INTERNATIONAL TRADE

- **The broad topics covered in this chapters are:**

1. **THEORIES OF INTERNATIONAL TRADE**
2. **INSTRUMENTS OF TRADE POLICY**
3. **TRADE NEGOTIATIONS**
4. **EXCHANGE RATE AND ITS EFFECTS**
5. **INTERNATIONAL CAPITAL MOVEMENTS**

INTERNATIONAL TRADE – DEFINATION/INTRODUCTION

International trade is the exchange of goods and services as well as resources between countries. It involves transaction between residents of different countries. It involves:-

- **Multiple currencies**
- **Greater complexity**
- **Differences in legal systems**
- **Diverse restrictions**
  - Taxes
  - Regulations
  - Duties
  - Tariffs
  - Quotas
  - Trade barriers
    - Standards

ADVANTAGES OF INTERNATIONAL TRADE:-

1. Efficiency through cut throat competition. Access to new markets and new materials.
2. Foreign exchange reserves.
3. Development of technologies.
4. Creates job opportunities
5. It attracts Foreign Direct Investment (FDI)
6. It expands the market region
7. Human resource development
8. World Peace

DISADVANTAGES OF INTERNATIONAL TRADE:-

1. Depress demand for unskilled workers
2. Excessive stress on exports
3. Change in patterns of demand
4. Risky dependence
5. shortage of many commodities
6. high inflation
7. Imports of harmful products
8. Distort actual investments.
9. Lack of transparency

THEORIES OF INTERNATIONAL TRADE

- **The Mercantilists view of international trade**
- **The theory of absolute advantage**
- **The theory of comparative advantage**

Opportunity cost:

The cost of a commodity is the amount of a second commodity that must be given up to release just enough resources to produce one extra unit of the first commodity.

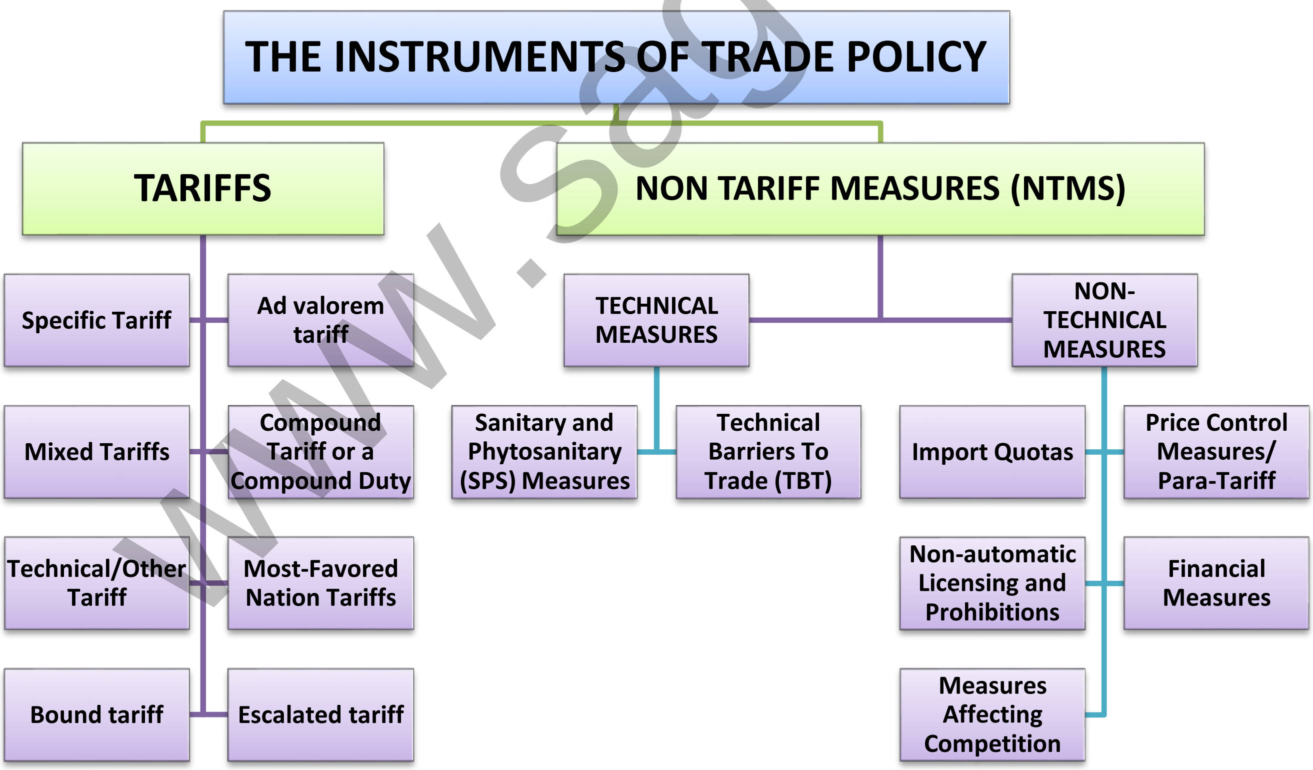
The nation with a lower opportunity cost in the production of a commodity has a comparative advantage in that commodity (and a comparative disadvantage in the second commodity)

FACTOR PRICE EQUALIZATION:

- International trade tends to equalize the factor prices between the trading nations
- Equalizes the absolute and relative returns to homogenous factors of production and their prices
- If the prices of the output of goods are equalized between countries engaged in free trade, then the price of the input factors will also be equalized between countries.

ASSUMPTION OF FACTOR PRICE EQUALIZATION

1. Demand pattern for commodities are same.
2. The level of technological progress is same in the different countries.
3. Only 2 factor of production. Labour and Capital
4. There is no restriction on trade.
5. No transport costs.
6. There is perfect competition in the market.



EFFECTS OF TARIFF

1. Tariff barriers create **obstacles to trade**,
2. **Decrease the volume** of imports and exports and therefore of international trade.
3. **Tariffs discourage domestic consumers from consuming imported foreign goods.**
4. **Increases producer surplus in the industry.**
5. Tariffs discourage efficient production in the rest of the world and encourage inefficient production in the home country.
6. Tariffs increase government revenues of the importing country by the value of the total tariff it charges.

International Trade

Trade Negotiations

RTAs | **GATT** | **WTO**

TAXONOMY OF REGIONAL TRADE AGREEMENTS (RTAS)

- UNILATERAL TRADE AGREEMENT
- REGIONAL PREFERENTIAL TRADE AGREEMENT
- BILATERAL TRADE AGREEMENT
- FREE TRADE AGREEMENT
- CUSTOM UNION
- COMMON MARKET

THE GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT)

- From 1948 To 1994
- Provided the rules for much of world trade for 47 years
- Multilateral Instrument
- Handle the trade side of international economic cooperation
- Eight rounds of multilateral negotiations known as "trade rounds" held under the auspices GATT

The GATT lost its relevance by 1980s because:

- It was obsolete to the fast evolving contemporary complex world trade scenario characterized by emerging globalization
- International investments had expanded substantially
- Intellectual property rights and trade in services were not covered by GATT
- World merchandise trade increased by leaps and bounds and was beyond its scope
- The ambiguities in the multilateral system could be heavily exploited
- Efforts at liberalizing agricultural trade were not successful

THE WORLD TRADE ORGANIZATION (WTO)

FUNCTIONS OF WTO

1. Trade without discrimination/ Most-favored-nation (MFN)
2. The National Treatment Principle (NTP)
3. Freer trade
4. Predictability
5. Principle of general prohibition of quantitative restrictions
6. Greater competitiveness
7. Tariffs as legitimate measures for the protection of domestic industries
8. Transparency in Decision Making
9. Progressive Liberalization
10. Market Access
11. Special privileges to less developed countries
12. Protection of Health & Environment
13. A transparent, effective and verifiable dispute settlement mechanism

Overview of the WTO agreements

The WTO agreements cover:-

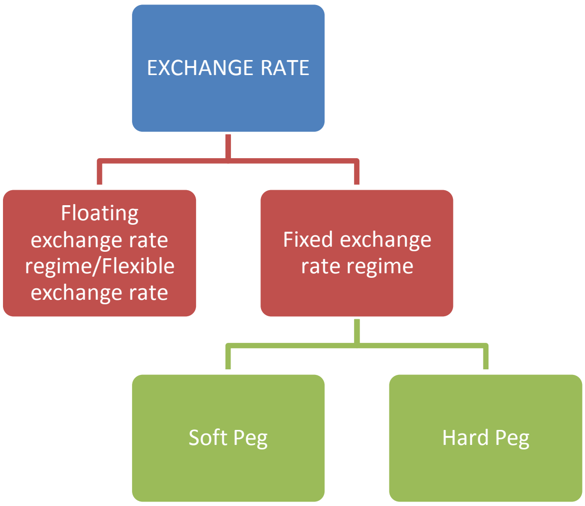
- Goods, services
- Intellectual property
- The WTO agreements are voluminous and multifaceted
- The 'Legal Texts' consist of a list of about 60 agreements
- Disciplines and improving agricultural trade
- It includes specific and binding

Technical Barriers to Trade (TBT)

- Prevent standards and conformity assessment systems from becoming unnecessary trade barriers
- Transparency and harmonization with international standards
- Safety/environment regulations act as trade barriers.

THE WTO: A FEW CONCERNS

- The progress of multilateral negotiations on trade liberalization is very slow
- Contemporary trade barriers are much more complex and difficult to negotiate in a multilateral forum
- Uncertainties and murkiness in the global trade system.
- The achievement in liberalizing trade in many sectors has been negligible.
- The latest negotiations, such as the Doha Development Round, have run into problems
- Expanding global trade has not materialized.
- The real expansion of trade in the three key areas of agriculture, textiles and services has been dismal.
- Protectionism and lack of willingness among developed countries to provide market access
- High tariffs on selected products
- Tariff escalation'
- Narrowing of differences between the normal and preferential rates.



ADVANTAGES OF A FIXED RATE

- A fixed exchange rate avoids currency fluctuations and eliminates exchange rate risks
- It can impede international flow of trade and investments
- It enhances international trade and investment.
- A fixed exchange rate system imposes discipline on a country's monetary authority
- Generate lower levels of inflation.
- The government can encourage greater trade and investment as stability encourages investment.
- Exchange rate peg can also enhance the credibility of the country's monetary policy

DISADVANTAGES OF A FIXED RATE

- The central bank is required to stand ready to intervene in the foreign exchange market.
- Maintain an adequate amount of foreign exchange reserves for this purpose.

REAL EXCHANGE RATE

$$\textit{Real exchange rate} = \textit{Nominal exchange rate} \times \frac{\textit{Domestic Price Index}}{\textit{Foreign price Index}}$$

REAL EFFECTIVE EXCHANGE RATE (REER)

An increase in REER implies that exports become more expensive and imports become cheaper; therefore, an increase in REER indicates a loss in trade competitiveness.

ADVANTAGES OF A FLOATING RATE

- Allows Central bank and /or government to pursue its own independent monetary policy
- Allows exchange rate to be used as a policy tool
- As there is no obligation or necessity to intervene in the currency markets, the central bank is not required to maintain a huge foreign exchange reserves.

DISDVANTAGES OF A FLOATING RATE

- Generate a lot of uncertainties in relation to international transactions
- Add a risk premium to the costs of goods and assets traded across borders
- Lacks flexibility
- But less stability

FOREIGN EXCHANGE MARKET

- Uses one currency to purchase another currency.
- Operates Worldwide
- largest market in the world in terms of cash value traded
- It is an electronically linked network of big banks
- no central trading location
- no set hours of trading
- The foreign exchange markets operate on very narrow spreads between buying and selling prices
- The major participants in the exchange market are central banks, commercial banks, governments

TYPES OF TRANSACTIONS IN THE FOREX MARKET

- **CURRENT TRANSACTIONS** which are carried out in the spot market and the exchange involves immediate delivery
- **CONTRACTS** to buy or sell currencies for future delivery which are carried out in forward and/or futures markets

DETERMINATION OF NOMINAL EXCHANGE RATE

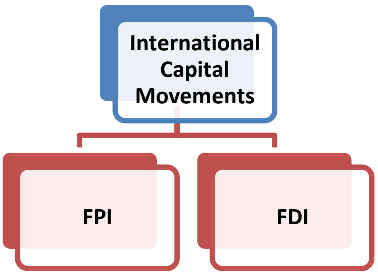
- Purchase goods and services from another country
- For unilateral transfers such as gifts, awards, grants, donations or endowments
- To make investment income payments abroad
- To purchase financial assets, stocks or bonds abroad
- To open a foreign bank account
- To acquire direct ownership of real capital, and
- For speculation and hedging activities related to risk-taking or risk-avoidance activity

CHANGES IN EXCHANGE RATES

- **CURRENCY APPRECIATION**
- **CURRENCY DEPRECIATION**

EFFECTS OF CURRENCY DEPRECIATION

- Windfall gains for export oriented sectors
- Remittances to homeland
- Enhance government revenues from import related taxes
- Higher amount of local currency for a given amount of foreign currency borrowings of government.
- Positive impact on controlling spiraling gold imports.



FOREIGN PORTFOLIO INVESTMENT (FPI)

A **portfolio investment** is a grouping of assets such as stocks, bonds, and cash equivalents, in economics, **foreign portfolio investment** is the entry of funds into a country where foreigners deposit money in a country's bank or make purchases in the country's stock and bond markets, sometimes for speculation.

COMPONENTS OF FOREIGN PORTFOLIO INVESTMENT

- FPI is not concerned with either manufacture of goods or with provision of services.
- Exercising voting power or controlling or managing not in the picture.
- Remunerative return is the main motive.

FOREIGN DIRECT INVESTMENT (FDI)

COMPONENTS

- The acquisition of at least ten percent of the shares of a business by nonresident investors makes it eligible to be categorized as foreign direct investment (FDI).
- FDI has three components:
  - *Equity Capital*
  - *Reinvested Earnings*
  - *Other direct capital in the form of intra-company*
- FDI may be individuals, incorporated or unincorporated private or public enterprises, Trust.
- the opening of overseas companies
- establishment of subsidiaries or branches
- creation of joint ventures on a contract basis
- Direct investments are real investments

REASONS FOR FOREIGN DIRECT INVESTMENT

- The increasing interdependence of national economies
- Internationalization of production
- Desire to reap economies of large-scale operation arising from technological growth
- Necessity to retain direct control of production knowledge or managerial skill
- Avoid future competition and the possible loss of export markets
- Risk diversification
- Optimal utilization of physical, human, financial and other resources
- Desire to capture large markets
- Lower environmental standards
- Stable political environment
- To obtain control of strategic raw material or resource
- Desire to secure access to minerals or raw material deposits (E g. FDI in petroleum)

FACTORS IN THE HOST COUNTRY THAT DISCOURAGE INFLOW OF FOREIGN INVESTMENTS

- infrastructure lags
- high rates of inflation
- balance of payment deficits
- poor literacy and low labour skills
- rigidity in the labour market
- bureaucracy and corruption
- unfavorable tax regime
- small size of market and lack of potential for its growth
- exchange rate volatility
- prevalence of non-tariff barriers
- language barriers
- high rates of industrial disputes
- lack of facilities for immigration
- employment of foreign technical and administrative personnel

MODES OF FOREIGN DIRECT INVESTMENT (FDI)

- Opening of a subsidiary or associate company in a foreign country
- Equity injection into an overseas company
- Acquiring a controlling interest in an existing foreign company
- Mergers and acquisitions(M&A)
- Joint venture with a foreign company.
- Green field investment (establishment of a new overseas affiliate for freshly starting production by a parent company).

BENEFITS OF FOREIGN DIRECT INVESTMENT

1. **Prevent Formation Of Monopolies**
   - Entry of foreign enterprises usually fosters competition and generates a competitive environment in the host country
   - International capital allows countries to finance more investment than can be supported by domestic savings.
2. **Technology**
   - the new technology can clearly enhance the recipient country's production possibilities.
   - Competition for FDI among national governments also has helped to promote political reforms important to attract foreign investors
3. **Employment**
   - it generates direct employment in the recipient country
   - generate indirect employment opportunities
   - promote relatively higher wages for skilled jobs
   - skill development for workers
   - it generates source of new tax revenue which can be used for development projects.
   - Better work culture and higher productivity standards

PROBLEMS OF FOREIGN DIRECT INVESTMENT

1. Inappropriate for a labour-abundant country
2. Accentuating the already existing income inequalities in the host country.
3. Causes the domestic governments to slow down
4. The host country loses tax revenues.
5. Crowding-out' effect.
6. Instability in the Balance Of Payments.
7. Distorted pattern of production and investment
8. Anti-ethical
9. Displacement of labour
10. Monopolists
11. Off –shoring
12. National security considerations

FOREIGN DIRECT INVESTMENT IN INDIA (FDI)

- Liberalization and reforms programme in **1991**
- **FIPB abolished w.e.f May 2017**
- Signing of the Multilateral Investment Guarantee Agency Protocol
- **100%** FDI in multitude of sectors
- Enactment of Foreign Exchange Management Act (FEMA)
- Passing of the SEZ Act in 2005
- Special Economic Zones (SEZ)
- India ranks as the **tenth highest recipient** of foreign direct investment globally in 2015
- India is **sixth most preferred investment destination.**
- The **services sector** attracted the highest FDI equity inflow
- India received the maximum FDI equity inflows from Mauritius (US$ 5.85 billion) followed by Singapore, Netherlands, Japan and the USA.

THE SECTORS IN INDIA WHERE FDI IS PROHIBITED/BANNED

- Lottery business including Government / private lottery, online lotteries, etc.
- Gambling and betting including casinos etc.
- Chit funds
- Nidhi company
- Trading in Transferable Development Rights (TDRs)
- Real Estate Business or Construction of Farm Houses
- Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes
- Activities / sectors not open to private sector investment e.g. atomic energy and railway operations (other than permitted activities).