# UNIVERSITY GRANTS COMMISSION

**COMMERCE** **CODE: 08**

## UNIT – 1: BUSINESS ENVIRONMENT AND INTERNATIONAL BUSINESS

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## SECTION – 1: UNITS AT A GLANCE

### Sub Unit – 1: CONCEPT AND ELEMENTS OF BUSINESS ENVIRONMENT

**Economic Environment:** The **economic environment** refers to all the economic factors that affect commercial and consumer behavior. The economic environment consists of all the external factors in the immediate marketplace and the broader economy. These factors can influence a business, i.e., how it operates and how successful it might become.

**Microeconomic factors:** The microeconomic environment refers to things that happen at the individual company or consumer level. They do not affect the whole economy. Below are some microeconomic factors that may influence a business:

**Macroeconomic factors:** The macroeconomic environment, on the other hand, refers to things that affect the entire economy. Macroeconomics is concerned with general or large-scale economic factors.

**Economic systems** are the means by which countries and governments distribute resources and trade goods and services. They are used to control the five factors of production, including: labor, capital, entrepreneurs, physical resources and information resources.

**What is an Economic Policy?** An economic policy refers to actions that a government may take to alter the economy of a city, state, or nation. It is usually comprised of various measures, through which the government seeks to influence the overall economy. There are three methods through which a government typically seeks to control the economy with its budget, known as the allocative, stabilization, and distributive functions.

**Monetary policy:** Monetary policy is a central bank's actions and communications that manage the money supply. That includes credit, cash, checks, and money market mutual funds. The most important of these forms of money is credit. It includes loans, bonds, and mortgages.

**Fiscal policy:** Fiscal policy is what the government employs to influence and balance the economy, using taxes and spending to accomplish this. Fiscal policy tries to nudge the economy in different ways through either expansionary or contractionary policy, which try to either increase economic growth through taxes and spending or slow economic growth to cutback inflation, respectively.

**Expansionary Fiscal Policy:** Expansionary fiscal policy is used by the government when attempting to balance out the contraction phase of the business cycle (especially when in or on the brink of a recession), and uses methods like cutting taxes or increasing government spending on things like public works in an attempt to stimulate economic growth. Expansionary fiscal policy, therefore, attempts to fix a decrease in demand by giving consumers tax cuts and other incentives to increase their purchasing power (and, how much they spend).

**Contractionary Fiscal Policy:** On the other hand, contractionary fiscal policy entails increasing tax rates and decreasing government spending in hopes of slowing economic growth for various reasons. In this way, the government may deem it necessary to halt or deter economic growth if inflation caused by increased supply and demand of cash gets out of hand.

**Political Environment:** Political Environment is the state, government and its institutions and legislations and the public and private stakeholders who operate and interact with or influence the system. The political atmosphere should be good and very stable for a firm to operate successfully. Political Environment forms the basis of business environment in a country.

**Legal Environment:** The government, in every country, regulates the business according to its defined priorities. Legal system of a country is framed by the government. The laws which are passed by the government for business operation is called legal environment. In every country, the government regulates business activities.

**Consumer Protection Act:** A Consumer Protection Act is piece of legislation that is passed with regard to the provision and administration of protecting the rights of consumers within a country or nation. Within the spectrum of both commercial law and consumer law, there exist a variety of roles which are undertaken by participatory individuals and groups operating within the scope of the commercial marketplace.

**FEMA:** The Foreign Exchange Management Act (1999) or in short FEMA has been introduced as a replacement for earlier Foreign Exchange Regulation Act (FERA). FEMA became an act on the 1st day of June, 2000.

**Corporate Social Responsibility (CSR):** Corporate Social Responsibility (also known as CSR, corporate conscience, and corporate citizenship) is the integration of socially beneficial programs and practices into a corporation's business model and culture. CSR aims to increase long-term profits for online and offline businesses by enabling them to become more efficient and attract positive attention for their efforts.

**Sub Unit – 2: INTERNATIONAL BUSINESS**

**Meaning of International Business:** International business is the process of implying business across the boundary of the country at a global level. It focuses on the resources of the globe and objectives of the organization on the global business.

Globalization: Globalization, in the most basic sense, can be defined as a trend in which countries across the globe are joining economically. Hill (2009) describes the major facets of globalization to include the globalization of markets and the globalization of production.

**Contractual Entry Modes:** Contractual entry modes are long term non-equity alliance between the company that wants to internalize and the company in target country for entry mode. There are many types of contractual entry mode namely technical agreements, Service contracts, managements, contract manufacture, Co-production agreements and others.

**Licensing**: Licensing concerns a product rights or the method of production marketing the product rights. These rights are usually protected by a patent or some other intellectual right. Licensing is when the exporter, the licensor, sells the right to manufacture or sell its products or services, on a certain market area, to the foreign party (the licensee).

**Franchising:** Franchising is a form of licensing, which is most often used as market entry modes for services such as fast foods, business to-consumer services and business-to-business services.

**Turnkey Project:** In turnkey projects, the contractor agrees to handle every detail of the project for a foreign client, including the training of operating personnel. At completion of the contract, the foreign client is handed the “key” to a plant that is ready for full operation. Hence we get the term turnkey.

**Joint Ventures:** A joint venture is a contractual arrangement whereby a separate entity is created to carry on trade or business on its own, separate from the core business of the participants. A joint venture occurs when new organizations are created, jointly owned by both partners. At least one of these partners must be from another country than the rest and the location of the company must be outside of at least one party’s home country.

**Strategic Alliances:** Strategic alliance is when the mutual coordination of strategic planning and management that enable two or more organizations to align their long term goals to the benefit of each organization and generally the organizations remain independent.

**Greenfield Investment**: Greenfield investment is a mode of entry where the firm starts from scratch in the new market and opens up own stores while using their expertise. It involves the transfer of assets, management of talent, and proprietary technology and manufacturing know-how.

**Acquisitions:** Acquisition is a very expensive mode of entry where the company acquirers or buys an already existing company in the foreign market. Acquisition is one way of entering a market by buying an already existing brand instead of trying to compete and launch the company’s products on the market and thereby lowering the chance of a profitable product.

**Sub Unit – 3: INTERNATIONAL TRADE**

**Absolute Advantage:** The Theory of **Absolute Advantage** is based on the notion of increasing the efficiencies in the production processes. In **1776**, Adam Smith, a renowned financial expert of the time being, proposed the theory that the manufacturing a product with high efficiency as compared to any other country on the globe is highly advantageous.

**Comparative Advantage**: As compared to absolute advantage, **Comparative Advantage** favors relative productivity. According to this concept, as put forward by David Ricardo in **1817**, a country with maximum absolute advantage in the creation of more than one product as compared to other, can still trade with another country with less efficient ways to create that product, that's readily available in first, to boost its productivity.

**Product Life Cycle Theory:** In the **1970s**, Raymond Vernon introduced the notion of using a product's life cycle to explain global trade patterns, in the field of marketing. According to theory, as the demand for a newly created product grows, the home country starts exporting it to other nations. Where when the demand grows, local manufacturing plants are opened to meet the request. And the scenario covers the whole globe time to time, thus making that product a standardization.

**Tariff Barriers**: Tariff is a customs duty or a tax on products that move across borders. The most important of tariff barriers is the customs duty imposed by the importing country. A tax may also be imposed by the exporting country on its exports.

**Non-tariff Barriers**: A non-tariff barrier is any barrier other than a tariff, that raises an obstacle to free flow of goods in overseas markets. Non-tariff barriers, do not affect the price of the imported goods, but only the quantity of imports.

**Sub Unit – 4: FOREIGN DIRECT INVESTMENT (FDI)**

**Foreign Direct Investment (FDI):** A foreign direct investment (FDI) is an investment in the form of a controlling ownership in a business in one country by an entity based in another country. It is thus distinguished from a foreign portfolio investment by a notion of direct control.

The origin of the investment does not impact the definition, as an FDI: the investment may be made either "inorganically" by buying a company in the target country or "organically" by expanding the operations of an existing business in that country.

**Methods of FDI:** The foreign direct investor may acquire voting power of an enterprise in an economy through any of the following methods:

- by incorporating a wholly owned subsidiary or company anywhere
- by acquiring shares in an associated enterprise
- through a merger or an acquisition of an unrelated enterprise
- participating in an equity joint venture with another investor or enterprise

**Foreign Portfolio Investment (FPI):** Foreign portfolio investment (FPI) consists of securities and other financial assets held by investors in another country. It does not provide the investor with direct ownership of a company's assets and is relatively liquid depending on the volatility of the market.

**Types of FDI**:

1. **Horizontal FDI** arises when a firm duplicates its home country-based activities at the same value chain stage in a host country through FDI.
2. **Platform FDI** Foreign direct investment from a source country into a destination country for the purpose of exporting to a third country.
3. **Vertical FDI** takes place when a firm through FDI moves upstream or downstream in different value chains i.e., when firms perform value-adding activities stage by stage in a vertical fashion in a host country.

**India's FDI Policy:** Government of India has taken various effective steps to simplify the Foreign Direct investment policy. The Foreign Direct Investment Policy (FDI Policy) of the Government of India prescribes the foreign investment cap in specified industrial sectors. But in the recent times many activities have been transferred to unrestricted sectors in which 100% Foreign Direct investment is permitted. Broadly, the industrial sectors are categorized as:

1. Restricted.
2. Prohibited.
3. Unrestricted Sectors (Up to 100% foreign ownership).

**Sub Unit – 5: BALANCE OF PAYMENT (BOP)**

**Balance of Payments or BOP:** It is a statement or record of all monetary and economic transactions made between a country and the rest of the world within a defined period (every quarter or year). These records include transactions made by individuals, companies and the government. Keeping a record of these transactions helps the country to monitor the flow of money and develop policies that would help in building a strong economy.

**Components of BOP:** The BOP consists of three main components—current account, capital account, and financial account. As mentioned earlier, the BOP should be zero. The current account must balance with the combined capital and financial accounts.

- **Current Account:** The current account monitors the flow of funds from goods and services trade (import and export) between countries.
- **Capital Account**: The capital account monitors the flow of international capital transactions.
- **Financial Account:** The financial account monitors the flow of funds pertaining to investments in businesses, real estate, and stocks.

**Sub Unit – 6: REGIONAL ECONOMIC INTEGRATION**

**Trade creation** is an economic term related to international economics in which trade flows are redirected due to the formation of a free trade area or a customs union. The issue was firstly brought into discussion by Jacob Viner (1950), together with the trade diversion effect.

**Regional Trade Agreements:** Regional trading agreements refer to a treaty that is signed by two or more countries to encourage free movement of goods and services across the borders of its members. The agreement comes with internal rules that member countries follow among themselves. When dealing with non-member countries, there are external rules in place that the members adhere to.

**European Union (EU): The** European Union **(**EU**)** is a political and economic union of 27 member states that are located primarily in Europe. Its members have a combined area of 4,233,255.3 km$^2$ (1,634,469.0 sq mi) and an estimated total population of about 447 million. The EU has developed an internal single market through a standardised system of laws that apply in all member states in those matters, and only those matters, where members have agreed to act as one. EU policies aim to ensure the free movement of people, goods, services and capital within the internal market, enact legislation in justice and home affairs and maintain common policies on trade, agriculture, fisheries and regional development.

**ASEAN:** ASEAN was preceded by an organization formed on 31 July 1961 called the Association of Southeast Asia (ASA), a group consisting of Thailand, the Philippines, and the Federation of Malaya. ASEAN itself was created on 8 August 1967, when the foreign ministers of five countries: Indonesia, Malaysia, the Philippines, Singapore, and Thailand, signed the ASEAN Declaration.

**SAARC:** The South Asian Association for Regional Cooperation (SAARC) was established with the signing of the SAARC Charter in Dhaka on 8 December 1985. SAARC comprises of eight Member States: Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. The Secretariat of the Association was set up in Kathmandu on 17 January 1987.

**NAFTA:** The North American Free Trade Agreement (NAFTA) was an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The agreement came into force on January 1, 1994, and superseded the 1988 Canada–United States Free Trade Agreement between the United States and Canada. The NAFTA trade bloc is one of the largest trade blocs in the world by gross domestic product.

**Sub Unit – 7: INTERNATIONAL ECONOMIC INSTITUTIONS**

**IMF:** The International Monetary Fund (IMF) is an organization of 189 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

Created in 1945, the IMF is governed by and accountable to the 189 countries that make up its near-global membership.

**WORLD BANK:** The World Bank is an international financial institution that provides loans and grants to the governments of poorer countries for the purpose of pursuing capital projects. It comprises two institutions: the International Bank for Reconstruction and Development (IBRD), and the International Development Association (IDA). The World Bank is a component of the World Bank Group.

**World Bank Group:** The World Bank Group is an extended family of five international organizations, and the parent organization of the World Bank, the collective name given to the first two listed organizations, the IBRD and the IDA:

- International Bank for Reconstruction and Development (IBRD)
- International Development Association (IDA)
- International Finance Corporation (IFC)
- Multilateral Investment Guarantee Agency (MIGA)
- International Centre for Settlement of Investment Disputes (ICSID)

**UNCTAD:** The **United Nations Conference on Trade and Development** (**UNCTAD**) was established in 1964 as a permanent intergovernmental body. UNCTAD is the part of the United Nations Secretariat dealing with trade, investment, and development issues. The organization's goals are to: "maximize the trade, investment and development opportunities of developing countries and assist them in their efforts to integrate into the world economy on an equitable basis".

**Sub Unit – 8: WORLD TRADE ORGANIZATION (WTO)**

**WTO:** The Uruguay round of GATT (1986-93) gave birth to World Trade Organization. The members of GATT singed on an agreement of Uruguay round in April 1994 in Morocco for establishing a new organization named WTO.

It was officially constituted on January 1, 1995 which took the place of GATT as an effective formal, organization. GATT was an informal organization which regulated world trade since 1948.

Contrary to the temporary nature of GATT, WTO is a permanent organization which has been established on the basis of an international treaty approved by participating countries. It achieved the international status like IMF and IBRD, but it is not an agency of the United Nations Organization (UNO).

**Agriculture and Agreement:** The **Agreement on Agriculture** (**AOA**) is an international treaty of the World Trade Organization. It was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO on January 1, 1995.

***Three pillars:*** The Agreement on Agriculture constitutes of three pillars—domestic support, market access, and export subsidies.

**GATS:** The General Agreement on Trade in Services (GATS) is the first multilateral agreement covering trade in services. It was negotiated during the last round of multilateral trade negotiations, called the Uruguay Round, and came into force in 1995. The GATS provides a framework of rules governing services trade, establishes a mechanism for countries to make commitments to liberalize trade in services and provides a mechanism for resolving disputes between countries.

**TRIPS:** Trade-Related Aspects of Intellectual Property Rights (TRIPS) is arguably the most important and comprehensive international agreement on intellectual property rights. Member countries of the WTO are automatically bound by the agreement. The Agreement covers most forms of intellectual property including patents, copyright, trademarks, geographical indications, industrial designs, trade secrets, and exclusionary rights over new plant varieties. It came into force on 1 January 1995 and is binding on all members of the World Trade Organization (WTO).

**TRIMS:** Under the Agreement on Trade-Related Investment Measures of the World Trade Organization (WTO), commonly known as the TRIMs Agreement, WTO members have agreed not to apply certain investment measures related to trade in goods that restrict or distort trade. The TRIMs Agreement prohibits certain measures that violate the national treatment and quantitative restrictions requirements of the General Agreement on Tariffs and Trade (GATT).

## SECTION – 2: KEY STATEMENTS

Every candidates appearing for NET/SET examination should follow these key (main) points those can help them a better understanding regarding this unit very quickly.

**Basic Key Statements:** Economic Environment (1.1.1), Microeconomic factors (1.1.1), Macroeconomic factors (1.1.1), Economic systems (1.1.1), Political Environment (1.1.2), Legal Environment (1.1.3), Corporate Social Responsibility (1.1.5), International Trade (1.3.1), Foreign Direct Investment (1. 4.1), 1.5 Balance of Payment (1.5), Regional Trade Agreements (1.6.3), ASEAN (1.6.5), SAARC (1.6.5), NAFTA (1.6.5), IMF (1.7.1), WORLD BANK (1.7.2), UNCTAD (1.7.3), 1.8.3 GATS (1.8.3), TRIPS (1.8.3), TRIMS (1.8.3).

**Standard Key Statements:** Monetary policy (1.1.1), Consumer Protection Act (1.1.3), International Business (1.2.1), Globalization (1.2.2), GATT (1.2.2), Ad valorem Duty (1.3.3), Anti-dumping Duty (1.3.3), Quota System (1.3.3), Current Account (1.5), Economic Union (1.6.1), European Union (1.6.4), World Trade Organization (1.8.1).

**Advanced Key Statements:** Fiscal policy (1.1.1), Expansionary Fiscal Policy (1.1.1), Contractionary Fiscal Policy (1.1.1), FEMA (1.1.3), Comparative Advantage (1.3.1), Product Life Cycle Theory (1.3.1), Foreign Portfolio Investment (1. 4.1), Capital Account (1.5), Agriculture and Agreement (1.8.2).

**[N.B. – Values in parenthesis are the reference number]**

## SECTION – 3: KEY FACTS AND FIGURES

### Sub Unit - 1: CONCEPT AND ELEMENTS OF BUSINESS ENVIRONMENT

**1.1.1 Economic Environment- Economic Systems, Economic Policies (Monetary and Fiscal Policies):**

**Economic Environment:** The **economic environment** refers to all the economic factors that affect commercial and consumer behavior. The economic environment consists of all the external factors in the immediate marketplace and the broader economy. These factors can influence a business, i.e., how it operates and how successful it might become.

The economic environment consists of different things for different people. For example, for a farmer, the weather and price of fertilizers are important factors.

"The term economic environment refers to all the external economic factors that influence buying habits of consumers and businesses and therefore affect the performance of a company."

"These factors are often beyond a company's control, and may be either large-scale (macro) or small-scale (micro)."

**Economic environment – factors:** The economic environment consists of microeconomic and macroeconomic factors.

**Microeconomic factors:** The microeconomic environment refers to things that happen at the individual company or consumer level. They do not affect the whole economy. Below are some microeconomic factors that may influence a business:

- Competitors.
- Demand.
- Market size.
- Suppliers.
- Supply.
- How you supply your goods, i.e., the distribution chain. For example, through retail stores, distributors, the Internet, etc.

**Macroeconomic factors:** The macroeconomic environment, on the other hand, refers to things that affect the entire economy. Macroeconomics is concerned with general or large-scale economic factors, such as:

- Unemployment
- Inflation.
- Interest rates.
- GDP growth. GDP stands for **G**ross **D**omestic **P**roduct. In other words, is the economy in recession, is it booming, etc.?
- Taxes.
- Exchange rates, i.e., how much currencies are worth in relation to one another.
- How much discretionary income consumers have, i.e., income after paying tax, social security, etc.
- Levels of consumer confidence.
- Savings rates.

**What is an Economic System?**

**Economic systems** are the means by which countries and governments distribute resources and trade goods and services. They are used to control the five factors of production, including: labor, capital, entrepreneurs, physical resources and information resources. In everyday terms, these production factors involve the employees and money a company has at its disposal, as well as access to **entrepreneurs**, the people who want to run companies or start their own businesses. The physical materials and resources needed to run a business, along with the data and knowledge companies use to be successful, are also factors in production. Different economic systems view the use of these factors in different ways.

**Types of Economic Systems:** There are many economies around the world. Each has its own distinguishing characteristics, although they all share some basic features. Each economy functions based on a unique set of conditions and assumptions. Economic systems can be categorized into four main types: traditional economies, command economies, mixed economies, and market economies.

*1. Traditional economic system:* The traditional economic system is based on goods, services, and work, all of which follow certain established trends. It relies a lot on people, and there is very little division of labor or specialization. In essence, the traditional economy is very basic and the most ancient of the four types.

Some parts of the world still function with a traditional economic system. It is commonly found in rural settings in second- and third-world nations, where economic activities are predominantly farming or other traditional income-generating activities.

There are usually very few resources to share in communities with traditional economic systems. Either few resources occur naturally in the region or access to them is restricted in some way. Thus, the traditional system, unlike the other three, lacks the potential to generate a surplus. Nevertheless, precisely because of its primitive nature, the traditional economic system is highly sustainable. In addition, due to its small output, there is very little wastage compared to the other three systems.

*2. Command economic system:* In a command system, there is a dominant, centralized authority – usually the government – that controls a significant portion of the economic structure. Also known as a planned system, the command economic system is common in communist societies since production decisions are the preserve of the government.

If an economy enjoys access to many resources, chances are that it may lean towards a command economic structure. In such a case, the government comes in and exercises control over the resources. Ideally, centralized control covers valuable resources such as gold or oil. The people regulate other less important sectors of the economy, such as agriculture.

In theory, the command system works very well as long as the central authority exercises control with the general population's best interests in mind. However, that rarely seems to be the case. Command economies are rigid compared to other systems. They react slowly to change because power is centralized. That makes them vulnerable to economic crises or emergencies, as they cannot quickly adjust to changed conditions.

*3. Market economic system:* Market economic systems are based on the concept of free markets. In other words, there is very little government interference. The government exercises little control over resources, and it does not interfere with important segments of the economy. Instead, regulation comes from the people and the relationship between supply and demand.
The market economic system is mostly theoretical. That is to say, a pure market system doesn’t really exist. Why? Well, all economic systems are subject to some kind of interference from a central authority. For instance, most governments enact laws that regulate fair trade and monopolies.
From a theoretical point of view, a market economy facilitates substantial growth. Arguably, growth is highest under a market economic system.
A market economy’s greatest downside is that it allows private entities to amass a lot of economic power, particularly those who own resources of great value. The distribution of resources is not equitable because those who succeed economically control most of them.

*4. Mixed system:* Mixed systems combine the characteristics of the market and command economic systems. For this reason, mixed systems are also known as dual systems. Sometimes the term is used to describe a market system under strict regulatory control.
Many countries in the West follow a mixed system. Most industries are private, while the rest, comprised primarily of public services, are under the control of the government.
Mixed systems are the norm globally. Supposedly, a mixed system combines the best features of market and command systems. However, practically speaking, mixed economies face the challenge of finding the right balance between free markets and government control. Governments tend to exert much more control than is necessary.
**What is an Economic Policy?** An economic policy refers to actions that a government may take to alter the economy of a city, state, or nation. It is usually comprised of various measures, through which the government seeks to influence the overall economy. There are three methods through which a government typically seeks to control the economy with its budget, known as the allocative, stabilization, and distributive functions. While all three functions are always used collaboratively, their emphasis may change with each new government, era, and global economy.
The allocative function refers to how much of the government’s budget will be allocated to certain projects.
**Monetary policy:** Monetary policy is a central bank's actions and communications that manage the money supply. That includes credit, cash, checks, and money market mutual funds. The most important of these forms of money is credit. It includes loans, bonds, and mortgages.

Monetary policy increases liquidity to create economic growth. It reduces liquidity to prevent inflation. Central banks use interest rates, bank reserve requirements, and the number of government bonds that banks must hold. All these tools affect how much banks can lend. The volume of loans affects the money supply.

**Objectives of Monetary Policy:** Central banks have three monetary policy objectives.[1] The most important is to manage inflation. The secondary objective is to reduce unemployment, but only after controlling inflation. The third objective is to promote moderate long-term interest rates.

**Types of Monetary Policy:** Central banks use contractionary monetary policy to reduce inflation. They reduce the money supply by restricting the amount of money banks can lend. The banks charge a higher interest rate, making loans more expensive. Fewer businesses and individuals borrow, slowing growth.

Central banks use expansionary monetary policy to lower unemployment and avoid recession. They increase liquidity by giving banks more money to lend. Banks lower interest rates, making loans cheaper. Businesses borrow more to buy equipment, hire employees, and expand their operations. Individuals borrow more to buy more homes, cars, and appliances. That increases demand and spurs economic growth.

**Monetary Policy Tools:** All central banks have three tools of monetary policy in common. First, they all use open market operations. They buy and sell government bonds and other securities from member banks. This changes the reserve amount the banks have on hand. A higher reserve means banks can lend less. That's a contractionary policy. In the United States, the Fed sells Treasury's to member banks.

The second tool is the reserve requirement, in which the central banks tell their members how much money they must keep on reserve each night. Not everyone needs all their money each day, so it is safe for the banks to lend most of it out. That way, they have enough cash on hand to meet most demands for redemption. Previously, this reserve requirement has been 10%. However, effective March 26, 2020, the Fed has reduced the reserve requirement to zero.[8]

When a central bank wants to restrict liquidity, it raises the reserve requirement. That gives banks less money to lend. When it wants to expand liquidity, it lowers the requirement. That gives members banks more money to lend. Central banks rarely change the reserve requirement because it requires a lot of paperwork for the members.

The third tool is the discount rate. That's how much a central bank charges members to borrow funds from its discount window. It raises the discount rate to discourage banks from borrowing. That reduces liquidity and slows the economy. It lowers the discount rate to encourage borrowing. That increases liquidity and boosts growth.[9]

In the United States, the Federal Open Market Committee sets the discount rate a half-point higher than the fed funds rate. The Fed prefers banks to borrow from each other.

Most central banks have many more tools. They work together to manage bank reserves.

**Fiscal policy:** Fiscal policy is what the government employs to influence and balance the economy, using taxes and spending to accomplish this. Fiscal policy tries to nudge the economy in different ways through either expansionary or contractionary policy, which try to either increase economic growth through taxes and spending or slow economic growth to cutback inflation, respectively. Basically, fiscal policy intercedes in the business cycle by counteracting issues in an attempt to establish a healthier economy, and uses two tools - taxes and spending - to accomplish this.

Fiscal policy is often utilized alongside monetary policy, which involves the banking system, the management of interest rates and the supply of money in circulation.

The main goals of fiscal policy are to achieve and maintain full employment, reach a high rate of economic growth, and to keep prices and wages stable. But, fiscal policy is also used to curtail inflation, increase aggregate demand and other macroeconomic issues.

**Tools of Fiscal policy**: The first tool is taxation. That includes income, capital gains from investments, property, and sales. Taxes provide the income that funds the government. The downside of taxes is that whatever or whoever is taxed has less income to spend on themselves, which is why taxes are unpopular.

The second tool is government spending—which includes subsidies, welfare programs, public works projects, and government salaries. Whoever receives the funds has more money to spend, which increases demand and economic growth.

**Types of Fiscal Policy:** Expansionary Fiscal Policy and Contractionary Fiscal Policy

- **Expansionary Fiscal Policy:** Expansionary fiscal policy is used by the government when attempting to balance out the contraction phase of the business cycle (especially when in or on the brink of a recession), and uses methods like cutting taxes or increasing government spending on things like public works in an attempt to stimulate economic growth. Expansionary fiscal policy, therefore, attempts to fix a decrease in demand by giving consumers tax cuts and other incentives to increase their purchasing power (and, how much they spend).

  The goal behind expansionary fiscal policy is to lower tax rates and increase consumer aggregate demand, which will increase demand for products, requiring businesses to hire more employees to support the higher demand - and thus, increase employment.
- **Contractionary Fiscal Policy:** On the other hand, contractionary fiscal policy entails increasing tax rates and decreasing government spending in hopes of slowing economic growth for various reasons. In this way, the government may deem it necessary to halt or deter economic growth if inflation caused by increased supply and demand of cash gets out of hand.

  In this manner, contractionary fiscal policy reduces the amount of money in circulation, and, therefore - the amount available for consumers to spend. If an economy is booming and growing too rapidly (as may be caused by expansionary fiscal policy) - which, according to normal rates, should be no more than 3% per year - contractionary fiscal policy may be required to right it.

So, contractionary fiscal policy is often employed when the growth of the economy is unsustainable and is causing inflation, high investment prices, unemployment below healthy levels and recession.

**Fiscal Policy Versus Monetary Policy Comparison Chart**

| | Fiscal Policy | Monetary Policy |
|---|---|---|
| **Definition** | Fiscal policy is the use of government expenditure and revenue collection to influence the economy. | Monetary policy is the process by which th monetary authority of a country controls the suppl of money, often targeting a rate of interest to attai a set of objectives oriented towards the growth an stability of the economy. |
| **Principle** | Manipulating the level of aggregate demand in the economy to achieve economic objectives of price stability, full employment, and economic growth. | Manipulating the supply of money to influenc outcomes like economic growth, inflatior exchange rates with other currencies an unemployment. |
| **Policy-maker** | Government (e.g. U.S. Congress, Treasury Secretary) | Central Bank (e.g. U.S. Federal Reserve c European Central Bank) |
| **Policy Tools** | Taxes; amount of government spending | Interest rates; reserve requirements; currency peg discount window; quantitative easing; open marke operations; signaling |

### 1.1.2 Political Environment- Role of Government in Business

**Political Environment:** Political Environment is the state, government and its institutions and legislations and the public and private stakeholders who operate and interact with or influence the system. The political atmosphere should be good and very stable for a firm to operate successfully. Political Environment forms the basis of business environment in a country. If the policies of government are stable and better then businesses would get impacted in a positive way and vice versa.

**Role of Government in Business:** The Government's responsibilities towards business are as follows:

- **Enacting and Enforcing Laws:** Enacting and enforcing laws is the prime responsibility of the Government of each country. This is because laws and regulations only enable the businesses to function smoothly. Further, Government provides a system of court for adjudicating differences between firms, individual or Government agencies.

- **Maintaining Law and Order:** Maintaining law and order and protecting persons and property is another responsibility of the Government of the country. It would be impossible to carry on business in the absence of a peaceful atmosphere.
- **Providing Monetary System:** The Government has to provide monetary system so that business transactions can be affected. Further, it is also the responsibility of the Government to regulate money and credit, and protect the money value of the currency in terms of other currencies.
- **Balanced Regional Development and Growth:** It is the responsibility of the Government to make sure that there are balanced regional developments and growth.
- **Provision of Basic Infrastructure:** Government should provide basic infrastructural facilities such as transportation, power, finance, trained personnel and civic amenities, which are indispensable for the effective functioning of business concerns.
- **Supply of Information:** It is the responsibility of the Governments to provide information, which is useful to businessmen in carrying out their business activities. Government agencies publish and provide a large volume of information, which is used extensively by business firms. This information normally relates to economic and business activity, specific lines of business, scientific and technological developments, and many other things of interest to business houses or business leaders.
- **Assistance to Small-scale Industries:** It the responsibility of the Government to provide the required facilities and encourage the development of small-scale industries to overcome the problem faced by them.
- **Transfer of Technology:** It is the responsibility of the Government to transfer to private industries whatever discoveries are made by the Government – owned Research Institutions so that they can be used for commercial production.
- **Conducting Inspections:** It is the responsibility of the Government to inspect the private business concerns in order to make sure that they produce quality products, and also to prevent the production and sale of sub-standard goods.
- **Incentives to Home Industries:** It is the responsibility of the Government to encourage the development of home industries by providing them various incentives and subsidies.

### 1.1.3 Legal Environment- Consumer Protection Act, FEMA

**Legal Environment:** The government, in every country, regulates the business according to its defined priorities. Legal system of a country is framed by the government. The laws which are passed by the government for business operation is called legal environment. In every country, the government regulates business activities. These regulations of government are considered as legal environment. In practice legal and regulatory goes hand in hand. The limits for business operations are decided by regulatory environment & this is also called legal environment.

Legal environment in a country has a dominating position on all decisions of organization. As all business policies are highly influenced by government, the organization should have thorough knowledge of these policies because non-implementation of legal policies results in heavy fines, penalties & punishment & therefore every organization must follow all these regulations.

Following are some of the government Acts & government policies relating to legal or regulatory environment for business operations:

- The Sale of Goods Act, 1930.
- Indian Companies Act, 1956.
- Income Tax Act, 1961.
- The Consumer Protection Act, 1986.
- The Weights & Measures Act, 1958.
- Environment Protection Act, 1986.
- Agricultural Policy.
- Industrial Policy.
- Foreign Investment Policy.
- Monetary Policy.
- The Factories Act, 1948.
- The Minimum Wages act, 1948.

**Consumer Protection Act:** A Consumer Protection Act is piece of legislation that is passed with regard to the provision and administration of protecting the rights of consumers within a country or nation. Within the spectrum of both commercial law and consumer law, there exist a variety of roles which are undertaken by participatory individuals and groups operating within the scope of the commercial marketplace.

A Consumer Protection Act ensures that the rights of all involved parties are protected with regard to both the regulation of activity undertaken, in addition to ensuring that ethical and legal practices are employed.

**Consumer Protection Acts and the Commercial Marketplace:** Within the commercial marketplace, there exist 2 primary identifiers that are allocated to individuals and entities participatory in commercial exchange; within the scope of this activity, the roles, legislation, statutes, and requirements differ with regard to both – these roles are identified as consumers and suppliers. The notion of a Consumer Protection Act differs both in the country in which it is passed, in addition to the individual or entity for which it provides protection and regulation:

**Consumers:** Consumers are identified as individuals or entities who willingly participate within the commercial marketplace upon engaging in purchase and financial transaction with regard to products and services available for commercial purchase. On an international level, the passing of a respective Consumer Protection Act serves as a regulatory measure enacted in order to protect the rights of consumers.

**Supplier:** Suppliers – or vendors – are named as the individuals or entities within the commercial marketplace that provide products or services made available for consumer purchase. Although there exist a wide variety of statutory legislation with regard to acceptable practices with regard to suppliers, requirements including the provision of fair pricing, the illegality of commercial monopolization, and the abstinence from fraudulent advertising and product description are typical.

**Consumer Protection Acts Around the Globe**: The following Consumer Protection Acts have been passed and are currently enacted within various international locales:

In the United Kingdom, the Consumer Protection Act (1987) was passed in order to protect consumers from predatory or fraudulent commercial activity undertaken by suppliers or vendors; this Consumer Protection Act typifies and authorizes fair and ethical practices required by suppliers with regard to fair advertising, product liability, and ethical pricing structures – violations of this Consumer Protection Act may be regarded as either as a tort or criminal activity

In the United States, the Federal Trade Commission (FTC) is the governmental branch responsible for the administration and regulation of commercial affairs and the protection of consumer rights; the Federal Trade Commission has been responsible for the administration of Consumer Protection Acts including the Magnuson-Moss Warranty Act – this act clearly delineates the expectations, requirements, and legal responsibilities of suppliers

In India, the judicial system includes a legal venue called the Consumer Court; this court was implemented in order to solely hear, review, and try cases in which there exist disputes involving the violation of consumer rights

**Consumer Warranties and Service Contracts:** Whenever you buy merchandise, it comes with a warranty. This is a guarantee that it will serve the purpose it was purchased for—in other words; it will function.

The two basic types of warranty are express and implied. An express warranty is a promise from the seller, either written, oral, or expressed in an ad, promising that the item will perform its function for a specified period. Whether the item purchased is new or used, an express warranty is a guarantee that the item will work. However, not all items come with an express warranty.

The law automatically provides the second type of warranty, the implied warranty. Implied warranties are a part of all retail sales of new and used consumer goods. The retailer of an item implies that the item will work properly and be of average grade and quality, as long as it is used for the purpose it was sold. For example, a refrigerator will keep stuff cool as long as you are not trying to cool the entire room, and a blender will blend as long as you are not blending rocks.

Whenever you buy something, it's important to get warranty specifics in writing. Find out what the warranty covers. Does it include service fees if the item needs to be repaired? How long is the warranty? According to the Federal Trade Commission (FTC), an implied warranty can last as long as four years, but the actual time period can vary according to the state.

**Dealing with Warranty Breach:** If a warranty is breached, get the item replaced or repaired by the seller. If that doesn't work, try resolving the dispute through mediation. If that fails, you have the right to sue the manufacturer or seller.

Service contracts cannot be canceled after you've signed them, but according to the FTC, there is a cooling-off period in which, under certain circumstances, you might be able to void a contract. Contact the Federal Trade Commission at FTC.gov for information on the right way to approach your particular situation.

To file a complaint about a seller or manufacturer, you can contact the Federal Trade Commission, Consumer Product Safety Commission, or call up your local prosecutor and ask for the consumer fraud division. If you were defrauded by a telephone solicitor or fell into a TV advertisers trap, the Federal Communications Commission is the place to turn for help.

**Avoiding Scams:** According to the book "The Truth About Avoiding Scams," by Steve Weisman, scam artists always take advantage of whatever is happening at a particular place in time. In the wake of the housing bust of 2008, for example, there were a lot of phony foreclosure rescues that caused people to lose the equity in their house to so-called rescuers. There are also numerous scams involving popular social websites like Facebook.

It also helps to use credit cards, not debit cards, for online shopping. Debit cards offer fewer protections. A debit card could also give access to your entire checking or savings account.

Keeping an Eye on Scams

Closely review every item on your monthly bills. If there is a transaction you don't recognize, question the creditor in writing. If you think a charge is fraudulent, also notify your card company in writing no later than 60 days after the charge appears. Customers should use a separate email account for their online shopping. This method helps avoid spam. Also, never respond to emails asking you to "confirm" recent transactions after you shop because they can be phishing scams.

**Getting Your Facts:** Under the Fair and Accurate Credit Transaction Act (FACTA), you are entitled to a free copy of your credit report, at your request, once every 12 months. Financial institutions use the information contained in this report to determine risk in lending to you. Consumers usually find out about this report only after there has been negative information reported (mishandled accounts, erroneous data, and so on).

A report can be obtained annually for free from credit reporting agencies. It contains accounts opened and checks ordered in your name. However, it is not the same as the free full consumer credit report. This report is a completely separate report that the mass majority of consumers only find out about after they have been declined by a financial institution to open a checking or savings account. The majority of banks and credit unions use the information contained in the report to approve, decline, or determine what type of account if any, can be opened at their financial institution. Consumers who have a negative report may not be able to open a checking or savings account for five years.

**The Bottom Line:** Finding out about the warranties of products you buy, reading service contracts, avoiding scams, and obtaining a consumer report is part of the overall maintenance of your financial health. Staying on top of these details helps you to make better-informed decisions and get more out of your hard-earned money. There are many other acts worth learning about that apply in certain situations, including the Home Owner Protection Act, the Home Affordable Modification Program, the *Fair Credit Reporting Act* (FCRA), the Electronic Funds Transfer Act, the *Fair Debt Collection Act,* and the Fair Credit Billing Act.

**FEMA:** The Foreign Exchange Management Act (1999) or in short FEMA has been introduced as a replacement for earlier Foreign Exchange Regulation Act (FERA). FEMA became an act on the 1st day of June, 2000. FEMA was introduced because the FERA didn't fit in with post-liberalization policies. A significant change that the FEMA brought with it, was that it made all offenses regarding foreign exchange civil offenses, as opposed to criminal offenses as dictated by FERA.

The **main objective** behind the Foreign Exchange Management Act (1999) is to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments. It was also formulated to promote the orderly development and maintenance of foreign exchange market in India.

FEMA is applicable to all parts of India. The act is also applicable to all branches, offices and agencies outside India owned or controlled by a person who is a resident of India. The FEMA head-office, also known as Enforcement Directorate is situated in New Delhi and is headed by a Director. The Directorate is further divided into 5 zonal offices in Delhi, Mumbai, Kolkata, Chennai and Jalandhar and each office is headed by a Deputy Director. Each zone is further divided into 7 sub-zonal offices headed by the Assistant Directors and 5 field units headed by Chief Enforcement Officers.

**Important FEMA Guidelines and Features** Most significantly, FEMA regarded all forex-related offences as civil offences, whereas FERA regarded them as criminal offences. Additionally, there were other important guidelines such as:

- FEMA did not apply to Indian citizens who resided outside India. This criterion was checked by calculating the number of days a person resided in India during the previous financial year (182 days or more to be a resident). It was noted that even an office, a branch, or an agency could be a 'person' for the purpose of checking residency.
- FEMA authorized the central government to impose restrictions on and supervise three things – payments made to any person outside India or receipts from them, forex, and foreign security deals.
- It specified the areas around acquisition/holding of forex that required specific permission of the Reserve Bank of India (RBI) or the government.

- FEMA put foreign exchange transactions into two categories – capital account and current account. A capital account transaction altered the assets and liabilities outside India or inside India but of a person resident outside India. Thus, any transaction that changed overseas assets and liabilities for an Indian resident in a foreign country, or vice versa, was classified as a capital account transaction. Any other transaction fell into the current account category.

**FEMA and Capital Account Transactions:** FEMA also gave the RBI the authority to regulate capital account transactions. As per the Foreign Exchange Management (Permissible Capital Account Transactions) Regulations of 2000, "no person shall undertake or sell or draw foreign exchange to or from an authorized person for any capital account transaction". The Regulations prohibited any person resident outside India from investing in Indian firms or organizations in the business of chit funds such as a Nidhi company, agricultural or plantation activities, real estate (excluding development of townships, construction of residential/commercial premises, roads or bridges), or construction of farm houses, and/or in trading in Transferable Development Rights (TDRs).

It did allow for transactions carried out by Indian residents that included investments in foreign securities, foreign currency loans raised in and out of India, transfer of immovable property outside India, the issue of guarantees in favor of anybody living outside India, and the export/import and holding of currency/currency notes.

**FEMA and Current Account Transactions:** Under The Foreign Exchange Management Act, the central government issued the Foreign Exchange Management (Current Account Transaction) Rules of 2000 which restricted forex deals made by authorized persons under their current account. Under the FEMA rules, current account transactions that were prohibited, not prohibited, and permitted, required the prior approval of the central government and/or RBI.

Prohibited transactions included the remittance of lottery winnings, income from racing/riding, purchase of lottery tickets, banned/proscribed magazines, football pools, sweepstakes, commission on exports made towards equity investment in JVs/wholly owned subsidiaries of Indian companies abroad, amongst others. Additionally, Nepal and Bhutan allowed the use of Indian currency for local transactions, and the citizens of these countries were considered at par with Indian citizens from a legal standpoint. Because of these provisions allowing for a common currency market in India, Nepal and Bhutan, use of forex for transactions in – or with the residents of – Nepal and Bhutan was also prohibited.

Moreover, FEMA recognized the growing international presence of Indians as well as the rising contribution of Non-Resident Indians (NRIs) to the Indian economy. Thus, it allowed individuals to avail forex facility (up to a limit of US$250,000) for a variety of purposes that included international travel to any country (except Nepal and Bhutan), gifts, donations, travel for overseas employment, emigration and maintenance of close relatives living abroad.

**How Does FEMA Empower Authorities and Citizens?** The RBI was the overall controlling authority as far as FEMA was concerned. It worked with and empowered the central bank to specify the different classes of capital account transactions along with the exchange rate admissible for each such transaction.

- Authorized persons could withdraw or sell forex; however, the Act empowered the RBI to put several restrictions on their capital account. Authorized persons were expected to provide details and information regarding forex transactions to the RBI on a regular basis.
- FEMA allowed Indian residents to carry out transactions in forex, foreign security, or to own immovable property abroad. This was permitted if the currency, security, or property was owned or acquired when he/she was living outside India, or if it was inherited by him/her from someone living outside India.
- FEMA regulations covered forex transactions and remittances which included individuals or entrepreneurs moving money in or out of India, or exchanging foreign currency in India for travel purposes.
- There were many subsequent regulations and notifications issued under the Act addressing specific issues such as authentication of documents, current account transactions, adjudication proceedings and appeal, compounding proceedings, permissible capital account transactions and borrowing or lending in forex, amongst others.

Indeed, FEMA was drafted to create a more liberal foreign exchange market in India. The Act encouraged deregulation of foreign exchange and smooth international trade. FEMA also has a distinct administrative difference from FERA, which sought to impose sweeping regulations on every aspect of India forex transaction. On the other hand, FEMA aimed to manage only certain forex transactions that might have an impact on national security and the wider national economy, and opened up individual forex transactions to the free market.

With *Drip Capital's* expert guidance and consulting, entities can better comply with FEMA. This includes specific guidance on FEMA-applicable areas and export businesses within India as well as all branches, offices, and agencies located outside India that are owned or controlled by a resident of India.

**Objectives of FEMA:** The main objective for which FEMA was introduced in Indian was to facilitate external trade and payments. In addition to this, FEMA was also formulated to assist orderly development and maintenance of the Indian forex market. FEMA outlines the formalities and procedures for the dealings of all foreign exchange transactions in India. These foreign exchange transactions have been classified into two categories — Capital Account Transactions and Current Account Transactions.

Under the FEMA Act, the balance of payment is the record of dealings between the citizen of different countries in goods, services and assets. It is mainly divided into two categories, i.e. Capital Account and Current Account. Capital Account comprises all capital transactions whereas Current Account comprises trade of merchandise.
Current Account transactions are those transactions which involve inflow and outflow of

money to and from the country/countries during a year, due to the trading/rendering of commodity, service, and income. The current account is an indicator of an economy's status.

As mentioned above the balance of payment comprises current and capital accounts, the remainder of the Balance of Payment is Capital Account, which consists the movement of capital in the economy due to capital receipts and expenditure. Capital account recognizes domestic investment in foreign assets and foreign investment in domestic.

**Applicability of FEMA Act:** FEMA (Foreign Exchange Management Act) is applicable to the whole of India and equally applicable to the agencies and offices located outside India (which are owned or managed by an Indian Citizen). The head office of FEMA is situated at New Delhi and known as Enforcement Directorate.

FEMA is applicable to:

- Foreign exchange
- Foreign security
- Exportation of any commodity and/or service from India to a country outside India
- Importation of any commodity and/or services from outside India
- Securities as defined under Public Debt Act 1994
- Purchase, sale and exchange of any kind (i.e. Transfer)
- Banking, financial and insurance services
- Any overseas company owned by an NRI (Non-Resident Indian) and the owner is 60% or more
- Any citizen of India, residing in the country or outside (NRI)

The Current Account transactions under the FEMA Act has been categorized into three parts which, namely-

(i) Transactions prohibited by FEMA,
(ii) The transaction requires Central Government's permission,
(iii) The transaction requires RBI's permission.

**Prohibition on Drawal of Foreign Exchange:**

- Any kind of remittance out of winning the lottery
- Any kind of remittance from the income on racing/riding etc,
- Any remittance for buying of a lottery ticket, football pools, sweepstakes, banned/prescribed magazines etc.,
- Commission payment on exports towards equity investment of Indian Companies in Joint ventures/wholly owned subsidiaries abroad.
- Remittance of dividend by any company. However, this clause is applicable only if the requirement of dividend balancing is applicable.
- Commission payment on exportation under Rupees State Credit Routes except commission up to 10% of invoice value of export of tea and tobacco,
- Payment regarding " Call back Services" of telephones
- A travel to Bhutan and/or Nepal

- Remittance of interest income on funds held in NRSR Account i.e. Non-resident Special Rupees Scheme account
- A transaction with a resident of Bhutan or Nepal.

**Route for Drawal of Foreign Exchange:** According to Reserve Bank of India foreign Exchange can be drawn from any authorized dealer by the Prior Approval Route or General Permission Route.

| S.No. | Particulars | Limitations |
|---|---|---|
| 1. | Visiting privarely to any country (except Bhutan and Nepal) | 10,000 US dollars or its equivalents for one or more private visits in one year. |
| 2 | Donations/Gift per donor | Remittance should not exceed 1,25,000 US dollar during a Financial Year |
| 3 | Corporate Donations | 1 percent of the forex earnings during the preceeding three Financial Year or 5 million US dollar, whichever is less, for a specified purpose |
| 4 | Going out of India for the purpose of employment | 1,00,000 US dollar one time only |
| 5 | Remittance facility for emigrations | 1,00,000 US dollar or the prescribed amount by country of emigration not exceeding 1,00,000 US dollar one time only. |
| 6 | Remittance for maintenance of relatives (only close relative) outside India | salary (after the deduction of income tax, Provident Fund and other deduction) of a person not being a permanent resident in India and a citizen of foreign state other than Pakistan.<br>Or<br>1,00,000 US dollar a year per recipient in all other cases |
| 7 | Business Travel Abroad | 25000 US dollar per trip respective of stay |
| 8 | Attending specialized training or conference | 25000 US Dollar |
| 9 | For Medical treatment | 1,00,000 US Dollar |

| | | |
|---|---|---|
| 10 | Maintenance of a patient going for medical check-up or medical treatment abroad | 25000 US Dollar |
| 11 | For Studying in Abroad | 1,00,000 US Dollar per academic Year or the Institution’s estimation whichever is higher. |
| 12 | Meeting the expenses of a person accompanying as attendance to a patient going medical check-up or for medical treatment abroad | 25000 US Dollar |
| 13 | Payment of commission to an agent outside India for selling of commercial or residential plot or flats in India | 25000 US Dollar or 5 % of inward remittance per transactions whichever is higher |
| 14 | Consultancy services from abroad | 1 million US Dollar per project to 10 million US Dollar per project (for infrastructure project)<br>1 million US Dollar In all other cases. |
| 15 | Pre-incorporation’s expenses reimbursement | 100,000 US Dollar or 5 percent of the investment brought into India whichever is higher, |
| 16 | Remittance for purchase and/or use of Trade mark | Allowed without any approval of Reserve Bank of India |
| 17 | Remittance for securing Health Insurance for from a foreign company | Freely allow |
| 18 | Remittance of royalty and payment of lump sum fee under the technical collaboration agreement | Freely allow without any prior approval of RBI |
| 19 | Release of exchange for medical treatment outside India when a person has fallen sick after proceeding abroad | Extent of USD 1,00,000 without any hassles and any loss of time on the basis of self declarations |
| 20 | Small Value Remittance | Up to USD 25000 (form A2) |

Transactions for which Central Government prior approval is required for Drawl of foreign exchange

- Cultural tours.
- Advertisement in print media of a foreign country for any purpose other than promoting tourism, international bidding and foreign investments (exceeding 10000 US Dollar) by a State Government and its Public Sector Units.
- Payment of importation by a Public Sector Unit or a department of government on c.i.f. basis only for importation through ocean transport.
- Remittance of freight of vessels chartered.
- Remittance of detention charges of container exceeding the DGS's (Director General of Shipping) prescribed rate.
- Remittance of Prize money/sponsorship of any activity of sport outside India by a person other than national/ international/street level sports bodies, if the amount of the prize money/sponsorship exceeds 1,00,000 US Dollars.
- Remittance of hiring charges of transponders:
- Internet Service Providers
- TV channels
- Remittance for P&I Club ministry's membership.
- Remittance by Multi-model transport operators to their agents in abroad

**1.1.4 Socio-cultural Factors and their Influence on Business:** Our business doesn't operate in a vacuum, especially if you do a lot of work overseas. This means societal and cultural changes can have an impact on your company based on how your target audience's attitudes and moods shift over time. Socio-cultural factors can involve social attitudes, beliefs, education, legal structure and political ideology.

**Changing Preferences Require Adaptation:** One of the major socio-cultural factors influencing businesses and business decisions is changing consumer preferences. What was popular and fashionable 20 years ago may not be popular today or 10 years down the road. Different styles and priorities can undermine long successful products and services. For example, a clothing company must constantly be aware of changing preferences when creating new products or it will quickly become outdated.

**Changing Demographics Affect How You Target Your Audience:** Changes in demographics are also a significant factor in the business world. As populations age, for example, markets for popular music and fashions may shrink while markets for luxury goods and health products may increase. Additionally, changes in the proportion of genders and different racial, religious and ethnic groups within a society may also have a significant impact on the way a company does business.

This is especially true when it comes to marketing products and services to a younger generation. For example, clothing styles are always changing, but the most significant change occurs in the demographics of prospective buyers. It used to be that business owners in the clothing industry could cast a wide net and reel in customers, but with audiences so segmented, understanding the growing power of Generation Z, for example, is vital. This audience is often categorized as buyers born in 1995 onwards, and they have emerged over the past five years as a motivated consumer group.

**Gender and Racial Attitudes Impact Internal Work Environment:** In addition to a company's interactions with the market and its customers, socio-cultural factors also impact a company's internal decision-making process. For example, changing gender roles and increasing emphasis on family life have led to increased respect for maternity and paternity leave with organizations. Additionally, attitudes toward racial discrimination and sexual harassment have changed drastically over the years as a result of a socio-cultural change.

More recently, sexual harassment has become an explosive issue, driven by the countless number of powerful corporate leaders that have run afoul of harassment charges. As a result, societal attitudes about how women should be treated in the workplace have dramatically shifted. In the past, an “old boys’ network” was tolerable if only because women didn’t feel empowered to push back against entrenched ideas about their work roles. But as women have begun speaking up and telling their stories regarding harassment, company leaders have taken note.

It’s no longer acceptable for you to take a laissez-faire attitude about how your female employees are treated by male colleagues. Business leaders that maintain this type of work environment not only risk breaking the law; they risk the reputation of a permissive, hostile workplace that will ultimately damage their brand.

### 1.1.5 Corporate Social Responsibility (CSR)

**Definition**: Corporate Social Responsibility (also known as CSR, corporate conscience, and corporate citizenship) is the integration of socially beneficial programs and practices into a corporation's business model and culture. CSR aims to increase long-term profits for online and offline businesses by enabling them to become more efficient and attract positive attention for their efforts.

What Benefits Does CSR Offer to Businesses? Both ecommerce and brick-and-mortar businesses stand to benefit from the implementation of CSR strategies. Some activities that fall under the umbrella of CSR, with their corresponding benefits, include:

- Prevent financial ramifications: Compliance with the spirit and letter of the law — both nationally and internationally — through self-regulatory processes will prevent fines, put your business "low on regulators' radar screens," and lower legal expenses.

- Increase employee loyalty: Treating your employees fairly and generously is a part of corporate social responsibility. By providing good jobs and encouraging high professional and moral standards, you increase employee loyalty, and by procuring only those overseas products produced at factories where workers were treated ethically, you gain support among "Fair Trade" advocates.
- Maintain a positive reputation: Demonstrated consciousness in a variety of areas can garner publicity and give a business tangible proof of their conduct, which can be proudly displayed on a company website. These include:
    - Environmental consciousness: Reducing waste, recycling, minimizing carbon footprint, and other best practices can. Using or producing only sustainable products, lowering energy usage, and supporting environmental causes will boost a business's "green reputation" among environmentally concerned clients.
    - Social Concern: Donating to humanitarian causes that fight persistent poverty, help the victims of epidemics like AIDS or Ebola, or assist those displaced by hurricanes or earthquakes shows concern for issues that consumers are more and more aware of in our modern, interconnected world.
    - Local Community: Involvement in local community projects, either through financial donations, employee participation, connecting your customers with project leaders, or promotion of the project through advertising and fundraising enhances your CSR credentials with clients in the given location.

**Four Corporate responsibility types your business can practice:** Recognizing how important socially responsible efforts are to their customers, employees and stakeholders, many companies now focus on a few broad CSR categories:

1. Environmental efforts: One primary focus of corporate social responsibility is the environment. Businesses, regardless of size, have large carbon footprints. Any steps they can take to reduce those footprints are considered good for both the company and society.
2. Philanthropy: Businesses can practice social responsibility by donating money, products or services to social causes and nonprofits. Larger companies tend to have a lot of resources that can benefit charities and local community programs. It is best to consult with these organizations about their specific needs before donating.
3. Ethical labor practices: By treating employees fairly and ethically, companies can demonstrate their social responsibility. This is especially true of businesses that operate in international locations with labor laws that differ from those in the United States.
4. Volunteering: Attending volunteer events says a lot about a company's sincerity. By doing good deeds without expecting anything in return, companies can express their concern for specific issues and commitment to certain organizations.

## Sub Unit - 2: INTERNATIONAL BUSINESS

### 1.2.1 Scope and Importance of International Business

**Meaning of International Business:** International business is the process of implying business across the boundary of the country at a global level. It focuses on the resources of the globe and objectives of the organization on the global business.

International business refers to the global trade of goods/services outside the boundaries of a country. International business conducts business transactions all over the world, it is also known as Global Business. It includes transaction between the parties in different global location.

If you are making a transaction with the International e-commerce websites i.e, AliExpress, Amazon, E-bay than you are making an International transaction. The trade allows a country to specialize in producing and exporting the most efficient products that can be produced in that country. International business consists of the movement to other countries of goods, products, technology, experience of management and resources.

**Scope of International Business**

***Foreign Investments:*** Foreign investment is an important part of international business. Foreign investment contains investments of funds from the abroad in exchange for financial return. Foreign investment is done through investment in foreign countries through international business. Foreign investments are two types which are direct investment and portfolio investment.

***Exports and Imports of Merchandise:*** Merchandise are the goods which are tangible. (those goods which can be seen and touched.). As mentioned above, merchandise export means sending the home country's goods to other countries which are tangible and merchandise imports means bringing tangible goods to the home country.

***Licensing and Franchising:*** Franchising means giving permission to the new party of the foreign country in order to produce and sell goods under your trademarks, patents or copyrights in exchange of some fee is also the way to enter into the international business. Licensing system refers to the companies like Pepsi and Coca-Cola which are produced and sold by local bottlers in foreign countries.

***Service Exports and Imports:*** Services exports and imports consist of the intangible items which cannot be seen and touched. The trade between the countries of the services is also known as invisible trade. There is a variety of services like tourism, travel, boarding, lodging, constructing, training, educational, financial services etc. Tourism and travel are major components of world trade in services.

***Growth Opportunities*:** There are lots of growth opportunities for both of the countries, developing and under-developing countries by trading with each other at a global level. The imports and exports of the countries grow their profits and help them to grow at a global level.

Benefiting from Currency Exchange

International business also plays an important role while the currency exchange rate as one can take advantage of the currency fluctuations. For example, when the U.S. dollar is down, you might be able to export more as foreign customers benefit from the favourable currency exchange rate.

***Limitations of the Domestic Market:*** If the domestic market of a country is small then the international business is a good option for the growth of the business in the host country. Depression of domestic market firms will force to explore foreign markets.

**Importance of International Business:**

1. To achieve higher rate of profits
2. Expanding the production capacity beyond the demand of the domestic country
3. Severe competition in the home country
4. Limited home market
5. Political conditions
6. Availability of technology and managerial competence
7. Cost of manpower, transportation
8. Nearness to raw material
9. Liberalization, Privatization and Globalization (LPG)
10. To increase market share
11. Increase in cross border business is due to falling trade barriers (WTO), decreasing costs in telecommunications and transportation; and freer capital markets

**1.2.2 Globalization and its Drivers:** Globalization, in the most basic sense, can be defined as a trend in which countries across the globe are joining economically. Hill (2009) describes the major facets of globalization to include the globalization of markets and the globalization of production. The globalization of markets is a result of merging local and national markets to create one somewhat homogenous "global" market whereby the individual preferences of regions, or nations, have converged. On the other hand, the globalization of production has allowed firms to split their operations internationally. As a result, each stage of production for these firms takes place in countries around the world in areas where work can be accomplished at the lowest cost. The decrease in international trade and investment barriers and advancements in technology have served as the major drivers of globalization. Furthermore, Hill (2009) identifies that globalization has had an effect on the demographics of the global economy. This paper provides an analysis of the major drivers and effects of globalization and recognizes some of international trade theories that support the need for a global economy. ***Drivers of Globalization:*** The first major driver influencing the spread of globalization is the decline in barriers to free trade. Since the end of World War II, the advanced nations of the West have advocated the free flow of goods, services, and capitol between nations. Hence, the General Agreement on Tariffs and Trade (GATT) and, later, the World Trade Organization (WTO) have worked toward reducing or removing many of the longstanding trade barriers. Additionally, many countries have begun removing restrictions to foreign direct investment. Consequently, firms can more easily invest in business opportunities in another country.

**1.2.3 Modes of Entry into International Business:** The different types of entry modes, to penetrate a foreign market, arise due to globalization. The latter has drastically changed the way business conduct at international level. Owing to advances in transportation, technology and communications, nowadays practically every business of any size can supply or distribute goods, services, or intellectual property. However, when companies deal with international markets, it is complicated as the companies must be prepared to surmount differences in currency issues, language problems, cultural norms, and legal and regulatory regimes. Only the largest companies have the capital and knowledge to overcome these complications on their own. Many other businesses simply do not have the means to efficiently and affordably deal with all those variables in foreign jurisdictions, without a partner in the host country.

**1. Export Entry Modes:** Export mode is the most common strategy to use when entering international markets. Exporting is the shipment of products, manufactured in the domestic market or a third country, across national borders to fulfill foreign orders. Shipments may go directly to the end user, to a distributor or to a wholesaler. Exporting is mainly used in initial entry and gradually evolves towards foreign-based operations. Export entry modes are different from contractual entry modes and investment entry modes in a way that they are directly related to manufacturing. Export can be divided into direct and indirect export depending on the number and type of intermediaries.

***1.1 Direct Exporting (Sell to Buyers):*** Direct exporting means that the firm has its own department of export which sells the products via an intermediary in the foreign economy namely direct agent and direct distributor. This way of exporting provides more control over the international operations than indirect exporting. Hence, this alternative often increases the sales potential and also the profit. There is as well a higher risk involved and more financial and human investments are needed.

There are differences between distributors and agents. The basis of an agent's selling is commissions, while the distributors' income is a margin between the prices the distributor buys the product for and the final price to the wholesalers or retailers. In contrast to agents the distributors usually maintain the product range. The agents also do not position the products, and do not hold payments while the distributors do both and as well as provide customers with after sales services. Using agents or distributors to introduce the products to a foreign market will have the advantages that they have knowledge about the market, customs, and have established business contacts.

**Advantages of Direct Export:**

- Access to the local market experience and contacts to potential customers.
- Shorter distribution chain (compared to indirect exporting).
- More control over marketing mix (especially with agents).
- Local selling support and services available.

**Disadvantages of Direct Export:**

- Little control over market price because of tariffs and lack of distribution control (especially with distributors).
- Some investment in sales organization required (contact from home base with distributor or agents).
- Cultural difference, providing communications problems and information filtering (transaction cost occurs).
- Possible trade restrictions.

***1.2 Indirect Exporting (Sell to Intermediaries):*** Indirect exporting is when the exporting manufactures are using independent organizations that are located in the foreign country. The sale in indirect exporting is like a domestic sale, and the company is not really involved in the global marketing, since the foreign company itself takes the products abroad.

Indirect export is often the fastest way for a company to get its products into a foreign market since customer relationships and marketing systems are already established. Through indirect export, it is the third party who will handle the whole transactions. This approach for exporting is useful for companies with limited international expansion objectives and if the sales are primarily viewed as a way of disposing remaining production, or as marginal. The types of indirect export are as follows:

- Export management companies
- Export trading companies
- Export broker agents

**Advantages of Indirect Export:**

- Limited resources and investment required.
- High degree of market diversification is possible as the company utilize the internationalization of an experienced exporter.
- Minimal risk (market and political).
- NO export experience required.

**Disadvantages of Indirect Export:**

- No control over marketing mix elements other than product.
- An additional domestic member in the distribution chain may add costs, leaving smaller profit to producer.
- Lack of contact with market (no market knowledge acquired).
- Limited product experience (based on commercial selling).

**2. Contractual Entry Modes:** Contractual entry modes are long term non-equity alliance between the company that wants to internalize and the company in target country for entry mode. There are many types of contractual entry mode namely technical agreements, Service contracts, managements, contract manufacture, Co-production agreements and others. The most use contractual entry modes are Licensing, Franchising and Turnkey projects which is going to be explained below.

**2.1 Licensing**: Licensing concerns a product rights or the method of production marketing the product rights. These rights are usually protected by a patent or some other intellectual right. Licensing is when the exporter, the licensor, sells the right to manufacture or sell its products or services, on a certain market area, to the foreign party (the licensee). Based on the agreement, the exporter receives a onetime fee, a royalty or both. The royalty can vary, often between 0.125 and 15 per cent of the sales revenue. In other words, in a licensing agreement, the licensor offers propriety assets to the licensee. The latter is in the foreign market and has to pay royalty fees or made a lump sum payment to the licensor for assets like e.g. trademark, technology, patents and know-how. Licensing agreement's content is usually quite complex, wide and periodic.

Other than the intellectual property rights, the licensing contract might also include turning-in unprotected know-how. In this licensing contract, the licensor is committed to give all the information to the licensee about the operation. There are many types of licensing arrangements. In a licensing arrangement, the core is patents and know-how, which can be completed by trademarks, models, copyrights and marketing and management's know-how.

Licensing contract is divided into three main **types of licensing**:

- Product licensing, the idea of licensing is to agree on usage, manufacturing or marketing right of the whole product, a partial product, a component or a product improvement.
- Method licensing, the method licensing agreement turns in the right to use a certain manufacturing method or a part of it and also possibly the right to use model protection.
- Representation licensing agreement is usually done within two companies that are concentrated on project deliveries, in this case the contract will relate to for example projecting systems, sharing manufacturing and marketing procedures.

**Advantages of licensing:**

- The ability to enter several foreign markets simultaneously by using several licensees or one licensee with access to a regional market, for example the European Union.
- Enter market with high trade barriers.
- It is a non-equity mode; therefore, licensor make profit quickly without big investments. The firm does not have to bear the development costs and risks associated with opening a foreign market.
- Licensing also saves marketing and distribution costs, which are left for the licensee.
- Licensing also enables the licensor to get insight of licensee's market knowledge, business relations and cost advantages.
- The licensor decreases the exposure to economic and political instabilities in the foreign country.
- Can be used by inexperienced companies in international business.
- Avoid the cost to customer of shipping large bulky products to foreign markets.

**Disadvantages of licensing:**

- There is a risk that the licensee may become a competitor once the term of the agreement concludes, by using the licensor's technology and taking their customers.
- Not every company can use this entry model unless in possess certain type of intellectual property right or the name of the company is of enough interest to the other party.
- The licensor's income from royalties is not as much as would be gained when manufacturing and marketing the product themselves.
- There is another risk that the licensee will under-report sales in order to lower the royalty payment

**2.2 Franchising:** Franchising is a form of licensing, which is most often used as market entry modes for services such as fast foods, business to-consumer services and business-to-business services. Franchising is somewhat like licensing where the franchiser gives the franchisee right to use trademarks, know-how and trade name for royalty. Franchising does not only cover products (like licensing) but it usually contains the entire business operation including products, suppliers, technological know-how, and even the look of the business. The normal time for a franchisee agreement is 10 years and the arrangement may or may not include operation manuals, marketing plan and training and quality monitoring.

The idea of the franchising chain is that all parties use a uniform model in order to make the customer of a franchising chain may feel that he is dealing with franchisor's company itself. In fact, regarding to the law, the customer is dealing with independents companies that have even have different owners. Franchising agreement usually includes training and offers management services, as the operations are done in accordance with the franchisor's directions. Franchising has especially spread to areas, where certain selling style, name and the quality of service are crucial.

Franchisee has different customs on the payments to the franchisor. Normally when a company joins the franchising chain it pays a one-time joining fee. As the operation goes on, the franchisee pays continues service fess that usually are based on the sales volumes of the franchisee company.

**Advantages of franchising:**

- Same as licensing above.
- Like with licensing, the franchisor gain local knowledge of the market place and in this case the domestic franchisee is highly motivated.
- The fast expansion to a foreign market with low capital expenditures, standardized marketing, motivated franchisees and taking of low political risk.

**Disadvantages of franchising:**

- Same as in licensing above.
- Since franchising requires more capital initially, it is more suitable to large and well-established companies with good brand images. So small firm get often problem to use this entry modes.

- Home country franchisor does not have daily operational control of foreign store. There is a risk that franchisees may not perform at desired quality level.
- more responsibilities, more complicated and greater commitment to foreign firm than licensing or exports.

**2.3 Turnkey Project:** In turnkey projects, the contractor agrees to handle every detail of the project for a foreign client, including the training of operating personnel. At completion of the contract, the foreign client is handed the "key" to a plant that is ready for full operation. Hence, we get the term turnkey. The company, who make the turnkey project, works overseas to build a facility for a local private company or agency of a state, province or municipality. This is actually a means of exporting process technology to another country. Typically, these projects are large public sector project such as urban transit stations, commercial airport and telecommunications infrastructure.

Sometimes a turnkey project such as an urban transit system takes the form of a build-operate-transfer or a built-own-operate-transfer project. A sophisticated type of counter trade, in which the builder operates and may also own a public sector project for a specified period of years before turning it over to the government.

**Advantages of Turnkey Projects:**

- They are a way of earning great economic returns from the know-how required to assemble and run a technologically complex process, for example contractor must train and prepare owner to operate facility.
- Turnkey projects may also make sense in a country where the political and economic environment is such that a longer-term investment might expose the firm to unacceptable political and/or economic risk.
- Less risky than conventional FDI.

**Disadvantages of Turnkey Projects:**

- The firm that enters into a turnkey deal will have no long-term interest in the foreign country.
- The firm that enters into a turnkey project may create a competitor. If the firm's process technology is a source of competitive advantage, then selling this technology through a turnkey project is also selling competitive advantage to potential and/or actual competitors.

**3. Investment Entry Modes:** Investment entry modes are about acquiring ownership in a company that is located in the foreign market. In other word, the activities within this category involve ownership of production units or other facilities in the overseas market, based on some sort of equity investment. Several companies want to have ownership in some or all of their international ventures. This can be achieved by joint ventures (equity based), acquisitions, green-field investment.

***3.1 Joint Ventures:*** A joint venture is a contractual arrangement whereby a separate entity is created to carry on trade or business on its own, separate from the core business of the participants. A joint venture occurs when new organizations are created, jointly owned by both partners. At least one of these partners must be from another country than the rest and the location of the company must be outside of at least one party's home country.

Typically, a company forming a joint venture will often partner with one of its customers, vendors, distributors, or even one of its competitors. These businesses agree to exchange resources, share risks, and divide rewards from a joint enterprise, which is usually physically located in one of the partners' jurisdictions. The contributions of joint venture partners often differ. The local joint venture partner will frequently supply physical space, channels of distribution, sources of supply, and on-the ground knowledge and information. The other partner usually provides cash, key marketing personnel, certain operating personnel, and intellectual property rights.

Joint venture is an equity entry mode. Ownership of the venture may be 50% for each party, or may be other proportions with one party holding the majority share. In order to make a joint venture remain successful on a long-term-basis, there must be willingness and careful advance planning from both parties to renegotiate the venture terms as soon as possible. When multiple partners participate in the joint venture, the venture maybe called a consortium.

**Advantages of a Joint venture:**

- Joint venture makes faster access to foreign markets. The local partner to the joint venture may have already established itself in the marketplace and often will have already obtained, or have access to, government contacts, lines of credit, regulatory approvals, scarce supplies and utilities, qualified employees, and cultural knowledge. Upon formation of the Joint venture, the non-resident partner has access to the local partner's pre-established ties to the local market.
- When the development costs and/or risks of opening a foreign market are high, a firm might gain by sharing these costs and/or risks with a local partner. In many countries, political considerations make joint ventures the only feasible entry mode.
- The reputation of the resident partner gives the joint venture credibility in the local marketplace, especially with existing key suppliers and customers.

**Disadvantages of Joint venture:**

- Shared ownership can lead to conflicts and battles for control if goals and objectives differ or change over time.
- Joint venture can foreclose other opportunities for entry into a foreign marketplace.

- It can be difficult for a joint venture to independently obtain financing, particularly debt financing. That is, in part, because Joint venture are usually finite in their duration and lack permanence. Thus, the parents of a joint venture should expect either to adequately capitalise the entity up front or to guarantee loans made to the joint venture.
- Another potential disadvantage of joint venture a firm that enters into a joint venture risks giving control of its technology to its partner and there is the possibility you might wind up turning your own joint venture partner into a competitor. However, this danger can be ameliorated by non-competition, non-solicitation, and confidentiality provisions in the joint venture agreement.

***3.2 Strategic Alliances:*** Strategic alliance is when the mutual coordination of strategic planning and management that enable two or more organizations to align their long term goals to the benefit of each organization and generally the organizations remain independent. Strategic alliances are cooperative relationships on different levels in the organization. Licensing, joint ventures, research and development partnerships are just few of the alliances possible when exploring new markets. In other words, strategic alliances can be described as a partnership between businesses with the purpose of achieving common goals while minimizing risk, maximizing leverage and benefiting from those facets of their operations that complement each other’s. A strategic alliance might be entered into for a one-off activity, or it might focus on just one part of a business, or its objective might be new products jointly developed for a particular market.

Generally, each company involved in the strategic alliance will benefit by working together. The arrangement they enter into may not be as formal as a joint venture agreement. Alliances are usually accomplished with a written contract, often with agreed termination points, and do not result in the creation of an independent business organization. The objective of a strategic alliance is to gain a competitive advantage to a company’s strategic position. Strategic alliances have increased a great deal since globalization became an opportunity for companies.

***There are different types of strategic alliances:***

1. Marketing alliances where the companies jointly market products that are complementary produced by one or both of the firms.
2. A promotional alliance refers to the collaboration where one firm agrees to join in promotion for the other firm’s products.
3. Logistics alliance is one more type of cooperation where one company offers, to another company, distribution services for their products.
4. Collaborations between businesses arise when the firms do not for example have the capacity or the financial means to develop new technologies.

**Advantages of Strategic alliance:**

- Increased leverage – Strategic alliances allow you to gain greater results from your company's core strengths.
- Risk sharing – A strategic alliance with an international company will help to offset your market exposure and allow you to jointly exploit new opportunities.
- Opportunities for growth – Strategic alliances can create the means by which small companies can grow. By "marrying" your company's product to somebody else's distribution, or your R&D to a partner's production skills, you may be able to expand your business overseas more quickly and more cheaply than by other means.
- Greater responsiveness – By allowing you to focus on developing your core strengths, strategic alliances provide the ability to respond more quickly to change and opportunity.

**Disadvantages of Strategic alliance:**

- High commitment — time, money, people.
- Difficulty of identifying a compatible partner.
- Potential for conflict between the partners.
- A small company risks being subsumed by a larger partner.
- Strategic priorities change over time.
- Political risk in the country where the strategic alliance is based.
- If the relationship breaks down, the cost/ownership of market information, market intelligence and jointly developed products can be an issue.

**3.3 Wholly Owned Subsidiaries:** A company will use a wholly owned subsidiary when the company wants to have 100 percent ownership. This is a very expensive mode where the firm has to do everything itself with the company's financial and human resources. Thus, more it is the large multinational corporations that could select this entry mode rather than small and medium sized enterprises. A wholly owned subsidiary could be divided in two separate ways Greenfield investment and Acquisitions.

**3.4 Greenfield Investment**: Greenfield investment is a mode of entry where the firm starts from scratch in the new market and opens up own stores while using their expertise. It involves the transfer of assets, management of talent, and proprietary technology and manufacturing know-how. It requires the skill to operate and manage in another culture with different business practices, labor forces and government regulations. The degree of risk varies according to the political and economic conditions in the host country. Despite these risks many companies prefer to use this mode of entry because of its total control over strategy, operation and profits.

**Advantages of Greenfield investment:**

- A wholly owned subsidiary gives a firm the tight control over operations in different countries that are necessary for engaging in global strategic coordination (i.e., using profits from one country to support competitive attacks in another).

- A wholly owned subsidiary maybe required if a firm is trying to realize location and experience curve economies.
- Local production lessens transport/import-related costs, taxes & fees.
- Availability of goods can be guaranteed, delays may be eliminated.
- More uniform quality of product or service.
- Local production says that the firm is willing to adapt products & services to the local customer requirements.

**Disadvantages of Greenfield investment:**

- Higher risk exposure namely political risk and economic risk.
- Heavier pre-decision information gathering & research evaluation.
- “Country-of-origin” effects can be lost by manufacturing elsewhere.
- Establishing a wholly owned subsidiary is generally the most costly method of serving a foreign market.

***3.5 Acquisitions:*** Acquisition is a very expensive mode of entry where the company acquirers or buys an already existing company in the foreign market. Acquisition is one way of entering a market by buying an already existing brand instead of trying to compete and launch the company’s products on the market and thereby lowering the chance of a profitable product. Acquisition is a risky alternative though, because the culture of the corporation is hard to transfer to the acquired firm. Most important, it is a very expensive alternative and both great profit and great losses could be the end product of this entry mode.

**Advantages of Acquisitions:**

- They are quick to execute.
- Acquisitions enable firms to preempt their competitors.
- Managers may believe acquisitions are less risky than green-field ventures.

**Disadvantages of Acquisitions:**

- The acquiring firms often overpay for the assets of the acquired firm.
- There may be a clash between the cultures of the acquiring and acquired firm.
- Attempts to realize synergies by integrating the operations of the acquired and acquiring entities often run into roadblocks and take much longer than forecast.
- There is inadequate pre-acquisition screening.

## Sub Unit - 3: INTERNATIONAL TRADE

**1.3.1 Theories of International Trade:** For the success of business, it is important to understand all the key types of international trade theories. The concept of international trading is not limited to, just sending and receiving products and services and putting all of the profits in the pockets. Instead, it's a lot more complicated thing. In fact, its current shape is the result of many different types of **international trade theories** that helped it in its evolution through various eras. Honestly saying, apart from making your syllabus boring, these theories can be of great assist in the long run since most parts of these ideas still, hold right. So in this article, we will go through each and every theory and will provide you with a somewhat in-depth detail of these.

**7 – Types of International Trade Theories**

1. Mercantilism
2. Absolute Advantage
3. Comparative Advantage
4. Heckscher-Ohlin Theory
5. Product Life Cycle Theory
6. Global Strategic Rivalry Theory
7. National Competitive Advantage Theory

Above are the 7 different types of international trade theories, which are presented by the various authors in between 1630 and 1990.

- **Mercantilism:** The oldest of all international trade theories, **Mercantilism**, dates back to **1630**. At that time, Thomas Mun stated that the economic strength of any country depends on the amounts of silver and gold holdings. Greater are the holdings, more economically independent a country is.

  Furthermore, the idea of favoring greater exports and promoting efforts to minimize imports also belongs to the same theory. Well! The thinking behind this concept is evident since you pay for the imports from the pay that you get from exports. So, if you a country has a lot to pay for the imported products then it will get from exported products, its economy will get inclined towards declination. Even though the view is old but the roots of modern thinking towards the financials is deeply embedded in it.
- **Absolute Advantage:** The Theory of **Absolute Advantage** is based on the notion of increasing the efficiencies in the production processes. In **1776**, Adam Smith, a renowned financial expert of the time being, proposed the theory that the manufacturing a product with high efficiency as compared to any other country on the globe is highly advantageous.

  The concept can just be understood by the idea that if two countries specialize in exactly same kind of product. But the product of one country being better in quality or lower in price will bring tremendous absolute advantage to the country as compared to the other one. From another point of view, if two countries specialize in entirely different products, then they can quickly increase their influence in their localities by having trade with each other (by creating absolute advantages at both ends).

- **Comparative Advantage**: As compared to absolute advantage, **Comparative Advantage** favors relative productivity. According to this concept, as put forward by David Ricardo in **1817**, a country with maximum absolute advantage in the creation of more than one product as compared to other, can still trade with another country with less efficient ways to create that product, that's readily available in first, to boost its productivity.
  To illustrate this idea with an example, let's say that I have expertise in two fields like graphics designing and writing, where designing lets me earn a lot more than writing. Keeping in mind that I can work on only one side at a time, I will most likely hire a writer, and we both will work in a comparative atmosphere.
- **Heckscher-Ohlin Theory:** Both the Absolute as well as Comparative international trade theories assume that the choice of the product that can prove itself to be of great advantage is led by free and open markets instead of using the resources available inland. That's what caused Bertil Ohlin and Eli Heckscher to put forward the idea of determination of the prices that relies on the differences in supply and demands.
  This can just be understood as, if the supply of a product grows greater than it is in demand in the market, its price falls and vice versa. So, export of a country should mainly consist of the product that is abundantly available in it, and imports should count the products that are in high demand. Since, this concept ensures utilization the country's factors like labor, land and funding sources for the purpose of product manufacturing that's why it is also known by the name of "factor proportion theory."
- **Product Life Cycle Theory:** In the **1970s**, Raymond Vernon introduced the notion of using a product's life cycle to explain global trade patterns, in the field of marketing. According to theory, as the demand for a newly created product grows, the home country starts exporting it to other nations. Where when the demand grows, local manufacturing plants are opened to meet the request. And the scenario covers the whole globe time to time, thus making that product a standardization.
  You can take the example of computers in consideration to understand how this works. The earlier personal computers appeared in **1970's** available only in a few countries and from **1980's to 1990's**, the product was moving through the stage of maturity where the production spread to many other nations. And now in 21st century, every third house has a PC in it.
- **Global Strategic Rivalry Theory:** The continuous evolutionary behavior of international trade theories brings us back in the **1980's** where Kalvin Lancaster and Paul Krugman introduced the concept of strategies, based on global level rivalries, targeting multinational corporations and the struggle needed in achieving higher advantages as compared to other international companies.

According to the concept, a new firm needs to optimize a few factors that will lead the brand in overcoming all the barriers to success and gaining an influential recognition in that global market. In all these factors, a thorough research and timed developmental steps are crucial. Whereas, having the complete ownership rights of intellectual properties is also necessary. Furthermore, the introduction of unique and useful methods for manufacturing as well as controlling the access to raw material will also come handy in the way.

- **National Competitive Advantage Theory:** Michael Porter in **1990's** suggested that the success of any business in international trade depends on upgradable and innovational capacities of the industry as well as four other factors, which determine how that firm is going to perform in this global level race. The main concept behind this theory gives the feel of holding factor proportion as well as many other international trade theories in it.

  One of those factors is the availability of resources in the local market and their prices which are necessary for providing a sustainable and stable environment for the trade to grow. Moreover, the ability of the firm to face competitors and its capacity to upgrade itself also determines the success rate of that brand. Furthermore, keeping the track of the change in demand and the behavior of local suppliers is also important.

**1.3.2 Government Intervention in International Trade:** Strategic arguments those are non-economic reasons for government intervention in international trade. These include:

*1. National Security Argument:* Each nation protects some industries to guard its national security. The most obvious examples are weapons, aerospace, advanced electronics, semiconductors, and strategic minerals (e.g., exotic ores used in jet aircraft), etc. Protection for the sake of making available specific minerals or resources does not appear to be an optimal policy. A better alternative is to stockpile such resources during peacetime when they are cheap.

Protagonists of national security argument claim that a nation should be. Self-reliant and be ready to pay for inefficiency when the case relates to **national security**. Recently, Pentagon has pressed for development of flat-panel industry even though the same can be bought much cheaper from Asian countries. One must remember that in today's world no nation can be fully self-reliant.

*2. Foreign Policy Goals Argument:* Commerce has become an important tool to achieve foreign policy goals. Preferential treatment may be given to a country or countries with which strong relations are to be built. Pakistan was rewarded when it provided its airbase to the US during the Afghan war. Iraq was punished through imposition of trade sanctions after it invaded Kuwait.

The US has maintained long- running trade sanctions against Cuba. At times trade sanctions have been applied against the countries doing trade with such countries. Iran, North Korea and Libya were also in the list of unfavorable nations of the US. India was denied high tech computers when it exploded nuclear bomb in 1998.

*3. Strategic Trade Policy Argument*: P. Krugman proposed a new trade theory. The theory argues that an industry has economies of scale and the world market will profitably support only few firms. Countries may predominate in export of certain products simply because they had firms who were able to capture first-mover advantages. The dominance of Boeing in the commercial aircraft industry is attributed to such factors.

According to strategic trade policy argument, a government should use subsidies to support such firms; the second argument is that it might pay government to intervene in an industry if it helps its domestic firms overcome the barriers to entry created by foreign firms that have already reaped the first-mover advantages. This has been the logic of government support of Airbus Industries.

The governments of Britain, France, Germany and Spain had given a subsidy of $13.5 billion to Airbus. The US government had also given huge R&D grant to Boeing during 1950w and 1960s. Japanese government did the same for Japanese semi-conductor industry to compete with the first-mover advantage-holder semi-conductor industry of the US.

*4. Safety Argument:* Governments have all over been concerned to protect consumers from ‘unsafe’ products. Most countries prohibit imports of marijuana and products made from endangered animal species. The US in its desire to increase public safety, permanently banned in 1978 the imports of 58 types of military-style assault weapons. Chile restricted imports of Salmon eggs by contending that they might be diseased. The EU banned the import of hormone-treated beef to protect its populace from the probable negative health consequences.

Recently, many countries shifted orders for apparel from China to India and Pakistan, as China had been reeling under SARS (severely acute respiratory syndrome). Government of India was in two minds to allow or disallow use of GM (genetically modified) cotton seeds. Many of the EU nations, such as, Germany, Switzerland, Austria, and Luxembourg are against genetically altered organisms. Developed countries are very tough with regard to quality when the agri commodities come from developing countries.

In medical services, the interests of patients are protected by the enforcement of standards for the qualifications of medical doctors and others.

*5. Emotional Argument:* Many arguments may have no economic rationale but they are so strong that no logic works. Rice is a very emotional issue among the Japanese. For years it has been told that rice grown outside Japan is not suitable for their palates and also not healthy. China limits rice import since rice farming has been a historical and cohesive force in uniting Chinese families.

Preserving cultural identity and heritage has been a very strong argument. Countries, at times, prohibit import of products and services that might undermine this identity. The French government protects its movie industry by limiting foreign films on French television and gives subsidies to the French film makers to produce films.
It is out of fear that the English language and Anglo-Saxon culture will weaken its cultural identity. Similarly, Canada limits foreign publishing, cable TV, bookselling, and musical performance. India does not allow foreign investment in print media out of emotions.
Many democratic countries create barriers by raising the bogey of human rights. China was not granted 'most favored nation' status for a long time due to its poor human rights record. At other times restrictions are placed against a country to protest against child labor.-Many a time, punitive measures are undertaken on the perception that the other country is not providing free access to its markets.
Environmental issues have also been the reasons for imposition of trade restrictions. Many nationalists and patriots argue for restrictions on the ground that international trade will lead to outflow of wealth from local people to foreigners, as is locals will get no value in return.

**1.3.3 Tariff and Non- tariff Barriers:** Trade barriers are restrictions imposed on movement of goods between countries. Trade barriers are imposed not only on imports but also on exports. The trade barriers can be broadly divided into two broad groups: (a) Tariff Barriers, and (b) Non-tariff Barriers.

**TARIFF BARRIERS**

Tariff is a customs duty or a tax on products that move across borders. The most important of tariff barriers is the customs duty imposed by the importing country. A tax may also be imposed by the exporting country on its exports. However, governments rarely impose tariff on exports, because, countries want to sell as much as possible to other countries. The main important tariff barriers are as follows:

**1. Specific Duty:** Specific duty is based on the physical characteristics of goods. When a fixed sum of money, keeping in view the weight or measurement of a commodity, is levied as tariff, it is known as specific duty.
For instance, a fixed sum of import duty may be levied on the import of every barrel of oil, irrespective of quality and value. It discourages cheap imports. Specific duties are easy to administer as they do not involve the problem of determining the value of imported goods. However, a specific duty cannot be levied on certain articles like works of art. For instance, a painting cannot be taxed on the basis of its weight and size.

**2. Ad valorem Duty:** These duties are imposed "according to value." When a fixed percent of value of a commodity is added as a tariff it is known as ad valorem duty. It ignores the consideration of weight, size or volume of commodity.

The imposition of ad valorem duty is more justified in case of those goods whose values cannot be determined on the basis of their physical and chemical characteristics, such as costly works of art, rare manuscripts, etc. In practice, this type of duty is mostly levied on majority of items.

**3. Combined or Compound Duty:** It is a combination of the specific duty and ad valorem duty on a single product. For instance, there can be a combined duty when 10% of value (ad valorem) and Re 1/- on every meter of cloth is charged as duty. Thus, in this case, both duties are charged together.

**4. Sliding Scale Duty:** The import duties which vary with the prices of commodities are called sliding scale duties. Historically, these duties are confined to agricultural products, as their prices frequently vary, mostly due to natural factors. These are also called as seasonal duties.

**5. Countervailing Duty:** It is imposed on certain imports where products are subsidised by exporting governments. As a result of government subsidy, imports become more cheaper than domestic goods. To nullify the effect of subsidy, this duty is imposed in addition to normal duties.

**6. Revenue Tariff:** A tariff which is designed to provide revenue to the home government is called revenue tariff. Generally, a tariff is imposed with a view of earning revenue by imposing duty on consumer goods, particularly, on luxury goods whose demand from the rich is inelastic.

**7. Anti-dumping Duty:** At times, exporters attempt to capture foreign markets by selling goods at rock-bottom prices, such practice is called dumping. As a result of dumping, domestic industries find it difficult to compete with imported goods. To offset anti-dumping effects, duties are levied in addition to normal duties.

**8. Protective Tariff:** In order to protect domestic industries from stiff competition of imported goods, protective tariff is levied on imports. Normally, a very high duty is imposed, so as to either discourage imports or to make the imports more expensive as that of domestic products.

**Note:** Tariffs can be also levied on the basis of international relations. This includes single column duty, double column duty and triple column duty.

**NON-TARIFF BARRIERS**: A non-tariff barrier is any barrier other than a tariff, that raises an obstacle to free flow of goods in overseas markets. Non-tariff barriers, do not affect the price of the imported goods, but only the quantity of imports. Some of the important non-tariff barriers are as follows:

**1. Quota System:** Under this system, a country may fix in advance, the limit of import quantity of a commodity that would be permitted for import from various countries during a given period. The quota system can be divided into the following categories:

(a) Tariff/Customs Quota (b) Unilateral Quota
(c) Bilateral Quota (d) Multilateral Quota

• **Tariff/Customs Quota:** Certain specified quantity of imports is allowed at duty free or at a reduced rate of import duty. Additional imports beyond the specified quantity are permitted only at increased rate of duty. A tariff quota, therefore, combines the features of a tariff and an import quota.

• **Unilateral Quota:** The total import quantity is fixed without prior consultations with the exporting countries.
• **Bilateral Quota:** In this case, quotas are fixed after negotiations between the quota fixing importing country and the exporting country.
• **Multilateral Quota:** A group of countries can come together and fix quotas for exports as well as imports for each country.

**2. Product Standards:** Most developed countries impose product standards for imported items. If the imported items do not conform to established standards, the imports are not allowed. For instance, the pharmaceutical products must conform to pharmacopoeia standards.

**3. Domestic Content Requirements:** Governments impose domestic content requirements to boost domestic production. For instance, in the US bailout package (to bailout General Motors and other organizations), the US Govt. introduced 'Buy American Clause' which means the US firms that receive bailout package must purchase domestic content rather than import from elsewhere.

**4. Product Labelling:** Certain nations insist on specific labeling of the products. For instance, the European Union insists on product labeling in major languages spoken in EU. Such formalities create problems for exporters.

**5. Packaging Requirements:** Certain nations insist on particular type of packaging materials. For instance, EU insists on recyclable packing materials, otherwise, the imported goods may be rejected.

**6. Consular Formalities:** A number of importing countries demand that the shipping documents should include consular invoice certified by their consulate stationed in the exporting country.

**7. State Trading:** In some countries like India, certain items are imported or exported only through canalizing agencies like MMTC. Individual importers or exporters are not allowed to import or export canalized items directly on their own.

**8. Preferential Arrangements:** Some nations form trading groups for preferential arrangements in respect of trade amongst themselves. Imports from member countries are given preferences, whereas, those from other countries are subject to various tariffs and other regulations.

**9. Foreign Exchange Regulations:** The importer has to ensure that adequate foreign exchange is available for import of goods by obtaining a clearance from exchange control authorities prior to the concluding of contract with the supplier.

**10. Other Non-Tariff Barriers:** There are a number of other non – tariff barriers such as health and safety regulations, technical formalities, environmental regulations, embargoes, etc.

**Difference between tariff and non-tariff barriers:**

1. With tariffs the Government receives the revenue whereas no revenue is received by the Government by applying non-tariff measures.

However, it is favored as an appropriate measure to meet the demand of the country and to protect the industry.

2. Non-tariff measures protect the procedures and make them feel more secure than under a tariff. But incentives are not there under tariffs.

3. In tariff customer's classification and valuation procedures pose a problem before the customs authorities. Where-as under non-tariff measures no such problem arises.

4. Non-tariff barriers to trade induce the domestic producers to form monopolistic organizations with a view to keeping output low and prices high. This is not possible under import duty.

Non-tariff barriers remain ineffective if monopolistic tendencies prevail in the country.

5. Non-tariff measures are flexible than tariff. Imposition of tariff and amendments are subject to legislative enactment.

6. In non-tariff the price differences will be greater in two countries because there is no free flow of imports; but in tariff—price differentiation will be equal to the cost of tariff and transportation between exporting and importing countries.

7. Tariffs are simple to operate. Tariff rates once fixed through legislation require no individual allocation of licensing quotas or exchange.

For non-tariff measures numbers of authorities are there to administer. It may result in political interference or corruption.

8. Tariff favors particularly to efficient firms in the country but non-tariff measures benefit established firm because they get quotas or import licenses.

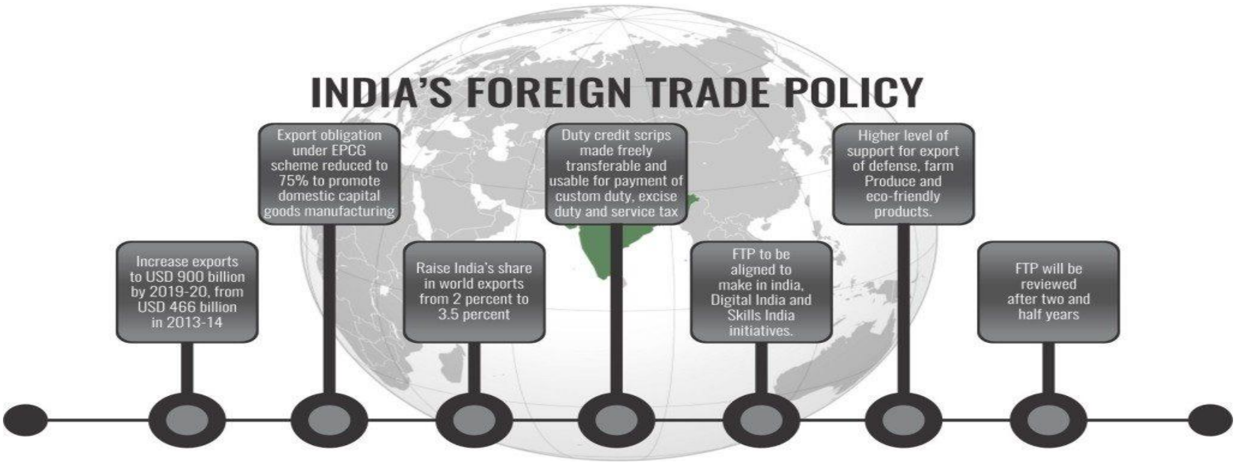
9. Non-tariffs discriminate against new-comers but tariff do not discriminate.

**1.3.4 India's Foreign Trade Policy:** Foreign trade**,** as the name suggests is trade between different countries, this can also be referred to as *International Trade, or Inter Region* trade. It is basically a guideline around import and export trades. The reason to have a foreign trade policy is to maintain a mutual agreement of wants and needs while trading. For a successful economic development of a country, a robust foreign trade policy is crucial.

India is known as one of the most important and emerging players in the global economy. Its foreign trade policies and government reforms have made it a significant destination for foreign investments around the world. Also, technological and infrastructural developments being carried out all over the country enable efficient trade and economic practices. For the successful economic development of a country, vigorous foreign trade policy is of great importance. Therefore, India adopted a foreign trade policy known as the EXIM Policy or the Export-Import policy.

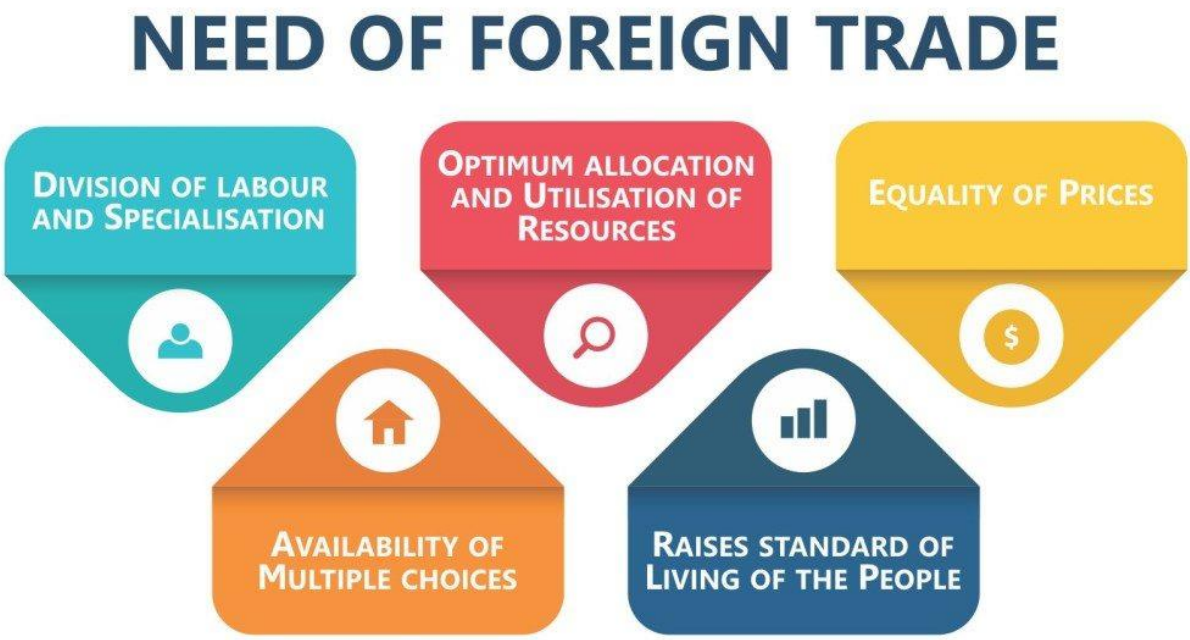
The current Foreign Trade Policy is for the period 2015 – 2020 announced by the Government of India, Ministry of Commerce and Industry on 01st April 2015. Foreign trade policy needs amendments every five years and aims at developing export capability, improving export performance and structure, encouraging foreign trade, and creating a suitable balance of payments position. It is updated every year on the 31st of March, and the modifications, improvements and new schemes become effective from 1st April each year.

India in 1991, after liberalization, totally lifted all sorts of restrictions from trade for the purpose of improvement in the balance of payment position. A strong need was felt for Indian markets to work globally, and the economy was set free. But in a developing economy, it is not possible to develop industries without the protection of policies. Therefore, later, it was necessary for India to impose a restriction on its economy through trade policies to regulate import and export.




***Foreign trade policies are essential of two types:***

*Free Trade Policy*: As the name suggests in the free trade policy there are no restrictions on areas such as *Exchange of Goods or Services*, between countries that are trading, there are no bars or limitations on production or consumptions, neither are there any taxes, subsidies or tariffs to adhere to. The arrangement of free trade works quite well for developed countries. *Protective Trade Policy: The Protective Trade Policy* overall protects the domestic economy from external competition in goods, that might threaten the domestic market for their products and goods. Such a policy is ideal for developing economies like India.




*Foreign Trade policy of India is very important from the viewpoint of developing economies.* For example, in India, we have a strong Iron and Coal reserve, these are established industry opportunities, However, for the growth of this industry, we need to import the technical know-how from other countries who pioneer in it. Assuming that we as a country, did not have a foreign trade policy, then it would become both, a daunting task and an expensive effort.

Another area which would bring our country to a standstill is the inability to fulfil the demands of the petroleum products. An absence of a foreign trade policy would massively hinder the economic development of our country.

India, during the recent years, is referred to as one of the most important players in the global economic setting. There are many factors contributing to this, the present trade policies, economic reforms, also India's intrinsic strengths are most sought after in the global space. The country is also promoting infrastructure and technological developments, which are promising for the economic sector in the years to come. With the forthcoming foreign trade policy, our exports are expected to reach US$ 750 billion by the year 2018-2019.

**Objectives of the Foreign Trade Policy in India:** Trade enables economic growth and national development. The main aim is not the mere earning of foreign exchange, but encouraging greater economic activity. The foreign trade policy of India is based on the following major objectives as follows:

- To enable substantial growth in exports from India and import to India to boost the economy.

- To at least double the percentage share of global merchandise trade conducted within the next five years.
- To improve the balance of payment and trade.
- To act as an effective instrument of economic growth by creating employment opportunities for the citizens; the larger the expansion of trade activities, the more the workforce required.
- To provide for sustainable growth by giving access to essential raw materials for production and other components, consumables and capital goods required for increasing production and providing efficient services.
- To raise the technological capacity for production and cost-effectiveness of industry and services, thereby improving their competitive strength in comparison to other countries, and to encourage the accomplishment of internationally accepted standards of quality.
- To provide buyers or clients with high-quality goods and services at globally competitive rates and quality. 'Canalization'- an important feature of Foreign Trade Policy under which specific class of goods can be imported only by designated agencies.
- Creation of opportunities by engaging in good and ethical practices.
- Accelerating the economy from low-level economic activities to high-level economic activities by making it a globally oriented and vibrant economy
- To derive maximum benefits from expanding the global market and seizing the best opportunities available.
- Making policies that favor ease of doing business and e-governance.
- To allow for hassle-free transactions for both import and export.
- Reducing the interference between the exporters and Directorate General of Foreign Trade by reducing the number of export documents.
- To allow the import of technology and equipment's which may help in achieving better international standards of quality and reduce the cost of production.
- Establishing the Advance Licensing System for imported goods needed for manufacturing various goods for export. An Advance License is issued by the Directorate General of Foreign Trade to allow duty-free import of inputs, which are physically integrated with the export product (making normal allowance for wastage).
- To allow the import of certain goods as listed in the Open General License; a kind of export license which is issued by Government to domestic suppliers.

## Sub Unit - 4: FOREIGN DIRECT INVESTMENT (FDI)

### 1. 4.1 Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI)

**Foreign Direct Investment (FDI):** A foreign direct investment (FDI) is an investment in the form of a controlling ownership in a business in one country by an entity based in another country. It is thus distinguished from a foreign portfolio investment by a notion of direct control.

The origin of the investment does not impact the definition, as an FDI: the investment may be made either "inorganically" by buying a company in the target country or "organically" by expanding the operations of an existing business in that country.

**Importance and barriers to FDI**

The rapid growth of world population since 1950 has occurred mostly in developing countries. This growth has been matched by more rapid increases in gross domestic product, and thus income per capita has increased in most countries around the world since 1950.

An increase in FDI may be associated with improved economic growth due to the influx of capital and increased tax revenues for the host country. Besides, the trade regime of the host country is named as an important factor for the investor's decision-making. Host countries often try to channel FDI investment into new infrastructure and other projects to boost development. Greater competition from new companies can lead to productivity gains and greater efficiency in the host country and it has been suggested that the application of a foreign entity's policies to a domestic subsidiary may improve corporate governance standards. Furthermore, foreign investment can result in the transfer of soft skills through training and job creation, the availability of more advanced technology for the domestic market and access to research and development resources. The local population may benefit from the employment opportunities created by new businesses. In many instances, the investing company is simply transferring its older production capacity and machines, which might still be appealing to the host country because of technological lags or under-development, in order to avoid competition against its own products by the host country/company.

**Forms of FDI incentives:** Foreign direct investment incentives may take the following forms:

- Low corporate tax and individual income tax rates
- tax holidays
- other types of tax concessions
- preferential tariffs
- special economic zones
- EPZ – Export Processing Zones
- Bonded warehouses
- Maquiladoras
- investment financial subsidies
- free land or land subsidies
- relocation & expatriation

- infrastructure subsidies
- R&D support
- Energy
- derogation from regulations (usually for very large projects)

**Methods of FDI:** The foreign direct investor may acquire voting power of an enterprise in an economy through any of the following methods:

- by incorporating a wholly owned subsidiary or company anywhere
- by acquiring shares in an associated enterprise
- through a merger or an acquisition of an unrelated enterprise
- participating in an equity joint venture with another investor or enterprise

**Foreign Portfolio Investment (FPI):** Foreign portfolio investment (FPI) consists of securities and other financial assets held by investors in another country. It does not provide the investor with direct ownership of a company's assets and is relatively liquid depending on the volatility of the market. Along with foreign direct investment (FDI), FPI is one of the common ways to invest in an overseas economy. FDI and FPI are both important sources of funding for most economies.

Portfolio investment involves the making and holding of a hands-off—or passive—investment of securities, done with the expectation of earning a return. In foreign portfolio investment, these securities can include stocks, american depositary receipts (ADRs), or global depositary receipts of companies headquartered outside the investor's nation. Holding also includes bonds or other debt issued by these companies or foreign governments, mutual funds, or exchange traded funds (ETFs) that invest in assets abroad or overseas.

An individual investor interested in opportunities outside their own country is most likely to invest through an FPI. On a more macro level, foreign portfolio investment is part of a country’s capital account and shown on its balance of payments (BOP). The BOP measures the amount of money flowing from one country to other countries over one monetary year.

**FPI vs. Foreign Direct Investment (FDI):** With FPI—as with portfolio investment in general—an investor does not actively manage the investments or the companies that issue the investments. They do not have direct control over the assets or the businesses.

In contrast, foreign direct investment (FDI) lets an investor purchase a direct business interest in a foreign country. For example, say an investor based in New York City purchases a warehouse in Berlin to lease to a German company that needs space to expand its operations. The investor’s goal is to create a long-term income stream while helping the company increase its profits.

This FDI investor controls their monetary investments and often actively manages the company into which they put money. The investor helps to build the business and waits to see their return on investment (ROI). However, because the investor’s money is tied up in a company, they face less liquidity and more risk when trying to sell this interest. The investor also faces currency exchange risk, which may decrease the value of the investment when converted from the country's currency to the home currency or U.S. dollars. An additional risk is with political risk, which may make the foreign economy and his investment shaky.

*Pros:*

- Feasible for retail investors
- Quicker return on investment
- Highly liquid

*Cons:*

- No direct control/management of investments
- Volatile
- Cause of economic disruption (if withdrawn)

Although some of these risks affect foreign portfolio investments as well, it is to a lesser degree than with foreign direct investments. Since the FPI investments are financial assets, not the property or a direct stake in a company, they are inherently more marketable.

So FPI is more liquid than FDI and offers the investor a chance for a quicker return on his money—or a quicker exit. However, as with most investments offering a short-term horizon, FPI assets can suffer from volatility. FPI money often departs the country of investment whenever there is uncertainty or negative news in a foreign land, which can further aggravate economic problems there.

Foreign portfolio investments are more suited to the average retail investor, while FDI is more the province of institutional investors, ultra-high-net-worth individuals, and companies. However, these large investors may also use foreign portfolio investments.

**1. 4.2 Types of FDI**:

4. **Horizontal FDI** arises when a firm duplicates its home country-based activities at the same value chain stage in a host country through FDI.
5. **Platform FDI** Foreign direct investment from a source country into a destination country for the purpose of exporting to a third country.
6. **Vertical FDI** takes place when a firm through FDI moves upstream or downstream in different value chains i.e., when firms perform value-adding activities stage by stage in a vertical fashion in a host country.

**1. 4.3 Costs and Benefits of FDI to Home and Host Centers**

**Costs and Benefits:** Let us discuss the costs and benefits of FDI to both home countries and host countries.

**Benefits of FDI to the host country:** Hill (2005) suggested that there are three main benefits to the host country derived out of FDI. They are resource transfer effects, employment effects and balance of payment effects. Whenever a company invests in a foreign firm, the resources are capital, technology and managerial skills. In terms of capital, the host country will have a higher financial status than the home country. The change in technology and managerial skills will have a drastic effect on the operations carried out by the company. In the host country due to FDI, it creates many employment opportunities through which the citizens of that particular country would be benefited. The balance of payments keeps tracks of FDI inflow and outflows through two types of accounts, current account and capital account. “The current account is a record of a country’s export and import of goods” (Hill, 2005) and the capital account maintain purchase or sale details of assets by the country. By using FDI, the country can achieve a current account surplus (where exports are greater than imports) and reduce current account deficit (where imports are greater than exports).

**Costs of FDI to the host country:** The negative effects are termed as ‘costs’. There are also significant effects which affects the host country. When a foreign firm establishes with the superior technological skills which can produce quality items at cheaper rates, it adversely affects the domestic producers. Balance of payments are also affected by inward FDI by two sources. When there is a initial capital inflow there must be subsequent capital outflow and this will be recorded as debits on capital account. The second source is due to import of goods from other countries which will be recorded as debits in current account. The foreign firm can alter the economic stability of a country as they will be focusing only on the profit. Eventually all the inhabitants of the country will have an emotional outbreak to apparent loss of national sovereignty.

**Benefits of FDI to the home country:** The benefit to the home country also includes the factors similar to that of host country. In terms of balance of payments, what is debit to host country is credit to home country. The outward FDI also leads to creation of new job market with great expertise and necessary skills. Reverse resource transfer effect takes place whenever resources like managerial skills are transferred back to the home country. The profit of the foreign firm goes back to the home country unlike domestic producers which contributes to their country. The home country is exposed to create new market share and it is liable to create many in the future.

**Costs of FDI to the home country:** Due to FDI, the home country is mainly affected by capital and employment. Suppose a country ‘A’ decides to invest in country ‘B’, using its capital and technology there will be an addition of financial position to the host country than home country. Even in future, if the country ‘A’ wants to make any advancement, much focus will be given to the company in country ‘B’ and implement changes. As a result the production in home country decreases and it sometimes result in shutting down all its operations and completely concentrate on the host country. This badly affects the home country’s economy and employment.

**1.4.4 Trends in FDI:** The decade gone by would be considered as the golden year for foreign direct investment (FDI) in India. Between year 2000-11, India attracted cumulative FDI inflow of USD 237 Billion. 70 per cent of this FDI constituted equity inflows, the rest being reinvested earnings and other capital. Over the last decade, FDI in India grew at CAGR 23 per cent.
The bull nm in India FDI started in FY 2006-07 when it grew by 146 per cent over the previous year. FDI peaked in year FY 2007-08 and only marginally declined in the following years of economic crisis. For the eight months of FY 2011/12 (Apr-Nov 2011), India has already garnered USD 33 Billion of FDI matching the full year FDI of the year 2010-11.
Share of top five investing countries in India stood at 69 per cent. Mauritius was the top country of origin for FDI flows into India, primarily driven by the tax haven status enjoyed by Mauritius. Services sector (Financial and Non-financial) attracted the largest FDI equity flows amounting USD 31 Billion. (20.5 per cent share).
Other high share sectors in top five were -Telecom (8 per cent). Computer Software and Hardware (7 per cent). Housing and Real Estate (7 per cent) and Construction (7 per cent). Over the years, Automatic route has become the most used entry route for FDI investments in India indicating the gradual liberalization of FDI policy, hi FY 2010-11, 64 per cent of Equity FDI inflows in India came via “Automatic Route” almost trebling from 22 per cent share in FY 2000- 01. “Acquisition of shares” constituted 25 per cent and “FIPB/SIA” constituted 11 per cent of equity inflows in 2010-11.
India’s FDI policy progressively liberalized since the nineties and only a few sectors, primarily in services sector now have an FDI capp on investment. India’s inward investment regime is now be considered most liberal and transparent amongst emerging economies.

| **No.** | **Country** | **Cumulative Inflows (2000-2011)** |
|---|---|---|
| (1) | Mauritius | 41% |
| (2) | Singapore | 10% |
| (3) | USA | 7% |
| (4) | UK | 6% |
| (5) | Japan | 5% |
| **Top 5 Total** | **69%** | |

**1.4.5 India's FDI Policy:** Government of India has taken various effective steps to simplify the Foreign Direct investment policy. The Foreign Direct Investment Policy (FDI Policy) of the Government of India prescribes the foreign investment cap in specified industrial sectors. But in the recent times many activities have been transferred to unrestricted sectors in which 100% Foreign Direct investment is permitted. Broadly, the industrial sectors are categorized as:

4. Restricted
5. Prohibited
6. Unrestricted Sectors (Up to 100% foreign ownership)

All the sectors other than those mentioned below subject to terms and conditions in the FDI policy come under unrestricted sectors for example:

- Mining (except Mining and mineral separation of titanium bearing minerals and ores, its value addition and integrated activities)
- Manufacturing related commercial activities
- Information Technology related activities
- E-commerce (permitted in marketplace model and not the inventory based model. Also, it applies only to Business to Business e-commerce and not business to consumer e-commerce)

**Restricted Sectors-**

| **Sector** | **Entry Route** |
|---|---|
| **Upto 20% foreign ownership** | |
| Banking- Public Sector (Subject to Banking Companies (Acquisition & Transfer of Undertakings) Acts 1970/80) | Government permission necessary |
| **Upto 26% foreign ownership** | |
| Broadcasting Content Service (Terrestrial Broadcasting FM(FM Radio) and Up-linking of 'News & Current Affairs' TV | Government permission necessary |
| Channels (Other conditions specified by Ministry of Information and Broadcasting, Government of India )) | Government permission necessary |
| Print Media (Publishing of newspaper and periodicals dealing with news and current affairs and Publication of Indian editions of foreign magazines dealing with news and current affairs) | Government permission necessary |

| Up to 49% foreign ownership | |
|---|---|
| Defense Industry (subject to Industrial License under the Industries (Development & Regulation) Act, 1951) and other regulations | Automatic up to 49% and above 49% under Government route with approval of Cabinet Committee on Security for state of the art technology |
| Cable Networks (Other Multi System Operators not undertaking upgradation of networks towards digitalization and addressability and Local Cable Operators) | Automatic |
| Petroleum and Natural Gas (Petroleum refining by the Public Cabinet Committee Sector Undertakings (PSU), without any disinvestment or dilution of domestic equity in the existing PSUs.) | Automatic route |
| **Scheduled Air Transport Service/ Domestic Scheduled Passenger Airline** | Automatic route |
| **Insurance** | Automatic route |
| **Private Security Agencies** | Automatic route |
| Telecom & related Services (including Telecom Infrastructure Providers Category-I) All telecom services including Telecom Infrastructure Providers Category-I, viz. Basic, Cellular, United Access Services, Unified License (Access Services), Unified License, National/International Long Distance, Commercial V-Sat, Public Mobile Radio Trunked Services | Automatic up to 49% and Government route beyond 49% and up to 100%. |
| Commodity Exchange | Automatic route |
| Single Brand product retail trading | Automatic up to 49% and Government route beyond 49% |
| Asset Reconstruction Company | Automatic up to 49% and Government route beyond 49% |
| Pension Sector | Automatic route |

| | |
|---|---|
| Power Exchanges (Power Exchanges registered under the Central Electricity Regulatory Commission (Power Market) Regulations, 2010.) | Automatic route |
| Infrastructure Company in the Securities Market (namely, stock exchanges, depositories and clearing corporations, in compliance with SEBI Regulations) | Automatic route |
| **Upto 51% foreign ownership** | |
| Multi Brand Retail Trading | Government |
| **Upto 74% foreign ownership** | |
| Credit Information Companies | Automatic route |
| Civil Aviation (Ground Handling Services subject to sectoral regulations and security clearance) | Automatic up to 49% and Government route beyond 49% and up to 74% |
| Airports (Existing projects) | Automatic up to 74% and Government route beyond 74% |
| Satellites (Establishment and operation, subject to the sectoral guidelines of Department of Space/ISRO) | Government |
| Banking & Finance - Private Sector | Automatic up to 49% and Government route beyond 49% and up to 74%. |

**Prohibited Sectors**

- 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 are Atomic Energy and Railway Operations

## Sub Unit - 5: BALANCE OF PAYMENT (BOP)

The Balance of Payments or BoP is a statement or record of all monetary and economic transactions made between a country and the rest of the world within a defined period (every quarter or year). These records include transactions made by individuals, companies and the government. Keeping a record of these transactions helps the country to monitor the flow of money and develop policies that would help in building a strong economy.

**1.5.1 Importance of BOP:** The BOP statement provides a clear picture of the economic relations between different countries. It is an integral aspect of international financial management. Now that you have understood BOP and its components, let's look at why it is important.

To begin with, the BOP statement provides information pertaining to the demand and supply of the country's currency. The trade data shows a clear picture of whether the country's currency is appreciating or depreciating in comparison with other countries. Next, the country's BOP determines its potential as a constructive economic partner. In addition, a country's BoP indicates its position in international economic growth.

By studying its BOP statement and its components closely, a country would be able to identify trends that may be beneficial or harmful to the economy and take appropriate measures.

**1.5.2 Components of BOP:** The BOP consists of three main components—current account, capital account, and financial account. As mentioned earlier, the BOP should be zero. The current account must balance with the combined capital and financial accounts.

**Current Account:** The current account monitors the flow of funds from goods and services trade (import and export) between countries. Now this includes money received or spent on manufactured goods and raw materials. It also includes revenue from tourism, transportation receipts, revenue from specialized services (medicine, law, engineering), and royalties from patents and copyrights. In addition, the current account includes revenue from stocks.

**Capital Account:** The capital account monitors the flow of international capital transactions. These transactions include the purchase or disposal of non-financial assets (for example, land) and non-produced assets. The capital account also includes money received from debt-forgiveness and gift taxes. In addition, the capital account records the flow of the financial assets by migrants leaving or entering a country and the transfer, sale, or purchase of fixed assets.

**Financial Account:** The financial account monitors the flow of funds pertaining to investments in businesses, real estate, and stocks. It also includes government-owned assets such as gold and Special Drawing Rights (SDRs) held with the International Monetary Fund (IMF). In addition, it includes foreign investments and assets held abroad by nationals. Similarly, the financial account includes a record of the assets owned by foreign nationals.

## Sub Unit - 6: REGIONAL ECONOMIC INTEGRATION

**1.6.1 Levels of Regional Economic Integration:** Regional economic integration has enabled countries to focus on issues that are relevant to their stage of development as well as encourage trade between neighbors.

There are four main types of regional economic integration.

1. **Free trade area.** This is the most basic form of economic cooperation. Member countries remove all barriers to trade between themselves but are free to independently determine trade policies with nonmember nations. An example is the North American Free Trade Agreement (NAFTA).
2. **Customs union.** This type provides for economic cooperation as in a free-trade zone. Barriers to trade are removed between member countries. The primary difference from the free trade area is that members agree to treat trade with nonmember countries in a similar manner.
3. **Common market.** This type allows for the creation of economically integrated markets between member countries. Trade barriers are removed, as are any restrictions on the movement of labor and capital between member countries. Like customs unions, there is a common trade policy for trade with nonmember nations. The primary advantage to workers is that they no longer need a visa or work permit to work in another member country of a common market. An example is the Common Market for Eastern and Southern Africa (COMESA).
4. **Economic union.** This type is created when countries enter into an economic agreement to remove barriers to trade and adopt common economic policies. An example is the European Union (EU).

In the past decade, there has been an increase in these trading blocs with more than one hundred agreements in place and more in discussion. A trade bloc is basically a free-trade zone, or near-free-trade zone, formed by one or more tax, tariff, and trade agreements between two or more countries. Some trading blocs have resulted in agreements that have been more substantive than others in creating economic cooperation. Of course, there are pros and cons for creating regional agreements.

**Pros**: The pros of creating regional agreements include the following:

- **Trade creation.** These agreements create more opportunities for countries to trade with one another by removing the barriers to trade and investment. Due to a reduction or removal of tariffs, cooperation results in cheaper prices for consumers in the bloc countries. Studies indicate that regional economic integration significantly contributes to the relatively high growth rates in the less-developed countries.
- **Employment opportunities.** By removing restrictions on labor movement, economic integration can help expand job opportunities.

- **Consensus and cooperation.** Member nations may find it easier to agree with smaller numbers of countries. Regional understanding and similarities may also facilitate closer political cooperation.

**Cons**: The cons involved in creating regional agreements include the following:

- **Trade diversion.** The flip side to trade creation is trade diversion. Member countries may trade more with each other than with nonmember nations. This may mean increased trade with a less efficient or more expensive producer because it is in a member country. In this sense, weaker companies can be protected inadvertently with the bloc agreement acting as a trade barrier. In essence, regional agreements have formed new trade barriers with countries outside of the trading bloc.
- **Employment shifts and reductions.** Countries may move production to cheaper labor markets in member countries. Similarly, workers may move to gain access to better jobs and wages. Sudden shifts in employment can tax the resources of member countries.
- **Loss of national sovereignty.** With each new round of discussions and agreements within a regional bloc, nations may find that they have to give up more of their political and economic rights. In the opening case study, you learned how the economic crisis in Greece is threatening not only the EU in general but also the rights of Greece and other member nations to determine their own domestic economic policies.

**Major Areas of Regional Economic Integration and Cooperation:** There are more than one hundred regional trade agreements in place, a number that is continuously evolving as countries reconfigure their economic and political interests and priorities. Additionally, the expansion of the World Trade Organization (WTO) has caused smaller regional agreements to become obsolete. Some of the regional blocs also created side agreements with other regional groups leading to a web of trade agreements and understandings.

The North American Free Trade Agreement (NAFTA) came into being during a period when free trade and trading blocs were popular and positively perceived. In 1988, the United States and Canada signed the Canada–United States Free Trade Agreement. Shortly after it was approved and implemented, the United States started to negotiate a similar agreement with Mexico. When Canada asked to be party to any negotiations to preserve its rights under the most-favored-nation clause (MFN), the negotiations began for NAFTA, which was finally signed in 1992 and implemented in 1994.

The goal of NAFTA has been to encourage trade between Canada, the United States, and Mexico. By reducing tariffs and trade barriers, the countries hope to create a free-trade zone where companies can benefit from the transfer of goods. In the 1980s, Mexico had tariffs as high as 100 percent on select goods. Over the first decade of the agreement, almost all tariffs between Mexico, Canada, and the United States were phased out.

The rules governing origin of content are key to NAFTA. As a free trade agreement, the member countries can establish their own trading rules for nonmember countries. NAFTA's rules ensure that a foreign exporter won't just ship to the NAFTA country with the lowest tariff for nonmember countries. NAFTA rules require that at least 50 percent of the net cost of most products must come from or be incurred in the NAFTA region. There are higher requirements for footwear and cars. For example, this origin of content rule has ensured that cheap Asian manufacturers wouldn't negotiate lower tariffs with one NAFTA country, such as Mexico, and dump cheap products into Canada and the United States. Mexican *maquiladoras* have fared well in this arrangement by being the final production stop before entering the United States or Canada. *Maquiladoras* are production facilities located in border towns in Mexico that take imported materials and produce the finished good for export, primarily to Canada or the United States.

**Current Challenges and Opportunities**: Canadian and US consumers have benefited from the lower-cost Mexican agricultural products. Similarly, Canadian and US companies have sought to enter the expanding Mexican domestic market. Many Canadian and US companies have chosen to locate their manufacturing or production facilities in Mexico rather than Asia, which was geographically far from their North American bases.

When it was introduced, NAFTA was highly controversial, particularly in the United States, where many felt it would send US jobs to Mexico. In the long run, NAFTA hasn't been as impactful as its supporters had hoped nor as detrimental to workers and companies as its critics had feared. As part of NAFTA, two side agreements addressing labor and environmental standards were put into place. The expectation was that these side agreements would ensure that Mexico had to move toward improving working conditions.

Mexico has fared the best from NAFTA as trade has increased dramatically. *Maquiladoras* in Mexico have seen a 15 percent annual increase in income. By and large, Canadians have been supportive of NAFTA and exports to the region have increased in the period since implementation. "Tri-lateral [merchandise] trade has nearly tripled since NAFTA came into force in 1994. It topped $1 trillion in 2008.

### 1.6.2 Trade Creation and Diversification Effects

**Trade creation** is an economic term related to international economics in which trade flows are redirected due to the formation of a free trade area or a customs union. The issue was firstly brought into discussion by Jacob Viner (1950), together with the trade diversion effect.

In the former case after the formation of economic union, the cost of the goods considered is decreased, leading to an increase of efficiency of economic integration. Hence, trade creation's essence is in elimination of customs tariffs on inner border of unifying states (usually already trading with each other), causing further decrease of price of the goods, while there may be a case of new trade flow creation of the goods between the states decided to economically integrate.

The opposite takes place in case of trade diversion, when the trade flow is diverted from actually cost-efficient partner state to less efficient one – but which became a member of economic union and made its goods cheaper within a union, but higher compared to the rest of the world. In practice, both trade creation and diversion effects take place due to formation of economic union. Efficiency of economic integration of specific union right now is assessed as a final outcome between trade creation and diversion effects: it is cost-effective in case of prevailing of the trade creation effects, and vice versa.

**Occurrence of trade creation:** When a customs union is formed, the member nations establish a free trade area amongst themselves and a common external tariff on non-member nations. As a result, the member nations establish greater trading ties between themselves now that protectionist barriers such as tariffs, import quotas, non-tariff barriers and subsidies have been eliminated. The result is an increase in trade among member nations in the good or service of each nation's comparative advantage. In other words, increase in trade causes greater revenues, (more profitable).

**Downside of trade creation:** The creation of trade is important to the nation entering the customs union in that increased specialization may hurt other industries. Arguments for protectionism, such as the infant industry argument, national defense, outsourcing, and issues with health and safety regulations are brought to mind. However, customs unions are typically formed with friendly nations, eliminating the national defense argument.

**Trade diversion** is an economic term related to international economics in which trade is diverted from a more efficient exporter towards a less efficient one by the formation of a free trade agreement or a customs union. Total cost of good becomes cheaper when trading within the agreement because of the low tariff. This is as compared to trading with countries outside the agreement with lower cost goods but higher tariff. The related term **Trade creation** is when the formation of a trade agreement between countries decreases the price of the goods for more consumers, and therefore increases overall trade. In this case the more efficient producer with the agreement increases trade.

**1.6.3 Regional Trade Agreements:** Regional trading agreements refer to a treaty that is signed by two or more countries to encourage free movement of goods and services across the borders of its members. The agreement comes with internal rules that member countries follow among themselves. When dealing with non-member countries, there are external rules in place that the members adhere to.

**Types of Regional Trading Agreements:** Regional trading agreements vary depending on the level of commitment and the arrangement among the member countries.

1. Preferential Trade Areas: *The preferential trading agreement requires the lowest level of commitment to reducing trade barriers. Trade barriers are legal measures put into place primarily to protect a nation's home economy. They typically reduce the quantity of goods and services that can be imported. Such trade barriers take the form of tariffs or taxes and, though member countries do not eliminate the barriers among themselves. Also, preferential trade areas do not share common external trade barriers.*

*2. Free Trade Area:* In a free trade agreement, all trade barriers among members are eliminated, which means that they can freely move goods and services among themselves. When it comes to dealing with non-members, the trade policies of each member still take effect.
*3. Customs Union:* A customs union is an agreement between two or more neighboring countries to remove trade barriers, reduce or abolish customs duty, and eliminate quotas. Such unions were defined by the General Agreement on Tariffs and Trade (GATT) and are the third stage of economic integration. remove trade barriers among themselves and adopt common external trade barriers.
*4. Common Market:* A common market is a type of trading agreement wherein members remove internal trade barriers, adopt common policies when it comes to dealing with non-members, and allow members to move resources among themselves freely.
*5. Economic Union:* An economic union is one of the different types of trade blocs. It refers to an agreement between countries that allows products, services, and workers to cross borders freely. The union is aimed at eliminating internal trade barriers between the member countries, with the goal of economically benefitting all the member countries. is a trading agreement wherein members eliminate trade barriers among themselves, adopt common external barriers, allow free import and export of resources, adopt a set of economic policies, and use one currency.
*6. Full Integration:* The full integration of member countries is the final level of trading agreements.

**Benefits of Regional Trading Agreements**

Regional trading agreements offer the following benefits:

**1. Boosts Economic Growth:** Member countries benefit from trade agreements, particularly in the form of generation of more job opportunities, lower unemployment rates, and market expansions. Also, since trade agreements usually come with investment guarantees, investors who want to invest in developing countries are protected against political risk.

**2. Volume of Trade:** Businesses in member countries enjoy greater incentives to trade in new markets, thanks to attractive trading conditions due to the policies included in the agreements.

**3. Quality and Variety of Goods:** Trade agreements open a lot of doors for businesses. As they gain access to new markets, the competition becomes more intense. The increased competition compels businesses to produce higher quality products. It also leads to more variety for consumers. When there is a wide variety of high-quality products, businesses can improve customer satisfaction.

**1.6.4 European Union (EU):** The **European Union** (**EU**) is a political and economic union of 27 member states that are located primarily in Europe. Its members have a combined area of 4,233,255.3 $km^2$ (1,634,469.0 sq mi) and an estimated total population of about 447 million. The EU has developed an internal single market through a standardized system of laws that apply in all member states in those matters, and only those matters, where members have agreed to act as one. EU policies aim to ensure the free movement of people, goods, services and capital within the internal market, enact legislation in justice and home affairs and maintain common policies on trade, agriculture, fisheries and regional development. For travel within the Schengen Area, passport controls have been abolished. A monetary union was established in 1999, coming into full force in 2002, and is composed of 19 EU member states which use the euro currency.

The EU and European citizenship were established when the Maastricht Treaty came into force in 1993. The EU traces its origins to the European Coal and Steel Community (ECSC) and the European Economic Community (EEC), established, respectively, by the 1951 Treaty of Paris and 1957 Treaty of Rome. The original members of what came to be known as the European Communities were the Inner Six: Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany. The Communities and their successors have grown in size by the accession of new member states and in power by the addition of policy areas to their remit. The latest major amendment to the constitutional basis of the EU, the Treaty of Lisbon, came into force in 2009.

In January 2020, the United Kingdom became the first member state ever to leave the EU. Following a 2016 referendum, the UK signified its intention to leave and negotiated a withdrawal agreement. The UK is in a transitional phase until at least 31 December 2020, during which it remains subject to EU law and part of the EU single market and customs union. Before this, three territories of member states had left the EU or its forerunners, these being French Algeria (in 1962, upon independence), Greenland (in 1985, following a referendum) and Saint Barthélemy (in 2012).

Containing in 2020 some 5.8% of the world population, the EU in 2017 (including the United Kingdom) had generated a nominal gross domestic product (GDP) of around 20 trillion US dollars, constituting approximately 25% of global nominal GDP. Additionally, all EU countries have a very high Human Development Index, according to the United Nations Development Programme. In 2012, the EU was awarded the Nobel Peace Prize. Through the Common Foreign and Security Policy, the EU has developed a role in external relations and defense. The union maintains permanent diplomatic missions throughout the world and represents itself at the United Nations, the World Trade Organization, the G7 and the G20. Due to its global influence, the European Union has been described as an emerging superpower.

**1.6.5 ASEAN, SAARC, NAFTA**

**ASEAN:** ASEAN was preceded by an organization formed on 31 July 1961 called the **Association of Southeast Asia** (**ASA**), a group consisting of Thailand, the Philippines, and the Federation of Malaya. ASEAN itself was created on 8 August 1967, when the foreign ministers of five countries: Indonesia, Malaysia, the Philippines, Singapore, and Thailand, signed the ASEAN Declaration. As set out in the Declaration, the aims and purposes of ASEAN are to accelerate economic growth, social progress, and cultural development in the region, to promote regional peace, collaboration and mutual assistance on matters of common interest, to provide assistance to each other in the form of training and research facilities, to collaborate for better utilization of agriculture and industry to raise the living standards of the people, to promote Southeast Asian studies and to maintain close, beneficial co-operation with existing international organizations with similar aims and purposes.

The creation of ASEAN was motivated by a common fear of communism.[21] The group achieved greater cohesion in the mid-1970s following a change in the balance of power after the end of the Vietnam War in 1975. The region's dynamic economic growth during the 1970s strengthened the organization, enabling ASEAN to adopt a unified response to Vietnam's invasion of Cambodia in 1979. ASEAN's first summit meeting, held in Bali, Indonesia in 1976, resulted in an agreement on several industrial projects and the signing of a Treaty of Amity and Cooperation, and a Declaration of Concord. The end of the Cold War allowed ASEAN countries to exercise greater political independence in the region, and in the 1990s ASEAN emerged as a leading voice on regional trade and security issues.

**SAARC:** The South Asian Association for Regional Cooperation (SAARC) was established with the signing of the SAARC Charter in Dhaka on 8 December 1985. SAARC comprises of eight Member States: Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. The Secretariat of the Association was set up in Kathmandu on 17 January 1987.

The objectives of the Association as outlined in the SAARC Charter are: to promote the welfare of the peoples of South Asia and to improve their quality of life; to accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realize their full potentials; to promote and strengthen collective self-reliance among the countries of South Asia; to contribute to mutual trust, understanding and appreciation of one another's problems; to promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields; to strengthen cooperation with other developing countries; to strengthen cooperation among themselves in international forums on matters of common interests; and to cooperate with international and regional organizations with similar aims and purposes.

Decisions at all levels are to be taken on the basis of unanimity; and bilateral and contentious issues are excluded from the deliberations of the Association.

**NAFTA:** The **North American Free Trade Agreement** (**NAFTA)** was an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The agreement came into force on January 1, 1994, and superseded the 1988 Canada–United States Free Trade Agreement between the United States and Canada. The NAFTA trade bloc is one of the largest trade blocs in the world by gross domestic product.

The impetus for a North American free trade zone began with U.S. president Ronald Reagan, who made the idea part of his 1980 presidential campaign. After the signing of the Canada–

United States Free Trade Agreement in 1988, the administrations of U.S. president George H. W. Bush, Mexican president Carlos Salinas de Gortari, and Canadian prime minister Brian Mulroney agreed to negotiate what became NAFTA. Each submitted the agreement for ratification in their respective capitals in December 1992, but NAFTA faced significant opposition in both the United States and Canada. All three countries ratified NAFTA in 1993 after the addition of two side agreements, the North American Agreement on Labor Cooperation (NAALC) and the North American Agreement on Environmental Cooperation (NAAEC).

Passage of NAFTA resulted in the elimination or reduction of barriers to trade and investment between the U.S., Canada, and Mexico. The effects of the agreement regarding issues such as employment, the environment, and economic growth have been the subject of political disputes. Most economic analyses indicate that NAFTA has been beneficial to the North American economies and the average citizen, but has harmed a small minority of workers in industries exposed to trade competition. Economists hold that withdrawing from NAFTA or renegotiating NAFTA in a way that reestablishes trade barriers would adversely affect the U.S. economy and cost jobs. However, Mexico would be much more severely affected by job loss and reduction of economic growth in both the short term and long term.

After U.S. president Donald Trump took office in January 2017, he sought to replace NAFTA with a new agreement, beginning negotiations with Canada and Mexico. In September 2018, the United States, Mexico, and Canada reached an agreement to replace NAFTA with the United States–Mexico–Canada Agreement (USMCA), and all three countries had ratified it by March 2020. NAFTA remained in force until USMCA was implemented. As of April 2020, Canada and Mexico have notified the U.S. that they are ready to implement the agreement.

## Sub Unit - 7: INTERNATIONAL ECONOMIC INSTITUTIONS

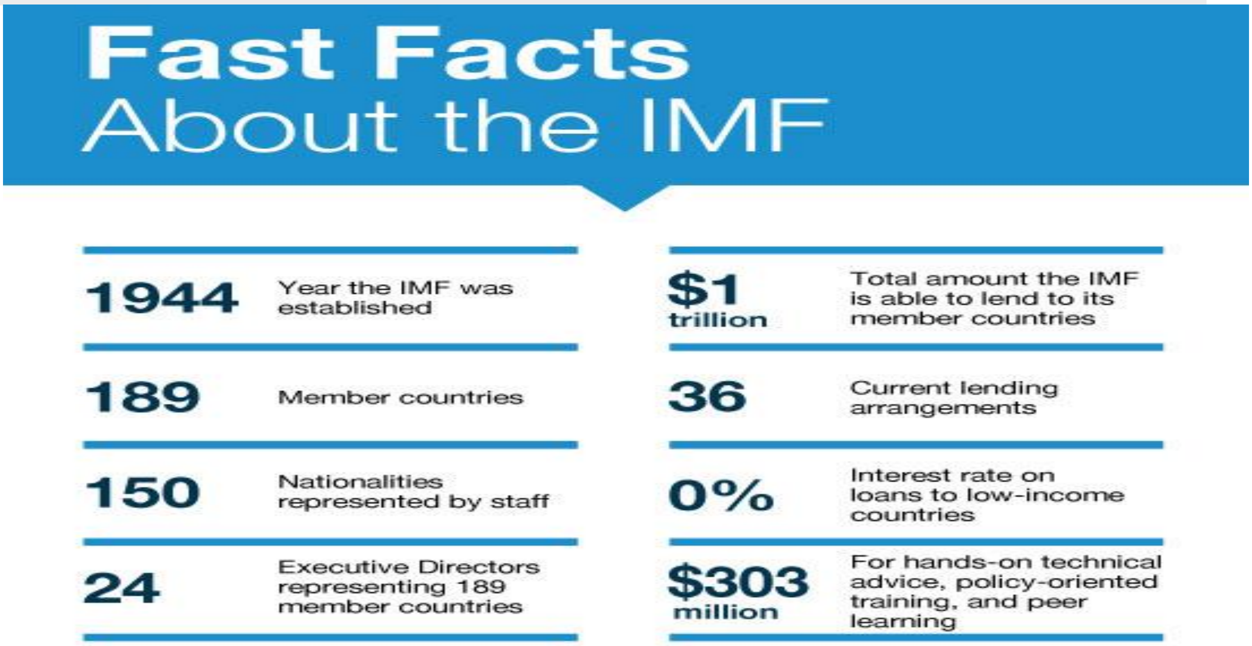
### 1.7.1 IMF:

**The IMF at a Glance**

The International Monetary Fund (IMF) is an organization of 189 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

Created in 1945, the IMF is governed by and accountable to the 189 countries that make up its near-global membership.

The IMF's primary purpose is to ensure the stability of the international monetary system—the system of exchange rates and international payments that enables countries (and their citizens) to transact with each other. The Fund's mandate was updated in 2012 to include all macroeconomic and financial sector issues that bear on global stability.




**What We Do:** The IMF's fundamental mission is to ensure the stability of the international monetary system. It does so in three ways: keeping track of the global economy and the economies of member countries; lending to countries with balance of payments difficulties; and giving practical help to members.

*Economic Surveillance*

The IMF oversees the international monetary system and monitors the economic and financial policies of its 189 member countries. As part of this process, which takes place both at the global level and in individual countries, the IMF highlights possible risks to stability and advises on needed policy adjustments.

*Lending*

The IMF provides loans to member countries experiencing actual or potential balance of payments problems to help them rebuild their international reserves, stabilize their currencies, continue paying for imports, and restore conditions for strong economic growth, while correcting underlying problems.

*Capacity Development*

The IMF works with governments around the world to modernize their economic policies and institutions, and train their people. This helps countries strengthen their economy, improve growth and create jobs.

**Organization & Finances:** The IMF has a management team and 17 departments that carry out its country, policy, analytical, and technical work. One department is charged with managing the IMF's resources. This section also explains where the IMF gets its resources and how they are used.

*Management*

The IMF has a Managing Director, who is head of the staff and Chairperson of the Executive Board. The Managing Director is appointed by the Executive Board for a renewable term of five years and is assisted by a First Deputy Managing Director and three Deputy Managing Directors.

*Staff*

The IMF's employees come from all over the world; they are responsible to the IMF and not to the authorities of the countries of which they are citizens. The IMF staff is organized mainly into area; functional; and information, liaison, and support responsibilities.

*IMF Resources*

Most resources for IMF loans are provided by member countries, primarily through their payment of quotas.

*Quotas*

Quota subscriptions are a central component of the IMF's financial resources. Each member country of the IMF is assigned a quota, based broadly on its relative position in the world economy.

*Special Drawing Rights (SDR)*

The SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves.

*Gold*

Gold remains an important asset in the reserve holdings of several countries, and the IMF is still one of the world's largest official holders of gold.

*Borrowing Arrangements*

While quota subscriptions of member countries are the IMF's main source of financing, the Fund can supplement its quota resources through borrowing if it believes that they might fall short of members' needs.

**Governance**

*Governance Structure*

The IMF has evolved along with the global economy throughout its 70-year history, allowing the organization to retain a central role within the international financial architecture.

*Country Representation*

Unlike the General Assembly of the United Nations, where each country has one vote, decision making at the IMF was designed to reflect the relative positions of its member countries in the global economy. The IMF continues to undertake reforms to ensure that its governance structure adequately reflects fundamental changes taking place in the world economy.

*Accountability*

Created in 1945, the IMF is governed by and accountable to the 189 countries that make up its near-global membership. Decision making at the IMF was designed to reflect the relative positions of its member countries in the global economy.

*Transparency*

The IMF has policies in place to ensure that meaningful and accurate information—both about its own role in the global economy and the economies of its member countries—is provided in real time to its global audiences.

*Corporate Giving*

The IMF Giving Together campaign guides the IMF's humanitarian and community outreach efforts.

**History**

*The IMF in History*

In 1944, representatives of 44 nations met in Bretton Woods, New Hampshire, to draw up a plan for the post-World War II economic order. Their goal was to avoid a repetition of the destructive policies that could spark another conflict. So they created the IMF to promote international monetary cooperation. Ever since, the IMF has played a vital role in maintaining global economic stability and ensuring broadly shared prosperity.

**1.7.2 WORLD BANK:** The **World Bank** is an international financial institution that provides loans and grants to the governments of poorer countries for the purpose of pursuing capital projects. It comprises two institutions: the International Bank for Reconstruction and Development (IBRD), and the International Development Association (IDA). The World Bank is a component of the World Bank Group.

The World Bank's most recent stated goal is the reduction of poverty. As of November 2018, the largest recipients of World Bank loans were India ($859 million in 2018) and China ($370 million in 2018), through loans from IBRD.

The World Bank was created at the 1944 Bretton Woods Conference, along with the International Monetary Fund (IMF). The president of the World Bank is, traditionally, an American. The World Bank and the IMF are both based in Washington, D.C., and work closely with each other.

**World Bank Group:** The World Bank Group is an extended family of five international organizations, and the parent organization of the World Bank, the collective name given to the first two listed organizations, the IBRD and the IDA:

- International Bank for Reconstruction and Development (IBRD)
- International Development Association (IDA)
- International Finance Corporation (IFC)
- Multilateral Investment Guarantee Agency (MIGA)
- International Centre for Settlement of Investment Disputes (ICSID)

**Leadership:** The President of the Bank is the president of the entire World Bank Group. The president is responsible for chairing meetings of the Boards of Directors and for overall management of the Bank. Traditionally, the President of the Bank has always been a US citizen nominated by the United States, the largest shareholder in the bank (the managing director of the International Monetary Fund having always been a European). The nominee is subject to confirmation by the Board of Executive Directors, to serve for a five-year, renewable term. While most World Bank presidents have had banking experience, some have not.

The vice presidents of the Bank are its principal managers, in charge of regions, sectors, networks and functions. There are two Executive Vice presidents, three Senior Vice presidents, and 24 Vice presidents.

The Boards of Directors consist of the World Bank Group President and 25 Executive Directors. The President is the presiding officer, and ordinarily has no vote except a deciding vote in case of an equal division. The Executive Directors as individuals cannot exercise any power nor commit or represent the Bank unless specifically authorized by the Boards to do so. With the term beginning 1 November 2010, the number of Executive Directors increased by one, to 25.

Members

The International Bank for Reconstruction and Development (IBRD) has 189 member countries, while the International Development Association (IDA) has 173 members. Each member state of IBRD should also be a member of the International Monetary Fund (IMF) and only members of IBRD are allowed to join other institutions within the Bank (such as IDA).

**Voting power:** In 2010 voting powers at the World Bank were revised to increase the voice of developing countries, notably China. The countries with most voting power are now the United States (15.85%), Japan (6.84%), China (4.42%), Germany (4.00%), the United Kingdom (3.75%), France (3.75%), India (2.91%), Russia (2.77%), Saudi Arabia (2.77%) and Italy (2.64%). Under the changes, known as 'Voice Reform – Phase 2', countries other than China that saw significant gains included South Korea, Turkey, Mexico, Singapore, Greece, Brazil, India, and Spain. Most developed countries' voting power was reduced, along with a few developing countries such as Nigeria. The voting powers of the United States, Russia and Saudi Arabia were unchanged.

The changes were brought about with the goal of making voting more universal in regards to standards, rule-based with objective indicators, and transparent among other things. Now, developing countries have an increased voice in the "Pool Model", backed especially by

Europe. Additionally, voting power is based on economic size in addition to International Development Association contributions.

**Poverty reduction strategies:** For the poorest developing countries in the world, the bank's assistance plans are based on poverty reduction strategies; by combining an analysis of local groups with an analysis of the country's financial and economic situation the World Bank develops a plan pertaining to the country in question. The government then identifies the country's priorities and targets for the reduction of poverty, and the World Bank instigates its aid efforts correspondingly.

Forty-five countries pledged US$25.1 billion in "aid for the world's poorest countries", aid that goes to the World Bank International Development Association (IDA), which distributes the loans to eighty poorer countries. Wealthier nations sometimes fund their own aid projects, including those for diseases. Robert B. Zoellick, the former president of the World Bank, said when the loans were announced on 15 December 2007, that IDA money "is the core funding that the poorest developing countries rely on".

World Bank organizes the Development Marketplace Awards, a grant program that surfaces and funds development projects with potential for development impact that are scalable and/or replicable. The grant beneficiaries are social enterprises with projects that aim to deliver social and public services to groups with lowest incomes.

**Global partnerships and initiatives:** The World Bank has been assigned temporary management responsibility of the Clean Technology Fund (CTF), focused on making renewable energy cost-competitive with coal-fired power as quickly as possible, but this may not continue after UN's Copenhagen climate change conference in December 2009, because of the Bank's continued investment in coal-fired power plants. (In December 2017, Kim announced the World Bank would no longer finance fossil fuel development.)

Together with the World Health Organization, the World Bank administers the International Health Partnership (IHP+). IHP+ is a group of partners committed to improving the health of citizens in developing countries. Partners work together to put international principles for aid effectiveness and development cooperation into practice in the health sector. IHP+ mobilizes national governments, development agencies, civil society and others to support a single, country-led national health strategy in a well-coordinated way.

**1.7.3 UNCTAD:** The **United Nations Conference on Trade and Development** (**UNCTAD**) was established in 1964 as a permanent intergovernmental body. UNCTAD is the part of the United Nations Secretariat dealing with trade, investment, and development issues. The organization's goals are to: "maximize the trade, investment and development opportunities of developing countries and assist them in their efforts to integrate into the world economy on an equitable basis". UNCTAD was established by the United Nations General Assembly in 1964 and it reports to the UN General Assembly and United Nations Economic and Social Council.

The ***primary objective*** of UNCTAD is to formulate policies relating to all aspects of development including trade, aid, transport, finance and technology. The conference ordinarily meets once in four years; the permanent secretariat is in Geneva.

One of the principal achievements of UNCTAD (1964) has been to conceive and implement the Generalized System of Preferences (GSP). It was argued in UNCTAD that to promote exports of manufactured goods from developing countries, it would be necessary to offer special tariff concessions to such exports. Accepting this argument, the developed countries formulated the GSP scheme under which manufacturers' exports and import of some agricultural goods from the developing countries enter duty-free or at reduced rates in the developed countries. Since imports of such items from other developed countries are subject to the normal rates of duties, imports of the same items from developing countries would enjoy a competitive advantage.

The creation of UNCTAD in 1964 was based on concerns of developing countries over the international market, multi-national corporations, and great disparity between developed nations and developing nations. The United Nations Conference on Trade and Development was established to provide a forum where the developing countries could discuss the problems relating to their economic development. The organization grew from the view that existing institutions like GATT (now replaced by the World Trade Organization, WTO), the International Monetary Fund (IMF), and World Bank were not properly organized to handle the particular problems of developing countries. Later, in the 1970s and 1980s, UNCTAD was closely associated with the idea of a New International Economic Order (NIEO).

The first UNCTAD conference took place in Geneva in 1964, the second in New Delhi in 1968, the third in Santiago in 1972, fourth in Nairobi in 1976, the fifth in Manila in 1979, the sixth in Belgrade in 1983, the seventh in Geneva in 1987, the eighth in Cartagena in 1992, the ninth at Johannesburg (South Africa) in 1996, the tenth in Bangkok (Thailand) in 2000, the eleventh in São Paulo (Brazil) in 2004, the twelfth in Accra in 2008, the thirteenth in Doha (Qatar) in 2012 and the fourteenth in Nairobi (Kenya) in 2016.

Currently, UNCTAD has 195 member states and is headquartered in Geneva, Switzerland. UNCTAD has 400 staff members and a bi-annual (2010–2011) regular budget of $138 million in core expenditures and $72 million in extra-budgetary technical assistance funds. It is a member of the United Nations Development Group. There are non-governmental organizations participating in the activities of UNCTAD.

Membership

As of May 2018, 195 states are UNCTAD members:[4] all UN members plus UN observer states Palestine and the Holy See. UNCTAD members are divided into four lists, the division being based on United Nations Regional Groups with six members unassigned: Armenia, Kiribati, Nauru, South Sudan, Tajikistan, Tuvalu. List A consists mostly of countries in the African and Asia-Pacific Groups of the UN. List B consists of countries of the Western

European and Others Group. List C consists of countries of the Group of Latin American and Caribbean States (GRULAC). List D consists of countries of the Eastern European Group.
The lists, originally defined in 19th General Assembly resolution 1995 serve to balance geographical distribution of member states' representation on the Trade Development Board and other UNCTAD structures. The lists are similar to those of UNIDO, an UN specialized agency. The most recent member are the Palestinians

## Sub Unit - 8: WORLD TRADE ORGANIZATION (WTO)

**1.8.1 Functions and Objectives of WTO:** The Uruguay round of GATT (1986-93) gave birth to World Trade Organization. The members of GATT singed on an agreement of Uruguay round in April 1994 in Morocco for establishing a new organization named WTO.

It was officially constituted on January 1, 1995 which took the place of GATT as an effective formal, organization. GATT was an informal organization which regulated world trade since 1948.

Contrary to the temporary nature of GATT, WTO is a permanent organization which has been established on the basis of an international treaty approved by participating countries. It achieved the international status like IMF and IBRD, but it is not an agency of the United Nations Organization (UNO).

*Structure:*

The WTO has nearly 153 members accounting for over 97% of world trade. Around 30 others are negotiating membership. Decisions are made by the entire membership. This is typically by consensus.

A majority vote is also possible but it has never been used in the WTO and was extremely rare under the WTO's predecessor, GATT. The WTO's agreements have been ratified in all members' parliaments.

The WTO's top-level decision-making body is the Ministerial Conferences which meets at least once in every two years. Below this is the General Council (normally ambassadors and heads of delegation in Geneva, but sometimes officials sent from members' capitals) which meets several times a year in the Geneva headquarters. The General Council also meets as the Trade Policy Review Body and the Disputes Settlement Body.

At the next level, the Goods Council, Services Council and Intellectual Property (TRIPs) Council report to the General Council. Numerous specialized committees, working groups and working parties deal with the individual agreements and other areas such as, the environment, development, membership applications and regional trade agreements.

*Secretariat:*

The WTO secretariat, based in Geneva, has around 600 staff and is headed by a Director-General. Its annual budget is roughly 160 million Swiss Francs. It does not have branch offices outside Geneva. Since decisions are taken by the members themselves, the secretariat does not have the decision making the role that other international bureaucracies are given.

The secretariat s main duties to supply technical support for the various councils and committees and the ministerial conferences, to provide technical assistance for developing countries, to analyze world trade and to explain WTO affairs to the public and media. The secretariat also provides some forms of legal assistance in the dispute settlement process and advises governments wishing to become members of the WTO.

*Objectives of WTO:*

**The important objectives of WTO are:**
1. To improve the standard of living of people in the member countries.
2. To ensure full employment and broad increase in effective demand.
3. To enlarge production and trade of goods.
4. To increase the trade of services.
5. To ensure optimum utilization of world resources.
6. To protect the environment.
7. To accept the concept of sustainable development.

*Functions of WTO:*

**The main functions of WTO are discussed below:**
1. To implement rules and provisions related to trade policy review mechanism.
2. To provide a platform to member countries to decide future strategies related to trade and tariff.
3. To provide facilities for implementation, administration and operation of multilateral and bilateral agreements of the world trade.
4. To administer the rules and processes related to dispute settlement.
5. To ensure the optimum use of world resources.
6. To assist international organizations such as, IMF and IBRD for establishing coherence in Universal Economic Policy determination.

**1.8.2 Agriculture and Agreement:** The **Agreement on Agriculture** (**AOA**) is an international treaty of the World Trade Organization. It was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO on January 1, 1995.

***Three pillars:*** The Agreement on Agriculture constitutes of three pillars—domestic support, market access, and export subsidies.

**Domestic support:** The first pillar of the Agreement on Agriculture is "domestic support". AOA divides domestic support into two categories: trade-distorting and non-trade-distorting (or minimally trade-distorting). The WTO Agreement on Agriculture negotiated in the Uruguay Round (1986–1994) includes the classification of subsidies by "boxes" depending on consequences of production and trade: amber (most directly linked to production levels), blue (production-limiting programmes that still distort trade), and green (minimal distortion). While payments in the amber box had to be reduced, those in the green box were exempt from reduction commitments. Detailed rules for green box payments are set out in Annex 2 of the AoA. However, all must comply with the "fundamental requirement" in paragraph 1, to cause not more than minimal distortion of trade or production, and must be provided through a government-funded programme that does not involve transfers from consumers or price support to producers.

The Agreement on Agriculture's domestic support system currently allows Europe and the United States to spend $380 billion a year on agricultural subsidies. The World Bank dismissed the EU and the United States' argument that small farmers needed protection, noting that more than half of the EU's Common Agricultural Policy subsidies go to 1% of producers while in the United States 70% of subsidies go to 10% of its producers, mainly agribusinesses. These subsidies end up flooding global markets with below-cost commodities, depressing prices, and undercutting producers in poor countries, a practice known as dumping.

**Market access**: Market access refers to the reduction of tariff (or non-tariff) barriers to trade by WTO members. The 1995 Agreement on Agriculture consists of tariff reductions of:

- 36% average reduction - developed countries - with a minimum of 15% per-tariff line reduction in next six years.
- 24% average reduction - developing countries - with a minimum of 10% per-tariff line reduction in next ten years.

Least developed countries (LDCs) were exempt from tariff reductions, but they either had to convert non-tariff barriers to tariffs—a process called tariffication—or "bind" their tariffs, creating a ceiling that could not be increased in future.

**Export subsidies:** Export subsidies are the third pillar. The 1995 Agreement on Agriculture required developed countries to reduce export subsidies by at least 36% (by value) or by 21% (by volume) over six years. For developing countries, the agreement required cuts were 14% (by volume) and 24% (by value) over ten years.

1.8.3 GATS, TRIPS, TRIMS

**GATS:** The General Agreement on Trade in Services (GATS) is the first multilateral agreement covering trade in services. It was negotiated during the last round of multilateral trade negotiations, called the Uruguay Round, and came into force in 1995. The GATS provides a framework of rules governing services trade, establishes a mechanism for countries to make commitments to liberalize trade in services and provides a mechanism for resolving disputes between countries. All members of the WTO are parties to the GATS. The basic WTO principle of most favoured nation (MFN) applies to GATS as well. However, upon accession, members may introduce temporary exemptions to this rule. Similar in principle to the General Agreement on Tariffs and Trade (GATT), which deals with trade in goods, the GATS has two primary objectives: first, to ensure that all signatories are treated equitably when accessing foreign markets; and second, to promote progressive liberalization of trade in services (over time, eliminating trade barriers to enable further participation in one another's markets).

While the overall goal of GATS is to remove barriers to trade, members are free to choose which sectors are to be progressively "liberalized" (i.e. marketized and privatized); which mode of supply would apply to a particular sector; and to what extent that "liberalization" will occur over a given period of time. Members' commitments are governed by a ratchet effect: commitments are one-way and are not to be wound back once entered into. The reason for the rule is to create a stable trading climate (i.e. a market). However, Article XXI allows members to withdraw commitments, and so far, two members have exercised the option (US and EU). In November 2008, Bolivia gave a notification that it will withdraw its health services commitments.

Some activist groups consider that GATS risks undermining the ability and authority of governments to regulate commercial activities within their own boundaries, with the effect of ceding power to business interests ahead of the interests of citizens. In 2003, the *GATS watch* network published a critical statement supported by over 500 organizations in 60 countries. At the same time, countries are not under any obligation to enter international agreements such as GATS. For countries that like to attract trade and investment, GATS adds a measure of transparency and legal predictability. Legal obstacles to services trade can have legitimate policy reasons, but they can also be an effective tool for large scale corruption (De Soto, Hernando. The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else.)

**Four modes of supply:** The GATS agreement covers four modes of supply for the delivery of services in cross-border trade:

| **Mode** | **Criteria** | **Supplier Presence** |
|---|---|---|
| Mode 1: Cross-border supply | Service delivered within the territory of the Member, from the territory of another Member | Service supplier not present within the territory of the member |
| Mode 2: Consumption abroad | Service delivered outside the territory of the Member, in the territory of another Member, to a service consumer of the Member | |
| Mode 3: Commercial presence | Service delivered within the territory of the Member, through the commercial presence of the supplier | Service supplier present within the territory of the Member |
| Mode 4: Presence of a natural person | Service delivered within the territory of the Member, with supplier present as a natural person | |

**Sectors addressed:** Services Sector Classifications addressed in the GATS are defined in the so-called "W/120 list", which provides a list of all sectors which can be negotiated under the GATS. The title refers to the name of the official WTO document, *MTN.GNS/W/120*.

The sectors covered by the GATS are twelve service sectors (Business; Communication; Construction and Engineering; Distribution; Education; Environment; Financial; Health; Tourism and Travel; Recreation, Cultural, and Sporting; Transport; "Other") which, in turn, are divided into sub-sectors.

**Criticisms:** The GATS agreement has been criticized for tending to substitute the authority of national legislation and judiciary with that of a GATS Disputes Panel conducting closed hearings. WTO member-government spokespersons are obliged to dismiss such criticism because of prior commitment to perceived benefits of prevailing commercial principles of competition and 'liberalization'.

While national governments have the option to exclude any specific service from liberalisation under GATS, they are also under pressure from international business interests to refrain from excluding any service "provided on a commercial basis". Important public utilities such as water and electricity most commonly involve purchase by consumers and are thus demonstrably "provided on a commercial basis". The same may be said of many health and education services which are sought to be 'exported' by some countries as profitable industries. This definition defines virtually any public service as being "provided on a commercial basis" and is already extending into such areas as police, the military, prisons, the justice system, public administration, and government. Over a fairly short time perspective, this could open up for the privatization or marketisation of large parts, and possibly all, of what today are considered public services currently available for the whole population of a country as a social entitlement, to be restructured, marketized, contracted out to for-profit providers, and eventually fully privatized and available only to those who can pay for them. This process is currently far advanced in most countries, usually (and intentionally) without properly informing or consulting the public as to whether or not this is what they desire.

**TRIPS:** Trade-Related Aspects of Intellectual Property Rights (TRIPS) is arguably the most important and comprehensive international agreement on intellectual property rights. Member countries of the WTO are automatically bound by the agreement. The Agreement covers most forms of intellectual property including patents, copyright, trademarks, geographical indications, industrial designs, trade secrets, and exclusionary rights over new plant varieties. It came into force on 1 January 1995 and is binding on all members of the World Trade Organization (WTO).

Intellectual Property Rights are the rights given to persons/agencies for their creativity/innovations. These rights usually give the creator, an exclusive right over the use of his/her creation for a certain period of time. The importance of intellectual property in India is well established at all levels- statutory, administrative and judicial.

This Agreement, inter-alia, contains an Agreement on Trade Related Aspects of Intellectual Property Rights **(TRIPS)** which came into force from 1st January 1995. It lays down minimum standards for protection and enforcement of intellectual property rights in member countries which are required to promote effective and adequate protection of intellectual property rights with a view to reducing distortions and impediments to international trade. The obligations under the TRIPS Agreement relate to provision of minimum standard of protection within the member countries legal systems and practices.

**The Agreement provides for norms and standards in respect of following areas of intellectual property:**

- Patents
- Trade Marks
- Copyrights
- Geographical Indications
- Industrial Designs

The basic obligation in the area of patents is that, invention in all branches of technology whether products or processes shall be patentable if they meet the three tests of being new involving an inventive step and being capable of industrial application. In addition to the general security exemption which applied to the entire TRIPS Agreement, specific exclusions are permissible from the scope of patentability of inventions, the prevention of whose commercial exploitation is necessary to protect public order or morality, human, animal, plant life or health or to avoid serious prejudice to the environment.

**TRIMS:** Under the Agreement on Trade-Related Investment Measures of the World Trade Organization (WTO), commonly known as the TRIMs Agreement, WTO members have agreed not to apply certain investment measures related to trade in goods that restrict or distort trade. The TRIMs Agreement prohibits certain measures that violate the national treatment and quantitative restrictions requirements of the General Agreement on Tariffs and Trade (GATT). The agreement on the Trade Related Investment Measures (TRIMS) calls for introducing national treatment of foreign investment and removal of quantities restrictions. It identifies five investment measures which are inconsistent with the General Agreement on Trade and Tariff (GATT) on according national treatment and on general elimination of quantitative restrictions. These are measure which are imposed on the foreign investors the obligation to use local inputs, to produce for export as a condition to obtain imported goods as inputs, to balance foreign exchange outgo on importing inputs with foreign exchange earnings through export and not to export more than a specified proportion of the local production.

Trade-Related Investment Measures is the name of one of the four principal legal agreements of the World Trade Organization (WTO), trade treaty. TRIMs are rules that restrict preference of domestic firms and thereby enable international firms to operate more easily within foreign markets. The TRIMs Agreement prohibits certain measures that violate the national treatment and quantitative restrictions requirements of the General Agreement on Tariffs and Trade (GATT).

**TRIMs may include requirements to:**

I. Achieve a certain level of local content;
II. Produce locally;
III. Export a given level/percentage of goods;
IV. Balance the amount/percentage of imports with the amount/percentage of exports;
V. Transfer of technology or proprietary business information to local persons;

These requirements may be mandatory conditions for investment, or can be attached to fiscal or other incentives. The TRIMs Agreement does not cover services. All WTO member countries (offsite link) are parties to this Agreement. This Agreement went into effect on January 1, 1995. It has no expiration date.

The Agreement requires all WTO Members to notify the TRIMs that are inconsistent with the provisions of the Agreement, and to eliminate them after the expiry of the transition period provided in the Agreement. Transition periods of two years in the case of developed countries, five years in the case of developing countries and seven years in the case of LDCs.

**India's Notified TRIMs**: As per the provisions of Article. 5.1 of the TRIMs Agreement India had notified three trade related investment measures as inconsistent with the provisions of the Agreement:

1. Local content (mixing) requirements in the production of News Print,
2. Local content requirement in the production of Rifampicin (a medicine) and Penicillin – G, and
3. Dividend balancing requirement in the case of investment in 22 categories of consumer goods.

Such notified TRIMs were due to be eliminated by 31st December, 1999. None of these measures is in force at present. Therefore, India does not have any outstanding obligations under the TRIMs agreement as far as notified TRIMs are concerned.

The TRIMs Agreement has been found by the developing countries to be standing in the way of sustained industrialization of developing countries, without exposing them to balance of payment shocks, by reducing substantially the policy space available to these countries. Developed countries, on the other hand, have been arguing for a further expansion in the list of prohibited TRIM. But India should be careful while giving its node to the expansion of TRIMS because it may make Indian manufacture more vulnerable against the cheap products of developed countries.