**CERTIFICATE COURSE IN BUDGET FORMULATION, IMPLEMENTATION, MANAGEMENT & CONTROL**

**Instructions**

**Attempt all questions**

**All questions have equal marks**

1. **How do MNCs come into existence? What steps may an MNC follow in becoming global?**

A multinational corporation (MNC) or worldwide enterprise is a corporate organization that owns or controls production of goods or services in at least one country other than its home country. A company or group should be considered a multinational corporation if it derives 25% or more of its revenue from out-of-home-country operations. A multinational corporation can also be referred to as a multinational enterprise (MNE), a transnational enterprise (TNE), a transnational corporation (TNC), an international corporation, or a stateless corporation. The two main characteristics of MNCs are their large size and the fact that their worldwide activities are centrally controlled by the parent companies and involves;

* Importing and exporting goods and services.
* Making significant investments in a foreign country.
* Buying and selling licenses in foreign markets.
* Engaging in contract manufacturing — permitting a local manufacturer in a foreign country to produce their products.
* Opening manufacturing facilities or assembly operations in foreign countries.

The steps to follow to become a MNC are;

Open Branches. Branches are the more straightforward way to expand to another country. Simply take some cash, get the pertinent business licenses, hire a localization team, and set up a branch in a foreign country. You obviously want to set up your branch in a busy, international area - for example, if you company is attempting to expand into China, you should set up in cosmopolitan Shanghai, and not the nether regions of Urumqi. You'll obviously pay more rent and taxes in Shanghai, but you have to make sure your company is highly exposed to other businesses that matter, paving the way to future local partnerships.

Subsidiaries. If you company is cash rich, then acquisitions may be a better strategy than establishing branches. Acquiring a local company for the purpose of vertical or horizontal integration is fast and comparatively easy, provided that you plan to leave the original business (branch management, infrastructure) intact. By making the acquired company your subsidiary, you have the advantages of instant localization, name recognition and an experienced team at the helm. However, do your homework before acquiring a subsidiary, lest your company experience acquisition indigestion.

Joint Venture. Perhaps you don't want to purchase local companies due to the hefty price tag. Maybe a local competitor, which cannot be acquired, is already dominating the market. In this case, the old adage "if you can't beat 'em, join 'em" comes into play. Establishing a joint venture - or a partnership with a foreign company in the same industry - is an attractive option. Both companies set aside capital, resources and technology in a new, shared company which is separate from the main operations at both companies. This is a popular option in countries, such as China, where the law is extremely strict with foreign businesses. Joint ventures have all the advantages of foreign acquisitions - such as localization and brand recognition - at a fraction of the cost. Most joint ventures split expenditures and profits 50/50.

Franchises. Franchises in foreign countries operate similarly to those in the United States. A foreign affiliate will purchase a license from your company to use your brand in a foreign country. While the foreign affiliate retains ownership of your branded business, your company will receive royalties from each franchise. Franchising is the cheapest option, and the fastest way to build an established presence in a foreign country with minimal risk. The higher risks (sales, profitability) are all absorbed by the foreign affiliate. However, foreign franchises have to be monitored closely, since the geographic and cultural divide can mask brewing problems.

Turn Key Projects. Turnkey projects are more common in businesses requiring precise technological expertise - such as power plants, factories or oil drilling platforms. In this setup, your business sells its technological know-how to a foreign firm, which pays your company to build a modified copy of your plant to their specifications, from scratch to the operational stage. This includes all of your technologies and trade secrets. Once the plant is completed, you hand over the keys to the fully working plant to the foreign firm. All they have to do is "turn the key" to get started. While selling factories is extremely profitable, you also forfeit your own direct expansion plans in the country, due to another firm already holding the license to your technology. This is the trickiest of the five criteria and the one you're least likely to encounter, unless your company specializes in mass production or resource exploration plants focused on developing markets.

However most of the largest and most influential companies of the modern age are publicly traded multinational corporations, including Forbes Global 2000 companies. Multinational corporations are subject to criticisms for lacking ethical standards. They have also become associated with multinational tax havens and base erosion and profit shifting tax avoidance activities.

1. **Describe the different kinds of international financial flows.**

International financial flows take a variety of forms, one of the most important categories being that of foreign direct investment. Reserve assets consist of those external assets that are readily available to, and controlled by, monetary authorities of individual countries for the financing of payments imbalances.

International investment or capital flows fall into four principal categories:

* Commercial loans. Commercial loans primarily take the form of bank loans issued to foreign businesses or governments
* Official flows. Official flows refer generally to the forms of development assistance that developed nations give to developing ones.
* Foreign direct investment (FDI), Foreign direct investment (FDI) pertains to international investment in which the investor obtains a lasting interest in an enterprise in another country. Most concretely, it may take the form of buying or constructing a factory in a foreign country or adding improvements to such a facility, in the form of property, plants, or equipment.
* And foreign portfolio investment (FPI). FDI is calculated to include all kinds of capital contributions, such as the purchases of stocks, as well as the reinvestment of earnings by a wholly owned company incorporated abroad (subsidiary), and the lending of funds to a foreign subsidiary or branch. The reinvestment of earnings and transfer of assets between a parent company and its subsidiary often constitutes a significant part of FDI calculations.

According to the United Nations Conference on Trade and Development (UNCTAD), the global expansion of FDI is currently being driven by over 65,000 transnational corporations with more than 850,000 foreign affiliates. An investor’s earnings on FDI take the form of profits such as dividends, retained earnings, management fees and royalty payments.

1. **Comment on the structure of balance of payments. What are the basic principles governing recording of the flows?**

The monetary transactions that happen between a resident of the country and the rest of the world are recorded. These are recorded in a statement called the balance of payment. The Structure of balance of payments includes current account, capital account, etc.

Balance of payment includes all the transactions that are made by corporates, individuals, and the government. Thus, it helps in monitoring the funds for the development of the country. So, when all the elements are added in the BOP, it should essentially sum up to zero.

Thus, the inflows and outflows of a country should balance out. But in reality, this does not happen. This statement is useful to identify whether the country has a surplus or deficit. Thus, to identify it if the country has more exports or more imports. The BOP for a country is vital for the following reasons:

* It reveals the economic and financial details of a country.
* The BOP statement can be an indicator to determine whether the currency of a country is appreciating or depreciating.
* Also, BOP helps the government on trade and fiscal policies.
* Thus, it provides important information to understand and analyse the economic dealings of one country with the other.

There are three main components that form the basis of the structure of balance of payments; the financial account, capital account, and current account.

Current Account. The current account is useful for monitoring inflow and outflow of goods and services. Thus, this account covers all the payments and receipts that are made with respect to manufactured goods and raw materials. Furthermore, it also includes receipts from tourism, engineering, business services, transportation, etc. There are many categories of trades that occur between the countries. These trades could be visible or invisible. When trades happen in goods between the countries than it is called as visible items. While the trade happening in import or exports of services, is referred to as invisible items.

Capital Account. The capital transactions that occur between the countries are monitored under the capital account. Thus, capital transactions include the sale and purchase of assets like properties. Furthermore, the capital account also includes the flow of taxes, sales and purchases of fixed assets for a migrant moving in or out of the country. The three major elements of the capital account are investments, foreign exchange reserves, and loans and borrowings.

Financial Account. This is the flow of funds to and from foreign countries via various investments in real estate, FDI, business ventures, etc. are monitored through the financial account. Also, this account measures the variation in foreign ownership. When you analyze this, you can understand whether a country us acquiring more or selling more. Example, suppose the value of exported goods via India is 110 crores. While the value of imported goods to India is 90 crores. Thus, it can be said that India has a trade surplus of 20 crores.

BOP helps as an economic indicator in order to identify a trade surplus or deficit of a country. There are many components in BOP that provides a clear indication of which sector is doing economically well. The balance of payments account of a country is constructed in table below.

**Illustration of Balance of Payment Account**

***Credits (+) Debits (-) (Receipts) (Payments)***

1. ***Currents Accounts***

***Exports Imports***

1. ***Goods a) Goods***
2. ***Services b) Services***
3. ***Transfer payments c) Transfer payments***
4. ***Capital Accounts***
5. ***Borrowing from foreign countries a) Lending to foreign countries***
6. ***Direct investment by foreign countries b) Direct investment in foreign countries***
7. ***Official settlement Accounts***
8. ***Increase in foreign official holdings a) Increase in official reserve of gold & foreign currencies***

***Errors & Omissions***

1. **How can the trade deficit be reduced or eliminated? Give your arguments based on the elasticity approach,**

The value of a country’s currency depends on the overall economy of the country. This includes manufacturing, foreign investments, employment, trade balance and many other economic indicators. All of the transactions that the country conducts with other countries represent part of the balance of payment. Economists use different tools to analyze and come up with methods for increasing, decreasing and balancing trade between countries.

Elasticity represents responsiveness. In economics, elasticity determines how demand changes when you change something about a product or service. In most cases, the concept of elasticity demonstrates how demand of a product or service will change as a result of a price increase or decrease. The elasticity approach to the balance of payments demonstrates how the change in the value of the currency affects a country's balance of payments.

The elasticity approach tries to predict the outcome policy changes will have on the balance of payments. For example, this approach illustrates how exchange rates will affect the balance. Further, the elasticity approach assumes that if the BOP is in equilibrium, devaluation can improve the balance of payments. However, for devaluation to function successfully, the total of the price elasticity of domestic and foreign demand for imports has to increase. When a country devalues a currency, it improves the balance of payments under ideal conditions. This ideal condition is known as the Marshall-Lerner condition. Named after English economist Alfred Marshall and Romanian economist Abba Lerner, the Marshall-Lerner Condition states that a currency devaluation will eventually improve the balance of payments. In order to accomplish this increase in the BOP, however, the sum of demand elasticity for imports and exports has to increase. When a country devalues its currency, the price of exports will decrease. This, in theory, will increase the demand for these exports. However, for increased demand to occur, the exported products have to be elastic products.

Higher tariffs on one country or product divert trade to other countries or products, distorting consumption but leaving the trade balance roughly unchanged. Higher tariffs on all countries will reduce imports, but they will also reduce exports, again leaving the trade balance roughly unchanged.

Three ways to reduce the trade deficit are:

* Consume less and save more. If US households or the government reduce consumption (businesses save more than they spend), imports will drop and less borrowing from abroad will be needed to pay for consumption. This means that consumption taxes—like those that nearly all other countries in the world have—could help reduce the deficit, by discouraging consumption, increasing saving, and reducing the government deficit. In contrast, an unfunded tax cut, such as the one proposed by the administration, will expand the deficit because the government will be consuming more relative to its earnings.
* Depreciate the exchange rate. Trade deficit reversals are typically driven by a significant real exchange rate depreciation. A weaker dollar makes imports more expensive and exports cheaper and improves the trade balance. Given the dollar is the world's reserve currency, and still regarded as the safest for investors, it tends to run stronger than other currencies. But when foreign governments actively push the dollar up to maintain their surpluses, the United States could counteract intervention by selling dollars and buying foreign currencies. The administration could also encourage the adoption of other major currencies, such as the euro, yen, or renminbi, as alternative reserve currencies. A weaker dollar would be good for the US economy, but relinquishing the role as the dominant currency would reduce the power of the United States in global markets and the seigniorage (profit) earned.
* Tax capital inflows. One of the reasons that the United States runs a trade deficit is because borrowing from abroad is cheap and easy. If it were more expensive, US citizens and the government would borrow less. A tax on (non–foreign direct investment) capital inflows that rises with the size of the inflow could reduce excessive borrowing for consumption and help close the government imbalance. While some worry that capital controls could distort asset prices and reduce investment, they could also curb excessive speculative investment, such as happened before the financial crisis.

1. **Why are MNCs driving investments in South Asian Countries like Thailand, Malaysia and Indonesia?**

The three South Asian Countries have been following consistent economic reform policy measures emphasizing the market economy and aimed at integrating their economies with the rest of the world. Consequently, they experienced higher economic growth and an improvement in most macroeconomic indicators both in the domestic and external sector. Indeed, the South Asian region has been one of the fastest growing regions in the world in recent years. Overall, the FDI environment has undergone a sea change in South Asian countries during the 1990s, and more so in recent years. With their liberalized approach to FDI and constant changes in improving the FDI policy framework, it is certain that South Asia has become an important destination for investment. Thus, one can conclude that there has been a positive change in policies with regard to FDI with efforts directed more towards bilateral trade agreements and providing investment incentives to foreign investors in all South Asian countries. However, there are still procedural delays, reserved industries where foreign investors are not allowed to invest and ceilings in many industries/sectors in each of these countries.

Accelerating the economic reform process and making their economies politically stable and free from internal conflict would go a long way toward making South Asia an attractive destination for FDI. The basic indicators, including infrastructure, show that the south Asian countries lack adequate infrastructure facilities and governance. Thus, more effective public investment on economic and social infrastructure, along with stable economic policies to create an enabling environment, would attract more foreign direct investment. Analyses of FDI flows to south Asian countries reveal that there has been an increasing trend of FDI into South Asian countries. However the share as well as the absolute volume of FDI inflow to these countries is negligible. FDI in South Asia is mostly concentrated in manufacturing and services. The results of FDI impact on growth show that FDI has a positive and significant impact on growth for the three south Asian countries.

Other significant factors that contribute to growth are exports, gross domestic capital formation and infrastructure. Therefore South Asian countries need to improve their domestic investment, exports and infrastructure facilities, along with more foreign investment, to achieve higher growth. Further, FDI has a positive impact on export growth through its positive spillovers for South Asian countries. Though FDI does not affect domestic investment in the current period, it has a positive and significant impact affect over time through dynamic effects.

The results of a panel co-integration estimation reveal that FDI and all its potential determinants have a long run equilibrium relationship. Major determinants of FDI in South Asia are market size, labor force growth, infrastructure index and trade openness. Overall, South Asian countries need to maintain growth momentum to improve the market size, frame policies for better use of the abundant labor force, improve infrastructure facilities and follow more open trade policies to attract increased FDI.

1. **Why are China and India emerging as attractive centres of FDI in recent years?**

**According to a report by Carl J. Dahlman,”** Asia’s economic groundswell is no longer breaking news, but the critical details of this transformation and its staying power are just coming into focus”. Although the growing economic stature of China and India is widely recognized, the factors underlying their success are still not well understood. The advantage of a large low-wage workforce is apparent to everyone, but that can never be the foundation of an economic superpower. True economic leadership comes only with the ability to produce high-quality high-technology goods and services and to create innovative new products and technologies. To appreciate the long-term potential of China and India, we need to take a comprehensive look at their innovative capacity.

China and India are the two most populous countries, accounting for 20.4% and 17.0% of the world’s population. Although they are still developing countries with per capita incomes of just $1,740 and $720 (2005), they already are the fourth and eleventh largest economies in the world at nominal exchange rates. However, in terms of purchasing power parity (PPP), they already have been for some time the second and fourth largest economies. Moreover, they are growing more than three times faster than the world average. Even though the percentage of persons with higher education in their populations is still low by developed country standards, because of their enormous size, they have a critical mass of highly educated people and of scientists and engineers. In addition, they have a critical mass of expenditures on Resersch and Development (R&D). As a result they have a large innovation capacity that is being deployed not only for their own needs but also to perform R&D for multinational companies. They are becoming increasingly important players on the global stage.

Innovation in China and India should be understood to include not just knowledge that is new to the world, but also knowledge that is new to these countries. It is important to consider this second dimension of innovation because it helps to understand why these economies are growing so fast and how rapidly they are likely to grow in the future.

Illustrious histories. China and India are among the world’s oldest civilizations, stretching back three to four millennia. To put their current rising prominence in perspective, it is useful to briefly review their relative importance over the past two millenniums. For most of the first millennium AD, China and India accounted for a quarter and a third of total world economic activity. During the last 200 years of the first millennium and for most of the second millennium they lost prominence with the rise of Japan and Western Europe. This loss of relative economic size was particularly rapid in the past 250 years, a period of rapid economic growth in Western Europe, the United States, and Japan. The main reason for this was not that their economies collapsed, but that they missed the Industrial Revolution. Thus, they did not benefit from the rapid growth that came to the countries that pioneered and quickly adopted industrial production technology.

In the past 25 years China and India have been rapidly increasing their share of global gross domestic product (GDP). To a large extent it is because they are tapping into global knowledge and integrating themselves more into to the global economy. They are re-emerging as major global players.

Roughly in the middle of the 20th century both countries underwent a radical regime change. India won its independence from England in 1947, and Mao’s communist revolution triumphed in China in 1949. Initially, both countries followed a development strategy heavily influenced by Russia, including five-year industrial development plans marked by state control of the economy and strongly autarkic trade policies.

China began to move to a market economy and to open itself up to the rest of the world in the late 1970s. Its pace of reform speeded up in the 1980s and the 1990s. This included the proliferation of special economic zones, increasing receptivity to direct foreign investment, and the decision to join the World Trade Organization in 2001. Since then, the movement to a market economy has accelerated with the growing recognition of private property rights and rapid integration into the world’s trading system. China is now a major global player on the world trade and investment scene. The speed, scope, and scale of its entry into the global system are unprecedented in economic history. It has been growing at 8% to 10% per year since the late 1970s and has become the third largest exporter of merchandise goods. It has earned the reputation as the manufacturing center for the world.

India began relaxing its tight grip on the private sector in the late 1980s, and its rate of growth began to increase. However, it over-borrowed on the international capital market and suffered a major financial crisis in 1991. To overcome that crisis, India undertook some trade liberalization, further loosening of the controls on business, and some gradual opening to direct foreign investment. These measures boosted its rate of growth from an average of 2% to 3% since independence to 6% in the 1990s. Since the turn of the century, it has undertaken some further liberalization of business regulations, trade, and openness to foreign investment. In the past three years, its rate of growth has increased to 8% per year. Much of this recent growth has been driven by its rapid expansion of information technology (IT) enabled services, business services, commerce, and banking. Internationally, India has acquired a reputation as the IT-enabled service center of the world.

Current conditions. In 1980, the per capita income of China and India were roughly equal at about $250. Because of China’s faster rate of GDP growth in the past 25 years, its GDP per capita in 2005 was $1,740, compared with $720 in India. The life expectancy in China is 8 years longer than it is in India. In 2005, China’s population was 30% larger than India’s, and the size of the Chinese economy was roughly three times India’s. For comparison, the U.S. economy is almost six times as large as the Chinese economy with less than one quarter of its population.

One of the reasons for China’s faster growth has been its much higher investment rate. In the past 10 years, for example, investment has averaged 36% of GDP in China and 25% in India’s. Another reason for China’s high per capita income growth is that as a result of its one-child policy, its average annual population growth during the period 1990-2004 was only 0.9%, compared with India’s rate of 1.7 %. Demographers project that by 2040 India will surpass China to become the world’s most populous country.

As a result of India’s much higher population-growth rate, the population age pyramid is much wider at the bottom in India than in China or the United States. Nearly one-third of the population in India is less than 15 years old. China will be facing the challenge of a more rapidly aging population and a rapidly increasing dependency ratio. India has the demographic surplus of much younger population, but it needs to educate that young population to reap its benefits. Both China and India are still largely rural economies— 60% of the population in China, 71% in India.

The rapid per capita growth rate in China has helped to lift many people out of poverty. The share of persons below the international poverty line of $1day has been reduced to just 17% in China. In India the share of persons below the $1/day poverty line has also been reduced, but to 35%. In addition, in both countries a large share of the population is just barely above this poverty line. The percentage earning less than $2/day 47% in China and 52% in India. Moreover, there has been a significant increase in inequality as result of rapid and uneven growth. In China, the Gini coefficient (a measure of income inequality that ranges from 0 for perfect equality to 1 for complete inequality) has increased from 0.30 in 1990 to 0.45 in 2000, which is higher than the U.S. rate. In India is was just 0.32 in 2000, but it is most likely to have been increasing over the past five years as a result of India’s recent unevenly distributed growth.

China has advanced much more rapidly than India in improving literacy and overall educational attainment. Literacy in China is 91%, but only 61% in India. The average educational attainment of the Chinese population 15 years old and above in 2000 was 6.4 years in China and only 5.0 in India (compared to 12 in the US and most other developed countries). Moreover, in the past 10 years, China has been investing very heavily in expanding its higher education system. China raised its tertiary enrollment rate from 5.3% of the population of the tertiary age cohort in 1995 to 19.1% by 2004. India, on the other hand, increased its rate from 6.6% in 1995 to 11.8% by 2004. The tertiary enrollment rate in the US is 82.4%, one of the highest in the world. However, as of 2005 there were a greater absolute number of tertiary students in China than in the United States, and 40% of them were studying math, science, or engineering.

The overall quality of tertiary students from China and India is still very low. Nevertheless, the graduates of the best institutions are very capable and are one of the main reasons why there is so much foreign investment in R&D facilities by U.S. companies in China and India. Also, the large number of Indian graduates who are fluent in English has been one of the main reasons for India’s reputation as the source of off-shored services than can be delivered over the Internet.

The Chinese economy has undergone significant industrial restructuring over the past 25 years. Agriculture’s share of GDP has fallen to 13%, while industry’s share has risen to 46%—one of the highest percentages in the world. The Indian economy has not undergone such drastic structural change. Agriculture’s share of GDP is still 21%, and industry’s share is just 27%. In fact, the share of the manufacturing sector has not changed over the past 20 years. However, there has been a significant growth of the service sector. Part of this has been forced growth of self-employment in low-value service activities because the modern sector of the economy has not been able to absorb the rapidly growing labor force. However, there has been a rapid increase in high-value business services. These include not just offshore services, but also the establishment of many banking and consulting service operations in India, including many managed by major multinational companies such as General Electric, IBM, other technology firms, and investment banks.

Tapping global knowledge: One of the main differences in the development strategies of these two giants is the extent, timing, and means through which they have acquired global knowledge. It is also part of the explanation for their different performance and growth paths. As a broad characterization, China has embraced globalization and has been benefiting very much from this. India has been much more autarkic and circumspect. It opened up much later and much more slowly, and is still not as integrated. The main means of tapping into global knowledge are trade, foreign direct investment, technology licensing, copying and reverse engineering, foreign education and training, and accessing foreign technical print information and through the internet (see Table 2 for comparative data on all but the last of these means). On all these counts, China has been more aggressive and systematic than has India

Trade. China began opening up to the world much earlier than did India and has become much more integrated into the global economy. The share of imports and exports in China was 67% of GDP in 2004 compared with only 42% in India (see Table 2). China’s high degree of trade integration was second only to Germany’s among the world’s large economies at the time, and it is likely that it has surpassed Germany by now. Purchases of foreign products and services are a key way to gain access to knowledge embodied in those goods and services. Unlike China, which has significantly removed tariff and non-tariff barriers to trade as part of its joining the WTO, India is still one of the most closed economies in the world. Having to export in competition with the rest of the world also forces exporters to keep up with the new products, designs, and process technologies, quality improvements, and even new business models of competitors. Also, having close exposure to foreign goods and services provides greater opportunity to copy and reverse engineer them.

Foreign Direct Investment. The inflows of foreign direct investment into China have been several multiples those into India . This is the result of several factors. First, China opened up its regulatory regime towards foreign direct investment earlier and wider than did India. Second, China’s larger and richer market has been an important pull factor. Third, China has many cost advantages over India even though its labor costs are now generally higher than India’s: Transportation is more efficient, service infrastructure is more developed, and the red tape for trade in physical products is less burdensome. As a result, China has been very attractive not just as the world’s fastest growing market, but also as a production platform for global operations. This strong pull of producing in China has also permitted the government to encourage strong competition among foreign multinational firms to bring their very best technology when they locate in China, even though they are very aware of poor intellectual property protection and the risk that their technology will be pirated.

Foreign education. China has been sending more tertiary level students abroad for education and training, even now that it has a much larger tertiary education system than India in absolute and relative terms. In 2004, more than 15% of all the 2.7 million students studying outside their home country were from China (not counting Hong Kong), and 5% were from India. Foreign education and training are very important means to tap into global knowledge. These students not only learn what they study, but a large number of them are the researchers at higher education institutions around the world. Many also go on to work in the high technology firms in the United States and Europe. Until a few years ago, many of them stayed on in their host countries. However, in the past five years more of them are returning to China and India, in part because of increasing opportunities in their home countries and attractive incentive programs designed by their home countries to stem this brain drain. The United States has encouraged this trend by responding the 9/11 attacks by making it more difficult for foreigners to obtain student visas.

Copying and reverse engineering. Greater access to foreign knowledge through all the formal channels listed above, higher levels of human and technological capital, and a policy (now changing) of ignoring intellectual property rights laws have given China an advantage in copying and reverse-engineering foreign technology.

R&D by multinational companies. A relatively recent development in both China and India has been increasing R&D by multinational companies (MNCs), which now operate more than 750 R&D labs in China and more than 250 in India. Part of the reason for this has been the need for MNCs to do R&D locally to adapt their goods and services to the domestic markets. In addition, MNCs increasingly have begun to set up R&D centers aimed at developing products and services for the global market. The initial motivation was the cost effectiveness of hiring relatively low-wage Chinese or Indian scientists and engineers. However, the rapidly growing demand has revealed that the supply of high-quality researchers was smaller than expected and salaries are rising rapidly. The limited supply of qualified researchers is this becoming a constraint on MNC-funded R&D, particularly in India.

On the other hand, both countries face large internal challenges. Both have to confront growing regional and personal income inequality and environmental constraints. Additional challenges for China are a weak financial system and the tension between a one-party state and the transition to an autonomous market economy with an increasingly educated population. Additional challenges for India are the difficulty of generating consensus for critical reforms in a very diverse population still constrained by the legacy of the caste system, very high illiteracy rates (52% among women), and constraints on the expansion of the higher education system.

Trade. In terms of real dollars, instead of PPP, China is projected to surpass the United States as the world’s leader in merchandise exports in 2007. India’s exports have also been growing faster more recently, but India is still a relatively small player on the global export scene. One of the constraints on India’s exports is poor physical infrastructure, including not only electricity but also roads, ports, and railways. Another is the excessive bureaucracy and red tape that burden imports and exports. Indian policymakers are trying to address some of these constraints, and it is likely that there will be growth in Indian exports.

The expansion of trade from these two large economies will have positive and negative benefits on world trade. The benefits are increasing specialization and exchange, which will lead to reductions in the cost of products and services and an increase in global innovation. The world has already benefited from the lower cost of manufactured goods from China and IT-enabled services from India, and this is likely to continue for some time. Another benefit is the large and rapidly growing markets of these two large economies. As they continue to grow and prosper, they will be demanding more goods and services from the rest of the world, including the United States. They will also be attractive locations for direct and portfolio investment.

On the negative side, there are likely to be increasing adjustment and restructuring pressures as these two giant economies enlarge their footprint on global trade. Lower-cost goods and services will displace competing industries in the home and foreign markets of other countries, including the United States. Although the increase in imports by these economies should help balance their increase in exports, some parts of the world and some industries will face significant restructuring pressures. For example, the United States is experiencing stress in the textile, shoe, and garments industries, as well as in a host of services that can be digitized and out-sourced or off-shored to India. Some adjustment pain will be unavoidable, but the negative effects can be reduced to the extent that the U.S. economy can quickly redeploy resources and workers from the declining industries to new goods and services where the country is more competitive.

Intellectual property rights. In the past quarter century the pace of the creation and dissemination of knowledge has accelerated. The nexus of global competitiveness has shifted from natural resources and other static advantages to innovation, and the market for knowledge and innovation has become increasingly global. Research is being done in more places, scientific and technical papers are more likely to have coauthors from different countries, and strategic technological alliances are more likely to include firms from more than one country.

Multinational corporations are becoming truly global, conducting R&D as well as production in many countries. This dispersion of high-level activity is generating anxiety about protection of intellectual property (IP). The relatively lax IP protection laws in China and India have been a particular source of concern. Both countries have begun efforts to align their IP rules with international norms, but enforcement is still weak in both countries. The complaints about IP violations tend to be stronger regarding China, probably because of the greater capability of its firms to reverse engineer or outright copy proprietary foreign technology. Although most multinationals investing in China and India know that their IP is likely to be pirated, they often cannot afford not to be in the Chinese or Indian market. They make their investments with the hope that they can innovate faster than they can be copied, but this is becoming increasingly difficult as the technological capability of these countries continues to improve.

The reigning economic assumption has been that as firms from developing countries gain greater capability and begin to move up the value chain, firms from developed countries invest more in high-level human resources and in R&D for innovation. That assumption must now be reconsidered in the light of reduced transportation and communication costs, the digitization and outsourcing of knowledge services, and the increasing ability for firms in developing countries to copy and reverse engineer. No longer able to simply outrun the competition from the emerging economies, the United States and other developed countries will have to pay closer attention to IP issues in their relations with China and India.

1. **What is internationalization theory of FDI? Discuss strengths and weakness of the theory?**

Internalization theory of FDI are theories which try to explain international operations of multinational enterprises. It is a branch of economics that is used to analyse international business behavior. The strengths and weakenesses of the theory is presented in figure below.

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| --- | --- | --- |
| **Theory of FDI** | **Strenght** | **Weaknesses** |
| **1. MACRO ECONOMICS APPROCHES**  a. Foreign Direct Investment by MNEs as International Capital Flows:  Capital flow theory suggests that capital (financial) moves between countries in relation to differing interest rates in different countries (Hymer, 1979).  It is also pointed out that interest rates would vary depending on the "factor endowment ratios of labor and capital and risk premium" (Hymer, 1979:2). By the same logic, it is believed that MNEs occur in countries where the return on investment is higher (Parry, 1980). | It is also pointed out that interest rates would vary depending on the "factor endowment ratios of labor and capital and risk premium" (Hymer, 1979:2). By the same logic, it is believed that MNEs occur in countries where the return on investment is higher (Parry, 1980) | No distinction was made between portfolio investment and equity involvement by MNEs. This explanation failed on the following grounds: (a) MNEs were not only the transfer of capital but also, technology, management and organizational skills and these were transferred within the firm retaining control over their use (Dunning, 1979), (b) majority of MNEs were not going to the countries poorly endowed with capital (Hennart, 1982) and financial institutions were not prevailing among MNEs , (c) the US was attracting portfolio investment but exporting FDI (Caves, 1982), (d) some countries were both home and host for MNEs. Owing to the fact that the above contradictions could not be explained, this hypothesis was abandoned. |
| b. Location Theory of International Investment  Location theory is of two kind; "supply oriented location theory" explains that production takes place where the factor costs for production (including distribution) are the lowest (Dunning, 1973). Conversely, "demand oriented location theory" asserts that the location of a firm is governed by the location of its market and competitors (Dunning, 1973) | This approach provided valuable insights as to geographical distributions of MNEs | It fell short to explain "how it was that foreign owned firms could outcompete domestic firms in supplying their own market" (Dunning, 1979:273), neither did it give any hint about the origin countries of MNEs. |
| c. Government Imposed Distortions  It is often articulated that tariffs, trade barriers (i.e., quotas) and non-tariff barriers (i.e., regulations for imported goods) are a major cause for the presence of MNEs (Calvet, 1981; Ragazzi, 1973). Most of the time, MNEs are thought to be a reaction to protected markets. Empirical studies found a correlation between high tariffs protecting an industry and the share of MNEs sales in that industry (Caves, 1982). "Levy of taxes" and "price and profit regulations" are also considered as government disruption affecting the decision of firms to operate abroad (Calvet, 1981). | Empirical studies found a correlation between high tariffs protecting an industry and the share of MNEs sales in that industry (Caves, 1982). | This assumption is clearly far from explaining the existence of MNEs. Because, it only sheds light on how firms overcome trade barriers and rationalize their operations in other countries, it says nothing as to the origin of their desire and ability to do so. Moreover, it is not clear why these trade barriers are not overcome by other means (i.e., licensing) (Calvet, 1981). |
| d. The Aliber Theory.  Aliber (1970) sought to explain MNEs through financial market relations, namely "exchange risk" and "the market's preferences for holding assets denominated in selected currencies". More specifically he hypothesized that it is the financial market which enables firms to have advantages over host country firms and applicable to all firms whose assets and borrowing are based in selected currencies. | On the other hand, Cantwell (1991) sees the theory as giving useful insights about the "timing" of FDI and "take-overs" of MNEs which move into an unrelated business sector. | Critics of Aliber argued that while the view is compatible with the early post-war American domination, it gave no account of the rise of European and Japanese MNEs (Buckley and Casson, 1976; Ragazzi, 1973).  Another criticism pin-pointed an important issue that many MNEs raise much of their funds for investment in host countries and currencies where the  166  Salih Kuşluvan  investments take place and financial capital is not the most important component of MNEs (Hennart, 1982). |
| e. MNEs as Supplement to International Trade.  This is so owing to the fact that each country has certain endowments of factors of production and that demand differs internationally | "each country will specialise in the production and export of those goods that it can produce at relatively lower cost (in which it is relatively more efficient than other countries), conversely, each country will import goods which it produces at relatively high cost (in which it is relatively less efficient than other countries)" (Samuelson and Nordhaus, 1989:901). | "First, it can neither explain nor evaluate the welfare implications of those types of FDI prompted by the desire to rationalise international production and to benefit from the common governance of cross-border activities. Second, it ignores the internalisation of intermediate product markets and market failures(transactional or structural).  Nevertheless, although some countries are well endowed with natural resources or labor, they are not able to produce efficiently because of lack of intermediate products, namely capital, technological knowledge and managerial capacity. |
| **2. MACRO ECONOMICS APPROCHES**  a. Business Administration Approach.  There are two versions of the business administration approach; first one regards MNEs as a result of the growth of the firm (Kindleberger, 1969), and the second sees MNEs as a process of internalization in the decision making "as a result of reduction of psychic distance through manager's gradual accumulation of experiential knowledge for foreign markets" (Sullivan and Bauerschmidt, 1990:19).  According to the first assumption firms grow in two ways: (1) by reinvesting the internally generated finance which is a cheaper source, (2) firms grow as their markets grow (Kindleberger, 1969). | According to the first assumption firms grow in two ways: (1) by reinvesting the internally generated finance which is a cheaper source, (2) firms grow as their markets grow (Kindleberger, 1969). | The 1st assumption is not a plausible argument for it takes no account of MNEs which are financed in the host country. Concerning the latter if markets grow it does not follow that MNEs should take place in that foreign market, it could be served by exports or licensing.  There is no answer why local firms are inferior to home country firms in growing by reinvesting internally generated funds and in serving the local market. The second version, internationalization in the decision making, fails to explain the factors leading to that decision. |
| b. Hymer-Kindleberger Theory.  This theory is also known as "monopolistic or oligopolistic power", "structural market imperfection", "market power" and "industrial organization" theory. | He tried to answer three fundamental questions: (a) why do firms go abroad? (b) how are they able to survive in foreign markets in which they bear initial costs (i.e. communication, misunderstanding) *vis-à-vis* native firms? (c) why do they want to retain control and ownership? (the case of FDI) (Hymer, 1979).  Basically, he found two kind of incentives; "monopolistic or oligopolistic advantages" the home country firms enjoyed over host country firms and "removal of competition" between the firms in different countries. He noted that "international firms do not operate under conditions of perfect competition" (1979:3). | With respect to the first motive he did not put any particular emphasis on a single advantage, but he stressed that "there are as many kinds of advantages as there are functions in making and selling a product" (Yamin, 1991:41). According to Hymer, the second motive could be achieved by way of "collusive agreements". In Hymer's view, the tendency toward the choice between licensing or contractual agreements and FDI would depend on "the degree of imperfection, danger of loosing advantage and comparative rate of return" (Yamin, 1991:75) |
| c. Product Cycle Theory  In line with Hymer's market imperfections and monopolistic advantages theory, Vernon (1966;1979) argued that technological innovations (development and production of new products) in consumer and industrial goods could explain international investments of firms. Assuming that  "(a) products undergo predictable changes in production and marketing, (b) restricted information is available on technology, (c) production process changes overtime and economies of scale prevalent, (d) tastes differ according to income and products can be standardised at various income level" (Buckley, 1985:7).  Vernon distinguished three different stages in the life of a product; "the new product", "the maturing product" and "the standardized product". The argument goes as follows.  The first stage takes place in large markets (because of demand and effective communication with the market) with high income per capita and in industries with high labor cost (USA). After the feedback is received from the market and product is modified accordingly, the new product emerges. Even if the new product is outside the US, the producer is induced to the US owing to the convenient market  170 *Salih Kuşluvan*  conditions. At the second stage "a certain degree of standardization" comes into existence because of the increase in demand and "the commitment to achieve economies of scale" (1966:196).  Product differentiation does not come to an end, specialization in product for different market segments prevail and the cost of production gains more attention and importance. Competition begins to appear at this stage. The location of production is unlikely to move somewhere out of the country. Vernon notes that this stage is crucial for the firms whether to invest in other advanced countries or to continue to export. He mentions a host of considerations for this decision (cost of production, protected patent position, threats of new competition in the country of import, the level of tariff protection and the political situation). After careful evaluation, he believes that more advanced countries would be the first to receive FDI because of threat either from home country or host country competitors. At the last stage of product cycle (the standardized product), the less developed countries are considered to provide competitive advantages especially in terms of labor cost. | "(a) products undergo predictable changes in production and marketing, (b) restricted information is available on technology, (c) production process changes overtime and economies of scale prevalent, (d) tastes differ according to income and products can be standardised at various income level" (Buckley, 1985:7). | A few shortcomings of product cycle theory are expressed. Rugman et al argued (1985) that it did not take into account various comparative advantages of different countries at the initial stage of production. As a point in case, it is shown that resource oriented MNEs do not fit in this theory (Hood and Young, 1979). It is added that products are developed not only for a particular market but also for different markets continuously (Buckley and Casson, 1976). Recently, Vernon (1985) acknowledged that although the theory had some explanatory power of the US MNEs, it had declined. |
| d. MNEs as Oligopolistic Reactions of Firms  This view suggests that oligopolistic firms will respond to initial FDI of rival firms in order to seize a market share (Knickerbocker, 1973). |  | In the test of the hypotheses on 187 American MNEs. Knickerbocker discovered that foreign subsidiaries are bunched together within very close time periods. Clearly, this does    not form a separate theory of MNEs. What is needed to be explained is the initial act of MNEs. |
| e. Internalization (Transaction Cost) Theory of MNEs.  Based on the profit maximization and growth principles of firms, Buckley and Casson (1976) argued that because of market imperfections in intermediate products, notable knowledge, firms will create an internal market (internalize external market) in order to increase profits and avoid certain costs. This theory differed from that of Hymer in that firms do not need monopolistic or oligopolistic power at the beginning, though it is acknowledged later that monopolistic or oligopolistic advantages could also be internalized (Casson, 1986) (Teece, 1981) or internalization of intermediate products could lead to monopolistic or oligopolistic advantages (Casson, 1987). | To sum up, internalization (transaction) theory holds that  "(1) firms choose the least cost location for each activity they perform, and (2) firms grow by internalising markets up to the point where the benefits of further internalisation are outweighed by the costs" (Buckley, 1988:182-82).  Whether be it monopolistic or oligopolistic advantages, transaction cost advantages or collusive agreements to internalize markets, internalization theory based on the growth and profit maximization of firms accommodates all. In all the above cases, knowledge is seen as the single most important intermediate product to internalize external markets. | Transaction cost approach seem to have diverted attentions from market power to the efficient functioning of the internal markets of the firms. For instance, Dunning and Rugman (1985:229) argue that  "if an exogenous market imperfection leads MNEs to organise an internal market or to replace more expensive modes of transactions, then the process of internalisation improves efficiency. No rents would be expected for the MNEs". |
| f. Eclectic Paradigm as a General Theory of Multinational Enterprises  Because of the implicity of internalization theory in emphasizing locational and firm specific factors as incentives to internalize markets, Dunning (1979, 1980, 1988) brought the strands of different theories and developed an eclectic paradigm or so called “OLI (Ownership, Location, Internalisation) paradigm. He put forward three sets of advantages to determine the "extent", "form" and "pattern" of international value-adding operations of firms. These advantages are ownership (firm specific), internalization and location advantages.  Dunning reasoned that in order for multinational firms to compete with domestic firms in the host country, they must posses certain advantages specific to the nature and/or nationality of their ownership. Otherwise they would not be able to compete with domestic firms for they have to bear extra costs of setting up and operating foreign value-adding activities in addition to those faced by the domestic firms. | The advantages of MNEs may be exclusive and privileged access to specific technological, managerial, financial or marketing assets or MNEs possess better organisational capabilities to succesfully integrate separate value-adding activities which draw on such assets.  Once again, Dunning made a distinction between structural market imperfections (i.e. government distortions) and transactional imperfections resulting in transaction gains such as transfer price manipulation, reduction in costs, gains from leads and lags in payments in different locations.  The third advantage, internalization, refers to the advantages of controlling, coordinating ownership and location specific advantages within the MNEs rather than selling the right to use those advantages to domestic firms in the host country. The utilisation of these advantages depends primarily on the relative cost of equity and non-equity forms of managing interrelated economic activities. The benefits to the firm of better planning, coordination, and opportunities to increase profits must be weighed against communication and control difficulties (Buckley, 1987). That means that internalisation depends on whether or not transferring ownership specific advantages is in the best interests of enterprises within the firm. If internal market is perceived to provide more gains *vis-à-vis* external market, then internalization will take place. Although it is acknowledged that eclectic paradigm has wide applications to explain FDI and new forms of international investment (Either, 1986), Casson (1986) argued that internalization theory encompass ownership and locational advantages. |  |

In conclusion theories of MNEs give a hint or clue either about motives for firms to go abroad or advantages that enable national firms to go abroad or timing of going abroad. In this sense it can be said that every theory has some explanatory power as to the international investments of firms. However it seems that OLI paradigm provides a better framework for a single general theory of MNEs. Not only does OLI have the feature of encompassing all other theories of MNEs, but it also has analytical power in examining (1) what motivates national firms to go abroad, (2) what the reasons for different forms of investment of national firms abroad are and (3) what enables national firms to go abroad and be successful. Future research may be directed to pinpointing ownership, internalization and location advantages of different forms of international investments of firms in different industry branches.

1. **Gold standard provided domestic price stability and automatic adjustment in balance of payments and in exchange rate. Discuss**.

Although pound had been minted of gold as far back as in the 17'x' century, gold standard originated in England in 1816 when gold became the official tender. By 1870s, gold standard stood widely accepted among countries and it reigned with full fervour till the outbreak of the Great War in 1914.

Gold standard had three forms; one was the gold specie standard in which coins were minted of gold. The paper currency could be converted into gold on demand. The price of gold was fixed under law. The second form was the gold bullion standard with no compulsion to mint gold coins, Paper currency was not convertible into gold on demand; rather gold bars could be bought from the central bank at fixed rates. The third was the gold exchange standard with no compulsion to mint gold coins, nor the exchange of paper currency into gold either on demand or through purchase of gold bars. The currency being on gold exchange standard was convertible into the currency being on the gold specie standard and the latter was convertible into gold, For example, rouble could be exchanged for gold via British pound.

Whatever the form might be, there was no restriction on the inter-country flow of gold, the central bank of a gold-specie/ gold bullion standard country did have 100 per cent backing of gold behind its currency.

The broad rules of the gold standard were manifest in automatic mechanism for;

* + Fixed exchange rates
  + Adjustment in the balance of payments
  + Domestic price stability

The exchange rate depended upon the content of gold in different currencies. In practice, one ounce of gold was then valued at £ 4.24 and the same weight of gold with similar fineness was valued at $ 20.67. Naturally, one pound was exchanged for $ 20.67 14.24 or $ 4.87. This rate was known as mint parity or mint exchange rate. The actual exchange rate remained close to mint parity because free flow of gold between two countries helped avoid any major deviation. Suppose the value of dollar depreciated to $ 5.25/£, the arbitrageur would buy one ounce of gold in the United States for $ 20.67 and sell it in the United Kingdom for £ 4.24 and then they could exchange the pound for dollar in the foreign exchange market for $ 5.25 x 4.24 = $ 22.26. This brought them a profit of $ 22.26 - 20.67 = $ 1.59. The process of arbitrage continued till the original parity was reestablished. It may be noted that this process involved transaction cost or transportation cost of gold that might not help equate the actual exchange rate to mint parity. But the difference from the mint parity was limited to only that amount.

Turning to automatic adjustment in the balance of payments, one finds that any deficit was made up through price-specie flow. Suppose that England faced a deficit on trade account. It could lead to outflow of gold for the settlement of trade. The outflow of gold lessened the money supply within the country. The emerging deflation in the wake of shrinkage of money supply would make the English exports competitive. This led to a rise in the export wiping out any deficit on this account.

There was one more explanation for automatic adjustment in the balance of payments. Reduced money supply raised interest rate. The banking system restricted credit in view of reduced money supply and to this end the central bank raised the bank rate. Ultimately, in lure of higher interest rate, foreign investment moved into the economy meeting any deficit on the capital account.

Last but not least, domestic price was stable. Currency was backed fully by gold. Money supply was constant in view of constant gold reserves. With constant money supply, prices were constant. Any deviation could occur only after discovery of gold mines that was the case in the USA when Californian gold mines were discovered in 1847. Prices increased and this increase was transmitted to other countries through the flow of gold.

Gold standard was not tenable during the War. It is because the War needed greater amount of money, but the printing of currency was not possible in view of 100 per cent backing of gold behind the currency. So it was suspended. After the War, when it was readopted, the international economic scenario was-too different to sustain it, Germany and Austria were in the grip of hyperinflation. Pound stood over-valued when France devalued its currency. And again, the expansionary monetary policy was to be introduced to combat the Great Depression of 1930s that was not feasible under the gold standard. In short, the gold standard of the inter-War years failed to fit in the changed international economic scenario. Finally, the UK abandoned it in 1931. The USA got rid of it in 1933 and France took the step in 1936.

In Conclusion, Gold standard was a sophisticated version of commodity specie standard. It possessed the merits of automatic adjustment of exchange rates and balance of payments and of domestic price stability. But it could not go with monetary expansion plan; and as a result, it Was abandoned.

1. **Mention the features of the fixed parity system of exchange rate. What were the causes behind its collapse?**

What led to the establishment of the IMF in 1945? In fact, after the abandonment of the gold standard, the exchange rate fluctuated widely. That, in turn, affected the global trade. It is true that the currency areas were created in 1930s. The intro-area exchange rate was fixed, but there was no control on the inter-currency area exchange rate. Thus in order to bring the situation under control, it was resolved at the Bretton Woods Conference of 1944 to create an international monetary institution that could design the exchange rate system based on then international economic scenario and could have surveillance over it. The IMF carne into being as a Bretton Woods child.

The broad features of the exchange rate designed was known as the fixed parity system with adjustable pegs. In fact, it was designed at Bretton Woods and so it was also known as the Bretton Woods exchange rate system.

In the fixed parity system, each member country was to set a fixed value-called the par value-of its currency in terms of gold or US dollar. It was the par value that determined the rate of exchange between two currencies. Minor fluctuations in the exchange rate within a narrow band of one per cent above and below the established parities could not be ruled out. They were to be corrected through active intervention of the monetary authorities of that country.

It may, however, be mentioned that the fixed parity under the Bretton Woods system was not like that of gold standard of 1880-1914. It was a fixed parity with adjustable pegs meaning that any member country could alter the value of its currency or, in other words, could devalue its currency in case of "fundamental disequilibrium" in the balance of payments. Changes up to five per cent did not require prior approval of the IMF, but beyond it, IMF's approval was necessary. Fundamental disequilibrium was never formally defined; but in practice, it meant continued and chronic balance of payments problem and colossal loss of reserves. The purpose of the adjustable peg system was, therefore, to establish a balance between the objectives of stable exchange rates and the macro-economic goals of the countries going for such adjustments as also to help avoid any use of exchange control and trade-restrictive measures. In other words, it brought flexibility in the fixed exchange rate system for the purpose of attaining equilibrium in the balance of payments. The provisions also contained cautions so that there might not be competitive devaluation. It was maintained through supervision and scrutiny over desired exchange rate changes.

Again, an important aspect of the Bretton Woods exchange rate system was that the US dollar was convertible into gold at a fixed rate of $ 35 a troy ounce of gold. The other currencies were convertible into gold via US dollar. This currency was given the position or intervention currency in the system in view of the fact that in the immediate post-War period, it was the strongest currency. This system was, therefore, likened with the gold exchange standard where countries redeemed their currency into gold-convertible currency and not necessarily into gold directly. In the post-War system, the US dollar came to be the intervention currency what was the British pound during the early decades of the twentieth century.

Collapse of the system. The system performed well during 1940s and till late 1950s. The US dollar did do well as an intervention currency insofar as it was as good as gold in view of the strong position of the US economy. The central bank in many countries held the dollar-denominated securities as reserves. But when the US balance of payments began experiencing growing deficits on account of widening trade deficit and outflow of dollar, the real value of dollar turned lower compared to its nominal value. It shook confidence in dollar and the central banks began converting the US dollar denominated securities into gold. It led to the outflow of gold from the USA that in turn slashed further the real value of dollar. A vicious circle emerged between falling real value of dollar, loss of confidence in dollar, conversion of US dollar denominated securities into gold and the outflow of gold from the USA. The outflow of gold was so huge in August 1971 that the then President Nixon suspended the convertibility of US dollar into gold. This decision threatened the very fundamentals of the fixed parity system.

In order to bring back confidence in US dollar, the Smithsonian Committee resolutions of December 197 I devalued dollar and re-valued upwardly some major currencies. At the same time, the normal fluctuation band was widened to +/- 2.25 per cent. But the Smithsonian measures failed to generate confidence. A few currencies came on to float, and finally, the fixed parity system collapsed in February 1973.

A committee was formed to suggest a feasible system. The new system, as suggested by the Committee, provided various options to the member countries. The member countries adopted them depending upon their convenience, although the system was given a legal shape through amending the Articles of Agreement of the IMF that came into force from April 1978. The new system, which is still in vogue, provided many options to the member countries, such as fixed exchange rate, floating exchange rate, crawling peg and target-zone arrangement. The options have merits and demerits. The member countries have adopted a particular option according to their own convenience.

1. **Do you agree that fixed exchange rate is better than floating rates? Explain.**

**Floating Rate vs. Fixed Rate: An Overview**

If one looks at the options over a period of time, there is a definite shift in preference among the member countries in favour of floating exchange rate. At present, 35 out of 187 countries have an independent floating system. The other 51 countries have managed floating system. While 53 countries have some or the other kind of fixed exchange rate. 7 countries have gone for a crawling peg. The European Monetary Union (EMU) and other 20 countries of Africa and the Caribbean region have target-zone arrangement. Lastly 9 countries do not have their own currency as legal tender (IMF, 2005)

In a fixed exchange rate system, the government of a country can peg its currency to the currency of another country. It is normally done in a case where the other currency accounts for a sizeable trade with that country. The currency of Bhutan is, for example, pegged to Indian rupee.

A currency can be pegged to a basket of currencies. Indian rupee was, for example, pegged to a basket of five currencies prior to 1993. The reason is that the appreciation and depreciation of currencies in the basket make the weighted average comparatively stable.

A few currencies were pegged to Special Drawing Reserves (SDRs) when the latter was more stable. But now no currency is pegged to SDRs. Sometimes pegging is a legislative commitment that 'is often known as the currency board arrangement. The currency board pegs the domestic currency to another nation's currency and buys and sells foreign currency reserves in order to maintain the parity value. Again, it is a fact that the exchange rate is fixed in case of pegging, yet it fluctuates within a narrow margin of +/- 1.0 per cent around the central rate. On the contrary, in some countries, the fluctuation band is wider and the arrangement is known as pegged exchange rates within horizontal bands.

Floating Exchange Rate on the other hand is determined by the market forces of supply and demand. A particular currency is subject to fluctuations depending upon the changes in the demand and supply positions. Suppose the exchange rate between Indian rupee and the US dollar is determined by the demand for, and supply of, US dollar in the foreign exchange market. If dollar experiences greater demand, the value of dollar vis-a-vis Indian rupee will appreciate; or in other words, Indian rupee will depreciate vis-a-vis US dollar. On the other hand, if supply of US dollar increases, the reverse will be the case.

Floating rate system may be either independent or it may be managed. Theoretically speaking, there is no intervention by the central bank of a country in case of the independent floating. On the contrary, it does occur in a managed floating rate system. But the experiences show that intervention is a common phenomenon irrespective of the system being independent or managed. It is because of this fact that the IMF gives a clarification. If the purpose of intervention is to moderate the exchange rate and to check undue fluctuation, it will be an independent floating. But if the central bank intervenes to establish a level for the exchange rate, this will be a case of managed floating.

Intervention mean nothing but the sale and purchase of foreign currency by the central bank in the foreign exchange market in order to influence the demand and supply positions of the foreign currency and thereby to influence its value vis-a-vis the domestic currency. So if the Reserve Bank of India sells US dollar in the foreign exchange market, the supply of dollar will increase and rupee will appreciate vis-a-vis dollar. If it buys dollar in the market, demand for dollar will increase and rupee will depreciate vis-a-vis dollar.

After delineating the features of the fixed and the floating exchange rate regimes, it would be worthwhile to pinpoint which one of the two is more suitable. The advocates of the floating rate argue that:

* The exchange rate changes automatically with the changes in the macro-economic fundamentals. As a result, there does not appear any gap in the real and the nominal exchange rates. The economy remains free from any ill effects of the emergence of such a gap.
* The floating rate regime possesses insulation properties meaning that the currency of a country is not influenced by the changes in the macro-economic fundamentals in the other country. In other words, currency shocks emanating in one country does not permeate to other countries.

The arguments do have reasoning but any large-scale fluctuation in the exchange rate depending upon changing macro-economic fundaments and the psyche and behaviour of the participants in the foreign exchange market cannot be ruled out. MacDonald (1988) finds that the exchange rate changes among the countries on floating rate during 1973-85 were much more volatile than the changes warranted by the fundamental monetary variables.

Again, the insulation properties too are absent in many cases. Dunn (1983) finds that when the USA was pursuing tight monetary policy through raising the interest rate, the European countries had to raise interest rate so as to prevent large-scale capital outflow.

Yet again, the floating rate may not be suitable for many developing countries in view of their weak economic structure. It is our experience that the currency with weak economic support often tends to depreciate vis-a-vis strong currencies.

**Good luck!**