International Trade

Unit – 1: Theories of International Trade

Define International Trade and describe how it differs from Internal Trade?

- International Trade is the exchange of goods and services as well as resources between countries.
- It involves transactions between residents of different countries; whereas Domestic Trade or Internal Trade involves exchange of goods and services within the domestic territory of a country.
- International Trade involves transactions in multiple currencies; whereas Domestic Trade only uses domestic currency.

Compared to Internal Trade, International Trade has greater complexity as it involves

- heterogeneity of customers and currencies,
- differences in legal systems,
- more elaborate documentation,
- diverse restrictions in the form of taxes, regulations, duties, tariffs, quotas, trade barriers, standards, and restraints to movement of specified goods and services;
- issues related to shipping and transportation.

Arguments in the favour of International Trade:

- It is a powerful stimulus to economic efficiency and contributes to economic growth and rising incomes.
- It induces companies to reap the quantitative and qualitative benefits of extended division of labour.
- Enlarges Manufacturing capabilities and benefits from economies of large scale production.
- Reduction in domestic price due to increased competition thereby increasing the living standard of citizens.
- Exports stimulate economic growth by creating jobs, which could potentially reduce poverty.
- International Trade provides access to new market and new material and enables sourcing of inputs and components internationally at competitive prices.

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Arguments against International Trade:

- Possible negative labour market outcomes in terms of labour-saving technological change that depress demand for unskilled workers, loss of labourers bargaining power.
- Economic exploitation is a likely outcome when underprivileged countries become vulnerable to the growing political power of corporations operating globally.
- Excessive stress on exports and profit-driven exhaustion of natural resources due to unsustainable production and consumption.
- It may have adverse effect on the development of domestic industries and may even threaten the survival of infant industries.
- Risky dependence of underdeveloped countries on foreign nation impairs economic autonomy and endangers their political sovereignty.
- Instead of cooperation among nations, trade may breed rivalry on account of severe competition.
- Liberal global trade and investments are often criticized as detrimental to national interest.
- The domestic entities can be easily outperformed by financially stronger transactional companies.

Important Theories of International Trade:

The Mercantilists' View of International Trade:
Mercantilism was based on the premise that national wealth and power are best served by increasing exports and collecting precious metals in return.

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Mercantilists believed that:

- The more gold and silver a country accumulates, the richer it becomes.
- Maximizing exports in order to bring in more ***"specie"*** (money in the form of precious metals rather than notes) and minimizing imports through the state imposing very high tariffs on foreign goods.
- Trade is a ***'zero-sum game'*** (one country's gain is equal to another country's loss).

The Theory of Absolute Advantage:

- International trade is not a zero-sum game.

- Absolute cost advantage is the determinant of mutually beneficial international trade.
- The absolute cost advantage theory points out exchange of goods between two countries will take place only if each of the two countries can produce one commodity at an absolutely lower production cost than the other country.
- The value of goods is determined by measuring the labour incorporated in them.
- The theory is generally presented with an example of a hypothetical two countries and two commodities model.
- Absolute advantage exists between nations when they differ in their ability to produce goods.
- Each nation can produce one good with less expenditure of human labour or more cheaply than the other.

Therefore, it can be concluded mutually gainful trade is possible only when one country has absolute advantage and the other has absolute disadvantage in the production of at least one commodity.

The Theory of Comparative Advantage:

The ***Law of Comparative Advantage*** states that even if one nation is less efficient than (has an absolute disadvantage with respect to) the other nation in the production of all commodities, there is still scope for mutually beneficial trade.

The first nation should specialize in the production and export of the commodity in which its absolute disadvantage is smaller (this is the commodity of its comparative advantage) and import the commodity in which its absolute disadvantage is greater (this is the commodity of its comparative disadvantage).

Comparative advantage differences between nations are explained by exogenous factors i.e. the differences in national characteristics.

Labour differs in its productivity internationally and different goods have different labour requirements, therefore comparative labour productivity advantage was Ricardo's ***predictor of trade***.

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The opportunity cost concept of Haberler's concludes that there is no assumption made in respect of labour as the source of value.

Opportunity Cost is basically the value of the forgone option. It is the 'real' cost in microeconomic terms, as opposed to cost given in monetary units. According to the opportunity cost theory, 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 Heckscher-Ohlin theory of International Trade:

- The Heckscher–Ohlin model is a theory in economics explaining that ***countries export what can be most efficiently and plentifully produced.***
- This model is to evaluate trade and, more specifically, the ***equilibrium of trade between two countries*** that have varying specialties and natural resources.
- Emphasis is placed on the ***export of goods*** requiring factors of production that a country has in abundance and the ***import of goods*** that a nation cannot produce as effectively.
- According to this theory, international trade is but a ***special case of Inter-Regional Trade.***
- Different ***regions have different factor endowments,*** that is, some regions have abundance of labour, but scarcity of capital; whereas other regions have abundance of capital, but scarcity of labour.
- Different ***goods have different production functions,*** that is, factors of production are combined in different proportions to produce different commodities.
- While some goods are produced by employing a relatively larger proportion of labour and relatively smaller proportion of capital, other goods are produced by employing a relatively smaller proportion of labour and relatively larger proportion of capital.
- Therefore, difference in factor endowment is the main cause of international trade as well as inter-regional trade.
- The immediate cause of inter-regional trade is that goods can be bought cheaper in terms of money than they can be produced at home and this is the case of international trade as well.

- The cause of difference in the relative prices of goods is the difference in the amount of factor endowments, like capital and labour, between two countries.

Comparison of Theory of Comparative Costs and Modern Theory

Theory of Comparative Costs	*Modern Theory*
The basis is the difference between countries is comparative costs	Explains the causes of differences in comparative costs as differences in factor endowments
Based on labour theory of value	Based on money cost which is more realistic.
Considered labour as the sole factor of production and presents a one- factor (labour) model	Widened the scope to include labour and capital as important factors of production. This is 2-factor model and can be extended to more factors.
Treats international trade as quite distinct from domestic trade	International trade is only a special case of inter-regional trade.
Studies only comparative costs of the goods concerned	Considers the relative prices of the factors which influence the comparative costs of the goods
Attributes the differences in comparative advantage to differences in productive efficiency of workers	Attributes the differences in comparative advantage to the differences in factor endowments.
Does not take into account the factor price differences	Considers factor price differences as the main cause of commodity price differences
Does not provide the cause of differences in comparative advantage.	Explains the differences in comparative advantage in terms of differences in factor endowments.
Normative; tries to demonstrate the gains from international trade	Positive; concentrates on the basis of trade

New Trade Theory – An Introduction:

Why developed and big countries are trade partners when they are trading similar goods and services?

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- This is particularly in key economic sectors such as electronics, IT, food, and automotive.
- These are usually products that come from large, global industries that directly impact international economies.
- Those countries with the advantages will dominate the market, and the market takes the form of monopolistic competition.

Monopolistic Competition:

The firms are producing a similar product that isn't exactly the same, but awfully close.

Two key concepts that give advantages to countries that import goods to compete with products from the home country:

- Economic of Scale
- Network Effects

Economies of Scale:

As a firm produces more of a product, its cost per unit keeps going down. So, if the firm serves domestic as well as foreign market instead of just one, then it can reap the benefit of large scale of production consequently the profits are likely to be higher.

Network Effects:

It refers to the way one person's value for a good or service is affected by the value of that good or service to others.

The value of the product or service is enhanced as the number of individuals using it increases. This is also referred to as the ***'Bandwagon Effect'***.

Consumers like more choices, but they also want products and services with high utility, and the network effect increases utility obtained from these products over others.

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Unit – 2: The Instruments of Trade Policy

Trade Policy:

Trade policy encompasses all instruments that governments may use to promote or restrict imports and exports. Trade policy also includes the approach taken by countries in trade negotiations.

Major objectives of Trade Policy:

- To provide a stable and sustainable policy environment for foreign trade in merchandise and services.
- To link rules, procedures and incentives for exports and imports with other initiative such as "Make in India", Digital India and skill India to create an 'Export Promotion Mission' for India.
- To provide a mechanism for regular appraisal in order to rationalize import and reduce the trade imbalance.
- To allow import of technology and equipments which may help in establishing new industrial enterprises, produce new product and adopt a new process for higher production levels.
- To accelerate the country's transition to a globally oriented vibrant economy to deriving maximum benefits from expanding global market opportunities;
- To provide consumers with good quality product at reasonable prices through regulated imports of such products.

Use of "Tariffs" as policy instrument:

- A Tariff is a tax imposed on the import or export of goods.
- In general parlance, however, it refers to "Import Duties" charged at the time goods are imported.
- Tariff is also a policy tool to protect domestic industries by changing the conditions under which goods compete in such a way that competitive imports are placed at a disadvantage.
- In point of fact, a cursory examination of the tariff rates employed by different countries does seem to indicate that they reflect, to a considerable extent, the competitiveness of domestic industries.

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Forms of Import Tariffs:

Specific Tariff:

A Specific Tariff is an import duty that assigns a fixed monetary tax per physical unit of the goods imported.

It is calculated on the basis of unit measure, such as weight, volume, etc., of the imported goods.

Ad valorem tariff:

An ad valorem tariff is levied as a constant percentage of the monetary value of one unit of the imported goods.

Mixed Tariffs:

Mixed tariffs are expressed either on the basis of the value of the imported goods (an ad valorem rate) or on the basis of a unit of measure of the imported goods (a specific duty) depending on which generates the most income; e.g. Cotton.

Compound Tariff or a Compound Duty:

- It is a combination of an ad valorem and a specific tariff.
- That is, the tariff is calculated on the basis of both the value of the imported goods (an ad valorem duty) and a unit of measure of the imported goods (a specific duty).
- It is generally calculated by adding up a specific duty to an ad valorem duty; e.g. Cheese.

Technical / Other Tariff:

These are calculated on the basis of the specific contents of the imported goods i.e. the duties are payable by its components or related items; e.g. Solar Panels.

Tariff Rate Quotas:

Tariff Rate Quotas (TRQs) combine two policy instruments:

- Quotas and Tariffs.
- Imports entering under the specified quota portion are usually subject to a Lower (sometimes Zero), tariff rate.
- Imports above the quantitative threshold of the quota face a much higher tariff.

Most-Favored Nation Tariffs (MFN Tariffs):

MFN Tariffs refers to import tariffs which countries promise to impose on imports from other members of the WTO, unless the country is part of a preferential trade agreement ***(such as a free trade area or customs union).***

Variable Tariff:

A duty typically fixed to bring the price of an imported commodity up to level of the domestic support price for the commodity.

Preferential Tariff:

- A lower tariff is charged from goods imported from a country which is given preferential treatment over MFNs.
- These agreements are reciprocal.
- A lower tariff is charged from goods imported from a country which is given preferential treatment.

Examples are preferential duties in the ***European Union (EU)*** region under which a good coming into one EU country from another is charged Zero tariffs.

Bound Tariff:

- A bound tariff is a tariff in which a WTO member binds itself with a legal commitment not to raise it above a certain level.
- The bound rates are specific to individual products and represent the maximum level of import duty that can be levied on a product imported by that member.
- A member is always free to impose a tariff that is lower than the bound level.
- Once bound, a tariff rate becomes permanent and a member can only increase its level after negotiating with its trading partners and compensating them for possible losses of trade.
- A bound tariff ensures transparency and predictability.

Applied Tariffs:

It is charged on imports on a Most Favoured Nation (MFN) basis. A WTO member can have an applied tariff for product that differs from the bound tariff for that product as long as the applied level is not higher than the bound level.

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Escalated Tariff:

It refers to the system wherein the nominal tariff rates on imports of manufactured goods are higher than the nominal tariff rates on intermediate inputs and raw materials, i.e. the tariff on a product increases as that product moves through the value-added chain.

Prohibitive Tariff:

A prohibitive tariff is one that is set so high that no imports can enter.

Import subsidies:

An import subsidy is simply a payment per unit or as a percent of value for the importation of a good (i.e., a negative import tariff).

Tariffs as Response to Trade Distortions:

- Sometimes countries engage in 'unfair' foreign-trade practices which are trade distorting in nature and adverse to the interests of the domestic firms.
- The affected importing countries, upon confirmation of the distortion, respond quickly by measures in the form of tariff responses to offset the distortion.
- These policies are often referred to as "Trigger-Price" mechanisms.

Anti-dumping Duties:

- An anti-dumping duty is a protectionist tariff that a domestic government imposes on foreign imports that it believes are priced below fair market value.
- Dumping is process where a company exports a product at a price lower than the price it normally charges in its own home market.
- To protect local business and markets, many countries impose stiff duties on products they believed are being dumped in their national market.
- Dumping may be persistent, seasonal, or cyclical.
- Dumping may also be resorted to as a predatory pricing practice to drive out established domestic producers from the market and to establish monopoly position.
- Dumping is an international price discrimination where the exporters deliberately forego money in order to harm the domestic producers of the importing country.

- This is unfair and constitutes a threat to domestic producers.

Countervailing Duties:

- It is levied on imported goods to offset subsidies made to producers of these goods in the exporting country.
- Countervailing Duties (CVD) are meant to level the playing field between domestic producers of a product and foreign producers of the same product who can afford to sell it at a lower price because of the subsidy they receive from their government.

If left unchecked, such subsidized imports can have a severe effect on domestic industry, forcing factory closures and causing huge job losses. As export subsidies are considered to be an unfair trade practice, the WTO (which deals with the global rules of trade between nations), has detailed procedures in place to establish the circumstance under which countervailing duties can be imposed by an importing nation.

For example, in 2016, in order to protect its domestic industry, India imposed 12.5% countervailing duty on Gold jewellery imports from ASEAN.

Effect of Tariffs:

- Tariff barriers create obstacles to trade, decrease the volume of imports and exports and therefore of international trade.
- Tariffs encourage consumption and production of the domestically produced import substitutes and thus protect domestic industries.
- Producers in the importing country experience an increase in well – being, as an imposition of tariff.
- The price increase of their product in the domestic market increases producer's surplus in the industry.
- The price increase also induces an increase in the output of existing firms and possibly addition of new firms due to entry into industry to take advantage of the new high profits and consequently an increase in employment in the industry.
- Tariffs create trade distortions by disregarding comparative advantage and prevent countries from enjoying gains from trade arising from comparative advantage.
- Tariffs increases government revenues of the importing country by the value of the tariff it charges.

Different Non–Tariff Measures adopted by countries:

Non-Tariff Measures (NTMs) are policy measures that can potentially have an economic effect on international trade in goods, changing quantities traded, or prices or both.

1. **Technical Measures:**

   Technical measures refer to product-specific properties such as characteristics of the product, technical specifications and production processes. These measures are intended for ensuring product quality, food safety, environmental protection, national security and protection of animal and plant health.

   a. **Sanitary and Phytosanitary (SPS) Measures:**

   - SPS measures are applied to protect human, animal or plant life from risks arising from additives, pests, contaminants, toxins or disease–causing organisms and to protect biodiversity.
   - These include ban or prohibition of import of certain goods, all measures governing quality and hygienic requirement, production processes, and associated compliance assessments.

   For Example:

   Prohibition of import of poultry from countries affected by avian flu, meat and poultry processing standards to reduce pathogens, residue limits for pesticides in foods etc.

   b. **Technical Barriers to Trade (TBT):**

   Technical Barriers to Trade (TBT) which cover both food and non-food traded products refer to mandatory 'Standards and Technical Regulation' that define the specific characteristic that a product should have, such as its size, shape, design, labelling /marketing /packaging, functionality or performance and production methods, excluding measures covered by the SPS Agreement.

2. **Non-Technical Measures**

   These include different types of trade protective measures which are put into operation to neutralize the possible adverse effects of imports in the market of the importing country.

a. ***Import Quotas:***

- An import quota is a direct restriction which specifies that only a certain physical amount of the good will be allowed into country during a given time period, usually one year.
- Import quotas are typically set below the free trade level of imports and usually enforced by issuing licenses.

b. ***Price Control Measures:***

Price control measures (including additional taxes and charges) are steps taken to control or influence the prices of imported goods in order to support the domestic price of certain products when the import prices of these goods are lower.

c. ***Non-automatic Licensing and Prohibitions:***

- These measures are normally aimed at limiting the quantity of goods that can be imported, regardless of whether they originate from different sources or from one particular supplier.
- These measures may take the form of non-automatic licensing, or complete prohibitions.

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d. ***Financial Measures:***

- The objective of financial measures is to increase import costs by regulating the access to and cost of foreign exchange for imports and to define the terms of payment.
- It includes measures such as advance payment requirements and foreign exchange controls denying the use of foreign exchange for certain types of imports or for goods imported from certain countries.

e. ***Measures Affecting Competition:***

- These measures are aimed at granting exclusive or special preferences or privileges to one or a few limited groups of economic operators.
- It may include government imposed special channel or enterprises, and compulsory use of national services.

f. Government Procurement Policies:

Government Procurement Policies may interfere with trade if they involve mandates that the whole of a specified percentage of government purchases should be from domestic firms rather than foreign firms, despite higher prices than similar foreign suppliers.

g. Trade-Related Investment Measures:

These measures include rules on local content requirements that mandate a specified fraction of a final good should be produced domestically.

h. Distribution Restrictions:

- Distribution restrictions are limitations imposed on the distribution of goods in the importing country involving additional license or certification requirements.
- These may relate to geographical restrictions or restrictions as to the type of agents who may resell.

For example:

A restriction that imported fruits may be sold only through outlets having refrigeration facilities.

i. Restriction on Post-sales Services:

- Producers may be restricted from providing after-sales services for exported goods in the importing country.
- Such services may be reserved to local service companies of the importing country.

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j. Administrative Procedures:

- Another potential obstruction to free trade is the costly and time-consuming administrative procedures which are mandatory for import of foreign goods.
- These will increase transaction costs and discourage imports.
- The domestic import-competing industries gain by such non-tariff measures.

For example:

Specifying particular procedures and formalities, requiring licenses, administrative delay, red-tape and corruption in customs clearing

frustrating the potential importers, procedural obstacles linked to prove compliance etc.

k. Rules of origin;

- Country of origin means the country in which a good was produced, or in the case of a traded service, the home country of the service provider.
- Rules of origin are the criteria needed by governments of importing countries to determine the national source of a product.
- Their importance is derived from the fact that duties and restrictions in several cases depend upon the source of imports.
- Important procedural obstacles occur in the home countries for making available certifications regarding origin of goods, especially when different components of the product originate in different countries.

l. Safeguard Measures:

- These are initiated by countries to restrict imports of a product temporarily if its domestic industry is injured or threatened with serious injury caused by a surge in imports.
- Restrictions must be for a limited time and non-discriminatory.

m. Embargos:

- It is a total ban imposed by government on import or export of some or all commodities to particular country or regions for a specified or indefinite period.
- This may be done due to political reasons or for other reasons such as health, religious sentiments.
- This is the most extreme form of trade barrier.

Export-related Measures:

Ban on exports:

- Export-related measures refer to all measures applied by the government of the exporting country including both technical and non- technical measures.
- Export restrictions have an important effect on international markets.

- By reducing international supply, export restrictions have been effective in increasing international prices.

Export Taxes:

- It is a tax collected on exported goods and may be either specific or ad valorem.
- The effect of an export tax is to raise the price of the good and to decrease exports thereby resulting in increase in domestic supply.
- It also reduces domestic prices and leads to higher domestic consumption.

Voluntary Export Restraints:

- Voluntary Export Restraints (VERs) refers to a type of informal quota administered by an exporting country voluntarily restraining the quantity of goods that can be exported out of that country during a specified period of time.
- Such restrains originate primarily from political considerations and are imposed based on negotiation of the importer with the exporter.
- The inducement for the exporter to agree to a VER is mostly to appease the importing country and to avoid the effects of possible retaliatory trade restraints that may be imposed by the importer.
- VERs cause, as do tariffs and quotas, domestic prices to rise and cause loss of domestic consumer surplus.
- Typically, VER is a result of requests made by the importing country to provide a measure of protection for its domestic businesses that produces competing goods.
- VERs are often created because the exporting countries would prefer to impose their own restriction than risk sustaining worse terms from tariffs and/or quotas.
- Producers in the importing country experience an increase in well-being, though, as there is decreased competition, increased price, profits, and employment.
- In spite of these benefits to producers, VERs reduce national welfare, by creating negative trade effect, negative consumption distortions, and negative production distortions.

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Unit – 3: Trade Negotiations

Describe the structure and guiding principles of the World Trade Organization.

- The World Trade Organization (WTO) is the only global international organization dealing with the rules of trade between nations.
- At its core are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments.
- The goal is to help producers of goods and services, exporters and importers conduct their business.
- The WTO is the international organization whose primary purpose is to open trade for the benefit of all.
- The WTO activities are supported by a Secretariat located in Geneva, headed by a Director General.
- It has a three-tier system of decision making.
- The WTO's top level decision-making body is the Ministerial Conference which can take decision on all matters under any of the multilateral trade agreements.
- The Ministerial Conference meets at least once every two years.
- At the next level, the Goods Council, Services Council and Intellectual Property (*T*rade *R*elated aspects of *I*ntellectual *P*roperty Right*S* – *TRIPS*) Council report to the General Council.
- These councils are responsible for overseeing the implementation of the WTO agreements in their respective areas of specialization.
- Right from its inception, the WTO has been driven by a number of fundamental principles which are the foundations of the multilateral trading system.

Explain the major guiding principles of WTO?

Trade without discrimination:

- Under the agreements, countries cannot normally discriminate between their trading partners.
- If a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all other members.

The National Treatment Principle (NTP):

Any country should not discriminate between its own and foreign products, services or nationals.

For instance, once imported apples reach Indian market, they cannot be discriminated against and should be treated at par in respect of marketing opportunities, product visibility or any other aspect with locally produced apples.

Freer trade: Lowering trade barriers for opening up markets is one of the most obvious means of encouraging trade as dictated by the WTO.

Predictability:

Foreign companies, investors and governments should be confident that the trade barriers will not be raised arbitrarily.

This is achieved through 'binding' tariff rates, discouraging the use of quotas and other measures used to set limits on quantities of imports, establishing market-opening commitments and other measures to ensure transparency.

Principle of general prohibition of quantitative restrictions:

One reason for this prohibition is that quantitative restrictions are considered to have a greater protective effect than tariff measures and are more likely to distort the free flow of trade

Greater competitiveness:

This is to be achieved by discouraging "unfair" practices such as export subsidies, dumping etc.

Tariffs as legitimate measures for the protection of domestic industries:

The imposition of tariffs should be the only method of protection, and tariff rates for individual items should be gradually reduced through negotiation 'on a reciprocal and mutually advantageous' basis.

Transparency in Decision Making:

The WTO insists that any decision by members in the sphere of trade or in respect of matter affecting trade should be transparent verifiable.

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Progressive Liberalization:

Many trade issues of a controversial nature similar to labour standards, non-agricultural market access, etc. be liberalized after discussion.

Market Access:

The WTO aims to increase world trade by enhancing market access by converting all non- tariff barriers into tariffs which are subject to country specific limits. Further, in major multilateral agreements like the Agreement on Agriculture (AOA), specific targets have been specified for ensuring market access.

Special privileges to less developed countries:

With majority of WTO members being developing countries and countries in transition to market economics, the WTO deliberations favour less developed countries by giving them greater flexibility, special privileges and permission to phase out the transition period.

Protection of Health & Environment:

The WTO's agreements support measures to protect not only the environment but also human, animal as well as plant health.

A transparent, effective and verifiable dispute settlement mechanism:

Trade relations frequently involve conflicting interests. Any dispute arising out of violation of trade rules leading to infringement of right under the agreement or misunderstanding arising as regards the interpretation of rules are to be settled through consultation.

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Functions of WTO:

Following are some of the major concerns in respect off functioning of the WTO:

- The progress of multilateral negotiation on trade liberalization is very slow and the requirement of consensus among all members acts as a constraint and create rigidity in the system.
- As a result, countries find regionalism a plausible alternative.
- The complex network of regional agreements, introduces uncertainties and murkiness in the global trade system.

- The achievement in liberalizing trade in agriculture, textiles, and apparel, and in many other areas of international commerce has been negligible.
- The latest negotiations, such as the Doha Development Round, have run into problems, and their definitive success is doubtful.
- Most countries, particularly developing countries are dissatisfied with the WTO because, in practice, most of the promises of the Uruguay Round agreement to expand global trade has not materialized.

Unit – 4: Exchange Rate & its Economic Effects

The Exchange Rate:

The term ***'Foreign Exchange'*** refers to the price of one currency expressed in terms of units of another currency and represents the number of units of one currency that exchanges for a unit of another.

A ***Direct Quote*** is the number of units of a local currency exchangeable for one unit of a foreign currency. In a direct quotation, the foreign currency is the base currency and the domestic currency is the counter currency.

An ***Indirect Quote*** is the reciprocal of the direct quote.

The Exchange Rate Regimes:

There are two major types of exchange rate regimes:

1. floating exchange rate regime (also called a flexible exchange rate), and
2. fixed exchange rate regime

Floating exchange rate regime:

Under this regime, the equilibrium value of the exchange rate of a country's currency is market-determined i.e. the demand for and supply of currency relative to other currencies determine the exchange rate.

Fixed Exchange Rate Regime:

Also referred to as ***Pegged Exchanged Rate,*** is an exchange rate regime under which a country's Central Bank or its Government, announces what its currency will be worth in terms of either another country's currency or a basket of currencies or another measure of value, such as gold.

In order to maintain the exchange rate at the predetermined level, the central bank intervenes in the foreign exchange market.

In reality, there are intermediate exchange rate regimes, that lie in between these two extremes (fixed and flexible).
A Soft Peg refers to an exchange rate policy under which the exchange rate is generally determined by the market, but in case the exchange rate

tends to move speedily in one direction, the central bank will intervene in the market.

A Hard Peg exchange rate policy, under which the central bank sets a fixed and unchanging value for the exchange rate. Both soft peg and hard peg policy require that the central bank intervenes in the foreign exchange market.

Advantages of a Fixed Rate Regime are:

1. Avoids currency fluctuations and eliminates exchange rate risks and transaction costs that can impede international flow of trade and investments.
2. Reduction in speculation on exchange rate movements.
3. Imposes discipline on a country's monetary authority and therefore generates lower levels of inflation.
4. The government can encourage greater trade and investment as stability encourages investment.
5. It can also enhance the credibility of the country's monetary-policy.
6. the central bank's intervention is required to maintain an adequate amount of foreign exchange reserves.

Advantages of Floating Exchange Rate Regime:

1. It allows Central bank and /or government to pursue its own independent monetary policy.
2. It allows exchange rate to be used as a policy tool.
3. The central bank is not required to maintain a huge foreign exchange reserve.

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Hence, it can be concluded that a fixed rate brings in more currency and monetary stability and credibility; but it lacks flexibility. On the contrary, a floating rate has greater policy flexibility; but less stability.

Nominal Versus Real Exchange Rates:

Nominal Exchange Rate refers to the rate at which a person can trade the currency of one country for the currency of another country. It can be used to find the domestic price of foreign goods.

Real Exchange Rate refers to the rate at which a person can trade the goods and services of one country for the goods and services of another.

A country's Real Exchange Rate is a key determinant of its net exports of goods and services.

Calculating Real Exchange Rate, (trade in a single good):

Real Exchange Rate

$$= \text{Nominal Exchange Rate} \times \frac{\text{Domestic Price}}{\text{Foreign Price}}$$

Calculating Real Exchange Rate (economy as a whole):

Real Exchange Rate

$$= \text{Nominal Exchange Rate} \times \frac{\text{Domestic Price Index}}{\text{Foreign Price Index}}$$

The functioning of the Foreign Exchange Market:

- The participants use one currency to purchase another currency.
- It is the largest market in the world in terms of cash value traded.
- It's an over-the-counter market
- It involves enormous volume of foreign exchange being traded worldwide.

The major participants in the foreign exchange market are:

Central Banks:

They participate in the foreign exchange markets, not to make profit, but essentially to contain the volatility of exchange rate to avoid sudden and large appreciation or depreciation of domestic currency and to maintain stability in exchange rate in keeping with the requirements of national economy.

Commercial Banks:

They participate in the foreign exchange market either on their own account (as speculators or arbitrageurs) or for their clients.

Foreign Exchange Brokers:

They participate as intermediaries between different dealers or banks.

Arbitrageurs:
They make profit by discovering price differences between pairs of currencies with different dealers or banks.
Arbitrage refers to the practice of making risk-less profits by intelligently exploiting price differences of an asset at different dealing locations.

Speculators:
These are bulls or bears, are deliberate risk-takers who participate in the market to make gains which result from unanticipated changes in exchange rates.

In the foreign exchange market, there are two types of transactions:

1. Current Transactions
2. Future Transactions

Applicable Exchange rates:

i. Spot Trading: Spot Exchange Rates.
ii. Future Transactions: Forward Exchange Rates.

Difference between Spot Exchange Rate and Forward Exchange Rate:

Spot Exchange Rate	Forward Exchange Rate
It is an exchange rate which is quoted at a particular time and payable on the spot for immediate delivery of foreign currency.	It is a rate which is quoted for a transaction over the period of time. The actual transaction would materialized in future at a predetermined rate.
Physical delivery of foreign exchange takes place immediately.	There is no immediate physical delivery as transaction takes place in future.
Spot exchange rate is a rate at current date which is determined by market force of demand & supply.	It is used for transaction in future. This rate is agreed upon by buyers & sellers at predetermined price.

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Spot exchange rate doesn't provide hedging facility as transaction is done on the spot.	Forward exchange rate is a part of hedging process which helps to minimize foreign exchange fluctuation risk.

Determination of Nominal Exchange Rate

On the demand side, people desire foreign currency to:

i. purchase goods and services from another country

ii. for unilateral transfers such as gifts, awards, grants, donations or endowments

iii. to make investment income payments abroad

iv. to purchase financial assets, stocks or bonds abroad

v. to open a foreign bank account

vi. to acquire direct ownership of real capital, and

vii. for speculation and hedging activities related to risk-taking or risk-avoidance activity

On the supply side, people desire foreign currency to:

i. purchases of home exports

ii. unilateral transfers to home country

iii. investment income payments

iv. foreign direct investments and portfolio investments

v. placement of bank deposits and speculation.

Changes in Exchange Rates:

Currency appreciates when its value increases with respect to the value of another currency or a basket of other currencies. On the contrary, currency depreciates when its value falls with respect to the value of another currency or a basket of other currencies.

In other words,

Home-currency depreciation is an increase in the home currency price of the foreign currency.

Home-currency appreciation is a decrease in the home currency price of foreign currency.

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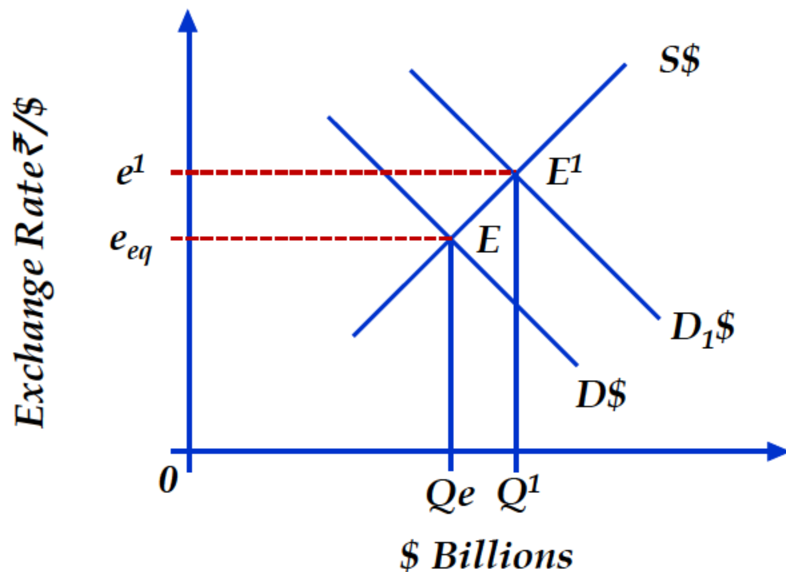
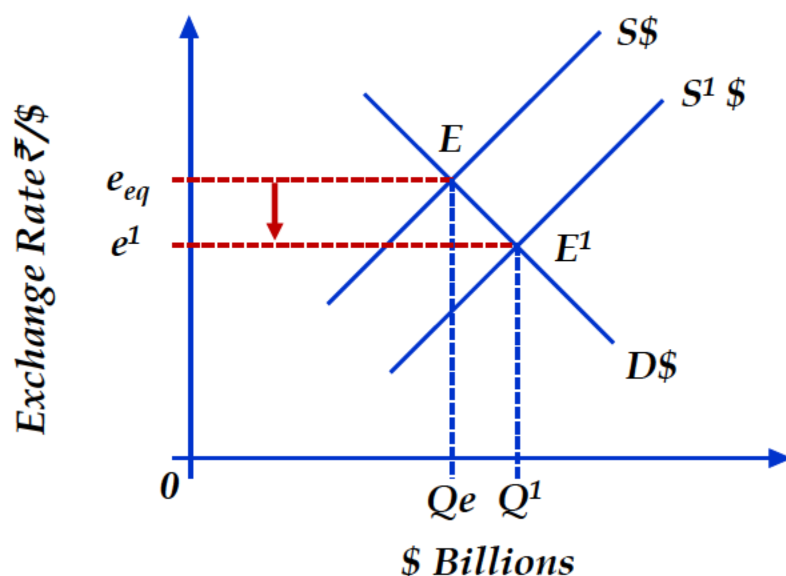
Home-Currency Depreciation under Floating Exchange Rates:



The market reaches equilibrium at point 'E' with equilibrium exchange rate 'e_{eq}'. An increase in domestic demand for the foreign currency, with supply of dollars remaining constant, is represented by a rightward shift of the demand curve to 'D1$".

The equilibrium exchange rate rises to 'e_1'. It means that more units of domestic currency (here Indian Rupees) are required to buy a unit of foreign exchange (dollar) and that the domestic currency (the Rupee) has depreciated.

Home-currency Appreciation under Floating Exchange Rates:



An increase in the supply of foreign exchange shifts the supply curve to the right to ***'S[1] $'*** and as a consequence, the exchange rate declines to ***'e1'***. It means, that lesser units of domestic currency (here Indian Rupees) are required to buy a unit of foreign exchange (dollar), and that the domestic currency (the Rupee) has appreciated.

Devaluation (Revaluation) Vs Depreciation (Appreciation):

Devaluation:

It is a deliberate downward adjustment in the value of a country's currency relative to another country's currency or group of currencies or standard. It is a monetary policy tool used by countries that have a fixed exchange rate or nearly fixed exchange rate regime.

Revaluation:

It is the opposite of devaluation and the term refers to a discrete official increase of the otherwise fixed par value of a nation's currency.

Depreciation:

It is a decrease in a currency's value (relative to other major currency benchmarks) due to market forces of demand and supply under a floating exchange rate and not due to any government or central bank policy actions.

Appreciation:

It refers to an increase in a currency's value (relative to other major currencies) due to market forces of demand and supply under a floating exchange rate and not due to any government or central bank policy interventions.

Impacts of Exchange Rate Fluctuations on Domestic Economy

1. They determine the nature and extent of a country's trade and affect the economy by changing the relative prices of domestically-produced and foreign-produced goods and services.
2. Exchange rate changes affect economic activity in the domestic economy. By lowering export prices, currency depreciation increase the international competitiveness of domestic industries, the volume of exports and promotes trade balance.
3. By changing the relative prices, depreciation may increase windfall profits in export and import-competing industries. However, depreciation may also cause contractionary effects.

4. For an economy where exports are significantly high, a depreciated currency would mean a lot of gain. In addition, if exports originate from labour- intensive industries, increased export prices will have positive effect on employment and potentially on wages.
5. Depreciation add to consumer price inflation in the short run.
6. When a country's currency depreciates, production for exports and of import substitutes become more profitable. The reverse will be true when the currency appreciates.
7. A depreciation or devaluation is also likely to affect a country's terms of trade (Terms of trade is the ratio of the price of a country's export commodity to the price of its import commodity).
8. Countries with foreign currency denominated government debts, currency depreciation will increase the interest burden and cause strain to the exchequer for repaying and servicing foreign debt.
9. Exchange rate fluctuations make financial forecasting more difficult for firms.
10. Exchange rate movements have become the single most important factor affecting the value of investments at international level.
11. Foreign investors are likely to be indecisive or highly cautious before investing in a country which has high exchange rate volatility

The other impacts of currency depreciation are:

1. Windfall gains for export-oriented sectors (such as IT sector, textile, pharmaceuticals, gems and jewellery in the case of India).
2. Remittances to homeland by non-residents and businesses abroad fetches more in terms of domestic currency
3. It would enhance government revenues from import related taxes, especially if the country imports more of essential goods
4. It would result in higher amount of local currency for a given amount of foreign currency borrowings of government.
5. It also can have a positive impact on country's trade deficit as it makes imports more expensive for domestic consumers and exports cheaper for foreigners.
6. It can have a positive impact on controlling spiralling gold imports (mostly wasteful) and thereby improve trade balance.

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An appreciation will have the following consequences on real economy:

1. An appreciation of currency raises the price of exports which results in decline in the domestic aggregate demand and impacting economic growth negatively.
2. If appreciation sets in during the recessionary phase, it would result in further fall in aggregate demand and higher levels of unemployment. If the economy is facing a boom, an appreciation of domestic currency would trim down inflationary pressures and soften the rate of growth of the economy.
3. It may cause reduction in the levels of inflation because imports are cheaper.
4. With increasing export prices, the competitiveness of domestic industry is adversely affected and therefore, firms have greater incentives to introduce technological innovations and capital-intensive production to cut costs to remain competitive.
5. Increasing imports and declining exports are liable to cause larger deficits and worsen the current account.
6. Loss of competitiveness will be insignificant if currency appreciation is because of strong fundamentals of the economy.

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Unit – 5: International Capital Movements

What are the different types of Foreign Capital?

'Foreign Capital' is a comprehensive term which takes into consideration any inflow of capital into the home country from abroad. Foreign capital may flow into an economy in different ways. Some of the important components of foreign capital flows are:

1. Foreign aid or assistance
2. Borrowings
3. Deposits from Non-Resident Indians (NRIs)
4. Investments

Foreign aid or assistance which may be:

a. Bilateral or direct inter-government grants
b. Multilateral aid from many governments who pool funds to international organization like the World Bank
c. Tied aid with strict mandates regarding the use of money or united aid where there are no such stipulations
d. Foreign grant which are voluntary transfer of resources by governments, institutions, agencies or organizations

Borrowings which may take different forms such as:

a. Direct inter-government loans
b. Loans from international institutions (e.g. world bank, IMF, ADB)
c. Soft loans for e.g. from affiliates of World Bank such as IDA
d. External commercial borrowing, and
e. Trade credit facilities

Investments in the form of:

a. Foreign Portfolio Investment (FPI) in bonds, stocks and securities, and
b. Foreign Direct Investment (FDI) in industrial, commercial and similar other enterprises.

Foreign Direct Investment (FDI):

Foreign Direct Investment (FDI) is an investment made by a company or individual in one country, in business interest in another country, in the form of either establishing business operations or acquiring business

assets in the other country, such as ownership or controlling interest in a foreign company.

FDI has three components, viz., equity capital, reinvested earnings and other direct capital in the form of intra-company loans between direct investors (parent enterprises) and affiliate enterprises.

Foreign direct investor may be individuals, incorporated private or public enterprises, associated groups of individuals or enterprises, governments or government agencies, estates, trusts, or other organizations or any combination of the above mentioned entities.

The main forms of direct investments are:

The opening of overseas companies, including the establishment of subsidiaries of branches, creation of joint ventures on a contract basis, joint development of natural resources and purchase or annexation of companies in the country receiving foreign capital.

Following are the main features of FDI:

- Investment involves creation of physical assets
- Has a long term interest and therefore remain invested for long
- Relatively difficult to withdraw
- Not speculative in nature
- Often accompanied by transfer of Funds, resources, technology, strategies, know-how etc.
- Direct impact on employment of labour and wages
- Provides interest in management and control

Based on the nature of foreign investments, FDI may be categorized as horizontal, vertical or conglomerate.

i. A ***Horizontal Direct Investment*** is said to take place when the investor establishes the same type of business operation in a foreign country as it operates in its home country.

ii. A ***Vertical Investment*** is one under which the investor establishes or acquires a business activity in a foreign country which is different from the investor's main business activity yet in some way supplements its major activity.

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iii. A *Conglomerate* type of foreign direct investment is one where an investor makes a foreign investment in a business that is unrelated to its existing business in its home country. This is often in the form of a joint venture with a foreign firm already operating in the industry, as the investor has no previous experience.

Yet another category of investment is 'two-way direct foreign investments' which are reciprocal investments between countries. These investments occur when some industries are more advanced in one nation, while other industries are more efficient in other nations.

Characteristics of Foreign Portfolio Investment (FPI):

Foreign Portfolio Investment (FPI) also very commonly known as Foreign Institutional Investment (FII), consists of securities and other financial assets passively held by foreign investors. It does not provide the investor with direct ownership of financial assets and is relatively liquid depending on the volatility of the market.

Unlike FDI, portfolio capital, in general, moves to investment in financial stocks, bonds and other financial instruments and is effected largely by individuals and institutions through the mechanism of capital market. These flows of financial capital have their immediate effect on balance or exchange rates rather than on production or income generation.

Foreign Portfolio Investment (FPI) is not concerned with either manufacture of goods or with provision of services.

Such investor also do not have any intention of exercising voting power or controlling or managing the affairs of the company in whose securities they invest.

The singular intention of a foreign portfolio investor is to earn a remunerative return through investment in foreign securities and is primarily concerned about the safety of their capital, the likelihood of appreciation in its value, and the return generated. Logically, portfolio capital moves to a recipient country which has reveled its potential for higher returns and profitability.

Following are the main characteristics of FPI:

- Investment is only in financial assets

- Only short term interest and generally remain invested for short periods.
- Relatively easy to withdraw
- Speculative in nature
- Transfer of Funds only
- No direct impact on employment of labour and wages
- Increase in capital inflow in the country only.
- No abiding interest in management and control
- Securities are held purely as a financial investment and no significant degree of influence on the management of the enterprise

Following are the main factors influencing foreign direct investments:

- The increasing interdependence of national economies and the consequent trade relations and international industrial cooperation established among them
- Internationalization of production and investment of transnational corporations in their subsidiaries and affiliates.
- Desire to reap economies of large-scale operation arising from technological growth
- Lack of feasibility of licensing agreement with foreign producers in view of the rapid rate of technological innovations
- Necessity to retain direct control of production knowledge or managerial skill (usually found in monopolistic or oligopolistic markets) that could easily and profitably be utilized by corporations
- Desire to procure a promising foreign firm to avoid future competition and the possible loss of export markets.
- Risk diversification so that recessions or downturns may be experienced with reduced severity
- Shared common language or common boundaries and possible saving in time and transport costs because of geographical proximity
- Necessity to retain complete control over its trade patent and to ensure consistent quality and service or for creating monopolies in a global context
- Promoting optimal utilization of physical, human, financial and other resources

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- Lower environment standards in the host country and the consequent relative saving in costs
- Stable political environment and overall favourable investment climate in the host country

Main factors that may discourage inflow of foreign capital:

- Host country discouraging inflow of foreign investment are infrastructure lags,
- High rate of inflation,
- Balance of payment deficits,
- Poor literacy and low labour skills,
- Rigidity in the labour market,
- Bureaucracy and corruption,
- Unfavourable tax regime and cumbersome legal formalities and delays,
- Small size of market and lack of potential for its growth,
- Political instability,
- Absence of well-defined property rights,
- Exchange rate volatility,
- Poor track-record of investments,
- Prevalence of non-tariff barriers and stringent regulations,
- Lack of openness,
- Language barriers

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Foreign direct investments can be made in a variety of ways (modes), such as:

- 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 foreign company.
- Green flied investment (establishment of a new overseas affiliates for freshly starting production by a parent company).

Merits of FDI:

Following are some of the benefits of Foreign Direct Investments in the host country:

- FDI foster competition and generates a competitive environment in the host country. The domestic enterprises are compelled to compete with the foreign enterprises operating in the domestic market. This results in positive outcomes in the form of cost-reducing and quality-improving innovations, higher efficiency.
- FDI can accelerate growth and foster economic development by providing the much needed capital, technological know-how, management skills and marketing methods and critical human capital skills in the form of managers and technicians.
- Competition for FDI among national governments also has helped to promote political reforms important to attract foreign investors, including legal systems and macroeconomics polices.
- FDI generates direct employment in the host country. Subsequent FDI as well as domestic investments propelled in the downstream and upstream project that comes up in multitude of other services generate multiplier effects on employment and income.
- There is also greater possibility for the promotion of ancillary units resulting in job creation and skill development for workers.
- Increased competition resulting from the inflow of foreign direct investments, facilitates weakening of the market power of domestic monopolies.

Arguments put forth against the entry of foreign capital:

- FDI are likely to concentrate on capital-intensive methods of production and service so that they need to hire only relatively few workers. This may lead to severe unemployment in a labour abundant economies.
- If the host corporations are able to secure incentives in form of tax holidays or similar provisions, the host country loses tax revenues.
- When profits are repatriated, a strain is placed on the host country's balance of payments and the home currency leading to its depreciation.
- Jobs that require expertise and entrepreneurial skills for creative decision making may generally be retained in the home country and

therefore the host country is left with routine management jobs that demand only lower levels of skills and ability.

- Foreign entities are usually accused of being anti-ethical as they frequently resort to methods like aggressive advertising and anticompetitive practices which would induce market distortions.
- FDI is also held responsible by many for ruthless exploitation of natural resources and the possible environmental damage.

Distinguish between FDI and FPI

Foreign Direct Investment (FDI)	Foreign Portfolio Investment (FPI)
Investment involves creation of physical assets	Investment is only in financial assets
Has a long term interest and therefore remain invested for long	Only short term interest and generally remain invested for short periods
Relatively difficult to withdraw	Relatively easy to withdraw
Not speculative in nature	Speculative in nature
Often accompanied by transfer of Funds, resources, technology, strategies, know-how etc.	Transfer of Funds only.
Direct impact on employment of labour and wages	No direct impact on employment of labour and wages
Increase in country's Gross Domestic Product (GDP)	Increase in capital inflow in the country only

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Which are the sectors in India where FDI is prohibited?

In India, foreign investment is prohibited in the following sectors:

1. Lottery business including Government/private lottery, online lotteries, etc.
2. Gambling and betting including casinos etc.
3. Chit funds
4. Nidhi company
5. Trading in Transferable Development Right (TDRs)
6. Real Estate Business or Construction of Farm Houses
7. Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes.