt and detailed notification of all preliminary or final anti-dumping actions to a Committee on Anti-Dumping Practices. The agreement will afford parties the opportunity of consulting on any matter relating to the operation of the agreement or the furtherance of its objectives, and to request the establishment of panels to examine disputes.

Case Study

Spirit of Contention

The prospectus for Scotch whiskies in India, post QR, improve but the issue of high duties remains unresolved.

After 18 months of acerbic duels, both sides of the Indian alcoholic beverage industry — the multinationals and the domestic majors — are settling down on the road to the future. The Indian government is on course to curb import tariffs on bottled-in-origin (BIO) liquor to the WTO bound rate of 150 per cent by March 2004.

On April 1, 2001, India lifted quantitative restrictions (QRs) on BIO liquor but came up with new additional duties, ostensibly to provide enough time for the domestic companies to tackle the import menace. The Indian lobby's argument that it was unfair to push them to face immediate global competition after shifting growth for decades, found takers in the North Block. In Finance Minister Yashwant Sinha's Budget that year, the basic import duty remained at 210 per cent, while a new graded additional duty linked to CIF price saw tax incidence on imported liquor soaring to prohibitive highs.

It varied from 464 per cent to 710 per cent based on the principle of 'cheaper the price, higher the duty'. At that level, a 750 ml bottle of Chivas Regal, Johnnie Walker or Jack Daniel's, after all the duties paid, retailed at roughly ₹ 4,300. Only a handful of the 200-odd brands waiting to tap the BIO route reached the open retail trade that year.

Predictably, the indignant liquor transnational responded with international diplomatic pressure on New Delhi. The Scotch Whisky Manufacturers' Association, Euro Club and the UK's Labour government, headed by Tony Blair, picked up the gauntlet on behalf of the liquor multinationals, more precisely, the Scotch whisky industry.

A year later, in 2002, the Finance Minister changed the script. The basic duty was down to 182 per cent and the additional duty was rationalised into two slabs from three earlier. The cumulative taxation of the cheapest imports was down to 413 per cent from 710 per cent in the previous year. The duties imposed on the more expensive products dropped from 464 per cent to 340 per cent. Sure, the domestic companies protested, but their posturing was laced with a sense of inevitability. The transnational lobby welcomed the move and

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added that more was expected from the Government. "The reduction was only notional. Jack Daniel's still costs ₹ 3,500 instead of the ₹ 4,300 a year ago," says Amrit Kiran Singh, Vice-President and Area Director of Brown Forman. Ditto for Chivas Regal or Johnnie Walker.

How did the market respond to imports while the lobbies worked hard to influence policy decisions? With duties remaining high, the floodgates for cheap imports did not open. Till now, cheap Scotch whiskies such as Macnair's, Scot Bard and Northern Scott have not tested Indian taste buds. It was feared that these brands, carrying a CIF price tag between $7.5 and $20 per case, would pose a serious threat to dominant Indian whisky labels. The expected arrival of ad-mix brands and inexpensive vodkas from Eastern Europe too did not happen. However, it is interesting to note that most of the premium imported brands have exuded high optimism levels in the Indian market, especially with the decline in tariff barriers, which is now expected to gain momentum as March 2004 draws closer.

In this context, United Distillers & Vintner's (UDV) decision to sell off its Indian whiskies and focus only on international brands such as Johnnie Walker, J&B and Smirnoff is interesting and an important pointer to the future.

Srikant Illuri, Chief Executive Officer of Allied Domecq Spirits & Wines (I) Ltd, says the company's emphasis is on building the equity of its international brands in the local market. In fact, Allied Domecq has decided to go slow in developing an India-specific whisky, whose launch it had announced sometime ago.

But a few worries remain. As on March 2002, only 12 of the 31 Indian states have laid out a policy framework to allow BIO imports into their markets. This perhaps explains why very few multinational corporations have taken their BIO products to open retail.

Despite high duties, the early indications from Indian tipplers may enthuse the multinationals. Reliable industry figures suggest that bulk consumption of Scotch in India moved up by over 15 per cent on a year-on-year basis. Incidentally, the Indian companies are using increasing quantities of Scotch for blending it with their local whiskies. More pertinently, sales of branded Scotch whiskies with a current existing base of 8.5 lakh cases annually are growing between 5 and 10 per cent.

Dinesh Jain of the Edinburgh-based Highland Distillers, maker of the famous Grouse Scotch whisky, says a growth of 5 to 10 per cent is not insignificant considering that Scotch sales worldwide are under increasing pressure. It is then not surprising that leading domestic spirit companies such as McDowell & Co and Shaw Wallace are poised to bring new Scotch brands into their portfolio either through distribution agreements or purchase of brand rights for India.

Brown-Forman's Singh claims that Jack Daniel's, a leading Tennessee whisky with global sales of over 6.5 million cases (which is more than the combined sales of Chivas Regal and Johnnie Walker), is reporting a growth of 25 to 30 per cent, even though on a small base. It recently sponsored well-known painter Subodh Kerkar's "Spirit Of Manhattan" exhibition in New Delhi and took prints of the work to launch a promotion across 25 leading bars and restaurants in the city.

Jack Daniel's is the base of the famous cocktail drink named after Manhattan. Brown-Forman plans to take this promotion to other major cities across the country. In October, the company intends to make a big promotional splash for its Finlandia vodka, which is associated with Pierce Brosnan in the next James Bond movie, *Die Another Day*. "We are investing in marketing initiatives and promotions to tap the opportunities here in the future," says Singh.

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Many transnational liquor corporations have given clear indications about the brands they intend to import into India. Given the surging growth of white spirits in urban India, Bacardi-Martini's Bombay Sapphire Gin and Allied Domecq's Beefeater Gin look like certain entrants into the market. The growth of the white spirits market is primarily brand-led rather than category-driven, says Allied Domecq's Illuri, when asked whether the company was worried about the stagnant gin market in the country. This provides an ideal platform for the international labels to make an impact in premium urban niches. Illuri adds that the company may also look at the possibility of bringing in its leading tequila brand, Sauza. Similarly, the ready-to-drink (RTD) segment may see action with brands such as Smirnoff Ice and Bacardi Breezer coming in.

Meanwhile, the multinational liquor corporations are bracing for a meeting with the new Finance Minister, Jaswant Singh, to press for more duty cuts. In recent times, they have banked heavily on the diplomatic influence of the US to wrest favourable decisions. As lobbying continues, it's a long wait for Indian tipplers to savour imported liquor at affordable rates.

Question

What was the issue all about? What was WTO's role in the case?

Source: International Marketing, 3rd Edition, P. K. Vasudeva, Excel Books, New Delhi

Self Assessment

Fill in the blanks:

12. Anti-Dumping Agreement concluded at the end of the ..... Round.
13. ..... refers to the domestic producers, as a whole, of like products or to those of them whose collective output of the products constitutes a major proportion of the total domestic production of those products.

8.5 India and WTO

The Indian economy experienced a major transformation during the decade of the 1990s. Apart from the impact of various unilateral economic reforms undertaken since 1991, the economy has had to reorient itself to the changing multilateral trade discipline within the newly written GATT/WTO framework. The unilateral trade policy measures have encompassed exchange-rate policy, foreign investment, external borrowing, import licensing, custom tariffs and export subsidies. The multilateral aspect of India's trade policy refers to India's WTO commitments with regard to trade in goods and services, trade related investment measures, and intellectual property rights.

The multilateral trade liberalisation under the auspices of the Uruguay Round Agreement and the forthcoming WTO negotiations is aimed at reducing tariff and non-tariff barriers on international trade.

India is a founding member of the GATT (1947) as well as of the WTO, which came into effect from January 1, 1995. By virtue of its WTO membership, India automatically avails of Most Favoured Nation Treatment (MFN) and National Treatment (NT) from all WTO members for its exports and vice versa. Its participation in this increasingly rule-based system is aimed towards ensuring more stability and predictability in its international trade.

The Uruguay Round resulted in increased tariff binding commitments by developing countries.

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Example: India bound 67% of its tariff lines compared to 6% prior to this round.

The government has simplified the tariff, eliminated quantitative restrictions on imports, and reduced export restrictions. It plans to further simplify and reduce the tariff.

All agricultural tariff lines and nearly 62% of the tariff lines for industrial goods are now bound. Ceiling bindings for industrial goods are generally at 40% ad valorem for finished goods and 25% on intermediate goods, machinery and equipment. The phased reduction to these bound levels is to be achieved during the 10-year period commencing in 1995. Tariff rates on equipment covered under the Information Technology Agreement were to be brought down to zero by 2005.

Quantitative Restrictions (QRs) on imports are maintained on Balance-of-Payments (BOP) grounds but nation is reducing QRs gradually.

India has fulfilled its commitment by reducing tariff and eliminating QR, it had also implemented the TRIPS measures by implementing new patent laws and presently, Indian patent law is at par with international patent law following a product patent and that too for 20 years. India has also implemented Trade Related Investment Measures (TRIMs) and General Agreement on Trade and Services (GATS).

The Indian economy has grown rapidly over the past decade, with real GDP growth averaging some 6% annually, in part due to the continued structural reform, including trade liberalisation, according to a WTO Secretariat report on the trade policies and practices of India. Social indicators such as poverty and infant mortality have also improved during the last ten years.

Task Write an article on India's association with WTO- how it has benefitted India and its impact on the Indian economy.

Self Assessment

State whether the following statements are true or false:

14. India is one of the founding members of both GATT and WTO.
15. India has reduced tariffs and eliminated Quantitative Restrictions on imports.

8.6 Summary

- The WTO agreements deal with various sectors like agriculture, textiles and clothing, banking, telecommunications, government purchases, industrial standards and product safety, food sanitation regulations, intellectual property etc.
- A set of fundamental principles run throughout all of these documents. These principles are the foundation of the multilateral trading system.
- About two thirds of the WTO, around 150 members are developing countries. Developing countries are a highly diverse group often with very different views and concerns. The WTO deals with the special needs of developing countries by preferential treatment.
- The objective of GATT was that trade shall be conducted on a non-discriminatory basis, protection shall be afforded to domestic industries through customs tariffs, not through such commercial measures as import quotas, and consultation shall be the primary method used to solve global trade problems.

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- Of all rounds of GATT talk, the most important was the eight set, the Uruguay Round of negotiations that began in 1986 and concluded in September 1993.
- In a nutshell, the WTO helps developing and transition economies, helps in economic policy-making, taking information, giving information to public, encouraging development and economic reform.
- The WTO functions on the basis of the following rules: Binding and Cutting of Tariff, Agriculture Rules and Policies, Standard and Safety, Textile Services, Trade Related Intellectual Property Rights, Anti Dumping Measures and Countervailing Duties, Emergency Protection from Imports Surge, Non-Tariff Barrier, Plurilaterals.
- WTO has also special provision for developing countries. India is also influenced by the WTO. Almost all the industries will be influenced by it directly or indirectly.
- Major and instant impact will be on Agriculture, Pharmaceuticals, Information technology, Textiles and clothing, Liquor companies, and the services sector.

8.7 Keywords

Countervailing duty: Additional import duty imposed to offset the effect of concessions and subsidies granted by an exporting country to its exporters.

Dumping: Dumping means selling the product at below the ongoing market price and/or at the price below the cost of production.

GATS: This treaty was created to extend the multilateral trading system to service sector, in the same way the General Agreement on Tariffs and Trade (GAT T) provides such a system for merchandise trade.

GATT: It is a multilateral treaty among the member countries that lays down certain agreed rules for conducting international trade.

MFN: Most Favoured Nation: That principle of GATT which means treating one's trading partner equally on the principle of non-discrimination.

Ministerial Conference: It is the top decision making body of the World Trade Organisation

Plurilateral: At the WTO, there are a few agreements which have only a few signatories. They were negotiated at the Tokyo Round and are known as "plurilateral agreements".

Sustainable development: Development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

World Trade Organisation: It is a regulatory body that deals with the rules of trade between nations at a global or near-global level.

8.8 Review Questions

1. Describe the basic idea behind introducing GATT.
2. How and when was WTO established?
3. Explain the concept of 'Most Favoured Nation'.
4. "WTO, contrary to popular belief, is not a "free trade" institution." Validate.
5. Describe the structure of WTO in detail. Also state the functions of the WTO.
6. If a new country wants to join WTO, how can it do so?

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7. Discuss the Uruguay Rounds. What was the motive behind the Eighth Uruguay Round?
8. Describe the non-tariff measures defined in the Seventh Uruguay Round.
9. What is dumping? What is WTO's stand on dumping?
10. Explain the impact of WTO on India.

Answers: Self Assessment

1.	(b)	2.	(a)
3.	(d)	4.	(c)
5.	True	6.	False
7.	True	8.	1st January, 1995
9.	National treatment	10.	Ministerial Conference
11.	Final Act of the Uruguay Round	12.	Tokyo
13.	Domestic industry	14.	True
15.	True		

8.9 Further Readings

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Aswathappa, K., *Business Environment for Strategic Management*, Mumbai: Himalaya Publishing House

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Unit 9: Multinational Corporations

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Objectives

After studying this unit, you should be able to:

- Define the term 'Multinational Corporation'
- Identify the factors that contributed to the growth of MNCs
- State the advantages and disadvantages of MNCs
- Discuss the control and organization structure in MNCs
- Know the state of MNCs in India

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Introduction

Multinationals Corporations are major players in international business. In an era of WTO, Regional Groupings, Liberalisation, and Globalisation, the role of MNCs has increased tremendously. Almost ¾ of the total GDP of South Korea comes from only 5 MNCs of South Korea. Out of the 50 largest "economies", 14 are MNCs. In America, Japan, South Korea, Singapore, Malaysia, etc., there are now approximately 63,000 multinational corporations – defined as firms that engage in international production – with over 690,000 foreign affiliates. In 1997, these firms controlled $12 trillion in foreign assets, employed 30 million workers and earned $9.5 trillion in revenues – larger than the annual GDP of the United States or the European Union (EU). The rapid growth of MNCs is a direct result of the worldwide liberalisation of trade and investment. Corporations have grown larger because they now compete in much bigger markets.

MNCs play a significant role in all aspects of life, in fact, they play a significant role in national politics as well. Most of the MNCs work on the philosophy that a Merchant doesn't have any nationality. USA has the maximum number of MNCs. Among Asian countries, Japan had the maximum number of MNCs.

9.1 Definition

MNCs are defined as an enterprise that is headquartered in one country but has operations in one or more countries. Sometimes it is difficult to know if a firm is an MNC because multinationals often downplay the fact that they are foreign held.

Did u know? Most of the people in India are unaware that Bata is a Canadian company, Bayer is a German company, Nestle is a Swiss company and Cadbury–a British company.

Various definitions have been given to describe to MNCs. Sak Onkwist and John J. Shah have described MNCs in following manner:

9.1.1 Definition by Size

MNCs refer to a company which is big in size, but this size has many dimensions. One company may be big in terms of turnover while another may be in terms of profit and still another in terms of market value. But corporate size in terms of 'sales' is primarily used to describe a company as a Multinational Corporation. The World Investment Report 1997 indicates that there were about 45,000 MNCs with some 2,80,000 affiliates, whereas according to the World Investment Report 2002, there were about 65,000 of them with about 8.5 lakh foreign affiliates. But corporate size alone cannot be used as a criterion to be classified as MNC. GM does not become multinational because it was large but it became large as a result of going international.

9.1.2 Definition by Structure

This definition measures MNCs by how many countries it is operating in and by the citizenship of its corporate owners and top managers.

Example: Coca Cola operates in approximately 200 nations and has widespread share holdings.

The boardroom and the top management of top companies is becoming global.

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9.1.3 Definition by Performance

Definitions by performance depend on such characteristics as earnings, sales and assets. These performance characteristics indicate the extent of the commitment of corporate resources to foreign operations and the amount of reward from that commitment.

Example: A major chunk of Coca Cola's revenue comes from overseas operations. In India, Ranbaxy is considered as a true MNC as half to its turnover comes from the overseas market and this proportion is expected to significantly increase in the coming years.

Human resource or overseas employees are customarily considered as part of the performance requirement rather than as part of the structural requirement. Company's willingness to use overseas personnel is a significant criterion for multinationals.

9.1.4 Definition by Behaviour

According to this definition, it is the behavioural characteristics of the top management which decides whether a firm is a multinational or not. Thus, a company becomes more multinational if its management is more international. If a management has a geocentric thinking then this firm is treated as a true MNC. In a geocentric approach, the firm considers the whole world rather than the particular country as its target market.

Self Assessment

Fill in the blanks:

1. Bata is a MNC with its origin in .....
2. A company becomes more multinational if its management is more .....

9.2 Factors that Contributed to Growth of MNCs

Undoubtedly, firms cross national boundaries and accept the risk of operating in an unknown environment in the hope of earning more profit and increasing their shareholders' wealth. Besides this, there are many other reasons such as survival, new sources of supplies, cheap human resources and even just to keep busy the nearest rival in its home country. Some of the key reasons of crossing national boundaries are as follows:

Survival: Most countries are not as fortunate as that of India, Russia, China or the US in terms of size, resources and opportunities. Most European nations are small in size or most Middle East and South East countries are rich in only one or very few resources. In these countries, organizations are bound to do business in and with other countries to survive. Even organisations of big countries are bound to look out for new markets for their products and cheap resources to remain competitive and to survive.

Growth of Overseas Market (Sales): This has been the biggest reason for more and more companies expanding overseas. In the last 20 years, many economies have opened their doors for the world. This resulted in a big opportunity in terms of Market. Most of the European nations, USA, Canada, Japan, etc., have a stagnant population growth and very low GDP growth.

All these factors led to companies searching for a new market. Emerging economies like India, China, and South East Asia form a significant market—perhaps more than 35% of the world market. This has given them opportunities and MNCs have started expanding their wings in these parts of the world.

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Example: India and China are amongst the top five countries of the world in terms of Purchasing Power Parity. All this attracted many organizations to tap new markets in emerging economies.

Besides this, agreements/groups like GATT, GATS, ASEAN, EU, SAPTA, NAFTA, etc., have also created huge opportunities of business for organizations and to tap these, they are going abroad.

Diversification: No organization wishes to keep all its eggs in one basket. Every organization wants to diversify its risk and internationalisation is a good manner to do that, along with sticking to its core competency or old business. Different countries have different trade cycles for the same product. When there is a recession in one economy, there could be a boom in the other and an organization can cover losses in one country by profits.

Did u know? The Ispat group has steel plants almost all over the world. It is number two in most of the countries but it is number one in terms of sales in India. Levers which is behind P&G in USA, is much ahead of P&G in India.

Resources: In today's cut-throat competition, cost cutting is the key to success. Prices are controlled by consumers and the only thing which can be manipulated to increase profit is cost. Organizations go abroad in search of economical sources of supply. A truly global firm always locates its processing in the best available location in the world and outsource HR and other physical resources from the best suited place available. In fact, this is the reason that more and more companies are establishing their call centres in India.

Example: Even Wal-Mart, the biggest retailer of the world, does not have any retail shop in India but it does have cash-and-carry stores in India. Nike gets its shoes manufactured in South East Asia. Besides Nike, even Nokia, IBM, Toyota, Sony, Philips, Samsung, Mitsihuta, Boeing, Airbus, Adidas, GM, Ford, etc., have their manufacturing capacities, research centres, and ancillary units at places best-suited for their purposes. Thus, companies cross borders to have access to economical resources.

To Protect Market Share: Firms also become MNEs in response to increased foreign competition and a desire to protect their home market share. Using a "follow the competitor" strategy, a growing number of MNEs have now set up operations in the home countries of their own major competitors. This approach serves as a dual purpose: (1) it takes away business from their competitors by offering customers other varied choices, and (2) it lets competitors know that, if they attack the MNEs home markets, they will face a similar response.

Tariff and Non-Tariff Barrier: Organizations establish their operations overseas to deal with tariff and non-tariff barriers. Many countries impose tariff and non-tariff restrictions on imports. In such cases, organizations establish their production unit in the host country so that it can be treated as a local company. In the late 1970s, when the US imposed some non-tariff restrictions on the automobile import of Japan, Japanese firms began establishing their units in the US so that in terms of taxes they could be treated at par with US firms. Soon, America became the playground of Japanese firms.

Technology Expertise: One reason for becoming an MNE is to take the advantage of technological expertise by manufacturing goods directly (by FDI) rather than allowing others to do it under a license. Many MNCs feel it unwise to give another firm access to proprietary information such as patent, trademarks or technological expertise.

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Access to Economical Human Resources: In most of the cases, companies cross borders to have access to economical human resource. Organizations which used to earlier import Human Resource from our country are now establishing their operations in India itself, only to take advantage of economical human resource. Various companies are crossing borders because the cost of human resource is rising.

Task Find out the first country or countries that these companies targeted after their home country:
General Motors, Tata Motors, Adidas, and Sony.

Self Assessment

State whether the following statements are true or false:

3. Companies in larger countries like USA and China do not need to look for diverse markets.
4. MNCs diversify risk through internationalisation.
5. To avoid tariff and non-tariff barriers, organisations establish their production unit in the host country so that it can be treated as a local company.
6. Many companies are crossing borders because the cost of human resource is rising.

9.3 Advantages of MNCs

Multinational firms play a pivotal role in the global economy, linking rich and poor economies, and transmitting capital, knowledge, ideas and value systems across borders. Their interaction with institutions, organizations and individuals is generating positive and negative spillovers for stakeholders in host countries. As a consequence they have become focal points in the popular debate on the merits and dangers of globalisation, especially when it comes to developing countries. MNE are profit maximising, thus naturally not interested in creating benefits for others without obtaining a good price for it.

Impact on the Trade Balance

The macroeconomic effect of FDI is their impact on the trade balance. MNEs have a competitive advantage in both, accessing global markets in importing their products to local markets. The ability to produce at central locations with large economies of scale and supply markets in several countries is a core strategy of many manufacturing MNEs. Hence, they frequently export more than domestic firms, but also import a larger share of their inputs. A large share of both exports and imports is typically to or from affiliated companies, i.e., intra-firm international trade. Any analysis of trade impact of FDI has to consider their impact on both exports and imports.

Caution If a country runs a trade deficit, it must compensate for that deficit by reducing its reserves or receiving an influx of capital. The more capital inflow a country receives, the more it can import. Thus, it can run a trade deficit. In recent times, FDI helped Indian MNEs in managing trade deficit.

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Moreover, MNEs may open new export markets for local followers that can build on the country of origin's reputation that foreign investors may help building and use the same trade channels. MNEs are more likely to share such general knowledge, as it is less industry-specific and it is not part of their core capabilities, and its diffusion to local businesses does not endanger their own competitive advantage.

Table 9.1: The Impact of Balance of Payment on Selected Items

Balance of Payment	
Capital Outflows	**Capital Inflows**
Imports • Intermediate goods for local assembly and sale • Machinery for local production facilities • Investors' global products for local sale	Exports • Final goods for global markets • Intermediate goods for global markets
Service imports • Fees for licenses and other services	Service exports • Tourism and business travel receipts
Capital Import • Initial equity investment • Loans from parent to affiliate	Capital Export • Profit remittance • Interest payments • Repayment of loans

Promote Small Scale/Ancillary Industry

MNCs often catalyse the export of complex, technology-intensive products made by small and medium size firms (SMEs) located in host countries.

Example: Approximately two-thirds of consumer electronic products made in Korea and Taiwan are sold to MNCs such as GE, IBM and Toshiba on an "original equipment manufacturer" basis. In India too, companies like Maruti Suzuki, Hyundai, Samsung, LG, etc., do most of their purchases from India itself as it promotes ancillary industry.

Knowledge Transfer

Host countries, especially developing economies, aim to create an indigenous technological capability, that is, "skills – technical, managerial and institutional" – that allow productive enterprises to utilise equipment and technical information efficiently. Foreign investors are a potential source for knowledge at the technical and systemic level. They can contribute not only by transferring information, but also by stimulating directly or indirectly the generation of new knowledge in the host country.

Improves the Level of Technology of Local Firms

In the era of globalised capital markets, where overseas borrowing can be used to supplement domestic savings, the importance of FDI perhaps lies less on the quantity of capital inflow and more on its ability to transfer technology and business best practices to the domestic firms in the host country.

Transfer of technology and business best practices significantly improves the productivity of domestic firms in the recipient countries. These firms would improve their international competitiveness and the impact of this spillover effect on the economy of the recipient country is arguably much greater than the impact of the FDI itself. To maximise such benefits to local firms, governments in many developing countries have stipulated that foreign firms set up business operations in these countries in the form of Joint Ventures (JVs), assuming that such

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cooperation among multinational enterprises and their local partners would facilitate the transfer of technology and business practices.

Utilization of Resources

Investment by MNEs enhances the local development through a more optimum combination of unemployed production factors and the utilisation or upgrading of resources. It is said that India is a rich country, where people live only because of its rich mineral resources but unfortunately they have not utilised them well. MNEs may enable idle resources to be used. MNE not only uses idle resources but also use them at an optimum level as they use modern equipment, technology and appropriate production methods. This increases their productivity and reduces the cost of production.

Development of Infrastructure and Economic Development

FDI is a transfer of capital across borders, which allows the receiving economy to increase investment beyond its own savings rate. Traditionally, developing economies focused on this addition to the capital stock as core contribution of foreign investment to economic development. FDI is a source of capital because it has a more long-term character than portfolio investment. It cannot be withdrawn quickly if the volatile environment goes through an economic downturn such as the exchange rate crises in Mexico in 1995, East Asia in 1997 or Russia in 1998.

Inter-industry Linkage Effects

There is a strong industry linkage in terms of vertical integration. Vertical integration could be forward and backward. In forward integration, an organization goes one step ahead to the customer and in backward linkage they go one step backward from the customer. This means that in forward linkage the new unit is the customer of organization and in backward linkage it is the old unit, whereas in backward linkage new unit becomes the supplier of organization. If an MNC establishes any type of relation (forward and backward integration) with a local entity, it improves its productivity.

Forward and Backward Linkages

Foreign firms often purchase intermediate goods (backward integration) from domestic suppliers. These backward linkages create several effects on the domestic supplier. Foreign investors may transfer knowledge directly to local suppliers by training and even joint product development. MNEs improve the productivity of indigenous firms by providing technical assistance and training of employees to increase the quality of suppliers' products by helping in management and organization, by assisting them in purchasing of raw materials.

Increases Employment

MNCs generate new opportunities of employment in the host country. MNCs transfers their routine jobs and non-core jobs to the destination where labour is cheap, which is the reason that lot of jobs from Europe and the US have been transferred to India during the last decade. MNCs also transfer their operations to new and economical destination which also increases the opportunity for employment. MNCs play a critical role in economic development and in raising the income level of people, in turn, increasing the level of employment. In the last decade, directly or indirectly, MNCs have created millions of jobs in India in almost all the sectors such as infrastructure, software, hardware, old economy industry, entertainment, media, etc.

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Case Study

Cola Drinks on the Move

With net profitability and a 40 percent surge in volumes under its belt, Coca-Cola India (CCI) is now undertaking its fastest capacity expansion yet in the domestic market.

The soft drink major is in the process of setting into operation 30 new lines for its Carbonated Soft Drink (CSD) business. Mr. Sanjiv Gupta, the company's Deputy Division President said that the capacity expansion was being done for both glass and PET bottles. "Of the 30 new lines, six are new plants in Tamil Nadu, Andhra Pradesh and Karnataka, while 27 lines have been added in existing plants," he said. These are a combination of company – owned and franchisee-owned operations.

A significant portion of the $100 million investment allocated for the current year has been ploughed into this capacity expansion exercise, Mr. Gupta said.

The company's rural penetration has increased by 40,000 villages this year, and nine million cases of glass have been added in the first five months of the year, he added. While CCI's 200-ml bottles, priced at ₹ 5, continue to be mainstay of the season, the company will continue with its variable pricing strategy (between ₹ 7 and 8) for its 300 ml bottles.

While the month of April saw the soft drinks industry hit by the transporters strike, the current month has seen recovery. "the highlights of the year so far have been lower fixed asset costs, price compliance, costs efficiencies and packaging innovation. Till one year back, CSDs was a highly seasonal market with over 45 per cent volumes being generated from the peak season which lasted about three months. The industry dynamics are changing now."

A global market can balance good markets with bad ones. While there is no question that the US cola market is the biggest one in the world, it is a highly mature market, and the profit potential is limited. Cola has shrunk from 63.3 percent of soft-drink sales in the United States in 1984 to 58.8 percent in 1993 – a loss of $2.4 billion in potential retail sales.

The United States leads the world in Cola-Cola consumption, averaging 296 eight-ounce servings per person per year. The comparable figures for other markets are Mexico (275 servings), Germany (189), Canada (169) Japan (124), Great Britain (89), France (56), Egypt (18), Russia (2) and China (1). In the case of India's 890 million people, each person only consumes an average of three servings in a year, well below the levels found in Pakistan (9) and Thailand (75).

In addition to being the world's most populous nations, China and India are two of the world's fastest growing economies, and Japanese, European, and American firms are all quite excited about doing business with and in China and India. Undoubtedly, China and India have plenty of room to grow as a market. If the Chinese and Indians can be persuaded to drink just one more serving per person a year, Coca-Cola and Pepsi can derive additional sales of more than two billion cans.

Coca-Cola has been particularly aggressive in East Europe, Asia, and South America. It has opened plants in Romania, Norway, Fiji and India while planning several more in China, Hungary, Lithuania, Russia and Thailand. When the Soviet Union Collapsed, PepsiCo held on to its network of state-run bottlers so as to utilize their ties to old-line management. Coca-Cola, on the other hand, quickly got rid of the government link and

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spent more than $ 1.5 billion in former East bloc countries to build a new business from scratch. As a result, Pepsi's lead due to its early distribution deals evaporated. Coke now leads in market share in every Eastern European country. In addition it also has a wide lead in Latin America.

Questions

1. What was the motive behind such a move?
2. How would the expansion help developing countries like India?

Source: "Pepsi Fights for India's Beverage Business," The Wall Street Journal,

Self Assessment

Fill in the blanks:

7. The macroeconomic effect of FDI is their impact on the .....
8. The more capital inflow a country receives the ..... it can import.
9. FDI is a ..... of capital because it has a more long-term character than portfolio investment.
10. When foreign firms purchase intermediate goods from domestic suppliers, it is known as .....

9.4 Disadvantages of MNCs

Multinational corporations have become too powerful in absolute terms as well as relative to governments.

The enormous resources controlled by multinational corporations give them a tremendous amount of power, especially over individuals and governments. The ongoing erosion of national barriers to trade and investment enables these firms to close shop and head overseas if government, workers or NGOs place restrictions (e.g., minimum wage, taxation, labour standards, fines for pollution, etc.) on them or otherwise inhibit their ability to earn profits.

Caution Certainly, there is a danger to any organization that controls resources and market share on par with giant conglomerates like HUL, Reliance, TATA, or AV Birla may abuse their power in ways that undermine democratic processes or hurt consumers. But these corporations earn their profits through efficiency and innovation, without which they would quickly lose market share to rivals. They employ millions of workers with competitive wages, provide relatively low-cost/high-quality goods and services to consumers and enrich shareholders. Moreover, they must accomplish all of this without stepping beyond the boundaries of Competition/Anti-trust Law/Consumer Act in the countries in which they operate. In light of the profit motive, firms spend money to influence legislation to its favour in case doing so is likely to enhance profitability.

Multinational Corporations put Profits before People: Critics contend that too much emphasis is placed on attaining profits and enhancing shareholder value. The sharp focus on shareholder value causes firms to undertake activities that reduce the level of social welfare in order to make a quick buck. It is true that the sole focus of a corporation is to earn profits.

However, the simplicity of the corporate incentive system facilitates regulation while encouraging efficiency.

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Example: A firm will not pollute if the cost (e.g., a fine, for instance) is greater than the benefit (e.g., money saved by bypassing proper disposal). That is why legislation based on the "polluter pays" principle is effective and efficient.

A corporation will not abuse its workers, consumers or shareholders, lest these parties abandon the corporation for one of its competitors. Laws, penalties and surveillance are, in most cases, sufficient to prevent such collusion. Moreover, the rapidly growing capacity of civil society, particularly NGOs, places a heavy check on corporate practices.

Exploitation of Workers: Another contention is that multinational firms are too powerful in relation to workers and even unions. Lliberalisation magnifies this mismatch. Fleet-footed multinationals can simply pick up and move jobs overseas to a place where unions are weak or illegal, wages are low and working conditions are horrific. The liberalisation of trade and investment, allows MNCs to move operations from rich countries with high labour standards to poorer countries with lower or non-existent labour standards. Workers, on the other hand, cannot just pack up and head overseas in search of better wages and working conditions. The result, according to this 'logic', is a 'race to the bottom' in terms of labour standards and wages.

Oligopoly of MNC (Impact on Host Country): If local firms are forced to exit (or are taken over) this can lead to oligopolistic market structures that may hinder endogenous technological development, reverse the downward pressure on prices, and even trigger adverse political economy effects. In a worst-case scenario, the foreign investor may attain monopolistic market power and thus extract rents in imperfectly competitive markets that are transferred out of the country. This, however, would only occur in very specific cases, notably if competition is constrained by high barriers to entry.

M&A Activities by MNCs (Impact on Host Country): Mergers and Acquisitions (M&As) have become increasingly important channels of cross-border industrial restructuring and foreign direct investment all over the world. In India, the liberalisation policy in the 1990s facilitated M&As, including cross-border M&As. As a result, the M&A activity has boomed over the past few years. In tune with the worldwide trend, M&As have become an important conduit for FDI inflows in India in the recent years.

Opportunity Loss (Impact on Host Country): Some critics have claimed that MNEs are making investment that domestic companies otherwise would have undertaken. The result is the displacement of local entrepreneurial drive or the bidding up of prices without additional output. MNCs have an ability to raise funds in various countries, MNEs thus can reduce their capital cost relative to that of local companies and apply the savings wither to attracting the best personnel or to enticing customers from competitors through greater promotional efforts.

Key Sector Control (Impact on Host Country): If foreign ownership dominates key industries, then decisions made outside of the country may have adverse effects on the local economy or may exert an influence on local politics. MNEs are more loyal to their home country as they have majority of their assets, sales, employees, managers, and stockholders in their home counties. Their home countries have access to their global financial records and can tax them on their global earnings and even influence their decision, which obviously host country governments cannot do.

MNE Independence (Impact on Host Country): Companies can, by playing one country against another, avoid coming under almost any unfavourable restriction. For instance, if they do not like wage rates, union laws, fair employment requirements or pollution and safety codes in one country, they can move elsewhere or at least threaten to do so. In addition, they can develop structures to minimise their payment of taxes anywhere.

Transfer Pricing: A transfer price is the price on goods and services sold by one member of a corporate family to another, such as from a parent to its subsidiary in a foreign country.

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Companies establish arbitrary transfer price because of difference in taxation between countries. If tax is higher in host country then the MNE will charge higher prices from its subsidiary in the host country for all its export from home to host countries. Thus, it will earn profits in the home country and will evade tax in the host country. Companies also set arbitrary transfer prices for competitive reasons or because of restrictions on currency flows. If the parent sells a product at low transfer price to the subsidiary, the subsidiary will be able to sell the product to local consumers for less, thus improving the competitive position. And, if the country where the subsidiary has currency controls on dividend flows, the parent can get more hard currency out of the country by shipping in products at a high transfer price or by receiving products at a low transfer price.

Loss of Job (Home Country): MNCs may be a source of employment generation for host country but they are responsible for cutting of jobs in the home country. Once a US senator said regarding the job transferring from USA to India and China that, 'China is taking our dinner and India is taking our lunch'. MNCs from USA and Europe are shifting their production centre from home country to cost effective destinations like South East Asia, China and India. Obviously all this resulted in loss of jobs in the home country.

Self Assessment

State whether the following statements are true or false:

11. MNCs put too much emphasis on attaining profits and enhancing shareholder value.
12. Growth of MNCs can lead to formation of oligopolies in the country by forcing the local players out of business.
13. A transfer price is the price on goods and services sold by one company of an industry to another.

9.5 Control Over MNCs and Organisation Structure

Organization Structure, we mean three things: First, the formal division of the organization into subunits such as product divisions, national operations, and location of decision-making responsibilities within that structure (e.g., centralized or decentralized); and third, the establishment of integrating mechanisms to coordinate the activities of subunits including cross functional teams and or pan-regional committees.

Control Systems are the metrics used to measure the performance of subunits and make judgments about how well managers are running those subunits.

Example: historically Unilever measured the performance of national operating subsidiary companies according to profitability - profitability was the metric. Incentives are the devices used to reward appropriate managerial behavior.

Incentives are very closely tied to performance metrics. For example, the incentives of a manager in charge of a national operating subsidiary might be linked to the performance of that company. Specifically, she might receive a bonus if her subsidiary exceeds its performance targets.

9.5.1 The Foreign Subsidiary Structure

Environmental changes, such as increased demand in foreign markets, or a foreign government's mandate, or changing conditions in the home market, often force international corporations to cease exporting and being establishing manufacturing facilities in the foreign markets – they establish subsidiaries in foreign countries. These firms thus restructure their organization; they

change from an international division structure to a foreign subsidiary structure. Each foreign subsidiary is treated as an entity. Each reports directly to top management at headquarters. Coordination between product and service departments is carried out at the headquarters office. These firms therefore apply the multi-domestic strategy. Applying a multi-domestic strategy, the headquarters' managers generally allow the subsidiaries to function as a loose federation with local managers processing substantial autonomy, allowing them to respond quickly to local situations.

Advantages of the Foreign Subsidiary Structure

- ***Autonomy of affiliates:*** The affiliate subsidiaries operate free of layers of management between them and top management. These independent affiliate companies are generally allowed to operate with the little control from above and can thus develop their own local identity.
- ***Direct top management involvement:*** Problems beyond the affiliates talents go to top management for response and resolution. This enables top management to reflect long-range corporate goals rather than parochial interests. Also, it forces top management to develop a stake in international business and acquire knowledge in that area.

Disadvantages of the Foreign Subsidiary Structure

- ***Diffuseness of international responsibility:*** there is no center for international operations responsibility. With so many groups reporting directly to the board, clarity and focus can be lost – although the board can delegate the responsibility to certain expert members.
- ***Potential unwieldiness:*** Many items that could be resolved without board action, such as by experts, are often pushed to the board level again, the board could delegate many responsibilities to expert members.

9.5.2 The Product Division Structure

A company that sells a diversified selection of goods or services will likely organized on a product group structure. Many corporations are diversified and use this structure. Under the product division structure, each of the enterprises product divisions has responsibility for the sale and profits of its product. Therefore, each division has its own functional, environmental, sales, and manufacturing responsibilities. When a product division decides to internationalize its operations, as in the case of one product companies, it may first begin by indirect exporting, subsequently establishing its own export division, and then establishing foreign subsidiaries. This means that if sales in foreign markets by firms with numerous product divisions became substantial, these enterprises could end up operating numerous subsidiary companies in a single foreign territory.

Example: Ford Motors began restructuring itself along the product line in the early 1990s Canon Corporation used the product division structure when it became a multi product enterprise in 1962.

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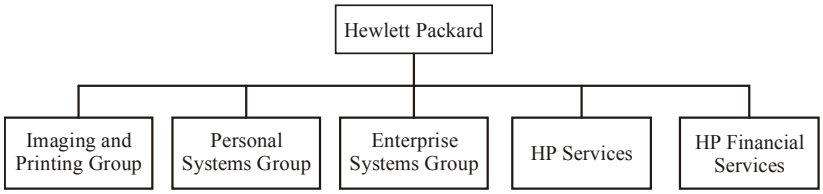
Figure 9.1: Product Division Structure



Advantages of the Product Division Structure

- ***Product and technology emphasis:*** Since both the domestic and international units report to the product division and compared with the whole, product divisions tent to be small, closer ties could result. Therefore, because of the common product benefit and the closer ties, products and technology can be easily transferred between the domestic and international units.
- ***Worldwide product planning:*** Foreign and domestic plans can be more easily integrated in a product division than in an international division. A worldwide division perspective could therefore evolve.
- ***Conflict minimized:*** The problem of substantiating the difference between international and domestic needs may be less difficult than when the international function is in the international division. Having both functions in the same division may lead to similar loyalties and the Managers are able to gain expertise in all aspects of a product or products.
- Efficiencies in production are facilitated.
- Production can be coordinated at a variety of facilities reflecting International demand and cost fluctuations.
- Managers are in a position to incorporate new technologies into their products and respond quickly and flexibly to technological changes that affect their market.
- Clear focus on market segment helps meet customers' needs.
- Positive competition between divisions.
- Better control as each division can act as separate profit centre.

Disadvantages of the Product Division Structure

- ***Division managers often lack international skills:*** International product managers are often selected on the basis of domestic performance and may therefore lack the required international skills.
- ***Weakness in worldwide know-how:*** Managers of individual product divisions may become knowledgeable in operating in certain markets, but worldwide knowledge is often impossible.

Example: In the past, many managers of U.S. domestic enterprises that internationalized their operations have developed strong skills in the Canadian and European markets but weaker skills in other parts of the world. This may result in weak performance in certain markets.

- ***Inherent weakness of multiproduct systems.*** Managers of the overall corporate system may encounter conflicting international demands from the different product divisions.

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Since managers are part of the overall corporate system, they may not posses adequate abilities to handle such conflicting demands.

- ***Foreign coordination problems.*** Managers of different product divisions operating in the same foreign country may not coordinate efforts to attain overall corporate efficiency because they are too busy looking out for each other's interests.

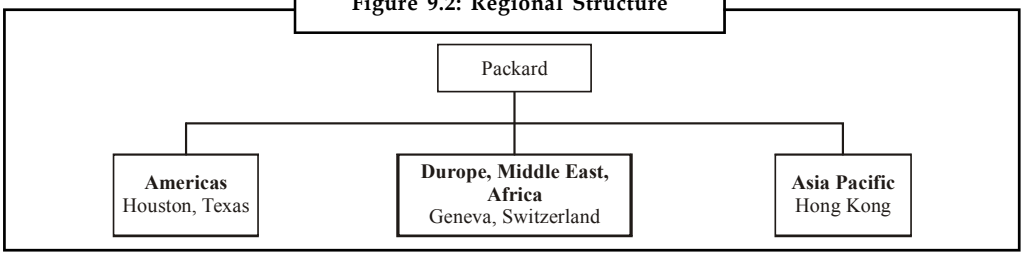
Example: To cut costs, perhaps some support functions typically carried out in all product divisions, such as personnel and payroll, could be carried out by a single unit.

- It may encourage expensive duplication in functional areas and even in physical facilities.
- Each product group must develop its own knowledge about the local environment.
- Coordination and corporate learning across product groups is more difficult.
- Duplication of functions (e.g. different sales force for each division).
- Negative effects of competition.
- Lack of central control over each separate division.

9.5.3 Regional Structure

The most common form of the group structure defines activities by geographic regions. Under the regional structure, regional heads are made responsible for specific territories, usually consisting of areas such as, Asia, South America, North America, etc., and report directly to their CEO or his or her designated executives at the headquarters. In general, firms with low technology and a high marketing orientation tend to use this structure. Firms whose foreign subsidiary or foreign product structure has became too large and too complex to manage from a single headquarters often restructure themselves using this form. This type of structure enables regional heads to keep abreast of, and provide for, the needs of their respective regional markets. Managers at regional headquarters are typically responsible for a range of activities, such as production for and marketing in their respective regions. Pharmaceutical, food, and oil companies trend to use this structure.

Figure 9.2: Regional Structure



Advantages of the Regional Structure

- ***Decentralization:*** Authority and responsibility, and therefore performance accountability, is delegated directly to the regional office. The management tasks of planning and strategy are less complex than if the central headquarters were to hold this responsibility.
- ***Adaptation:*** Regional managers are better able to adapt to local needs than headquarters managers because they are in closer touch with local changes and requirements.
- ***Single management units posses regional knowledge:*** Regional managers develop local expertise because they are responsible for regional strategies and daily operations. Regional

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differences exist throughout the world. Inputs from knowledgeable regional managers can enable central headquarters managers to use these differences effectively in developing and attaining overall corporate objectives.

Disadvantages of the Regional Structure

- ***Policy barriers:*** Inconsistent overall corporate management practices may evolve. This is specially so when central management tries to, or is persuaded to, satisfy specific regional needs.
- ***Weak worldwide product emphasis and technical knowledge:*** Because technical knowledge is spread out, a International perspective on products is sometimes difficult to attain. And because the emphasis is usually on regional concerns, the formulation of worldwide strategy formulation can be difficult.
- ***Technology transfer barriers:*** Employee loyalty is often focused on the region rather than on the overall organization, and each regional manager tends to claim that things are different in his or her region. Therefore, when headquarters managers attempt to implement new technology on an overall corporate basis, it may not be readily accepted by the regional.
- ***Costly application:*** The typical support functions shown. Exist in each regional division. Costly duplication of efforts results. Efficiency could result if these support functions were combines, but in this structure, the number of functional product staff specialists tends to increase through the years.
- ***Weak communications:*** Necessary information may not reach top management because of the regional managers' focus on regional performance. Overall corporate performance may therefore be weakened.

9.5.4 Worldwide Area Structure

A worldwide area structure tends to be favored by firms with a low degree of diversification and a domestic structure based on function. Under this structure, the world is divided into geographic areas. An area may be a country (if the market is large enough) or a group of countries. Each area tends to be a self-contained, largely autonomous entity with its own set of value creation activities (e.g., its own production, marketing, R&D, human resources, and finance functions). Operations authority and strategic decisions relating to each of these activities are typically decentralized to each area, with headquarters retaining authority for the overall strategic direction of the firm and financial control.

Caution This structure facilitates local responsiveness. Because decision-making responsibilities are decentralized, each area can customize product offerings, marketing strategy, and business strategy to the local conditions. However, this structure encourages fragmentation of the organization into highly autonomous entities. This can make it difficult to transfer core competencies and skills between areas and to realize location and experience curve economies. In other words, the structure is consistent with a multi domestic strategy buy with little else. Firms structured on this basis may encounter significant problems if local responsiveness is less critical than reducing costs or transferring core competencies for establishing a competitive advantage.

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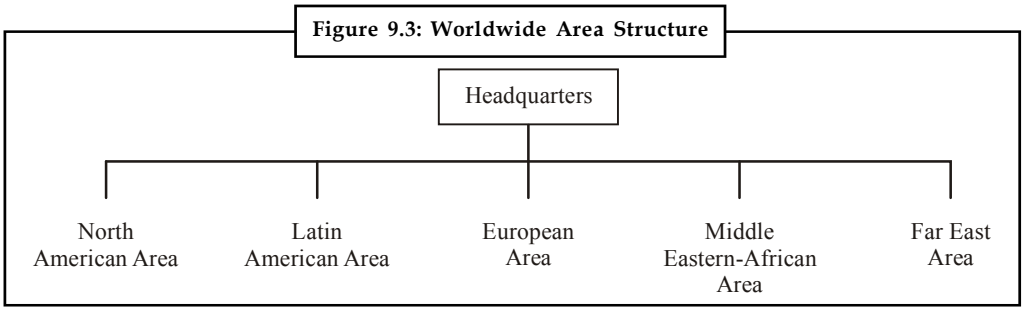
Figure 9.3: Worldwide Area Structure



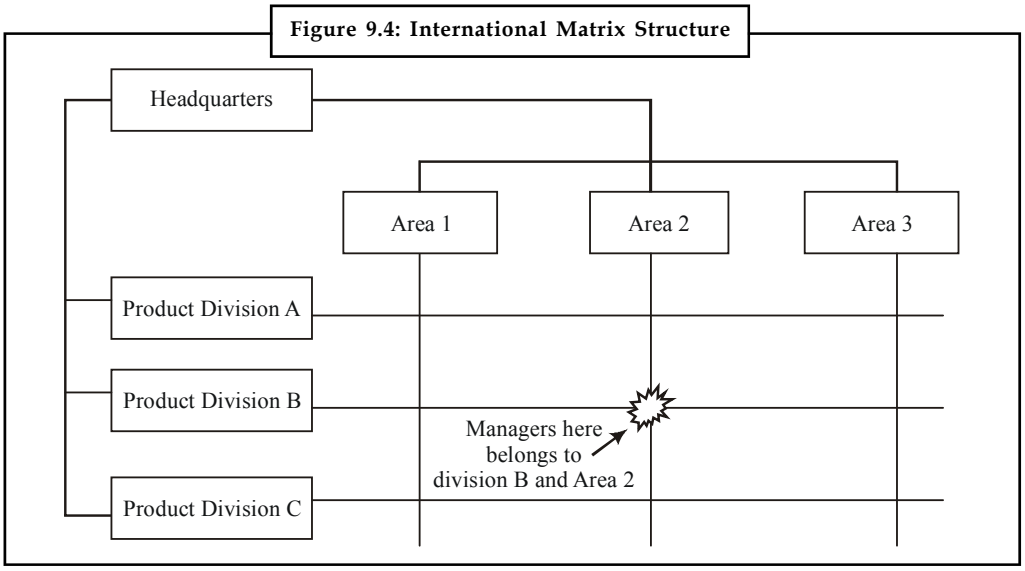
9.5.5 The Matrix Structure

Matrix structure is a team approach to project development within an organisation. The team is comprised of members from different functional areas or departments within the company. The ideal International corporation is strongly decentralized. It allows local subsidiaries to develop products that fit into local markets. Yet at its core it is very centralized; it allows companies to coordinate activities across the globe and capitalize on synergies and economies of scale.

To accomplish this, many international businesses have adopted matrix structures.

Example: Companies such as Nestle have adopted matrix organizations that allow for highly decentralized decision making and development while simultaneously maintaining a centralized corporate strategy and vision.

Figure 9.4: International Matrix Structure



Advantages of the Matrix Structure

- It allows firms to draw on the functional and product expertise of its employees because it brings together the functional, area, and product expertise of the firm into teams that can develop new products or respond to a changing marketplace.
- Coordination and cooperation across subunits enable the firm to use its overall resources efficiently and therefore to respond well to International competition in any market.
- Overall corporate International performance is highlighted.

Notes

- Many internal conflicts are resolved at the lowest possible level, and those that cannot be resolved are pushed up.
- It promotes organisational flexibility and promotes coordination and communication across divisions.
- Improves individual motivation.
- Increases job satisfaction.
- Enhance and evolve the organisation's pool of available expertise and knowledge, thus making the organisation more flexible.

Disadvantages of the Matrix Structure

- Worldwide responsibility may be given to product managers with weak international experience.
- The organization tends to create a mountain of paperwork.
- The dual-boss, cross-communication system is expensive and complex.
- Decisions sometimes must be made quickly. Quick decisions can be made by one person. In this matrix group decision-making process, decisions are usually made slowly.
- It is inappropriate for firms that have few products and operate in relatively stable markets.
- Employees have more than one boss.
- It creates a paradox regarding authority.
- It tends to promote compromises or decisions based on the relative political clout of the managers involved.

9.5.6 Contractual Alliance Structure

Many enterprises enter foreign markets via non-equity based joint ventures, often referred to as contractual alliances and strategic alliances.

Example: One firm's strength may be production and another firm's distribution. Instead of these two firms forming equity-based joint ventures to capitalize on each other's strengths, they form a non-equity-based contractual alliance.

Thus, when the two firms no longer need each other, in theory, they simply break up the partnership. The advantage of this partnership arrangement is that when there is a breakup, there is no long, drawn-out-fight for the division of assets, as often is the case when equity-based partnership breaks up.

There are disadvantages to this approach, however. For instance, when one partner acquires the other partner's skills, and the reverse is not the case, the learned partner may leave the unlearned partner in a dubious situation or the learned partner may easily take over the unlearned partner. Of course, this type of arrangement can work only when neither partner possesses a secret motive.

9.5.7 Networking

Somewhat similar to the contractual alliance arrangement is networking. Applying this approach, a corporation subcontracts its manufacturing function to other companies.

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Example: Nike, the American shoe maker, subcontracts the manufacture of its athletic shoes and clothing to forty separate locations, mostly in Asia Networking, a typical twentieth-century organisation has not operated well in a rapidly changing environment.

Structure, systems, practices, and culture have often been more of a drag on change than a facilitator. If environmental volatility continues to increase, as most people now predict, the standard organisation of the twentieth-century will likely become a dinosaur. Organisational structures change with the changing business and social environment. Increasingly, organisations are project-based, expanding and contracting as projects of different sizes come and go. In some cases the organisation exists only for one major project, e.g. a film production. However in most cases there is a core organisation which continues between projects, and indeed holds the projects together. The individual projects are not only tied together administratively but more importantly are linked in terms of a central business strategy, charitable purpose or artistic mission. The core organisation selects projects strategically to fit its mission and core skills. In this way, synergies are achieved. The characteristics of a network organisation are:

1. Independent teams.
2. Departments which share common values.
3. Projects which support each other.
4. Multiple links between projects.
5. Information and Communications Technology is used to connect the projects.

There is a key coordinating role for the Chief Executive to construct the teams and manage the interrelationship of projects. When an organization enters into such contractual alliances or networking agreements, it must create a unit whose responsibility is to monitor the arrangement. For instance, IBM has created an alliance council of key executives who meet monthly to keep track of more than forty partnerships throughout the globe.

9.5.8 The Mixed (Hybrid Structure)

The traditional and contemporary alternative structures described above are not independent entities that cannot co-exist within the same company. By mixing the structural types, the weaknesses of each type can be minimized.

Example: Companies with worldwide product division structure can appoint regional coordinates who attempt to supply the concentrated environmental expertise that is usually absent in the product division structure.

Similarly, companies with regional structures (either worldwide or within an international division) can set up positions for product coordinators. While such coordinator positions are not particularly new, giving them some real influence short of classical line authority is a relatively recent development. Furthermore, international organizations can centralize some functions, such as an accounting division that provides services for all worldwide subsidiaries, while other functions, such as marketing, remain decentralized.

9.5.9 Flat Structure

Regardless of which structure is used, it should be as flat as possible. That is, it should have fewer managerial layers than traditional hierarchical organizations. A flat structure is needed because a twelve-layer company cannot compete with the three-layer company.

Notes

Notes **GM vs. Toyota**

A decade or so ago, General Motors, the U.S. based car manufacturer, had an organizational structure consisting of more than fifteen managerial levels. General Motors had a problem competing with Toyota, the Japanese car manufacturer at least partially because Toyota's organizational structure contained only four managerial levels. (This is in part because Japanese employees are not motivated by the opportunity to climb up the hierarchy as are American employees.) One reason companies with tall structures are less competitive than firms with flat structures is that they have to pay more managers at more levels, thus increasing their costs.

Another reason is that an organization can create an atmosphere of maximum creativity only if it reduces hierarchical elements to a minimum and creates a corporate culture in which its vision, company philosophy, and strategies can be implemented by employees who think independently and take initiative. The flatter structure means that managers have to communicate with more employees than do managers in tall structures. The ability to communicate with more subordinates has been made possible by the enormous advancements in communications technologies, which, as American management authority Peter F. Drucker noted, enables managers to communicate with a far wider span of individuals than was possible in the past. Spans of control thus give way to spans of communication.

9.5.10 Organic versus Mechanistic Structures

Another problem confronting managers is determining how organic or how mechanistic the organizational structure should be. Basically managers in organic structures allow employees considerable discretion in defining their roles and the organization's objectives, In mechanistic organizations roles and objectives are clearly and rigidly outlines for employees – managers and subordinates are allowed little or no discretion. Historically, large organizations have tended to adopt the mechanistic form and small organizations the organic form; mass producing organizations have tended to adopt the mechanistic form and firms producing specialized products have tended to adopt the organic form.

Thus, the form an organization adopts is determined by varying situational factors.

In making a determination as to which approach is appropriate for an organization functioning across nations, managers also need to consider national cultural factors.

Example: Organizational structures tend to be more mechanistic in strong uncertainty avoidance cultures, such as France and Germany, than in weak uncertainty avoidance cultures, such as Great Britain, and organic structures tend to be more prevalent in the latter cultures than in the former.

If one adheres to the national cultural factors model, subsidiaries in some nations will be more structured than subsidiaries in other nations; but if one adheres to the situational factors model, the same structure is applied in the same situation in all nations.

Factors that Influencing Centralization of Decision-making

The following factors are influencing the MNCs to go for centralization of decision making authority:

- Corporate culture — mainly referring to accepted management models and practices (decentralised, partly centralised or fully centralised)

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- Industry type and business maturity — including both generic industry features (e.g. manufacturing vs. services, wholesale vs. retail, market leadership, market and competition dynamics, etc.) as well as enterprise specific characteristics (e.g. size, growth, geographic distribution, sophistication, etc.)
- Technology infrastructure and architecture — current status in so far as an open and common environment, IT management models and strategies
- Third-party services sourcing philosophy — attitude towards single rather than multiple providers, internal rather external service provision orientation, previous experience, etc.
- Tax, legal and regulatory restrictions — deriving from the external environment as well as from the legal structure and the business model of the organisation
- Highly competitive environment
- Large size
- Relatively high importance to MNC
- Low level of product diversification
- Homogeneous product lines
- More experience in international business.

Factors that Influencing Decentralization of Decision-making

- Availability of experienced professionals
- Stable environment
- Small investment
- High level of product diversification
- Low interdependence between the units
- Heterogeneous product lines

9.5.11 Participative Decision-making in Multinational Corporations

In almost all foreign countries, we are seeking more participation by the employees in decision making. No longer is the employee accepting a passive role of simply reacting to management decisions. What is now wanted is to know what is being considered and for one's views to be taken into account. In some way, the employee wants to feel associated with the decision-making process of the enterprise for which she or he works. What traditionally has been reserved for unilateral decisions by management members is now being opened to some degree for participation by all the employees or their representatives.

No longer accepted as a matter of course is for the manager alone to decide the working hours, to determine how the work is organized, and to handle work distribution. In short, a recasting of the employer-employee work relationship is taking place in most foreign countries.

Example: The new relationships between employer and employee have met with approval by many U.S workers who work for foreign corporations. As one American auto worker employed by a Japanese firm said, "When something goes wrong, you're not afraid to tell the foreman.

Notes

Decisions of considerable importance are analysed with extreme care, and the effort is taken to ascertain the viewpoints of all who may be affected by them as well as everyone in the company who may influence their outcome. The result is a minimum of disagreement over decisions implemented. The superior does not alter the decision but motivates and assists the writer of it to change and improve it so that consensus can be reached. The initiator of a decision always carefully checks it to make certain nothing in it will offend the superior or evoke outright disapproval. Thus conflict is avoided.

The Japanese decision-making procedure is centuries old, yet it features modern management techniques from the U.S viewpoint and is giving excellent results to Japanese industries. The approach stresses asking the right Review Questions and logically from this the right answers emerge. It is also claimed that formulating the decisions after all have had their say is superior to making the decision at the beginning and then striving to sell it to others.

Perhaps the hallmark of foreign-run business in US is the open communication of workers with top management. A German manager of a US plant regularly walks the production floor. Foremen and workers at a Japanese-owned company hold 10- minute meetings twice a day and employees hear management reminute meetings twice a day and employees hear management reports on growth twice a day. Nurturing the individual has paid off for those firms in low turnover rates, improved productivity, and higher profits.

9.5.12 Headquarters and Subsidiary Relationships in International Firms

The success of an international firm can be greatly affected by the control techniques they practices. To maintain proper control systems, an appropriate organizational structure is essential. Along with identifying the appropriate structure, headquarters management must decide whether the headquarters foreign subsidiaries relationship should be centralized or decentralized. In a centralized system, most of the important decisions relative to local matters are made by the headquarters management. In a decentralized system, managers at the subsidiary are given the autonomy to make most of the important decisions relative to local matters.

When decision making is decentralized, judgments made by local managers may sometimes have negative consequences for other subsidiaries and/or may not be the best decision when overall firm's objectives are considered.

Example: A decision made by managers at the Rio-de-Janeiro subsidiary to pay generous benefits to their workers may demoralize workers in other subsidiaries if they perceive their benefits to be comparatively unfair. Centralized decision making would thus enable headquarters managers to consider the consequences of a decision on all of the firm's subsidiaries. Centralization, in this respect, would be advantageous.

9.5.13 Headquarters-Foreign Subsidiary Governance Mechanisms

Governance Mechanism

- Centralization.
- Formalization.
- Normative Integration

A contemporary idea on headquarters-subsidiary governance relationships (HSRs) has been discussed by business professors Sumantra Ghoshal and Nitin Nohria, from INSEAD, France, and Harvard Business School, respectively. They described the relationships in terms of three basic headquarters– subsidiary government mechanisms:

Notes

- ***Centralization:*** Concerns to the role of formal authority and hierarchical mechanism in the company's decision making processes.
- ***Formalization:*** Represents decision making through bureaucratic mechanisms such as formal systems, established rules, and prescribed procedures; and
- ***Normative Integration:*** Relies neither on direct headquarters involvement nor on impersonal rules but on the socialization of managers into a set of shared goals, values, and beliefs that then shape their perspectives and behavior.

The following sections present two schemes that identify factors to help determine the right headquarters-foreign subsidiary control relationship. The first scheme proposes that certain situational factors influence the relationship in all countries. The second proposes that certain factors influence the relationship in all countries.

Schemes for Control

- National culture scheme
- Situational scheme

National Culture Scheme

Cross-cultural researcher Geert Hofstede proposed a paradigm to study the impact of national culture on individual behavior. He developed a typology consisting of four national cultural dimensions by which a society can be classified as:

1 Power distance,

2. Individualism,

3. Uncertainty avoidance,

4. Masculinity.

5. Confucianism.

The ensuing section indicates whether the headquarters-subsidiary relationship (HSR) with subsidiaries located in these cultures leans toward low and high centralization (C), low or high formalization (F), or low or high Normative Integration (NI).

International Cultural Framework

Table 9.2: International Cultural Framework

Global Cultural Framework

CULTURAL DETERMINANTS	HEADQUQRTERS-FOREIGN SUBSIDARY CONTROL RELATIONSHIP
Large power distance	HC
Small power distance	LC, HF, or HNI
High power distance	HC or HF
Low individualism	LR,HNI
Strong uncertainty avoidance	HF OR HC
Weak uncertainty avoidance	LC or HNI
Confucianism	LF,HC,HNI
High masculinity	HF
Low masculinity	LC,HNI

C = Centralization, F = Formalization , NI = Normative Integration,

H = High, L = Low (Source : Empowerment in organisations ,Carl.A.Rodrigues)

Notes

1. ***Power Distance:*** Power distance refers to the degree to which people in a society accept centralized power and depend on supervisors for structure and direction.

   (a) *Moderate-to-Large Power Distance:*Individuals in societies dominated by this dimension tend to accept centralized power and depend heavily on superiors for direction. Therefore, an HSR leaning toward high C probably would be preferred by subsidiary managers who are dominated by this cultural dimension.

   (b) *Moderate-to-Small Power Distance:* Individuals in societies dominated by this cultural dimension do not tolerate highly centralized power and expect to be consulted, at least, in decision-making.

   Furthermore, Hofstede remarked that status differences in these countries are suspect. Thus, subsidiary managers who are dominated by this cultural dimension probably would favor an HSR leaning toward low C, high NI, or high F.

2. ***Individualism:***

   (a) *Moderate-to-High Individualism:* Individuals in societies dominated by this dimension think in "me" terms and look after primarily their own interests. Since these individuals often consider their own objectives to be more important than the organization's, the HSR that involves in subsidiaries managed by people influenced by this cultural dimension probably leans toward high C or high F.

   (b) *Moderate-to-low Individualism:* Low individualism societies are tightly integrated and individuals belong to "in groups" from which they cannot detach themselves. People think in "we' as opposed to "me" terms and obtain satisfaction from a job well done by the group. Individuals in these societies are controlled mainly by the group's norms and values. These people would therefore require less formal structure than individuals who think in "me" terms. An HSR leaning toward high NI would thus fit these societies.

   Finding by some researchers lend support to the above contentions. These researchers concluded that control systems in the United States are designed under the assumption that workers and management seek "primary control" over their work environments. Primary control is manifested when employees with individualistic tendencies attempt to shape the existing social and behavioral factors surrounding them, including co-workers, specific events, or their environments, with the intention of increasing their rewards. Thus many employees exhibit behaviors and establish goals that may diverge from those desired by the organization. For these reasons, control systems consisting of rules, standards, and norms of behavior are established to guide, motivate, and evaluate employees' behavioral performance (high F). On the other hand, organizations in Japan (a low individualism culture) rely more on "secondary controls," controls that rely mostly on informal peer pressure (high NI). And Japanese corporations with subsidiaries in the United States tend to give American managers working for them little or no authority.

3. ***Uncertainty Avoidance:***

   (a) *Moderate-to-Strong Uncertainty Avoidance:* Individuals in these cultures feel uneasy in situations of uncertainty and ambiguity and prefer structure and direction. Therefore, because it tends to reduce uncertainty for individuals, managers of subsidiaries who are influenced by this cultural dimension probably would prefer an HSR leaning toward high F or high C. Hofstede has proposed that improving quality of life for employees in these societies implies offering more security and perhaps more task structure on the job.

Notes

(b) *Moderate-to-Weak Uncertainty Avoidance:* Hofstede found that in countries dominated by a moderate-to-weak uncertainty avoidance dimension, individuals tend to be relatively tolerant of uncertainty and ambiguity; they do not require as much high C or high F as do people in strong uncertainty avoidance cultures. Thus, an HSR leaning toward low C or high NI, since it provides more challenge than does high C and high F, probably would be preferred by managers of subsidiaries who are dominated by this cultural dimension.

Example: Managers in Britain, a weak uncertainty avoidance culture, end to value achievement and autonomy (low C or high NI behavior) and managers in France, a strong uncertainty avoidance society, value competent supervision, sound company policies, fringe benefits, security, and comfortable working conditions (high C and high F). French manages do not believe matrix organizations , which tend to apply high NI-like behavior, are feasible; they view them as violating the principle of unit of command.

4. ***Confucianism:*** Individuals in East Asian cultures (the People's Republic of China, South Korea, Japan, Hong Kong, and Singapore) are also influenced by the Confucian cultural dimension. In essence, individuals in Confucian based organizations are forced to adhere to rigid, informal group norms and values (high NI like relationship). Since individuals are so strictly bound to group norms, organizations based on the Confucian cultural dimension probably apply less formalization (low F) than do organizations in the West. This contention is partially supported by research findings that organizations in China, where the Confucian influence is still strong, tend to be far less formalized than Western organizations. There is evidence that Confucian-based organizations apply high C. for example, South Korean managers demonstrate the Confucian virtues of loyalty and obedience to authorities and they tend not to adopt systems of shared management and power equalization within organizations. Chinese subordinates have been found to be passive, preferring that orders make decisions for them (high C).

5. ***Masculinity:***

   (a) *Moderate-to-High Masculinity:* Societies dominated by this dimension stress material success and assertiveness and assign different roles to males and females. To review, males are expected to carry out the competitive roles in the society; females are expected to care for the nonmaterial quality of life. In strong masculine countries where people perceive such behavior as being inequitable, an HSR leaning toward high F, emphasizing reduction of such social inequities would probably preferred.

   (b) *Moderate-to-Low Masculinity:* Hofstede also concluded that those nations dominated by a low masculine cultural dimension stress interpersonal relationship, a concern for others, and the overall quality of life, and define relatively overlapping social roles for males and females. In these cultures, neither male nor female need be ambitious or competitive; both may aspire to a life that does not assign great values to material success and respects others. According to Hofstede, improved quality of work life for individuals in these societies means offering opportunities for developing relationships on the job, which is perhaps best accomplished through low C or high NI-like HSR. For example, people in Sweden, a low masculine society, generally prefer organic (low C, NI-like) organizational structures and they like to be involved in the decision-making process.

Situational Scheme

Headquarters-subsidiary control relationships not only influenced by the cultural factors but various other situational factors also plays a pivotal role.

Notes

The following section describes those factors:

1. ***Size of the organization:*** This has been found to be a factor in determining HRRs. Large–scale operations have tend to apply structural relationships leaning toward high formalization and small-scale organisations tend to apply a high normative integration or high centralization relationship. However this factor is influenced by the organization's strategy. Some international business establishes International strategy.

2. ***Subsidiary's local context:*** Local context of the subsidiary can be conceptualized based on the environmental complexity and amount of local resources available to the subsidiary. For different levels context a governing mechanism scheme is as follows: Low environmental complexity and low levels of local resources dictate a high level of centralization and low levels of formalization and normative integration. Low environmental complexity and high levels of resources dictate a low levels of centralization and high levels of formalization and normative integration. High environment complexity and low resource levels dictate a moderate level of centralization, a Low level of formalization, and high level of normative integration. High environment complexity and high resource level indicate a low level of centralization, a moderate level of formalization, and a high level of normative integration.

3. ***Preference of the management:*** Preference of the management towards the control of the subsidiary also forms the strategy. High centralization may be used to maintain strong control over activities of the subsidiary. When the management prefers a strong organizational stability high formalization can be followed.

4. ***Communication:*** The availability of internet, Web, and video-conferencing is forcing may organizations to rethink of their organization structure and control techniques. As improvement in technology reduces communication and coordination costs, the preferred way to make decisions moves in the following stages .When communication costs are high, the best way to make decision is via independent decentralized decision makers which means lower centralization. When communication costs are less organizations can prefer highly normative integration.

An effective International corporation needs to establish a balanced headquarters subsidiary relationship and that balance can be attained through the implementation of an International corporate culture and values.

Task Identify a few MNCs that follow:

a. Product division structure,

b. Matrix structure and

c. Networking

Self Assessment

Match the following sets:

	Set A		Set B
14.	Product division structure	a.	Firms with low technology and a high marketing orientation tend to use this structure.
15.	Regional structure	b.	Canon used to use this type of structure

Notes

16.	Worldwide Area Structure	c.	Firms with a low degree of diversification and a domestic structure based on function tend to use this structure
17.	Matrix structure	d.	It allows local subsidiaries to develop products that fit into local markets.

9.6 MNCs in India

"When the Bangalore-based telecom software product company ***Subex Systems*** acquired Alcatel's Fraud Management Group (FMG), it took quite a few by surprise in the industry. After all, Subex with revenues of 90 crores and Alcatel the € 25 Billion French giant were in totally different leagues. It was a part of Subex's well thought out strategy to move centre stage in the global arena of its chosen space of telecom fraud management and revenue maximisation. With this acquisition, Subex claims to be the largest vendor the world over for Fraud Management Systems, based on the number of installations. It currently has 61 customers with 105 networks spread across 37 countries." *(Business India,* December 20, 2004 to January 2, 2005.)

"Not many know that most new generation vehicles that ply the Indian roads have Moterson's inputs—be it Toyota, Honda, Mercedes, Ford, Hyundai or even the homegrown Maruti. From wiring harnessing to cockpits, door trims to bumpers and plastic components, it chips in with its produce, not just for the cars rolled out in India but also for those rolled out in the Far East. The Group has 13 plants including one each at Sharjah and Ireland." (*Business India,* September 26-October 9, 2005.)

"If you were to ask which Indian company leads the world in a given product/segment, chances are that you would get it wrong. It is neither Reliance nor a company from the stable of TATA or the Birlas, Infosys or even Wipro of the country. The right answer is Subhash Chandra's Essel Propack (EPL), the single largest specialty packaging company in the world manufacturing laminated and seamless tubes catering to oral care, cosmetics, personal care, pharmaceuticals, food and industrial sectors."

Holding an international market share of 32 per cent in laminated tubes globally, EPL is multinational with manufacturing facilities in 14 countries through 23 plants including the India, China, USA, UK, Germany, Russia, Mexico, Colombia, Venezuela, Philippines, Indonesia, Egypt, Singapore and Nepal. It has wholly owned subsidiaries in the UK, China, Mexico, Mauritius, USA, Cyprus, Russia, Venezuela, Colombia, Philippines, Panama and Nepal. Its customers include multinationals such as Colgate Palmolive, Unilever, P&G, Glaxo Smith Kline (GSK), Sara Lee, Revlon, Oriflame, etc. EPL was established in 1984, ventured out to become a global player in 1993 by setting its first overseas venture in Egypt. Four years later, it formed a wholly-owned subsidiary in Guanghou, China. In 2000, it acquired Switzerland's Propack A. G. which was then the world's fourth largest laminated tubes company. This helped Essel gain access to markets in Latin America, Indonesia, and China.

Caselet

Ranbaxy Laboratories

Ranbaxy Laboratories Limited, incorporated in the year 1961, crossed a sales turnover of ₹ 5 billion by the year 1997. In India, Ranbaxy is the largest pharmaceutical company by sales, with a domestic market share of 4.83% and is ranked third on the retail market.

Contd...

Notes

In the case of Ranbaxy, two surveillance audits in 2000 renewed the ISO 9002 Certification for Mumbai and Baroda locations. The company is working towards getting the ISO 14001 Certification, which includes all processes, besides ensuring safety and environmental protection. The successful establishment of Ranbaxy in US can be explained by the following sequence of events:

1. In 1988, Ranbaxy's plant at Toansa, Punjab got US FDA approval.
2. In 1990 and 1991, Ranbaxy was granted a US patent for its products.
3. In 1995, it acquired Ohm Laboratories, a manufacturing facility in the US.
4. In 1998, Ranbaxy entered USA, the world's largest pharmaceuticals market, with products under its own name.
5. Located at Gurgaon (Haryana) near New Delhi, set amidst 17 acres of land, the Ranbaxy Research Centre is one of the finest R&D facilities in India.
6. Ranbaxy today has a presence in 23 of the top 25 pharmaceutical markets of the world. The Company has a global footprint in 46 countries, world-class manufacturing facilities in 7 countries and serves customers in over 125 countries. In June 2008, Ranbaxy entered into an alliance with one of the largest Japanese innovator companies, Daiichi Sankyo Company Ltd., to create an innovator and generic pharmaceutical powerhouse. The combined entity now ranks among the top 20 pharmaceutical companies, globally.

The company's global sales in 2010 stood at ₹ 8,550.7 crores reflecting a growth of 23%. During 2011, the company expects to achieve base case sales of nearly ' 8,400 crores. Driven by the passion of it's around 14,000 strong multicultural workforce comprising of over 50 nationalities, Ranbaxy continues to aggressively pursue its mission of 'Enriching lives globally, with quality and affordable pharmaceuticals'.

Source: Business Environment: Text and Cases, Vivek Mittal, Excel Books, New Delhi

Self Assessment

State whether the following statements are true or false:

18. Coca Cola was the first MNC in India.
19. Reliance in one of the biggest Indian MNCs.

9.7 Summary

- It has been said that the Multinational Corporation (MNC) is the most powerful institution in the world today. MNCs are major players in international business. They have expanded across national borders in two ways: trade and Foreign Direct Investment (FDI).
- Each has contributed to stable, lasting benefits to the world economy. In an era of WTO, regional groupings, liberalisation, and globalisation, the role of MNCs has increased tremendously. MNCs are defined as an enterprise that is headquartered in one country but has operations in one or more countries.
- There is a widespread impact of MNCs on both host and home countries. MNCs influence trade balance of a country, promote small scale/ancillary industry as they use them as suppliers and MNCs transfer knowledge and improve the technology of local firms.
- MNCs also help in economic development and development of infrastructure.

Notes

- Besides all these advantages, MNCs are also considered responsible for putting profit before people, for exploitation of workers, engaging in M&A activities instead of Greenfield projects. Sometimes they become so big that they control the key sectors of the economy.
- Organisation design, sometimes called organisation structure, is the overall pattern of structural components and configurations used to manage the total organisation.
- Organizational structures generally establish internal authority relationships, responsibility for work performance, and paths of communication and control required for a company to achieve its objectives.
- These structures are typically set up to blend the specialized expertise needed to facilitate decision making on a variety of short- and long-range problems. The development of structures should generally be planned and managed.

9.8 Keywords

Centralization: It concerns to the role of formal authority and hierarchical mechanism in the company's decision making processes.

Diversification: To extend (business activities) into disparate fields.

Formalization: It represents decision making through bureaucratic mechanisms such as formal systems, established rules, and prescribed procedures.

Knowledge transfer: The process through which one unit (e.g., group, department, or division) is affected by the experience of another.

Matrix organization: An organizational structure that facilitates the horizontal flow of skills and information.

Multinational Corporation: A corporation that has its facilities and other assets in at least one country other than its home country.

Normative Integration: It relies neither on direct headquarters involvement nor on impersonal rules but on the socialization of managers into a set of shared goals, values, and beliefs that then shape their perspectives and behavior.

Production division structure: This type of structure is used by a company that sells a diversified selection of goods or services.

Transfer Pricing: A transfer price is price on good.

9.9 Review Questions

1. Define Multinational Corporation.
2. Discuss the factors that contributed to the growth of MNCs. Use suitable examples.
3. "Companies cross borders to have access to economical human resource." How does this help MNCs and their growth?
4. "The macroeconomic effect of FDI is their impact on the trade balance." Substantiate.
5. How does 'employment' become both an advantage and a disadvantage for a MNC?
6. "Multinational Corporations put profits before people". Do you agree? Give suitable reasons to justify your answer.
7. How does expansion of a company across national borders lead to an opportunity loss?

Notes

8. Explain how companies based on product division structure and regional structure work.
9. Discuss the advantages and disadvantages of Matrix structure.
10. Compare and contrast Contractual Alliance Structure and Network structure.
11. "The form an organization adopts is determined by varying situational factors." Explain.
12. Explain the factors that induce centralized and decentralized decision making in MNCs.
13. Discuss the two schemes for control in MNCs in detail.

Answers: Self Assessment

1.	Canada	2.	International
3.	False	4.	True
5.	True	6.	True
7.	Trade balance	8.	More
9.	Source	10.	Backward integration
11.	True	12.	True
13.	False	14.	(b)
15.	(a)	16.	(c)
17.	(d)	18.	False
19.	True		

9.10 Further Readings

Books

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Gosh, B, *Economic Environment of Business*, New Delhi: South Asia Book

Bhalla, V. K. & Ramu, S. S, *International Business Environment & Management*, New Delhi: Anmol Publication Pvt. Ltd.

Mittal, V, *Business Environment: Text and Cases*, 2nd Edition, New Delhi: Excel Books

Online links

http://www.businessmate.org/Article.php?ArtikelId=186

http://www2.econ.iastate.edu/classes/econ355/choi/mnc.htm

http://www.britannica.com/EBchecked/topic/397067/multinational-corporation-MNC

http://www.wisegeek.com/what-is-a-multinational-corporation.htm

Notes

Unit 10: Conflicts and Negotiations in International Business

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Objectives

After studying this unit, you should be able to:

- Identify the factors that cause conflict in international business
- Describe the basis of conflict between host country and transnational company

Introduction

All of us have experienced conflict of various types, yet we probably fail to recognise the variety of conflicts that occur in organisations. Conflict can be a serious problem in any organisation. A better understanding of the important areas of conflict will help managers to use the people in the organisation more effectively to reach the organisation's objectives. Failure to be concerned about conflict is very costly, since ignoring it will almost guarantee that work and interpersonal relations will deteriorate. Conflict refers to a disagreement, opposition, or struggle between two or more people or groups.

Where there are conflicts, there are negotiations. It is imperative to understand the various negotiation tactics, negotiation styles, unique regulations, and other cultural issues that influence behaviors during negotiation in international business. The topic area of international trade negotiation was identified because it is an emerging field of inquiry resulting from globalisation. Knowledge is being developed about it, which compares different races, countries and cultures.

Negotiation is the process by which at least two parties try to reach an agreement on matters of mutual interest. The negotiation proceeds as a perception, and information processing and reaction. "*Negotiation is a dynamic process, and outcomes develop from patterned exchanges between negotiating parties and their constituencies*"– Druckman.

10.1 Factors Causing Conflict

The factors causing conflict are divergent. The factors differ for organisational conflicts, project conflicts and so on.

Notes

10.1.1 Causes of Organisational Conflicts

- ***Structural factors cause organisational conflict.*** Structural factors normally impose rigidity while businesses need dynamic adjustment. Personnel who could not tend or mend the organisation, but required to show targeted results see conflict between responsibility and authority. This is an organisational conflict.
- Specialisation of functions in organisations leads to conflict because generally the experts in fields fail to agree.

Caution It is usual for 'n' experts to come with 'n+1' views. Hence the conflict that blows. Technical organisations have this problem.

- Interdependence amongst organisational divisions/departments is the order of the day and conflicts develop between departments because one department is either lethargic in its commitment or it is over-smart and others could not find home. As none can operate without the other, conflict arises. This is an organisational conflict.
- Sharing Common Resources such as a facility leads to conflict because one person/ division over draws and the deprived others disagree to pull together. This is an organisational or social conflict. There are societies claiming stake in the same resource – land, water, temple, etc. interstate water disputes and conflicts are common in South India. In some villages stakes to access temples pose conflicts.
- Goal Differences such as one person wants to push production and others want R&D to rise, leading to conflict. This is an organisational conflict. The parent organisation and subsidiary may see different opportunities and conflict mutually.
- Authority relationships may lead the boss and employees beneath him/her do not see in the same inclination, especially when the boss claims 'boss is always right', conflict arises. This is an organisational conflict.
- Status Inconsistencies such as excessive/scanty power, power without sincerity, and too much politically charged atmosphere cause conflict. This is an organisational conflict.
- Inconsistencies in asset endowments cause conflict. May be it is class conflict the communists leaders project.
- Jurisdictional Ambiguities who will report/discipline who lead to conflict in issuing and receiving communications. This is a kind of intra-organisation conflict.
- Personal Factors like perversion, misunderstanding, selfishness, etc. of people lead to conflict of opinions and hence actions. This happens at home / office / private or social or official gatherings. Personality clash where two equally placed persons or heads do not simply accept one another, leads to conflict. Perception differences where the sensitivity or understanding of people on certain phenomena differs, lead to conflict.
- ***Values and Ethics can cause conflicts:*** Differing commitment levels to, or interpretation of values and ethics of people may lead to conflict. Eventually 'means-ends' tussle erupt. Communication barriers result in no communication, missile-like communication or misleading communication. Eventually somewhat long-term conflicts form.
- ***Cultural Differences:*** Culture tells people what emotions ought to be expressed in particular situations and what emotions are to be felt. Cultures differ. These differences like lack of tolerance for diversity result in conflict of cultures. One suggests rituals simply not acceptable to others. Conflicts creep.

Notes

- ***Emotion causes result in conflicts:*** Conflict involves emotion because something 'triggers' it. The events triggering conflict are events that elicit emotion. Some hold the view that 'Conflict is emotionally defined and driven', and 'does not exist in the absence of emotion'. Conflict is emotionally defined and is emotionally balanced. Emotion levels during conflict can be intense or less intense. The intensity levels may be indicative of the importance and meaning of the conflict issues for each party. Where applicable, there are many components to the emotions that are intertwined with conflict. There are behavioral, physiological and cognitive components.
  - *Behavioral:* The way emotional experience gets expressed which can be verbal or non-verbal and intentional or un-intentional.
  - *Physiological:* The bodily experience of emotion. The way emotions make us feel in comparison to our identity.
  - *Cognitive:* The mental process of "assessing or appraising" an event to reveal its relevancy to oneself. These three components collectively constitute 'emotional experience' determined by cultural values, beliefs, and practices'. The emotion-conflict relationship is not acceptable to the Economists.
- ***Scarcity leads to conflict, according to Economists:*** This is not acceptable to Psychologists. It can be said, scarcity of emotional balance is the cause of conflict! Deprivation, economic or emotional, leads the conflict. In the circumstance of economic deprivation emotional disturbances are rational as well. Thus subject of conflict is purely rational and related to deprivation.
- ***Moral stance leads to conflict:*** When an event occurs it can be interpreted as moral or immoral. Judging something as immoral may lead to conflict.
- ***Identity or individuality issues may lead to conflict:*** Emotions and Identity are a part of conflict. When a person knows their values, beliefs, and morals they are able to determine whether the conflict is personal, relevant and moral. Identity related conflicts are potentially more destructive.
- ***Conflict is relational:*** Conflict is relational in the sense that emotional communication conveys relational definitions that impact conflict. Key relational elements are power and social status.
- ***Societies with weak institutions witness more conflicts:*** Violent conflict is more common in societies with weak institutions and chronic poverty.

Did u know? Of the 32 countries in the low human development 22 have experienced conflicts at some point since 1990 and five of these experienced human development reversals over the decade (UNDP 2005). Furthermore, conflict gives rise to chain reactions that perpetuate and extend economic losses: a slowing economy, weak rule of law, corruption and an uncertain security setting represent powerful disincentives for investment.

Task Give examples of infamous cases where an organisational conflict within a MNC was made public.

Notes

10.1.2 Causes of Project related Conflicts

- ***Large infrastructure projects and conflicts:***Second, large infrastructure projects and conflicts go together.

Example: Multilateral Project finance is a widely used method for financing large infrastructure projects and certain types of natural resource extraction activities like power plants, oil and gas pipelines and hydroelectric dams.

These activities are often linked to conflicts at local and national levels due to their strategic significance, heir large environmental, social and revenue 'footprint', and the need to protect such assets with security forces. Large projects may require resettlement, alienate communities from their land, or otherwise affect socio-cultural groups whose needs are not addressed by the government or the project. In addition, natural resource extraction projects are generally associated with the phenomenon known as the 'resource curse', which describes the structural link that has been demonstrated to exist between dependence on natural resources and underdevelopment or conflict. So project finance often occurs in the context of developing countries and socially/environmentally sensitive large projects.

- ***Project loans/advising/promotion for controversial projects and conflicts:*** Project finance draws a clear line of responsibility connecting financiers with the social impacts caused by particular projects.

Example: A bank that arranges a project loan for a controversial dam can run the risk of being held publicly accountable for capitalising that project and for the conflict that might ensue at the time of delivering projects.

- ***Capital flight and money laundering and conflicts:*** Every corrupt dictator that has transferred money offshore for personal enrichment has done so with the aid of correspondent and/or private banking services. Such grand-scale corruption is often a correlate with violent conflict.

Example: A US bank was unknowingly involved in a case with a former Chilean dictator.

- ***Financial advising and conflicts:*** Financial advising is an important service offered to sovereign governments, but sometimes this advice is employed for dubious ends.

Example: This happened in Papua New Guinea a decade ago in 1997 and a London based financial service provider was unknowingly involved in this.

- ***Sovereign loans/bonds/book-runners and conflicts:*** Financiers provide loans to sovereign governments that may engage in human rights abuses or war-mongering activities.

Example: Apartheid South Africa used a UK-based bank to fund such activities. Guatemala's links to human rights abuses and political repression was inadvertently facilitated by sovereign bond offerings by two international investment banker based in New York, US.

- ***Financing state-owned enterprises and conflicts:*** According to the NGO Global Witness, 'much of the money from loans from global bankers especially from Swiss ostensibly got for funding an Angolan state-owned oil company was used to purchase weapons.
- ***Trade facilities indirectly used to war-purposes and conflicts:*** Merchant banks provided trade facilities that enabled governments to import weapons, communications equipment, and other articles of wars. Financiers may also support the manufacture of these items.

Notes

- ***Export credits and support of arms sales and conflicts:*** A significant proportion of export credit guarantees awarded by banks in support of the defence industry to recognised sovereign governments and in line with international regulation has slipped into faulty hands.
- ***Conflict commodities and conflicts:*** Timber, cobalt, tin, diamonds, gold and oil may generate hard currency for tyrannical regimes, civil war or violent conflict, as has been the case in some African countries such as Liberia and Angola. Links between international financial markets and conflict commodities are well documented. Terrorist organisations have started making money through the investment markets, it is reported, even in developed countries.
- ***Host Governments against the MNE projects:*** Host Governments are against the MNE projects in some countries now and most countries 3 decades ago.

Example: When the Janata Party came to power in India during 1977 at the national level following the Emergency, Industry Minister George Fernandes forced the exit of Coca-Cola from the country.

Sometimes major political parties out of power and in attempt to catch on to power-ladder just cry foul against MNE projects or shun out-sourcing to a third country some low end jobs through subsidiaries of companies of their countries. They can whip public outcry by simply fuelling passion against MNEs or their outfits.

A Consultant's View of Conflict

Part and parcel of any organisation is the presence of conflict. Kenneth Sole, president of Kenneth Sole and Associates, training and consulting firm, believes that since conflict is inevitable, his task is to reduce its adverse impact on corporations.

Sole says every conflict can be turned into a positive or negative situation, depending upon the attitudes participants bring to it. The worst mistake is to suppress conflict once it has been perceived. Sole says if people were better able to allow conflict to surface naturally, there would be more battles, but less costly ones.

Sole argues that it is better to react initially than to let trouble brew over time. By suppressing conflict, misattribution may arise and the conflict is taken out on innocent bystanders.

Talking around the issue is another problem resulting from suppressed conflict. Sole says this situation damages the people and the organisation until someone realises it rests on one basic conflict.

Self Assessment

State whether the following statements are true or false:

1. The negotiation proceeds as a perception, and information processing and reaction.
2. Specialisation of functions in organisations leads to conflict because generally the experts in fields fail to agree.
3. Status Inconsistencies between employees can also lead to conflicts.
4. The cultural difference between countries is a source of conflict resolution.
5. As per both the economists and the psychologists, scarcity can lead to conflicts.
6. Societies with weak institutions witness lesser conflicts.

Notes

7. There are lesser conflicts in large infrastructure projects.
8. Host Governments are against the MNE projects in some countries.
9. Culture tells people what emotions ought to be expressed in particular situations and what emotions are to be felt.
10. The events triggering conflict are events that elicit emotion.
11. When an event occurs it can be interpreted as moral or immoral and judging something as immoral can lead to conflict.
12. Violent conflict is more common in societies with weak institutions and chronic poverty.
13. Economists advocate emotion-conflict relationship.

10.2 Conflict between Host and Transnational Company

Profit is the motivating force that drives multinational corporations, which also are driven to occupy larger market shares and to ensure long-term competitiveness in the host countries. Conflict of interest between these corporations and host societies arise on a range of issues including intellectual property rights, operational decisions that may affect the environment or human rights, and the repatriation of profits. While multinational corporations base their decisions on economics, many host countries want these decisions to be in sync with the country's social and political needs.

Exporters should project a good image of the country abroad to promote exports. With this objective in mind, an enduring relationship with foreign buyers is of the utmost importance, and trade disputes, whenever they arise, should be settled as soon as possible.

The majority of complaints from foreign buyers are with regard to quality. Other complaints are usually for unethical commercial dealings on the part of Indian exporters and can be categorised as non-supply of goods after confirmation of the orders, non-payment of agreed commission, non-adherence to the delivery schedule etc. The work relating to dealing such complaints of foreign buyers has been centralised with the 'Nodal Officer' and its assisting cell viz., the Trade Disputes Cell in the office of the Director General of Foreign Trades, Ministry of Commerce, Udyog Bhawan, New Delhi.

Task Discuss any famous case where a multinational company was in conflict with the host country's government.

Action against Erring Exporters

1. Enforcement action in the office of Director General of Foreign Trade against erring exporters can be taken under the existing Rules & Regulations depending on the offence as follows:

   Non-payment of commission, supply of sub-standard goods, non-adherence of delivery schedules, indulgence in unethical commercial dealings, amount to breach of contract for which action can be taken under clause 7 of the Export (Control) Order, by which the Central Government or Director General of Foreign Trade or an authorised officer may debar an exporter from exporting any goods if he commits a willful breach of contract. This applies to the cases pertaining to a period prior to 19-6-1992.

Notes

2. Certain export products have been notified for Compulsory Quality Control and Pre-shipment Inspection prior to their export. Penal action can be taken under the Export (Quality Control and Inspection) Act, 1963 as amended in 1984, against exporters who do not conform to the standards and or provisions of Act as laid down for such products.

Complaints

Besides foreign trade (development & regulation) act and export (quality control & inspection) act, there are other laws such as Indian coffee act, tea act, coir industry act, dangerous drugs act, Customs act etc. to ensure that only quality products are exported. Inspite of these provisions, there are complaints from foreign buyers. It has, therefore, been decided by the ministry of commerce that in order to develop our export on a sustained and enduring basis and at the same time improve the image of our exports in international market, it is essential that such complaints are checked, sorted out and resolved quickly and amicably before taking recourse to penal action. At the same time, ways and means should be found to reduce complaints/disputes to the minimum.

Self Assessment

Fill in the blanks:

14. ..... is the motivating force that drives multinational corporations.

15. The majority of complaints from foreign buyers are with regard to .....

Case Study

Nickel, Bit No Dimes

The timing was awful. Last April, Marcos Portal, Cuba's basic industries minister, trailed round Europe seeking funds to develop the island's vast nickel reserves. Before setting off, as a member of Cuba's Council of State, Mr. Portal had voted to execute three hijackers who had seized a ferry in a bid to reach the United States. The executions, and the jailing of dozens of democracy activists, plunged relations between Cuba's Communist government and the European Union into acrimony. Mr. Portal was received politely, but returned with nothing substantial.

Nickel is a potential bonanza for Cuba. Exports of nickel and cobalt totalled $600m last year, more than sugar. The island is the world's sixth – biggest nickel producer and holds 30% of the world's reserves of the metal, used in stainless steel and other alloys. The United States is a big nickel-importer, and Cuba's natural market; but the trade embargo means that American firms can do no more than sniff around. So Europe takes three-quarters of Cuba's nickel. Canada's Sherritt International and various European banks have invested $400m in one nickel-concentrate plant, run as a joint venture, and in two state-run plants. Output at the plants has tripled, but investors have balked at building costly new facilities.

That means that Cuba will find it hard to take advantage of current high prices for nickel. The government wants to boost output, from 75,200 tonnes last year to 100,000 tonnes by 2007 and 150,000 tonnes within 15 years, by enlarging the plants. But that would cost $1.2 billion. European diplomats say little of the money has been secured. Several potential

Contd...

Notes

investors have come, looked, and gone again. Australia's Western Mining reneged on a plan to build a $1 billion nickel plant and refinery.

Question

How can these disputes be settled at the international level?

Source: International Marketing-3rd Edition, P. K. Vasudeva, Excel Books

10.3 Summary

- Conflict refers to a disagreement, opposition, or struggle between two or more people or groups.
- Negotiation is the process by which at least two parties try to reach an agreement on matters of mutual interest.
- The negotiation proceeds as a perception, and information processing and reaction.
- Sharing Common Resources such as a facility leads to conflict because one person/ division over draws and the deprived others disagree to pull together. This is an organisational or social conflict.
- Goal Differences such as one person wants to push production and others want R&D to rise, leading to conflict.
- Societies with weak institutions witness more conflicts. Violent conflict is more common in societies with weak institutions and chronic poverty.
- Emotions and Identity are a part of conflict. When a person knows their values, beliefs, and morals they are able to determine whether the conflict is personal, relevant, and moral. Identity related conflicts are potentially more destructive.
- Personal Factors like perversion, misunderstanding, selfishness, etc. of people lead to conflict of opinions and hence actions.
- Exporters should project a good image of the country abroad to promote exports. With this objective in mind, an enduring relationship with foreign buyers is of the utmost importance, and trade disputes, whenever they arise, should be settled as soon as possible.

10.4 Keywords

Book runner: The managing underwriter for a new issue.

Conflict: It refers to a disagreement, opposition, or struggle between two or more people or groups.

Culture: The totality of socially transmitted behavior patterns, arts, beliefs, institutions, and all other products of human work and thought.

Emotion: A natural instinctive state of mind deriving from one's circumstances, mood, or relationships with others.

Money laundering: Concealing the source of illegally gotten money.

Negotiation: It is the process by which at least two parties try to reach an agreement on matters of mutual interest.

Personality: The combination of characteristics or qualities that form an individual's distinctive character.

Notes

Values: Important and enduring beliefs or ideals shared by the members of a culture about what is good or desirable and what is not

10.5 Review Questions

1. Define conflict and negotiation.
2. Discuss the factors that cause organisational conflict at the international level.
3. Describe the factors that cause conflicts in an international project.
4. Do you think employees' personality can be a source of organisational conflict? Give reasons to support your answer.
5. "Inconsistencies in asset endowments cause conflict." Discuss.
6. Values and Ethics can cause conflicts. Do you agree with the statement? Justify your answer.
7. Conflict involves emotion because something 'triggers' it. Substantiate.
8. Societies with weak institutions witness more conflicts. What do you mean by this statement?
9. It is said that the exporters should project a good image of the country abroad to promote exports. Why is that so?

Answers: Self Assessment

1.	True	2.	True
3.	True	4.	False
5.	False	6.	False
7.	False	8.	True
9.	True	10.	True
11.	True	12.	True
13.	False	14.	Profit
15.	Quality		

10.6 Further Readings

Books

Vasudeva, P. K. (2010), *International Marketing*, 4th edition, New Delhi: Excel Books

Bhattacharya, B, *Going International Response Strategies for Indian Sector*, New Delhi: Wheeler Publishing Co

Black and Sundaram, *International Business Environment*, New Delhi: Prentice Hall of India

Gosh, Biswanath, *Economic Environment of Business*, New Delhi: South Asia Book

Notes

Online links

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http://miha.ef.uni-lj.si/_dokumenti3plus2/192804/Class_6_reading_-_Bennett.pdf

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Unit 11: International Trade Policies

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Objectives

After studying this unit, you should be able to:

- Know the highlights of the Import Policy Prior to 1991
- State the main points of the New Trade Policy (1991)
- Discuss the highlights of the Foreign Trade Policy, 2009-2014
- Assess the condition of SEZ in India and New SEZ Policy

Introduction

Indian foreign trade under colonial rule was controlled by the British for their own interests. After independence, the then government incorporated the Import and Export (Control) Act, 1947 with the objective of regulating imports and exports. At that time, the Indian economy was affected by scarcity. To safeguard the domestic industry and to restrict the export of essential goods, it was essential to regulate international trade.

The National Planning Commission (NPC) has said, "The objective of the country as a whole was the attainment, as far as possible, of national sufficiency. International trade was certainly to be included but we were anxious to avoid being drawn into the whirlpool of economic imperialism."

So in subsequent years, import substitution and protection of domestic industry became the main thrust of the EXIM policy for most of the period during 1950-51 to 1990-91. It was in 1991 that the Indian EXIM policy saw a drastic change in the form of liberalisation.

Notes

11.1 Import Policy Prior to 1991

In the pre-reform period Indian import policy had two constituents:

1. ***Import Restrictions:*** In the initial phases of development, India had to import capital equipment, machinery, spare parts, industrial raw material, etc. From time to time it had to import food grains too, but because of stagnant exports, government had to decide to import curtail. Import was classified under the categories of: Banned items, restricted items, canalized items and items under OGL (Open General License). Severe restrictions were imposed on imports of not-essential goods. High import tariffs were used to control import.
2. ***Import Substitution:*** Import substitution means reducing the dependability on imports, i.e., to produce goods that we are importing. Two broad objectives of the programme of import substitution in India were:
   (i) To save scarce foreign currency for the import of more important goods,
   (ii) To achieve self-reliance in the production of as many goods as possible.

Self Assessment

Fill in the blanks:

1. Prior to 1991, ... were used to control import.
2. Import ..... means reducing the dependability on imports.

11.2 New Trade Policy (1991)

The new policy substantially eliminates licensing, quantitative restrictions, and other regulatory and discretionary controls. The main features of the new trade policy are:

1. ***Free Import and Export:*** The new trade policy made major changes in the import licensing system by replacing a large part of administered licensing of imports by import entitlements linked to export earnings. The system of advance license, designed to provide exporters with duty free access to inputs, was strengthened further by simplifying and speeding up the process of issuing these licenses.

   The procedure of import of capital goods was simplified following the Industrial Policy of 1991. New units and units undergoing substantial expansion would be automatically granted licenses for import of capital goods without any clearance from the indigenous availability angle, provided their import is fully covered by foreign equity or the import requirement was up to 25% of the value of plant and machinery subject to a maximum of ₹ 2 crores.

   Import of OGL capital goods, non-OGL capital goods and restricted goods would be allowed without a specific license, provided clearance was given by the RBI and foreign exchange, because their imports are fully covered by foreign equity.
2. ***Rationalisation of Tariff Structure:*** On the recommendation of Chelliah Committee, import duty was drastically reduced to establish parity in prices of goods produced domestically and internationally.

Notes

Caution The 1993-94 Budget reduced the maximum rate of duty on all goods from 110% to 85%, except for few goods, which was further reduced to 40% in 1998-99 and further to 35% in 2000-01.

3. ***Decanalisation:*** The new trade policy aimed at progressive decanalisation. The government decontrolled 116 items allowing their exports without any licensing formalities. Another 29 items were shifted to OGL. It also decanalised 16 export items and 20 import items including new print, non-ferrous metals, natural rubber, intermediate and raw material for fertilizers. However, eight items (petroleum products, fertilisers, etc.) remained canalised.

4. ***Exchange Rate Reforms:*** The government devalued the rupee in July 1991, which led to depreciation in the value of the rupee against the five major international currencies by roughly 22%. It also made the rupee convertible:

   (i) *Partial Convertibility of Rupee:* In the Budget of 1992-93, the then finance minister announced Liberalised Exchange Rate Management System (LERMS) under which 40% of the foreign exchange receipts were to be exchanged through the RBI at the official exchange rate and rest was allowed to be converted at market exchange rate. The official exchange rate was lower than the market exchange rate.

   (ii) *Fully Convertible on Current Account:* The rupee was made fully convertible. Current account convertibility means the freedom to buy or sell foreign exchange for the following international transactions: (a) all payment due in connection with foreign trade, current business, and normal short-term banking and credit facilities, (b) payment due as interest on loans and as net income from other investments, (c) payments of moderate amount of amortisation of loans or for depreciation of direct investment, and (d) moderate remittances for family living expenses.

5. ***Phased Manufacturing Programme:*** PMP, according to which organisations were required to substitute all the imported parts with Indian parts in a specified period, was abolished.

6. ***Trading House:*** In 1991, the policy allowed export houses and trading houses to import a wide range of items. The government also permitted the setting up of trading houses with 51% foreign equity for the purpose of promoting exports. Under the 1992-97 trade policy, export houses and trading houses were provided the benefit of self-certification under the advance license system, which permits duty free imports for exports.

7. ***Export Oriented Units (EOUs), Electronic Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) and Bio-Technology Parks (BTPs):*** The units undertaking to export their entire production of goods and services (except permissible sales in Domestic Tariff Area {DTA}), may be set up under the Export Oriented Unit (EOU) Scheme, Electronics Hardware Technology Park (EHTP) Scheme, Software Technology Park (STP) Scheme or Bio-Technology Park (BTP) Scheme for manufacture of goods, including repair, re-making, reconditioning, reengineering and rendering of services. Trading units are not covered under these schemes.

   An EOU/EHTP/STP/BTP unit may import and/or procure, from Domestic Tariff Area (DTA) or bonded warehouses in DTA/international exhibition held in India, without payment of duty, all types of goods, including capital goods, required for its activities, provided they are not prohibited items of import in the ITC (HS). Any permission required for import under any other law shall be applicable to these goods. Units shall also be permitted to import goods including capital goods required for approved activity, free of cost or on loan /lease from clients. Import of capital goods will be on a self-certification

Notes

basis. Goods imported by a unit shall be in actual user condition and shall be utilized for export production. State Trading regime shall not apply to EOU manufacturing units.

EOU/EHTP/STP/BTP units may import/procure from DTA, without payment of duty, certain specified goods for creating a central facility. Software EOU/DTA units may use such facility for export of software.

8. ***Free Trade & Warehousing Zones:*** The Free Trade & Warehousing Zones (FTWZ) shall be a special category of Special Economic Zones with a focus on trading and warehousing. The objective of FTWZ is to create trade-related infrastructure to facilitate the import and export of goods and services with freedom to carry out trade transactions in free currency. The scheme envisages the creation of world-class infrastructure for warehousing of various products, state-of-the-art equipment, transportation and handling facilities; commercial office-space, water, power, communications and connectivity; with one-stop clearance of import and export formality and to support the integrated zones as 'international trading hubs'. These Zones would be established in the nearby areas to seaports, airports or dry ports so as to offer easy access by rail and road.

9. ***Deemed Exports:*** Deemed Exports refer to those transactions in which goods supplied do not leave country, and payment for such supplies is received either in Indian rupees or in free foreign exchange.

Caution Following categories of supply of goods by main/subcontractors shall be regarded as "Deemed Exports" under FTP, provided goods are manufactured in India:

(i) Supply of goods against Advance Authorisation /Advance Authorisation for annual requirement/DFIA;

(ii) Supply of goods to EOU/STP/EHTP/BTP;

(iii) Supply of capital goods to EPCG Authorisation holders;

(iv) Supply of goods to projects financed by multilateral or bilateral Agencies/Funds as notified by the Department of Economic Affairs (DEA), MoF under International Competitive Bidding (ICB) in accordance with procedures of those Agencies/Funds, where legal agreements provide for tender evaluation without including customs duty; supply and installation of goods and equipment (single responsibility of turnkey contracts) to projects financed by multilateral or bilateral Agencies/Funds as notified by DEA, MoF under ICB, in accordance with procedures of those Agencies/ Funds, which bids may have been invited and evaluated on the basis of Delivered Duty Paid (DDP) prices for goods manufactured abroad;

(v) Supply of capital goods, including goods in unassembled/disassembled condition as well as plants, machinery, accessories, tools, dies and such goods which are used for installation purposes till the stage of commercial production, and spares to the extent of 10% of FOR value to fertilizer plants;

(vi) Supply of goods to any project or purpose in respect of which the MoF, by a notification, permits import of such goods at zero customs duty;

(vii) Supply of goods to power projects and refineries not covered in the point above;

(viii) Supply of marine freight containers by 100% EOU (Domestic freight containers-manufacturers) provided said containers are exported out of India within six months or such further period as permitted by customs;

(ix) Supply to projects funded by UN Agencies;

Notes

Besides all these, various concessions and exemptions were granted during the nineties to liberalise imports and promote exports. Liberalisation also allowed FDI in many sectors. Foreign companies are allowed to open branch offices, foreign technology agreements were allowed, and the Foreign Investment Promotion Board (FIPB) was established to process and give speedy approvals for foreign investment proposals. Automatic approval was allowed for technical collaboration and foreign equity participation up to 51% in Indian companies in 34% high priority industries.

In totality, we followed a policy of globalisation after 1991 as far as foreign trade is concerned. This may seem like a threat to the domestic industry, but it only helped Indian industry. Now, domestic industry has to face competition at an international level, which only improves their competitive position. It also allows them to import raw material and machines that improve the quality of their products and reduce the cost.

Because of the abolition of Phased Manufacturing Programme (PMP), the domestic industry now doesn't have to go for Indianisation. It reduces their cost and releases the R&D budget for something new instead of investing on that which is available in the international market at competitive prices.

Task Prepare a presentation on the Foreign Trade Policy and its implications.

Self Assessment

State whether the following statements are true or false:

3. The procedure of import of capital goods was simplified following the Industrial Policy of 1991.
4. The new trade policy of 1991 aimed at progressive canalisation.
5. Current account convertibility means the freedom to buy or sell foreign exchange for the selected international transactions.
6. As per the New Trade Policy of 1991, the Free Trade & Warehousing Zones (FTWZ) shall be a special category of Special Economic Zones with a focus on trading and warehousing.
7. Deemed Exports refer to those transactions in which goods supplied do not leave country, and payment for such supplies is received either in Indian rupees or in free foreign exchange.

11.3 Foreign Trade Policy 2009-2014

Following are the highlights of the Foreign Trade Policy, 2009-2014.

Higher Support for Market and Product Diversification

1. Incentive schemes have been expanded by adding new products and markets.
2. Twenty Six new markets have been added under Focus Market Scheme. These include 16 new markets in Latin America and 10 in Asia-Oceania.
3. The incentive available under Focus Market Scheme (FMS) has been raised from 2.5% to 3%.
4. The incentive available under Focus Product Scheme (FPS) has been raised from 1.25% to 2%.

Notes

5. A large number of products from various sectors have been included for benefits under FPS. These include—Engineering products (agricultural machinery, parts of trailers, sewing machines, hand tools, garden tools, musical instruments, clocks and watches, railway locomotives, etc.), Plastic (value-added products), Jute and Sisal products, Technical Textiles, Green Technology products (wind mills, wind turbines, electric operated vehicles, etc.), Project goods, Vegetable textiles and certain Electronic items.

6. Market-linked Focus Product Scheme (MLFPS) has been greatly expanded by inclusion of products classified under as many as 153 ITC (HS) Codes at 4 digit level. Some major products include—Pharmaceuticals, Synthetic textile fabrics, Value-added rubber products, Value-added plastic goods, textile made-ups, knitted and crocheted fabrics, glass products, certain iron and steel products and certain articles of aluminium among others. Benefits to these products will be provided, if exports are made to 13 identified markets (Algeria, Egypt, Kenya, Nigeria, South Africa, Tanzania, Brazil, Mexico, Ukraine, Vietnam, Cambodia, Australia and New Zealand).

7. MLFPS benefits also extended for export to additional new markets for certain products. These products include auto-components, motor cars, bicycle and its parts, and apparels among others.

8. A common simplified application form has been introduced for taking benefits under FPS, FMS, MLFPS and VKGUY.

EPCG Scheme Relaxations

9. To increase the life of existing plant and machinery, export obligation on import of spares, moulds, etc., under EPCG Scheme has been reduced to 50% of the normal specific export obligation.

10. Taking into account the decline in exports, the facility of Re-fixation of Annual Average Export Obligation for a particular financial year in which there is decline in exports from the country, has been extended for the Five year Policy period 2009-14.

Stability/Continuity of the Foreign Trade Policy

11. Income Tax exemption to 100% EOUs and to STPI units under Section 10B and 10A of Income Tax Act, has been extended for the financial year 2010-11 in the Budget 2009-10.

12. Fisheries have been included in the sectors which are exempted from maintenance of average EO under EPCG Scheme, subject to the condition that Fishing Trawlers, boats, ships and other similar items shall not be allowed to be imported under this provision. This would provide a fillip to the marine sector which has been affected by the present downturn in exports.

13. Additional flexibility under Target Plus Scheme (TPS)/ Duty-Free Certificate of Entitlement (DFCE) Scheme for Status Holders has been given to the Marine sector.

Gems & Jewellery Sector

14. In an endeavour to make India a diamond international trading hub, it is planned to establish a 'Diamond Bourse(s)'.

15. A new facility to allow import on consignment basis of cut and polished diamonds for the purpose of grading/certification has been introduced.

16. To promote the export of Gems & Jewellery products, the value limits of personal carriage have been increased from US$ 2 million to US$ 5 million in case of participation in overseas exhibitions. The limit in case of personal carriage, as samples, for export promotion tours, has also been increased from US$ 0.1 million to US$ 1 million.

Notes

Agriculture Sector

17. To reduce transaction and handling costs, a single window system to facilitate the export of perishable agricultural produce has been introduced. The system will involve creation of multi-functional nodal agencies to be accredited by APEDA.

Leather Sector

18. Leather sector shall be allowed re-export of unsold imported raw hides and skins and semi-finished leather from public bonded warehouses, subject to payment of 50% of the applicable export duty.
19. Enhancement of FPS rate to 2% would also significantly benefit the leather sector.
20. Minimum value addition under Advance Authorisation Scheme for export of tea has been reduced from the existing 100% to 50%.
21. DTA sale limit of instant tea by EOU units has been increased from the existing 30% to 50%.
22. Export of tea has been covered under VKGUY Scheme benefits.

Pharmaceutical Sector

23. Export Obligation Period for Advance Authorization issued with 6-APA as input has been increased from the existing six months to 36 months, as is available for other products.
24. Pharma sector has been extensively covered under MLFPS for countries in Africa and Latin America and for some countries in Oceania and Far East.

EOUs

25. EOUs have been allowed to sell products manufactured by them in DTA up to a limit of 90% instead of existing 75%, without changing the criteria of 'similar goods', within the overall entitlement of 50% for DTA sale.
26. To provide clarity to the customs field formations, DOR shall issue a clarification to enable the procurement of spares beyond 5% by granite sector EOUs.
27. EOUs will now be allowed to procure finished goods for consolidation along with their manufactured goods, subject to certain safeguards.
28. EOUs will now be allowed CENVAT Credit facility for the component of SAD and Education Cess on DTA sale.

Simplification of Procedures

29. To facilitate duty-free import of samples by exporters, number of samples/pieces has been increased from the existing 15 to 50. Customs clearance of such samples shall be based on declarations given by the importers with regard to the limit of value and quantity of samples.
30. To allow exemption for up to two stages from payment of excise duty in lieu of refund, in case of supply to an Advance Authorisation holder (against invalidation letter) by the domestic intermediate manufacturer. It would allow exemption for supplies made to a manufacturer, if such manufacturer, in turn, supplies the products to an ultimate exporter. At present, exemption is allowed up to one stage only.
31. Greater flexibility has been permitted to allow conversion of Shipping Bills from one Export Promotion Scheme to other scheme. Customs shall now permit this conversion within three months, instead of the present limited period of only one month.

Notes

32. To reduce transaction costs, dispatch of imported goods directly from the Port to the site has been allowed under Advance Authorisation scheme for deemed supplies. At present, the duty-free imported goods could be taken only to the manufacturing unit of the authorisation holder or its supporting manufacturer.

33. Regional Authorities have now been authorised to issue licences for the import of sports' weapons by 'renowned shooters', on the basis of NOC from the Ministry of Sports & Youth Affairs. Now there will be no need to approach DGFT (Hqrs.) in such cases.

34. Automobile industry, having their own R&D establishment, would be allowed free import of reference fuels (petrol and diesel), up to a maximum of 5 KL per annum, which are not produced in India.

Directorate of Trade Remedy Measures

35. To enable support to Indian industry and exporters, especially the MSMEs, in availing their rights through trade remedy instruments, a Directorate of Trade Remedy Measures shall be set up.

Notes ***APEDA:*** Agricultural and Processed food products Export Development Authority

VKGUY: Vishesh Krishi and Gram Udyog Yojana

DOR: Department of Revenue

CENVAT: Central Value Added Tax

NOC: No Objection Certificate

DGFT: Directorate General of Foreign Trade

Case Study

Gain an International Competitive Advantage with Halo Financial

As a leading specialist currency dealer, foreign exchange is our core business. We have the expertise, high-tech resources and the time to successfully manage your currency exposures and speedily transfer your payments, enabling you to concentrate on running and growing your business profitably.

At Halo Financial, we are 100% aligned with our client's financial goals. We are committed to helping businesses and the people behind them. We extend our services to companies large or small, quoted or unquoted, mid-size corporate or owner-managed family enterprises and we forge close working relationships with managing directors, finance directors, treasurers and their respective teams.

As commerce becomes ever more global, our expertise will underpin your initiatives in penetrating new international markets and business opportunities. We will assist you in managing your cash-flow and currency exposure, encouraging the belief that foreign exchange can be a profit centre rather than a loss-making chore. Harnessing our specialist skills leaves you free to focus on your core business.

Contd...

Notes

Specialist Currency Management

Working as your own dedicated external treasury, Halo Financial will provide your business with the foreign exchange solutions you need for successful currency management. We'll help you minimise your currency exposure, work at increasing your bottom line profit, ensure international tenders are appropriately priced and assist in streamlining your business processes. We do this by providing simple, flexible currency solutions and access to accurate and incisive analysis of the foreign exchange market. The transfer of your payments will then be made through our technologically advanced back office systems to ensure your domestic or international payments are made on time, every time.

Move your FX business to Halo Financial and enjoy the following key features and benefits

We will:

- Save you money on your currency transactions
- Minimise the currency risks your business faces
- Maximise the profit margins in your international deals
- Provide all the benefits of a dedicated, in-house foreign exchange department without the costs
- Streamline your international payments

We deliver:

- Market leading exchange rates
- 24-hour monitoring of target exchange rates
- Protection against exchange rate volatility
- Fast onward domestic or international payments
- A personal, dedicated currency dealer (no call centre/automated answer phones)
- Expert analysis of developing trends and market sentiment
- A concise but incisive plain English daily currency report
- The information you need, when you need it
- Appropriate trading strategies
- Highly trained, experienced and knowledgeable staff
- Transparency and accountability
- Security and satisfaction

Added Value

Whatever the nature of your business, whether you are a buyer or seller of currency, we have a flexible solution for you. Using our network of counter-parties we can offer significant savings on exchange rates and transaction costs. Whatever the size of your trade, we will use our expertise to protect and enhance your payments and receipts.

Questions

1. How is Halo Financial affected by Foreign Trade Policy 2009-2014?
2. How will the Company enhance their Foreign Trade with the latest policy?

Source: International Marketing, 4th Edition, P K Vasudeva, Excel Books, New Delhi

Notes

Self Assessment

Fill in the blanks:

8. In Foreign Trade Policy, 2009-2014, the incentive available under Focus Market Scheme (FMS) has been raised from 2.5% to .....
9. In an attempt to make India a diamond international trading hub, it is planned to establish a .....
10. Enhancement of FPS rate to .....would also significantly benefit the leather sector.
11. Customs shall now permit conversion of shipping bills from one Export Promotion Scheme to other scheme within ..... months.

11.4 SEZ in India

Export-led economic growth has been an important part of the economic strategy prescribed to developing countries for their progress and development especially since the 1970s.

Did u know? The first Export Processing Zone (EPZ) was set up in Ireland in 1959 and the first EPZ in Asia was established in India at Kandla in 1965.

Originally conceived as the zones of experiments with the free market in an otherwise protected economy, these zones were established with increasing intensity and varying results in Asia since 1970.

In later years, the concept EPZ has gradually been replaced by SEZ. Between 1975 and 2006, the number of Free Zones has shot up from 79 in 25 countries to 3500 in 130 countries. Over the last decade, many new zones have been developed in Africa, Eastern Europe and transitional economies.

The idea behind SEZs was to promote and create hassle-free territorial production complexes that could be established to secure regional balance in development opportunities.

11.4.1 Importance/Contribution of SEZ

The major contributions of SEZs for the development of the economy are briefly accounted as follows:

1. The SEZs attract foreign and domestic investment in enclaves. Because of the provision of facilities and amenities on the one hand and incentives on the other, the capital flows in.
2. The SEZs stimulate exports. This is the major purpose of the SEZs.
3. The SEZs cannot be counted as a solution to the unemployment problem, for they are a viable source of employment creation.
4. The creation of SEZ leads to balanced development of the region. Though it is good to develop all the regions simultaneously, such balanced development requires a lot of resources at a time. So the regional development can be undertaken in stages. Thus, to develop certain areas as leading areas, SEZs is a solution.
5. The SEZs foster linkages with the economy. Deepening backward and forward linkages with the rest of the economy may bring in technological development and quality production of goods when SEZs interact with DTA (domestic tariff area). New production sectors and catalytic effect to export are induced into non-SEZ area due to demonstration effect.

Notes

11.4.2 New SEZ (Special Economic Zones) Policy

In 2000, Murasoli Maran, the then Minister of Commerce under NDA government, visited the Special Economic Zone in China. Impressed by the razzle-dazzle of Chinese SEZs, Maran introduced a policy in India for SEZ on April 1, 2000. Immediately, the existing EPZs were converted into SEZs. In 2004, a Bill was introduced under NDA government. The intervening elections in 2004 and the change in government from the NDA to the UPA, made no difference to the process of steering this bill. On May 10, 2005, the bill was tabled in the parliament. It was passed by both the houses, within two days, by May 12, 2005. No proper deliberation and debate was made in the parliament on such an important issue which was going to affect the future of agriculture, agriculturally-dependent population, the whole rural sector, land use, employment generation, urbanization process and whole social fabric.

Caution The Special Economic Zones Act, 2005, was passed by the Parliament in May, 2005 which received Presidential assent on 23rd of June, 2005. The draft SEZ Rules were widely discussed and put on the website of the Department of Commerce offering suggestions/ comments. Around 800 suggestions were received on the draft rules. After extensive consultations, the SEZ Act, 2005, supported by SEZ Rules, came into effect on 10th February, 2006, providing for drastic simplification of procedures and for single window clearance on matters relating to central as well as state governments. In India, as per the Act, a SEZ is 'a specifically delineated duty-free enclave and shall be deemed to be foreign territory for the purposes of trade operations and duties and tariffs.' Special Economic Zone comprises of both processing and non-processing areas.

The main objectives of the SEZ Act are:

1. Export promotion,
2. Export-oriented production of services,
3. Free trade and warehousing,
4. Generation of additional economic activity,
5. Promotion of exports of goods and services;
6. Promotion of investment from domestic and foreign sources;
7. Creation of employment opportunities;
8. Development of infrastructure facilities.

Task Select any successful SEZ and prepare a report on the success story.

11.4.3 Incentives and Facilities offered to the SEZs

The incentives and facilities offered to the units in SEZs for attracting investments into the SEZs, including foreign investment include:

1. Duty free import/domestic procurement of goods for development, operation and maintenance of SEZ units.

Notes

2. 100% Income Tax exemption on export income for SEZ units under Section 10AA of the Income Tax Act for first 5 years, 50% for next 5 years thereafter, and 50% of the ploughed back export profit for next 5 years.
3. Exemption from minimum alternate tax under section 115JB of the Income Tax Act.
4. External commercial borrowing by SEZ units up to US$ 500 million in a year without any maturity restriction through recognized banking channels.
5. Exemption from Central Sales Tax.
6. Exemption from Service Tax.
7. Single window clearance for Central and State level approvals.
8. Exemption from State sales tax and other levies as extended by the respective State Governments.

The major incentives and facilities available to SEZ developers include:

1. Exemption from customs/excise duties for development of SEZs for authorized operations approved by the BOA.
2. Income Tax exemption on income derived from the business of development of the SEZ in a block of 10 years in 15 years under Section 80-IAB of the Income Tax Act.
3. Exemption from minimum alternate tax under Section 115 JB of the Income Tax Act.
4. Exemption from dividend distribution tax under Section 115 O of the Income Tax Act.
5. Exemption from Central Sales Tax (CST).
6. Exemption from Service Tax (Section 7, 26 and Second Schedule of the SEZ Act).

Table 11.1: Exports from the Functioning SEZs During the Last Few Years

Year	Value (₹ Crore)	Growth Rate (over previous year)
2003-2004	13,854	39%
2004-2005	18,314	32%
2005-2006	22,840	25%
2006-2007	34,615	52%
2007-2008	66,638	93%
2008-2009	99,689	50%
2009-2010	2,20,711.39	121.40%

11.4.4 Critical Appraisal of the SEZ Policy (Views against SEZ Policy)

The finance ministry has always been uncomfortable with so many duty-free enclaves scattered all over the country. Besides revenue losses, it has been apprehensive about the administrative hassles. Land acquisition issues, global economic uncertainty and now, uncertainty about tax breaks have contributed to a lack of enthusiasm about SEZ scheme but more important are the serious questions being raised about the social benefits of the SEZ scheme.

Hundreds of SEZs were approved in a span of a few months and large investments were committed. Unfortunately, somewhere down the line, the SEZ policy lost focus and started drifting. There was a mad rush for SEZ approvals and many non-serious players entered the fray. They primarily saw SEZs as a real estate play. The SEZ applications became a tool for acquiring land rather than for creating infrastructure. This cast a shadow over the entire SEZ

Notes

policy. The aftermath of Nandigram saw the Land Acquisition Act itself being questioned, and executive instructions were issued that barred state governments from assisting SEZ developers from acquiring land. It proved to be the final nail in the SEZ coffin. Industrialists had enough problems due to the financial meltdown without adding the SEZ baggage to their woes. So, today we have reached a situation where the queue of developers waiting to get their SEZs denotified is almost as long as the queue made by the same developers just two years ago to have their SEZs notified.

The creation of SEZ gave birth to many socio-economic problems. The biggest of them is the acquisition of agriculture land. The NGOs and other social organizations claim that value of the agriculture land cannot be calculated in terms of money. The farmers and other local inhabitant doesn't have acumen to invest that money in various means to get stable income for long-term rather they will finish all the money in few months or years and will be compelled to become labors to earn a living. Since the land earns bread and butter for a farmer, thus if we acquire his land then in a sense, we are acquiring his life.

Because of the above reasons, now the Center has issued some guidelines that State/Central government will not help private organizations in acquiring land for SEZs rather new guidelines clearly says that now SEZ will be preferably allowed in non-agriculture land.

Caselet

Bangladesh Welcomes Indian Companies into SEZs

Last year in Dhaka, the Bangladesh Government had invited Indian companies to set up operations in Special Economic Zones (SEZs) being planned by the country.

The Bangladesh Prime Minister, Ms Sheikh Hasina, during her recent interaction with a 51 member FICCI delegation in Dhaka, said, "We have already decided to set up SEZs…there are already some areas…If you want to invest, you can identify and we will facilitate the investment."

She was responding to FICCI's suggestion that creation of an SEZ in Bangladesh exclusively for Indian businesses would go a long way in boosting bilateral trade.

In a hour-long interaction with Indian businesses, the Bangladesh Premier said, "We want to open doors but we also want to take care of our people's interest…There are certain issues…We want those issues to be resolved, with a view to increasing business and trade."

Setting up of dedicated SEZs to attract Indian investment was among the suggestions made by the Indian side. FICCI also suggested a multi-pronged agenda for the creation of a favourable investment climate for Indian companies in Bangladesh, in an effort aimed at doubling the bilateral trade by 2011. Bilateral trade stood at $3175 million in 2007-08. The recommendations include reduction of tariff to increase market access.

Source: thehindubusinessline.com

Self Assessment

State whether the following statements are true or false:

12. The concept of EPZ has replaced the concept of SEZ in the country.
13. SEZ facilitates both forward and backward linkages.

Notes

14. The Special Economic Zones Act, 2005, was passed by the Parliament in June, 2005 which received Presidential assent on 23rd of June, 2006.

15. Creation of SEZ resulted in many socio-economic problems like the acquisition of agriculture land.

11.5 Summary

- Till 1956, there was no clear EXIM policy in free India. Import substitution and protection of domestic industry became the main thrust of EXIM policy for most of the period during 1950-51 to 1990-91, though various incentives were provided for exports.
- In 1985, the government announced an EXIM policy for three years though there was not any major deviation from the earlier policy.
- But it did represent some simplification as the number of items in the category of Open General License for capital goods import increased from nil in 1975 to over 1,100 items in the 1988. After 1985, several incentives were introduced.
- The new policy (1991) substantially eliminates licensing, quantitative restrictions, and other regulatory and discretionary controls, and introduced many trade boosting policies like Free Import and Export, Rationalization of Tariffs Structure, Decanalisation, Exchange Rate Reforms, etc. Foreign investors are allowed to invest in Indian companies through GDR route without any lock-in period.
- In December 2000, the government allowed automatic approval for FDI/NRI/OCB investment except a small negative list.
- Accordingly, on April 5, 2000, RBI stated that all items excluding specific sectors would be eligible for foreign investment under automatic route up to even 100%. Foreign Trade (Development and Regulation, 1992) Act is designed to authorize Central Government to formulate Export and Import policy and change the policy as per changing situations.
- Indian government supports and promotes exports by giving many incentives like EPCG, pass book Duty draw-back system, advance license, setting up of free trade zones, etc.
- The then Union Minister Kamalnath unveiled the new foreign trade policy (2004-07), which was earlier known as EXIM Policy. All goods and services exported including those from Domestic Tariff Area have been exempted from service tax and all exporters with a minimum turnover of ₹ 5 crore have been exempted from furnishing bank guarantees which will reduce their transaction cost. The new foreign trade policy is more rural-oriented as many schemes to boost the exports from rural economy were introduced.

11.6 Keywords

Canalisation: Erstwhile import of certain commodities was allowed only through specific government agency. This is called canalisation, where the import of these goods is canalised through government agency.

Decanalisation: Removal of canalisation system.

Diamond Bourse: A wholesale diamond exchange dealing mainly in polished diamonds.

Export Processing Zone: A designated area in a country in which production for export is encouraged, usually by special tax treatment and by permitting firms to import duty-free so long as the imports are used as inputs to production of export.

Notes

Import substitution: It means decreasing the dependability on imports i.e. is to produce goods that we import. It was a policy followed by India after independence.

Liberalized Exchange Rate Management System (LERMS): It is a system under which 40% of the foreign exchange receipts were to be exchanged through RBI at the official exchange rate and rest is allowed to be converted at market exchange rate.

OGL (Open General License): Items included in the list of OGL can be imported easily without much government restriction.

Special economic zones: Designated areas in countries that possess special economic regulations that are different from other areas in the same

11.7 Review Questions

1. Discuss the role of Foreign Trade Policy in Indian Economy.
2. Explain the New Trade Policy (1991) and discuss how it is different from earlier policies.
3. "Indian Government supports and promotes the exports". Discuss this statement and explain various Incentives and Promotions schemes for exports.
4. Describe the concept of canalization and decanalisation.
5. State the exchange rate reforms that followed New Trade Policy of 1991.
6. What do you mean by 'deemed exports'? What all are included under 'deemed exports'?
7. Describe the Market-linked Focus Product Scheme.
8. State the provision mentioned in the Foreign Trade Policy of 2009-2014 concerning agricultural, leather and pharmaceutical
9. Explain in detail the Foreign Trade Policy 2009-2014.
10. Explain the concept of SEZ. Also mention its benefits.
11. Discuss the New SEZ policy of 2005.
12. Critically evaluate the SEZ policy of India.

Answers: Self Assessment

1.	High import tariffs	2.	Substitution
3.	True	4.	False
5.	True	6.	True
7.	True	8.	3%
9.	Diamond Bourse	10.	2%
11.	Three	12.	False
13.	True	14.	False
15.	True		

Notes

11.8 Further Readings

Books

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Unit 12: Trade Blocks

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Objectives

After studying this unit, you should be able to:

- Identify the types of regional groupings
- State the advantages of trade blocks
- Know about major trade blocks

Introduction

Globalisation is today's buzzword. International trade barriers are coming down, nations are coming closer, they are negotiating with each other on the common table to access other markets, and they are negotiating for fair competition in the world. Nations are altering their domestic law according to international standards, and above all, today 153 nations sit together on one table at the WTO and discuss trade.

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But the other side of the coin is also true. The world is not globalising, in fact it is regionalising. Trade blocks of the world, NAFTA, EU, SAPTA, ASEAN, etc., are expanding. Nearly all the WTO members have concluded Regional Trade Agreements (RTAs) with other countries. Over 150 RTAs were in existence at the end of 2006. All these trade blocks are demolishing trade barriers among themselves and are creating unified markets and policy. One trade block is negotiating with the other for market access, thus the whole world is shifting from globalisation to regionalisation.

12.1 Types of Regional Groupings

Regional groupings can be of the following types:

1. ***Preferential Trade Agreement:*** Here the member countries lower the barrier for imports of identified products from one another, like the SAARC Preferential Trading Arrangement (SAPTA).

2. ***Free Trade Area (FTA):*** In FTA, countries eliminate duties among themselves while maintaining the same with the outsiders. The free trade area is the least restrictive and most loose form of economic integration among countries. Its goal is to abolish all tariffs between member countries. This is usually done in a phased manner.

   As the tariffs are eliminated, FTA members might explore other forms of cooperation such as the reduction of non-tariff barrier or trade in services and investment. In FTAs, the focus is usually on eliminating tariffs only. The first free trade agreement signed by the United States was with Israel in 1985. SAPTA (South Asia Preferential Agreement) establishes the FTA among the SAARC nations. FTA allows the member countries to follow a different policy with the non-member country. Thus, every non member country can have different tariff structure with other non-member countries.

3. ***Custom Union:*** The objective of a custom union is to harmonise trade regulations and to establish common barriers against outsiders. A custom union is an extension of FTAs. In addition to the elimination of tariff among themselves, they also agree to a common external tariff on goods imported from non-members. This takes the form of a common external tariff whereby imports from non-members are subject to the same tariff when sold to any member country.

   Tariffs revenues are then shared among members according to a prescribed formula. It removes the drawback of FTAs where an exporting country can export the goods to the FTA through a member nation having low tariff and thus, can have access to all FTA members. In a custom union all the member nations have common tariffs against the non-member, whichever route it takes. The world's oldest custom union is the Benelux Custom Union (Belgium, the Netherlands, and Luxembourg).

4. ***Common Market:*** A common market is a higher and more complex level of economic integration than either a free trade area or a custom union. A common market has all the elements of a custom union and in addition to that, it allows free movement of all factors of production (such as labour, capital, raw material, services etc.). A common market agreement eliminates all tariffs and other restrictions on internal trade, adopts a set of common external tariffs, and removes all restrictions on the free flow of capital and labour among member nations.

   Thus, restrictions on immigration, emigration and cross border investment are abolished. In a common market there is a free movement of factors of production. Productivity increases in a common market as the factors of production are employed, where their productivity is higher.

Notes

Example: The European Union (EU) formed under the Treaty of Rome in 1957 is a classic example of a common market.

In 1993, the EU and the European Fair Trade Association (EFTA) formed the world's largest and most lucrative common market—the European Economic Area.

5. ***Economic Union:*** When the members of a common market agree to have common economic policies, then it becomes an economic union. A true economic union has an integration of economic policies among member countries. The members of an economic union harmonise their monetary, taxation and fiscal policy and therefore, have to surrender their economic sovereignty. Members of the economic union work as a single nation, as far as economic policy is concerned.

   Economic unions have one currency. Though some authors distinguish between economic and **monetary union.** In essence, Monetary Union means one money (i.e., a single currency). The Delors committee, chaired by Jacques Delors ("Delors Report Suggests Step by Step Process of European Integration," IMF survey, 10 July 1989, 209,219), president of the European Commission, issued a report entitled Economic and Monetary Union in the European Community that defines monetary union having three basic characteristics:

   (i) Total and irreversible convertibility of currencies.

   (ii) Complete freedom of capital movement in fully integrated financial markets.

   (iii) Irrevocably fixed exchange rates with no fluctuation margins between member currencies, ultimately leading to a single currency.

The European Commission's One Market, One Money report defines an Economic Union as a single market for goods, services, capital and labour, complemented by common policies and coordination in several economies and structural areas. Economic Unions improve trade and capital mobility as they eliminate the cost associated with converting one currency into another and also eliminates foreign exchange risk.

According to the Delors Committee, the basic element of an economic union includes the following: *a single market within which person, goods, services, and capital could move freely, a joint competition policy to strengthen market mechanism, common competition, structural and regional policies, and sufficient coordination of macroeconomic policies, including binding rules on budgetary policies regarding the size and financing of national budget deficit.*

Self Assessment

Match the following sets:

	Set A		Set B
1.	Preferential Agreement	a.	There is a free movement of factors of production
2.	Free Trade Area	b.	It aims to harmonise trade regulations and to establish common barriers against outsiders
3.	Custom Union	c.	In this, the countries eliminate duties among themselves while maintaining the same with the outsiders.
4.	Common Market	d.	In this, the member countries lower the barrier for imports of identified products from one another

Notes

12.2 Advantages of Regional Groupings

When two or more nations come together for the sake of business and reduce the barrier of international trade amongst themselves, then a regional trading block comes into existence. A trading block is a preferential economic integration among a group of countries. Countries tend to ally for several reasons. Some of them are as follows:

- Countries prefer to go for regional agreements for finished goods market and to take comparative advantage as allies may also be supplying goods not available with the host countries.
- Countries feel that RTAs such as GATT and WTO are more advantageous. They feel that it is difficult to save national interest in the case of GATT. But in RTAs they have preferential economic integration among a few nations willingly selected after proper evaluation of all pros and cons.
- In RTAs, countries can give much more leeway to each other than that in GATT. They can go to the extent of a Common Market. Negotiation. With only a few countries participating, it is also easier.
- RTAs also increase the bargaining power of trading blocks in the WTO because they cooperate with each other in the process of negotiation. It also helps in decreasing the bargain power of other countries because with the formation of RTAs among the developing nations like G-15 and ASEAN, their bargain power has increased significantly.
- In international trade, most of the countries follow the principle of 80/20, that is, about 80% of their business comes from 20% of the nations. Therefore, they feel that it is better to have close ties with these 20% nations and so they form RTAs, which are more logical and advantageous.

Besides the above, the following arguments are given in favour of Economic Integration:

1. ***Trade Creation and Trade Diversion:*** Economic integration helps in generating trade because trade shifts to a member either because of its comparative advantage in production of particular goods or it drives a cost advantage because of elimination of trade barriers.

   While the generation of trade is a benefit, trade diversion is the cost of economic integration. Trade diversion is a cost to a particular non-member country when a group of countries trade among themselves. The trade diverts from the non-member to member country. It can be understood from the following example:

Example: India and Pakistan are both producers of Basmati Rice and export to Turkey. Import of agricultural products attracts the same tariff whether it is imported from Pakistan or India, say 20%. If India is a low cost producer of rice compared to Pakistan, then India's export to Turkey may cost ₹ 100 per bushel, plus 20% tariff, so the total cost becomes ₹ 120.

On the other hand, Pakistan produces rice at ₹ 110 per Bushel and 20% tariffs make it ₹ 132. So obviously India will be at an advantage and will receive the orders. But if Pakistan and Turkey signed a FTA then import from Pakistan will not attract any tariffs in Turkey and the result will be that now import from Pakistan will cost ₹ 110 per bushel to Turkey and produce from India (from it being a non-member) will attract tariffs. Thus, it will cost ₹ 120 per bushel. As a result of FTA, trade is created for Pakistan. When trading competitiveness is shifted from one country to another country in this manner, it is termed as 'trade diversion'.

2. ***Reduced Import Price:*** Smaller countries do not have much bargaining power. If they increase import tariffs, the exporter wouldn't bother much. He will either look for a new

market or simply increase prices. But if the country is a member of some trading block, then its bargaining power increases. If the block countries impose tariffs on the exporting country, the damage in terms of lost sales will be very high and exporting country will be bound to reduce its price. Trade blocks are therefore, beneficial for people of member countries. Among the member countries, the tariffs get eliminated, leading to a decrease in the import price for them.

3. ***Increased Competition and Economies of Scale:*** Integration results in increased market size that attracts a number of competing firms resulting in increased competition, greater efficiency and lower prices for consumers. Because large market firms also operate on economies of scale, as a corollary, cost per unit decreases. Common markets also lend the advantage of external economies of scale. Because a common market allows factors of production to flow freely, firms can have access to cheaper capital, more skilled labour, or superior technology. These factors will improve the quality of the firm's product or service, will lower costs, or even do both.

4. ***Higher Factor Productivity:*** With economic integration, mobility will lead to the movement of labour and capital from areas of low productivity to areas of high productivity, resulting in decrease in production costs. In addition to this, there are other benefits which cannot be easily quantified such as free movement of labour that leads to a higher level of communication across cultures. This in turns leads to a higher degree of cross-cultural understanding.

5. ***Better International Political Relations:*** In most cases, international political relations are governed by economics and business. Business and SAPTA are two reasons why India and Pakistan are coming closer. Trade will increase between the two because they are both signatories of SAPTA.

Did u know? It is because of trade and business that Russia, arch rival of the USA and Western Europe are today close partners. It is trade because of which North Korea is coming closer to South Korea. It is again for trade only that warm discussions on strategic issues are going on between India and China. Totally different types of economies and ethnic groups of ASEAN nations which include even very arch rival viz., S. Korea and Japan are today, very close allies.

Task Find the various business opportunities which have emerged or can emerge in India because of any FTA signed by India.

Self Assessment

State whether the following statements are true or false:

5. In trade blocks, countries can give much more leeway to each other than that in GATT.
6. Trade diversion is a cost to a particular non-member country when a group of countries trade among themselves.
7. With economic integration, mobility will lead to the movement of labour and capital from areas of high productivity to areas of low productivity, resulting in decrease in production costs.
8. SAPTA is one of the reasons why India and Pakistan are coming closer.

Notes

12.3 Major Trade Blocks

In this section we will discuss about major trade blocks and their modus operandi.

12.3.1 ASEAN

The Association of Southeast Asian Nations (ASEAN) is a primary multinational trade group of A sia**.** The goals of this group are economic integration and cooperation through complementary industry programmes; preferential trading, including reduced tariff and non tariff barrier; guaranteed member access to markets throughout the region; harmonised investment incentives.

Today, ASEAN economic cooperation covers the following areas: trade, investment, industry, services, finance, agriculture, forestry, energy, transportation and communication, intellectual property, small and medium enterprises, and tourism.

Did u know? ASEAN was established on August 8, 1967 in Bangkok by the five original member countries, namely, Indonesia, Malaysia, Philippines, Singapore, and Thailand. Brunei Darussalam joined on January 8, 1984, Vietnam on July 28, 1995, Laos and Myanmar on July 23, 1997, and Cambodia on April 30, 1999.

The ASEAN region has a population of about 500 million, a total area of 4.5 million square kilometres, a combined gross domestic product of US$737 billion, and a total trade of US$ 720 billion.

The Treaty of Amity and Cooperation (TAC) in Southeast Asia was signed at the First ASEAN Summit on February 24, 1976.

The TAC stated that ASEAN political and security dialogue and cooperation should aim to promote regional peace and stability by enhancing regional resilience. Regional resilience shall be achieved by cooperating in all fields based on the principles of self-confidence, self-reliance, mutual respect, cooperation, and solidarity, which shall constitute the foundation for a strong and viable community of nations in Southeast Asia.

Economic and Functional Cooperation

The Framework Agreement on Enhancing Economic Cooperation was adopted at the Fourth ASEAN Summit in Singapore in 1992, which included the launching of a scheme towards an ASEAN Free Trade Area or AFTA. The strategic objective of AFTA is to increase the ASEAN region's competitive advantage as a single production unit. The elimination of tariff and non-tariff barriers among the member countries is expected to promote greater economic efficiency, productivity, and competitiveness.

Under AFTA agreement, the tariffs have to be reduced from 95% to 5% or below. Most products will attract the tariff of 0% to 5% at least in five original members. The Fifth ASEAN Summit held in Bangkok in 1995 adopted the Agenda for Greater Economic Integration, which included the acceleration of the timetable for the realisation of AFTA from the original 15-year timeframe to 10 years.

Caution One result of the Asian financial crisis of 1997-98 was the creation of ASEAN+3 (ASEAN + China, Japan and South Korea) to deal with trade and monetary issues facing Asia. Foreign and Finance ministers of ASEAN + 3 meet annually after ASEAN meeting.

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In addition to trade and investment liberalisation, regional economic integration is being pursued through the development of Trans-ASEAN transportation network consisting of major interstate highway and railway networks, principal ports and sea lanes for maritime traffic, inland waterway transport, and major civil aviation links. ASEAN is promoting the inter-operability and interconnectivity of the national telecommunications equipment and services. Building of Trans-ASEAN energy networks, which consist of the ASEAN Power Grid and the Trans-ASEAN Gas Pipeline Projects are also being developed.

ASEAN cooperation has resulted in greater regional integration. Within three years from the launching of AFTA, exports among ASEAN countries grew from US$43.26 billion in 1993 to almost US$80 billion in 1996, an average yearly growth rate of 28.3 percent. In the process, the share of intra-regional trade from ASEAN's total trade rose from 20 percent to almost 25 percent. Tourists from ASEAN countries themselves have been representing an increasingly important share of tourism in the region. In 1996, of the 28.6 million tourist arrivals in ASEAN, 11.2 million or almost 40 percent, came from within ASEAN itself.

The Framework for elevating functional cooperation to a higher plan was adopted in 1996 with a theme: "Shared prosperity through human development, technological competitiveness, and social cohesiveness." Functional cooperation is guided by the following plans:

- ASEAN Plan of Action on Social Development;
- ASEAN Plan of Action on Culture and Information;
- ASEAN Plan of Action on Science and Technology;
- ASEAN Strategic Plan of Action on the Environment;
- ASEAN Plan of Action on Drug Abuse Control; and
- ASEAN Plan of Action in Combating Transnational Crime.

ASEAN's dialogue partners include Australia, Canada, China, the European Union, India, Japan, the Republic of Korea, New Zealand, the Russian Federation, the United States of America, and the United Nations Development Programme. ASEAN also promotes cooperation with Pakistan in certain sectors.

India and ASEAN

India is a close trading partner of ASEAN and has signed the free trade agreement with them. It had separately signed a Free Trade Agreement with Thailand and Singapore (Comprehensive Economic Cooperation Agreement between India and Singapore). Singapore is one of the top ten FDI investors in India. India has taken up another sub-regional initiative for a road link between India, Myanmar and Thailand, which would eventually become part of an elaborate regional communications network. Did **You Know?** India's engagement with the ASEAN started with its "Look East Policy" in the year 1991.

The end of the Cold War removed the hurdles to better India-ASEAN co-operation. India became a sectoral dialogue partner of ASEAN in 1992, full dialogue partner in 1995, and joined the ASEAN Regional Forum in 1996. India signed an agreement in October 2003 for an FTA with Thailand. The pact with Thailand is to be followed by a similar agreement with Singapore and, ultimately, the entire ASEAN region, and India is committed to aligning its peak tariff to East Asian.

India has also signed a Comprehensive Economic Cooperation Agreement (CECA) with Singapore and sub-regional cooperation has also accelerated. The Mekong-Ganga Cooperation (MGC) and the BIMST-EC (Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Cooperation) are indicators to this effect. In 2003, India acceded to the Treaty of Amity and Cooperation (TAC) in South-East Asia, signed a declaration to combat international terrorism,

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and agreed on comprehensive economic cooperation to step up their current trade turnover of $12 billion.

Trade between India and ASEAN is increasing by leaps and bounds. It is expected that by 2020 ASEAN will be the one of largest trade partners of India. India-ASEAN trade in 2002-03 was about $9.76 billion, about four times the 1993-94 trade figure of $2.5 billion. Growth in India's exports to ASEAN in recent years has been much higher in comparison to other destinations. India's trade with the world in 2003 stood at $114.13 billion, ASEAN accounting for 8.56% of India's global trade.

The 1st ASEAN Economic Ministers (AEM) – India Consultations were held on September 15, 2002 in Brunei, where the Ministers, after discussing the Joint Study Report decided to establish an ASEAN-India Economic Linkages Task Force (AIELTF). The AIELTF was asked to prepare a draft Framework Agreement to enhance the ASEAN-India trade and economic cooperation before the 2nd AEM – India Consultations. Subsequently, at the First ASEAN-India Summit held on November 5, 2002 in Phnom Penh, Cambodia, the erstwhile Prime Minister of India made the following major announcements:

1. India will extend special and differential trade treatment to ASEAN countries, based on their levels of development to improve their market access to India;
2. FTA within 10 years timeframe; and
3. India is committed to aligning its peak tariffs to East-Asian levels by 2005.

India and ASEAN members signed a Framework Agreement on Comprehensive Economic Cooperation between the ASEAN and India during the Second ASEAN – India Summit on October 8, 2003 in Bali, Indonesia.

The key elements of the Agreement cover FTA in goods, services and investment, as well as areas of economic cooperation. The Agreement also provides for an Early Harvest Programme (EHP) which covers areas of economic cooperation and a common list of items for exchange of tariff concessions as a confidence building measure.

Table 12.1: Relative Importance of India's Trade with ASEAN

Figures in $million, for the year 2002-03

India's total global trade 114,131.56	India's total trade with ASEAN 9,768.71	Percentage share of India's trade with ASEAN 8.56%
India's total global export 52,719.43	India's total export to ASEAN 4618.54	8.76%
India's total global import 61,412.13	India's total import to ASEAN 5150.17	8.39%

Source: Export Import Data Bank

12.3.2 SAARC

The South Asian Association for Regional Cooperation (SAARC) was established on December 8, 1985. It involves seven states of the Indian sub-continent—Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. The objective of the Association is to promote the welfare of the people of South Asia and to improve their quality of life through accelerated economic growth, social progress and cultural development in the region.

The Secretariat of the Association is at Kathmandu, Nepal. Summits, which are the highest authority in SAARC, are to be held annually. The country hosting the Summit holds the Chair of the Association. The Council of Ministers comprising Foreign Ministers of member nations, meet at least twice a year. Its functions include formulating policy, reviewing progress of

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regional cooperation, identifying new areas of cooperation and establishing additional mechanisms that may be necessary. The Governors of the Central Banks of Member States under the auspices of SAARCFINANCE meet regularly to consider cooperation in financial matters.

Beyond official linkages, SAARC also encourages and facilitates cooperation in private sector through the SAARC Chamber of Commerce and Industry (SCCI), which is a SAARC Apex Body. Other such bodies are SAARC LAW and the South Asian Federation of Accountants (SAFA). In addition, professional groups in South Asia have been given status of SAARC Recognized Bodies. These bodies include: Architects, Management Development Institutions, University Women, Town Planners, Cardiologists, Dermatologists, Teachers, Writers, Insurance Organizations, Diploma Engineers, Radiological and Surgical Care Societies.

The SAARC Secretariat is based in Kathmandu. It coordinates and monitors implementation of activities, prepares for and services meetings, and serves as a channel of communication between the Association and its member states as well as other regional organizations.

Areas of Cooperation

SAARC seeks cooperation in the following thrust areas:

1. Agriculture and Rural Development
2. Health and Population Activities
3. Women, Youth and Children
4. Environment and Forestry
5. Science and Technology and Meteorology
6. Human Resources Development
7. Transport
8. Information and Communications Technology
9. Biotechnology
10. Intellectual Property Rights
11. Tourism
12. Energy

12.3.3 SAPTA

South Asian Preferential Arrangement (SAPTA) was signed by the SAARC members on April 11, 1993 and came into force in December 1995. The objective of the SAPTA is the creation of trade among the SAARC countries through the reduction of tariffs and on preferential basis. It thus, seeks the economic development of all the SAARC nations. The biggest argument in favour of SAPTA is that there is geographical proximity (a big scope for cross border railway and road link) among the member nations and nations are also culturally close to each other.

Even after that, intra-regional trade among SAARC nations has remained very low in South Asia compared to other similar regional trade blocs; approximately 2.4 percent of total SAARC trade in 1990.

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Did u know? The trade between SAARC's Big Two, India and Pakistan, through official channels, is $200 million a year. But, the overall trade via third countries like Singapore and Dubai is estimated at $1.5 billion a year.

It shows the potential for SAPTA/SAFTA. SAPTA was seen as a first step towards South Asian Free Trade Area (SAFTA) which was initially planned to be established before 2005, leading subsequently towards a Customs Union, Common Market and Economic Union.

The basic principles underlying SAPTA are:

1. Overall reciprocity and mutuality of advantages so as to benefit equitably all contracting states, taking into account their respective level of economic and industrial development, the pattern of their external trade, and trade and tariff policies and systems;
2. Negotiation of tariff reform step by step, improved and extended in successive stages through periodic reviews;
3. Recognition of the special needs of the Least Developed Contracting States and agreement on concrete preferential measures in their favour; and
4. Inclusion of all products, manufactures and commodities in their raw, semi-processed and processed forms.

It was anticipated that SAPTA would facilitate greater specialisation and cost reduction, generating substantial trade in the region in the view of significant tariff reductions and removal of other Non-Tariff Barriers (NTBs), given the existing complements of resource endowment, technical know-how and expanding production capability.

12.3.4 SAFTA

The South Asian Free Trade Area (SAFTA) Agreement came into force in January 2006, with a ten year period for full-fledged implementation. SAFTA is supposed to open a new vista of regional economic cooperation and integration. The SAFTA agreement replaces SAARC Preferential Trading Agreement (SAPTA). SAFTA moves the region to higher levels of trade and economic cooperation by "removing barriers to cross-border flow of goods. It provides Bhutan, Bangladesh, Maldives, Nepal, and Sri Lanka - the Least Developed Countries (LDCs) - special and differential treatment "commensurate with their development needs." It bills India and Pakistan as "Non-Least Developed Countries" (NLDCs). The objectives of this agreement are to promote and enhance mutual trade and economic cooperation among contracting states by *inter alia*:

1. Eliminating barriers to trade in, and facilitating the cross-border movement of goods between the territories of the Contracting States;
2. Promoting conditions of fair competition in the free trade area, and ensuring equitable benefits to all Contracting States, taking into account their respective levels and pattern of economic development;
3. Creating effective mechanism for the implementation and application of this agreement, for its joint administration and for the resolution of disputes; and
4. Establishing a framework for further regional cooperation to expand and enhance the mutual benefits of this agreement.

Three countries of SAFTA (India, Pakistan, Sri Lanka) are Developing Countries (DCs), while the other four (Bangladesh, the Maldives, Nepal, and Bhutan) are Least Developed Countries (LDCs). SAFTA DCs will reduce customs duties to 0% to 5% by 2013 and LDCs will do it by 2018.

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In addition, DCs will have an early harvest programme (by 2009) of duty reduction for imports from LDCs. The agreement also has the clause to compensate the LDCs for revenue loss arising due to the trade liberalisation programme under SAFTA. While Bangladesh, Bhutan and Nepal are entitled to compensation for four years, Maldives can seek compensation for six years.

It provides for free movement of goods in the region through elimination of tariffs, para-tariffs that include border charges and fees, and non-tariff restrictions on movement of goods and any other equivalent measures. SAFTA also provides for simplification and harmonisation of standards, customs clearance, import licensing, import financing by banks, transit facilities especially for landlocked countries, promoting intra-SAARC investments, development of communications and transport, and speedy grant of business visas.

Caution **Sensitive List**: Each country will maintain a sensitive list to protect the interests of the domestic stakeholders. This will be subject to a maximum ceiling and shall be finalised after negotiations among the Contracting States with flexibility to the Least Developed Contracting States to seek derogation in respect of the products of their export interest. This in effect means that the non-LDC member states would maintain smaller Sensitive List for the LDC member states. The Sensitive Lists are subject to review after every four years or earlier with a view to reducing the number of items which are to be traded freely among the SAARC countries.

If implemented honestly, SAFTA can prove to be a boon for the member countries and its people. As even today, the trade among SAARC nations through the grey countries and through third countries is manifold. Trade among SAFTA nations also gives advantage in terms of reduction of transportation cost. Because all the nations are easily accessible it will also reap the benefit of internal and external economies of scale and factor cost advantage. If we see the results of other FTAs, we expect that it will create new jobs and will help in reducing poverty that all the SAARC nations are fighting. It is a fact that the world over, except in South Asia, the trade between neighbouring countries runs into high levels of volume.

The trade within NAFTA is 60% of the total trade of the regional countries; similarly 55 percent of the total trade of the EU is within the European region; this figure is 30% for ASEAN, whereas it is only 5% for the SAARC region. It is expected that SAFTA has the potential to increase regional trade manifold, but to reap these benefits, our political leadership would have to be pressed to make SAFTA stronger.

Table 12.2: Economic Indicators of k-Economy in the SAARC

Country	GDP per capita (PPP), US$[a]		Real GDP growth rate (%)[b]		Share of GDP by sector (%), 2008[c]			Manufactured exports (1)[d]		THE (2)[e]		IR (3)[f]	UR (4)[g]
	2001	2006	2000	2008	Agriculture	Industry	Services	1990	2005	1990	2005	2008	2008
Bangladesh	346	404	5.2	4.9	19.1	28.6	52.3	77	90	0.1	N/A	9.4	2.5
India	466	813	5.5	6.6	17.2	29.1	53.7	70	70	2.4	4.9	7.8	6.8
Pakistan	461	803	3.1	5.8	20.4	26.6	53	79	82	0.4	1.6	20.8	7.4
Sri Lanka	786	1,352	3.7	6	15.5	27	57.5	54	70	0.6	1.5	14.4	5.2
Nepal	219	253	3.4	5.6	32.5	16.6	50.9	83	74	N/A	0.1	7.7	46
Bhutan	249	1,121	7.0	6.6	63	6	31	42	N/A	N/A	N/A	4.9	2.5
Maldives	2,098	3,107	7.0	5.7	22	18	7.0	N/A	8	N/A	2.1	12.8	14.4
CV (%)	100.06	85.04	32.93	10.03	61.62	39.44	65.76	23.89	366.12	–	80.95	48.06	127.74
Selected APT countries													
Singapore	26,500	29,700	10.1	4.5	0.0	33.2	66.8 (2007)	72	85.0	40.0	59.0	0.3	3.4
South Korea	16,100	20,300	9.0	3.7	3.8	41.4	54.8	94.0	93.0	18.0	32.0	2.8	3.7
Hong Kong, China (SAR)	25,400	36,800	10.0	7.0	0.1	10.0	89.9	95.0	93.0	N/A	13.0	0.9	5.8
Malaysia	10,300	10,400	8.6	5.1	7.2	44.6	45.7	54	77.0	38.0	58.0	2.9	3.6
Thailand	6,700	8,300	4.2	4.6	9.3	45.1	45.6	63.0	75.0	21.0	30.0	4.8	1.4
CV (%)	52.00	58.08	28.87	24.69	101.96	41.76	26.42	24.32	10.08	40.74	51.51	76.06	43.29

Notes: CV – coefficient of variation; (1) – manufactured export as percentage of merchandise export (APT: 1990 and 2003); (2) – high-technology export as percentage of merchandise export (APT: 1990 and 2003); (3) – inflation rate, 2008 (APT: 2005); (4) – unemployment rate, 2008 (APT: 2005)
Source: Adapted and calculated from CIA World Factbook (2000) (APT: 2001, 2005) and 2008 for superscripts a, b (APT: 2000 and 2005), c (APT: 2005), f, g; United Nations Human Development Report (APT: 2005) (2007-2008) d and e (for all the data the years are given otherwise mentioned in the parenthesis), Hossain (2006)

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12.3.5 BIMST-EC Free Trade Area

The initiative to establish Bangladesh-India-Sri Lanka-Thailand Economic Cooperation (BIST-EC) was taken by Thailand in 1994 to explore economic cooperation on a sub-regional basis involving contiguous countries of South East & South Asia grouped around the Bay of Bengal. Myanmar was admitted in December, 1997 and the initiative was renamed as BIMST-EC. It may be mentioned that the initiative involves 3 members of SAARC (India, Bangladesh & Sri Lanka) and 2 members of ASEAN (Thailand, Myanmar). BIMST-EC is an important element in India's "Look East" strategy and adds a new dimension to our economic cooperation with South East Asian countries.

Caution Bangladesh, India, Myanmar, Sri Lanka and Thailand, are the Member States of BIMST-EC, also called the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMST-EC). The objective is to take advantage of regional proximity and thus create trade for the region. According to Article 1 of the Agreement, its objectives are:

1. Strengthen and enhance economic, trade and investment cooperation;
2. Progressively liberalise and promote trade in goods and services, create a transparent, liberal and facilitative investment regime;
3. Explore new areas and develop appropriate measures for closer cooperation among the nations; and
4. Facilitate the more effective economic integration of the least developed countries in the region, and bridge the development gap among the parties.

BIMST-EC seeks to achieve FTAs and to strengthen economic cooperation through the following steps as mentioned in Article 2 of the agreement:

1. Progressive elimination of tariffs and non-tariff barriers in substantially all trade in goods;
2. Progressive liberalisation of trade in services with substantial sectoral coverage;
3. Establishing an open and competitive investment regime that facilitates and promotes investments within the BIMST-EC FTA;
4. Provision for special and differential treatment and flexibility to the least developed countries in the region;
5. Flexibility to the parties in the BIMST-EC FTA negotiations to address their sensitive areas in the goods, services and investment sectors based on agreed principles of reciprocity and mutual benefits;
6. Establishing effective trade and investment facilitating measures, including, but not limited to, simplification of customs procedures and development of mutual recognition arrangements;
7. Expanding economic cooperation in areas as may be mutually agreed among the parties that will complement the deepening of trade and investment links among the parties and formulating action plans and programmes in the agreed sectors/areas of cooperation and;
8. Establishing appropriate mechanisms for implementation of this Agreement.

BIMST-EC seeks to abolish the trade tariffs by 2017 in a phased manner. Besides elimination of trade tariffs, BIMST-EC also identified six priority areas of cooperation. They include Trade and

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Investment, Technology, Transport and Communication, Energy, Tourism, Agriculture and Fisheries.

12.3.6 India-Thailand FTA

A Framework Agreement for establishing Free Trade Area between India and Thailand was signed by the Commerce Ministers of the two sides on October 9, 2003 in Bangkok, Thailand. The key elements of the Framework Agreement cover FTA in Goods, Services and Investment, and Areas of Economic Cooperation. The Framework Agreement also provides for an Early Harvest Scheme (EHS) under which common items of export interest to the sides have been agreed for elimination of tariffs on a fast track basis. The tariffs will be abolished in a two phased manner.

On the fast track basis, tariffs will be eliminated on certain goods by March 2006, and on all other goods, they will be eliminated by 2010. Besides elimination of tariffs and promotion of investment and trade, the agreement seeks mutual cooperation in the following areas:

Trade Facilitation, removal of Non-Tariff Barriers (NTBs), customs co-operation, business visa and travel facilitation, fisheries and aquaculture, information and communications technology, space technology, biotechnology, finance and banking, tourism, infrastructure development, healthcare, construction, education, government procurement, trade and investment promotion, trade and investment fairs and exhibitions, India-Thailand portal, and business sector dialogues, intellectual property rights, Small and Medium Enterprises (SMEs), civil aviation, environment, forestry and forestry products, mining, energy and sub-regional development, promotion of electronic commerce; capacity building; and technology transfer.

Task Collect appropriate data and prepare a report/project on the impact of India-Thailand FTA on the Auto components industry of India.

12.3.7 India-Singapore Comprehensive Economic Cooperation Agreement (CECA)

India and Singapore are mutually important economic partners. Singapore is India's most important trading partner among the ASEAN countries and also India's gateway to ASEAN and China. It is India's largest export partner and the second largest source of imports from ASEAN.

In 2003-04, India was Singapore's 14th largest trading partner, with total trade worth US$ 6.4 billion. This phenomenal rate of growth in recent years is attributed to the excellent economic and political relationship between India and Singapore.

India and Singapore singed the Comprehensive Economic Cooperation Agreement (CECA), in June 2005. Thus, they paved the way for an integrated package of trade in goods and services; an agreement on investments; mutual recognition in services; a cooperation pact in customs, science and technology, education, e-commerce, intellectual property and media. The Singapore Commerce Minister, Mr. Lim H. Kiang, told a news conference that the CECA, *"will go beyond free trade"* as it has other elements such as special visa arrangements and liberalisation of air transport. The objectives of this Agreement (Article 1.2) are:

1. To strengthen and enhance the economic, trade and investment cooperation between the parties;

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2. To liberalise and promote trade in goods in accordance with Article XXIV of the General Agreement on Trade and Tariffs;
3. To liberalise and promote trade in services in accordance with Article V of the General Agreement on Trade in Services, including promotion of mutual recognition of professions;
4. To establish a transparent, predictable and facilitative investment regime;
5. To improve the efficiency and competitiveness of their manufacturing and services sectors and to expand trade and investment between the parties, including joint exploitation of commercial and economic opportunities in non-parties;
6. To explore new areas of economic cooperation and develop appropriate measures for closer economic cooperation between the Parties;
7. To facilitate and enhance regional economic cooperation and integration, in particular, to form a bridge between India and the ASEAN region and serve as a pathfinder for the India-ASEAN free trade agreement; and
8. To build upon their commitments at the World Trade Organization.

India would cut tariffs on imports from Singapore under the CECA, gradually cutting them to zero over a five-year period. Singapore has zero customs tariff on all products except six and Singapore has agreed to bind all their tariff lines at zero customs duty for India, including beer. Under the early harvest programme for duty cuts, as many as 506 products, mostly information technology items and aeroplane parts, would be allowed duty-free to India from Singapore.

For the first time New Delhi has agreed to grant pre-establishment National Treatment on a positive basis. India has taken commitments in 22 areas such as manufacture of food products and of textiles, manufacturing of wearing apparel, dressing and dyeing of fur, tanning, beverages, leather, manufacture of luggage, handbags, harness and footwear, manufacture of paper and paper products, chemicals and chemical products, radio, television and communication equipment and apparatus, manufacture of motor vehicles, trailers and semi-trailers, development of township, housing, built-up infrastructure and construction development projects. India has agreed to commit for Singapore the recent policy liberalisation on FDI in township and housing, as these are priority areas for attracting FDI.

On trade in services, India has taken commitments in nine sectors that include professional services (including accounting, taxation (advisory only), architecture, engineering, medical and dental, services by nursing, midwives and veterinary services, computer and related services, R&D services, real estate services (for consultancy), rental/leasing services without operators, other business services such as advertising services, management consulting services, technical testing and analysis services, services incidental to fishing, mining, manufacturing; energy distribution, placement and supply of services of personnel, maintenance and repair of equipment, photographic services, packaging services, telecommunication and audiovisual services, construction and related engineering services, financial services, health, tourism, recreational, cultural and sporting services, maritime transport services and some sectors of air transport services.

While Singapore has taken commitments in a dozen service sectors, it has offered partial/full commitments in all the services sectors in which India has offered commitments. Such sectors include legal (for consultancy) services, other business service areas include market research and public opinion polling, services incidental to agriculture, forestry, security consultations, alarm monitoring, unarmed guard services, telephone answering services, retail trading and franchising under distribution services, education services, environment and health.

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Notes **India – Sri Lanka Bilateral Free Trade Area**

A Bilateral Free Trade Agreement was signed between India and Sri Lanka in New Delhi on December 28, 1998 and has been in operation since March 2000. This was the first FTA India had signed by then. The Agreement seeks to establish a Free Trade Area (FTA) through elimination of tariffs in a phased manner as under:

India's Commitments

India would reduce tariffs to zero on 1350 tariff lines immediately on implementation of the Agreement. For the rest, except 429 items included in the Negative List, across the board duty free access would be given over a period of 3 years from the date of implementation of the Agreement. There is a tariff rate quota on tea for 15 million kg and on garments for 8 million pieces.

Sri Lanka's Commitments

Sri Lanka would give 100% duty concessions on 319 tariff lines on the date of operation of the Agreement. In addition, it has given 50% tariff concessions on 839 tariff lines from the date of operationalisation of the Agreement, which has been deepened to 100% as of today. For the remaining items, Sri Lanka would reduce tariffs to zero percent over a period of 8 years in three phases, i.e., by 35% and 70% and 100% before the expiry of 3rd, 6th and 8th year respectively. In other words, India's exports on these items get 35% duty concessions from Sri Lanka as of today. Sri Lanka's Negative List comprises of 1180 tariff lines.

12.3.8 India-MERCOSUR PTA

India-MERCOSUR PTA has come into effect from 1st June, 2009. India with a total trade of US $ 4773.39 million with MERCOSUR during 2007-08, had exports of about US $ 2904.8 million during 2007-08 while imports stood at about US $ 1868.39 million during the same period.

The major product groups covered in the offer are food preparations, organic chemicals, pharmaceuticals, essential oils, plastics & articles thereof, rubber and rubber products, tools and implements, machinery items, electrical machinery and equipments. The break-up of the number of tariff lines for different MOPs is: - 393 tariff lines - 10%, 45 tariff lines - 20% and 14 tariff lines-100%.

The major sectors covered in offer list of India are meat and meat products, inorganic chemicals, organic chemicals, dyes & pigments, raw hides and skins, leather articles, wool, cotton yarn, glass and glassware, articles of iron and steel, machinery items, electrical machinery & equipments, optical, photographic & cinematographic apparatus. The break-up of the number of tariff lines for different margin of preferences (MOP) is:- 93 tariff lines - 10%, 336 tariff lines - 20% and 21 tariff lines - 100%.

MERCOSUR is a trading bloc in South America region comprising of Argentina, Brazil, Paraguay and Uruguay. It was formed in 1991 with the objective of free movement of goods, services, capital and people and became a customs union in January 1995. MERCOSUR's role model is European Union.

A Framework Agreement had been signed between India and MERCOSUR on 17th June 2003 at Asuncion, Paraguay. The aim of this Framework Agreement was to create conditions and mechanisms for negotiations in the first stage, by granting reciprocal tariff preferences and in the second stage, to negotiate a free trade area between the two parties.

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As a follow up to the said Framework Agreement, a Preferential Trade Agreement (PTA) between India and MERCOSUR was signed in New Delhi on January 25, 2004 and five annexes to this Agreement were signed incorporated on March 19, 2005. By this PTA, India and MERCOSUR have agreed to give tariff concessions, ranging from 10% to 100% to the other side on 450 and 452 tariff lines respectively.

Did u know? A Preferential Trade Agreement (PTA) was signed in New Delhi on January 25, 2004, between India and MERCOSUR. The aim of this Preferential Trade Agreement is to expand and strengthen the existing relations between MERCOSUR and India, promote the expansion of trade by granting reciprocal tariff reductions and ultimately to create a free trade area between them.

Case Study

Polyplastics

Polyplastics was established in the year 1967 for the manufacturing of components for Telecommunication Industry. Products were exported to many European countries in seventy's and eighty's. Till the year 1983, it manufactured products for telephone, textile, defence & homeappliance industries. It was in the year 1983, that Polyplastics started moving towards auto components manufacturing and currently, it makes parts only for the automotive industry.

Polyplastics, though being not located in one of the auto component manufacturing hubs has succeeded in building its business brick by brick. Polyplastics is engaged in the business of electroplating of various components, Painted & Hot stamped badge & Monograms, Wheel rim covers, Radiator grills, RR Garnishes/Ducklid Handles Assembly control brackets, Dash board components, Door handles, Ash trays, Auto electrical assemblies. Polyplastics realized early in its growth journey that it needs to be the best manufacturer of the critical components that it manufacturers. In order to achieve this, it entered into technical collaboration with Sakae Riken Kogyo Co., Japan for Electroplating on plastics and Extrusion mouldings. It also entered into technical collaborated with Zanini Auto Group, Spain in the year 2006 for manufacturing Wheel covers.

Polyplastics has developed expertise and experience to make products meet global specifications. The collaborations have helped to build up further confidence in the domestic OEMs, Maruti Udyog Ltd., Tata Motors Ltd., Toyota Kirloskar Motors Pvt. Ltd., General Motors India Pvt. Ltd., Swaraj Mazda LTD., Ford India Ltd., Honda Siel Cars India Ltd., Mahindra Renault, Fiat. Further it has also helped it to upgrade its manufacturing technology with the result get orders from Global OEMs such as General Motors, Nissan & Renault for their overseas locations to endless but serious enquiries are being released from all over the Globe.

Polyplastics has also been a supplier to General Motors, Thailand. The quality of its products has helped it get bigger orders from other OEMs. The increased demand for its products has necessitated expansion of its facilities. Two years ago, a manufacturing facility was created in Gurgaon which is almost 100% utilized. The Pune facility, which will manufacture the similar components, is coming up with an investment of ₹ 25 Crore. This facility will become operational by end of the year 2008. Also the groundwork for a manufacturing facility in Chennai has already started.

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While Polyplastics did not have any major problem in any of the Joint Ventures so far, it feels that the Government shall works towards making Indian arbitration institutions and systems internationally credible. Such an arbitration process will install confidence between the two Joint Venture partners.

Polyplastics though feels that continuously increasing prices of raw material and disparity in the pricing policy of the global raw material suppliers is fast making Indian auto component manufacturers less competitive in the globalized economy. Another factor that is making India less competitive is the lack of availability of dedicated manpower. The quality of its products has helped it get bigger orders from other OEMs. Till the year 2004, it exported very small components like emblems to GM-Thailand. In 2004, it got an order from GMThailand for the supply of Chevy Bowtie. This component was a very complicated one. Because, there were three processes, Injection molding, vacuum metalizing and painting involved to produce the parts.

The design of the part was in Unigraphics, for which the company did not have software in-house; yet, it successfully developed the part, without any major problem. It was one of the first auto components (Assy of two parts ABS +PMMA with vacuum metalizing), which Polyplastics had developed in-house for the overseas customers.

Keeping in mind the successful development and supply of above part, GM again selected Polyplastics for their new programme S4200 car for their Mexico plant and awarded order for 4 components to it. These parts are presently under approval stage.

The growing confidence of GM in the company has resulted in some of its getting tested in China and USA and have resulted in satisfactory quality. This is likely to help them getting selected as approved global suppliers. Similar situation happened with the Renault. Polyplastics was an unknown supplier to Renault. But after the successful development of components for Logan car (Being produced by their Indian JV company Mahindra Renault), they awarded order to it for two more components for their manufacturing plant in Turkey and France. Testing of these parts have been cleared by Renault approved test labs in France. This further deepened the relationship and further orders are likely to placed with Polyplastics. Renault is having alliance with Nissan. The successful development of the above projects has helped it in getting business from Nissan for their plant in UK and Spain as well. The Renault/ Nissan requirements in terms of Systems are very stringent. The OEM has worked with the Polyplastics in guiding them improve their systems from the score "D" to "C" and is further guiding the company to improve its systems to level B. Recently, it finalized three emblems and one wheel rim cover for their forthcoming project in Chennai.

The management of Polyplastics is excepting orders for their many more projects in future also. The management of the Polyplastics credits team spirit in the company to its current and future growth. Looking into the success of Polyplastics to deliver quality products and rapid improvement in the system, OEMs are sending many Requests for Quotation (RFQ) for its products. While the company did not have any major problem in any of the JVs so far, it feels that the Government should work towards making Indian arbitration institutions and systems internationally credible. Such an arbitration process will instill confidence between the two JV partners.

Case Notes

More than 60 percent of the exports of auto components are to USA and Europe, which constitute high AQL (Accepted Quality Level) countries. The global focus of the Indian auto component sector is expected to gain further momentum with a shift in the focus of Indian component companies from the replacement market to the OE (original equipment)

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market. The structure of the customer base in the global markets has also undergone a major change. In the last decade, the aftermarket share of exports has come down from 65 percent to 25 percent in 2007. The share of the component exports to OEMs and tier-I suppliers is increasing gradually, ensuring long-term relationships and repeat orders on a regular basis. Geographically, there has been a shift in the markets with the more developed markets of USA and Europe accounting for a majority of exports. Of the total auto component exports to OEMs and tier-I Suppliers, America and Europe together accounts for 57.5 percent, Asia accounts for 20 percent and Africa accounts for 10.8 percent of the export earnings and other regions such as Oceania, etc. constitute the rest. The share of Asia in the global pie is gradually on the rise. This signifies that the Indian component industry has now reached a high degree of maturity in terms of quality and productivity and has also developed capabilities in the area of design and engineering, which are critical requirements for being a part of the global supply chain.

The total exports to OEMs and tier-I suppliers in 2006 amounted to INR 8,400 crores and the rest were supplied to tier-II/ tier-III suppliers.

MERCOSUR - India Preferential Trade Agreement (PTA) (Refer to Business Environment by Vivek Mittal, Excel books, pp 509).

The PTA was signed between India and MERCOSUR in 2004 Implications for the Indian Auto Components Industry: The auto components industry in MERCOSUR enjoys significant economies of scale in comparison to India. Both the imports and exports of components are significant in MERCOSUR vis-à-vis India. The component market in MERCOSUR is mainly Brazil and Argentina. The auto component industry of Brazil is three times that of India and that of Argentina is marginally less than India.

Global tier-I suppliers have followed their OEMs into Brazil and have set up significant capacities. The Brazilian auto component industry is very competitive but is not profitable at the moment and most local tier-II/ tier-III manufacturers are getting out of the business. Brazil imports stamping components, engines, gearboxes and other sub-assembly (e.g. steering column). Brazil is a highly protected market and is expected to remain so. The Argentina auto component industry lacks economies of scale but component manufacturing is profitable. Imports account for 50 percent of the turnover of the component industry. Argentina imports electrical motors and systems, differentials, transmission systems, body components and interiors. Argentina is competitive in stampings, seats, glass, plastics, panels and tyres where logistics cost is high and natural protection is thus ensured. Argentina is a highly protected market and is expected to remain so. Importing components by OEMs in MERCOSUR is mainly a strategic issue.

Question

Discuss how MERCOSUR - India Preferential Trade Agreement will influence the future course of action of the Polyplastics.

Source: Business Environment: Text and Cases, 2nd Edition, Vivek Mittal, Excel Books, New Delhi

12.3.9 European Union

The European Union or EU is an intergovernmental and supranational union of 25 European countries, known as member states. The European Union was established under that name in 1992 by the *Treaty on European Union* (the Maastricht Treaty). However, many aspects of the Union existed before that date through a series of predecessor relationships, dating back to 1951.

The foundation of the European Union was laid in 1952 with the European Coal and Steel Community (ECSC). Six countries—Germany, France, Belgium, Luxembourg, Italy and the

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Netherlands—agreed to place the control of those industries under a central authority. The success of that arrangement led to the creation of the European Economic Community in 1958. New members were added: Denmark, Ireland and the United Kingdom in 1973; Greece in 1981; Spain and Portugal in 1986; Austria, Finland, and Sweden in 1995. At present, the EU has 25 members. In 1995, the list was as follows:

1. Austria (EUR)
2. Belgium (EUR)
3. Denmark
4. Finland (EUR)
5. France (EUR)
6. Germany (EUR)
7. Greece (EUR)
8. Ireland (EUR)
9. Italy (EUR)
10. Luxembourg (EUR)
11. Netherlands (EUR)
12. Portugal (EUR)
13. Spain (EUR)
14. Sweden
15. United Kingdom of Great Britain and Northern Ireland

The following ten countries joined the EU on May 1, 2004:

Cyprus (Greek part), the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.

In 2007, two new countries have jointed the EU: Bulgaria and Romania.

The European Economic community (now called the European Union) was formerly established by the Treaty of Rome. The Treaty of Rome also established Euratom, a European agency regulating nuclear energy. Rome Treaty is the operating constitution for the economic integration of Western Europe. The Treaty of Rome is a monumental document composed of more than 200 articles. The main provisions of the Treaty are:

1. Formation of a free trade area: the gradual elimination of tariffs, quotas and other barrier to trade among members.
2. Formation of Custom Union; the creation of uniform tariff schedule applicable to imports from the rest of the world.
3. Formation of common market; the removal of barrier to the movement of labour, capital and business enterprise.
4. Adoption of common agricultural processes.
5. The creation of an investment fund to channel capital from the more advanced to the less developed regions of the community.

In 1960, the Stockholm Convention established the European Free Trade Association (EFTA) among seven European Countries (Austria, Denmark, Norway, Portugal, Sweden, Switzerland,

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the United Kingdom). In 1979, the European Currency Unit was created. All members except UK agreed to maintain their exchange rates within specific margins. Global competition from Japan and USA prompted the European Union to take steps to remove the obstacle to free trade. Thus in 1987, the Single European Act was introduced which stated that "the community shall adopt measures with the aim of progressively establishing the internal market over a period expiring on December 31, 1992."

In addition to dismantling the existing barriers, the Single European Act proposed a wide range of new commercial policies, including single European standards regarding products and services. Technical standards for the electrical products can illustrate it in a better manner how difficult the task was. There were 29 types of electrical outlets, 10 types of plugs, and 12 types of cords used by EC members countries. The estimated cost for all EC nations to change the wiring systems and electrical standards to a single European Standard was 80 billion European currency Units (ECUs), or about 95 billion dollars.

Considering the time it will take to achieve uniform Euro-Standards for health, safety, technical, and other areas, the Single European Act provides the policy of harmonisation and mutual recognition. The harmonisation and mutual reorganization, when implemented, eliminated national standards as a barrier to trade. Among the first and most welcome reforms were the single customs document that replaced the 70 forms originally required of transborder shipment to member countries, the elimination of cabotage rules (which kept a trucker from returning with a loaded truck after delivery.), and the creation of EC-wide transport licensing. More than 60,000 customs and tax formalities previously imposed at country borders have been eliminated. These changes alone were estimated to have reduced distribution cost by 50% for companies doing cross-border in the EC.

12.3.10 NAFTA

In January 1994, Canada, the United States and Mexico launched the North American Free Trade Agreement (NAFTA) and formed the world's largest free trade area. The Agreement has brought economic growth and rising standards of living for people in all three countries. In addition, NAFTA has established a strong foundation for future growth and has set a valuable example of the benefits of trade liberalisation. Canada and U.S had signed a Free Trade Agreement which came in effect on January 1, 1989, and later Mexico approached the United States to establish one. The result was that on January 1, 1994, North America Free Trade Agreement came into effect.

NAFTA covers the following areas:

1. ***Market Access:*** Within 10 years of implementation all tariffs would be eliminated on North American Industrial products traded between Canada, Mexico and United States.
2. ***Non-Tariff Barrier:*** A host of non-tariff barriers and other trade distorting restrictions will be eliminated. Mexican barriers such as local intent, local production, and export performance requirement, etc., have to be eliminated.
3. ***Rules of Origin:*** NAFTA reduces tariffs only for goods made in North America. The Rule of Origin will determine whether goods qualify for preferential tariff treatment under NAFTA.
4. ***Custom Administration:*** Under NAFTA, all the signatories agreed to implement uniform customs procedures and regulations.
5. ***Investment:*** NAFTA eliminates investment conditions that restrict the trade of goods and services to Mexico.
6. ***Services:*** NAFTA establishes a comprehensive set of principles governing services trade. Signatories are allowed to open wholly owned subsidiaries, and all restrictions on the services will be lifted.

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7. ***Intellectual Property:*** NAFTA provides protection to intellectual property rights. The agreement covers patents, trademark, copyright, trade secrets, semiconductors, integrated circuits, and copyright for North American movies, computer software, and records.

8. ***Government Procurement:*** NAFTA guarantees fair business and open competition for procurement in North America through a transparent and predictable procurement procedure.

9. ***Standards:*** NAFTA prohibits the use of standards and technical regulations used as obstacles to trade.

NAFTA proved to be a boon for all the three nations. Low end manufacturing moved south (Mexico) and sophisticated manufacturing services increased in the United States and Canada. Many companies simply started moving to Mexico.

Example: General Electric divisions even advised their suppliers that they better go to Mexico as it will cut the cost, or bear the risk of being dropped as a GE supplier. Auto manufacturing from all over world began moving to Mexico. Over 500,000 Mexicans make parts and assemble vehicles for all of the world's major auto producers.

The rule of origin, which requires 62.5% regional content, forced European and Asian automakers to establish their units in Mexico as it is more cost effective. Daimler Chrysler (DC) produces 45,000 cars and 200,000 trucks in Mexico of which, between 80% to 90% is exported to USA and Canada. The story for Daimler Chrysler's production in the United States is similar. That is, the US plant of DC exported only 5,300 vehicles in 1993 and the year after the signing of NAFTA it exported 17,500 and in 2000, it exported 60,000 vehicles. Total trade among these three countries more than doubled from $306 billion to almost $621 billion between 1993 and 2002. For Mexico alone, exports to the US and Canada grew by over 200% during this period.

With a strong, stable and transparent framework for investment, the region has attracted foreign investment at record levels, not just from NAFTA partners, but from around the world. At the same time, all three countries have experienced strong economic growth. The NAFTA commission reports indicate that after signing of NAFTA, more than $189 billion was invested in the three countries in 1997. Meanwhile, total FDI into the NAFTA countries has reached $864 billion. Job creation has surged in all the three countries. Since NAFTA was implemented, employment has grown by 10.1% (1.3 million) in Canada, by 22% (2.2 million jobs) in Mexico and by over 7% (12.8 million jobs) in the United States.

12.3.11 Southern Cone Free Trade Area (MERCOSUR)

The Treaty of Asuncion which provided the legal basis for MERCOSUR was signed in 1991 and formally inaugurated in 1995 and thus, MERCOSUR (Mercado Comun Del Sur in Spanish) came into existence. The signatories of the treaty were Brazil, Argentina, Paraguay, and Uruguay. In addition, MERCOSUR signed a free trade agreement with Bolivia and Chile and is negotiating with EU and other countries to do the same. MERCOSUR has become a successful market of about 200 million people representing about 1 trillion dollars of GDP and 190 billion dollars of trade. It is the fourth largest integrated market after the European Union (EU), North American Free Trade Agreement (NAFTA) and ASEAN. MERCOSUR has three main objectives:

1. Establishment of Free Trade Area
2. A Common External Tariff
3. Free Movement of Capital labour and service.

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12.3.12 Asia Pacific Economic Integration

Asia Pacific Economic Cooperation (APEC) was formed in 1989. It has 21 member countries which account for more than a third of the world's population (2.6 billion people), approximately 60% of world GDP (US$19, 254 billion) and about 47% of world trade. It also proudly represents the most economically dynamic region in the world having generated nearly 70% of global economic growth in its first 10 years. Leaders of APEC have adopted their vision referred to as the 'Bogor Goals' *of free and open trade and investment in the Asia-Pacific by 2010 for industrialised economies and 2020 for developing economies*. In 1991, APEC members agreed on specific objectives:

1. To sustain the growth and development of the region.
2. To encourage the flow of goods, services, capital and technology.
3. To develop and strengthen an open multilateral trading system.
4. To reduce barriers to trade in goods and services among participants.

Member economies of the APEC are: Australia; Brunei; Canada; Chile; People's Republic of China; Hong Kong (China); Indonesia; Japan; Republic of Korea; Malaysia; Mexico; New Zealand; Papua New Guinea; Peru; Philippines; Russian; Singapore; Taiwan; Thailand; United States of America; Vietnam.

APEC focuses on three key areas:

1. Trade and Investment Liberalisation
2. Business Facilitation
3. Economic and Technical Cooperation (ECOTECH)

Trade and Investment Liberalisation reduces and eliminates tariff and other non-tariff barrier and thus, focuses on opening of markets. Business facilitation reduces the costs of business transactions, ensures free flow of business information and aligning policy and business strategies to facilitate free and open trade. ECOTECH provides the training and cooperation to build capacities in all APEC Member Economies to take advantage of global trade and the New Economy.

Caution A highlight of APEC's achievements in the first 10 years are:

- Exports increased by 113% to over US$2.5 trillion.
- Foreign direct investment grew by 210% overall, and by 475% in lower income APEC economies.
- Real gross national product grew by about a third overall, and by 74% in lower income APEC economies.
- Gross domestic product per person in lower income APEC economies grew by 61%.

12.3.13 Cartels and Commodity Price Agreements

Producers and consumers of primary commodities also come together and make a cartel or enter into an agreement to stabilise commodity prices and supply. These cartels are very important for countries like in the Middle East and African countries where a major portion of the export consists of crude petroleum, natural gas, copper, tobacco, coffee, cocoa, tea and sugar.

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Commodity agreements are of two basic types:

1. Producers' Alliances:
2. International Commodity Agreements (ICCAs)

Producers' alliances are exclusive membership agreements between producing and exporting countries. Examples are the Organization of Petroleum Exporting Countries (OPEC) and the Union of Banana Exporting Countries. ICCAs are agreement between producing and consuming countries. Examples of ICCAs are the International Cocoa Organization (ICCO) and International Sugar Organization (ISO). For example, membership of the 1993 ICCO Agreement comprises 42 countries plus the European Union and represents over 80% of the world's cocoa production and over 70% of world cocoa consumption.

Production of these primary products is often dependant on uncontrollable factors such as the weather. Because of this the export earnings of developing countries dependent on these commodities are highly volatile. Hence they try to stabilise the price and supply. Countries counteract price instability through several different schemes:

1. Stabilisation of world commodity prices through the exercise of market power by a monopolistic producer or producer cartel or through international commodity agreements.
2. Stabilisation of producer revenues through the use of risk-management instruments, such as commodities futures.
3. Stabilisation of government revenues through precautionary savings funds, compensatory financing.
4. Another approach of domestic producer and consumer prices through variable exports access or tariffs, agriculture marketing boards, or domestic stockpiles and stabilisation funds.

Another approach is the quota system in which producer countries determine the total output and then divide the total output and sales among themselves to stabilise the price. The quota system is very effective if one country has the lion's share and is in a position to dictate the terms of the quota system. OPEC follows the quota system, Australia controls the quota system of wool and DeBeers controls the quota system of Diamonds because it controls the most of the mining of diamonds in the world.

Caselet

OPEC

Oil producing and Exporting Countries (OPEC) is a group/cartel of oil producing countries that controls price by controlling the total output. It establishes the production quota on the member countries. Among OPEC nations, Saudi Arabia is a dominant supplier which can influence prices and supply of oil. One of the reasons Iraq gave for the Kuwait invasion was that Kuwait was producing more than its quota. This led to the reduction in the oil prices and resulted in Iraq losing its revenue.

OPEC members are: Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela. In 1970s OPEC played a dominant role in world economy. Irked by the US support to Israel in the war, they declared an embargo on the shipment of oil to the United States and quadrupled the price of oil - from approximately $3 to $ 12 per barrel. Continued increase in the price brought the average price per barrel

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to nearly $35 by 1981. Because of the increase of price at that time India also faced a severe problem of balance of payment. At that time, Iraq helped India by supplying oil to India.

At present the share of OPEC in the world market is falling and it is losing its control in dictating the price and supply of oil because of oil conservation; alternative sources of fuel, and increased oil production by non-members. There was a recent surge in the oil prices because of tension between USA and Iran (the second largest producer of oil in OPEC) on the issue of Iran's nuclear programme.

Self Assessment

Fill in the blanks:

9. ASEAN was established on August 8, 1967 in .....
10. SAARC involves seven states of the ..... sub-continent.
11. ..... and ..... are often referred to as SAARC's big two.
12. SAPTA has been replaced by .....
13. BIMST-EC is an important element in India's ..... strategy.
14. MERCOSUR is a trading block in Latin America comprising Brazil, Argentina, Uruguay and ..... as its members.
15. The foundation of the ..... was laid in 1952 with the European Coal and Steel Community.
16. NAFTA is an agreement between USA, Canada and .....

12.4 Summary

- After the era of Globalisation, we are entering the era of Regionalisation. Except a few nations, almost all the signatories of WTO are also members of any RTA (Regional Trade Agreement) and most of them are members of more than one RTA. India too has entered into many free trade agreements.
- India signed a comprehensive treaty with Singapore; Britain hopes that India will also sign the same treaty with European Union.
- Every country is in a hurry to gain entry in other nations' markets and to have access to the raw material of other nations.
- When two or more nations come together for the sake of business and reduce the barrier of international trade among them, then a regional trading block comes into existence.
- RTAs have many advantages as they result in Trade Creation and Trade Diversion, reduces and eliminates the import duty and other non-trade barriers, thus allowing the free movement of goods and services among nations.
- It also helps in achieving the economies of scale, to take advantages of higher factor productivity which results in reduction in the prices of goods and services in the member nations and in creation of jobs in member nations.
- RTAs can be of many types such as Preferential Trade Agreement, Free Trade Area (FTA), Custom Union and Common Market. Some of the most famous RTAs are European Union, APEC, MERCOSUR, NAFTA, ASEAN, etc.

Notes

- India has also signed RTAs such as India-ASEAN, SAFTA, Bangladesh-India-Sri Lanka-Thailand Economic Cooperation (BIST-EC), India-Thailand FTA, India-Sri Lanka Bilateral Free Trade Area, and India-Singapore Comprehensive Economic Cooperation Agreement (CECA).

12.5 Keywords

APEC: Asia Pacific Economic Cooperation (APEC) consisting of 21 countries was formed in 1989.

ASEAN: The Association of Southeast Asian Nations was established by five member countries, namely Indonesia, Malaysia, Philippines, Singapore, and Thailand. Later Brunei, Darussalam, Vietnam, Laos and Myanmar and Cambodia also joined.

CECA: India-Singapore Comprehensive Economic Cooperation Agreement (CECA).

European Union: The European Union or EU is an intergovernmental and supranational union of 25 European countries, known as member states.

Free Trade Area (FTA): In free trade area, countries eliminate duties among themselves while maintaining them with the outsiders

MERCOSUR: It is a trading block in Latin America comprising Brazil, Argentina, Uruguay and Paraguay as its members.

NAFTA: In January 1994, Canada, the United States and Mexico launched the North American Free Trade Agreement (NAFTA)

OPEC: Oil Producing and Exporting Countries (OPEC) is a group/cartel of Oil producing countries. OPEC controls Oil prices by controlling the total output.

Regional Trade Agreement/Regional Trade Block: When two or more nations come together for the sake of business and reduce barriers of international trade among themselves, then a regional trading block comes into existence.

SAARC: The South Asian Association for Regional Cooperation was established on December 8, 1985. It involves seven States of the Indian Sub-Continent, i.e., Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

SAPTA: South Asian Preferential Arrangement (SAPTA) signed by the SAARC members.

Trade Creation: In trade creation, trade shifts to a member (member country of regional block) either because of countries' comparative advantage in production of particular goods or because the country simply gets the cost advantage because of elimination of trade barriers.

Trade Diversion: Trade diversion is a cost to a particular non-member (of some RTA) country when a group of countries trade among themselves. Thus, trade diverts from the non-member to member country.

12.6 Review Questions

1. Discuss the various FTAs which India has signed.
2. "The world is not globalising, it is regionalising." Critically evaluate the statement.
3. What is RTA? Describe various types of RTAs.
4. What are the advantages and disadvantages of RTAs to a nation?
5. Is economic integration a boon or a bane? Give reasons for your answer.

Notes

6. Discuss the economic and functional cooperation of ASEAN nations.
7. Explain the role of India in ASEAN.
8. Regional conflicts are the obstacles in the successful implementation of SAFTA. Critically evaluate the statement.
9. Describe the EU and its impact on trade.
10. Write short notes on: ASEAN, NAFTA, Trade Diversion, and Trade Creation.

Answers: Self Assessment

1.	(d)	2.	(c)
3.	(b)	4.	(a)
5.	True	6.	True
7.	False	8.	True
9.	Bangkok	10.	Indian
11.	India and Pakistan	12.	SAFTA
13.	Look East	14.	Paraguay
15.	European Union	16.	Mexico

12.7 Further Readings

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Unit 13: International Finance and Foreign Exchange

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Objectives

After studying this unit, you should be able to:

- State the functions and organisation of foreign exchange markets
- Assess exchange rate policy and its management
- Explain triangular arbitrage
- Contrast futures and forwards market
- List the types of foreign currency options
- Discuss methods and problems of foreign exchange forecasting
- Explain the role of IMF, World Bank, International Finance Corporation and OECD

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Introduction

The financial system, consisting of financial institutions, financial instruments and financial markets, provides and effective payments and credit system and thereby facilitates channeling of funds from the savers to the investors in the economy. The task of financial institutions or financial intermediaries is to mobile savings and ensures efficient allocation of these funds to high yielding investment projects.

The market where one currency is traded for another is called foreign exchange market. It is a non-localised market, which exists in the network of information system, and there is no particular place that can be called foreign exchange market. The purpose of this unit is to provide you with this information. It discusses the organisation of the most important foreign exchange market — the Interbank market — including the spot market, the market in which currencies are traded for immediate delivery, and the forward market, in which currencies are traded for future delivery. It also describes the link between the spot and forward markets.

Foreign exchange transactions are derived from the transactions in the market for commodities, services or assets among the people of two nations. The trade in currency is the consequence of the people's wish to trade in underlying commodities, services or assets.

13.1 The Foreign Exchange Market

"The Spaniards, coming into the West Indies, had many commodities of the country which they needed, brought unto them by the inhabitants, to who when they offered them money, goodly pieces of gold coin, the Indians, taking the money, would put it into their mouths, and spit it out to the Spaniards again signifying that they could not eat it, or make use of it, and, therefore, would not part with their commodities for money, unless they had such other commodities as would serve their use."

—Edward Leigh (1671)

Did u know? The volume of international transactions has grown enormously since the end of Second World War. US exports of goods and services now account for about 10 per cent of gross national product, or over $500 billion annually. For both Canada and Great Britain, this figure exceeds 25 per cent. Imports are about the same size.

The trading of currencies takes place in foreign exchange markets whose primary function is to facilitate international trade and investment. Knowledge of the operation and mechanics of these markets, therefore, is important for any fundamental understanding of international financial management.

The foreign exchange market has two segments (a) Spot Market and (b) Forward Market.

Spot Market

Spot market is the market where transactions are conducted for the spot delivery of currencies. Here spot delivery means delivery after two days of spot contract being closed.

The rate at which one currency is traded for another is called exchange rate. The exchange rate for immediate delivery is called Spot Exchange Rate and is denoted by S(.) where S(.) is the relationship between two currencies.

Notes

Example: S (₹/$) = ₹ 46.68/$, is the relationship between the rupee and the dollar, which says that one dollar is equivalent to ₹ 46.68.

Instead of single currency (dollar) this can be a basket of currencies such as SDR (Special Drawing Right). In this case we write spot rates as: S (₹/SDR). Here immediate delivery means delivery after two business days (or less in the case of Latin American countries or for particular transactions) in the countries of the currencies involved in the transactions. The market where the purchase and sale of currencies is contracted for spot delivery is called the Spot Market. In a free float system, the spot rate of a currency is determined by the interaction of demand and supply of the currency.

Forward Market

The forward market consists of transactions that require delivery of currency at an agreed upon future date. The rate at which this forward transaction will be completed is determined at the time the parties agree on a contract to buy and sell. The time between the establishment of contracts and the actual exchange of currencies can range from two weeks to more than a year. The more common maturities for forward contracts are one, two, three, or six months. Some forward transactions are termed outright forwards, to distinguish them from swap transactions.

Forward transactions typically occur when exporters, importers, or others involved in the foreign exchange market must either pay or receive foreign currency amounts at a future date. In such situations there is an element of risk for the receiving party if the currency it is going to receive depreciates during the intervening period.

To fix a minimum value on the foreign exchange proceeds, these recipients can lock into a rate in advance by entering into a forward contract with their bank. Under such a contract, the bank is obligated to purchase the currency from the exporter at the agreed upon rate, regardless of the rate that prevails on the day when the foreign currency is actually delivered by the exporter. Banks in turn enter into contracts with other banks to offset these customer contracts, which give rise to interbank transactions in the forward market.

The date on which the currencies are to be delivered under a forward contract is fixed in advance and is usually specific. In some customer contracts, however, the banks provide an option to the customers to deliver currencies within a certain time range that can be from the beginning of a month up to ten, twenty, or thirty days. The costs of such contracts are, naturally, higher than contracts with specific maturity dates, because banks have to incur additional costs and efforts to create offsetting contracts in the interbank market.

Organisation of the Foreign Exchange Market

If there were a single international currency, there would be no need for a foreign exchange market. As it is, in any international transaction, at least one party is dealing in a foreign currency. The purpose of the foreign exchange market is to permit transfers of purchasing power denominated in one currency to another — that is, to trade one currency for another currency.

Most currency transactions are channelled through the worldwide interbank market, the wholesale market, in which banks trade with one another. This market is normally referred to as the foreign exchange market. In the spot market, currencies are traded for immediate delivery, which is actually within two business days after the transaction has been concluded. In the forward market, contracts are made to buy or sell currencies for future delivery.

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The foreign exchange market is not a physical place; rather, it is an electronically linked network of banks, foreign exchange brokers, and dealers whose function is to bring together buyers and sellers of foreign exchange. It is not confined to any one country but is dispersed throughout the leading financial centres of the world.

Example: London, New York City, Paris, Zurich, Amsterdam, Tokyo, Milan, Frankfurt, and other cities.

Trading is generally done by telephone or telex machine. Foreign exchange traders in each bank usually operate out of a separate foreign exchange trading room. Each trader has several telephones and is surrounded by display monitors and telex machines feeding up to the minute information.

Participants

The major participants in the foreign exchange market are the large commercial banks; foreign exchange brokers in the interbank market; commercial customers, primarily multinational corporations; and central banks, which intervene in the market from time to time to smooth exchange rate fluctuations or to maintain target exchange rates. Central bank intervention involving buying or selling in the market is often indistinguishable from the foreign exchange dealings of commercial banks or other private participants.

Caution Only the head offices or regional offices of the major commercial banks are actually market makers — that is, they actively deal in foreign exchange for their own accounts. These banks stand ready to buy or sell any of the major currencies on a more or less continuous basis.

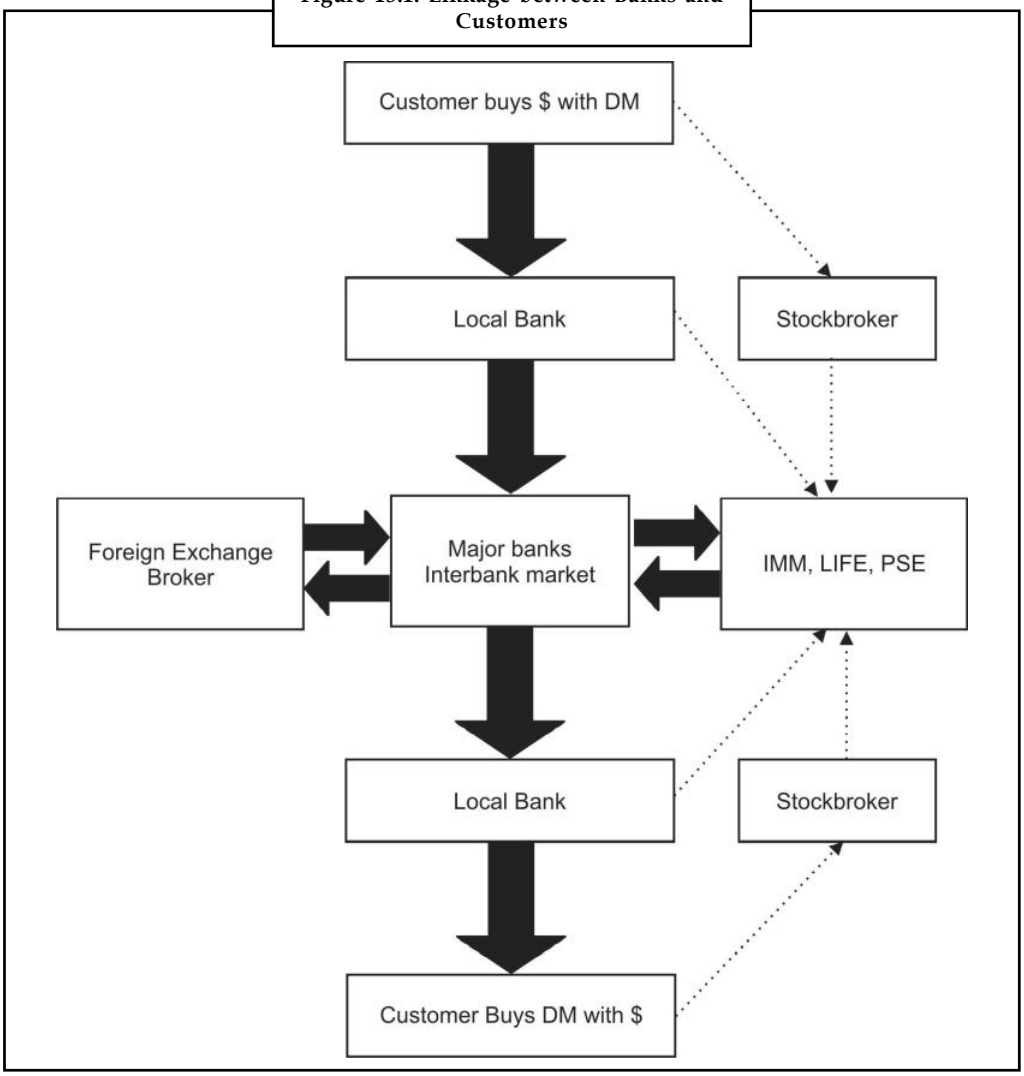
A large fraction of the interbank transactions in the United States is conducted through foreign exchange brokers, specialists in matching net supplier and demander banks. These brokers, of whom there are about a half dozen at present (located in New York City), receive a small commission on all trades. Some brokers tend to specialise in certain currencies, but they all handle major currencies such as the pound sterling, Canadian dollar, Deutsche mark, and Swiss franc.

Commercial and central bank customers buy and sell foreign exchange through their banks. However, most small banks and local offices of major banks do not deal directly in the interbank market. Rather, they typically will have a credit line with a large bank or with their home office. Thus, transactions with local banks will involve an extra step. The customer deals with a local bank that in turn deals with its head office or a major bank. The various linkages between banks and their customers are depicted in Figure 13.1. Note that the diagram includes linkages with currency futures and options markets.

Notes The International Money Market (IMM), Chicago, trades foreign exchange futures and DM futures options. The London International Futures Exchange (LIFE) trades foreign exchange futures. The Philadelphia Stock Exchange (PSE) trades foreign currency options.

Notes

Figure 13.1: Linkage between Banks and Customers



Source: Review, Federal Reserve Bank of St. Louis, March 1984

Size

The foreign exchange market is by far the largest financial market in the world.

Did u know? During 2003-04 the average monthly turnover in the Indian foreign exchange market touched about 175 billion US dollars. Compare this with the monthly trading volume of about 120 billion US dollars for all cash, derivatives and debt instruments put together in the country, and the sheer size of the foreign exchange market becomes evident. Since then, the foreign exchange market activity has more than doubled with the average monthly turnover reaching 359 billion USD in 2005-2006, over ten times the daily turnover of the Bombay Stock Exchange. As in the rest of the world, in India too, foreign exchange constitutes the largest financial market by far.

The largest foreign exchange markets centres in the world are London, which trades the highest daily volume, followed by New York and then Tokyo market is the third largest. Other big

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forex centres in Europe are Frankfurt, Paris and Amsterdam. In America the biggest forex centres are New York and Chicago, while in the Far East, Hong Kong, Singapore, Tokyo and Sydney are the main forex centres.

Unlike American stocks which you are unable to trade when the New York Stock Exchange closes, the dollar doesn't cease to be traded simply because the New York forex market has closed, it will continue to be traded in the Far East and then on into Europe.

Among smaller foreign exchange markets, the central banks reported average daily volume in the Swiss market at $ 57 billion, Hong Kong at $ 49 billion, France at $ 26 billion, Holland at $ 16 billion, and Canada at $ 15 billion. Germany's Bundesbank did not participate in the survey. However, Germany's foreign exchange volume would certainly place it among the top four in the world.

Caselet

Exporters Seek Fixed Interest Rates

Troubled by the appreciation of the rupee, which strengthened to an 18-month peak of below ₹ 45 to a dollar, the Federation of Indian Export Organisations (FIEO) has asked the Finance Ministry to provide exporters with a fixed exchange rate to enhance the competitiveness of Indian exports.

FIEO is the apex body for exporters.

In the letter, the FIEO President, Mr A. Sakthivel, said competing countries such as China and Bangladesh follow a similar policy, adding that, "The (Indian) Government can also contemplate to provide a fixed rate of exchange for exports on an optional basis."

"An exporter opting for a fixed rate for a year may be credited at ₹ 47.50 to a US dollar irrespective of the market value of US dollar. The scheme may be operational for one year from April 1, 2010 to March 31, 2011 and exporters opting for this scheme should give an irrevocable option to remain under it for a period of one year," Mr Sakthivel said.

Indian exports have been hurt by the appreciation of the rupee by about 8 per cent in the last one year, he said.

Noting that a major reason for rupee appreciation was FIIs pumping in more money, the FIEO President said, "FIIs are making short-term profits and pulling out the money leading to sharp exchange rate movements. To avoid such fluctuations, there is a need to regulate the FII investment so that FII money stays in India for a minimum period of two years."

The Export Promotion Council for Handicrafts Chairman, Mr R. K. Malhotra, said though the Government had given some incentives to the employment-intensive handicrafts sector, the currency appreciation has wiped out the benefits.

Source: www.hindubusinessline.com

Self Assessment

State whether the following statements are true or false:

1. US Dollar is the most acceptable payment means in all the countries.
2. The primary function of foreign exchange market is to improve the condition of international trade and investment.
3. The spot rate of a currency is determined by government and market, in a free float system.

13.2 Exchange Rate Policy and Management

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Recent years, particularly in the context of globalisation and currency crises, have seen a renewed interest in issues relating to the exchange rate regime, which is evident in a large and growing body of theoretical and empirical literature on the subject. Nevertheless, both in theory as well as in practice, the debate is unsettled and unresolved. A worldwide consensus is still evolving in search of an appropriate and credible exchange rate regime.

The exchange rate regimes, as seen today, are significantly different from those that prevailed during the pre-Bretton Woods system of gold standard and also under the Bretton Woods system of par value, both conceptually as well as functionally.

Notes According to IMF (2001), the exchange rate regime can be broadly classified into eight categories (1) exchange arrangements with no separate legal tender (2) currency board arrangements (3) other conventional fixed peg arrangements (4) pegged exchange rates within horizontal bands (5) crawling pegs (6) exchange rates within crawling bands (7) managed floating with no pre-announced path for the exchange rate and (8) independently floating. Conceptually, however, the focus has been on three areas, viz. (a) fixed rate regime (b) flexible rate regime and (c) intermediate rate regime.

The supporters of the fixed exchange rate regime argue that it provides credibility, transparency, very low inflation and financial stability. A particularly attractive feature of super fixed regime is that, in principle, by reducing speculation and devaluation risks, domestic interest rate will be lower and more stable than under alternative regime. However, achieving credibility under the super fixed regime is not automatic. Some of the key issues like fiscal solvency, clear demarcation of lender of last resort function, a strong domestic banking sector and sufficient holding of foreign reserves need to be addressed.

In view of the growing financial openness, the view in recent years has tended to polarize the choice, viz., either float freely or adopt as strict as possible a fixed regime. This development in literature is known as corner solution or bipolar view. From the historical prospective, however, the current support for the two corners approach is largely based on the shortcomings of the intermediate systems — pegged but adjustable, managed float and (narrow) bands — and not on the historical merits of either of the two corners systems. The reason for this is that, in emerging markets, there have been very few historical experiences with either super-fixity or with floating.

At present, there appears to be a trend by most of the countries to adopt more flexible and market based exchange rate arrangements. This shift in emphasis is reflected by a variety of factors including the changing economic conditions and policy objectives of countries over time, the liberalisation and globalisation of financial markets, accompanying increase in capital mobility and the emergence of tension between the objectives of lower inflation and external competitions.

Example: almost one half of the total countries, 186 at end December 2000 were at the corners. In contrast, the proportion of countries at the corners was only one-fourth at the end of December 1991.

Out of a total of 92 corner countries at end September 2001, the distribution between super fixers (46 countries) and freely floating (46) was equal. Countries under dollarisation dominate the group "super fixers" while countries under recurrence board arrangements are more modest. As regards countries with an intermediate regime, the predominant group is "conventional

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fixed pegs" (44 countries) followed by "managed floating" and bands/pegs. This classification of countries into various regimes, and the so called hollowing out of the intermediate regime is, however, based on the authorities self-description which may differ in some cases, especially in the context of the "freely floating" group, from the *de facto* arrangements. More recently, Calvo and Reinhart and Reinhart have argued that there seems to be an epidemic case of fear of floating and the so called demise of fixed exchange rates is a myth since countries that say they allow their exchange rates to float mostly do not. The fear to float, all-pervasive even amongst the developed countries, is essentially on account of lack of credibility, which could be manifested in multiple ways including volatile interest rates and sovereign credit ratings.

Task Prepare a report on: Condition of foreign exchange market in African countries.

Self Assessment

State whether the following statements are true or false:

4. The date on which the currencies are to be delivered under the forward contract can vary according to convenience.
5. There can't be a system where there is a total free float foreign exchange market.

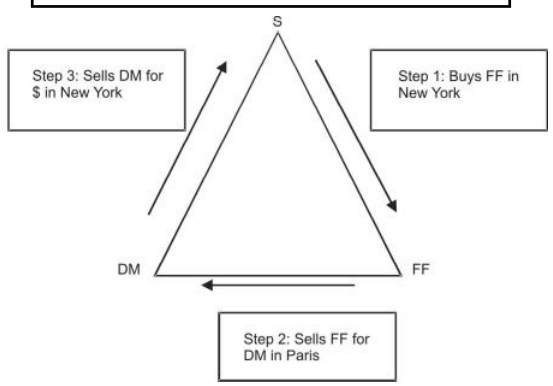
13.3 Triangular Arbitrage

Occasionally, prices of one currency can vary from one market to the other. A currency may be cheaper in New York and costlier in London. If such a situation arises, it provides an opportunity for market participants to buy the currency in New York and sell it in London. This activity is known as triangular arbitrage or inter-market arbitrage (see Figure 13.2). Whether such arbitrage is possible is indicated by comparing actual quotations for a currency in one market and its price in another market from cross-rate quotations. There are several steps an arbitrager must take to profit from such an opportunity. For example, assume that the following exchange rates are quoted in the interbank market:

$$\text{NewYork}: \frac{\text{US\$/FF} = \text{FF5.2350}}{\text{US\$/DM} = \text{DM1.765}}$$

Paris: FF/DM = FF2.9200

Figure 13.2: An Example of Triangular Arbitrage



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The French franc and deutsche mark are each quoted against the US dollar in New York and against each other in Paris, but we can also compute the exchange rate of francs against the deutsche mark in the New York market though the mechanism of cross rates:

$$\frac{FF5.2350}{DM1.7650} = FF2.9660$$

It is evident that the two rates for French franc in terms of the deutsche mark in New York and Paris are not the same. It would be profitable, therefore, to buy French francs in New York and sell them in Paris. Thus, a US arbitrager can get 523,500 French francs in the New York market for $100,000, and then sell these in Paris for 179,281 deutsche marks. The deutsche marks can then be sold in the New York market and bring $101,575.54. The arbitrager can make a clean profit of $1,575.54 without incurring any risk.

Arbitrage opportunities exist for a very short time in the interbank markets, because market movements quickly bring the rates back into line.

If such an opportunity were indeed present in the interbank market, there would be an enormous number of arbitragers acting upon the same strategy. Thus, the first step in selling the US dollars and acquiring French francs would push up the demand for French francs and decrease the demand for US dollars. As a result, there would be upward pressure on the price of French francs in the New York market. The second step, the sale of French francs acquired in New York for deutsche marks in Paris, would lead to enormous selling pressure on French francs a buying pressure on deutsche marks. This would push down the price of French francs and push up the price of deutsche marks in this market. Large quantities of deutsche marks would be unloaded in the New York market for US dollars, again pushing down the price of deutsche marks and increasing the price of the US dollar. The net effect of these pressures would be an increase in the price of French francs in New York, while the price of French francs in Paris would go down.

The converse movement would soon be enough to equalise prices in the two markets and eliminate the arbitrage opportunity. In fact, with modern information and computing technology arbitrage opportunities hardly ever exist. If they arise momentarily, they are almost instantaneously eliminated as exchange traders are able to spot them simultaneously and execute transactions that move the rates back into proper alignment, i.e., the cross-rates and quoted rates for currencies in different markets are the same.

Self Assessment

Fill in the blanks:

6. You buy a currency in one market and sell it off in another, due to higher returns. This is known as .....
7. Arbitrage opportunities exist for a ..... time in the interbank markets

13.4 Future and Forward Market

Forward market has been discussed in section 13.1 of this unit.

Currency futures are standard value forward contracts that obligate the parties to exchange a particular currency on a specific date at a pre determined exchange rate. Currency futures are traded at the International Money Market Division (IMM) of the Chicago Mercantile Exchange (CME). These futures were introduced in 1972 because in the new environment of floating exchange rates, it was believed that the interbank market would not be able to provide foreign exchange services to small investors or corporations that wanted to speculate in currency fluctuations through a daily trading strategy. Speculators are the main participants in the currency

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futures market, which has a daily turnover in excess of $40 billion. More recently, commercial banks have begun to deal in currency futures through arbitrage companies, which grew out of the IMM operations. The activity of the IMM adds liquidity to the interbank market.

Differences between Futures and Forward Markets

Although futures are similar to forward contracts, they allow market participants to fix their forward liability by locking into a future exchange rate, there are important differences between the two.

One of the most important differences is that while forward contracts can be of any size, futures contracts are of specific sizes.

Example: Canadian $50,000 or 125,000 Swiss francs

Thus, if a company wishes to buy Swiss francs currency future, it will have to enter into a contract for atleast SF125000. Larger contracts will be in multiples of this amount. Forward contracts are available in a variety of currencies, including some that are not actively traded. Currency futures contracts are available only in specific currencies, usually the currencies of the industrialised countries.

Futures contracts have standardised maturity dates that are regulated by the exchange authorities, while forward contracts have a relatively wide range of maturities. The element of standardisation also affects the future margin requirements. (Margins are deposits paid by persons entering into contracts as security for ensuring compliance with contractual obligations.) Futures contracts stipulate specific initial and maintenance margins, but forward contract margins are negotiable between banks and their clients. The futures markets are highly regulated and brokers can charge only fixed commissions. Regulation in forward markets is almost none existent and commissions can vary.

Futures markets are highly speculative in nature, and rate movements are more volatile than the forward market. In fact, this extreme volatility has resulted in the fixing of maximum price changes that are permissible on a particular trading day. Similarly, standards of minimum movements in rates have been fixed to affect a change in futures quotes. Operationally, perhaps the greatest difference between the two markets is the facility to exit or liquidate a position in the futures market, which is not available in the forward market. In the futures market, corporations or individuals can liquidate their existing position before settlement date by selling an equivalent futures contract. This facility makes it easier for the speculators and hedgers in the futures markets to cut their losses or take their profits without having to wait for the contract period to expire.

Fundamentally, forward and futures contracts have the same function: both types of contracts allow people to buy or sell a specific type of asset at a specific time at a given price.

However, it is in the specific details that these contracts differ. First of all, futures contracts are exchange-traded and, therefore, are standardized contracts. Forward contracts, on the other hand, are private agreements between two parties and are not as rigid in their stated terms and conditions. Because forward contracts are private agreements, there is always a chance that a party may default on its side of the agreement. Futures contracts have clearing houses that guarantee the transactions, which drastically lowers the probability of default to almost never.

Secondly, the specific details concerning settlement and delivery are quite distinct. For forward contracts, settlement of the contract occurs at the end of the contract. Futures contracts are marked-to-market daily, which means that daily changes are settled day by day until the end of the contract. Furthermore, settlement for futures contracts can occur over a range of dates. Forward contracts, on the other hand, only possess one settlement date.

Lastly, because futures contracts are quite frequently employed by speculators, who bet on the direction in which an asset's price will move, they are usually closed out prior to maturity and delivery usually never happens. On the other hand, forward contracts are mostly used by hedgers that want to eliminate the volatility of an asset's price, and delivery of the asset or cash settlement will usually take place.

Currency Swap Options

A swap that involves the exchange of principal and interest in one currency for the same in another currency. It is considered to be a foreign exchange transaction and is not required by law to be shown on a company's balance sheet.

Currency swaps are over-the-counter derivatives, and are closely related to interest rate swaps. However, unlike interest rate swaps, currency swaps can involve the exchange of the principal. There are three different ways in which currency swaps can exchange loans:

1. The simplest currency swap structure is to exchange only the principal with the counterparty at a specified point in the future at a rate agreed now. Such an agreement performs a function equivalent to a forward contract or futures. The cost of finding a counterparty (either directly or through an intermediary), and drawing up an agreement with them, makes swaps more expensive than alternative derivatives (and thus rarely used) as a method to fix shorter term forward exchange rates. However for the longer term future, commonly up to 10 years, where spreads are wider for alternative derivatives, principal-only currency swaps are often used as a cost-effective way to fix forward rates. This type of currency swap is also known as an FX-swap.
2. Another currency swap structure is to combine the exchange of loan principal, as above, with an interest rate swap. In such a swap, interest cash flows are not netted before they are paid to the counterparty (as they would be in a vanilla interest rate swap) because they are denominated in different currencies. As each party effectively borrows on the other's behalf, this type of swap is also known as a back-to-back loan.
3. Last here, but certainly not least important, is to swap only interest payment cash flows on loans of the same size and term. Again, as this is a currency swap, the exchanged cash flows are in different denominations and so are not netted. An example of such a swap is the exchange of fixed-rate US dollar interest payments for floating-rate interest payments in Euro. This type of swap is also known as a cross-currency interest rate swap, or cross currency swap.

For example, suppose a U.S.-based company needs to acquire Swiss francs and a Swiss-based company needs to acquire U.S. dollars. These two companies could arrange to swap currencies by establishing an interest rate, an agreed upon amount and a common maturity date for the exchange. Currency swap maturities are negotiable for at least 10 years, making them a very flexible method of foreign exchange.

Currency swaps were originally done to get around exchange controls.

Self Assessment

Fill in the blanks:

8. ……..are standard value forwards that obligate the parties to exchange currencies at a particular date.
9. In futures market, the individuals can……, which is not possible in forwards market and it is the greatest operational difference between the two.

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13.5 Foreign Currency Options

Foreign currency options are contracts that give the buyer the right but not the obligation to buy or sell a specified amount of foreign exchange at a set price for an agreed upon period.

Example: A US corporation enters into an option contract to buy 100,000 Swiss francs within a two-month period at a rate of 3.6 Swiss francs per US dollar. If the rate of the Swiss francs appreciates against the US dollar to where each franc is equal to one dollar, the corporation can exercise the option and acquire the foreign currency at the previous rate and not the prevailing rate. On the other hand, if the Swiss franc depreciates to, say, four francs to the dollar, then it would not be economical for the corpora ion to utilise the contract at the fixed rate of 3.6 francs to the dollar. Thus, the corporation would choose to buy its Swiss francs off the market and let the option go unexercised.

There are two types of options. A call option allows the option purchaser to buy the underlying foreign currency. A put option allows the option buyer to sell the underlying currency.

Options Terminology

Options markets are characterised by their unique terminology, which describes essential features of the contracts. Eight of the important terms are:

1. ***Writer:*** A person who confers the right but not the obligation to another person to buy or sell the foreign currency.
2. ***Strike price or exercise price:*** The rate at which the option can be exercised, that is, the rate at which the writer of the option will buy or sell the underlying foreign currency to the purchaser in the event the larger exercises his option.
3. ***At the money option:*** An option whose exercise or strike price is the same as the prevailing spot exchange rate.
4. ***In the money option:*** An option whose exercise price is better at the time of contract writing than the spot price for the relative currency.
5. ***Out of the money option:*** A currency option whose exercise price is worse for the purchaser than the prevailing spot price.
6. ***American option:*** An option that can be exercised at any date between the initiation of the contract and maturity date.
7. ***European option:*** An option that can be exercised only on maturity date.
8. ***Option premium:*** The price paid by the purchaser of the option to its writer. Option premium is higher for in the money options and lower for out of the money options. Moreover, option premiums are higher than the prevailing forward premiums in the Interbank markets for contracts of similar maturities.

Self Assessment

Fill in the blanks:

10. …….option is the option whose exercise price is same as the prevailing spot price.
11. …….option is the option whose exercise price is better than the prevailing spot price

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12. ……. option can be exercised at any date between its initiation and maturity.
13. ……option can be realize only at the maturity date.

13.6 Forecasting Foreign Exchange Rates

Forecasting exchange rates is often vital to the successful conduct of international business. Inaccurate foreign exchange forecasts or projections can eliminate entire profits from international transactions or result in enormous cost overruns that could threaten the viability of overseas options. Exchange rates must be forecast for any decision that involves the transfer of funds from one currency to another over a period time.

Example: When companies approach foreign markets to borrow or invest foreign currencies, they must project future exchange rates to compute even roughly heir possible costs and returns. If a British company is borrowing Japanese yen, it will have to forecast the long-term pound yen rate to compute what its repayment liabilities are going to be over the life of the loan and amortisation period.

Similarly, decisions involving both financial and non-financial investments overseas require foreign exchange forecasts to calculate the returns profile, because it depends considerably on the rate at which the foreign currency is going to be acquired for investment and the rate at which earnings will eventually be repatriated. Even when it is simply a question of hedging foreign exchange risks, currency forecast are important. Let us know some more about foreign exchange rate forecasting, discussed in subsequent subsections.

13.6.1 Problems in Forecasting Foreign Exchange Rates

It is generally recognised that there is no perfect foreign exchange forecast, not even a perfect methodology to forecast foreign exchange rates. There is no accurate and precise explanation for the manner in which exchange rates more. Movements of exchange rates depend upon the simultaneous interaction of a variety of factors. How these factors influence each other and how they influence exchange rate movements is impossible to quantify or predict. Exchange rates have been known to react violently to single, unexpected events, which have thrown many forecasts and theories completely off balance for that period.

Participants in foreign exchange markets, especially corporate treasurers, grapple with uncertainty and use a variety of techniques to develop some sense of what exchange rates are going to do in the future.

13.6.2 Fundamental Forecasting

Fundamental forecasting is a technique that attempts to predict future exchange rates by examining the influence of major macroeconomic variables on the foreign exchange markets. The main macroeconomic variables that are used in this analysis are inflation rates, interest rates, the balance of payment situation, economic growth trends, unemployment trends, and industrial and other major economic activities.

A major problem with fundamental forecasting is that the timing of the events that influence exchange rates, and the gap between the occurrence of these events and their impact on exchange rates, is very difficult to measure. The latest data to make precise quantitative estimates of the relevant macroeconomic variables are seldom readily available. Perhaps the greatest weakness of fundamental analysis in forecasting exchange rates is that it takes into account only some of the factors that influence the movement of rates in the foreign exchange markets. There are

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several other non economic, non tangible factors, such as market sentiment, investor fears, speculative intentions, and political events that have an enormous influence on exchange rates and can override, at least in the short run, other fundamental considerations and factors.

13.6.3 Technical Forecasting

Technical forecasting relies on past exchange rate data to develop quantitative models and charts that can be used to predict future exchange rates. Technical analysis tries to see historical patterns in the previous exchange rate movements and attempt to build future patterns on that basis. This approach relies more on personal views and perceptions than on strong economic analysis. There are other technical models that use economic techniques to forecast exchange rates.

Technical models have been found to be of questionable use in practice. Studies conducted over the past few years have shown that technical models have not proved to be accurate predictors of future exchange rate movements; but their widespread adoption by many market participants has given them a unique influence as factors to exchange rate movements. Because a large number of market participants using similar models will tend to behave in a similar manner, moving the exchange rate in the direction indicated by their model is a sort of a self-fulfilling prophesy. Usually, technical models concentrate on the near term and are favoured more by participants who have an interest in short-term trading and speculation in the exchange markets. Many companies, however, use technical models to provide a way of looking at foreign exchange possibilities, and if they are in agreement with the corporate view, they could serve to reinforce that view.

Case Study

G-7 Pressures Japan, China on Exchange Rates

The tensions had been building up for quite some time. And it was high time. Japan's and China's trade surpluses with the US have been skyrocketing with the former in the vicinity of $70-80 billion and the later as much as $150 billion.

Very noticeable in normal times, they have become even more so as the US grapples with the worst employment market it has had in recent years.

US industry and labour have long complained that the Japanese and Chinese currencies are kept artificially weak. Japan's main hope in its worst economic crisis after the last World War is exports. And exports obviously require a cheap currency. Things generally worked well for Japan from the second half of the nineties and at its low the yen fell to 150 a dollar.

But the last year or so has seen a reversal, with the US economy and stock market going through difficult times. The dollar's attraction has waned.

The yen has retraced quite a bit of ground to rise to 120 levels against the greenback, where Japan has been trying to draw a line in the sand to prevent it from rising further.

Its inventions to stop its currency from breaking below 115 are too numerous to be counted. In this, so far, it has had US support.

That may now be changing. The US is unlikely to sit back and watch imports carving out an ever-greater share of its domestic market.

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Its policy-makers are starting to think it is unfair to use the exchange rate to drive exports. Hence, the mounting pressure on Japan and china to allow their currencies to appreciate. This will not only reduce imports, but also make US goods more competitive in international trade, if not a growth driver.

Mr. John Snow, the present US Treasury Secretary, comes from industry. His concerns and perspective are very different from those of his predecessor, Mr. Robert Rubin, an ex-banker who enunciated the strong dollar policy.

Mr. Snow and the Bush Administration are anxious to stem the loss of jobs in US manufacturing with the Presidential election looming up next year.

They are likely to jettison (if they not have already done so) the exchange rate and promote the domestic economy.

Thus, the call in the G-7 Finance Ministers' meet in Dubai over the weekend to allow market forces to determine exchange rates.

The market was not slow to react to the new stance of the world's most powerful economic czars.

The dollar fell across the board: to below 112 yen, around 1.15 against the euro and 1.65 against sterling. The US Treasury yields climbed up as the market saw less demand for US bonds from foreign investors, given the depreciating currency.

China has overtaken Japan as the biggest exporter to the US.

There is equal pressure on the Chinese to allow their currency to appreciate.

It will be hard to resist this, although an immediate switch to a complete float looks unlikely.

Turbulent times are ahead in global currency and bond markets.

Questions

1. What do you understand by Global Currencies and Bond Market?
2. How is the export affected with the fluctuations of currencies?
3. Why were Snow and Bush worried about declining position of dollar and improved position of Yen?

Source: International Marketing, 4th Edition, Excel Books, New Delhi

Self Assessment

Fill in the blanks:

4. …….method of exchange rate forecasting considers the influence of macroeconomic variables to determine rates.
5. ……method of exchange rate forecasting depends heavily on past data on exchange rates.

13.7 International Financial Institutions

After the Second World War there had been recession in the international market. It was the aim of the developed countries to help the developing countries and less developed countries for market access so that they grow economically. Hence, a number of financial institutions have been established from where the developing and the least developed countries can get loan and

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other financial support so that they can grow along with the developed countries. Some of the institutions that have been developed during 1946-47 are as under:

- International Monetary Fund (IMF)
- International Bank for Reconstruction and Development (IBRD) – The World Bank
- International Finance Corporation
- Organisation for Economic Corporation and Development (OECD)

13.7.1 International Monetary Fund

The International Monetary Fund was established on 27 December 1945 as an independent international organisation and began financial operations on 1st March 1947; its relationship with the UN is defined in an agreement of mutual cooperation, which came into force on 15th November 1947. The first amendment to the IMF's articles creating the Special Drawing Right (SDR) took effect on 28th July 1969. The second amendment took effect on 1st April 1978. The third amendment came into force on 11 November 1992; it allows for the suspension of voting and related rights of a member, which persists in its failure to settle its outstanding obligations to the IMF.

Aims: To promote international monetary cooperation, the expansion of international trade and exchange rate stability; to assist in the removal of exchange restrictions and the establishment of a multilateral system of payments; and to alleviate any serious disequilibrium in members' international balance of payments by making the financial resources of the IMF available to them, usually subject to economic policy conditions to ensure the revolving nature of IMF resources.

Activities: Each member of the IMF undertakes a broad obligation to collaborate with the IMF and other members to ensure orderly exchange arrangements and to promote a system of stable exchange rates. In addition, members are subject to certain obligations relating to domestic and external policies that can affect the balance of payments and the exchange rates. The IMF makes its resources available, under proper safeguards, to its members to meet short-term or medium-term payment difficulties.

Did u know? The first allocation of SDRs was made on 1st January 1970 with 5 SDR allocations since then. SDRs totaled SDR 21,400m in March 1998.

To enhance its balance of payments assistance to its members, the IMF established a Compensatory Financing Facility on 27 February 1963; temporary oil facilities in 1974 and 1975; a Trust Fund in 1976; and an Extended Fund Facility (EFF) for medium term assistance to members with special balance of payments problems on 13 September 1974. In March 1986 it established the Structural Adjustment Facility (SAF) to provide assistance to low-income countries. In December 1987 it established the Enhanced Structural Adjustment Facility (ESAF) to provide further assistance to low-income countries facing high levels of indebtedness.

In October 1999 the ESAF was renamed as the Poverty Reduction and Growth Facility (PRGF) to reflect the increased focus on poverty reduction. In August 1988 the Compensatory and Contingency Financing Facility was established, succeeding the Compensatory Financing Facility. The new facility provides broader protection to members pursuing IMF-supported adjustment programmes. Because of the importance of continuing concessional ESAF support, the IMF in 1996 endorsed proposals for a continuation of ESAF operations beyond the year 2000, when current ESAF/PRGF resources are expected to be fully committed. There is to be an interim period of operations from 2001-04 for which new financing would be mobilized. This would be followed in 2005, or earlier, by a self-sustained PRGF.

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Capital Resources: In April 1997 the Interim Committee of the Fund's Board of Governors endorsed the concept of an amendment that would make the promotion of capital account liberalisation one of the Fund's purposes and would give the Fund the appropriate jurisdiction over capital movements. The capital resources of the IMF comprise SDRs and currencies that the members pay under quotas calculated for them when they join the IMF. A member's quota is largely determined by its economic position relative to other members; it is also linked to their drawing rights on the IMF under both regular and special facilities, their voting power, and their share of SDR allocations. Every IMF member is required to subscribe to the IMF an amount equal to its quota. An amount not exceeding 25% of the quota has to be paid in reserve assets, the balance in the member's own currency. The members with the largest quotas are: 1st, the USA; joint 2nd, Germany and Japan; joint 4th, France and the UK.

Borrowing Resources: The IMF is authorised under its Articles of Agreement to supplement its resources by borrowing. In January 1962 a 4 year agreement was concluded with 10 industrial members (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, UK, USA) who undertook to lend the IMF up to US$6,000 m. in their own currencies, if this should be needed to forestall or cope with an impairment of the international monetary system. Switzerland subsequently joined the group. These arrangements, known as the General Arrangements to Borrow (GAB), have been extended several times. In early 1983 agreement was reached to increase the credit arrangements under the GAB to SDR 17,000m, to permit use of GAB resources in transactions with IMF members that are not GAB participants; to authorise Swiss participation; and to permit borrowing arrangements with non-participating members to be associated with the GAB. Saudi Arabia and the IMF have entered into such an arrangement under which the IMF will be able to same purpose and under the same circumstances as in the GAB. The changes became effective by 26th December 1983. In view of the expected continuing high demand for IMF's resources, a doubling of borrowed resources under the GAB to SDR 34,000m was endorsed through the development of New Arrangements to Borrow (NAB) in January 1997, with 25 member countries agreeing to make loans to the IMF when supplementary resources are needed to forestall or cope with an impairment of or threat to the international monetary system.

In order to oversee the compliance of members with their obligations under the Articles of Agreement, the IMF is required to exercise firm surveillance over members' exchange rate policies. In conjunction with the need for up-to-date reliable data to support its surveillance activities, it encourages member countries to make available to the public and to financial markets core financial and economic data. In April 1996 the IMF established the Special Data Dissemination Standard (SDDS) to improve access to reliable economic statistical information for member countries that have, or are seeking, access to international capital markets. In December 1997 it established the General Data Dissemination Standard (GDDS), which applies to all member countries and focuses on improved production and dissemination of core economic data. Information on both is available on the IMF's website.

The IMF works with the IBRD (World Bank) to address the problems of the most heavily indebted poor countries (most in Sub-Saharan Africa) through their Initiative for the Heavily Indebted Poor Countries (HIPCs). It is designed to ensure that HIPCs with a sound track record of economic adjustment receive debt relief sufficient to help them attain a sustainable debt situation over the medium term. The HIPC Initiative was enhanced in late 1999 to provide deeper and more rapid debt relief to a larger number of countries.

Organisation: The highest authority is the Board of Governors, on which each member government is represented. Normally the Governors meet once a year, and may take votes by mail or other means between meetings. The Board of Governors has delegated many of its powers to the 24 executive directors in Washington, who are appointed or elected by individual member countries or groups of countries. Each appointed director has voting power proportionate to the quota of the government he or she represents, while each elected directors

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casts all the votes of the countries represented. The managing director is selected by the executive directors and serves as Chairman of the Executive Board, but may not vote except in case of a tie.

Caution The term of office is for 5 years, but may be extended or terminated at the discretion of the executive directors. The managing director is responsible for the ordinary business of the IMF, under the direction of the executive directors, and supervises a staff of about 2,200. Under a long-standing, informal agreement, the managing director is European (while the President of the World Bank is a US national). There are 3 deputy-managing directors. In December 1998 the IMF had 182 members.

India's Quota and Ranking: India's current quota in the IMF is SDR (Special Drawing Rights) 4,158.20 million in the total quota of SDR 213 billion, giving it a share holding of 1.91 %. However, based on voting share, India (together with its constituency countries viz. Bangladesh, Bhutan and Sri Lanka) is ranked 21st in the list of 24 constituency.

The Fund's goal is "to promote international monetary cooperation, exchange stability...to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment". However, financial crises around the world have increased over the past 15 years, even as the IMF has committed ever-greater resources to combat them. In many cases, the recipients of IMF loans are worse off today (e.g., Argentina) than before the IMF loans began to flow.

The reason is simple. Financial crises are the result of poor policymaking and corruption, not of some inexplicable evil design.

Example: If the IMF were to bail out a country called Neverlearningland from an impending crisis, it would not allow Neverlearningland's leaders to face the consequences of poor policy-making and corruption. Hence, the leaders of Neverlearningland would have no incentive to change the poor way in which they run the country.

At the same time, Neverlearningland's government bonds would be sold in the market at a very high yield—reflecting the high risk of default from poor policy-making. But because the IMF continuously bails out Neverlearningland, regardless of continued corruption and poor policy, buying the bonds would become a unique investment: a high yield bond bearing no risk.

13.7.2 World Bank – International Bank for Reconstruction and Development

Origin: Conceived at the UN Monetary and Financial Conference at Bretton Woods (New Hampshire, USA) in July 1944, the IBRD, frequently called the World Bank, began operations in June 1946, its purpose being to provide funds, policy guidance and technical assistance to facilitate economic development in its poorer member countries. The group comprises 4 other organizations.

Activities: The bank obtains its funds from the following sources: capital paid in by member countries; sales of its own securities; sales of parts of its loans; repayments; and net earnings. A resolution of the Board of Governors of 27 April 1988 provides that the paid in portion of the shares authorised to be subscribed under it will be 3%.

Did u know? The Bank is self-supporting, raising most of its money on the world's financial markets. In the fiscal year ending 30 June 1997 it achieved a net income of US$1, 285 m.;

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medium and long-term borrowing equivalent of US$15,100 m. in 18 currencies; average medium to long-term borrowing costs, after swaps, of 5.01%; financial returns on its investment folio of 5%; a reserves-to-loan ratio of 14%; and decline in its net administrative expenditure in real terms to a figure set at $1,177m.

The bank lends in the region of US$22,000m a year. At 30 June 1997 it had lent a total of US$ 106,000m to member countries. 89% of borrowers took advantage of the new single-currency loans, which became available in June 1996 to provide borrowers with the flexibility to select IBRD loan terms that are consistent with their debt-managing strategy and suited to their debt-servicing capacity. In order to eliminate wasteful overlapping of development assistance and to ensure that the funds available are used to the best possible effect, the Bank has organized consortia or consultative groups of aid-giving nations for many countries. These include Bangladesh, Belarus, Bolivia, Bulgaria, Egypt, Ethiopia, Jordan, Kazakhstan, Kenya, Kyrgyzstan, Macedonia, Malawi, Mauritania, Moldova, Mozambique, Nicaragua, Pakistan, Peru, Romania, Sierra Leone, Tanzania, the {Palestinian} West Bank and Gaza Strip, Zambia, Zimbabwe and the Caribbean Group for Cooperation in Economic Development.

For the purposes of its analytical and operational work, in 1996 the IBRD characterised economies as follows: low-income (average annual per capita GNP of $785 or less); middle-income (between $786 and $9,635); and high income ($9636 or more).

A wide variety of technical assistance is at the core of IBRD's activities. It acts as executing agency for a number of pre-investment surveys financed by the UN Development Programme. Resident missions have been established in 64 developing member countries and there are regional offices for East and West Africa, the Baltic States and South-East Asia, which assist in the preparation and implementation of projects. The Bank maintains a staff college, the Economic Development Institute in Washington, D.C., for senior officials of member countries. In 1997 the institute held training workshops on anti-corruption strategies and public integrity in more than 10 countries as part of IBRD's initiative to combat corruption.

The Strategic Compact: Unanimously approved by the Executive Board in March 1997, the Strategic Compact set out a plan for fundamental reform to make the Bank more effective in delivering its regional programme and in achieving its basic mission of reducing poverty. Decentralizing the Bank's relationships with borrower countries is central to the reforms. The effectiveness of devolved country management and the bank's promotion of good governance and anti-corruption measures to developing countries are likely to be key policies of the new strategy.

Organisation: As of July 1997 the Bank had 180 members, each with voting power in the institution, based on shareholding, which in turn is based on a country's economic growth. The Bank's Board of Executive Directors selects the president. The Articles of Agreement do not specify the nationality of the president but by custom the US Executive Director makes a nomination, and by a long-standing, informal agreement, the president is a US national (while the managing director of the IMF is European). The initial term is 5 years, with a second of 5 years or less.

Other Organisations Related to the World Bank

International Development Associations (IDA)

A lending agency established in 1960 and administered by the IBRD to provide assistance on concessional terms to the poorest developing countries. Its resources consist of subscriptions and general replenishments from its more industrialised and developed members, special contributions, and transfers from the net earnings of IBRD.

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Did u know? In 1997, the IDA lent a total of US$101,600 m. for 2,780 development projects in around 100 countries. The same year, however, saw overall loan commitments for the poorest countries fall by almost a third, to US$4,600m., with commitments 15% down on the lower end of its US$5,300-6,600m planning range for that year. The biggest shortfall has been in lending to Africa.

Officers and staff of the IBRD serve concurrently as officers and staff of the IDA at the World Bank headquarters.

An examination of the record of IMF and World Bank performance in developing countries shows that, far from being the solution to global economic instability and poverty, these two international institutions are a major problem. For one thing, their lending practice deters growth because the money they loan removes incentives for governments to advance economic freedom, and breeds corruption. For these reasons, the vast majority of recipient countries have been unable to develop fully after depending on these institutions for over 40 years.

The International Development Association (IDA) is the branch of the World Bank Group that lends money to the world's poorest countries. India remains poor despite receiving $28.8 billion since 1961. That money did nothing to make India open its economy, which remains "mostly unfree" according to the Index.

Multilateral Investment Guarantee Agency (MIGA)

Established in 1998 to encourage the flow of foreign direct investment to, and among, developing member countries, MIGA is the insurance arm of the World Bank. It provides investors with investment guarantees against non-commercial risk, such as expropriation and war, and gives advice to governments on improving climate for foreign investment. It may insure up to 90% of an investment, with a current limit of US$50m per project. In March 1999 the Council of Governors adopted a resolution for a capital increase for the Agency of approximately US$850m. In addition US$ 150m was transferred to MIGA by the World Bank as operating capital. By 1999 it had 151 member countries and a further 15 countries in the process of fulfilling membership requirements.

Task Find out IMF's and World Bank's major contributions in the development of the Indian economy.

13.7.3 International Finance Corporation

Origin: It was established in July 1956 to help strengthen the private sector in developing countries, through the provision of long-term loans, equity investments, guarantees, standby financing, risk management and quasi equity instruments such as subordinated loans, preferred stock and income notes. It helps to finance new subordinated loans, preferred stock and income notes. It helps to finance new ventures and assist established enterprises to expand, improve or diversify, and provides a variety of advisory services to public and private sector clients.

About 80% of its funds are borrowed from the international financial markets through public bond issues or private placements, 20% from the IBRD.

Activities: IFC fosters sustainable economic growth in developing countries by financing private sector investment, mobilizing capital in the international financial markets, and providing advisory services to businesses and governments.

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IFC helps companies and financial institutions in emerging markets create jobs, generate tax revenues, improve corporate governance and environmental performance, and contribute to their local communities. The goal is to improve lives, especially for the people who most need the benefits of growth.

Strategic compact: IFC emphasizes five strategic priorities for maximizing its sustainable development impact:

- Strengthening its focus on frontier markets, particularly the SME sector;
- Building long-term partnerships with emerging global players in developing countries;
- Addressing climate change, and environment and social sustainability activities;
- Addressing constraints to private sector investment in infrastructure, health, and education; and
- Developing domestic financial markets through institution building and the use of innovative financial products.

For all new investments, IFC articulates the expected impact on sustainable development, and, as the projects mature, IFC assesses the quality of the development benefits realized.

Organisation: IFC coordinates its activities with the other institutions of the World Bank Group but is legally and financially independent. IFC's member countries, through a Board of Governors and a Board of Directors, guide IFC's programs and activities. Each country appoints one governor and one alternate.

IFC corporate powers are vested in the Board of Governors, which delegates most powers to a board of 24 directors. Voting power on issues brought before them is weighted according to the share capital each director represents.

The directors meet regularly at World Bank Group headquarters in Washington, DC, where they review and decide on investment projects and provide overall strategic guidance to IFC management.

Funding: The IFC's equity and quasi-equity investments are funded out of its paid-in capital and retained earnings (which comprise its net worth). Strong shareholder support, triple-A ratings, and a substantial capital base allow the IFC to raise funds on favorable terms in international capital markets. As of June 30, 2006, retained earnings represented almost three-quarters of the IFC's $9.8 billion net worth.

13.7.4 Organisation for Economic Cooperation and Development (OECD)

Origin: Founded in 1961 to replace the Organisation for European Economic Cooperation (OEEC), which was linked to the Marshall Plan and was established in 1948.

Caution The change of title marks the Organisation's altered status and functions, with the accession of Canada and USA as full members, it ceased to be a purely European body, and at the same time added development aid to the list of its priorities.

The aims of the organisation are to promote policies designed to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries, while maintaining financial stability, and thus to contribute to the development of the world economy; to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development and to contribute to the expansion of world trade on a multilateral non discriminatory basis in accordance with international obligations.

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Members: Australia, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea (Republic of), Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, UK and USA.

***Activities*:** The OECD's main fields of programming in 1999 were: economic policy; statistics; energy; development cooperation; sustainable development; public management; international trade; financial fiscal and enterprise affairs; food, agriculture and fisheries; territorial development; environment; science; technology and industry; biotechnology and biodiversity; electronic commerce; initiative to fight corruption; regulatory reform; ageing society; education; employment, labour and social affairs.

Relations with non-member countries: The Centre for Co-operation with Non Members (CCNM) serves as a focal point for policy dialogue between the OECD and countries who are not members of the organisation. The CNNM manages this dialogue through multi country thematic, regional and country programmes. The multi country thematic programmes – the Emerging Market Economy Forum (EMEF), the Transition Economy Programme (TEP) and the Emerging Asia Programme – address specific groups of countries with common problems. Key country programmes for China, Russia, Slovakia and Brazil meet the individual needs of each country. An active regional programme is well established for the Baltic States and there are other programmes under development for South-East Europe and Latin America.

Relations with developing countries: The OECD's Development Assistance Committee (DAC) is the principal body through which the Organisation deals with issues related to cooperation with developing countries and is one of the key forums in which the major bilateral donors work together to increase the effectiveness of their common effort to support sustainable development. Guided by the 'development partnership strategy' (OECD, 1996), the DAC's mission is to foster coordinated, integrated, effective and adequately financed international efforts in support of sustainable economic and social development. In addition, the Development Centre researches social and economic issues in the developing world and the club du Sahel acts as a forum between the countries of West Africa and OECD assistance agencies.

***Relations with other international organizations*:** Under a protocol signed at the same time as the OECD Convention, the European Commission generally takes part in the work of the ORCD. EFTA may also send representatives to attend OECD meetings. Formal relating exists with a number of other international organizations, including the ILO, FAO, IMF, IBRD, UNCTAD, IAEA, and the Council of Europe. A few non-governmental organizations have been granted consultative status enabling them to discuss subjects of common interest and be consulted in a particular field by the relevant ORCD Committee or its officers, notably the Business and Industry Advisory Committee to the OECD (BIAC) and the Trade Union Advisory Committee (TUAC).

Organisations: The governing body of OECD is the Council, on which each member country is represented. It meets from time to time (usually once a year) at the level of government ministers, with the chairmanship at ministerial level being rotated among member governments. The council also meets regularly at official level, when it comprises the Secretary-General (chairman) and the Permanent Representatives to OECD (ambassadors who head resident diplomatic missions). It is responsible for all questions of general policy and may establish subsidiary bodies as required to achieve the aims of the organisation. Decisions and recommendations of the Council are adopted by agreement of all its members.

Task Find out about the current initiatives of OECD. How is it helping the developing nations like Turkey and Greece to match up other European countries?

Self Assessment

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Match the following:

	Set A		Set B
16.	International Monetary Fund	a.	A large portion, around 4/5th, of its funds is raised through public bonds Issue and private placement.
17.	World Bank	b.	Its title has changed and the change of title marks the organisation's altered status and functions.
18.	International Finance Corporation	c.	It created a facility to help nations deal with potential problems due to year 2000 computer disruptions.
19.	Organisation for Economic Cooperation and Development	d.	It categorises the nations as low income, middle income and high income economies.

13.8 Summary

- The foreign exchange market acts as the intermediary through which complex transactions between different currencies are completed. Individuals and institutions, such as multinational corporations, pension funds, commercial banks, central banks, arbitragers, speculators, and foreign exchange brokers all participate in the market to varying degrees, with the large international banks being the most active.
- The three major transactions in the foreign exchange market are the spot, forward and swap transactions. Forward contracts, which are generally used by large international banks and MNCs, can be tailor-made for any contract size or currency, but they require execution of the transaction on the date of contract maturity.
- Futures contracts differ from forward contracts by offering standardised, regulated contracts of smaller sizes, which can be easily liquidated.
- Options are yet another form of currency contract, which, like futures contracts, are standardised and can be easily liquidated.
- Fundamental forecasting examines macroeconomic variables, such as balance of payments, inflation rates, and unemployment trends to predict future exchange rates, while technical forecasting relies on historical exchange rate data to predict future currency exchange rates.
- IMF Each member of the IMF undertakes a broad obligation to collaborate with the IMF and other members to ensure orderly exchange arrangements and to promote a system of stable exchange rates.
- The Fund's goal is "to promote international monetary cooperation, exchange stability to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment."
- World Bank began operations in June 1946, with its purpose being to provide funds, policy guidance and technical assistance to facilitate economic development in its poorer member countries. The Group comprises other organizations like IDA, MIGA and IFC.
- IFC was established to help strengthen the private sector in developing counties, through the provision of long-term loans, equity investments, guarantees, standby financing, risk management and quasi equity instruments such as subordinated loans, preferred stock and income notes.

Notes

- In OECD, The aims of the organisation are to promote policies designed to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy.

13.9 Keywords

Foreign exchange: The system by which one currency is exchanged for another

Forward market: It consists of transactions that require delivery of currency at an agreed upon future date

Future market: Market where the parties to exchange a particular currency on a specific date at a pre determined exchange rate

International Finance Corporation: United Nations agency that invests directly in companies and guarantees loans to private investors

International Monetary Fund: A United Nations agency to promote trade by increasing the exchange stability of the major currencies

Options: They are contracts that give the buyer the right but not the obligation to buy or sell a specified amount of foreign exchange at a set price for an agreed upon period

Organisation for Economic Cooperation and Development: An organization that acts as a meeting ground for 30 countries which believe strongly in the free market system

Special drawing rights: An artificial currency unit based upon several national currencies

Spot market: It is the market where transactions are conducted for the spot delivery of currencies

Triangular arbitrage: The opportunity to buy a currency in one country and sell it off in another as prices of one currency can vary from one market to the other

World Bank: An organization whose focus is on foreign exchange reserves and the balance of trade

13.10 Review Questions

1. Describe the basics of foreign exchange market and it operation.
2. Explain the concept of triangular arbitrage.
3. Contrast future and forward markets.
4. What do you mean by currency options? List various types of options.
5. Discuss fundamental and technical methods of exchange rate forecasting. What are the problems in forecasting exchange rates?
6. Why was IMF established? Mention the current activities of the IMF.
7. Discuss the reason for establishment of World Bank. How does it operate?
8. Discuss the major areas of work of the organisations under the World Bank.
9. State the main aim of establishing the International Finance Corporation. What are its priorities?
10. Differentiate between fundamental and technical forecasting.
11. Why there was a need to replace Organisation for European Economic Cooperation?
12. Explain OECD relation with other major international organisations.

Notes

Answers: Self Assessment

1.	False	2.	True
3.	False	4.	False
5.	True	6.	Triangular Arbitrage
7.	Very short	8.	Futures
9.	Liquidate Position	10.	At the money
11.	In the money	12.	American
13.	European	14.	Fundamental
15.	Technical	16.	(c)
17.	(d)	18.	(a)
19.	(b)		

13.11 Further Readings

Books

Apte P. G., *International Financial Management*, 4th Edition, Tata McGraw-Hill Publishing Company Limited

Cherenilan, F, *International Economics,* 4th, Edition, Tata McGraw-Hill Publishing Company Limited

Levi, M D., *International Finance*, 3rd Edition, Mc Graw-Hill, Inc

Hill, C. W. L., *International Business*, 4th Edition, Tata McGraw-Hill Publishing Company Limited

Online links

http://rbidocs.rbi.org.in/rdocs/publicationreport/pdfs/77577.pdf

http://www.tutorsonnet.com/homework_help/foreign_exchange_management/forex_market_mechanisms_conventions_ assignment_help_online_tutoring.htm

http://www.imf.org/external/country/ind/index.htm

http://www.oecd.org/pages/0,3417,en_36734052_36734103_1_1_1_1_1,00.html

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Unit 14: E-Business vis-à-vis International Business

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Objectives

After studying this unit, you should be able to:

- Define E-business and E-commerce
- Realise the importance of online databases
- Know how Emails and online press releases are managed
- Discuss website promotion strategies
- Contrast E-business and international business

Introduction

"A consumer visits a bookstore and inquires about the availability of an out-of-stock book. A bookstore employee downloads a digital copy of the book and prints it along with cover. Not an e-commerce retail transaction since agreement to purchase did not occur over an electronic network. However, the right to access the digital archived copy is an e-commerce service transaction."

E-commerce is a selling and transfer process requiring several institutes. It is systematic and organised network for the exchange of goods between produces and consumers. The Net aims to establish the interconnections between producers and consumers directly and in this, the Internet embraces all those related activities which are indispensable for maintaining a continuous, free and uninterrupted distribution and transfer of goods. The Website or portals may be categorised into commercial and non-commercial.

Any web site or portal that offers products and/or services for sale is a commercial web site. There are thousands of commercial web sites on the Internet. Some of them have been successful, and some weren't so lucky. What elements make up a good commercial web site? Of course, web

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pages should look attractive to a customer. However, even the most attractive web pages will not make a person come back to a web site where it takes too long to find the right product or where order forms don't work.

14.1 Concept of E-Business and E-Commerce

E-business covers not only the online transactions, but also extends to all Internet-based interactions with business partners, suppliers and customers such as: selling direct to consumers, manufacturers and suppliers; monitoring and exchanging information; auctioning surplus inventory; and collaborative product design. These online interactions are aimed at improving or transforming business processes and efficiency.

E-commerce is a general concept covering any form of business transaction or information exchange executed using Information and Communication Technologies (ICT's). E-commerce takes place between companies, between companies and their customers, or between companies and public administration. E-commerce includes electronic trading of both goods and services.

"E-commerce denotes the use of electronic transmission media (telecommunication) to engage in the exchange of products and services requiring transportation either physically or digitally, from location to location". M. Greenstein and T. M. Feinman.

"E-commerce describes the process of buying and selling (or exchanging) of products, services and information via computer networks including the internet". E. Turban.

E-commerce is the means to complete online transaction and integrate the supply chain into the transaction management process such as receiving orders, making payments and tracking down the deliveries or order.

"E-commerce can be defined as the technology-mediated exchanges between parties (individuals, organisations, or both) as well as the electronic based intra or inter organisational activities that facilitate such exchanges". J. F. Rayport and B. I. Jaworsk.

According to World Trade Organization (WTO)- E-commerce as a commercial process includes production, distribution, marketing, sale or delivery of goods and services electronically.

Examples of e-commerce transactions are:

- An individual purchases a book on the Internet.
- A government employee reserves a hotel room over the Internet.
- A business calls a toll free number and orders a computer using the seller's interactive telephone system.
- A business buys office supplies on-line or through an electronic auction.
- A retailer orders merchandise using an EDI network or a supplier's extranet.
- A manufacturing plant orders electronic components from another plant within the company using the company's intranet.
- An individual withdraws funds from an automatic teller machine (ATM).

E-commerce is used everywhere in everyday life. It ranges from credit/debit card authorization, travel reservation over a phone/network, wire fund transfers across the globe, Point of Sale (POS) transactions in retailing, electronic banking, electronic insurance, fund raising, political Campaigning, on-line education and training, on-line auction, on-line lottery and so on.

Notes

Caution Many people use the term e-commerce and e-business interchangeably, which is factually wrong.

Benefits of E-Business

Potential e-business benefits include:

- Improved accuracy, quality and time required for updating and delivering information on products and/or services.
- Access for customers to catalogues and prices - 24 hours x 7 days.
- Improved ease, speed and immediacy of customer ordering.
- Enhanced market, industry or competitor intelligence acquired through information gathering and research activities.
- New distribution channels via the electronic delivery of some products and services, for example, product design collaboration, publications, software, translation services, banking, etc.
- Expansion of customer base and growth in export opportunities.
- Reduces routine administrative tasks (invoices and order records) freeing staff to focus on more strategic activities.

Caselet

Amazon.com's Amazing Success

In 1995, Amazon.com sold its first book, which shipped from Jeff Bezos' garage in Seattle. In 2006, Amazon.com sells a lot more than books and has sites serving seven countries, with 21 fulfilment centers around the globe totaling more than 9 million square feet of warehouse space.

The story is an e-commerce dream, and Jeff Bezos was Time magazine's Person of the Year in 1999. The innovation and business savvy that sustains Amazon.com is legendary and, at times, controversial: The company owns dozens of patents on e-commerce processes that some argue should remain in the public domain.

Amazon.com's growth illustrates the importance of cracking the distribution problem for Internet retailers. By building regional distribution centers all over the U.S., Amazon can promise free or low-cost next day delivery, making eCommerce convenient and practically instant. Let's not ignore the larger implication of eBusiness though— in order to stock those distribution centers, they need a likely product inventory, cross-referenced with online and seasonal buying behavior. They also need to coordinate their marketing to reinforce that inventory.

Source: www.howstuffworks.com

Notes

Self Assessment

Fill in the blanks:

1. ..... includes electronic trading of both goods and services.
2. E-commerce can be defined as the exchanges between parties that are fuelled by .....
3. E-business can be accessed by a customer .....
4. E-commerce is the means to integrate the .....into the transaction management process such as receiving orders, making payments and tracking down the deliveries or order.

14.2 Power of On-line Databases

Before the advent of the Internet, you would have expected to pay a few hundred to several thousand dollars for marketing research information, contacts, trade directories and leads in printed and CD-ROM format.

Did u know? Today, the Net has enabled information companies to provide you with the same information on-line for prices starting at under $8 dollars a month for on-line access to a range of databases carrying a wealth of marketing information.

On-line databases are a blessing for the international marketer. Through them you can quickly analyze markets, compile lists of potential foreign contacts and evaluate these contacts all within a few hours from the comfort of your PC.

The variety of information kept by these databases is vast, ranging from financial and credit information to lists of buyers, sellers and manufacturers. Other databases keep data on import-export trade flows and other trade data. Others archive industry news clippings from around the world. There is a database for almost any need you have. Some of the better databases include:

PIERS (Port Import Export Reporting Service at www.agte.telebase.com): This is a vast on-line database of official U.S. Customs information, containing detailed information about all U.S. waterborne imports and exports. It enables you to track your competitors' shipments, know how much business they are doing, identify suppliers and buyers, know who the big buyers or sellers are, and identify new potential buyers or sellers to start business with.

The Asian Sources directory: This has a very large catalog of products and profiles from Asian suppliers. At Asian Sources, you will not only be able to get a short profile on thousands of exporters of a wide variety of products in Asia, but you will also be able to see these products in full color and get a price quote on them on-line or confidentially by Email.

The U.S. Department of Commerce STAT-USA service: This collects business, trade and economic information from 40 government agencies. It is a great source for trade leads and country, industry, economic and market intelligence and reports. (Discounted access to STAT-USA is available at www.access-trade.com).

Dun & Bradstreet, Dow Jones, Hoppenstedt, Kompass, Teikoku and the like: These services can give you detailed financial, historical and credit information and evaluations on companies worldwide. The cost for this information ranges between $5 and $230 per report, depending on the level of detail required and the location of the company being researched on. Generally, reports on companies in the USA cost the lowest because of the lower cost and difficulty of obtaining corporate data there. All of these services can be accessed centrally from the Global Business Intellibase (www.agte.telebase.com).

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Self Assessment

Match the following sets:

	Set A		Set B
5.	Port Import Export Reporting Service	a.	This collects business, trade and economic information from 40 government agencies.
6.	Asian Sources directory	b.	This has a very large catalog of products and profiles from Asian suppliers.
7.	U.S. Department of Commerce STAT-USA service	c.	This is a vast on-line database of official U.S. Customs information, containing detailed information about all U.S. waterborne imports and exports.
8.	Dun and Bradstreet	d.	These services can give you detailed financial, historical and credit information and evaluations on companies worldwide.

14.3 Optimising and Managing Email

Email is fast, cheap and direct. It can be a powerful communication and marketing tool if used wisely. Email is quickly becoming the most common communication tool for businesses. That means that you have to start making sure that your Email represents your company as appropriately as your letterhead or other company stationary does. For your Email to look the same on any Email program, monitor and computer used by the recipient, it's best to type Email in 10 point Courier using 60-character or less line lengths followed by hard returns (a hard return is when you press the 'enter' key to make a new line appear). One way to gauge a 60-character line length is by typing 60 hyphens (-) as the first line on your Email. After typing your Email, delete the hyphens. Soon you'll develop a sense for typing 60 characters.

Caution Just like conventional letters, professional Email should have a header that acts as your letterhead, and a footer that acts as a signature. The headers and footers should carry relevant automatic information, such as your title, contact, slogan and Web address. Most Email programs allow you to specify a header and footer to use and then insert those automatically into every new Email you write. Headers and footers should be no longer than 2 to 5 lines each.

Every Email should have a descriptive and captivating subject line. The subject line, being the first line that most people read, should drive the reader into wanting to read the rest of the message. The first 8 lines of the message body should quickly give the reader a good idea of what the message is all about so that an interest in reading the rest of the Email is created. Just like conventional letters, Email form letters can be created to automatically mail merge and mass-Email any number of customisable fields and recipients.

To best manage incoming Email, use an Email software package that allows you to filter, sort, block, auto-respond to an auto-delete various types and sources of Email. A good program that does this is Microsoft's Outlook 2007. You can also set up an auto responder that automatically sends out standard replies to frequently asked questions, saving you time and paper. You can

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even set up a system that allows your customers to query your product database by Email. There are many ways to use this versatile and powerful communication tool that is used by just about every business. In the history of humankind, no other means of communication has become so popular in such a short period of time. Email definitely has great implications to your on-line marketing and business success.

Task Identify the websites that offer free Email services. Compare and contrast their services. If you were a manager of a start-up E-business firm, which one would you use?

Self Assessment

State whether the following statements are true or false:

9. Email is fast but it is quite expensive.
10. The pattern of conventional business letters and Emails is different.
11. An E-business firm can even set up a system that allows your customers to query your product database by Email.

14.4 On-line Press Releases

Writing and sending press releases is yet another part of promotion that has been positively affected by the Internet. As you know, sending and having a press release accepted for publication can have very positive and effective results on sales. If you have a new, innovative or otherwise interesting product, service or event, you can write a press release and send it off to editors and journalists in your industry. Generally speaking, any news event about a product, service or event that has an immediate effect on a large number of a publications readers will get published free of charge.

In the past, you would have had to write your release and send it off by fax or postal mail to thousands or hundreds of journalists in the hope that a few of them will publish your release. That was costly, tedious and prevented many companies from using this powerful marketing tool.

Example: With the Web, you can now go to a press release posting service such as the Internet News Bureau (www.newsbureau.com) and select categories of journalists, publications and other media contacts that you wish to target.

You then enter your press release just once, and immediately have it transmitted via Email to thousands or hundreds of journalists worldwide at a relatively small cost. Alternatively, you can build your own media list by gathering the Email addresses of journalists and editors in publications in your industry. It is now easier to do so because many publications now have on-line versions or a Web site at the least.

Composing a press release is best left to a professional who not only knows how to write well, but also knows what editors are looking for in a release that will be published. Generally, a press release with a high chance of being published must carry information that will have an immediate impact on a broad section of a publication's readership. The headline has to be attention getting and relevant, and the body has to be simple and to the point. It has to be orderly and factual, yet interesting. A press release that has the "we are the best exporters" kind

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of language will get nowhere. It has to be short, about 200 words or so. If editors need more information, they will contact you. Finally, it has to be formatted in the standard press release format. Written and targeted well, press releases are invaluable and extremely effective.

Self Assessment

Fill in the blanks:

12. The ..... of a press release has to be attention getting and relevant, and the body has to be simple and to the point.
13. Any news event about a product, service or event that has an immediate effect on a large number of a publications reader will get published .....

14.5 Web Site Promotion Strategies

Having a Web site is not enough. You have to make sure that people end up coming to your Web site # that is the whole point of it!

Did u know? There are over 36,68,48,493 websites and that number is growing rapidly.

To make yours stand out in that crowd is something you have to work on. Most people find Web sites by going to their favorite search engine or directory, doing a keyword or key-phrase search, and going to the pages returned in the search results. Often, these results can contain tens or hundreds of thousands of pages that match the words searched for. Again, most people go through the first 10 or 20 results and never bother with the results returned after that. To be found by your target market, you have to make sure that the search engines and directories place you in the first 10 or 20 search results, otherwise you will have nobody coming to your Web site. It is as simple as that. Consider that in a given day, a certain keyword is searched for thousands or hundreds of thousands of times in any search engine or directory. If you appear in the top 10 search results, you will have thousands or hundreds of thousands of hits to your page per day. If not, you will have a few dozen hits a day.

There are many resources and tools on the Internet that show you exactly how you can appear in the top 10 results in a given keyword search. One of the best tools to do this is the Web Position Analyzer (www.webposition.com). Getting a top 10 position and maintaining it can sometimes be a lengthy process and you might want to let a positioning service (e.g. Did-it.com at www.did-it.com) do this for you. Simply put, all you need to do is to make a list of words and phrases that people are most likely to use when looking for whatever it is you provide, then make Web pages that rank highly on each of these words or phrases when scored using a particular search engines algorithm. Each search engine has a different algorithm that it uses to score Web pages on keyword relevance. Almost all engines use all or most of the following in calculating relevance: Web page filename, character and word counts, link popularity, Meta keywords tag, Meta description tag, image alt tags, headings, comment tags, keyword frequency and proximity, and keyword weight. There are hundreds of search engines and directories that you can submit your Web site to. Use a submitting service such as Submit-it (www.submit.com) or Exploit (www.exploit.com) to quickly get listed in all of them.

Example: The engines and directories that you need to pay special attention to and get ranked highly on are Google, Yahoo!, Alta Vista, Hot Bot, Lycos, Info Seek, Web Crawler and Excite.

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These seven will contribute to over 90% of all your traffic. Once you attain a top position, you have to consistently monitor it and maintain it, making sure that new Web pages do not score higher than yours do. Again, tools such as the Web Position Analyzer help you in this maintenance.

Search engines are the Web's most popular way of finding resources. By positioning your Web site well with them, you are virtually guaranteed a heavy stream of traffic. In fact, search engine positioning is the single most important element of on-line promotion. Best of all, it costs nothing (or almost nothing) unlike advertising, and brings you a lot more traffic.

Task Name the top ten search engines in the world.

Self Assessment

State whether the following statements are true or false:

14. A company has to make sure that people end up coming to its website.
15. Companies are virtually guaranteed a heavy stream of traffic if they position their website well with the search engines.

14.6 E-Business vs. International Business

Compared with traditional business, online business is just a selling mode, which cannot change traditional international business completely or ruin or replace traditional international business.

Compared with international business, online business cannot separate from logistic services as all the products must be delivered to the customers. Sometimes, the delivery cost and product cost total is still lower than those products sold at real stores.

For online business, brand, fame, reputation and credit are all very important for the seller to lure more customers to visit the shopping website.

The logistics of e-business typically have lesser constraints than international business. E-businesses are not limited to venue; they can be located anywhere and still serve the same customer.

E-businesses significantly emphasize technology and hire more people from the web design and development fields. In some cases, every employee may be required to have a technical background or receive in-house training for basic web development. On the other hand, international businesses are more diverse in hiring for nontechnical positions, such as sales representatives and display managers.

In marketing for international business, marketers can focus on all five human senses to influence the sale.

Example: Maintaining a proper display keeps the product aesthetically appealing. Consumers can also physically touch the product in an international store; this is particularly vital for physically sensitive items such as clothes.

E-businesses typically have to rely mainly on sight. The physical display is replaced with digital images. The inability to touch and test the product firsthand is replaced with technical text to visualize the details of the product; online retailers may also have the ability to present many more choices because they do not need to have the physical product on hand.

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The major financial difference between e-business and international business is cost. E-businesses usually have lesser startup and operational costs — buying an online domain is much cheaper than renting land and building facilities and buying equipment.

E-business management is typically flatter than international management. A flat company happens when there are few levels in between top management and the entry-level employee. In most e-businesses, low level management, such as store managers and division managers, is unnecessary. Instead, e-businesses expand horizontally by hiring external consultants and contract web development positions. These entities specialize in a business service, such as e-commerce setup and online marketing. They may work for the company but are not necessarily included in or affected by management decisions.

Case Study

Maintaining Your On-line Marketing Edge

Once you have applied all the marketing and lead generation techniques we have covered, you will achieve success. The Net virtually guarantees success if you do follow its rules. But because of its dynamic nature, you have actively maintained your marketing edge or somebody else will sooner or later come and take your place. Other than continuing with the activities that got you your success in the first place, you must provide a reason for your clients to keep coming back to you. Here are a few ideas on what you can do to keep your clients. Of course, not all of these suggestions will work for you, depending on your line of business.

Offer free information related to your line of expertise. By doing so, you will make your Web site a source of reference and build trust with your users. If the free information keeps getting updated periodically, people will keep coming back to your site. Those return visits generate goodwill and eventual sales.

Hold contests that are relevant to your business.

Have a sale with a time limit and publicize it.

Conduct surveys to find out what your clients really want. Reward them for answering the survey questions (e.g. give them a discount or an information article or something that does not cost you much).

Add your Web site address to all your stationary, packaging and the like.

Create something unique on your Web site. Think of something that is missing in your industry and create it.

Publish a weekly or monthly Email newsletter and invite your Web users to subscribe free. Most people will willingly subscribe to a newsletter that promises to keep them up to date on a Web site, industry or even pricing of things they are interested in.

Offer free initial consultations or something else free that will not cost you much but will build goodwill and future sales.

Consider buying banner advertising on other Web sites that serve your target market or in the search engines and directories.

Encourage webmasters of sites serving your target market to link to your site or, even better, put a banner linking to your site. In return, you would do the same for them.

Contd...

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If you do the right things, the Internet will be very kind to you. It can virtually guarantee that you will be successful. It truly does offer the international marketer an unprecedented opportunity to open new markets, find new import-export trading partners, gather competitive intelligence, and make and save a whole lot of money.

Question

Do you agree with the view of the writer? Why or why not?

Source: http://www.access-trade.com

Self Assessment

Fill in the blanks:

16. The logistics of e-business typically have ..... constraints than international business.
17. The major financial difference between e-business and international business is .....

14.7 Summary

- E-business not only includes e-commerce but also covers internal processes such as production, inventory management, product development, risk management, finance, knowledge management and human resources.
- E-business strategy is more complex, more focused on internal processes, and aimed at cost savings and improvements in efficiency, productivity and cost savings.
- Everybody knows that the Internet offers the international marketer an unprecedented opportunity to open new markets, find new import-export trading partners, gather competitive intelligence, and make and save a whole lot of money in the process.
- To start with, you must get your own Web site. The Web site is the building block of the Web. It is why people go on-line in the first place. Search engines, databases, directories, newsgroups and archives all enable you to find products, services, suppliers and buyers on-line.
- Today, the Net has enabled information companies to provide you with the same information on-line for prices starting at under $8 dollars a month for on-line access to a range of databases carrying a wealth of marketing information.
- The internet virtually guarantees success if you do follow its rules. But because of its dynamic nature, you have actively maintained your marketing edge or somebody else will sooner or later come and take your place.
- Compared with international business, online business is just a selling mode, which cannot change traditional business completely or ruin or replace traditional business.
- Compared with international business, online business cannot separate from logistic services as all the products must be delivered to the customers.

14.8 Keywords

E-Business: It relates to any commercial activity that is conducted in an electronic format. This includes commercial transactions conducted via the Internet, telephone and fax, electronic banking and payment systems, electronic purchasing and restocking, etc.

E-commerce: It refers to online transactions - buying and selling of goods and/or services over the Internet.

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Internet: It is a worldwide means of exchanging information and communicating through a series of interconnected computers.

Logistics: The management of business operations, such as the acquisition, storage, transportation and delivery of goods along the supply chain.

Online Database: It is a database accessible from a network, including from the Internet.

Search engine: A program for the retrieval of data, files, or documents from a database or network, esp. the Internet.

Website: a connected group of pages on the World Wide Web regarded as a single entity, usually maintained by one person or organization and devoted to a single topic or several closely related topics.

Web Browser: It provides the Internet visitors a necessary application programme to view and interact with different websites.

14.9 Review Questions

1. Compare and contrast E-business and E-commerce.
2. State the benefits of E-business over traditional international business.
3. How has the world of business changed since the advent of Internet? Use examples to support your answer.
4. As a manager of an online business company, how can you utilise online databases?
5. "Email is fast, cheap and direct." Discuss.
6. Every Email should have a descriptive and captivating subject line. What is its importance in relation to international business?
7. You are the marketing manager of new online retailing company. To promote your business and products, you need to launch a web promotion campaign and come out with online press releases. What strategy will you adopt for the above mentioned activities?
8. "Having a Web site is not enough." Substantiate.
9. How can search engines help in E-business?
10. Contrast E-business and international business.

Answers: Self Assessment

1.	E-commerce	2.	Technology
3.	24 x 7	4.	Supply chain
5.	(c)	6.	(b)
7.	(a)	8.	(d)
9.	False	10.	False
11.	True	12.	Headline
13.	Free of charge	14.	True
15.	True	16.	Less
17.	Cost		

14.10 Further Readings

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Books

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Cateora and Graham (2007), *International Marketing*, McGraw Hill

Terpstra and Sarathi, R, *International Marketing*, Chicago: Dryden Press

Mittal, V (2010) *Business Environment: Text and Cases*, 2nd Edition, New Delhi: Excel Books

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http://www.buzzle.com/articles/advantages-and-disadvantages-of-e-business.html

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http://www.sltda.gov.lk/e_business