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International Business

Institute of Open and Distance Education

Faculty of Management

International Business

2MBA8

DR. C.V. RAMAN UNIVERSITY

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LESSON

1

GATT/WTO

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1.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- Get an idea of the multilateral trade negotiating system
- Review the performance of GATT
- The role and functioning of WTO
- Evaluate the performance of WTO

1.1 INTRODUCTION

The WTO came into being on January 1, 1995, and is the successor to the General Agreement on Tariffs and Trade (GATT), which was created in 1947, and continued to operate for almost five decades as a de facto international organization.

1.2 HISTORY OF WTO

The General Agreement on Tariffs and Trade (typically abbreviated GATT) was originally created by the Bretton Woods Conference as part of a larger plan for economic recovery after World War II. The GATT's main purpose was to reduce barriers to international trade. This was achieved through the reduction of tariff barriers, quantitative restrictions and subsidies on trade through a series of different agreements. The GATT was an agreement, not an organization. Originally, the GATT was supposed to become a full international organization like the World Bank or IMF called the International Trade Organization. However, the agreement was not ratified, so the GATT remained simply an agreement. The functions of the GATT have been replaced by the World Trade Organization which was established through the final round of negotiations in the early 1990s.

The history of the GATT can be divided into three phases: the first, from 1947 until the Torquay round, largely concerned which commodities would be covered by the agreement and freezing existing tariff levels. A second phase, encompassing three rounds, from 1959 to 1979, focused on reducing tariffs. The third phase, consisting only of the Uruguay Round from 1986 to 1994, extended the agreement fully to new areas such as intellectual property, services, capital, and agriculture. Out of this round the WTO was born.

GATT 1947

The first version of GATT, developed in 1947 during the United Nations Conference on Trade and Employment in Havana, Cuba, is referred to as "GATT 1947". On January 1, 1948 the agreement was signed by 23 countries: Australia, Belgium, Brazil, Burma, Canada, Ceylon, Chile, the Republic of China, Cuba, the Czechoslovak Republic, France, India, Lebanon, Luxembourg, Netherlands, New Zealand, Norway, Pakistan, Southern Rhodesia, Syria, South Africa, the United Kingdom, and the United States. 45,000 tariff concessions were made influencing over $10 billion in trade which comprised 20% of the total global market at the time.

GATT 1947 in the US

The GATT, as an international agreement, is similar to a treaty. Under United States law it is classified as a congressional-executive agreement. Based on the Reciprocal Trade Agreements Act it allowed the executive branch negotiating power over trade agreements with temporary authority from Congress. At the time it functioned as a provisional, but promising trade system. The agreement is based on the "unconditional most favored nation principle." This means that the conditions applied to the most favored trading nation (i.e. the one with the least restrictions) apply to all trading

nations. In the US, there was large opposition against the International Trade Organization (which had been ratified in several countries, including Australia), and thus President Truman never even submitted it to Congress. This caused other countries to lose interest and left the orphaned GATT as the world's only multilateral trade agreement, coming into force on January 1, 1948.

GATT 1949

The second round took place in 1949 in Annecy, France. The main focus of the talks was more tariff reductions, around 5000 total.

GATT 1951

The third round occurred in Torquay, England in 1951. 8,700 tariff concessions were made totaling the remaining amount of tariffs to three-fourths of the tariffs which were in effect in 1948.

GATT 1955-1956

The fourth round returned to Geneva in 1955 and lasted until May 1956. $2.5 billion in tariffs were eliminated or reduced.

GATT "Dillon" 1960-1962

The fifth round occurred once more in Geneva and lasted from 1960 to 1962. The talks were named after Under Secretary of State General of the US, Douglas Dillon, who first proposed the talks. Along with reducing over $4.9 billion in tariffs, it also yielded discussion relating to the creation of the European Economic Community (EEC).

GATT "Kennedy" 1964-1967

The sixth round was the last to take place in Geneva from 1964 until 1967 and was named after the late US President Kennedy in his memory. Concessions were made on $40 billion worth of tariffs. Some of the GATT negotiation rules were also more clearly defined.

GATT 1973-1979

The seventh round of GATT took place in Tokyo from 1973 until 1979. The talks managed to reduce several trade barriers in addition to $300 billion in tariffs. Negotiations covered a range of topics including government procurement, customs valuation, subsidies, countervailing measures, antidumping, standards and import licensing.

Uruguay Round 1986-1993

The Uruguay Round began in 1986. It was the most ambitious round to date, hoping to expand the competence of the GATT to important new areas such as services, capital, intellectual property, and agriculture.

Agriculture was essentially exempted from previous agreements as it was given special status in the areas of import quotas and export subsidies, with only mild caveats. However, by the time of the Uruguay round, many countries considered the exception of agriculture to be sufficiently glaring that they refused to sign a new deal without some movement on agricultural products. These fourteen countries came to be known as the "Cairns Group", and included mostly small and medium sized agricultural exporters such as Australia, Brazil, Canada, Indonesia, and New Zealand.

GATT and the World Trade Organization

In 1994 the GATT was updated (GATT 1994) to include new obligations upon its signatories. One of the most significant changes was the creation of the World Trade Organization (WTO). The 75 existing GATT members and the European Communities became the founding members of the WTO on January 1, 1995. The other 52 GATT members rejoined the WTO in the following two years (the last being Congo in 1997). Since the founding of the WTO, 21 new non-GATT members have joined and 28 are currently negotiating membership.

Of the original GATT members, only the SFR Yugoslavia has not rejoined the WTO. Since FR Yugoslavia, (renamed to Serbia and Montenegro and with membership negotiations later split in two), is not recognised as a direct SFRY successor state; therefore, its application is considered a new (non-GATT) one. The contracting parties who founded the WTO ended official agreement of the "GATT 1947" terms on December 31, 1995.

Whereas GATT was a set of rules agreed upon by nations, the WTO is an institutional body. The WTO expanded its scope from traded goods to trade within the service sector and intellectual property rights. Although it was designed to serve multilateral agreements, during several rounds of GATT negotiations (particularly the Tokyo Round) plurilateral agreements created selective trading and caused fragmentation among members. WTO arrangements are generally a multilateral agreement settlement mechanism of GATT.

Rounds of GATT Trade Negotiations

GATT signatories occasionally negotiated new trade agreements that all countries would enter into. Each set of agreements was called a round. In general, each agreement bound members to reduce certain tariffs. Usually this would include many special-case treatments of individual products, with exceptions or modifications for each country.

1. ***Havana Round (1947):*** 23 countries. GATT enters into force.
2. ***Annecy Round (1949):*** 13 countries.
3. ***Torquay Round (1950):*** 34 countries.
4. ***Geneva Fourth Round (1956):*** 22 countries. Tariff reductions. Strategy set for future GATT policy toward developing countries, improving their positions as treaty participants.
5. ***Dillon Round (1960-1961):*** 45 countries. Tariff reductions. Named after C. Douglas Dillon, then U.S. Undersecretary of State.
6. ***Kennedy Round (1962-1967):*** 48 countries. Tariff reductions. This was an across-the-board reduction rather than a product-by-product specification, for the first time. Anti-dumping agreement (which, in the United States, was rejected by Congress).
7. ***Tokyo Round (1973-1979):*** 99 countries. Reduced non-tariff trade barriers. Also reduced tariffs on manufactured goods. Improvement and extension of GATT system.
8. ***Uruguay Round (1986-94):*** 125 countries. Created the World Trade Organization to replace the GATT treaty. Reduced tariffs and export subsidies, reduced other import limits and quotas over the next 20 years, agreement to enforce patents, trademarks, and copyrights (TRIPS), extending international trade law to the service sector (GATS) and open up foreign investment. It also made major changes in the dispute settlement mechanism of GATT.
9. ***Doha Round:*** see WTO.

GATT at a Glance

The key parts of the 22,000 page General Agreement on Tariffs and Trade:

Tariffs: Slashes border taxes by an average of 38 percent worldwide on products including food, electronics, cars and clothing. The Clinton administration has said this represents the largest tax cut in history, a reduction globally of $744 billion.

Agriculture: Reduces government supports to farmers that cost taxpayers in wealthy countries an estimated $160 billion annually. U.S. farmers hope it will make their products more competitive on overseas markets.

Textiles: Phases out quotas erected by the United States and other wealthy industrialized countries to limit imports from developing nations over a 10-year period. The quotas would be replaced in some cases by tariffs.

Intellectual Property: Establishes new rules to clamp down on theft of copyrights and patents, protect manufacturers and consumers against fake products, and encourage new inventions through better patent protection.

GATT Turns 60(a review of GATT)

Sixty years ago this week (April 10, 1947) at the Palais des Nations in Geneva, Switzerland, representatives from 23 nations opened a conference that attracted little attention at the time, but had far-reaching consequences for the world economy. The conferees met to negotiate tariff reductions and finalize the text of a General Agreement on Tariffs and Trade (GATT). They sought to create an open world trading system, one in which trade would flow relatively freely between countries with the understanding that new trade barriers would not be erected to impede this flow. In the 60 years since then, world trade and prosperity have flourished to a degree well beyond the hopes of the founders of the GATT, a result that can be attributed in part to their sage actions half a century ago.

The origins of the GATT can be found in the economic disaster of the interwar period. After World War I, the United States turned its back on the League of Nations and international economic cooperation. World leaders failed to put the world trade and payments system, which had been severely disrupted by the war, on a functional basis after the war.

On top of this came the Great Depression, and with it a dramatic contraction of world trade. The U.S. imposed the protectionist Smoot-Hawley tariff in 1930. Two years later, Britain abandoned its traditional free trade policy by imposing a General Tariff and signing the Ottawa agreements with its former colonies, creating a preferential trading bloc that discriminated against nonmembers. Germany strong-armed countries in southeastern Europe into special bilateral trading arrangements with the Reich. Japan created the Greater East Asian Co-Prosperity Sphere to siphon off Asian trade for its own benefit. Although the world economy recovered slowly from the depression, the spread of high tariffs, import quotas, discriminatory practices and foreign exchange restrictions meant that world trade remained stagnant and compartmentalized throughout the 1930s.

The tragic economic and political consequences of that "low dishonest decade" spurred some officials to think about a new economic framework. Marked by the bitter experience after World War I, Cordell Hull—FDR's Secretary of State—came to believe that "unhampered trade dovetail[s] with peace; high tariffs, trade barriers and unfair economic competition, with war." As he declared, "I will never falter in my belief that enduring peace and the welfare of nations are indissolubly connected with friendliness, fairness, equality and the maximum practicable degree of freedom in international trade." Due to Hull's guidance and persistence, Congress enacted the Reciprocal Trade Agreements Act of 1934, which gave the executive branch the authority to undertake bilateral negotiations to reduce tariffs. Although the trade

agreements negotiated during the 1930s had a limited effect, it marked a significant departure from the old non-negotiable high tariffs enacted by Congress, and set the stage for a new era in U.S. trade policy.

World War II provided the opportunity for Anglo-American cooperation on postwar commercial policy. While the Americans envisioned expanding the bilateral approach it had taken in the 1930s, the British advocated a much more ambitious multilateral approach. In 1942, James Meade, then a U.K. civil servant and later a professor and Nobel laureate in economics, drafted a plan for an International Commercial Union, the trade counterpart to John Maynard Keynes's proposal for an International Clearing Union for postwar finance. After the War Cabinet endorsed Meade's plan, British and American officials began informal discussions about the shape of the postwar trading system.

These informal meetings eventually led to the 1947 GATT conference in Geneva. The U.S. and Britain, along with other countries, exchanged tariff reductions and finalized the provisions of the GATT. Although the Anglo-American delegates agreed on the overriding objective of freeing trade, the negotiations were difficult and required many compromises.

The U.S. insisted that the most-favored nation (MFN) clause—ensuring nondiscrimination in trade – be the Article I cornerstone of the GATT because it wanted to prevent the spread of Imperial preferences that discriminated against its exports. Fearful of its postwar financial situation, Britain demanded large American tariff cuts in exchange for a reduction in preferences and wanted the freedom to impose quantitative restrictions on imports in case of balance of payments difficulties, something that became Article XII of the GATT.

Initially, the tariff reductions negotiated in Geneva had a limited impact on international trade because wartime exchange controls and quantitative restrictions remained in place. However, as these controls were phased out during the 1950s, the lower tariffs allowed world trade to grow rapidly. The expansion of world trade promoted the rapid economic recovery of Europe and Japan. In turn, the spread of economic growth allowed democracy to become firmly established in a way that had failed dismally during the interwar period.

By the 1960s, the flourishing world economy gave the GATT participants the confidence to build on this early success and reduce tariffs and non-tariff barriers even more. Thus followed the Kennedy Round in the 1960s, the Tokyo Round in the 1970s, and the Uruguay Round in the late 1980s and early 1990s, each of which chipped away at the protectionist walls blocking world trade. In 1995, the World Trade Organization (WTO) was established in recognition of the fact that world trade rules had been extended to services, intellectual property and other new areas of trade.

Over its 60-year history, the GATT has had many shortcomings. Agricultural trade has largely eluded liberalization. The current spread of preferential trade arrangements, in the form of bilateral and regional so-called free trade agreements, have reintroduced discriminatory trade practices in a way that weakens the multilateral system built on the MFN clause.

The GATT has also gone through many difficult phases. The world economy went through a particularly dangerous period in the late 1970s and early 1980s, when sluggish growth and painful structural adjustments led many countries to ignore the GATT rules altogether. Trade barriers in the form of voluntary export restraints and orderly marketing arrangements proliferated, restricting trade in sectors such as automobiles, steel and textiles. In this environment, the prospect for new trade negotiations seemed so dismal that some suggested "the GATT is dead."

Despite these shortcomings and difficulties, the GATT framework has survived as a durable code of conduct for commercial policy and dispute resolution. Tariffs have

been ratcheted down, the penchant for voluntary trade restrictions has been put to rest, and potential trade wars have been peacefully defused. The relevance of the GATT is reflected in the WTO's ever-growing membership, now up to 150 countries.

The prosperity of the world economy over the past half century owes a great deal to the growth of world trade which, in turn, is partly the result of farsighted officials who created the GATT. They established a set of procedures giving stability to the trade-policy environment and thereby facilitating the rapid growth of world trade. With the long run in view, the original GATT conferees helped put the world economy on a sound foundation and thereby improved the livelihood of hundreds of millions of people around the world.

The task for statesmen today is to look beyond short-term political considerations, arising from the complaints of special interests that fear market competition and the parsing of subsidies, and bring the ongoing Doha Round to a successful conclusion. If immediate steps cannot be taken to liberalize trade, then the phasing in of reforms and the phasing out of subsidies over many years is perfectly consistent with the long-term objectives of the GATT. We should remind ourselves how much poorer the world would be today without the politically courageous decisions made by visionary diplomats meeting in Geneva 60 years ago this month.

Even as the World Bank and International Monetary Fund struggle to rethink their role in the modern world economy, the role of the GATT and WTO is secure. The postwar expansion of world trade fostered by the GATT has made a lasting contribution to world prosperity and, as Cordell Hull suggested, to world peace as well.

Check Your Progress

Fill in the blanks:

The Preamble to the GATT mentioned the following as its important objectives:

1. Raising .... of ....
2. Ensuring .... and a large and steadily growing volume of real income and effective demand.
3. Developing full use of .... of the world.
4. Expansion of .... and ....

1.3 WORLD TRADE ORGANIZATION

Fact File

Location: Geneva, Switzerland
Established: 1st January 1995
Created by: Uruguay Round negotiations (1986-94)
Membership: 150 countries on 11th January 2007
Budget: 182 million Swiss francs for 2007
Secretariat staff: 625
Head: Pascal Lamy (Director-General)
Functions:
• Administering WTO trade agreements
• Forum for trade negotiations
• Handling trade disputes
• Monitoring national trade policies
• Technical assistance and training for developing countries
• Cooperation with other international organizations

The World Trade Organization deals with the rules of trade between nations at a near-global level; it is responsible for negotiating and implementing new trade agreements, and is in charge of policing member countries' adherence to all the WTO agreements, signed by the bulk of the world's trading nations and ratified in their parliaments. Most of the WTO's current work comes from the 1986-94 negotiations called the Uruguay Round, and earlier negotiations under the GATT. The organization is currently the host to new negotiations, under the Doha Development Agenda (DDA) launched in 2001.

The WTO is governed by a Ministerial Conference, which meets every two years; a General Council, which implements the conference's policy decisions and is responsible for day-to-day administration; and a director-general, who is appointed by the Ministerial Conference. The WTO's headquarters are in Geneva, Switzerland.

1.3.1 Mission, Functions and Principles

The WTO's stated goal is to improve the welfare of the peoples of its member countries, specifically by lowering trade barriers and providing a platform for negotiation of trade. Its main mission is "to ensure that trade flows as smoothly, predictably and freely as possible". This main mission is further specified in certain core functions serving and safeguarding five fundamental principles, which are the foundation of the multilateral trading system.

Functions

Among the various functions of the WTO, these are regarded by analysts as the most important:

- It oversees the implementation, administration and operation of the covered agreements.
- It provides a forum for negotiations and for settling disputes.

Additionally, it is the WTO's duty to review the national trade policies, and to ensure the coherence and transparency of trade policies through surveillance in global economic policy-making. Another priority of the WTO is the assistance of developing, least-developed and low-income countries in transition to adjust to WTO rules and disciplines through technical cooperation and training. The WTO is also a center of economic research and analysis: regular assessments of the global trade picture in its annual publications and research reports on specific topics are produced by the organization. Finally, the WTO cooperates closely with the two other components of the Bretton Woods system, the IMF and the World Bank.

Principles of the Trading System

The WTO establishes a framework for trade policies; it does not define or specify outcomes. That is, it is concerned with setting the rules of the trade policy games. Five principles are of particular importance in understanding both the pre-1994 GATT and the WTO:

1. ***Non-discrimination:*** It has two major components: the most favoured nation (MFN) rule, and the national treatment policy. Both are embedded in the main WTO rules on goods, services, and intellectual property, but their precise scope and nature differ across these areas. The MFN rule requires that a WTO member must apply the same conditions on all trade with other WTO members i.e. a WTO member has to grant the most favorable conditions under which it allows trade in a certain product type to all other WTO members. "Grant someone a special favour and you have to do the same for all other WTO members." National treatment means that imported and locally-produced goods should be treated equally (at least after the foreign goods have entered the market) and was

introduced to tackle non-tariff barriers to trade (e.g. technical standards, security standards *et al.* discriminating against imported goods).

2. ***Reciprocity:*** It reflects both a desire to limit the scope of free-riding that may arise because of the MFN rule, and a desire to obtain better access to foreign markets. A related point is that for a nation to negotiate, it is necessary that the gain from doing so be greater than the gain available from unilateral liberalization; reciprocal concessions intend to ensure that such gains will materialize.
3. ***Binding and enforceable commitments:*** The tariff commitments made by WTO members in a multilateral trade negotiation and on accession are enumerated in a schedules (list) of concessions. These schedules establish "ceiling bindings": a country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. If satisfaction is not obtained, the complaining country may invoke the WTO dispute settlement procedures.
4. ***Transparency:*** The WTO members are required to publish their trade regulations, to maintain institutions allowing for the review of administrative decisions affecting trade, to respond to requests for information by other members, and to notify changes in trade policies to the WTO. These internal transparency requirements are supplemented and facilitated by periodic country-specific reports (trade policy reviews) through the Trade Policy Review Mechanism (TPRM). The WTO system tries also to improve predictability and stability, discouraging the use of quotas and other measures used to set limits on quantities of imports.
5. ***Safety valves:*** In specific circumstances, governments are able to restrict trade. There are three types of provisions in this direction: articles allowing for the use of trade measures to attain non-economical objectives; articles aimed at ensuring "fair competition"; and provisions permitting intervention in trade for economic reasons.

1.3.2 Formal Structure

According to WTO rules, all WTO members may participate in all councils, committees, etc., except Appellate Body, Dispute Settlement panels, and plurilateral committees.

1.3.3 Highest Level: Ministerial Conference

The topmost decision-making body of the WTO is the Ministerial Conference, which has to meet at least every two years. It brings together all members of the WTO, all of which are countries or separate customs territories. The Ministerial Conference can make decisions on all matters under any of the multilateral trade agreements.

1.3.4 Second Level: General Council

The daily work of the ministerial conference is handled by three groups: the General Council, the Dispute Settlement Body, and the Trade Policy Review Body. All three consist of the same membership – representatives of all WTO members – but each meets under different rules.

1. The General Council, the WTO's highest-level decision-making body in Geneva, meets regularly to carry out the functions of the WTO. It has representatives (usually ambassadors or equivalent) from all member governments and has the authority to act on behalf of the ministerial conference which only meets about every two years. The council acts on behalf on the Ministerial Council on all of the WTO affairs. The current chairman is Amb. Muhamad Noor Yacob (Malaysia).

2. The Dispute Settlement Body is made up of all member governments, usually represented by ambassadors or equivalent. The current chairperson is H.E. Mr. Bruce Gosper (Australia).

3. The WTO General Council meets as the Trade Policy Review Body (TPRB) to undertake trade policy reviews of Members under the TRPM. The TPRB is thus open to all WTO Members. The current chairperson is H.E. Ms. Claudia Uribe (Colombia)

1.3.5 Third Level: Councils for Trade

The Councils for Trade work under the General Council. There are three councils – Council for Trade in Goods, Council for Trade-Related Aspects of Intellectual Property Rights, and Council for Trade in Services – each council works in different fields. Apart from these three councils, six other bodies report to the General Council reporting on issues such as trade and development, the environment, regional trading arrangements and administrative issues.

1. ***Council for Trade in Goods:*** The workings of the General Agreement on Tariffs and Trade (GATT) which covers international trade in goods, are the responsibility of the Council for Trade in Goods. It is made up of representatives from all WTO member countries. The current chairperson is Amb. Yonov Frederick Agah (Nigeria).

2. ***Council for Trade:*** Related Aspects of Intellectual Property Rights- Information on intellectual property in the WTO, news and official records of the activities of the TRIPS Council, and details of the WTO's work with other international organizations in the field.

3. ***Council for Trade in Services:*** The Council for Trade in Services operates under the guidance of the General Council and is responsible for overseeing the functioning of the General Agreement on Trade in Services (GATS). It's open to all WTO members, and can create subsidiary bodies as required.

1.3.6 Fourth Level: Subsidiary Bodies

There are subsidiary bodies under each of the three councils.

1. ***Goods Council:*** Subsidiary under the Council for Trade in Goods. It has 11 committees consisting of all member countries, dealing with specific subjects such as agriculture, market access, subsidies, anti-dumping measures and so on. Committees include the following:

   - Information Technology Agreement (ITA) Committee
   - State Trading Enterprises
   - Textiles Monitoring Body - Consists of a chairman and 10 members acting under it.
   - Groups dealing with notifications - process by which governments inform the WTO about new policies and measures in their countries.

2. ***Services Council:*** Subsidiary under the Council for Trade in Services which deals with financial services, domestic regulations and other specific commitments.

3. ***Dispute Settlement panels and Appellate Body:*** Subsidiary under the Dispute Settlement Body to resolve disputes and the Appellate Body to deal with appeals.

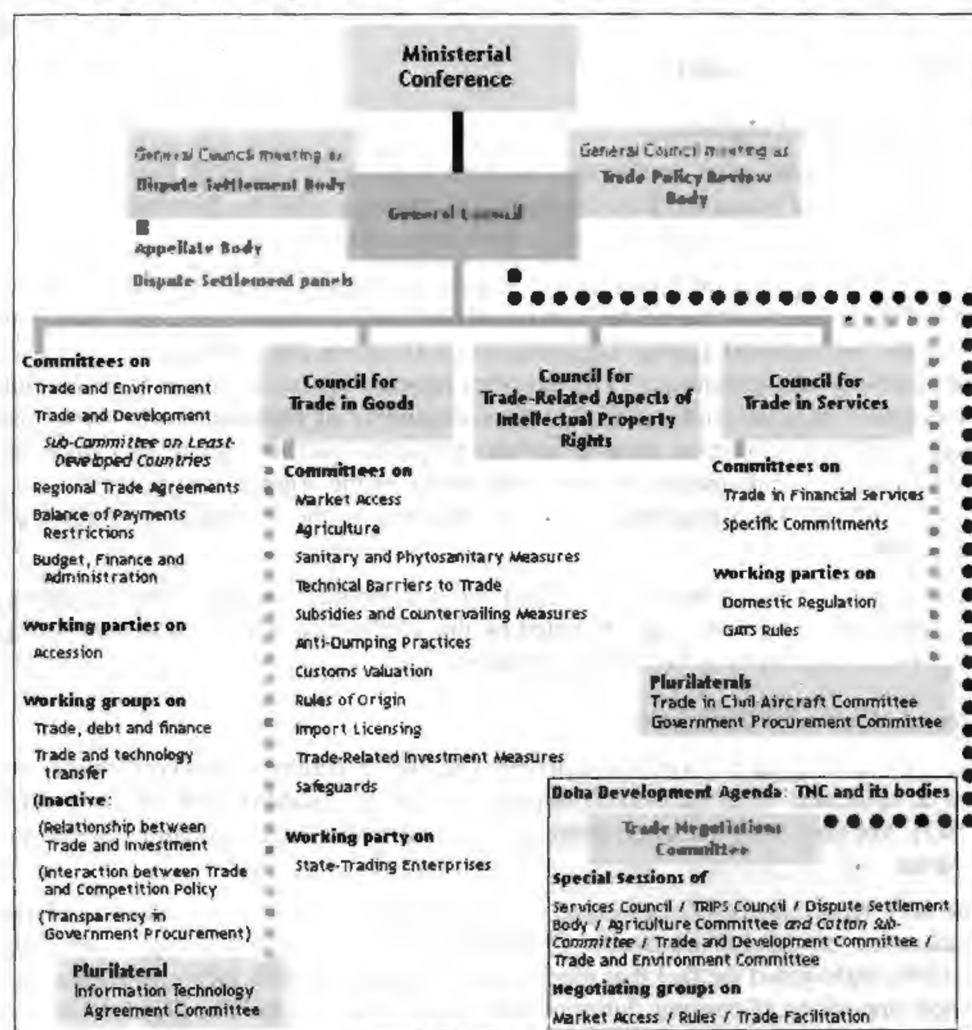
1.3.7 Other Committees

- ***Committees on***
  - Trade and Environment

- ❖ Trade and Development (Subcommittee on Least-Developed Countries)
- ❖ Regional Trade Agreements
- ❖ Balance of Payments Restrictions
- ❖ Budget, Finance and Administration

- ***Working parties on***
  - ❖ Accession
- ***Working groups on***
  - ❖ Trade, debt and finance
  - ❖ Trade and technology transfer

The WTO operates on a one country, one vote system, but actual votes have never been taken. Decision making is generally by consensus, and relative market size is the primary source of bargaining power. The advantage of consensus decision-making is that it encourages efforts to find the most widely acceptable decision. Main disadvantages include large time requirements and many rounds of negotiation to develop a consensus decision, and the tendency for final agreements to use ambiguous language on contentious points that makes future interpretation of treaties difficult.



Reporting to General Council (or a subsidiary)
Reporting to Dispute Settlement Body
Plurilateral committees inform the General Council or Goods Council of their activities, although these agreements are not signed by all WTO members
Trade Negotiations Committee reports to General Council

In reality, WTO negotiations proceed not by consensus of all members, but by a process of informal negotiations between small groups of countries. Such negotiations are often called "Green Room" negotiations (after the colour of the WTO Director-General's Office in Geneva), or "Mini-Ministerials", when they occur in other countries. These processes have been regularly criticized by many of the WTO's developing country members which are often totally excluded from the negotiations. Richard Steinberg (2002) argues that although the WTO's consensus governance model provides law-based initial bargaining, trading rounds close through power-based bargaining favouring Europe and the United States, and may not lead to Pareto improvement.

The General Council also meets as the Trade Policy Review Body and Dispute Settlement Body.

The negotiations mandated by the Doha Declaration take place in the Trade Negotiations Committee and its subsidiaries. This now includes the negotiations on agriculture and services begun in early 2000. The TNC operates under the authority of the General Council.

Each year new chairpersons for the major WTO bodies are approved by the General Council.

1.3.8 Ministerial Conferences

First Ministerial Conference

The inaugural ministerial conference was held in Singapore in 1996.The conference was unique since it was the First Ministerial Conference after the formation of WTO and also because there was 28 applicants for membership.

The focus was mainly on assessing the implementation of commitments made under the WTO agreements. One of the significant observations made by the ministers was about the International Labour Organisation (ILO) being the competent body to set and deal with labour standards. The ministers rejected the use of labour standards for protectionist purposes and agreed that the comparative of countries, particularly low wage developing countries, must in no way be put to question. There was stress on full and faithful implementation of the provisions of the Agreement on Textiles and Clothing (ATC) The Conference witnessed the birth of the Information Technology Agreement.

Disagreements between largely developed and developing economies emerged during this conference over four issues initiated by this conference, which led to them being collectively referred to as the "Singapore issues".

Second Ministerial Conference

Was held in Geneva in Switzerland in1998.The unique feature of this conference was that it coincided with the fiftieth anniversary of the establishment of the GATT (1947). The new WTO members present at Geneva were Congo, Mongolia, Niger and Panama.

The only substantive aspect emerged out of this conference was the adoption of the Declaration on Global Electronic Conference. The Declaration adopted on May 20,1998, highlighted the fact that members would continue with their current practice of non-imposition of customs duties on electronic transmissions. The Declaration also directed the General Council to establish a comprehensive work programme to ensure all trade-related issues relating to global electronic conference.

Third Ministerial Conference

The third conference in Seattle, Washington in 1999.This Conference was unique in that it was held in tumultuous conditions and amid protests by non-governmental

organisations and groups. The extraordinary situation that prevailed during the Conference, with massive demonstrations and police and National Guard crowd control efforts drawing worldwide attention.

The areas and issues covered at the conference included the following:

1. ***Agriculture Working Group:*** Two positions emerged during the discussions. One position favoured complete integration of agricultural trade into the same rules as other products, the total elimination of export subsidies and substantial increases in market access. The opposite position was that agriculture differed from other sectors and therefore did not favour the notion of integrating agricultural trade with that of other products. The proponents of this position did not accept the elimination of export subsidies and stressed the need to take into account the several important societal functions that came under the purview of the agricultural sector.

2. ***Working Group on Implementation and Rules:*** Many developing countries expressed concern and called attention to:

   - Difficulty in implementing certain WTO agreements and asked for extension of deadlines in TRIPS, TRIMS, Customs Valuation and,

   - Imbalance in certain agreements and called for changes in certain provisions of the anti-dumping, subsidies and textiles agreements.

3. ***Working Group on Market Access:*** The position of draft declaration on market access (reductions in import duties, access to service markets etc.) contained a number of unresolved issues that included-coverage, scope and methodology of the negotiations; the extent to which tariffs on non-agricultural products should be reduced and whether members should cut tariffs on a 'request-offer' bilateral basis as in the Uruguay Round or there should be a common multilateral approach at harmonising tariffs aspect or a mix of both; Non-tariff measure; concerns of developing country members with regard to a proposal that exports from Least Developed Countries (LDCs) should be given 'ground zero' tariffs in richer countries.

4. ***Systemic Issues:*** Issues raised by member governments were related to-De-restriction of documents, Improvement in transparency and decision making; improvements in information flows, and establishment of public understanding and participation in the workings of the organisation.

5. ***Trade and Labour Standards:*** A new working group was set up on the last day of the conference to discuss proposals for creating a labour standards working group within the WTO or a body operated jointly by a number of international organisation. Opinions differed, with a number of developing countries opposing the creation of either type of body.

Fourth Ministerial Conference

It was held in Doha in Persian Gulf nation of Qatar in November, 2001 in which Ministers from 142 member countries participated.

At the Fourth Ministerial Conference WTO member governments agreed to launch new negotiations. They also agreed to work on other issues, in particular the implementation of the present agreements. The entire package is called the Doha Development Agenda (DDA). It consist of three major issues: (i) on the negotiating agenda for the new WTO round, (ii) on some 40 implementation concerns of the developing countries and (iii) on the political statement dealing with patents and public health.

The negotiations take place in the Trade Negotiations Committee and its subsidiaries, which are usually, either regular councils and committees meeting in "special

sessions", or specially-created negotiating groups. Other work under the work programme takes place in other WTO councils and committees.

Fifth Ministerial Conference

The ministerial conference was held in Cancún, Mexico, aiming at forging agreement on the Doha round. An alliance of 22 southern states, the G20 (led by India, People's Republic of China and Brazil), resisted demands from the North for agreements on the so-called "Singapore issues" and called for an end to agricultural subsidies within the EU and the US. The talks broke down without progress.

The Fifth Ministerial Conference in Cancún, Mexico, in September 2003, was intended as a stock-taking meeting where members would agree on how to complete the rest of the negotiations. But the meeting was soured by discord on agricultural issues, including cotton, and ended in deadlock on the "Singapore issues". Real progress on the Singapore issues and agriculture was not evident until the early hours of 1st August 2004 with a set of decisions in the General Council (sometimes called the July 2004 package). The original 1st January 2005 deadline was missed. After that, members unofficially aimed to finish the negotiations by the end of 2006, again unsuccessfully. Further progress in narrowing members' differences was made at the Hong Kong Ministerial Conference in December 2005, but some gaps remained unbridgeable and Director-General Pascal Lamy suspended the negotiations in July 2006. Efforts then focused on trying to achieve a breakthrough in early 2007.

Sixth Ministerial Conference

The sixth WTO Conference Ministerial was held in Hong Kong from December 13 – December 18, 2005. It was considered vital if the four-year-old Doha Development Agenda negotiations were to move forward sufficiently to conclude the round in 2006. In this meeting, countries agreed to phase out all their agricultural export subsidies by the end of 2013, and terminate any cotton export subsidies by the end of 2006. Further concessions to developing countries included an agreement to introduce duty free, tariff free access for goods from the Least Developed Countries, following the Everything But Arms initiative of the European Union - but with up to 3% of tariff lines exempted. Other major issues were left for further negotiation to be completed by the end of 2006.

Accession and Membership

The process of becoming a WTO member is unique to each applicant country, and the terms of accession are dependent upon the country's stage of economic development and current trade regime. The process takes about five years, on average, but it can last more if the country is less than fully committed to the process or if political issues interfere. As is typical of WTO procedures, an offer of accession is only given once consensus is reached among interested parties.

1.3.9 Accession Process

Status of WTO Negotiations

- members (including dual-representation with the European Communities)
- draft Working Party Report or Factual Summary adopted
- goods and/or Services offers submitted
- memorandum on Foreign Trade Regime submitted
- observer, negotiations to start later or no Memorandum on FTR submitted
- frozen procedures or no negotiations in the last 3 years
- no official interaction with the WTO

A country wishing to accede to the WTO submits an application to the General Council, and has to describe all aspects of its trade and economic policies that have a bearing on WTO agreements. The application is submitted to the WTO in a memorandum which is examined by a working party open to all interested WTO Members. After all necessary background information has been acquired, the working party focuses on issues of discrepancy between the WTO rules and the applicant's international and domestic trade policies and laws. The working party determines the terms and conditions of entry into the WTO for the applicant nation, and may consider transitional periods to allow countries some leeway in complying with the WTO rules. The final phase of accession involves bilateral negotiations between the applicant nation and other working party members regarding the concessions and commitments on tariff levels and market access for goods and services. The new member's commitments are to apply equally to all WTO members under normal non-discrimination rules, even though they are negotiated bilaterally.

When the bilateral talks conclude, the working party sends to the General Council or Ministerial Conference an accession package, which includes a summary of all the working party meetings, the Protocol of Accession (a draft membership treaty), and lists ("schedules") of the member-to-be's commitments. Once the General Council or Ministerial Conference approves of the terms of accession, the applicant's parliament must ratify the Protocol of Accession before it can become a member.

1.3.10 Members and Observers

A World Map of WTO Participation

The WTO has 151 members (almost all of the 123 nations participating in the Uruguay Round signed on at its foundation, and the rest had to get membership). The 27 states of the European Union are represented also as the European Communities. WTO members do not have to be full sovereign nation-members. Instead, they must be a customs territory with full autonomy in the conduct of their external commercial relations. Thus Hong Kong became a GATT contracting party, and Chinese Taipei (Taiwan) acceded to the WTO in 2002. A number of non-members have been observers (31) at the WTO and are currently negotiating their membership. With the exception of the Holy See, observers must start accession negotiations within five years of becoming observers. Some international intergovernmental organizations are also granted observer status to WTO bodies. 15 states and 2 territories so far have no official interaction with the WTO.

1.4 AGREEMENTS

The WTO oversees about 60 different agreements which have the status of international legal texts. Member countries must sign and ratify all WTO agreements on accession. A list of WTO agreements can be found here. A discussion of some of the most important agreements follows:

1.4.1 Agreement on Agriculture (AoA)

The AoA came into effect with the establishment of the WTO at the beginning of 1995. The AoA has three central concepts, or "pillars": domestic support, market access and export subsidies.

Domestic Support

The first pillar of the AoA is "domestic support". The AoA structures domestic support (subsidies) into three categories or "boxes": a Green Box, an Amber Box and a Blue Box. The Green Box contains fixed payments to producers for environmental programmes, so long as the payments are "decoupled" from current production levels. The Amber Box contains domestic subsidies that governments have agreed to reduce

but not eliminate. The Blue Box contains subsidies which can be increased without limit, so long as payments are linked to production-limiting programmes.

The AoA's domestic support system currently allows Europe and the USA to spend $380 billion annually on agricultural subsidies alone. "It is often still argued that subsidies are needed to protect small farmers but, according to the World Bank, more than half of EU support goes to 1% of producers while in the US 70% of subsidies go to 10% of producers, mainly agri-businesses". The effect of these subsidies is to flood global markets with below–cost commodities, depressing prices and undercutting producers in poor countries – a practice known as dumping.

Market Access

"Market access" is the second pillar of the AoA, and refers to the reduction of tariff (or non-tariff) barriers to trade by WTO members. The 1995 AoA required tariff reductions of:

- 36% average reduction by developed countries, with a minimum per tariff line reduction of 15% over five years.
- 24% average reduction by developing countries with a minimum per tariff line reduction of 10% over nine years.

Least Developed Countries (LDCs) were exempted from tariff reductions, but either had to convert non–tariff barriers to tariffs—a process called tariffication—or "bind" their tariffs, creating a "ceiling" which could not be increased in future.

Export Subsidies

"Export subsidies" is the third pillar of the AoA. The 1995 AoA required developed countries to reduce export subsidies by at least 35% (by value) or by at least 21% (by volume) over the five years to 2000.

Special Safeguards Provisions (emergency actions)

A safeguard provision can be imposed if the price at which imports of those products entering the customs territory of the member granting the concession, as determined on the basis of the c.i.f. import price of the shipment concerned expressed in terms of its domestic currency, falls below a trigger price equal to the average 1986 to 1988 reference price for the product concerned.

The reference price used to invoke the provisions of this subparagraph should, in general, to the average c.i.f. unit value of the product concerned, or otherwise should be an appropriate price in terms of the quality of the product and its stage of processing. This reference price should be publicly specified and available to the extent necessary to allow other members to assess the additional duty that may be levied.

Imposition of the additional duty imposed under special safeguard provisions should be according to the following schedule:

(a) If the difference between the c.i.f. import price of the shipment expressed in terms of the domestic currency ("import price") and the trigger price as defined under that subparagraph is less than or equal to 10 per cent of the trigger price, no additional duty should be imposed.

(b) If the difference between the import price and the trigger price (hereinafter referred to as the "difference") is greater than 10 per cent but less than or equal to 40 per cent of the trigger price, the additional duty should equal to 30 per cent of the amount by which the difference exceeds 10 per cent;

[*Note:* If the difference, say, is 40 per cent, the additional safeguard duty will be 30% of (40% - 10%) = 30% of 30% = 9%]

(c) If the difference is greater than 40 per cent but less than or equal to 60 per cent of the trigger price, the additional duty should equal 50 per cent of the amount by which the difference exceeds 40 per cent, plus the additional duty allowed under(b).

(d) If the difference is greater than 60 per cent but less than or equal to 75 per cent of the trigger price, the additional duty should equal 70 per cent of the amount by which the difference exceeds 60 per cent, plus the additional duty allowed under(b).

(e) If the difference is greater than 75 of the trigger price, the additional duty should equal 90 per cent of the amount by which the difference exceeds 75 per cent of the trigger price ,plus the additional duty allowed under (b), (c) and (d).

Criticism

The AoA is criticized for reducing tariff protections for small farmers – a key source of income for developing countries – while allowing rich countries to continue to pay their farmers massive subsidies which developing countries cannot afford.

1.4.2 General Agreement on Trade in Services (GATS)

GATS is a set of multilateral rules covering international trade in services. The GATS, for the first time, extended internationally agreed rules and commitments into the area of international trade in services.

The GATS has two parts: the framework agreement containing the general rules and disciplines, and the national "schedules" which list individual countries' specific commitments on access to their domestic markets by foreign suppliers

Each WTO member lists, in its national schedule, those services for which it wishes to guarantee access to foreign suppliers. All commitments apply on a non-discriminatory basis to all other members unlike the GATT, the GATS gives complete freedom to members to choose which services to commit for opening up. In addition to the services committed the schedules limit the degree to which foreign service providers can operate in the market.

Further negotiations for progressive liberalization (mandated negotiations) commenced on January 1, 2000 as mandated under GATS.

GATS in Brief

Services mentioned in GATS are supplied neither on a commercial basis nor in competition with other suppliers such as social security schemes and central banking so also services in the air transport sector, traffic rights and all services directly related to the exercise of traffic rights.

Modes of Supply

The GATS sets out four modes of supplying services:

- Mode 1: Cross border trade
- Mode 2: Consumption abroad
- Mode 3: Commercial presence
- Mode 4: Presence of natural persons

General Principles

These are basic rules that apply to all members for all services

- ***MFN Treatment:*** This means that "Each member shall accord immediately and unconditionally to services and service suppliers of any other member, treatment

no less, than it accords to like services and service suppliers of all other country." However a member is permitted to maintain a measure inconsistent with the general MFN agreement if it has established an exception.

All exceptions are subject to review and in principle and do not last longer that 10 years.

- ***Transparency:*** The GATS require each member to publish promptly all relevant measures of general application that affect operation of agreement

Specific Obligations

These requirements apply only to scheduled sectors:

- ***Market access:*** The GATS also sets out different forms of measures affecting free market access that should be applied to a service provider or its supplier only after clear provisions have been made in the member scheduled.

  The market access limitations include:

  - Limitation on the number of service suppliers
  - Limitation on the total value of service transactions or assets
  - Limitations on the total number of service operations or the total quantity of service output
  - Percentage limitations and the participation of foreign capital or the limitations on the total value of foreign investment

- ***National treatment:*** Each member should treat to foreign services and service suppliers if measures affecting supply of services, no less favourably than to its own services and suppliers.

Exemptions: Members in specified circumstances are allowed to introduce or maintain measures in contravention of their obligations under the agreement, including the MFN requirement or specific commitments. These circumstances cover measures necessary to protect public morals or maintain public order, protect human, animal or plant life or health or secure compliance with laws or regulations not inconsistent with this Agreement including among others, measures necessary to prevent deceptive or fraudulent practices.

Irreversible Commitments: Member governments are always free to liberalise unilaterally without making commitments in the GATS .Nevertheless, GATS commitments like tariff bindings are not irreversible.

Regional Trading Arrangements: Apart from services provided in individual MFN exemption lists, the only permitted departure from most favoured-nation treatment under the GATS is among countries that are members of regional trading arrangements. The GATS rules on 'Economic Integration', in article V, are modelled on those in Article XXIV (Territorial Application-Frontier Traffic-Customs Unions and Free Trade Areas) of the GATT, although the absence of a services' equivalent to import duties means that there is no distinction comparable to that between customs unions and free trade area.

1.4.3 Sanitary and Phyto-Sanitary (SPS) Agreement

The Agreement on the Application of Sanitary and Phytosanitary Measures - also known as the SPS Agreement was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO at the beginning of 1995.

Under the SPS agreement, the WTO sets constraints on members' policies relating to food safety (bacterial contaminants, pesticides, inspection and labelling) as well as animal and plant health (imported pests and diseases).

SPS and Genetically Modified Organisms (GMOs)

In 2003, the United States challenged a number of EU laws restricting the importation of Genetically Modified Organisms (GMOs), arguing they are "unjustifiable" and illegal under SPS agreement. In May 2006, the WTO's dispute resolution panel issued a complex ruling which took issue with some aspects of the EU's regulation of GMOs, but dismissed many of the claims made by the U.S.

Criticism

Quarantine policies plays an important role in ensuring the protection of human, animal and plant health. Yet under the SPS agreement, quarantine barriers can be a 'technical trade barrier' used to keep out foreign competitors.

The SPS agreement gives the WTO the power to override a country's use of the precautionary principle – a principle which allows them to act on the side of caution if there is no scientific certainty about potential threats to human health and the environment. In EC measures Concerning Meat and Meat Products (Hormones) WT/DS/26/AB/R the Appellate Body of the WTO held that it was "less than clear" whether the precautionary principle had crystallized into a principle of customary international law, (EC-Hormones paragraph 123) and even if it had, it could not override the provisions of Articles 5.1 and 5.2 of the Agreement on the Application of Sanitary and Phytosanitary Measures (SPS Agreement) that require members to base their measures on a risk assessment. (EC-Hormones paragraphs 123, 124 and 125.See discussion K Kennedy "Resolving International Sanitary and Phytosanitary Disputes in the WTO: Lessons and Future Directions" (2000) Volume 55 Food and Drug Law Journal 81 at 95) The Appellate Body also pointed out that the principle had not been written into the SPS Agreement, although the Appellate Body conceded that the principle was reflected in the sixth paragraph of the preamble of the SPSA, as well as articles 3.3 and 5.7.(EC-Hormones paragraph 124) Article 3.3 allows members to implement quarantine measures higher than those found in international standards, as long as the measures otherwise comply with the SPS Agreement; while Article 5.7 allows provisional measures where there is insufficient scientific evidence. Additionally, the Appellate Body acknowledged that article 5.7 does not necessarily exhaust the relevance of the precautionary principle and that, where there are risks of irreversible damage, governments often act from the point of view of prudence. (EC-Hormones paragraph 124)

Under SPS rules, the burden of proof is on countries to demonstrate scientifically that something is dangerous before it can be regulated, even though scientists agree that it is impossible to predict all forms of damage posed by insects or pest plants.

1.4.4 Agreement on Trade Related Investments

The Agreement on Trade Related Investment Measures (the 'TRIMs Agreement') applies to investment measures related to trade in goods only. The Agreement restrains members from applying any investment measure that is inconsistent with the provisions of Article III (National treatment on Internal Taxation and Regulation) or Article XI (General Elimination of Quantitative Restrictions) of the GATT 1994. The Agreement carries an illustrative list of trade related investment measures that are inconsistent with the obligation of national treatment provided for in Paragraph 4 of Article III and the obligation of general elimination of quantitative restrictions provided for in paragraph I of Article XI of GATT 1994.

TRIMS Inconsistent

1. TRIMS that are inconsistent with the obligation of national treatment provided for in Paragraph 4 of Article III include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which require:

- The purchase or use by an enterprise of products of domestic origin, or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production("Local Content Requirements"); or
- That an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports.

2. TRIMs that are inconsistent with the obligation of general elimination of quantitative restrictions provided for in paragraph I of Article XI of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage and which restrict:
   - The importation by an enterprise of products used in or related to its local production, generally or to an amount related to the volume or value of local production that it exports (Trade Balancing Requirements);
   - The importation by an enterprise of products used in or related to its local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise (Foreign Exchange Balancing Requirements); or
   - The exportation or sale for export by an enterprise of products, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production (Export Performance Requirements).

Developing Country Members: Members categorised as developing countries are given special concessions. A developing country members facing balance of payment problems can deviate, temporarily though from the provisions of Articles III and XI of the GATT 1994.

Withdrawal of Measure: Members were required to follow a specified timetable for withdrawal of measures that were not compatible with TRIMS:

- ***Developed country member:*** within two years of the date of entry into force of the WTO Agreement, that is within January 1997.
- ***Developing country member:*** within five years of the date of entry into force of the WTO Agreement, that is within January 2000.
- ***Least-developed country member:*** within seven years of the date of entry into force of the WTO Agreement, that is within January 2002.

However the Council for Trade in Goods (CTG) was given the option to extend the transition period for the elimination of TRIMs for developing country and least-developed country members demonstrating particular difficulties in implementing the provisions of the Agreement. The CTG when considering such a request was required to take into account the individual development, financial and trade needs of the members making the request.

Apart from the above allowance given to developing country and LCD members, the Agreement took into consideration situations where an established enterprise subject to a TRIM notification had to meet new competition during the transition period.

Given such a condition, any member ,developed or developing, could apply the same TRIM to the new investment (i) where the products of such investment were like products to those of the established enterprises and (ii) where necessary to avoid distorting the conditions of competition between the new investment and the established enterprises. Such a new measure had to be notified to the CTG with the date of termination being the same for both the old and new members.

1.4.5 Agreement on Technical Barriers to Trade (TBT)

The Agreement on Technical Barriers to Trade - also known as the TBT Agreement 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 at the end of 1994.

The object of the TBT Agreement is to "to ensure that technical negotiations and standards, as well as testing and certification procedures, do not create unnecessary obstacles to trade".

1.4.6 Trade-related Aspects of Intellectual Property Rights (TRIPs) Agreement

The main objective is providing protection to the holder of the intellectual property right, which can be claimed by an individual, company or even people of a geographical region.

This right over an intellectual property can be called a 'monopoly right' conferred on the inventor (patent on an industrial product), creator (copyright over a literary work) or user (trademark of a business establishment) or regions (Geographical Indicators of Origin). This right, recognised as "legal property", however, can be claimed for fixed pre-determined periods of time except Trademarks and Geographical indications of Origin where protection is offered in perpetuity.

TRIPS Coverage

The agreement encompasses the following areas:

- ***Patents:*** Patents are given inventions that are-new (or Novel), non-obvious, should have industrial application (commercial use).
    - *Term of a patent:* A parent is valid for 20 years from the date of filing of the patent.
    - *Inventions that can be patented:* Biological inventions, computer hardware and peripherals, computer software, cosmetics, food inventions, machines, mechanical inventions, medical accessories and devices, medicines, musical instruments etc.
    - *Inventions that cannot be patented:* Ordre public or morality; Diagnostic, therapeutic and surgical methods; Plants and animals other than micro-organisms.
    - *Compulsory Licensing:* Compulsory licensing and government use without the authorisation of the right holder are allowed but are made subject to conditions aimed at protecting the legitimate interests of the right holder.
    - *Scope and Duration:* The scope and duration of such use without the authorisation of the right holder must be limited to the purpose for which it is authorised.
    - Non-exclusive Licenses
    - *The Indian Patents Act:* The salient features are:
        - Terms of every patient is 10 years from the date of filing
        - A new definition of 'invention' meaning a new product or process involving inventive step and capable of industrial application has been incorporated
        - A method or process of testing during the process of manufacture will be patentable.

- Process in case of plants, are now patentable while a process for diagnostic and therapeutic use has now been considered as non-patentable. Every patent (except in which a secrecy direction is given) will now be published just after 18 months from the date of filing/ priority and will be open for public on payment. As such, the filing intimation being published in the Gazette immediately after filing has been stopped.
- Provision for filing request for examination by any other interested person (other than applicant) also has been introduced.
- Provision for the withdrawal of application by applicant any time before grant has been introduced.
- Time for putting the application in order for acceptance has now been from 15/18 months to 12 months.
- Grounds for opposition as well as revocation have been enlarged by adding the following grounds (i) Non-disclosure or wrongly mentioning the source of geographical origin of biological material used for invention; (ii) Anticipation having regard to the knowledge, oral or otherwise available within local or indigenous community in India or elsewhere.

- ***Copyright:*** A copy right prohibits persons from reproducing or 'copying' any 'literary, dramatic, musical work' without the consent of the owner who has the copyright over that work. This protection also applies to cinematograph films, sound recordings and now, computer programmes.

  The TRIPS Agreement mentions that "copyright protection shall extend to expressions and not to ideas, procedures and methods of operation or mathematical concepts as such". Just as 'commercial use or utility' is an important precondition for the granting of a patent, ideas should have crystallised as expressions or artistic forms for the granting of a patent.

  Copyright subsists in the following class of 'works': Literary Work; Dramatic work; Artistic works.

- ***Trademarks:*** A trademark is a visual symbol in the form of a word, device, name, letter or numeral, brand, heading, signature or label or any combination of these that enable a person to make a connection between a product and the company involved in offering the product. The company can be one involved in manufacturing goods or offering services. In case of the latter, the term 'service mark' is used.

  The Indian Act: The Trademarks Act of 1999 came into effect on September 15, 2003, mentions the grounds for refusal of registration of a trademark. The reasons could be when the trademark:

  1. Is devoid of any distinctive character, that there is difficulty in distinguishing between goods or services
  2. Consists exclusively of marks or indications which have become customary in the current language, that is, an absence of distinctiveness
  3. Is of such a nature as to deserve the public or cause confusion
  4. Contains or comprises any matter that hurts religious feelings.
  5. Comprises or contains scandalous or obscene matter
  6. Consists exclusively of the shape of a good, e.g. the photo of mango by itself cannot be a trademark.

Under the Trade Marks Act of 1999, there is provision for infringement of a trademark.

- ***Geographical Indications:*** Geographical indications are place, names used to identify the origin and quality, reputation or other characteristics of products. The examples usually are "Champagne", "Tequila" or "Roquefort". However, countries such as India would like "Kancheepuram Saree" and perhaps even "Mysore Dosa" to become standard examples.

  Protection required under the TRIPS Agreement is defined in two Articles. All products are covered by Article 22, which defines a standard level of protection. This says that geographical indications have to be protected in order to avoid misleading the public and to prevent unfair competition.

  The protection being provided exclusively under Article 23 for wines and spirits is unfortunately not available to several products from the developing world.

- ***Layout Designs (Topographies) of Integrated Circuits:*** With regard to the treaty on intellectual property in respect of Integrated Circuits (IPIC Treaty), members agreed to provide protection to the layout-designs (topographies) of integrated circuits (referred in the WTO Agreement as "layout-designs")

  In the event of trading in an integrated circuit incorporating an unlawfully reproduced layout design or any article incorporating such an integrated circuit, the person concerned, upon being informed of such an act, shall pay the "holder a sum equivalent to a reasonable royalty such as would be payable under a freely negotiated license in respect of such a layout design".

The Indian IC Layout Design Act

The Semiconductor Integrated Circuits Layout Design Act, 2000, which received Presidential assent in September 2000, among other things, mentions the following:

"Layout Design" means a layout of transistors and other circuitry elements and included lead wires connecting such elements and expressed in any manner in a semiconductor circuit.

"Semiconductor Integrated Circuit" means a product having transistors and other circuitry elements which are inseparably formed on semiconductor material or on insulating material or inside semiconductor material and designed to perform an electronic circuitry function.

The Act disallows registration for IC layout design that is:

- Not original; or
- That has been commercially exploited anywhere in India or in a convention country; or
- That is not inherently distinctive; or
- That is not inherently distinguishable from any other registered layout design.

The registration of a layout design is for a period of 10 years from the date of filling of an application for registration or from the date of first commercial exploitation anywhere in India or any country, whichever is earlier.

- ***Industrial Designs:*** A design must satisfy the following:
  - It must be new or original, meaning that the design must have not been previously published.
  - It must relate to the features of shape.
  - It must be applied to any article by industrial process.
  - It should appeal to and be judged solely by the naked eye.

Article 25 on "Requirements for Protection" states that:

1. Members shall provide for the protection of independently created industrial designs that are new or original.
2. Each member shall ensure that requirements for securing protection for textile designs, in particular in regard to any cost, examination or publication, do not unreasonably impair the opportunity to seek and obtain such protection.

Article 26 on 'Protection' states that:

1. The owner of a protected industrial design shall have the right to prevent third parties not having the owner's consent from making, selling, selling or importing articles bearing or embodying a design which is a copy, or substantially a copy, of the protected design, when such acts are undertaken for commercial purposes.
2. The duration of protection available shall amount to at least 10 years. (The Indian Designs Act, 2000, also provides the same protection of 10 years)

The Indian Designs Act

The existing legislation on industrial designs in India is contained in the Designs Act, 2000.

Among other things, the Act mentions the following:

- 'Article' means any article of manufacture and any substance, artificial, or partly artificial and partly natural and includes any part of an article being made and sold separately.
- 'Design' means only the features of shape, configuration, pattern, ornament or composition of lines or colours applied to any article whether in two dimensional or three dimensional or in both forms, by any industrial process or means, whether manual, mechanical, or chemical, separate or combined, which in the finished article appeal to and are judged solely by the eye
- "Prohibition of Registration of Certain Designs"

A design will not be registered:

(a) If it is not new or original; or

(b) If it has been disclosed to the public anywhere in India or in any other country by publication in any tangible form or by use or in any other way prior to the filing date; or

(c) If it is not significantly distinguishable from known designs or combination of known designs; or

(d) If it comprises or contains scandalous or obscene material.

The copyright of a registered design will extend for 10 years from the date of registration, extendable on an application from the registered proprietor for a second period of five years from the expiration of the original period.

TRIPS and Control of Anti-competitive Practices

Under Section 8 regarding 'Control of Anti-competitive practices in Commercial Licenses', there is recognition "that some licensing practices or conditions pertaining to intellectual property rights which restrain competition may have adverse effects on trade and may impede the transfer and dimension of technology".

Thus members are allowed to specify in their legislation licensing practices or conditions that may in particular cases constitute an abuse of intellectual property rights having an adverse effect on competition in the relevant market.

1.4.7 Import Licensing

"It is understood that the requirement to take into account the "development purposes and financial needs of developing country members" in Article 1.2 of the agreement means that the burden of the administrative procedure used to implement import licensing regimes shall be further reduced in order to facilitate trade of developing country members and minimize possible adverse effects to their trade, including by making import licensing procedures as expeditious as possible" (Cancun Ministerial text, September, 2003).

1.4.8 Agreement on Anti-dumping

Salient facts in Anti-dumping:

1. The WTO agreement permits antidumping duty to be levied when goods are exported from a member country at a price lower than the normal value.
2. Cheap or low priced imports need not mean that the products are being dumped.
3. Anti-dumping duty is mostly exporter, and sometimes country, specific and thus differs from the normal customs duty which is applicable to all imports irrespective of the country of origin or exporter.
4. Dumping margin is the difference between the normal value and the export price of the product under anti-dumping investigation. The dumping margin is generally expressed as a percentage of the export price. If the normal value is US$ 110 per kg, and the export price $100 per kg., the dumping margin is US$ 10 per kg., i.e. 10% of the export price.
5. Dumped imports should cause injury to the domestic industry in terms of the reduced market share of the domestic industry or price undercutting or depression of prices.
6. Non-injurious Price (NIP) is that level of price which the domestic industry in the importing market is expected to have charged under normal circumstances during the investigation period.
7. NIP is the price that would have enabled the domestic industry to reasonably recover both the cost of production and profit. Those factors of production that could have adversely affected companies for which the dumped exports cannot be held responsible are not taken into consideration.
8. The injury margin id the difference between the NIP and the landed value of the dumped imports. (*Note:* The landed value is the assessable value under Indian customs Act plus the basic customs duty).
9. Exceeding the de minimis margin can lead to an anti-dumping investigation. The de minimis margin for individual exporter is two per cent of the export price. That is the normal value exceeds the export price by more than two per cent of the export price. If the normal value is US$100 the anti-dumping investigation can commence if the export price is US$97-99.
10. The de minimis margin is also calculated on the basis of share of dumped imports. In case of a particular country, the de minimis margin is three per cent share of the total imports of the product and for all countries the cumulative imports should not exceed seven per cent.
11. In India, it is the designated authority in the Ministry of Commerce that, after due investigation, recommends the imposition of the ant-dumping duty and it is the Ministry of Finance that actually levies and collects the duty.

12. The application for anti-dumping investigation should be supported by producers who account for more than 25 per cent of the total domestic production of the product under investigation.
13. The interested parties to an anti-dumping investigation include (a) domestic industry that has made the complaint (b) exporters or the foreign producers of the product (c) importers (d) the government(s) of the exporting country/countries and (e) the trade or business associations of the domestic producers/importers/user industries of the dumped product.
14. The designated authority can also initiate an anti-dumping investigation on its own initiative on the basis of information received from the collector of Customs with the other conditions remaining the same.
15. The period of investigation is generally expected to be not less than six months and not more than 18 months. Moreover, the period should be as representative as possible with the most desirable period being the financial year preceding the filing of the anti-dumping application provided that there is no wide gap between the financial year and the application period. However, for the purpose of injury analysis, the domestic industry has to furnish the relevant data for the past three years.
16. The various stages of the investigation process into dumping include (a) preliminary screening of application (b) initiation of the investigation within seven days of the receipt of application (c) Access to information by interested parties (d) preliminary findings generally within two months of the date of initiation (e) imposition of provisional duty, if any, after 60 days from the date of initiation and valid for a period of generally not exceeding six months (f) oral evidence and public hearing (g) Disclosure of information and (h) Final findings.
17. Anti-dumping can be levied on a retrospective basis if there is a history of dumping or if there is massive dumping in a relatively short time. However, the anti-dumping duty can be levied only for a maximum period of 90 days preceding the date of application of provisional measures. The anti-dumping duty can be recommended and levied at two stages: provisional and final. If the final duty is less than the provisional duty, the excess amount paid under provisional duty is refunded. But if the final duty is more than the provisional duty, the deficiency is not made up. If the provisional duty is withdrawn after investigation, the amount collected as provisional duty is refunded.
18. An anti-dumping measure can be generally in force for a period of five years but can be subject to a review after a year from the imposition date.

1.4.9 Agreement on Rules of Origin

"In regards to preferential rules under the common declaration in Annex II to the Agreement, the Ministerial Conference (Cancun Ministerial text, September, 2003) agrees that in their arrangements for mutual reduction or elimination of tariff or non-trade barriers, developing and least-developed country members shall have the right to adopt preferential rules of origin designed to achieve trade-policy objectives relating to their rapid economic development, particularly through generating regional trade.

Furthermore, the Ministerial Conference instructs the Director-General to take action to facilitate the increased participation of developing and least-developed country members in the activities of the technical committee on rules or Origin of the World Customs Organization as well as to coordinate with this organization in identifying technical and financial assistance needs of developing and least-developed country members, and report to the Committee on Rules of Origin and the council for Trade in goods periodically, and the General Council as appropriate."

1.4.10 Valuation of Goods at Customs

Summary

When customs duties are levied on an ad valorem basis (e.g. 10 % of the value of imported goods), the actual incidence of duty depends on how Customs determines dutiable value. The Agreement on Customs Valuation requires Customs to determine the value on the basis of the price paid or payable by the importer in the transaction that is being valued. As a result of a Decision adopted in the Uruguay Round, Customs can reject transaction values when it has reasons to doubt the truth or accuracy of the value declared by importers or of the documents submitted by them. In order to protect the interests of importers in such situations, Customs is required to provide them with an opportunity to justify their price. Where Customs is not satisfied with the justifications given, it is obliged to give to these importers in writing its reasons for not accepting the transaction value they have declared.

When the transaction value is not accepted by Customs, the Agreement lays down five methods for establishing value. In determining value on the basis of these methods, Customs is required to consult the importers and take their views into account. A number of developing countries currently use valuation systems based on the Brussels Definition of Value, developed by the World Customs Organization (WCO). These countries will have to modify their systems to bring them in conformity with the rules of the Agreement on Customs Valuation within the transitional period of five years (i.e. upto 1st January, 2000) that has been accorded to developing countries for changing over to the system established by the Agreement.

Types of Customs Duties

Customs duties are levied on an ad valorem basis (e.g. 20% of the value of the imported product) or as specific duties (e.g. $2 per kilogram or per litre).

Combined or mixed duties containing both ad valorem and specific rates are also levied (10% of the value + $2 per kilogram) on some products.

With a few exceptions, most countries levy ad valorem duties. Governments prefer to levy such duties for three broad reasons. First, it is easier for the authorities to estimate collectable revenue from ad valorem duties, which are assessed on the basis of value, than revenue from specific duties, which are levied on the basis of volume or weight. Second, ad valorem duties are more equitable than specific duties as their incidence is lower on cheaper products and higher on more expensive goods. For instance, a specific duty of $2 per litre would have an incidence of 50% on a bottle of wine costing $4, and 10% on a higher-priced wine costing $20 a bottle. An ad valorem duty of 10% would have an incidence of $0.20 on the cheaper bottle and $2 on the more expensive bottle. Third, in international negotiations for reductions in tariffs it is far easier to compare the level of tariffs and negotiate reductions if the duties are ad valorem.

However, the incidence of ad valorem duties depends to a large extent on the methods used to determine dutiable value. Thus, if Customs determines the dutiable value at $1,000, an ad valorem duty of 10% will result in a duty of $100. If, on the other hand, it determines value at $1,200, the importer will have to pay an import duty of $120 for the same goods. The benefits to the trade arising from tariff bindings could fall considerably if Customs uses prices other than invoice prices for determining values for customs purposes. The rules that are applied for the valuation of goods are therefore of crucial importance in ensuring that the incidence of duties as perceived by the importer is not higher than that indicated by the nominal rates shown in the importing country's tariff schedules.

Rules of the Agreement on Customs Valuation

Preamble: The detailed WTO rules on the valuation of goods for customs purposes are contained in the Agreement on Customs Valuation (full title: Agreement on Implementation of Article VII of GATT 1994). The Agreement's valuation system is based on simple and equitable criteria that take commercial practices into account. By requiring all member countries to harmonize their national legislation on the basis of the Agreement's rules, it seeks to ensure uniformity in the application of the rules so that importers can assess with certainty in advance the amounts of duties payable on imports.

Main Standard: transaction value: The basic rule of the Agreement is that the value for customs purposes should be based on the price actually paid or payable when sold for export to the country of importation (e.g. the invoice price), adjusted, where appropriate, to include certain payments made by buyers such as the costs of packing and containers, assists, royalties and license fees. The rules exclude buying commissions and special discounts obtained by sole agents and sole concessionaires from being taken into account in arriving at dutiable value.

Decision on Shifting the Burden of Proof: The Decision Regarding Cases where Customs Administrations Have Reasons to Doubt the Truth or Accuracy of the Declared Value (also known as the Decision on Shifting the Burden of Proof), adopted as a result of the initiative taken by developing countries during the Uruguay Round, corrects this lacuna. The Tokyo Round Agreement placed the burden of proof on Customs if it rejected the transaction value declared by the importer. The Uruguay Round decision shifts the burden of proof on to the importers when Customs, on the basis of the information on prices and other data available to it, "has reason to doubt the truth or accuracy of the particulars or of documents produced in support" of declarations made by the importers.

Determining customs value: permitted adjustments to the price paid for goods (Agreement on Customs Valuation, Article 8)

In order to arrive at the transaction value, Article 8 of the Agreement on Customs Valuation provides that payments made for the following elements can be added to the price actually paid or payable (i.e. the invoice price) by the importer for the imported goods:

1. Commissions and brokerage, except buying commissions;
2. Costs of, and charges for, packing and containers;
3. Assists, i.e. goods (materials, components, tools, dies, etc.) or services (designs, plans, etc.) supplied free or at reduced cost by the buyer for use in the production of the imported goods;
4. Royalties and license fees;
5. Subsequent proceeds of any sale accruing to the seller as a result of the resale or use of imported goods;
6. The cost of transport, insurance and related charges to the place of importation, if the country bases its valuation on CIF prices.

The Article further clarifies that no additions other than for the elements mentioned above shall be made to the price paid or payable in order to arrive at the transaction value. The Article, in addition, enumerates charges or costs that should not be added to customs value, if they can be distinguished from the price actually paid or payable.

These are:

(a) Freight after importation into the customs territory of the importing country;

(b) Cost of construction, erection, assembly, maintenance or technical assistance occurring after importation;

(c) Duties and taxes of the importing country.

Instances when customs can reject the transaction value declared by the importer

1. When there is no sale.
2. When there are restrictions on the disposition or use of the goods by the buyer. The transaction value need not be accepted if the sales contract imposes some restrictions on the use or disposition of goods except where:
   - The restriction is imposed by law (e.g. packaging requirements);
   - The restrictions limit the geographical area in which the goods may be sold (e.g. distribution contract which limits sales to European countries);
   - The restrictions do not affect the value of goods (e.g. the new model imported should not be sold before a particular date).
3. When the sale or price is subject to some conditions for which the value cannot be determined (e.g. the seller establishes the price of the imported goods on condition that the buyer also buys other goods in specified quantities).
4. When part of the proceeds of any subsequent resale by the buyer accrues to the seller.
5. Where the buyer and seller are related and if the price is influenced by the relationship.

In order to ensure that the transaction value is rejected by Customs in such cases on an objective basis, the Agreement on Customs Valuation stipulates that national legislation should provide certain rights to importers. First, where Customs expresses doubts as to the truth or accuracy of a declared value, importers should have a right to provide an explanation, including documents or other evidence to prove that the value declared by them reflects the correct value of the imported goods. Second, where Customs is not satisfied with the explanations given, importers should have a right to ask Customs to communicate to them in writing its reasons for doubting the truth or accuracy of the declared value. This provision is intended to safeguard the interests of importers, by giving them the right to appeal against the decision to higher authorities and, if necessary, to a tribunal or other independent body, within the customs administration.

Valuation, Article 2(a)

Valuation, Article 2(b)

The rule that transaction values declared by importers should be used for valuation of goods applies not only to arms-length transactions but also to transactions between related parties. In the latter transactions, which generally take place among transnational corporations and their subsidiaries or affiliates, prices are charged on the basis of transfer pricing which may not always reflect the correct or true value of the imported goods. Even in such cases, the Agreement requires Customs to enter into consultations with the importer, in order to ascertain the type of relationship, the circumstances surrounding the transaction and whether the relationship has influenced the price. If Customs after such examination finds that the relationship has not influenced the declared prices, the transaction value is to be determined on the basis of those prices.

Further, in order to ensure that in practice the transaction value is not rejected simply on the grounds that the parties are related, the Agreement gives importers the right to demand that the value should be accepted when they demonstrate that the value approximates the test values arrived at on the basis of:

1. Customs value determined in past import transactions occurring at about the same time between unrelated buyers and sellers of identical or similar goods, or
2. Deductive or computed values calculated for identical or similar goods (see below).

Five other standards Agreement on Customs

Valuation, Annex I:

General Note

How should Customs determine dutiable value when it decides to reject the transaction value declared by the importer? In order to protect the interests of importers and to ensure that the value in such cases is determined on a fair and neutral basis, the Agreement limits the discretion available to Customs to using the five standards it lays down. The Agreement further insists that these standards should be used in the sequence in which they appear in the text, and only if Customs finds that the first standard cannot be used should the value be determined on the basis of the succeeding standards.

The standards, presented in the sequence in which they are to be used, are discussed below:

1. ***The transaction value of identical goods:*** Where value cannot be determined on the basis of the transaction value, it should be established by using an already determined transaction value for identical goods.
2. ***The transaction value of similar goods:*** Where it is not possible to determine value on the basis of the above method, it should be determined on the basis of the transaction value of similar goods.

Under both these methods, the transactions selected must relate to imported goods that were sold for export to the country of importation and at about the same time as the goods being exported.

Deductive Value

The next two methods are the deductive method and the computed value method.

(a) ***Deductive value:*** It is determined on the basis of the unit sales price in the domestic market of the imported goods being valued or of identical or similar goods after making deductions for such elements as profits, customs duties and taxes, transport and insurance, and other expenses incurred in the country of importation.

(b) ***Computed value:*** The computed value is determined by adding to the cost of producing the goods being valued "an amount for profit and general expenses equal to that usually reflected in sales of goods of the same class or kind as the goods being valued which are made by producers in the country of exportation for export to the country of importation."

(c) ***Fall-back method:*** Where customs value cannot be determined by any of the four methods described above, it can be determined by using any of the previous methods.

Rules for determining whether goods are identical or similar (Agreement on Customs Valuation, Article 15:2)

Whether the goods are identical or similar to those in the transaction to be valued is determined by taking into account the characteristics described below.

- Goods are identical
- Goods are similar

Are the same in all respects including physical characteristics, quality and reputation. Closely resemble the goods being valued in terms of components, materials and characteristics; are capable of performing the same functions and are commercially interchangeable with the goods being valued.

In addition, in order to be treated as identical or similar, the goods must have been produced:

- in the same country
- by the same producer as the goods being valued.

Where, however, import transactions involving identical or similar goods produced by the same producer in the country of production of the goods being valued do not exist, goods produced by a different producer in the same country must be taken into account.

As a general rule, the Agreement visualizes that where a transaction value is not accepted, the value should be determined by using the above standards on the basis of the information available within the country of importation. However, it recognizes that in order to determine a computed value, it may be necessary to examine the costs of producing the goods being valued and other information which has to be obtained from outside the country of importation. The Agreement therefore suggests, in order to ensure that the importer is not subjected to unnecessary burdens, that the computed value standard should be used only when buyer and seller are related and the producer is prepared to provide to the customs authorities in the importing country the necessary cost data and facilities for their subsequent verification.

Developing Countries and the Agreement

Agreement on Customs Valuation, Article 20:1

Prior to 1st January 1995, only 11 countries were applying the Agreement's valuation system. When the Agreement was being negotiated, it was recognized that the majority of developing countries (which based their valuation systems on the Brussels Definition of Value %, a definition entirely different from that followed by the Agreement) would need some time to adopt the legislative and institutional framework and train the officials required for its implementation. The Agreement therefore gave a delay period of five years to developing countries which considered that an immediate change to the new system would be difficult for them.

A number of developing countries have now become members of the Agreement. However, about 50 countries (including some LDCs) have invoked the provisions on the delay .period. This period will expire for all countries by early or mid 2000. In order to facilitate adoption of the system by the target date, the WTO and WCO Secretariats have stepped up their technical assistance in training officials in the methods of the Agreement.

A request to extend the delay period of five years may be made to the Committee on Customs Valuation, which has been established under the Agreement. The developing country making the request must demonstrate the difficulties it is encountering in adopting the system. Any extension must be approved by the Committee.

Business Implications

The basic aim of the Agreement is to protect the interests of honest traders by requiring that Customs should accept for determining dutiable value the price actually

paid by the importer in a particular transaction. This applies to both arms-length and related-party transactions. The Agreement recognizes that the prices obtained by different importers for the same products may vary. The mere fact that the price obtained by a particular importer is lower than that at which other importers have imported the product cannot be used as a ground.

1.4.11 Agreement on Pre-shipment Inspection

Article 1 - Coverage - Definitions

1. This Agreement shall apply to all pre-shipment inspection activities carried out on the territory of Members, whether such activities are contracted or mandated by the government, or any government body, of a Member.
2. The term "user Member" means a Member of which the government or any government body contracts for or mandates the use of pre-shipment inspection activities.
3. Pre-shipment inspection activities are all activities relating to the verification of the quality, the quantity, the price, including currency exchange rate and financial terms, and/or the customs classification of goods to be exported to the territory of the user Member.
4. The term "pre-shipment inspection entity" is any entity contracted or mandated by a Member to carry out pre-shipment inspection activities.

Article 2 - Obligations of User Members - Non-discrimination

1. User Members shall ensure that pre-shipment inspection activities are carried out in a non-discriminatory manner, and that the procedures and criteria employed in the conduct of these activities are objective and are applied on an equal basis to all exporters affected by such activities. They shall ensure uniform performance of inspection by all the inspectors of the pre-shipment inspection entities contracted or mandated by them.

Governmental Requirements

2. User Members shall ensure that in the course of pre-shipment inspection activities relating to their laws, regulations and requirements, the provisions of paragraph 4 of Article III of GATT 1994 are respected to the extent that these are relevant.

Site of Inspection

3. User Members shall ensure that all pre-shipment inspection activities, including the issuance of a Clean Report of Findings or a note of non-issuance, are performed in the customs territory from which the goods are exported or, if the inspection cannot be carried out in that customs territory given the complex nature of the products involved, or if both parties agree, in the customs territory in which the goods are manufactured.

Standards

4. User Members shall ensure that quantity and quality inspections are performed in accordance with the standards defined by the seller and the buyer in the purchase agreement and that, in the absence of such standards, relevant international standards apply.

Transparency

5. User Members shall ensure that pre-shipment inspection activities are conducted in a transparent manner.

6. User Members shall ensure that, when initially contacted by exporters, pre-shipment inspection entities provide to the exporters a list of all the information which is necessary for the exporters to comply with inspection requirements. The pre-shipment inspection entities shall provide the actual information when so requested by exporters. This information shall include a reference to the laws and regulations of user Members relating to pre-shipment inspection activities, and shall also include the procedures and criteria used for inspection and for price and currency exchange-rate verification purposes, the exporters' rights vis-à-vis the inspection entities, and the appeals procedures set up under paragraph 21. Additional procedural requirements or changes in existing procedures shall not be applied to a shipment unless the exporter concerned is informed of these changes at the time the inspection date is arranged. However, in emergency situations of the types addressed by Articles XX and XXI of GATT 1994, such additional requirements or changes may be applied to a shipment before the exporter has been informed. This assistance shall not, however, relieve exporters from their obligations in respect of compliance with the import regulations of the user Members.
7. User Members shall ensure that the information referred to in paragraph 6 is made available to exporters in a convenient manner, and that the pre-shipment inspection offices maintained by pre-shipment inspection entities serve as information points where this information is available.
8. User Members shall publish promptly all applicable laws and regulations relating to pre-shipment inspection activities in such a manner as to enable other governments and traders to become acquainted with them.

Protection of Confidential Business Information

9. User Members shall ensure that pre-shipment inspection entities treat all information received in the course of the pre-shipment inspection as business confidential to the extent that such information is not already published, generally available to third parties, or otherwise in the public domain. User Members shall ensure that pre-shipment inspection entities maintain procedures to this end.
10. User Members shall provide information to Members on request on the measures they are taking to give effect to paragraph 9. The provisions of this paragraph shall not require any Member to disclose confidential information the disclosure of which would jeopardize the effectiveness of the pre-shipment inspection programmes or would prejudice the legitimate commercial interest of particular enterprises, public or private.
11. User Members shall ensure that pre-shipment inspection entities do not divulge confidential business information to any third party, except that pre-shipment inspection entities may share this information with the government entities that have contracted or mandated them. User Members shall ensure that confidential business information which they receive from pre-shipment inspection entities contracted or mandated by them is adequately safeguarded. Pre-shipment inspection entities shall share confidential business information with the governments contracting or mandating them only to the extent that such information is customarily required for letters of credit or other forms of payment or for customs, import licensing or exchange control purposes.
12. User Members shall ensure that pre-shipment inspection entities do not request exporters to provide information regarding:
    - manufacturing data related to patented, licensed or undisclosed processes, or to processes for which a patent is pending;
    - unpublished technical data other than data necessary to demonstrate compliance with technical regulations or standards;

- internal pricing, including manufacturing costs;
- profit levels;
- the terms of contracts between exporters and their suppliers unless it is not otherwise possible for the entity to conduct the inspection in question. In such cases, the entity shall only request the information necessary for this purpose.

13. The information referred to in paragraph 12, which pre-shipment inspection entities shall not otherwise request, may be released voluntarily by the exporter to illustrate a specific case.

Conflicts of Interest

14. User Members shall ensure that pre-shipment inspection entities, bearing in mind also the provisions on protection of confidential business information in paragraphs 9 through 13, maintain procedures to avoid conflicts of interest:
    - between pre-shipment inspection entities and any related entities of the pre-shipment inspection entities in question, including any entities in which the latter have a financial or commercial interest or any entities which have a financial interest in the pre-shipment inspection entities in question, and whose shipments the pre-shipment inspection entities are to inspect;
    - between pre-shipment inspection entities and any other entities, including other entities subject to pre-shipment inspection, with the exception of the government entities contracting or mandating the inspections;
    - with divisions of pre-shipment inspection entities engaged in activities other than those required to carry out the inspection process.

Delays

15. User Members shall ensure that pre-shipment inspection entities avoid unreasonable delays in inspection of shipments. User Members shall ensure that, once a pre-shipment inspection entity and an exporter agree on an inspection date, the pre-shipment inspection entity conducts the inspection on that date unless it is rescheduled on a mutually agreed basis between the exporter and the pre-shipment inspection entity, or the pre-shipment inspection entity is prevented from doing so by the exporter or by force majeure.

16. User Members shall ensure that, following receipt of the final documents and completion of the inspection, pre-shipment inspection entities, within five working days, either issue a Clean Report of Findings or provide a detailed written explanation specifying the reasons for non-issuance. User Members shall ensure that, in the latter case, pre-shipment inspection entities give exporters the opportunity to present their views in writing and, if exporters so request, arrange for re-inspection at the earliest mutually convenient date.

17. User Members shall ensure that, whenever so requested by the exporters, pre-shipment inspection entities undertake, prior to the date of physical inspection, a preliminary verification of price and, where applicable, of currency exchange rate, on the basis of the contract between exporter and importer, the pro forma invoice and, where applicable, the application for import authorization. User Members shall ensure that a price or currency exchange rate that has been accepted by a pre-shipment inspection entity on the basis of such preliminary verification is not withdrawn, providing the goods conform to the import documentation and/or import licence. They shall ensure that, after a preliminary verification has taken place, pre-shipment inspection entities immediately inform exporters in writing either of their acceptance or of their detailed reasons for non-acceptance of the price and/or currency exchange rate.

18. User Members shall ensure that, in order to avoid delays in payment, pre-shipment inspection entities send to exporters or to designated representatives of the exporters a Clean Report of Findings as expeditiously as possible.

19. User Members shall ensure that, in the event of a clerical error in the Clean Report of Findings, pre-shipment inspection entities correct the error and forward the corrected information to the appropriate parties as expeditiously as possible.

Price Verification

20. User Members shall ensure that, in order to prevent over- and under-invoicing and fraud, pre-shipment inspection entities conduct price verification according to the following guidelines:

    - pre-shipment inspection entities shall only reject a contract price agreed between an exporter and an importer if they can demonstrate that their findings of an unsatisfactory price are based on a verification process which is in conformity with the criteria set out in subparagraphs (b) through (e);

    - the pre-shipment inspection entity shall base its price comparison for the verification of the export price on the price(s) of identical or similar goods offered for export from the same country of exportation at or about the same time, under competitive and comparable conditions of sale, in conformity with customary commercial practices and net of any applicable standard discounts. Such comparison shall be based on the following:

        (i) only prices providing a valid basis of comparison shall be used, taking into account the relevant economic factors pertaining to the country of importation and a country or countries used for price comparison;

        (ii) the pre-shipment inspection entity shall not rely upon the price of goods offered for export to different countries of importation to arbitrarily impose the lowest price upon the shipment;

        (iii) the pre-shipment inspection entity shall take into account the specific elements listed in subparagraph (c);

        (iv) at any stage in the process described above, the pre-shipment inspection entity shall provide the exporter with an opportunity to explain the price;

    - when conducting price verification, pre-shipment inspection entities shall make appropriate allowances for the terms of the sales contract and generally applicable adjusting factors pertaining to the transaction; these factors shall include but not be limited to the commercial level and quantity of the sale, delivery periods and conditions, price escalation clauses, quality specifications, special design features, special shipping or packing specifications, order size, spot sales, seasonal influences, licence or other intellectual property fees, and services rendered as part of the contract if these are not customarily invoiced separately; they shall also include certain elements relating to the exporter's price, such as the contractual relationship between the exporter and importer;

    - the verification of transportation charges shall relate only to the agreed price of the mode of transport in the country of exportation as indicated in the sales contract;

    - the following shall not be used for price verification purposes:

        (i) the selling price in the country of importation of goods produced in such country;

        (ii) the price of goods for export from a country other than the country of exportation;

(iii) the cost of production;

(iv) arbitrary or fictitious prices or values.

Appeals Procedures

21. User Members shall ensure that pre-shipment inspection entities establish procedures to receive, consider and render decisions concerning grievances raised by exporters, and that information concerning such procedures is made available to exporters in accordance with the provisions of paragraphs 6 and 7. User Members shall ensure that the procedures are developed and maintained in accordance with the following guidelines:

    - pre-shipment inspection entities shall designate one or more officials who shall be available during normal business hours in each city or port in which they maintain a pre-shipment inspection administrative office to receive, consider and render decisions on exporters' appeals or grievances;
    - exporters shall provide in writing to the designated official(s) the facts concerning the specific transaction in question, the nature of the grievance and a suggested solution;
    - the designated official(s) shall afford sympathetic consideration to exporters' grievances and shall render a decision as soon as possible after receipt of the documentation referred to in subparagraph (b).

Derogation

22. By derogation to the provisions of Article 2, user Members shall provide that, with the exception of part shipments, shipments whose value is less than a minimum value applicable to such shipments as defined by the user Member shall not be inspected, except in exceptional circumstances. This minimum value shall form part of the information furnished to exporters under the provisions of paragraph 6.

Article 3 - Obligations of Exporter Members - Non-discrimination

1. Exporter Members shall ensure that their laws and regulations relating to pre-shipment inspection activities are applied in a non-discriminatory manner.

Transparency

2. Exporter Members shall publish promptly all applicable laws and regulations relating to pre-shipment inspection activities in such a manner as to enable other governments and traders to become acquainted with them.

Technical Assistance

3. Exporter Members shall offer to provide to user Members, if requested, technical assistance directed towards the achievement of the objectives of this Agreement on mutually agreed terms.

Article 4 - Independent Review Procedures

Members shall encourage pre-shipment inspection entities and exporters mutually to resolve their disputes. However, two working days after submission of the grievance in accordance with the provisions of paragraph 21 of Article 2, either party may refer the dispute to independent review. Members shall take such reasonable measures as may be available to them to ensure that the following procedures are established and maintained to this end:

(a) these procedures shall be administered by an independent entity constituted jointly by an organization representing pre-shipment inspection entities and an organization representing exporters for the purposes of this Agreement;

(b) the independent entity referred to in subparagraph (a) shall establish a list of experts as follows:

(i) a section of members nominated by an organization representing pre-shipment inspection entities;

(ii) a section of members nominated by an organization representing exporters;

(iii) a section of independent trade experts, nominated by the independent entity referred to in subparagraph (a).

The geographical distribution of the experts on this list shall be such as to enable any disputes raised under these procedures to be dealt with expeditiously. This list shall be drawn up within two months of the entry into force of the WTO Agreement and shall be updated annually. The list shall be publicly available. It shall be notified to the Secretariat and circulated to all Members;

(c) an exporter or pre-shipment inspection entity wishing to raise a dispute shall contact the independent entity referred to in subparagraph (a) and request the formation of a panel. The independent entity shall be responsible for establishing a panel. This panel shall consist of three members. The members of the panel shall be chosen so as to avoid unnecessary costs and delays. The first member shall be chosen from section (i) of the above list by the pre-shipment inspection entity concerned, provided that this member is not affiliated to that entity. The second member shall be chosen from section (ii) of the above list by the exporter concerned, provided that this member is not affiliated to that exporter. The third member shall be chosen from section (iii) of the above list by the independent entity referred to in subparagraph (a). No objections shall be made to any independent trade expert drawn from section (iii) of the above list;

(d) the independent trade expert drawn from section (iii) of the above list shall serve as the chairman of the panel. The independent trade expert shall take the necessary decisions to ensure an expeditious settlement of the dispute by the panel, for instance, whether the facts of the case require the panelists to meet and, if so, where such a meeting shall take place, taking into account the site of the inspection in question;

(e) if the parties to the dispute so agree, one independent trade expert could be selected from section (iii) of the above list by the independent entity referred to in subparagraph (a) to review the dispute in question. This expert shall take the necessary decisions to ensure an expeditious settlement of the dispute, for instance taking into account the site of the inspection in question;

(f) the object of the review shall be to establish whether, in the course of the inspection in dispute, the parties to the dispute have complied with the provisions of this Agreement. The procedures shall be expeditious and provide the opportunity for both parties to present their views in person or in writing;

(g) decisions by a three-member panel shall be taken by majority vote. The decision on the dispute shall be rendered within eight working days of the request for independent review and be communicated to the parties to the dispute. This time-limit could be extended upon agreement by the parties to the dispute. The panel or independent trade expert shall apportion the costs, based on the merits of the case;

(h) the decision of the panel shall be binding upon the pre-shipment inspection entity and the exporter which are parties to the dispute.

Article 5 - Notification

Members shall submit to the Secretariat copies of the laws and regulations by which they put this Agreement into force, as well as copies of any other laws and regulations relating to pre-shipment inspection, when the WTO Agreement enters into force with

respect to the Member concerned. No changes in the laws and regulations relating to pre-shipment inspection shall be enforced before such changes have been officially published. They shall be notified to the Secretariat immediately after their publication. The Secretariat shall inform the Members of the availability of this information.

Article 6 – Review

At the end of the second year from the date of entry into force of the WTO Agreement and every three years thereafter, the Ministerial Conference shall review the provisions, implementation and operation of this Agreement, taking into account the objectives thereof and experience gained in its operation. As a result of such review, the Ministerial Conference may amend the provisions of the Agreement.

Article 7 – Consultation

Members shall consult with other Members upon request with respect to any matter affecting the operation of this Agreement. In such cases, the provisions of Article XXII of GATT 1994, as elaborated and applied by the Dispute Settlement Understanding, are applicable to this Agreement.

Article 8 - Dispute Settlement

Any disputes among Members regarding the operation of this Agreement shall be subject to the provisions of Article XXIII of GATT 1994, as elaborated and applied by the Dispute Settlement Understanding.

Article 9 - Final Provisions

1. Members shall take the necessary measures for the implementation of the present Agreement.
2. Members shall ensure that their laws and regulations shall not be contrary to the provisions of this Agreement.
   - It is understood that this provision does not obligate Members to allow government entities of other Members to conduct pre-shipment inspection activities on their territory.
   - An international standard is a standard adopted by a governmental or non-governmental body whose membership is open to all Members, one of whose recognized activities is in the field of standardization.
   - It is understood that, for the purposes of this Agreement, "force majeure" shall mean "irresistible compulsion or coercion, unforeseeable course of events excusing from fulfilment of contract".
   - The obligations of user Members with respect to the services of pre-shipment inspection entities in connection with customs valuation shall be the obligations which they have accepted in GATT 1994 and the other Multilateral Trade Agreements included in Annex 1A of the WTO Agreement.
   - It is understood that such technical assistance may be given on a bilateral, plurilateral or multilateral basis.

1.5 CRITICISM OF WTO

Protestors clashing with Hong Kong police in Wan Chai (area of Waterfront) during the WTO Ministerial Conference of 2005.

Although the stated aim of the WTO is to promote free trade and stimulate economic growth, some believe that globally free trade results in the rich (both people and

countries) becoming richer, while the poor are getting poorer. Martin Khor, Director of the Third World Network, argues that the WTO does not manage the global economy impartially, but in its operation has a systematic bias toward rich countries and multinational corporations, harming smaller countries which have less negotiation power. He argues that developing countries have not benefited from the WTO Agreements of the Uruguay Round, because (among other reasons): market access in industry has not improved; these countries have had no gains yet from the phasing out of textiles quotas; non-tariff barriers such as anti-dumping measures have increased; domestic support and export subsidies for agricultural products in the rich countries remain high. Jagdish Bhagwati asserts however that there is greater tariff protection on manufacturers in the poor countries, which are also overtaking the rich nations in the number of anti-dumping filings.

Other critics claim that the issues of labor and environment are steadfastly ignored. Steve Charnovitz, former Director of the Global Environment and Trade Study (GETS), believes that the WTO "should begin to address the link between trade and labor and environmental concerns." Further, labor unions condemn the labor rights record of developing countries, arguing that to the extent the WTO succeeds at promoting globalization, then in equal measure do the environment and labor rights suffer. On the other side, Khor responds that "if environment and labor were to enter the WTO system [...] it would be conceptually difficult to argue why other social and cultural issues should also not enter." Bhagwati is also critical towards "rich-country lobbies seeking on imposing their unrelated agendas on trade agreements." Therefore, both Bhagwati and Arvind Panagariya have criticized the introduction of TRIPs into the WTO framework, fearing that such non-trade agendas might overwhelm the organization's function.

Other critics have characterized the decision making in the WTO as complicated, ineffective, unrepresentative and non-inclusive, and they have proposed the establishment of a small, informal steering committee (a "consultative board") that can be delegated responsibility for developing consensus on trade issues among the member countries. The Third World Network has called the WTO "the most non-transparent of international organisations", because "the vast majority of developing countries have very little real say in the WTO system"; the Network stresses that "civil society groups and institutions must be given genuine opportunities to express their views and to influence the outcome of policies and decisions." Certain non-governmental organizations, such as the World Federalist Movement, argue that democratic participation in the WTO could be enhanced through the creation of a parliamentary assembly, although other analysts have characterized this proposal as ineffective.

1.6 LET US SUM UP

The GATT was a product of the post-war free trade movement. The GATT was successful in lowering trade barriers on manufactured goods and commodities. The move towards greater free trade under the GATT appeared to stimulate economic growth.

The completion of the Uruguay Round of GATT talks and establishment of the World Trade Organization have strengthened the world trading system by extending GATT rules to services, increasing protection for intellectual property, reducing agricultural subsidies, and enhancing monitoring and enforcement mechanisms.

1.7 LESSON END ACTIVITY

Refer to latest annual issue of Government of India, Economic Survey and write a report on how Indian government has taken steps to comply with different agreement signed with WTO.

1.8 KEYWORDS

General Agreement on Tariffs and Trade (GATT): International treaty that committed signatories to lowering barriers to the free flow of goods across national borders and led to the WTO.

World Trade Organization (WTO): The organization that succeeded the General Agreement on tariffs and trade (GATT) as a result of the successful completion of the Uruguay round of GATT negotiations.

1.9 QUESTIONS FOR DISCUSSION

1. Describe the organisation structure of WTO. Explain WTO's role in liberalization of global trade in goods and services.
2. What do the terms "Observer Governments" and "WTO Accession" means?
3. Describe the limitation of GATT. How Dunkel's proposals led to the formation of WTO?
4. What was the outcome of the first two ministerial meetings of the WTO and the reasons responsible for the failure of the third meeting?
5. Analyse the role of India in WTO.
6. Discuss how the MFN clause resulted in dumping and the anti-dumping measures imposed by member countries?
7. Can you describe-WTO: what it is and what it does?

Check Your Progress: Model Answer

1. Standard of living
2. full employment
3. resources
4. production and international trade;

1.10 SUGGESTED READINGS

Cherenilan Francis, *International Economics*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Charles W.L. Hill *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Justin Paul, *International Business*, (3rd ed.), Prentice Hall of India.

LESSON

2

GLOBALIZATION

CONTENTS

2.0 Aims and Objectives
2.1 Introduction
2.2 Meaning and Definition
2.3 Features of Globalization
2.4 Globalization Process
2.5 Globalization of Markets
2.6 Globalization of Production
2.7 Globalization of Investment
2.8 Is Globalization Desirable?
2.9 Let us Sum up
2.10 Lesson End Activity
2.11 Keywords
2.12 Questions for Discussion
2.13 Suggested Readings

2.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- Globalization-its meaning, features, processes, advantages, disadvantages

2.1 INTRODUCTION

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

2.2 MEANING AND DEFINITION

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

Charles U.L. Hill define globalization as "The shift towards a more integrated and interdependent World Economy. Globalization has two main components-the globalization of markets and globalization of production."

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

2.3 FEATURES OF GLOBALIZATION

1. Opening and planning to expand business throughout the world.
2. Erasing the differences between domestic market and foreign market.
3. Buying and Selling goods and services from/to any country in the world.
4. Establishing manufacturing and distribution facilities in any part of the world based on the feasibility and ability rather than national consideration.
5. Product planning and development are based on market consideration of the entire world.
6. Sourcing of factors of production and inputs like raw materials, machinery, finance, technology, human resources, management skills from the entire global.
7. Global orientation in strategies, organization structure, organization culture and managerial expertise
8. Setting the mind and attitude to view the entire global as a single market

Global companies plan or venture not only on national markets, but also venture globally and view themselves as a global company. Executives and employees are trained and tuned in worldwide operations. For example: Employees in a global company based in India speak of London, New York, Mumbai, Tokyo, Singapore and the like as Indian businessmen speak of Delhi, Hyderabad, Ahmedabad, Mumbai, Chennai, Kolkata and the like. They make investments based on the feasibility of world wide projects and procure raw materials, human resources and other inputs from all parts of the world, where they are available at low cost and high quality.

Kenichi Ohamae observes that global companies develop a genuine equidistance of perspective. These companies view all the stakeholders from all the countries equally for their operations The example include Coca-Cola, Honda, P&G, Toyota, Xerox, Mazda, Dr. Reddy's Lab, Reliance etc. For example Mazda's sport car Mx-5 Marta was designed in California, its prototype product is created in England, assembled in Michigan and Mexico using advanced electronic components which are invented in New Jersey, fabricated in Japan by sourcing the finance from Tokyo and New York and marketed world-wide.

2.4 GLOBALIZATION PROCESS

It takes place gradually through an evolutionary approach. According to Ohamae, globalization has five stages:

1. Domestic company exports to foreign countries, through the dealers or distributors of the home country.
2. In the second stage, the domestic company exports to foreign countries directly on its own.
3. In the third stage the domestic company becomes an international company by establishing production and marketing operations in various key foreign countries.
4. In the fourth stage, the company replicates a foreign company in a foreign country by handling all the facilities including R& D, full fledged human resources etc.

5. In the fifth stage the company becomes a true foreign company by serving the needs of foreign customers just like the host country's company serves.

Thus globalization means globalizing the marketing, production, investment, technology and other activities.

2.5 GLOBALIZATION OF MARKETS

Globalization of markets refers to the process of integrating and merging of distant world markets into a single market. This process involves the identification of some common norm, value, taste, preference and convenience and slowly enables the cultural shift towards the use of a common product or service.

A number of consumer products have global acceptance. For example Coca-Cola, Pepsi, McDonald's burgers, Music of Madona, MTV, Sony Walkman, Levis jeans, Indian masala dosa, Indian Hyderabadi biryani, CitiCorp credit cards etc.

Features include:

1. The size of the company need not be too large to create a global market. Even small companies can create a global market. For example Harry Ramsden – a small British company with an annual sale of US $ 16 Million is trying to sell its products fish 'n' chips in Japan based on the Japanese culture.
2. The distinction of national markets is still prevailing, even after globalization of markets. These distinctions require the companies to formulate different strategies for each market. For example Coca Cola, Levis jeans and McDonalds employs separate strategies for each country.
3. Most of the foreign markets are the markets for non-consumer goods like industrial products, machinery, equipment, raw materials, computer, software, financial products etc.
4. The global business competes with each other frequently in different markets including their home markets. For example Coca Cola is the global rival of Pepsi. Similarly Ford and Toyota, Boeing and Air Bus, Caterpillar and Komatsu. Though these companies compete with each other they create global markets.

Reasons for Globalization of Markets

1. Large size industrialization enables mass production. The companies found that the size of the domestic market is very small to suffice the production output and hence opted for foreign markets.
2. To reduce the risk diversity the portfolio of countries
3. Companies globalize markets in order to increase their profits and achieve company goals
4. The adverse business environment in the home country pushed the companies to globalize their markets
5. To cater to the demand for their products in the foreign markets
6. The failure of the domestic companies in catering the needs of their customers pulled the foreign countries to market their products.

2.6 GLOBALIZATION OF PRODUCTION

The globalization of production refers to the sourcing of goods and services from locations across the globe to take advantage of national differences in the cost and quality of factors of production (such as labour, energy, time and capital). By doing this, companies hope to lower their overall cost structure and/or improve the quality or

functionality of their product offering thereby allowing them to compete more effectively.

Reasons for Globalization of Production

1. Imposition of restriction on imports by the foreign countries forces the MNCs to establish the manufacturing facilities in other countries. For example, Toyota of Japan established its plant in USA and UK due to import restrictions.
2. Availability of high quality raw materials and components in other countries.
3. Availability of inputs at low cost in foreign countries.
4. Availability of skilled labour resources at low cost.
5. Liberal labour laws in the foreign countries.
6. To reduce the cost of transportation and easy logistics management.
7. Facility of exporting to other neighbouring foreign countries.
8. To design and produce the products as per the varying tastes of customers in foreign countries.

The process of liberalization of production helps the companies to design the following strategies:

- Low cost leadership,
- Superior quality, and
- Superior speed

For example: Jet airlines-Boeing 777 has 132,500 major components. These components are produced in 545 different locations of the Globe. A small optical company in USA, Swan Optical, manufacturers its eyewear in low cost factories in Hong Kong, China, Japan and Italy.

2.7 GLOBALIZATION OF INVESTMENT

Globalization of investment refers to investment of capital by a Global company in any part of the world. Global company conducts the financial feasibility of new projects in different countries of the world and invests the capital in that country, where it is relatively more profitable. Globalization of investment is also known as Foreign Direct Investment (FDI).

FDI occurs when a firm invests directly in new facilities to produce and/or market a product or service in a foreign country. Coca-Cola acquired a number of bottling companies throughout India by investment directly.

Many countries before 1930 created barriers relating to exports, imports and foreign investment. The creation of General Agreement in Tariffs and Trade (GATT) reduced the trade restrictions significantly. Again the establishment of World Trade Organization (WTO) has contributed to the elimination of investment barriers phenomenally.

Many countries reduced barriers in investment. As many as 34 countries made 85 changes to the laws reducing investment barriers in 1991.

Government of India reduced investment barriers allowing more than 51 per cent of foreign investment in Indian companies.

Check Your Progress

State which is appropriate:

The process of liberalization of production helps the companies to design the following strategies:

(a) Low cost leadership.

(b) Superior quality and

(c) Superior speed

(d) (a) and (b)

(e) (a),(b) and (c)

Reasons for Globalization of Investment

- There has been a rapid increase in the volume of global trade. Many countries provide more favourable environment for direct investment e.g. Govt. of India provided for automatic approval for FDI up to 51% of capital of a company. It was extended up to 100 % for different industry.
- Significant amount of FDI id directed to the developing countries in Asia and Eastern Europe.
- In addition to increase in volume of FDI, its composition has also been changing. Initially it was directed towards USA, later it was directed towards countries like UK, Japan, France, China etc.
- Small and medium sized companies have started investing in various countries.
- Limitation of exporting and licensing force the domestic companies to enter foreign markets through FDI e.g. Toyota, a Japanese automobile company.
- Liberalizing the measure of flow of capital across the borders by various countries. For example, Indian Govt. allowed Foreign Institutional Investors (FIIs) to invest in Indian Capital Markets after registration with SEBI.
- Global companies in order to have control over manufacturing and marketing activities, invest in the foreign countries.
- Procure funds from any source in the Globe, wherever the cost of capital is low with feasible terms and conditions.

2.8 IS GLOBALIZATION DESIRABLE?

Advantages of Globalization

- ***Free flow of capital:*** Globalization helps free flow of capital for one country to the other. It helps the investor to get fair arte of interest or dividend. And the global companies to acquire finance at lower cost of capital. Further globalization increases capital flows from surplus countries to the needy countries thus increase in the global investment.
- ***Free flow of technology:*** Globalization helps free flow of technology from advanced countries to the developing countries. It helps the developing countries to implement new technology.

Free flow of capital along with the technology enable the developing countries to boost up industrialization in their countries. This ultimately increases global industrialization.

- ***Spread-out the manufacturing facilities:*** Globalization of production leads to spread up of manufacturing facilities in all the global countries depending upon the location and various favourable production factors.
- ***Balanced development of World economies:*** With the flow of capital, technology and locating manufacturing facilities in developing countries, the developing countries industrialize their economies. This in turn leads to the balanced development of all the countries.
- ***Increase in production and consumption:*** Increased industrialization in the globe leads to increase in production, thus results in balanced industrial development along with increase in income which in turn enhance the levels of consumption.
- ***Low prices with high quality:*** Increased industrialization, spread up of technology, increased production and consumption level enable the companies to produce and sell the products of high quality at low prices.
- ***Cultural exchange and demand for variety of products:*** Globalization reduces the physical distance among the countries and enable the people of different countries to acquire the culture of other countries. The cultural exchange, in turn, make the people to demand for a variety of products which are being consumed in other countries. For example demand for American pizza in India, and demand for "Masala Dosa" and "Hyderabadi Biryani" and Indian styled garment in USA and Europe.
- ***Increase in employment and income:*** Globalisation results in shift of manufacturing facilities to the low wage developing countries. As such it reduces job opportunities in advanced countries and alternatively create lab opportunities in developing countries. e.g. Harwood industries (US Cloth Manufacturer) shifted its operations from US (paying wages $9 per hour) to Honduras (wage rate 48 cents per hour). However advanced countries can specialize in producing high technology products resulting in enhancement of employment opportunities e.g. Microsoft cell phones in USA.
- ***Higher standard of living:*** Globalisation reduces prices and there by enhances consumption and living standards of living in all the countries of the world.
- ***Balanced human development:*** Increase in industrialization on balanced lines in the globe, improves the skills of people of developing countries. Further the increased economic development of the country enable the Govt. to provide welfare facilities like hospitals, educational institutes etc. which in turn contributes for balanced human development.
- ***Increase in welfare and prosperity:*** The balanced industrial, social and economic development of the world nations consequent upon the globalization along with the welfare measures provided by the government lead to increase in the welfare of the people and prosperity of the world countries.

Disadvantages of Globalization

- ***Globalization kills domestic business:*** The MNCs from advanced countries utilize the opportunities created by globalization, establish manufacturing and marketing facilities in developing countries. The domestic business of the developing countries fail to compete with the MNCs on the quality and technology front. This leads to closing down of domestic companies, which is already evident in India. There is also dumping from China, USA, Malaysia, Taiwan, South Korea etc. This has killed some of the small industries and created problems to large scale industries.
- ***Exploits human resources:*** The process of globalization helps companies to move to the developing countries which lack adequate laws and regulations to

protect human resources and the environment. The unscrupulous foreign industries abuse the labour and natural resources in order to have the cost advantage. These companies employ child labour, pollute environment, ignore work place safety and health issues. In fact the cost of production in developing world increases at par with advanced countries, if the foreign industries follow the regulations regarding human resources and environment.

- ***Leads to unemployment and under employment:*** MNCs produce the products in their home countries or in some other countries and market in developing countries resulting in reduction in domestic industry's operations. Thus in turn leads to reduction to employment opportunities particularly in less developed countries. In fact Indian economy has already started experiencing the problem of unemployment and under employment consequent upon globalization.
- ***Decline in demand for domestic products:*** Selling of high quality foreign products at low prices of MNCs' reduces the demand for the domestic products. Indian businessmen and farmers have already experienced this problem.
- ***Decline in income:*** Unemployment and decline in demand for domestic products of both industrial and agricultural goods (including services) leads to reduction in income of the people.
- ***Widening gap between rich and poor:*** Globalization not only results in decline in income but widens the gap between rich and poor. This is because, competent people, people with innovative skills, efficiency etc. get abnormal income while other average people have to strive for even a minimum wage. This results in widening of gap between rich and poor e.g. Indian software professionals earn a salary of more than Rs. 200,000 a month in USA whereas some of the graduates fail to earn even Rs. 2000 a month in India.
- ***Transfer of natural resources:*** MNCs establish their manufacturing facilities in developing countries, exploit their natural resources and sell the products in other countries. Through this, the natural resources of developing countries are transferred to other countries.
- ***Leads to commercial and political colonolism:*** The criticizers of globalization fear that the globalization ultimately results in commercial colonolism by the super powers like USA and EU. They also argue that the commercial colonolism ultimately results in political colonolism like what happened in India and many developing countries with England, France etc.
- ***National sovereignty at stake:*** The criticisers of globalization results in shift of economic power from the independent countries to the super natural organizations like World Trade Organization, European Union, United Nations etc. The sovereignty of the domestically elected Govt. is undermined as the policies are formulated and implemented mostly by the bureaucrats.

Globalisation - Balancing Act

Though the criticizers of globalization fear of the negative consequences of globalization, the supporters argue that, it is only a short-run phenomenon. In the long run, the process of globalization results in the overall development of all the world nations. At this point, it is viewed that the globalization in inevitable for the development of World nations.

The view of Peter F. Drucker and Mitchell also indicate the same "Globalisation for better or worse, has changed the way the world does business. Though still it's early, it is all but unstoppable. The challenges that individuals and business face is learning how to live with it, manage it and take the advantage of the benefit it offers".

Therefore "All institutions have to make global competitiveness a strategic goal. No institution, whether a business, a university or a hospital can hope to survive, let also succeed, unless it matches up to the standards set by the leaders in the field at any place in the world".

2.9 LET US SUM UP

With the world economy becoming global we have reviewed the main drivers of globalization which are thrusting nation states towards a more tightly integrated global economy. The lesson also reviewed the problems and prospects of globalization of Indian business.

2.10 LESSON END ACTIVITY

Review a company's activity by visiting them personally or scanning the net for answering the following critical question

How have changes in technology contributed to the globalization of markets and production? Would the globalization of production and markets have been possible without these technological changes?

2.11 KEYWORDS

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

Globalization: Trend away from distinct national economic units and toward one huge global market.

Globalisation of markets: Moving away from an economic system in which national markets are distinct entities isolated by trade barriers and barriers of distance, time, and culture, and towards a system in which national markets are merging into one global market.

Globalization of production: Trend by individual firms to disperse parts of their productive process to different locations around the globe to take advantage of differences in cost and quality of factors of production.

2.12 QUESTIONS FOR DISCUSSION

1. How have changes in technology contributed to the globalization of markets and production? Would the globalization of production and markets have been possible without these technology changes?
2. "Ultimately the study of international business is no different from the study of domestic business. Thus there is no point in having a separate course on international business". Evaluate this statement.
3. Explain the meaning, dimensions and stages of globalization.
4. Discuss the problems and prospects of globalization.
5. Examine the pros and cons of globalization with special reference to India.
6. What are the important globalization strategies employed by Indian companies?
7. What are the potential costs of adopting a free trade regime? Do you think governments should do anything to reduce these costs?
8. The benefits of Globalisation is (are):

   (a) Efficient allocation of capital

(b) Better working financial system

(c) Smoother consumption pattern enjoyed by all countries

(d) All of the above

(e) Both (a) and (b) above

Check Your Progress: Model Answer

(e)

2.13 SUGGESTED READINGS

Cherenilan Francis, *International Business: Text and Cases*, 3rd Edition, Prentice-Hall of India Private Limited.

Charles W.L. Hill, *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Justin Paul, *International Business*, (3rd ed), Prentice Hall of India.

LESSON

3

INTERNATIONAL TRADE

CONTENTS

3.0 Aims and Objectives
3.1 Introduction
3.2 Why Companies Engage in International Business?
3.3 Reasons for Phenomenon International Growth in Recent Years
3.4 Modes of International Business
3.5 External Influence on International Business
3.6 Let us Sum up
3.7 Lesson End Activity
3.8 Keyword
3.9 Questions for Discussion
3.10 Suggested Readings

3.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- Reasons for internationalization
- Various ways of entering into international market
- Companies social, physical and competitive environment

3.1 INTRODUCTION

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

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

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

3.2 WHY COMPANIES ENGAGE IN INTERNATIONAL BUSINESS?

To Expand Sales: Companies Sales are dependant on (a) the consumers' interest in their products or service and (b) the consumers' willingness and ability to buy them. The No. of people and the amount of their purchasing powers are higher for the world as a whole than for a single country, hence companies increase the potential market for their sales by pursuing international markets. Hence higher sales means higher profits because of economies of scale. So increased sales are a major motive for a company's expansion into international business.

To Acquire Resources: Manufacturers and distributors also look for foreign capital, Technologies and information that they can use at home, to reduce their costs. Sometimes a company operate abroad to acquire something not readily available in the home country so as to improve its product quality and differentiate itself from competitors-potentially increasing market share and profits.

To Minimize Risk: Companies seek out foreign markets to minimize swings in sales and profits arising out of business cycle-recessions and expansions-which occur differently in different countries. For example sales decrease or grow more slowly in a country that is in recession and increase or grow more rapidly in one that is expanding rapidly in one that is expanding economically. Many companies enter into international business for defensive reasons e.g. to counter, advantages competitors, might gain in foreign markets that in turn, can hurt them in the domestic market.

3.3 REASONS FOR PHENOMENON INTERNATIONAL GROWTH IN RECENT YEARS

Following five sometimes unrelated factors:

1. ***Rapid Increase in and Expansion of Technology:*** Tremendous progress in communications and transportation technology enable people in one part of the world to know about and demand products and services developed in another part of the world. Further the cost of improved communications and transportation has arisen more slowly than costs in general.

   By increasing the demand for new products and services, technology has had and continues to have a tremendous impact on international business. As demand increases so do the numbers of international business transactions. On the other hand, conducting business on an international business level usually involves greater distances than does conducting domestic business, and greater distances increase operating costs and make control of a company's foreign operations more difficult. On the other hand, improved communications and transportation speed up interactions and improve a manager's ability to control foreign operations.

2. ***Liberalization of Cross-border Movements of Trade and Resources:*** Every country restricts the movements across its borders of goods and services and the resources, such as workers and capital to produce both making international business more expensive. Governments today impose fewer restrictions on cross-border movements because of the following:

   (a) Their citizen wants easier access to a greater variety of goods and services at lower prices.

   (b) The domestic producers will become more efficient as a result of foreign competition.

   (c) They desire that other countries also should reduce barriers to international movements.

3. ***Developing of supporting services:*** Companies and Governments have developed services that facilitate and ease international business. For example, banks have developed facilities that allow companies to receive payment for their foreign sale.

   Although companies do barter internationally it can be cumbersome, time consuming, risky and expensive. Today most producers can be paid relatively easily for goods and services sold abroad because of, for example, bank credit agreements, clearing arrangements that correct one country's currency into another's' and insurance that covers damage reroute and non-payment by the buyer.

4. ***Consumer pressures:*** Because of innovations in transportation and communications consumers are aware of the products and services available in other countries. The consumers want more, new, better and differentiated products. This has promoted companies to respond by spending in research and development and by searching world wide via the internet, trade journals, trade fairs and trips to foreign countries for new and differentiated products that can be sold to ever more demanding customers.

5. ***Increase in Global Competition:*** More companies operate internationally because:

   - New products quickly become known globally
   - Companies can produce in different countries.
   - Domestic companies' competitors, suppliers and customers have become international.

Check Your Progress

Reasons for rapid growth of International Business in recent years:

(a) Liberalization in cross border movements

(b) Technological development

(c) Global competition

(d) All of the above

(e) Both (a) and (b) above

3.4 MODES OF INTERNATIONAL BUSINESS

1. ***Merchandise Exports and Imports:*** These are a country's most common international economic transaction. Merchandise exports are tangible products-goods-sent out of a country, merchandise imports are goods brought into a country. Because these goods can be seen leaving and entering a country, they are sometimes called visible exports and imports.

2. ***Service Exports and Imports:*** Service exports and imports generate non product international earnings/expenditure. The company or individual receiving payment is making a service export. The Company or individual receiving payment is making a service import. Service exports and imports may take the following forms:

   - *Tourism and transportation:* International tourism and transportation are important sources of revenue for airlines, shipping companies, travel agencies and hotels. Some countries' economies depend heavily on revenue from these economic sectors. For example, in Greece and Norway a significant part of employment, profits and foreign exchange earnings come from foreign cargo that is carried on ships owned by citizen of those countries.

- *Performance of services:* Some services-banking, insurance, rentals, engineering, management services and so on-net companies earnings in the form of fees (i.e. payments for the performance of those services). On an international level, for example, companies pay fees for engineering services that are often handled through turnkey operations-construction, performed under contract, of facilities that are transferred to the owner when they are ready to begin operations. Companies also pay fees for management contracts-arrangements by which one company provides personnel to perform general or specialized management functions to another company. Disney receives management fees from managing theme parks in France and Japan.

- *Use of assets:* When companies allow others to use their assets such as trademarks, copy rights or expertise under contracts, also known as licensing agreements, they receive earnings called royalties. Royalties also come from franchise contracts. Franchise is a mode of business in which one party (the franchisor) allows another party (the franchisee) to use a trademark that is an essential asset for the franchisees business. The franchisor also assists on a continuing business in the operation of the business-for example by providing components, management services and technology.

Dividends and interest paid on foreign investments are also treated as service exports and imports because they represent the use of assets (capital).

3. ***Investments:*** Foreign investment means ownership of foreign property in exchange for a financial return, such as interests and dividend foreign investment takes two forms:

(a) *Direct investment:* A direct investment is one that gives the investor a controlling interest in a foreign company such as direct investment is also known as Foreign Direct Investment. Control need not be a 100 per cent or even a 50% interest when two or more companies share ownership of a FDI the operation is a joint venture. When a Government joins a company in an FDI, the operation is called a mixed venture.

(b) *Portfolio investment:* A portfolio investment is a non-controlling interest in a company or grant of loan to another party. A portfolio investment takes one of two firms: share investment in a company or loans to a company or country in the form of bonds, bills or notes that the investor purchases.

Companies use portfolio investment for short term financial gain which allows a company to earn money on its money with relative safety. Company treasurers routinely move funds among countries to earn higher yield on short term investments.

3.5 EXTERNAL INFLUENCE ON INTERNATIONAL BUSINESS

The company forms its strategies and the means to implement them after examining the external environment. The external environment includes physical factors such as country's geographical and societal factors such as country's politics, law, culture and economy. It also includes competitive factors such as the number and strength of suppliers, customers and rival firms. The company faces different external environment in each country where it operates.

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

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

Domestic law includes regulations in both the home and host countries on such matters as taxation, employment and foreign exchange transactions. For example Japanese law determines how Lucas film revenues from Japanese screenings are taxed and how they can be exchanged from Yen to US dollars. US Law in turn determines how and when the losses or earnings from Japan are treated for tax purposes in US. International law in the form of legal agreements between two countries governs how the earnings are taxed by both International law may also determine how and whether companies can operate in certain locales.

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

Economics explains among others, why countries exchange goods and services with each other, why capital and people travel among countries in the course of business and why are country's currency have a certain value compared to another's. By studying economics, managers can better understand why, where and when one country can produce goods or services less expensively than another can. In addition, managers can obtain the analytical tools needed to determine the impact of an international company on the economies of the host and home countries and the effect of a country's policies and conditions on the company.

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

(b) ***Competitive Environment:*** The competitive environment varies by industry, company and country and accordingly lay down international strategies. For example, companies in industries with homogenous products such as copper tubing, compete more on price, than companies in industries that compete more on differentiated and innovative products such as branded toothpaste or state-of-the-act computer chips. Strategies for the former are focused on cost savings such as developing better equipment and operating methods, producing on a large scale to spread costs over more units and location to have cheap labour and materials.

Companies within the same industry also differ in their competitive strategies. Hondas greater concern about reducing automobile costs than BMW helps explain why the former has recently moved much of its automobile production to China to take advantage of lower labour costs while the latter has not. Still another competitive factor is the size of the company and the resources it has compared to its competitors.

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

3.6 LET US SUM UP

Study of international business has become important because (i) it comprises a large and growing portion of the world's total business. (ii) All companies are affected by

global events and competition whether large or small since most sell output to and secures raw materials and supplies from foreign countries. The No. of people and the amount of their purchasing powers are higher for the world as a whole than for a single country, hence companies increase the potential market for their sales by pursuing international markets. Companies seek out foreign markets to minimize swings in sales and profits arising out of business cycle-recessions and expansions-which occur differently in different countries. The company forms its strategies and the means to implement them after examining the external environment. The external environment includes physical factors such as country's geographical and societal factors such as country's politics, law, culture and economy.

3.7 LESSON END ACTIVITY

"The study of international business is fine if you are going to work in a multinational enterprise, but it has no relevance for individuals who are going to work in small firms". Evaluate this statement.

3.8 KEYWORD

International business: Any firm that engages in international trade or investment.

3.9 QUESTIONS FOR DISCUSSION

1. Why companies engage in international business?
2. What are the reasons for phenomenon international growth in recent years?
3. What are different modes of international business?
4. Write notes on external influence on international business.

Check Your Progress: Model Answer

(d)

3.10 SUGGESTED READINGS

Cherenilan Francis, *International Business: Text and Cases*, 3rd Edition, Prentice-Hall of India Private Limited.

Charles W.L. Hill, *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Justin Paul, *International Business*, (3rd ed.) Prentice Hall of India.

LESSON

4

WTO AND INTELLECTUAL PROPERTY RIGHTS

CONTENTS

4.0 Aims and Objectives
4.1 Introduction
4.2 Trade-related Aspects of Intellectual Property Rights (TRIPS) Agreement
4.3 The Indian Designs Act
4.4 WTO and Dispute Settlements
4.5 Let us Sum up
4.6 Lesson End Activity
4.7 Keywords
4.8 Questions for Discussion
4.9 Suggested Readings

4.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- TRIPs regime of the WTO
- Patent law in India

4.1 INTRODUCTION

The Trade-related Aspects of Intellectual Property rights, or the TRIPS Agreement, is as important as that of trade in goods (GATT) and trade in services (GATS).

4.2 TRADE-RELATED ASPECTS OF INTELLECTUAL PROPERTY RIGHTS (TRIPS) AGREEMENT

The main objective is providing protection to the holder of the intellectual property right, which can be claimed by an individual, company or even people of a geographical region.

This right over an intellectual property can be called a 'monopoly right' conferred on the inventor (patent on an industrial product), creator (copyright over a literary work) or user (trademark of a business establishment) or regions (Geographical Indicators of Origin). This right, recognised as "legal property", however, can be claimed for fixed pre-determined periods of time except Trademarks and Geographical indications of Origin where protection is offered in perpetuity.

TRIPS Coverage

The agreement encompasses the following areas:

- ***Patents:*** Patents are given inventions that are-new (or Novel), Non-obvious, should have industrial application (commercial use).

- *Term of a patent:* A parent is valid for 20 years from the date of filing of the patent.
- *Inventions that can be patented:* Biological inventions,, computer hardware and peripherals, computer software, cosmetics, food inventions, machines, mechanical inventions, medical accessories and devices, medicines, musical instruments etc.
- *Inventions that cannot be patented:* Ordre public or morality; Diagnostic, therapeutic and surgical methods; Plants and animals other than micro-organisms.
- *Compulsory Licensing:* Compulsory licensing and government use without the authorisation of the right holder are allowed but are made subject to conditions aimed at protecting the legitimate interests of the right holder.
- *Scope and Duration:* The scope and duration of such use without the authorisation of the right holder must be limited to the purpose for which it is authorised.
- *Non-exclusive Licenses*
- *The Indian Patents Act:* the Salient features are
  - Terms of every patient is 20 years from the date of filing.
  - A new definition of 'invention' meaning a new product or process involving inventive step and capable of industrial application has been incorporated.
  - A method or process of testing during the process of manufacture will be patentable.
  - Process in case of plants, are now patentable while a process for diagnostic and therapeutic use has now been considered as non-patentable. Every patent (except in which a secrecy direction is given) will now be published just after 18 months from the date of filing/priority and will be open for public on payment. As such, the filing intimation being published in the Gazette immediately after filing has been stopped.
  - Provision for filing request for examination by any other interested person (other than applicant) also has been introduced.
  - Provision for the withdrawal of application by applicant any time before grant has been introduced.
  - Time for putting the application in order for acceptance has now been from 15/18 months to 12 months.
  - Grounds for opposition as well as revocation have been enlarged by adding the following grounds: (i) Non-disclosure or wrongly mentioning the source of geographical origin of biological material used for invention; (ii) Anticipation having regard to the knowledge, oral or otherwise available within local or indigenous community in India or elsewhere.

- ***Copyright:*** A copy right prohibits persons from reproducing or 'copying' any 'literary, dramatic, musical work' without the consent of the owner who has the copyright over that work. This protection also applies to cinematograph films, sound recordings and now, computer programmes.

  The TRIPS Agreement mentions that "copyright protection shall extend to expressions and not to ideas, procedures and methods of operation or mathematical concepts as such". Just as 'commercial use or utility' is an

important precondition for the granting of a patent, ideas should have crystallised as expressions or artistic forms for the granting of a patent.

Copyright subsists in the following class of 'works': Literary Work; Dramatic work; Artistic works.

- ***Trademarks:*** A trademark is a visual symbol in the form of a word, device, name, letter or numeral, brand, heading, signature or label or any combination of these that enable a person to make a connection between a product and the company involved in offering the product. The company can be one-involved in manufacturing goods or offering services. In case of the latter, the term 'service mark' is used.

The Indian Act: The Trademarks Act of 1999 came into effect on September 15, 2003, mentions the grounds for refusal of registration of a trademark. The reasons could be when the trademark:

1. Is devoid of any distinctive character, that there is difficulty in distinguishing between goods or services
2. Consists exclusively of marks or indications which have become customary in the current language, that is, an absence of distinctiveness
3. Is of such a nature as to deserve the public or cause confusion
4. Contains or comprises any matter that hurts religious feelings
5. Comprises or contains scandalous or obscene matter
6. Consists exclusively of the shape of a good, e.g. the photo of mango by itself cannot be a trademark.

Under the Trade Marks Act of 1999, there is provision for infringement of a trademark.

- ***Geographical Indications:*** Geographical indications are place, names used to identify the origin and quality, reputation or other characteristics of products. The examples usually are "Champagne", "Tequila" or "Roquefort". However, countries such as India would like "Kancheepuram Saree" and perhaps even "Mysore Dosa" to become standard examples.

  Protection required under the TRIPS Agreement is defined in two Articles. All products are covered by Article 22, which defines a standard level of protection. This says that geographical indications have to be protected in order to avoid misleading the public and to prevent unfair competition.

  The protection being provided exclusively under Article 23 for wines and spirits is unfortunately not available to several products from the developing world.

- ***Layout Designs (Topographies) of Integrated Circuits:*** With regard to the treaty on Intellectual Property in respect of Integrated Circuits (IPIC Treaty), members agreed to provide protection to the layout-designs (topographies) of integrated circuits (referred in the WTO Agreement as "layout-designs").

In the event of trading in an integrated circuit incorporating an unlawfully reproduced layout design or any article incorporating such an integrated circuit, the person concerned, upon being informed of such an act, shall pay the "holder a sum equivalent to a reasonable royalty such as would be payable under a freely negotiated license in respect of such a layout design".

The Indian IC Layout Design Act

The Semiconductor Integrated Circuits Layout Design Act, 2000, which received Presidential assent in September 2000, among other things, mentions the following:

"Layout Design" means a layout of transistors and other circuitry elements and included lead wires connecting such elements and expressed in any manner in a semiconductor circuit.

"Semiconductor Integrated Circuit" means a product having transistors and other circuitry elements which are inseparably formed on semiconductor material or on insulating material or inside semiconductor material and designed to perform an electronic circuitry function.

The Act disallows registration for IC layout design that is:

- Not original; or
- That has been commercially exploited anywhere in India or in a convention country; or
- That is not inherently distinctive; or
- That is not inherently distinguishable from any other registered layout design.

The registration of a layout design is for a period of 10 years from the date of filling of an application for registration or from the date of first commercial exploitation anywhere in India or any country, whichever is earlier.

Industrial Designs

A design must satisfy the following:

- It must be new or original, meaning that the design must have not been previously published.
- It must relate to the features of shape
- It must be applied to any article by industrial process.
- It should appeal to and be judged solely by the naked eye.

Article 25 on "Requirements for Protection" states that:

1. Members shall provide for the protection of independently created industrial designs that are new or original.
2. each member shall ensure that requirements for securing protection for textile designs, in particular in regard to any cost, examination or publication, do not unreasonably impair the opportunity to seek and obtain such protection.

Article 26 on 'Protection' states that:

1. The owner of a protected industrial design shall have the right to prevent third parties not having the owner's consent from making, selling, selling or importing articles bearing or embodying a design which is a copy, or substantially a copy of the protected design, when such acts are undertaken for commercial purposes.
2. The duration of protection available shall amount to at least 10 years. (The Indian Designs Act, 2000, also provides the same protection of 10 years).

Check Your Progress

The Indian Geographical Indications Act includes food products and handicrafts. List out the names of food products and handicrafts in your region that could be covered by this act.

....

....

4.3 THE INDIAN DESIGNS ACT

The existing legislation on industrial designs in India is contained in the Designs Act, 2000.

Among other things, the Act mentions the following:

- 'Article' means any article of manufacture and any substance, artificial, or partly artificial and partly natural and includes any part of an article being made and sold separately.
- 'Design' means only the features of shape, configuration, pattern, ornament or composition of lines or colours applied to any article whether in two dimensional or three dimensional or in both forms, by any industrial process or means, whether manual, mechanical, or chemical, separate or combined, which in the finished article appeal to and are judged solely by the eye.
- "Prohibition of Registration of Certain Designs"

A design will not be registered:

(a) If it is not new or original; or

(b) If it has been disclosed to the public anywhere in India or in any other country by publication in any tangible form or by use or in any other way prior to the filing date; or

(c) If it is not significantly distinguishable from known designs or combination of known designs; or

(d) If it comprises or contains scandalous or obscene material

The copyright of a registered design will extend for 10 years from the date of registration, extendable on an application from the registered proprietor for a second period of five years from the expiration of the original period.

TRIPS and Control of Anti-competitive Practices

Under Section 8 regarding 'Control of Anti-competitive practices in Commercial Licenses' there is recognition "that some licensing practices or conditions pertaining to intellectual property rights which restrain competition may have adverse effects on trade and may impede the transfer and dimension of technology".

Thus members are allowed to specify in their legislation licensing practices or conditions that may in particular cases constitute an abuse of intellectual property rights having an adverse effect on competition in the relevant market.

4.4 WTO AND DISPUTE SETTLEMENTS

The daily work of the ministerial conference is handled by three groups: the General Council, the Dispute Settlement Body, and the Trade Policy Review Body.

The Dispute Settlement Body is made up of all member governments, usually represented by ambassadors or equivalent. The current chairperson is H.E. Mr. Bruce Gosper (Australia).

Dispute Settlement

"Prompt compliance with recommendations or rulings of the DSB is essential in order to ensure effective resolution of disputes to the benefit of all Members."

— *World Trade Organization, Article 21.1 of the DSU*

In 1994, the WTO members agreed on the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) annexed to the "Final Act" signed in

Marrakesh in 1994. Dispute settlement is regarded by the WTO as the central pillar of the multilateral trading system, and as a "unique contribution to the stability of the global economy". WTO members have agreed that, if they believe fellow-members are violating trade rules, they will use the multilateral system of settling disputes instead of taking action unilaterally.

Duration of a Dispute Settlement Procedure

These approximate periods for each stage of a dispute settlement procedure are target figures. The agreement is flexible. In addition, the countries can settle their dispute themselves at any stage. Totals are also approximate.

60 days	Consultations, mediation, etc
45 days	Panel set up and panelists appointed
6 months	Final panel report to parties
3 weeks	Final panel report to WTO members
60 days	Dispute Settlement Body adopts report (if no appeal)
Total = 1 year (without appeal)	
60-90 days	Appeals report
30 days	Dispute Settlement Body adopts appeals report
Total = 1 year 3 months (with appeal)	

Source: Understanding the WTO: Settling Disputes - A unique contribution

The operation of the WTO dispute settlement process involves the DSB panels, the Appellate Body, the WTO Secretariat, arbitrators, independent experts and several specialized institutions. The General Council discharges its responsibilities under the DSU through the Dispute Settlement Body (DSB). Like the General Council, the DSB is composed of representatives of all WTO Members. The DSB is responsible for administering the DSU, i.e. for overseeing the entire dispute settlement process. If a member state considers that a measure adopted by another member state has deprived it of a benefit accruing to it under one of the covered agreements, it may call for consultations with the other member state. If consultations fail to resolve the dispute within 60 days after receipt of the request for consultations, the complainant state may request the establishment of a panel. It is not possible for the respondent state to prevent or delay the establishment of a panel, unless the DSB by consensus decides otherwise. The panel, normally consisting of three members appointed ad hoc by the Secretariat, sits to receive written and oral submissions of the parties, on the basis of which it is expected to make findings and conclusions for presentation to the DSB. The proceedings are confidential, and even when private parties are directly concerned, they are not permitted to attend or make submissions separate from those of the state in question

The final version of the panel's report is distributed first to the parties, and two weeks later it is circulated to all the members of the WTO. The report must be adopted at a meeting of the DSB within 60 days of its circulation, unless the DSB by consensus decides not to adopt the report or a party to the dispute gives notice of its intention to appeal. A party may appeal a panel report to a standing Appellate Body, but only on issues of law, and legal interpretations developed by the panel. Members may express their views on the report of the Appellate Body, but they cannot derail it: an Appellate Body report shall be adopted by the DSB and unconditionally accepted by the parties, unless the DSB decides by consensus within thirty days of its circulation not to adopt the report.

Within thirty days of the adoption of the report, the member concerned is to inform the DSB of its intentions; if the member explains that it is impracticable to comply

immediately with the recommendations and rulings, it is to have a "reasonable period of time" in which to comply. If no agreement is reached about the reasonable period for compliance, that issue is to be the subject of binding arbitration. If there is a disagreement as to the satisfactory nature of the measures adopted by the respondent state to comply with the report that disagreement is to be decided by a panel, if possible the same panel that heard the original dispute, but apparently without the possibility of appeal from its decision.

If all else fails, two more possibilities are set out in the DSU:

- If a member fails within the "reasonable period" to carry out the recommendations and rulings, it may negotiate with the complaining state for a mutually acceptable compensation.
- If no agreement on compensation is reached within twenty days of the expiry of the "reasonable period", the prevailing state may request authorization from the DSB to suspend application to the member concerned of concessions or other obligations under the covered agreements. In contrast to prior GATT practice, authorization to suspend concessions in this context is semi-automatic, in that the DSB "shall grant the authorization [...] within thirty days of the expiry of the reasonable period", unless it decides by consensus to reject the request.

The DSU states that fellow members should give "special attention" to the problems and interest of the developing countries. If one party to a dispute is a developing country, that party is entitled to have at least one panelist who comes from a developing country. Further, if a complaint is brought against a developing country, the time for consultations (before a panel is convened) may be expended, and if the dispute goes to a panel, the deadlines for the developing country to make its submissions may be relaxed. Formal complaints against least developed countries are discouraged, and if consultations fail, the Director-General and the Chairman of the DSB stand ready to offer their good offices before a formal request for a panel is made. As to substance, the DSU provides that "particular attention" is to be paid to the interests of the developing countries, and that the report of panels shall "explicitly indicate" how account has been taken of the "differential and more favorable treatment" provisions of the agreement under which the complaint is brought. In order to assist developing countries overcome their limited expertise in WTO law and assist them in the management of complex trade disputes, an Advisory Centre on WTO Law was established in 2001.

4.5 LET US SUM UP

The main objective is providing protection to the holder of the intellectual property right, which can be claimed by an individual, company or even people of a geographical region. A copy right prohibits persons from reproducing or 'copying' any 'literary, dramatic, musical work' without the consent of the owner who has the copyright over that work. A trademark is a visual symbol in the form of a word, device, name, letter or numeral, brand, heading, signature or label or any combination of these that enable a person to make a connection between a product and the company involved in offering the product. Under the Trade Marks Act of 1999, there is provision for infringement of a trademark. The existing legislation on industrial designs in India is contained in the Designs Act, 2000. Under Section 8 regarding 'Control of Anti-competitive practices in Commercial Licenses' there is recognition "that some licensing practices or conditions pertaining to intellectual property rights which restrain competition may have adverse effects on trade and may impede the transfer and dimension of technology".

4.6 LESSON END ACTIVITY

Find out the latest estimates of the losses incurred by Microsoft due to software piracy. How does this compare with the total annual sales figure of the company during the same period? In which countries does Microsoft have the most royalty losses?

4.7 KEYWORDS

Patents are monopoly right conferred on the inventor (patent on an industrial product) property. These are given to inventions that are new (or novel), non-obvious, should have industrial application (commercial use).

Copyrights: Prohibits persons from reproducing or "copying" any "literary, dramatic, musical work" without the consent of the owner who has the copyright over that work.

Trademarks: It is a visual symbol in the form of word, device, name, letter or numeral, brand, heading, signature or label or any combination of these that enable a person to make a connection between a product and the company involved in offering the product.

4.8 QUESTIONS FOR DISCUSSION

1. Go to Indian Patent office Website (patentoffice.nic.in) and study the details given on patents and designs, application forms and patent procedures.
2. Find out the total number of patents granted by Indian patent offices over the past five years. How many patent applications were received from (a) companies situated within the country and (b) companies from outside the country during this period?
3. Find out the number of trademarks registered in (a) India (b) the European communities and (c) the United States in the last calendar year.
4. What is the procedure for dispute settlements under WTO?

Check Your Progress: Model Answer

Kancheepuram Saree, Mysore Dosa

4.9 SUGGESTED READINGS

Cherenilan Francis, *International Economics*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Charles W.L. Hill *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Justin Paul, *International Business*, (3rd ed.), Prentice Hall of India.

LESSON

5

HISTORY OF INDIA'S TRADE POLICY

CONTENTS

5.0 Aims and Objectives
5.1 Introduction
5.2 Scope of Exchange Control
5.3 Objectives of Exchange Control
5.4 Methods of Exchange Control
5.5 Historical Perspective of the Exchange Control
5.6 Objectives of the EXIM Policy 2002-07
5.7 Let us Sum up
5.8 Lesson End Activity
5.9 Keyword
5.10 Questions for Discussion
5.11 Suggested Readings

5.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- The genesis of trade restrictions as tney evolved in the last five or six decades in our country

5.1 INTRODUCTION

Exchange control is one of the important means of achieving certain national objectives like an improvement in the balance of payments position, restriction of inessential imports and conspicuous consumption, facilitation of import priority items, control of outflow of capital and maintenance of the external value of the currency.

5.2 SCOPE OF EXCHANGE CONTROL

- The whole foreign exchange resources of the nation, including those currently occurring to it, are usually brought directly under the control of the exchange control authority (the Central Bank, treasury or a specially constituted agency).
- Dealings and transactions in foreign exchange are regulated by the exchange control authority. Exporters have to surrender the foreign exchange earnings in exchange for home currency and the permission of the exchange control authority has to be obtained for making payments in foreign exchange. It is generally necessary to implement the overall regulations with a host of detailed provisions designed to eliminate evasion.
- The allocation of foreign exchange is made by the exchange control authority, on the basis of national priorities.

- Though the exchange control is administered by a central authority like the central bank, the day-to-day business of buying and selling foreign exchange is ordinarily handled by private exchange dealers, largely the exchange departments of commercial banks. For example, in India there are authorized dealers and money changers, entitled to conduct foreign exchange business.

5.3 OBJECTIVES OF EXCHANGE CONTROL

The important purposes of exchange control are outlined below:

1. To strengthen the Government-Exchange control measures increase government influence in a number of areas. For instance, control over the foreign exchange transactions and resources make the augmentation of resources for certain strategic needs like defense more easy.
2. To conserve foreign exchange resources of the country and the proper utilization thereof in the interest of the national development.
3. To check capital Flight from the country and to regulate the normal day-to-day capital movements.
4. To improve Balance of payments by restricting imports by means of exchange control.
5. To curb conspicuous Consumption, which are regarded as inessential 'luxury' goods by preventing imports and thereby their consumption.
6. To make possible essential imports like import of essential capital goods, know-how and certain essential inputs and consumer goods specially necessary for developing countries where foreign exchange is scarce.
7. To protect domestic Industries from foreign competition.
8. To check-recession induced exports into the country which is free from recession.
9. To safeguard Domestic programmes by pursuing policies of an anti-inflationary nature without being disturbed by factors such as recession-induced exports similar to that mentioned above, into the country.
10. To maintain exchange rate stability.
11. To control speculation in the foreign exchange market.
12. To regulate the business of foreign companies in the company.
13. To regulate export and transfer of securities form the country.
14. To facilitate discrimination and commercial bargaining by according exchange concessions, on a reciprocal basis, between the countries.
15. To enable the Government to repay foreign loans.
16. To lower the price of National Securities held abroad by preventing national from buying them thus enabling the Government to purchase such securities at a lower price.
17. To freeze Foreign Investments and prevent Repatriation of Funds. This is normally done by hostile countries.
18. To obtain revenue-The government/government agency can make profit out of foreign exchange business by keeping certain margin between the average purchase price of the selling exchange.

5.4 METHODS OF EXCHANGE CONTROL

The various methods of exchange control may be broadly classified into (i) Unilateral methods and (ii) Bilateral/multilateral methods:

- ***Unilateral methods:*** Refer to those methods which may be adopted by a country unilaterally i.e. without any reference to or understanding with other countries. The important unilateral methods are outlined below:
    - Regulation of bank rate–A change in the bank rate is usually followed by changes in all other rates of interest and this may effect the flow of foreign capital.
    - Regulation of foreign trade–The rate of exchange can be controlled by regulating the foreign trade of the country. For example, by encouraging exports and discouraging imporst, a country can increase the demand for, in relation to supply, its currency in the foreign exchange market and thus bring about an increase in the rate of exchange of the country's currency
    - Rationing of Foreign Exchange thereby restricting the influence of the free play of market forces of demand and supply and this maintain the exchange rate at a higher level.
    - Exchange pegging i.e. policy of the government of fixing the exchange rate arbitrarily either below or above the normal market rate. When it is fixed above the free market rate, it is known as pegging up and when it is fixed below the free market rate, it is known as pegging down.
    - Multiple Exchange Rates i.e. system of the fixing, by a country of the different rates of exchange for the trade of different commodities and/or for transactions with different countries. The main object of the system is to maximize the foreign exchange earnings of a country by increasing exports and reducing imports. The entire structure of the exchange is devised in a manner that makes imports cheaper and exports more expensive
    - Exchange Equalization Fund/Exchange Stabilization Account, the main object being to stabilize the exchange rate of the national currency through the sale and purchase of foreign currencies. When the demand for domestic currency exceeds its supply, the Fund starts purchasing foreign currency with the help of its own resources. This results in an increase in the demand for foreign currency and increases the supply of the national currency. The tendency of the rate of exchange of the national currency to ruse can this be checked.
    - Blocked accounts–In the case of blocked accounts, foreigners are prevented from withdrawing money from their deposit with banks for the purpose of remitting abroad. This measure makes the foreign exchange position of the country more comfortable. This is generally regarded as a wartime measure. Under this method, domestic debtors may be required to deposit their dues to foreign creditors into specifically designated bank accounts.
- ***Bilateral/Multilateral Methods:*** The important bi-lateral/multilateral methods are the following:
    - *Private Compensation Agreement:* Under this method, which closely resembles the barter system, a firm in one country is required to equalize its exports to the other country, with its imports from that country so that there is neither a surplus nor a deficit.
    - *Clearing Agreement:* Under this agreement, importers make payments in domestic currency to the clearing account and exporters obtain payments in domestic currency from the clearing fund. Thus under the clearing agreement the importer does not directly pay the exporter and hence the need for foreign

exchange does not arise, except for settling the net balance between the two currencies.

- *Stand still Agreement:* Seeks to provide debtor country some time to adjust her position by preventing the movement of capital out of the country through a moratorium on the outstanding short-term foreign debts.
- *Payments Agreement:* Under the payments agreement concluded between a debtor country and a creditor country, provision is made for the repayment of the principal and interest by the debtor country to the creditor country. the creditor country refrains from imposing restrictions on the imports from the debtor country in order to enable the debtor company to increase its exports to the creditor. On the other hand, the debtor country takes necessary measures to encourage exports to and discourage imports from the creditor country.

5.5 HISTORICAL PERSPECTIVE OF EXCHANGE CONTROL

The origin of import trade control in India dates back to the Second World War, when for the first time, restrictions under the Defence of India Rules (DIR) were imposed on imports into India. However, at that time the main aim was to reduce the pressure on the limited available shipping space. Starting with consumer goods, the restrictions were gradually extended to cover unmanufactured as well as semi-finished goods. In September 1946, with the lapse of the DIR, import trade control continued under the Emergency Provisions (Continuance) Ordinance, 1946. The ordinance was replaced by the Imports and Export (Control) Act, 1947 which was also replaced by the Foreign Trade (Development and Regulation) Act, 1992. Presently, import trade control is administered in India under the purview of Foreign Trade (Development and Regulation) Act, 1992, Foreign Trade (Regulations) Rules, 1993 and Foreign Trade (Exemption from Application of Rules in Certain Cases) Order, 1993.

For many years the accent of trade policies was on maintaining the level of imports within the available foreign exchange. This was done with the intention of protecting domestic industry and achieving price stability. However, these measures were not successful in containing the trade deficit. It was then that the Government of India realised the importance of export promotion.

The import export policy of 1985 can be considered as the first bold and dynamic policy initiative in this direction. Keeping in mind the importance of exports, the 1985 policy was announced incorporating the objectives of export promotion, import substitution and technological upgradation.

In the years 1990-1991, drastic measures (like pledging of gold by RBI to borrow foreign exchange) were introduced to tide over the severe balance of payments crisis which had reached dangerous levels because of the Gulf crisis. Even though the crisis was resolved, a need was felt to be better equipped for any such future recurrences. As a corollary, the Liberalised Exchange Rate Management System (LERMS) was introduced. The scheme came into effect on 1st March 1992. As per this scheme, 40% of current account receipts were required to be converted/surrendered to RBI at the official rate prescribed by RBI and the balance at market determined exchange rates. The success of this scheme led to the introduction of the Unified Exchange Rate System, which came into effect from 1st March 1993. Since then, authorised dealers at market-determined rates are putting through all foreign exchange transactions.

The other notable fallout of this crisis was the launching of economic and financial reforms by the Government of India. The main objective of the liberalisation process was to increase the wealth of the nation by higher economic growth that would bring about better income and living standards to the population. In the interdependent world of the 90s, it was felt that economic growth could only be achieved by

integrating the Indian economy with global economy in terms of free movement of goods, services and capital.

The liberalisation process was aimed at:

- Freeing Industry from Licenses, Permits and Government Control
- Reforming Fiscal and Monetary Policies
- Reforming the Banking and Financial Sectors and the Capital Market
- Creating vital infrastructure such as telecommunication, power and roads to facilitate economic growth
- Removing foreign exchange control barriers to the movement of Investment and Capital
- Removing quantitative and tariff barriers on International Trade and rationalising Tariffs.

As a sequence to the liberalisation process, the Government of India had also introduced significant changes in the import export policy. The export-import policy 1992-1997 was born in this context where an attempt was made to align India's international trade policies and practices to the overall liberalisation process and getting closer to free international trade. The trade policy that was hitherto called import export policy was rechristened as export import policy. The long-term export import policy for a period of five years was announced synchronising with the 8th five-year plan. The Exim Policy 1992-1997 saw the introduction of numerous changes and modifications.

Exports and Imports come under the purview of the Ministry of Commerce and it is the Director General of Foreign Trade functioning under the commerce ministry who is empowered to exercise control over exports/imports. Previously, the policy was being announced on an annual basis. However, in order to bring about continuity and stability in the policy, there was a shift from the usual annual policy to a three-year policy from April 1985. Beginning 1st April, 1992 the policy is being announced on a five-year basis and the policy currently in effect is the export and import policy 1st April, 2002 to 31st March, 2007. Revisions during the five-year period generally are published on 1st April of subsequent years during the five-year period, although changes may be made and announced by means of public notices/amendment orders at any time.

5.6 OBJECTIVES OF THE EXIM POLICY 2002-07

The major thrust of the new Exim Policy for the period 2002-07 is the acceleration of India's exports. In this direction, the policy has laid down a wide range of measures to restructure the various export promotion schemes. It has also advocated simplification and streamlining of procedures so as to inject greater transparency into the system, besides ensuring 'speed' in carrying out transactions. Continuing with the process of trade reforms and liberalisation, the policy aims at consolidating the achievements made possible during the preceding 5-year Exim Policy for 1997-2002. The need to ease controls as well as procedural bottlenecks was realised. Another focus area of the new Exim Policy was to enable domestic industry realise its full potential and improve its competitiveness in the global arena.

Putting it briefly, the major objectives of the new Exim Policy can be enumerated as under:

1. Facilitating the sustained growth in exports in order to capture a share of at least 1% of the global trade from the present level of 0.67%.

2. Stimulating sustained economic growth by providing access to essential Raw Materials, Intermediates, Components, Consumables and Capital Goods, derived from augmenting production.
3. Enhancing the technological strength and efficiency of Indian agriculture, industry and services, thereby improving their competitiveness while generating new employment opportunities.
4. Encouraging the attainment of internationally accepted standards of quality and providing consumers with good quality products at reasonable prices.

The Exim Policy 2002-2007 basically aims at imparting operational flexibility to the exporters. The changes brought about will enable exporters to tap new markets, and help them improve exports both in terms of quality and quantity.

Check Your Progress

Which of the following are the objectives of current EXIM Policy?

(a) Accelerating the country's transaction to a globally oriented vibrant economy.

(b) Encouraging attainment of internationally accepted standards of quality

(c) Enhancing technological strength and efficiency of Indian agriculture industry and services.

(d) Both (a) and (b) above

(e) All of (a), (b) and (c) above

5.7 LET US SUM UP

Countries have started realising the benefits of free trade and are slowly moving away from quotas and embargo towards positive and growth oriented economic policies to encash one's own unique potential competency vis-a-vis the treading partners. Our recent EXIM Policy is a pointer in that direction.

The major thrust of the new Exim policy for the period 2002-07 and 2004-09 is the acceleration of India's exports through a wide range of measures to restructure the various export promotion schemes and to advocate simplification and streamlining of procedures so as to inject greater transparency into the system, besides ensuring 'speed' in carrying out transactions.

The EXIM policy also issues trade regulations governing exports and imports. It lays down the trade procedures to be followed by exporters and importers.

5.8 LESSON END ACTIVITY

Visit a nearby company which exports goods and services, find out the procedure they follow for export of goods and services and what are the problems they encounter.

5.9 KEYWORD

Exchange Control: It is one of the important means of achieving national objectives.

5.10 QUESTIONS FOR DISCUSSION

1. What are the objectives of EXIM Policy 2002-07 and what are the highlights of EXIM Policy 2002-07 (as amended up to 31.3.2003)?
2. What is the purpose of the Export Import Bank?

3. Do you think that a country's government should assist private business in the conduct of international trade through direct loans, loan guarantees and/or credit insurance.
4. What are the objectives of EXIM POLICY 2004-09 and the strategies laid down?
5. What are the objectives and methods of foreign exchange control?
6. Identify the correct statement:
   (a) Export contracts are required to be denominated in freely convertible currency.
   (b) Export proceeds are to be realised within 6 months of the date of shipment or the due date of payment whichever is later.
   (c) Exports from India may be made without any restriction.
   (d) Both (a) and (c) above.
   (e) Both (b) and (c) above.
7. Which of the following is not true regarding import license?
   (a) Import licenses are valid only for the validity period specified on the license
   (b) The value indicated on import license is always for FOB value of goods authorised to be imported
   (c) Goods which require an import license can be imported only by the actual user, unless otherwise specified
   (d) Advance license is issued for duty free import of inputs subject to value addition and export obligation
   (e) Advance license is issued under the Duty Exemption Scheme
8. Canalised goods in relation to imports refer to those goods which can be:
   (a) Imported freely
   (b) Can be imported only by certain agencies
   (c) Cannot be imported
   (d) Fall under the restricted category of imports
   (e) Can be imported using a special import license
9. Which of the following fall under the category of deemed exports:
   (a) Supply of goods to projects funded by UN agencies
   (b) Supply of goods to export oriented units
   (c) Undertaking turnkey contracts abroad
   (d) Both (a) and (b) above
   (e) All of (a), (b) and (c) above
10. Which of the following is included in the prohibited list of exports?
    (a) Cattle
    (b) All forms of wild life
    (c) Petroleum products
    (d) Onions
    (e) Mineral ores

11. The export policy is announced for a period of:
    (a) 1 year
    (b) 2 years
    (c) 3 years
    (d) 4 years
    (e) 5 years
12. Exports and imports come under the purview of:
    (a) Ministry of Finance
    (b) Ministry of Commerce
    (c) Ministry of External Affairs
    (d) Ministry of Home Affairs
    (e) Ministry of Small Scale Industries
13. The Registration cum Membership is issued by:
    (a) Export Promotion Councils
    (b) Reserve Bank of India
    (c) Director General of Foreign Trade
    (d) Ministry of Commerce
    (e) Ministry of External Affairs
14. An advance license can be issued for which of the following:
    (a) Physical exports
    (b) Intermediate suppliers
    (c) Deemed exports
    (d) Both (a) and (c) above
    (e) All of (a), (b) and (c) above

Check Your Progress: Model Answer

(e)

5.11 SUGGESTED READINGS

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LESSON

6

HIGHLIGHTS OF FOREIGN TRADE POLICY (2004-09)

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6.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Learn the highlights of EXIM Policy 2004-09

6.1 INTRODUCTION

While increase in exports is of vital importance, we have also to facilitate those imports which are required to stimulate our economy. Coherence and consistency among trade and other economic policies is important for maximizing the contribution of such policies to development. Thus, while incorporating the existing practice of enunciating an annual Exim Policy, it is necessary to go much beyond and take an integrated approach to the developmental requirements of India's foreign trade. This was the context of the new Foreign Trade Policy 2004-09.

Trade is not an end in itself, but a means to economic growth and national development. The primary purpose is not the mere earning of foreign exchange, but the stimulation of greater economic activity. The Foreign Trade Policy is rooted in this belief and built around two major objectives. These are:

- To double our percentage share of global merchandise trade within the next five years; and
- To act as an effective instrument of economic growth by giving a thrust to employment generation.

These objectives were proposed to be achieved through the following objectives:

- Unshackling of controls and creating an atmosphere of trust and transparency to unleash the innate entrepreneurship of our businessmen, industrialists and traders.
- Simplifying procedures and bringing down transaction costs.
- Neutralizing incidence of all levies and duties on inputs used in export products, based on the fundamental principle that duties and levies should not be exported.
- Facilitating development of India as a global hub for manufacturing, trading and services.
- Identifying and nurturing special focus areas which would generate additional employment opportunities, particularly in semi-urban and rural areas, and developing a series of 'Initiatives' for each of these.
- Facilitating technological and infrastructural upgradation of all the sectors of the Indian economy, especially through import of capital goods and equipment, thereby increasing value addition and productivity, while attaining internationally accepted standards of quality.

- Avoiding inverted duty structures and ensuring that our domestic sectors are not disadvantaged in the Free Trade Agreements/Regional Trade Agreements/ Preferential Trade Agreements that we enter into in order to enhance our exports.
- Upgrading our infrastructural network, both physical and virtual, related to the entire Foreign Trade chain, to international standards.
- Revitalising the Board of Trade by redefining its role, giving it due recognition and inducting experts on Trade Policy.
- Activating our Embassies as key players in our export strategy and linking our Commercial Wings abroad through an electronic platform for real time trade intelligence and enquiry dissemination.

This Policy contains the basic principles and points the direction in which we propose to go. By virtue of its very dynamics, a trade policy cannot be fully comprehensive in all its details. It would naturally require modification from time to time. We propose to do this through continuous updation, based on the inevitable changing dynamics of international trade. It is in partnership with business and industry that we propose to erect milestones on this roadmap.

6.2 CHAPTER-1A: LEGAL FRAMEWORK

In exercise of the powers conferred under Section 5 of The Foreign Trade (Development and Regulation Act), 1992 (No. 22 of 1992), the Central Government hereby notifies the Foreign Trade Policy for the period 2004-2009 incorporating the Export and Import Policy for the period 2002-2007, as modified. This Policy shall come into force with effect from 1st September, 2004 and shall remain in force up to 31st March, 2009, unless as otherwise specified.

The Central.Government reserves the right in public interest to make any amendments to this Policy in exercise of the powers conferred by Section-5 of the Act. Such amendment sball be made by means of a Notification published in the Gazette of India.

Any Notifications made or Public Notices issued or anything done under the previous Export/Import policies, and in force immediately before the commencement of this Policy shall, in so far as they are not inconsistent with the provisions of this Policy, continue to be in force and shall be deemed to have been made, issued or done under this Policy.

Licences, certificates and permissions issued before the commencement of this Policy shall continue to be valid for the purpose and duration for which such licence, certificate or permission was issued unless otherwise stipulated.

In case an export or import that is permitted freely under this Policy is subsequently subjected to any restriction or regulation, such export or import will ordinarily be permitted notwithstanding such restriction or regulation, unless otherwise stipulated, provided that the shipment of the export or import is made within the original validity of an irrevocable letter of credit established before the date of imposition of such restriction.

6.3 CHAPTER-1B: SPECIAL FOCUS INITIATIVES

Those sectors which have significant export prospects abreast of potential for employment generation in the semi-urban and rural areas have been identified as the thrust sectors. For these areas, special sectoral strategies have been prepared. Further, from time to time, sectoral initiatives in other sectors will be announced. Currently Special Focus Initiatives have been prepared for the agriculture, handicrafts, gems & jewellery, handlooms and leather & footwear sectors. The threshold limit of

designated 'Towns of Export Excellence' has been reduced to Rs. 250 crore from Rs. 1,000 crore in these thrust sectors.

Agriculture: A new scheme called Vishesh Krishi Upaj Yojna introduced to boost exports of fruits, vegetables, flowers, minor forest produce and their value-added products. The capital goods which are imported under EPCG for agriculture are permitted to be installed anywhere in the agri export zone. The import of seeds, bulbs, tubers and planting material has been liberalised. The export of plant portions, derivatives and extracts has been liberalised with a few to promote export of medicinal plants and herbal products.

Gems & Jewellery: The consumables for metals other than gold and platinum is allowed to be imported duty free up to 2% of FOB value of exports. Duty free import of commercial samples of jewellery is increased to Rs. 1 lakh. The import of gold of 18 carat and above shall be allowed under replenishment scheme.

Handlooms & Handicrafts: Duty free import of trimmings and embellishments for handlooms & handicrafts sectors is increased to 5% of FOB value of exports. The import of trimmings and embellishments and samples shall be exempt from CVD. Handicraft Export Promotion Council (HEPC) is authorized to import trimmings, embellishments and samples for small manufacturers. A new handicraft special economic zone will be established.

Leather and Footwear: For leather industry, duty free entitlements of import trimmings, embellishments and footwear components is increased to 3% of FOB value of exports. For specified items for leather sector, duty free import increased to 5% of FOB value of exports. The machinery and equipment for effluent treatment plants for the leather industry shall be exempt from customs duty.

Target Plus Scheme: Target Plus, a new scheme is introduced to accelerate growth of exports. Exporters having achieved a quantum growth in exports will be entitled to a duty free credit based on incremental exports, substantially higher than the general actual export target fixed. Based on the tiered approach, rewards will be granted. For the incremental growth of more than 20%, 25% and 100%, the duty free credits will be 5%, 10% and 15% of FOB value of incremental exports.

6.4 CHAPTER-1C: BOARD OF TRADE

The Board of Trade shall be revamped and given a clear and dynamic role in advising government on relevant issues connected with Foreign Trade Policy. There would be a process of continuous interaction between the Board of Trade and Government in order to achieve the desired objective of boosting India's exports.

The Board of Trade would have the following terms of reference:

- To advise the Government on Policy measures for preparation and implementation of both short- and long-term plans for increasing exports in the light of emerging national and international economic scenarios;
- To review export performance of various sectors, identify constraints and suggest industry specific measures to optimize export earnings;
- To examine the existing institutional framework for imports & exports and suggest practical measures for further streamlining to achieve the desired objectives;
- To review the policy instruments and procedures for imports & exports and suggest steps to rationalize and channelise such schemes for optimum use;
- To examine issues which are considered relevant for promotion of India's foreign trade, and to strengthen the international competitiveness of Indian goods and services.
- To commission studies for furtherance of the above objectives.

- Export of samples and Free of charge goods shall be governed by the provisions

6.5 CHAPTER-2: GENERAL PROVISIONS REGARDING IMPORTS AND EXPORTS

- Exports and Imports shall be free, except in cases where they are regulated by the provisions of this Policy or any other law for the time being in force. The item wise export and import policy shall be, as specified in ITC(HS) published and notified by Director General of Foreign Trade, as amended from time to time.
- Every exporter or importer shall comply with the provisions of the Foreign Trade (Development and Regulation) Act, 1992, the Rules and Orders made there under, the provisions of this Policy and the terms and conditions of any licence/ certificate/permission granted to him, as well as provisions of any other law for the time being in force. All imported goods shall also be subject to domestic Laws, Rules, Orders, Regulations, technical specifications, environmental and safety norms as applicable to domestically produced goods. No import or export of rough diamonds shall be permitted unless the shipment parcel is accompanied by Kimberley Process (KP) Certificate required under the procedure specified by the Gem & Jewellery Export Promotion Council (GJEPC).
- If any question or doubt arises in respect of the interpretation of any provision contained in this Policy, or regarding the classification of any item in the ITC(HS) or Handbook (Vol.1) or Handbook (Vol.2), or Schedule Of DEPB Rate the said question or doubt shall be referred to the Director General of Foreign Trade whose decision thereon shall be final and binding.
- Any goods, the export or import of which is restricted under ITC(HS) may be exported or imported only in accordance with a licence/certificate/permission or a public notice issued in this behalf.
- Any goods, the import or export of which is governed through exclusive or special privileges granted to State Trading Enterprise(s), may be imported or exported by the State Trading Enterprise(s) as specified in the ITC(HS) Book subject to the conditions specified therein. The Director General of Foreign Trade may, however, grant a licence/certificate/permission to any other person to import or export any of these goods.
- No export or import shall be made by any person without an Importer-Exporter Code (IEC) number unless specifically exempted. An Importer-Exporter Code (IEC) number shall be granted on application by the competent authority in accordance with the procedure specified in the Handbook (Vol.1).
- After completion of the projects abroad, project contractors may import, without a licence/certificate/permission, used goods including capital goods provided they have been used for at least one year.
- Wherever any duty free import is allowed or where otherwise specifically stated, the importer shall execute a Legal Undertaking (LUT)/Bank Guarantee (BG)/ Bond with the Customs Authority before clearance of goods through the Customs, in the manner as may be prescribed. In case of indigenous sourcing, the licence/ certificate/permission holder shall furnish LUT/BG/Bond to the licensing authority before sourcing the material from the indigenous supplier/nominated agency.
- All the exporters who have an export turnover of at least Rupees 5 crore in the current or preceding licencing year and have a good track record of three years of exports will be exempted from furnishing a BG for any of the schemes under this Policy and may furnish a LUT in lieu of BG.
- Private/Public bonded warehouses may be set up in the Domestic Tariff Area as per the terms and conditions of notification issued by Department of Revenue.

- Export of samples and Free of charge goods shall be governed by the provisions given in Handbook (Vol.1).
- Goods, including edible items, of value not exceeding Rs. 5,00,000/- in a licensing year, may be exported as a gift. However, items mentioned as restricted for exports in ITC(HS) shall not be exported as a gift, without a licence/certificate/permission.
- Third party exports, as defined in Chapter 9 shall be allowed under the Policy.
- All export contracts and invoices shall be denominated either in freely convertible currency or Indian rupees but the export proceeds shall be realised in freely convertible currency.
- For all goods and services which are exported from units in Domestic Tariff Area (DTA), remission of service tax levied shall be allowed.
- Units in EOU/ EHTP/ STP/ BTP/ SEZ shall be exempted from service tax.

6.6 CHAPTER-3: PROMOTIONAL MEASURES

6.6.1 Assistance to States for Infrastructure Development of Exports (ASIDE)

The State Governments shall be encouraged to participate in promoting exports from their respective States. For this purpose, Department of Commerce has formulated a scheme called ASIDE. Suitable provision has been made in the Annual Plan of the Department of Commerce for allocation of funds to the states on the twin criteria of gross exports and the rate of growth of exports. The States shall utilise this amount for developing infrastructure such as roads connecting production centres with the ports, setting up of Inland Container Depots and Container Freight Stations, creation of new State level export promotion industrial parks/zones, augmenting common facilities in the existing zones, equity participation in infrastructure projects, development of minor ports and jetties, assistance in setting up of common effluent treatment facilities, stabilizing power supply and any other activity as may be notified by Department of Commerce from time to time.

6.6.2 Market Access Initiative (MAI)

MAI scheme is intended to provide financial assistance for medium-term export promotion efforts with a sharp focus on a country and product. The financial assistance is available for Export Promotion Councils, Industry and Trade associations, Agencies of State Governments, Indian Commercial Missions abroad and other eligible entities as may be notified from time to time.

6.6.3 Marketing Development Assistance (MDA)

- This scheme is intended to provide financial assistance for a range of export promotion activities implemented by export promotion councils, industry and trade associations on a regular basis every year.
- As per the revised MDA guidelines with effect from 1st April, 2004 assistance under MDA is available for exporters with annual export turnover up to Rs. 5 crores.
- Further, assistance for participation in Trade Fairs abroad and travel grant is available to such exporters if they travel to countries in one of the four Focus Areas, such as, Latin America, Africa, CIS Region, ASEAN countries, Australia and New Zealand.

6.6.4 Towns of Export Excellence

- Selected towns producing goods of Rs. 1000 crore or more will be notified as Towns of Exports Excellence on the basis of potential for growth in exports.
- However for the Towns of Export Excellence in the Handloom, Handicraft, Agriculture and Fisheries sector, the threshold limit would be Rs. 250 crores.
- Common service providers in these areas shall be entitled for the facility of the EPCG scheme.
- The recognised associations of units will be able to access the funds under the Market Access Initiative scheme for creating focused technological services.
- Further such areas will receive priority for assistance for rectifying identified critical infrastructure gaps from the ASIDE scheme.

6.6.5 Brand Promotion and Quality

The Central Government aims to encourage manufacturers and exporters to attain internationally accepted standards of quality for their products. The Central Government will extend support and assistance to Trade and Industry to launch a nationwide programme on quality awareness and to promote the concept of total quality management.

6.6.6 Test Houses

The Central Government will assist in the modernization and upgradation of test houses and laboratories in order to bring them at par with international standards.

6.6.7 Quality Complaints/Disputes

The Regional Sub-Committee on Quality Complaints (RSCQC) set up at the Regional Offices of the Directorate General of Foreign Trade shall investigate quality complaints received from foreign buyers. The guidelines for settlement of quality complaints, in particular, and such other complaints, in general, is given in Appendix-37 of Handbook (Vol.1).

6.6.8 Trade Disputes affecting Trade Relations

If it comes to the notice of the Director General of Foreign Trade or he has reason to believe that an export or import has been made in a manner that:

- is gravely prejudicial to the trade relations of India with any foreign country; or
- is gravely prejudicial to the interest of other persons engaged in exports or imports;
- has brought disrepute to the country;

The Director General Foreign Trade may take action against the exporter or importer concerned in accordance with the provisions of the Act, the Rules and Orders made thereunder and this Policy.

6.6.9 Star Export Houses

Merchant as well as Manufacturer Exporters, Service Providers, Export Oriented Units (EOUs) and Units located in Special Economic Zones (SEZs), Agri Export Zone (AEZ's), Electronic Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) and Bio Technology Parks (BTPs) shall be eligible for applying for status as Star Export Houses.

Status Category

The applicant shall be categorized depending on his total FOB/FOR export performance during the current plus the previous three years.

Category	Performance (in rupees)
One Star Export House	15 crore
Two Star Export House	100 crore
Three Star Export House	500 crore
Four Star Export House	1500 crore
Five Star Export House	5000 crore

6.6.10 Services Exports

Services include all the 161 tradable services covered under the General Agreement on Trade in Services where payment for such services is received in free foreign exchange. A list of services is given in Appendix-36 of Handbook (Vol.1). All provisions of this Policy shall apply mutatis mutandi to export of services as they apply to goods, unless otherwise specified.

Service exporters are required to register themselves with the Federation of Indian Exporters Organisation. However, software exporters shall register themselves with Electronic and Software Export Promotion Council.

In order to give proper direction, guidance and encouragement to the Services Sector, an exclusive Export Promotion Council for Services shall be set up.

The Services Export Promotion Council shall:

- Map opportunities for key services in key markets and develop strategic market access programmes for each component of the matrix.
- Co-ordinate with sectoral players in undertaking intensive brand building and marketing programmes in target markets.
- Make necessary interventions with regard to policies, procedures and bilateral/ multilateral issues, in co-ordination with recognised nodal bodies of the services industry.

Common Facility Centres

Government shall promote the establishment of Common Facility Centres for use by home-based service providers, particularly in areas like Engineering & Architectural design, Multi-media operations, software developers etc., in State and District-level towns, to draw in a vast multitude of home-based professionals into the services export arena.

6.6.11 'Served from India' Scheme

To accelerate growth in export of services in order to create a powerful and unique 'Served from India' brand which will be instantly recognised and respected the world over. Individual service providers earning foreign exchange of at least Rs. 5 lakh, and Rs. 10 lakh for other service providers will be eligible for a duty credit entitlement of 10% of total foreign exchange earned by them. For stand-alone restaurants and for hotels, the entitlement shall be 20% and 5% respectively. Hotels and restaurants may use their duty credit entitlement for import of food items and alcoholic beverages.

6.6.12 Target Plus Scheme

Target Plus, a new scheme is introduced to accelerate growth of exports. Exporters having achieved a quantum growth in exports will be entitled to a duty free credit

based on incremental exports, substantially higher than the general actual export target fixed. The objective of the scheme is to accelerate growth in exports by rewarding Star Export Houses who have achieved a quantum growth in exports. High performing Star Export Houses shall be entitled for a duty credit based on incremental exports substantially higher than the general annual export target fixed (Since the target fixed for 2004-05 is 16%, the lower limit of performance for qualifying for rewards is pegged at 20% for the current year.).

Based on the tiered approach, rewards will be granted. For the incremental growth of more than 20%, 25% and 100%, the duty free credits will be 5%, 10% and 15% of FOB value of incremental exports.

All Star Export Houses (including Status Holders as defined in para 3.7.2.1 of Exim Policy 2002-07) which have achieved a minimum export turnover in free foreign exchange of Rs. 10 crores in the previous licencing year are eligible for consideration under the Target Plus Scheme .

6.6.13 Vishesh Krishi Upaj Yojana

A new scheme called 'Vishesh Krishi Upaj Yojana' (Special Agricultural Produce Scheme) has been introduced to boost exports of fruits, vegetables, flowers, minor forest produce and their value added products. Export of these products shall qualify for duty free credit entitlement equivalent to 5 percent of FOB value of exports. The entitlement is freely transferable and can be used for import of a variety of inputs and goods.

Salient Features of Vishesh Krishi Upaj Yojana

- Exporters of such products shall be entitled for duty credit scrip equivalent to 5% of the FOB value of exports for each licencing year commencing from 1st April, 2004. The scrip and the items imported against it would be freely transferable.
- The Duty Credit may be used for import of inputs or goods including capital goods, as may be notified, provided the same is freely importable under ITC(HS).
- Imports from a port other than the port of export shall be allowed under TRA facility as per the terms and conditions of the notification issued by Department of Revenue.
- Additional customs duty/excise duty paid in cash or through debit under Vishesh Krishi Upaj Yojana shall be adjusted as CENVAT Credit or Duty Drawback as per rules framed by the Department of Revenue.
- Government reserves the right in public interest, to specify from time to time the export products which shall not be eligible for calculation of entitlement.

6.7 CHAPTER-4: DUTY EXEMPTION AND REMISSION SCHEMES

Duty exemption schemes enable duty free import of inputs required for export production. An Advance Licence is issued as a duty exemption scheme. A Duty Remission Scheme enables post export replenishment/ remission of duty on inputs used in the export product. Duty remission schemes consist of (a) DFRC (Duty Free Replenishment Certificate) and (b) DEPB (Duty Entitlement Passbook Scheme). DFRC permits duty free replenishment of inputs used in the export product. DEPB allows drawback of import charges on inputs used in the export product.

6.7.1 Advance Licence

An Advance Licence is issued to allow duty free import of inputs, which are physically incorporated in the export product (making normal allowance for wastage).

In addition, fuel, oil, energy, catalysts etc. which are consumed in the course of their use to obtain the export product, may also be allowed under the scheme.

Salient Features

- Duty free import of mandatory spares up to 10% of the CIF value of the licence which are required to be exported/supplied with the resultant product may also be allowed under Advance Licence.
- Advance Licences are issued on the basis of the inputs and export items given under SION. However, they can also be issued on the basis of *Ad hoc* norms or self declared norms as per para 4.7 of Handbook.

  Advance Licence can be issued for:

  Physical exports: Advance Licence may be issued for physical exports including exports to SEZ to a manufacturer exporter or merchant exporter tied to supporting manufacturer(s) for import of inputs required for the export product.

  Intermediate supplies: Advance Licence may be issued for intermediate supply exporter.

  - Manufacturer-exporter for the import of inputs required in the manufacture of goods to be supplied to the ultimate exporter/deemed exporter holding another Advance Licence.
  - Advance Licence can be issued for deemed export to the main contractor for import of inputs required in the manufacture of goods to be supplied to the categories mentioned in paragraph 8.2 (b), (c), (d), (e), (f), (g), (i) and (j) of the Policy.
  - In addition, in respect of supply of goods to specified projects mentioned in paragraph 8.2 (d), (e), (f), (g) and (j) of the Policy, an Advance Licence for deemed export can also be availed by the sub-contractor of the main contractor to such project provided the name of the sub contractor(s) appears in the main contract.

6.7.2 Duty Free Replenishment Certificate (DFRC)

- DFRC is issued to a merchant-exporter or manufacturer-exporter for the import of inputs used in the manufacture of goods without payment of basic customs duty. However, such inputs shall be subject to the payment of additional customs duty equal to the excise duty at the time of import.
- DFRC shall be issued on minimum value addition of 25% except for items in gems and jewellery sector for which value addition as given in paragraph 4.56.1 of the Handbook (Vol.1) shall be applicable.
- DFRC may be issued in respect of exports for which payments are received in non-convertible currency. Such exports shall, however, be subject to value addition and conditions as specified in Appendix-32 of Handbook (Vol.1).
- DFRC may also be issued for supplies effected under paragraph 8.2 of the Policy.
- DFRC shall be issued only in respect of products covered under the Standard Input Output Norms as notified by DGFT. However, in respect of Standard Input Output Norms which are subject to "actual user" condition or where the export proceeds have not been realised or for import of fuel under the general norms, DFRC shall be issued with actual user condition for these inputs.

However, for fuel, the import entitlement may be transferred only to the companies which have been granted authorization to market fuels by the Ministry of Petroleum & Natural Gas. In cases where Standard Input Output Norms allow import of Acetic

Anhydride, Ephedrine and Pseudo Ephedrine, DFRC shall be issued provided these items are specifically deleted from the list of import items.

- DFRC will not be issued against SION which prescribe a prior import condition for inputs.
- DFRC shall be issued for import of inputs as per SION as indicated in the shipping bills. The validity of such licences shall be 24 months. DFRC and or the material(s) imported against it shall be freely transferable. However, DFRC with actual user condition or the material(s) imported against it shall not be transferable. The export products, which are eligible for modified VAT, shall be eligible for CENVAT credit/service tax credit. However, non-excisable, non-dutiable or non-CENVAT products, shall be eligible for drawback at the time of exports in lieu of additional customs duty to be paid at the time of imports under the scheme.
- The exporter shall be entitled for drawback benefits in respect of any of the duty paid materials, whether imported or indigenous, used in the export product as per the drawback rate fixed by Directorate of Drawback (Ministry of Finance). The drawback shall however be restricted to the duty paid materials not covered under SION.
- Import of goods, including those mentioned as restricted in ITC(HS) but excluding prohibited items, supplied free of cost, may be permitted for the purpose of jobbing without a licence/certificate/permission as per the terms of notification issued by Department of Revenue from time to time. Similarly, import of goods for carrying out repairs, re-conditioning, re-engineering, testing etc. shall be allowed as per the terms and conditions of the Customs notification even though the goods may be restricted for imports under the Exim Policy/ITC(HS) Classification of Imports and Exports Book.

6.7.3 Duty Entitlement Passbook Scheme (DEPB)

The objective of DEPB is to neutralise the incidence of Customs duty on the import content of the export product. The neutralisation shall be provided by way of grant of duty credit against the export product.

Salient Features of DEPB

- Under the DEPB, an exporter may apply for credit, as a specified percentage of FOB value of exports, made in freely convertible currency.
- The credit shall be available against such export products and at such rates as may be specified by the Director General of Foreign Trade by way of public notice issued in this behalf, for import of raw materials, intermediates, components, parts, packaging material etc.

6.7.4 Gems and Jewellery

Exporters of gems and jewellery are eligible to import their inputs by obtaining Replenishment (REP) Licences from the licensing authorities in accordance with the procedure specified in this behalf.

The following items, if exported, would be eligible for the facilities under these schemes:

- Gold jewellery, including partly processed jewellery and any articles including medallions and coins (excluding the coins of the nature of legal tender), whether plain or studded, containing gold of 8 carats and above;
- Silver jewellery including partly processed jewellery, silverware, silver strips and any articles including medallions and coins (excluding the coins of the nature of

legal tender and any engineering goods) containing more than 50% silver by weight;

- Platinum jewellery including partly processed jewellery and any articles including medallions and coins (excluding the coins of the nature of legal tender and any engineering goods) containing more than 50% platinum by weight.

6.8 CHAPTER-5: EXPORT PROMOTION CAPITAL GOODS SCHEME

The scheme allows import of capital goods for pre production, production and post production (including CKD/SKD thereof as well as computer software systems) at 5% Customs duty subject to an export obligation equivalent to 8 times of duty saved on capital goods imported under EPCG scheme to be fulfilled over a period of 8 years reckoned from the date of issuance of licence. Capital goods would be allowed at 0% duty for exports of agricultural products and their value added variants.

However, in respect of EPCG licences with a duty saved of Rs.100 crore or more, the same export obligation shall be required to be fulfilled over a period of 12 years.

In case CVD is paid in cash on imports under EPCG, the incidence of CVD would not be taken for computation of net duty saved provided the same is not Cenvated.

The capital goods shall include spares (including refurbished/reconditioned spares), tools, jigs, fixtures, dies and moulds. EPCG licence may also be issued for import of components of such capital goods required for assembly or manufacturer of capital goods by the licence holder.

Second hand capital goods without any restriction on age may also be imported under the EPCG scheme.

Spares (including refurbished/reconditioned spares), tools, refractories, catalyst and consumable for the existing and new plant and machinery may also be imported under the EPCG scheme.

However, import of motor cars, sports utility vehicles/all purpose vehicles shall be allowed only to hotels, travel agents, tour operators or tour transport operators whose total foreign exchange earning in current and preceding three licencing years is Rs 1.5 crores. However, the parts of motor cars, sports utility vehicles/all purpose vehicles such as chassis etc. cannot be imported under the EPCG Scheme.

6.9 CHAPTER- 6: EXPORT ORIENTED UNITS (EOUs), ELECTRONICS HARDWARE TECHNOLOGY PARKS (EHTPs), SOFTWARE TECHNOLOGY PARKS (STPs) AND BIO-TECHNOLOGY PARKS (BTPs)

Units undertaking to export their entire production of goods and services (except permissible sales in the DTA), may be set up under the Export Oriented Unit (EOU) Scheme, Electronic Hardware Technology Park (EHTP) Scheme, Software Technology Park (STP) Scheme or Bio-Technology Park (BTP) scheme for manufacture of goods, including repair, re-making, reconditioning, re-engineering, and rendering of services. Trading units, however, are not covered under these schemes.

Export and Import of Goods

- An EOU/EHTP/STP/BTP unit may export all kinds of goods and services except items that are prohibited in the ITC (HS). Export of Special Chemicals, Organisms, Materials, Equipment and Technologies (SCOMET) shall be subject to fulfillment of the conditions indicated in the ITC (HS).

- An EOU/EHTP/STP/BTP unit may import and/or procure from DTA or bonded warehouses in DTA/international exhibition held in India without payment of duty all types of goods, including capital goods, required for its activities, provided they are not prohibited items of import in the ITC (HS). Any permission required for import under any other law shall be applicable. The units shall also be permitted to import goods including capital goods required for the approved activity, free of cost or on loan/lease from clients. The import of capital goods will be on a self certification basis.
- State Trading regime shall not apply to EOU manufacturing units.
- EOU/EHTP/STP/BTP units may import/procure from DTA without payment of duty certain specified goods for creating a central facility which will be used by software units. These software units can be EOU/ DTA units who will use the facility for export of software.
- An EOU engaged in agriculture, animal husbandry, aquaculture, floriculture, horticulture, pisciculture, viticulture, poultry or sericulture may be permitted to remove specified goods in connection with its activities for use outside the bonded area.
- Gems & jewellery EOUs may source gold/silver/platinum through the nominated agencies also. Units obtaining gold/silver/platinum from the nominated agencies shall export gold/silver/platinum jewellery within 60 days from the date of release. This shall not, however, apply to outright purchase of precious metal from the nominated agencies.
- EOU/EHTP/STP/BTP units, other than service units, may export to Russian Federation in Indian Rupees against repayment of State Credit/Escrow Rupee Account of the buyer subject to RBI clearance, if any.
- Procurement and supply of spares and consumables required for the goods manufactured by the units may be allowed to be exported along with goods up to 1.5% of FOB value of exports. This shall, however, not count towards NFE calculation, for concessional rate DTA sales or for Income Tax exemption.
- Second hand capital goods without any age limit, may also be imported duty free.

Leasing of Capital Goods

An EOU/EHTP/STP/BTP unit may, on the basis of a firm contract between the parties, source the capital goods from a domestic/foreign leasing company without payment of customs/excise duty. In such a case, the EOU/EHTP/STP/BTP unit and the domestic/foreign leasing company shall jointly file the documents to enable import/procurement of the capital goods without payment of duty.

Net Foreign Exchange Earnings

EOU/EHTP/STP/BTP unit shall be a positive net foreign exchange earner. Net Foreign Exchange Earnings (NFE) shall be calculated cumulatively in blocks of five years, starting from the commencement of production.

Letter of Permission/ Letter of Intent and Legal Undertaking

On approval, a Letter of Permission (LOP)/Letter of Intent (LOI) shall be issued by the Development Commissioner/designated officer to EOU/EHTP/STP/BTP unit. The LOP/LOI shall have an initial validity of 3 years by which time the unit should have commenced production. Its validity may be extended further up to 3 years by the competent authority. However, proposals for extension beyond six years shall be considered in exceptional circumstances, on a case-to-case basis by the BOA. Once the unit commences production, LOP/LOI issued shall be valid for a period of 5 years

for its activities. This period may be extended further by the Development Commissioner for a period of 5 years at a time.

Investment Criteria

Only projects having a minimum investment of Rs.1 crore in plant and machinery shall be considered for establishment as EOUs under the scheme. This shall, however, not apply to existing units and units in EHTP/STP/BTP, Handicrafts/Agriculture/ Floriculture/Aquaculture/Animal Husbandry/Information Technology, Services, Brass hardware, handmade Jewellery and such other sectors as may be decided by the BOA. Sector-wise investment criteria shall be fixed by BOA.

6.10 CHAPTER-7: SPECIAL ECONOMIC ZONES

Special Economic Zone (SEZ) is a specifically delineated duty free enclave and shall be deemed to be foreign territory for the purposes of trade operations and duties and tariffs.

Goods and services going into the SEZ area from DTA shall be treated as exports and goods coming from the SEZ area into DTA shall be treated as if these are being imported.

SEZ units may be set up for manufacture of goods and rendering of services.

Export and Import of Goods

- SEZ units may export goods and services including agro-products, partly processed goods, sub-assemblies and components except prohibited items of exports in ITC (HS). The units may also export by-products, rejects, waste scrap arising out of the production process. Export of Special Chemicals, Organisms, Materials, Equipment and Technologies (SCOMET) shall be subject to fulfillment of the conditions indicated in the ITC (HS) Classification of Export and Import Items. SEZ units, other than trading/service unit, may also export to Russian Federation in Indian Rupees against repayment of State Credit/Escrow Rupee Account of the buyer, subject to RBI clearance, if any.
- SEZ unit may import/procure from the DTA without payment of duty all types of goods and services, including capital goods, whether new or second hand, required by it for its activities or in connection therewith, provided they are not prohibited items of imports in the ITC(HS). However, any permission required for import under any other law shall be applicable. Goods shall include raw material for making capital goods for use within the unit. The units shall also be permitted to import goods required for the approved activity, including capital goods, free of cost or on loan from clients.
- SEZ units may procure goods required by it without payment of duty, from bonded warehouses in the DTA set up under the Policy and/or under Section 65 of the Customs Act and from International Exhibitions held in India.
- SEZ units, may import/procure from DTA, without payment of duty, all types of goods for creating a central facility for use by units in SEZ. The Central facility for software development can also be accessed by units in the DTA for export of software.
- Gem & Jewellery units may also source gold/silver/platinum through the nominated agencies.
- SEZ units may import/procure goods and services from DTA without payment of duty for setting up, operation and maintenance of units in the Zone.

Approvals and Applications

Applications for setting up a unit in SEZ other than proposals for setting up of unit in the services sector (except software and IT enabled services, trading or any other service activity as may be delegated by the BOA), shall be approved or rejected by the Units Approval Committee within 15 days as per procedure indicated in Annexure to Appendix 14-II of Handbook (Vol-I). In other cases approval may be granted by the Board of Approval.

Proposals for setting up units in SEZ requiring Industrial Licence may be granted approval by the Development Commissioner after clearance of the proposal by the SEZ Board of Approval and Department of Industrial Policy and Promotion within 45 days on merits.

Entitlement for Supplies from the DTA

Supplies from DTA to SEZ shall be entitled for the following:

(a) DTA supplier shall be entitled for:

   (i) Drawback or DEPB in lieu of Drawback

   (ii) Discharge of Export performance, if any, on the supplier.

(b) SEZ units shall be entitled for:

   (i) Exemption from Central Sales Tax;

   (ii) Exemption from payment of Central Excise Duty on all goods eligible for procurement by the unit.

   (iii) Reimbursement of Central Excise Duty, paid on bulk tea procured from the licenced auction centres by the Development Commissioner of concerned zone as long as levy on bulk tea in this regard is in force.

   (iv) Reimbursement of Duty paid on fuels or any other goods procured from DTA as per the rate of drawback notified by the Directorate General of Foreign Trade from the date of such notification.

(c) Supplier of precious and semi-precious stones, synthetic stones and processed pearls from Domestic Tariff Area to the units situated in SEZ shall be eligible for grant of Replenishment Licenses at the rates and for the items mentioned in the Handbook (Vol. I).

(d) The entitlements under paragraphs (a) and (b) (ii) above shall be available provided the goods supplied are manufactured in India.

6.11 CHAPTER-7A: FREE TRADE AND WAREHOUSING ZONES

The Free Trade and Warehousing Zones (FTWZ) shall be a special category of Special Economic Zones with a focus on trading and warehousing. With the purpose of making India into a global trading-hub, a new scheme to establish Free Trade and Warehousing Zones has been introduced. The Scheme seeks to create trade-related infrastructure so as to facilitate the import/ export of goods and services.

Such Zones will have the freedom to carry out trade transactions in free currency. Hundred percent FDI would be permitted for development and establishment of infrastructural facilities in these zones. Each zone would have minimum outlay of Rs.100 crore and five lakh sq. mts. of built up area. Units functioning from these zones would qualify for all other benefits as are applicable to SEZ units.

Entitlement of units under FTWZ

- Income Tax exemption as per 80 IA of the Income Tax Act.
- Exemption from Service Tax.
- Free foreign exchange currency transactions would be permitted.
- Other benefits mutatis mutandi as applicable to units in SEZs.

6.12 CHAPTER-8: DEEMED EXPORTS

Deemed Exports refers to those transactions in which the goods supplied do not leave the country and the payment for such supplies is received either in Indian rupees or in free foreign exchange.

The following categories of supply of goods by the main/ sub-contractors shall be regarded as "Deemed Exports" under this Policy, provided the goods are manufactured in India:

(a) Supply of goods against Advance Licence/Advance Licence for annual requirement/DFRC under the Duty Exemption/Remission Scheme;

(b) Supply of goods to Export Oriented Units (EOUs) or Software Technology Parks (STPs) or Electronic Hardware Technology Parks (EHTPs) or Bio Technology Parks (BTP);

(c) Supply of capital goods to holders of licences under the Export Promotion Capital Goods (EPCG) scheme;

(d) Supply of goods to projects financed by multilateral or bilateral agencies/funds as notified by the Department of Economic Affairs, Ministry of Finance under International Competitive Bidding in accordance with the procedures of those agencies/ funds, where the legal agreements provide for tender evaluation without including the customs duty;

(e) Supply of capital goods, including in unassembled/ disassembled condition as well as plants, machinery, accessories, tools, dies and such goods which are used for installation purposes till the stage of commercial production and spares to the extent of 10% of the FOR value to fertiliser plants.

(f) Supply of goods to any project or purpose in respect of which the Ministry of Finance, by a notification, permits the import of such goods at zero customs duty.

(g) Supply of goods to the power projects and refineries not covered in (f) above.

(h) Supply of marine freight containers by 100% EOU (Domestic freight containers–manufacturers) provided the said containers are exported out of India within 6 months or such further period as permitted by the Customs; and

(i) Supply to projects funded by UN agencies.

Benefits for Deemed Exports

Deemed exports shall be eligible for any/all of the following benefits in respect of manufacture and supply of goods qualifying as deemed exports subject to the terms and conditions as given in Handbook (Vol.1):

- Advance Licence for intermediate supply/deemed export/DFRC/DFRC for intermediate supplies.
- Deemed Export Drawback.
- Exemption from terminal excise duty where supplies are made against International Competitive Bidding. In other cases, refund of terminal excise duty will be given.

6.13 ANNUAL SUPPLEMENT 2006

Introduction

This Annual Supplement is the second in the series supplementing the Foreign Trade Policy 2004-09. In line with Government's promise of a stable Foreign Trade Policy regime, this year's supplement (in the same way as last year) does not alter the broad contours of the main Policy. However, recognizing the dynamic nature of international trade and the consequent need for periodic realignment of our international trade strategies, contemporary issues have to be addressed from time to time, and this is what this initiative does.

The changes in the Annual Supplement resulted from the inputs received through interactive sessions with various Export Promotion Councils, Industry organizations, Apex Chambers of Commerce & Industry and sister Departments of Government. The Board of Trade has emerged as an effective institutional mechanism and idea-generator for the FTP. A number of useful inputs have been obtained through the Working and Study Group reports and brain storming sessions of the Board of Trade.

Trade Performance

When the Government launched the new Foreign Trade Policy in August 2004, it set out with the ambitious objective of doubling India's percentage share of global merchandize trade within five years. Merchandize trade in the very first year of the policy period grew at the rate of 26%. This year's export figures are unprecedented. I am delighted to share with you that merchandize exports have crossed the 'magic figure' of 100 billion dollars. In fact, they have touched the 'auspicious figure' of 101 billion dollars. The annual growth rate is 25%.

Our imports have grown 32%, and stand at 140 billion dollars – but 43 billion is our oil bill. Thus, our non-oil imports are 97 billion dollars, a full 4 billion lower than our exports. On the non-oil front, therefore, we have a positive balance of trade.

Sectoral Export Growth

Exports from many sectors have surpassed our expectations. Project goods exports grew at the rate of 173%. Exports of non-ferrous metals, guar gum meal, computer software in physical form, rice, pulses, dairy products, all recorded a growth surpassing 50%. Commodities like man-made staple fibres, cosmetics and toiletries, iron-ore, coffee, processed food and transport equipment grew at the rate above the average, i.e. more than 25% during this period.

Market Share in Different Countries

India is steadily increasing its share in important markets. Growth in exports to UK has been 30%, to Singapore (with which we implemented the CECA) 54%. India's exports to South Africa grew at 44% while for China the growth rate is 35%. We shall be releasing detailed statistics on all this in the form of a Ready Reckoner next month, after exact figures come in.

Focus Product' and 'Focus Market' Schemes

The other chief objective of the Foreign Trade Policy was providing a thrust to employment generation, particularly in semi-urban and rural areas. We are therefore introducing two new schemes to nurture this. We realized that certain industrial products can generate large employment per unit of investment compared to other products, and promoting their export would in turn give a thrust to their manufacture. This realization led to the formulation of the 'Focus Product Scheme' which aims to promote such exports.

The Scheme allows duty credit facility at 2.5% of the FOB value of exports on fifty percent of the export turnover of notified products, such as value added fish and leather products, stationery items, fireworks, sports goods, and handloom & handicraft items.

It is also necessary to penetrate markets, especially to which our exports are comparatively low. Some of our competitors are aggressively 'occupying space' in Latin America, in Africa and other destinations which Indian exporters have unfortunately been neglecting, perhaps due to high freight costs & undeveloped networks. But these are the markets of the future, and it is of strategic necessity that we enlarge our market share here.

For this we have a 'Focus Market Scheme' which allows duty credit facility at 2.5% of the FOB value of exports of all products to the notified countries.

The scrip and the items imported against it for both these schemes would be freely transferable.

These two Schemes would replace the Target Plus Scheme.

To take the benefits of foreign trade further to rural areas, the Vishesh Krishi Upaj Yojana is being expanded to include village industries based products for export benefits, and it is therefore renamed as Vishesh Krishi Upaj aur Gram Udyog Yojana – a rather long name, but one which adequately reflects its intent and coverage.

Promoting Services Export

While Services account for 52% of our GDP, our total services trade – exports & imports – totals more than 100 billion dollars. Expansion of the Services sector is vital for providing jobs to urban educated youth. In the WTO too we are actively engaged in the Services negotiations. A number of features have been added in the Served from India Scheme to encourage service exports.

The Scheme ill now allow transfer of both the scrip and the imported input to the Group Service Company, whereas earlier transfer of imported material only was allowed.

Duty Free Import Authorisation Scheme

The salient features of the Advance Licensing scheme (which allows imports before exports) and Duty Free Replenishment Certificate (which allows transferability of import entitlements) have been clubbed to evolve a new scheme named Duty Free Import Authorisation Scheme. The new scheme offers the facility to import the required inputs before the exports. It allows transferability of scrip once the export obligation is complete.

Imports made under this authorisation will be exempt from payment of basic custom duty, additional customs duty, education cess, anti-dumping duty and safeguard duty, if any. The scheme will come into effect from 1st May, 2006.

Service Tax and Fringe Benefit Tax

The incidence of un-rebated Service Tax and Fringe Benefit Tax on exports will be factored in the various duty neutralisation and remission schemes.

EPCG Scheme

Government has introduced certain flexibilities in the conditions relating to maintenance of average export performance under the EPCG Scheme, and also in the extension of export obligation period by 2 years, based on certain conditions.

Interest Payment on Refunds

It has been decided that interest for delayed payment of refunds would be made by the Government to ensure accountability and cut delays.

Trade Facilitation

Clearance of import or export consignments are held up for want of test reports of samples drawn at the time of import or export. Therefore, to accelerate cargo clearances, it has been decided to allow pre-shipment test certificates from accredited international agencies in lieu of demanding only test reports.

6.14 ANNUAL SUPPLEMENT 2007

A comprehensive Foreign Trade Policy (FTP) for 2004-09 was announced on 31st August, 2004 and its Annual Supplement for the year 2007-08 was released on 19th April, 2007. The basic objective of this policy is to double the merchandise exports by 2009 and to make exports an effective instrument of economic growth by giving thrust to employment generation particularly in semi urban and rural areas through a number of policy initiatives. These include simplification of procedures, reduction in transaction cost, neutralisation of incidence of levies and duties on inputs used for exports and development of global hubs for manufacturing, trading and services. Keeping in view the interests of the domestic entrepreneur, farmers, traders as well as India's international commitments and bilateral treaties, amendments/ changes in policy are made from time to time as and when these become necessary in public interest.

Stability of policy regime has yielded positive results and India's merchandise exports is expected to surpass the objective of doubling by 2009. Some of the major initiatives taken recently, including measures announced in the Annual Supplement to FTP in April, 2007 are given below:

Focus Market Scheme and Focus Product Scheme

The Focus Market Scheme was introduced with effect from 1.4.2006 with a view to offsetting the high freight cost and other disabilities faced in accessing select international markets. The scheme allowed duty credit facility @ 2.5 per cent of the FOB value of exports of all products to the notified countries. In order to give further thrust to the Focus Market Scheme, 16 additional markets have been notified/ clarified during the year which shall be entitled for duty credit scrip on export with effect from 1.4.2007. In total, 57 markets are covered under the scheme. The scheme had enhanced India's export competitiveness in these regions.

The Focus Product Scheme was introduced with effect from 1.4.2006. It provides incentives for export of products which have high employment potential in rural and semi urban areas with a view to offset the inherent infrastructure bottlenecks and other associated costs involved in marketing of such products. The scheme allowed duty credit facility @ 1.5 per cent of the FOB value of exports of notified products, such as value added fish and leather products, stationery items, fireworks, sports goods, handloom products bearing handloom mark and handicraft items. In order to give further thrust to the Focus Product Scheme, 19 additional products have been notified/ clarified during the year which shall be entitled for duty credit scrip on export with effect from 1.4.2007. In total, 103 products are covered under the scheme. In addition to this, 2 more products have also been added/ notified during the year under the High Tech Products Scheme which is a part of Focus Product Scheme.

The scrip and the items imported against the Focus Market Scheme and Focus Product Scheme are eely transferable. The duty credit, thus obtained may be used for import of inputs or goods including capital goods provided the same is freely importable under ITC (HS), except a small list of items contained in Appendix 37B.

Vishesh Krishi and Gram Udyog Yojna

With a view to promote employment generation in rural and semi urban areas, the export of Gram Udyog products i.e. village and cottage industry products has been incentivised by awarding a duty credit scrip @ 5 per cent of FOB value of exports under the expanded Vishesh Krishi and Gram Udyog Yojna. However, the duty credit scrip is being granted only at a reduced rate of 3.5 per cent of the FOB value of exports, in cases where the exporter has availed the benefits under Chapter 4 of this Policy, for import of agriculture inputs (other than catalysts, consumable and packing materials) relating to the export item under this scheme. The certificate/scrip can be used for import of all freely importable items, except such items as notified by the government in Appendix 37B. The scrip and the items imported against it are freely transferable. In order to give further thrust to the scheme, 153 new products have been notified to be eligible for benefit under the Scheme w.e.f. 1.4.2007. In terms of value of duty credit scrip issued, there has been an increase to the extent of Rs. 299.64 crore during 2006-07 over the previous year, thus registering an annual growth rate of 113.564 per cent.

Exporters have the option to avail of the benefits in respect of the same exported product(s) under only one of the above three schemes i.e. the Focus Market Scheme, the Focus Product Scheme or the Vishesh Krishi and Gram Udyog Yojna.

Gems & Jewellery Sector

With a view to give competitive edge and also to sharpen the core strength of the promising gems and jewellery sectors and the handicraft sector, duty free access to tools, machinery and equipment has been provided. Export of rhodium polished silver jewellery has been encouraged further by way of enhanced entitlement of duty free consumables to 3% which would compensate the price rise of rhodium, an essential ingredient for polishing. To reduce the transaction cost for the diamond sector, testing facility at Dubai has been incorporated in the list of certifying agencies.

Duty Neutralisation Scheme

Developers and Co-Developer of Special Economic Zones have been notified for benefits under all duty neutralisation schemes like Duty Entitlement Pass Book (DEPB), Duty Free Import Authorisation Scheme (DFIA) and Advance Authorisation Schemes.

Duty Free Import Authorisation Scheme (DFIA)

A new Scheme called DFIA was made effective from 1.5.2006. It offers duty free imports for exports and transferability of scrip or the imported inputs, once the export obligation is completed. This scheme has undergone changes, making it more user friendly both in terms of procedural simplification and reduce interface with the government authorities.

Duty Entitlement Pass Book (DEPB) Scheme

The scheme shall continue till 31.3.2008. Facility of Brand Rate for customs duty on fuel, which remained un-rebated under the scheme and the 4 per cent Special Additional Duty was introduced under the scheme. DEPB rates of 9 product sectors were enhanced by 3 per cent and for the rest by 2 per cent w.e.f 1.4.07 so as to adjust for reduced value addition, rupee appreciation etc. The enhanced rates for 47 entries were slightly reduced w.e.f. 9.10.2007, though still higher than the rates which were prevalent before 1.4.2007. Formulation of a new scheme for rebating the State Indirect Taxes on exports is under consideration.

Service Tax on Exports

Government has announced in principle, that exporters should only export goods and not the taxes and duties thereon. In line with this, services rendered abroad and charged on exports from India, would be exempted from Service Tax. The Department of Revenue has been requested to expedite the issuance of corresponding Notification.

Service tax on services rendered in India and utilized by exporters would be exempted/remitted. While the Department of Revenue have issued Notification allowing refund of service tax on 10 services, remission mechanism for the balance services is being institutionalized, by way of working out of modalities.

Trade Facilitation Measures

- Duty free import of samples up to Rs. 75,000/- (presently Rs. 60,000/-) has been allowed for all exporters.
- With a view to reduce transaction time and cost, the Requirement of double verification process at customs under EPCG and Advance Authorization scheme has been done away. Now onwards, if required, random verification will be resorted to.
- Application forms have been down-sized thereby reducing transaction time.
- With a view to ensure greater predictability and stability in determining direct tax liability of domestic manufacturers, the word 'manufacturing' is being clearly defined in the new Income Tax Code.

Export Promotion Capital Goods (EPCG) Scheme

- To encourage the exports from the tiny and cottage sector, export obligation period is raised to 12 years.
- Service sector is required to maintain the average level of exports to avail new EPCG.
- Provision is made for waiver of export obligation, if because of Force Majeure reasons, the exporter is unable to fulfil export obligation.
- Issue of EPCG for import of spares, tools, spare refractory is also allowed for existing imported plant and machinery (though not imported under EPCG cover).

Export Oriented Units (EOUs)/Electronic Hardware Technology Park (EHTP)/ Software Technology Park (STP)/Biotechnology Park (BTP)

- Limit prescribed for procurement and export of spares/components under the Foreign Trade Policy has been enhanced from 1.5 per cent of FOB value of exports to 5 per cent, subject to the condition that it shall not count for NFE and direct tax benefits. The earlier condition of export of spares/components within the warranty period of the export article has been done away with.
- The requirement of permission from the Development Commissioner/Custom Authorities when part of the production process is sub-contracted abroad and goods are exported from the premises of the sub-contractor abroad, has been removed.
- Units having Premier Trading House status have been allowed the option to undertake DTA sales on monthly basis, besides quarterly, half-yearly or annual basis, as allowed to other units.
- Detailed Guidelines for conversion of DTA units into EOU/EHTP/STP/BTP unit have been incorporated in the Appendix 14-I-O in Handbook of Procedures.

- The general provisions in para 9.3 and 9.4 of Handbook of Procedures, regarding applications received after expiry of prescribed date of receipt and supplementary claims have been made applicable for CST refunds to these units.

Deemed Export

The time limit for claiming deemed export benefits has been enhanced from 6 months to 12 months from the date of payment. These claims can be filed Invalidation Letter/ARO wise, against individual licences, within the time limit as specified above. 100% TED refund will be allowed after 100% surplus have been made physically and payment received up to 90%.

Electronic Data Interchange (EDI) Initiatives

The following Electronic Data Interchange (EDI) initiatives are being undertaken with a view to simplify procedures relating to international trade and to put in place an exporter friendly regime for obtaining import authorizations under various Export Promotion Schemes:

- Bring all the community partners dealing with international trade on an EDI enabled platform to reduce transaction costs.
- Extend the online web enabled application procedure for issue of licence/ authorization to all categories of licences/authorization;
- Consolidate the message exchange system with Customs and extend its scope to cover all shipping Bills relating to different export promotion schemes.
- Doing away with the manual double verification of the authorization system by way of online validation with the Customs Authority, initially for the ports having EDI facility.

Grievance Redressal Committee

A Grievance Redressal Committee (GRC) headed by the Additional Secretary, Department of Commerce has since been set up to handle grievances of exporters against decisions of the DGFT relating to Trade and Policy. The Exporters shall send their grievances to the Committee in Electronic form, besides all other normal modes. Representations to the Committee may be forwarded by post addressed to the Chairman of the Committee. The application of the aggrieved party must contain the name of the applicant, IEC No., address (with contact Nos. and e-mail ID), the details of reference earlier made to DGFT, if any and the grounds in support of grievances, in brief. Any decision relating to Foreign Trade i.e. decisions of ALC, EPCG, PIC, PRC, EPZ/EOU etc. i.e. all non-statutory matters relating to Foreign Trade Policy which has caused grievances to the exporter/importer will be heard by the Committee. Thereafter, Grievance Committee functioning in DGFT may be approached in the first instance for redressal of the grievances. The petitioner may thereafter refer the matter to GRC if still aggrieved with the decision of the Grievance Committee of DGFT. The Committee would also afford a personal hearing to the petitioner to redress the grievance by considering applications in its meetings. The petitioners would be able to see the minutes of the meeting on the website of the Department of Commerce (http://commerce.gov.in). During the period April-December 2007, the Grievance Redressal Committee met 6 (six) times wherein 85 cases were considered and disposed off.

Important Policy Decisions taken during the year (after 19.4.2007)

- Import of reconditioned components of computer classified under Exim Code No.847330 has been restricted. [Notification No.8 dated 11.6.2007]
- Import of power tillers allowed subject to emission norms notified by Department of Road Transport and Highways. [Notification No.11 dated 3.7.2007]

- Import of rice in India allowed subject to the condition that the exporter is able to furnish a certificate from the concerned Government authorities that the exported rice is GM free. [Notification No.13 dated 10.7.2007]
- Import of dolomite and limestone of a size higher than one cubic feet has been restricted. [Notification No.17 dated 26.7.2007]
- MMTC Limited and TANCEM Limited were permitted to import cement without standard mark from such foreign manufacturers who have applied for registration with Bureau of Indian Standards. [Notification No.23 dated 14.8.2007]
- Import of wheat has been made free till further orders. [Notification No.35 dated 8.10.2007]
- Import of palm oil through port in Kerala has been restricted. [Notification No.39 dated 16.10.2007]
- Import prohibition on processed pig bristles has been removed. [Notification No.50 dated 14.11.2007]
- In addition to import of eligible shooters, import of 0.177 bore air guns and air pistols allowed freely by National Rifle Association of India (NRAI). [Notification No.52 dated 21.11.2007]
- The list of items where mandatory BIS standards is required for imports has been amended. The present list includes 68 items. [Notification No.53 dated 21.11.2007]
- Conditions have been imposed on import of certain chemicals as per Chemical Weapon Convention [Notification No.59 dated 30.11.2007].

6.15 ANNUAL SUPPLEMENT 2008-09 TO FTP: 2004-09

Duty Entitlement Passbook Scheme (DEPB)

To impart continuity and stability to our foreign trade regime, DEPB scheme is being extended till May 2009.

Refund of Service Tax

The Government has already announced refund of service tax on almost all the services, which are directly relatable to export production and supply. Some services related to export, which do not attract service tax have also been clarified through a Circular. A few remaining issues regarding refund of service tax will also be resolved shortly.

Income Tax on EOUs

Income tax benefit to 100% EOUs under Section 10B of I.T. Act, being extended by Govt. for one more year, beyond 31.3.2009.

Sectoral Initiatives

- ***Hi-Tech Products Export Promotion Scheme:*** The government has introduced the Hi-Tech Products Export Promotion Scheme in April 2008. Besides, exporters/associations would be entitled to use Market Access Initiatives (MAI) & Market Development Assistance (MDA) schemes to promote electronics and IT hardware exports. Hi-tech electronics and IT hardware products would also be considered for inclusion in the High-Tech Products Export Promotion Scheme. From April 1, 2008, units undertaking to export their entire production of goods and services – except permissible sales in the domestic tariff area (DTA) – have been allowed to be set up under the Export-Oriented Unit (EOU) scheme, the

Electronic Hardware Technology Park (EHTP) Scheme, the Software Technology Park (STP) Scheme or the Bio-Technology Park (BTP) Scheme for manufacturing goods, including repair, re-making, reconditioning, re-engineering and rendering of services. Trading units are not covered under these schemes. Such units have also been allowed to procure from the DTA certain specified goods to create a central facility without paying any duty.

- ***IT hardware sector as Special focus initiative:*** Specific items to be included for benefits under High Tech Product Scheme. There will also be earmarked funds for this sector under the MDA and MAI Schemes.
- Setting up a new Export Promotion Council for Telecom Sector to provide institutional support to exports from telecom sector.
- Export of Toys & Sports Goods will be given an additional duty credit scrip @ 5% (in addition to the existing benefits under Focus Product scheme). Separate funds for market promotion activities will also be given for promoting these exports under ongoing MDA Scheme and MAI Scheme.
- Additional duty credit scrip of 2.5% over and above the normal benefit available under VKGUY, for export of certain flowers, vegetables and fruits.

Relief to Sectors affected by Rupee Appreciation

(a) Interest subvention provided last year to sectors affected by rupee appreciation and to SMEs, has been extended by one more year.

(b) Reduced average export obligation under EPCG, for sectors, which have witnessed decline in exports in the previous year.

Promotion of High Value Added Manufactured Products

An enhanced duty credit scrip of 2.5% (instead of the normal 1.25% under FPS) would be allowed for export of High value added manufactured products. The list of products will be notified separately.

Export Promotion Capital Goods Scheme (EPCG)

(a) The customs duty payable under EPCG Scheme has been reduced from 5% to 3%.

(b) To improve export competitiveness of Indian exports, all exports made towards fulfillment of export obligation under EPCG scheme will now be eligible for incentives/rewards under promotional schemes.

(c) Average export obligation under EPCG for Premier Trading Houses shall, as an option, be calculated, based on the average of last 5 year's export, instead of the present 3 years.

Focus Market & Product Schemes

(a) Coverage of FMS has been increased and additional 10 countries have been included. These are Mongolia, Bosnia-Herzegovina, Albania, Macedonia, Croatia, Honduras, Djibouti, Sudan, Ghana and Colombia.

(b) FMS/FPS would also be calibrated, so that products of general high export intensity, presently not covered under FPS, but which have low penetration in countries, not covered under FMS, would be considered for export incentives as a focus product for that particular country.

Substantative Measures taken to Facilitate Exports

(a) To ensure that terminal excise duty and CST refund is made to the exporters in time, it has been decided that interest @ 6% per annum shall be paid to the exporter, in case refund is not made within one month of the due date. This

interest on delayed refund will be paid on all such claims that have become due on or after 1.4.2007.

(b) The facility of export on consignment basis has been extended to the export of coloured gem stones.

(c) In case of textile and granite sector EOUs, payment of only excise duty on DTA sale, in case the use of duty paid imported inputs is up to 3% of the FOB value of exports.

(d) Any waste or scrap or remnant generated during manufacturing or processing activities of an SEZ Unit/Developer/Co-developer to be disposed in DTA freely, subject to payment of applicable Customs Duty.

(e) Withdrawal of the requirement of submission of non-availment of MODVAT certificate in case of quantity based advance licence issued prior to 1.4.2002. This step is likely to lead to closure of approximately 7000 old advance licences.

(f) Surat Hira Bourse has been recognized as port of export for jewellery, in addition, to the existing facility for export diamonds from the Bourse.

(g) A few additional ports have been included under Export Promotion Schemes. This will help in reducing costs and adhering to delivery schedules. Some more ports are also under consideration.

Measures to Reduce Transaction Cost to Exporters

(a) Advance Authorisation Scheme and EPCG Scheme will be EDI enabled through the electronic message exchange with effect from 1.7.2008. This will do away with the present requirement of physical verification and registration at Customs end.

(b) W.e.f. 01.01.2009, all existing EDI ports will be treated as a single port and there will be no requirement of TRA under Advance Authorisation Scheme.

(c) Payment of duty under EPCG scheme through debit of duty credit scrips under the promotional schemes or DEPB w.e.f. 1.1.2009.

(d) Application fee for duty credit scrips and for EPCG Authorisations reduced from Rupees 5 per thousand to Rupees 2 per thousand. The application fee for Importer-Exporter Code Number has been reduced from Rupees 1000 to Rupees 250.

(e) Reduction of fee in case of supplementary claims from 10% to 2%.

Procedural Simplification

(a) EOUs shall be allowed to pay excise duty on monthly basis, instead of the present system of paying duty on consignment basis, subject to conditions/documentation to be notified by Dept. of Revenue.

(b) Prorata enhancement/reduction in CIF value or duty saved amount beyond 10% has been allowed under EPCG scheme, by Regional Authorities under DGFT.

(c) In respect of duty free import of R&D equipment, units not registered with Central Excise will be allowed to give installation certificate issued by an independent Chartered Engineer in place of excise authorities.

(d) Certificate of Registration as Exporter of Spices (CRES) issued by Spices Board shall be treated as Registration-Cum-Membership Certificate (RCMC) for all purposes under this Policy.

(e) Central Excise to issue installation certificate under EPCG Scheme within 30 days of intimation by the exporter.

(f) To facilitate faster clearance of deemed export benefits, Central Excise to endorse supply invoice within 21 days of supply.

(g) Split-up facility under DFIA Scheme introduced.

(h) Export of sawn timber processed from imported logs made easier from select Customs ports.

(i) The limit of duty free import of samples has been increased from Rs.75, 000 to Rs.1, 00,000.

(j) The time period for re-import of branded jewellery remaining unsold, has been extended from 180 days to 365 days.

(k) Value of jewellery parcels, through Foreign Post Office, raised from US$ 50,000 to US$ 75,000.

Check Your Progress

1. What is the major change in India's Exim Policy during the last 60 years?

....

....

2. What is the main legislation concerning the foreign trade in India?

....

....

6.16 LET US SUM UP

India's import substitution and inward-looking policy regime resulted in high tariffs on many products and creation of non-tariff barriers (NTBs). Hence, reduction and rationalization of tariffs and removal of NTBs has been an integral part of India's trade policy since 1991. India has taken major steps towards trade liberalisation since 1991, partly on its own initiative and partly from its commitments to WTO.

In India, the main legislation concerning foreign trade is the Foreign Trade (Development and Regulation) Act, 1992. With economic reforms, globalisation of the Indian economy has been the guiding factor in formulating the trade policies. The reform measures introduced in the subsequent policies have focused on liberalization, openness and transparency. They have provided an export friendly environment by simplifying the procedures for trade facilitation. The announcement of a new Foreign Trade Policy for a five year period of 2004-09, replacing the hitherto nomenclature of EXIM Policy by Foreign Trade Policy (FTP) is another step in this direction. It takes an integrated view of the overall development of India's foreign trade and provides a roadmap for the development of this sector. A vigorous export-led growth strategy of doubling India's share in global merchandise trade (in the next five years), with a focus on the sectors having prospects for export expansion and potential for employment generation, constitute the main plank of the policy. All such measures are expected to enhance India's international competitiveness and aid in further increasing the acceptability of Indian exports. The policy sets out the core objectives, identifies key strategies, spells out focus initiatives, outlines export incentives, and also addresses issues concerning institutional support including simplification of procedures relating to export activities.

The average tariff on consumer goods in 1997-98 was reduced to 25 percent as against 153 percent in 1990-91. The 2000-2001 budget reduced the peak rate to 38.5 percent. However, the additional special duty and countervailing duties add up and increase the tariff. Thus, simply comparing the peak rates will not give a real picture of trade restrictions. Though the peak rate is used as a guide for imposing tariff, applied tariff

can be much higher but below the bound rates. India's applied rates on several items are still very high compared to the ASEAN countries. Though policymakers have mentioned on several occasions inside and outside the Parliament that India's tariff will be similar to ASEAN very soon, with the present tariff structure, it is very difficult to expect that it would happen that soon. India has bound 68 percent of its tariff lines compared to 6 percent prior to the UR. All agricultural tariff lines and 62 percent of the tariff lines of industrial goods are bound. Though at present, the applied rates are below the bound levels, producer lobby may put pressure at any time on the Government to impose tariff very close to the bound rate. If that happens, this would be equivalent to the previous 'licence raj' system.

6.17 LESSON END ACTIVITY

Identify and discuss the major changes in India's foreign trade policy that have been adopted after independence.

6.18 KEYWORDS

Exim Policy: Policy related to commerce.

FTP: Foreign Trade Policy

Import Barrier: Any regulation or policy that restricts international trade.

Export Promotion: A strategy for economic development that stresses expanding exports, often through policies to assist them such as export subsidies, etc.

6.19 QUESTIONS FOR DISCUSSION

1. Discuss the new schemes initiated in the foreign trade policy, 2004.
2. What are the strategies to achieve the objectives of the FTP 2004-09?
3. Describe the features of "Serves from India Scheme".
4. What are the main features of the Foreign Trade Policy (Annual Supplement), 2008?

Check Your Progress: Model Answer

1. ***Major Change in India's Exim Policy During the Last 60 Years:*** For almost half a century, India maintained one of the restrictive trade regimes in the world. It imposed a system of high tariffs and stiff non-tariff barriers such as licensing and quotas, which virtually closed the economy from the international trade arena. India implemented economic reform since the middle of 1991, and has made drastic changes in trade policy to reorient itself to integrate with the global economy.
2. In India, the main legislation concerning foreign trade is the Foreign Trade (Development and Regulation) Act, 1992. With economic reforms, globalisation of the Indian economy has been the guiding factor in formulating the trade policies. The reform measures introduced in the subsequent policies have focused on liberalization, openness and transparency. They have provided an export friendly environment by simplifying the procedures for trade facilitation.

6.20 SUGGESTED READINGS

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LESSON

7

CHANGES IN THE GLOBAL ECONOMY AND ECONOMIC REFORMS

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7.17 Suggested Readings

7.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- Dynamic environment of international business
- Impact of economic reform on international business

7.1 INTRODUCTION

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

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

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

Figure 7.1 shows the relationship between the company's external environment – physical, societal and competitive and its influences on firms operations. The conduct of international operation depends on companies' objectives and the means with which they carry them out.

Figure 7.1: International Business Operations and Influence

To operate internationally, a company should consider its mission (what it will seek to do and become over the long term), its objectives (specific performance targets to fulfill its mission) and strategy (the means to fulfill its objectives).

7.2 CHANGES IN GLOBAL ECONOMY AND ECONOMIC REFORMS

Our review of the classical trade theories of Smith, Ricardo, and Heckscher-Ohlin showed that, in a world without trade barriers, trade patterns are determined by the relative productivity of different factors of production in different countries. Countries will specialize in products that they can make most efficiently, while importing products that they can produce less efficiently.

Let us look at the political reality of international trade. The political reality is that while many nations are nominally committed to free trade, they tend to intervene in international trade to protect the interests of politically important groups.

When governments intervene, they often do so by restricting imports of goods and services into their nation, while adopting policies that promote exports. Normally their moves are to protect domestic producers and jobs from foreign competition while increasing the foreign market for products of domestic producers.

7.3 GOVERNMENT'S INTERFERENCE WITH INTERNATIONAL TRADE

The government's interference with international trade for whatever motivations, creates barriers to trade. These barriers can be in different forms, but they generally fall into three distinct categories:

- ***Tariff barriers:*** Tariffs were originally intended to raise revenues for the government. However, they are now commonly used as a form of protectionism-to restrict imports to protect domestic industry or to restrict exports to preserve national endowments.
- ***Non-tariff barriers:*** Non-tariff barriers are restrictions arising from measures such as licensing, product testing, certifications, procedural hurdles, etc.
- ***Quota restrictions:*** Quota restrictions mean explicit limit (usually measured by volume or sometime by value) on the amount of a particular product that can be imported or exported during a specified time period.

Quotas are a specific form of non-tariff barriers. A quota may be applied on a selective basis, with varying limits set according to the country of origin. It may also be applied on a global basis, which only specifies the total limit and thus leads to benefit the more efficient suppliers.

7.4 REVISED CASE FOR FREE TRADE

The strategic trade policy arguments of the new trade theorists suggest an economic justification for government intervention in international trade.

There are two components to the strategic trade policy argument. First, it is argued that by appropriate actions, a government can help raise national income if it can somehow ensure that the firm or firms to gain first-mover advantages in such an industry are domestic rather than foreign enterprises. Thus, according to the strategic policy argument, a government should use subsidies to support promising firms that are active in newly emerging industries.

The second component of the strategic trade policy argument is that it might pay government to intervene in an industry if it helps domestic firms overcome the barriers to entry created by foreign firms that have already reaped first-mover advantages. This argument underlies government support of Airbus Industries, Boeing's major competitor.

This justification challenges the rationale for unrestricted free trade found in the work of classic trade theorists such as Adam Smith and David Ricardo. In response to this challenge to economic orthodoxy, a number of economists-including some of those responsible for the development of the new trade theory such as Paul Krugman of MIT-have been quick to point out that although strategic trade policy looks nice in theory, in practice it may be unworkable. This response to the strategic trade policy argument constitutes the revised case for free trade.

- ***Retaliation and Trade War:*** Krugman argues that a strategic trade policy aimed at establishing domestic firms in a dominant position in a global industry is a

beggar-thy-neighbour policy that boosts national income at the expense of other countries. A country that attempts to use such policies will probably provoke retaliation. In many cases, the resulting trade war between two or more interventionist governments will leave all countries involved worse off than if a hands-off approach had been adopted in the first place.

- ***Domestic Politics:*** Governments do not always act in the national interest when they intervene in the economy; politically important interest groups often influence them. Thus, a further reason for not embracing strategic trade policy, according to Krugman, is that such a policy is almost certain to be captured by special interest groups within the economy, who will distort it to their own ends.

- ***Development of the World Trading System:*** There are strong economic arguments for supporting unrestricted free trade, while many governments have recognized the value of these arguments, they have been unwilling to unilaterally lower their trade barriers for fear that other nations might not follow suit. Consider the problem that two neighbouring countries, say France and Italy, face when considering whether to lower their trade barriers to trade between them. In principle, the government of Italy might be in favour of lowering trade barriers, but it might be unwilling to do so for fear that France will not do the same. Instead, the government might fear that the French will take advantage of Italy's low barriers to enter the Italian market, while at the same time continuing to shut Italian products out of their market through high trade barriers. The French government might feel that it faces exactly the same dilemma. The essence of the problem is a lack of trust. Both governments recognize that their respective nations will benefit from lower trade barriers between them, but neither government is willing to lower barriers for fear that the other might not follow.

Such a deadlock can be resolved if both countries negotiate a set of rules to govern-border trade and lower trade barriers. But in order to monitor that the governments are following the trade rules, both the governments could set up an independent body whose function is to act as a referee and impose sanctions on a country if it does cheat in the trade game.

While it might sound unlikely that any governments would compromise its national sovereignty by submitting to such an arrangement, since World War II, an international trading framework has evolved that has exactly these features. For its first 50 years, this framework was known as the General Agreement on Tariffs and Trade (the GATT). Since 1995, it has been known as the World Trade Organization (WTO).

7.5 GATT/ WTO

The WTO came into being on January 1, 1995, and is the successor to the General Agreement on Tariffs and Trade (GATT), which was created in 1947, and continued to operate for almost five decades as a de facto international organization.

GATT at a Glance

The key parts of the 22,000- page General Agreement on Tariffs and Trade:

- ***Tariffs:*** Slashes border taxes by an average of 38 percent worldwide on products including food, electronics, cars and clothing. The Clinton administration has said this represents the largest tax cut in history, a reduction globally of $744 billion.

- ***Agriculture:*** Reduces government supports to farmers that cost taxpayers in wealthy countries an estimated $160 billion annually. U.S. farmers hope it will make their products more competitive on overseas markets.

- ***Textiles:*** Phases out quotas erected by the United States and other wealthy industrialized countries to limit imports from developing nations over a 10-year period. The quotas would be replaced in some cases by tariffs.
- ***Intellectual Property:*** Establishes new rules to clamp down on theft of copyrights and patents, protect manufacturers and consumers against fake products, and encourage new inventions through better patent protection.

7.6 IMPLICATIONS FOR INTERNATIONAL BUSINESS

International business is much more complicated than domestic business because countries differ in many ways: (i) Countries have different political, economic, and legal systems. (ii) Cultural practices can vary dramatically from country to country. (iii) educations and skill level of the population are different. (iv) countries are at different stages of economic development. All these differences have major implications for the practice of international business. They have a profound impact on the benefits, costs and risks associated with doing business in different countries; the way in which the operations in different countries should be managed, and the strategy international firms should pursue in different countries. More specifically:

- Political systems can be assessed according to two dimensions: the degree to which these emphasize collectivism as opposed to individualism, and the degree to which they are democratic or totalitarian.
- There are four broad types of economic systems: a market economy, a command economy, a mixed economy, and a state-directed economy. In a market economy prices are free of controls and private ownership is predominant. In a command economy, prices are set by central planners, productive assets are owned by the state, and private ownership is forbidden. A mixed economy has elements of both a market economy and a command economy. A state-directed economy is one in which the state plays a significant role in directing the investment activities of private enterprise through "industrial policy" and in otherwise regulating business activity in accordance with national goals.
- Differences in the structure of law between countries have important implications for the practice of international business. The degree to which property rights are protected can vary dramatically from country to country, as can product safety, and product liability legislation and the nature of contract law.

7.7 IMPLICATIONS FOR BUSINESS REGARDING DIFFERENCES IN POLITICAL ECONOMY

The implications for international business regarding national differences in Political Economy can be discussed into two broad categories. First, the political, economic and legal environment of a country clearly influences the attractiveness of that country as a market and/or investment site. The benefits, costs and risks associated with doing business in a country are a function of that country's political, economic, and legal systems. Second, the political, economic, and legal systems of a country can raise important ethical issues that have implications for the practice of international business.

- ***Attractiveness:*** The overall attractiveness of a country as a market and/or investment site depends on balancing the likely long-term benefits of doing business in that country against the likely costs and risks. We consider the determinants of benefits, costs and risks.
  - *Benefits:* The long-term monetary benefits of doing business in a country are a function of the size of the market, the present wealth (purchasing power) of consumers in that market, and the likely future wealth (purchasing power) of consumers. While some markets are very large when measured by the number

of consumers (e.g. China and India), low living standards may imply limited purchasing power and therefore, a relatively small market when measured in economic terms. The international business also needs to consider future prospects of a country.

By identifying and investing early in a future economic star, international firms may build brand loyalty and gain experience in that country's business practices. These will pay back substantial dividends if that country achieves sustained high economic growth rates. In contrast late entrants may find that that they lack the brand loyalty and experience necessary to achieve a significant presence in the market. In terms of business strategy, early entrants into future economic stars may be able to reap substantial first-mover advantages, while late entrants may fall victim to late-mover disadvantages.

A country's economic system and property rights regime are reasonably good predictors of economic prospects. Countries with free market economies in which property rights are well protected tend to achieve greater economic growth rates than command economies and/or economies where property rights are poorly protected. It follows that a country's economic system and property rights regime, when taken together with market size (in terms of population) probably constitute reasonably good indicators of the potential long-run benefits of doing business in a country.

- *Costs:* With regard to political factors the costs of doing business in a country can be increased by a need to pay off the politically powerful to be allowed by the government to do business in relatively primitive or undeveloped economies because of the lack of infrastructure and supporting business, which obviously raises costs.

  As for legal factors, it can be more costly to do business in a country where local laws and regulations set strict standards with regard to product safety, safety in the workplace, environmental pollution, and the like (since adhering to such regulations is costly). It can be more costly to do business in a country that lacks well-established laws for regulating business practice (as is the case in many of the former communist nations).

- *Risks:* As with costs, the risks of doing business in a country are determined by a number of political, economic and legal factors. Political risk has been defined as the likelihood that political forces will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a particular business enterprise. Social unrest typically finds expression in strikes, demonstrations, terrorism, and violent conflict. Such unrest is more likely to be found in countries that contain more than one ethnic nationality, in countries where competing ideologies are batting for political control, in countries where economic mismanagement has created high inflation and falling living standards, or in countries that straddle the "fault line" between civilizations such as Bosnia.

  Economic risks can be defined as the likelihood that economic mismanagement will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a particular business enterprise. Economic risks are not independent of political risk. Economic mismanagement may give rise to significant social unrest and hence political risk.

- *Legal risks:* On the legal front risks arise when a country's legal system fails to provide adequate safeguards in the case of contract violations or to protect property rights. When legal safeguards are weak, firms are more likely to break contracts and/or steal intellectual property if they perceive it as being in their interests to do so.

7.8 OVERALL ATTRACTIVENESS OF A COUNTRY

The overall attractiveness of a country as a potential market and/or investment site for an international business depends on balancing the benefits, costs, and risks associated with doing business in that country. Generally, the costs and risks associated with doing business in a foreign country are typically lower in economically advanced and politically stable democratic nations and greater in less developed and politically unstable nations. The calculus is complicated, however, by the fact that the potential long-run benefits are not only dependent upon a nation's current stage of economic development or political stability. Rather, the benefits depend on likely future economic growth rates.

7.9 ETHICS AND REGULATIONS

Country differences give rise to some important and contentious ethical issues .Three important issues that have been the focus of much debate in recent years are (1) the ethics of doing business in nations that violate human rights, (2) the ethics of doing business in countries with very lax labour and environmental regulations, and (3) the ethics of corruption.

- ***Ethics and Human Rights:*** One major ethical dilemma facing firms from democratic nations is whether they should do business in totalitarian countries, such as China, that routinely violate the human rights of their citizen. There are two sides to this issue. Some argue that investing in totalitarian countries provides comfort to dictators and can help prop in repressive regimes that abuse basic human rights.

  In contrast some argue that Western investment by raising the level of economic development of a totalitarian country, can help change it from within, they note that economic well being and political freedoms often go hand in hand.

- ***Ethics and Regulations:*** A second important ethical issue is whether an international firm should adhere to the same standards of product safety, work safety, and environment protection that are required in its home country. This is of particular concern to many firms based in Western nations, where product safety, worker safety and environment protection laws are among the toughest in the world. Should Western firms investing in less developed countries follow the tough Western standards, even though local regulations don't require them to do so?

- ***Ethics and Corruptions:*** A final ethical issue concerns bribes and corruption. To most Westerners bribery seems to be a corrupt and morally repugnant way of doing business, so the answer might initially be no. Some countries have laws prohibiting their citizens from paying bribes to foreign government officials in return for economic favours.

However, in many parts of the world, payoffs to government officials are apart of life one can argue that such investment can bring substantial benefits to local populace in terms of income and jobs. From a pragmatic standpoint, the practice of giving bribes although a little evil, might be the price that must be paid to do a greater good (assuming the investment creates jobs where none existed before and assuming the practice is not illegal). Some economists advocate this reasoning, suggesting that in the context of pervasive and cumbersome regulations in developing countries, corruption may actually improve efficiency and help growth.

However, other economists have argued that corruption reduces the returns on business investment. In a country where corruption is common, the profits from a business activity may be siphoned off by unproductive bureaucrats, who demand side payments for granting the enterprise permission to operate. This reduces the incentive that businesses have to invest and may hurt a country's economic growth rate.

7.10 STATES IN TRANSITION

The political economy of many of the world's nation-states has changed radically since the late 1980s. Two trends have been evident. First, during the late 1980s and early 1990s a wave of democratic revolutions swept the world. Second, there has been a strong move away from centrally planned and mixed economies and toward a more free market economic model.

Three main reasons account for spread of democracy. First, many totalitarian regimes failed to deliver economic progress to the vast bulk of their population. Second, new information and communication technologies, including shortwave radio, satellite television, fax machines, desktop publishing and the Internet have broken down the ability of the state to control access to uncensored information. These technologies have created new conduits for the spread of democratic ideals and information from free societies. Third, in many countries the economic advances of the last quarter century have led to the emergence of increasingly prosperous middle and working classes who have pushed for democratic reforms.

Rationale for spread of market-based systems has been the same the world over. In general, command and mixed economies failed to deliver the kind of sustained economic performance that was achieved by countries adopting market-based systems, such as the United States, Switzerland, Hong Kong, and Taiwan. As a consequence, even more states have gravitated toward the market-based model.

7.11 NATURE OF ECONOMIC TRANSFORMATION

The shift towards a market-based economic system involves a number of steps: deregulation, privatization, and creation of legal system to safeguard property rights.

- ***Deregulation:*** Deregulation involved removing price controls, thereby allowing prices to be set by the interplay between demand and supply; abolishing laws regulating the establishment and operation of private enterprises, and relaxing or removing restrictions on direct investment by foreign enterprises and international trade.

  India is a good example of a mixed economy that is currently deregulating large areas of its economy.

  Another example of deregulation concerns Japan. The Japanese government is trying to abolish some of the 11,000 regulations and 10,000 administrative guidelines that regulate and constrain private enterprises in that economy.

- ***Privatization:*** Privatization transfers the ownership of state property into the hands of private individuals, frequently by the sale of state assets through an auction. Privatization is seen as a way to unlock gains in economic efficiency by giving new private owners a powerful incentive, the reward of greater profits-to search for increases in productivity, to enter new markets and to exit losing ones. The privatization movement started in Great Britain in the early 1980 when the then government started to sell state-owned assets such as British telephone company, British Telecom (BT).

  The ownership structure of newly privatized firms is also important. Many former command economies, for example, lack the legal regulations regarding corporate governance that are found in advanced Western economies. In advanced market economies, board of directors are appointed by shareholders to make sure managers consider the interests of shareholders when making decisions and try to manage the firm in a manner that is consistent with maximizing the wealth of shareholders.

- ***Creation of legal systems to safeguard the property rights:*** Without a legal system that protects property rights, and without the machinery to enforce that system, the incentive to engage in economic activity can be reduced substantially by private and public entities, including organized crime, that expropriate the profits generated by the efforts of private-sector entrepreneurs. This has become a problem in many former Communist states, such as Russia, where organized crime has penetrated deeply into the fabric of many business enterprises. When communism collapsed, many of these countries lacked the legal structure required to protect property rights, all property having been held by the state. Although many states have made big strides toward instituting the required system, it will be many more years before the legal system is functioning as smoothly as it does in the West.

7.12 GLOBALIZATION AND INTERNAL REFORM PROCESS

7.12.1 Internal Structural Reforms Process in India

Since July 1991 Indian Govt. has adopted comprehensive liberalization measures to improve supply side of the economy.

The first phase of economic reforms started in 1985 when Prime Minister Rajiv Gandhi declared New Economic Policy which aimed at improving productivity, absorption of modern technology, fuller utilization of installed capacity and providing greater role to the private sector in order to achieve these objectives, under new policy several policy changes were introduced relating to technology up gradation, elimination of controls and restrictions, foreign equity capital, fiscal policy rationalizing and simplifying the system of fiscal and administrative regulation, export import policy etc. It was expected that these measures will increase investment in private sector that will help in achieving higher rate of economic development and modernization of Indian economy. However the first phase of economic reforms failed to deliver goods; and deficit in balance of trade during the Sixth Plan increased from Rs. 5935 crores to Rs. 10841 crores during seventh Plan the receipts on invisible account also declined significantly. Thus the country started facing serious balance of payments crisis. In order to save the country the Govt. had to approach the World Bank and IMF to sanction the loan of $7 billion. The IMF finally decided to advance the loan but it insisted that the economy be pot on the right track. So the government had to set certain macro economic targets and initiated certain policy measures for bringing about structural changes in Indian Economy. These measures may be summarized as follows:

1. ***Trade and Capital Flows Reforms:*** These measures include:
    - Devaluation of Rupee by 22% against currencies of the leading industrial countries.
    - Introduction of the convertibility of rupee first on trade account and then for entire current account transactions...
    - Liberalization of imports.
    - Substantial reduction in customs tariff rates and thrust on exports.
    - Liberation of capital flows in the form of foreign direct investment as a part of the package of external sector reforms.

    Foreign companies are now allowed to use their trade marks, accept appointment as technical and managerial advisers, borrow and accept deposits from the public and repatriate profits.

    These liberalization measures relating to foreign investment have exposed industrial activities to extensive controls of MNCs. It is also argued that MNCs

will be using capital intensive techniques which may result into displacement of labour and increase in unemployment.

2. The regulatory device had led to widespread inefficiency in the industrial sector so the Govt. relaxed some of these controls even before 1991. In July, 1991 industrial policy emphasized deregulation of the industrial economy substantially and opening up a large number of industries for private sector. The requirement of industrial licensing has been limited to 6 product categories. These include alcohol, cigarettes, hazardous chemicals, industrial explosives, electronics-aerospace, drugs and pharmaceuticals. Even the number of industries reserved for public sector has been reduced to 3 from 17. Now core industries like iron and steel electricity and even strategic industry like defense production have been opened up for the private sector.

3. ***Public Sector Reforms and Disinvestments:*** The main objective of establishing public sector units was to make them work as an engine of self sustained economic growth and to control the commanding heights of the economy and promote technological progress at a faster rate. Although the public sector has contributed towards widening industrial base, diversifying industrial structure but it failed to generate sufficient internal resources for further expansion and become a heavy burden on the government exchequer.

   Under structural reforms the Govt. decided to give greater autonomy in management of these public sector units and to function more efficiently.

   In addition it was decided to increase private sector competition in areas where social considerations are important and to go for partial disinvestment of equity in selected enterprises.

   By end of 2002 equity amounting to Rs. 29481 crores in 48 public sector units. Have been disinvested to public sector financial institutions, mutual funds private corporations and general public. When the Govt. constituted disinvestment commission in August, 1996 for suggesting modalities for carrying out disinvestments of equity in selected public sector units. Initially Govt. wanted to dispose off loss making public sector units and well performing units were to be given autonomy to enable them to develop as global Indian multinational corporations. It seems that Govt. is more interested in selling shares of public sector units for providing budget deficits only. It is also observed that disinvestment exercise is to transfer public assets to private companies at throwaway prices e.g. Bharat Aluminum.

4. In order to support the structural reforms effectively it is necessary to have an efficient and competitive financial system. The Govt. had set up committee on financial system in 1991 and on Banking Sector Reforms (Narasimhan Committees).

The committees recommendations include almost every aspect of the health of the financial sector. They deal with policy aspects, organizational issues, operational procedures, accounting practices etc.

The main emphasis of Narasimhan Committee was on enhancing the inherent strength of the financial institutions and improving their advances portfolio qualitatively. The Govt. had initiated lot of reform measures based on the Narasimhan Committee's report. Meanwhile lot of changes has taken place in the domestic economic and institutional scenes. There was an attempt towards global integration of financial services.

The second half of 1990's experienced the dangers associated with the mindless liberalization in the financial sector world over. Bank failures during the South East Asian countries exposed the problems arising from inadequate regulation and

supervision of banks. Hence the Banking Sector Reforms committee stressed on prudential measures like increase in the capital to Risk weighted Assets Ratio (CFAR), the introduction of market securities, the stricter Non-Performing Assets (NPAs) norms and provisioning norms and the introduction of asset–liability management guidelines and risk management guidelines.

In the light of the recommendations of the committee several measures have been announced by the Govt. to strengthen the banking system in India.

These measures include:

1. Raising the CRAR to 9%.
2. Strengthening prudential accounting norms.
3. Laying down Asset Liability Management (ALM).
4. Risk Management guidelines.
5. Directing banks to provide additional information in the notes to Accounts in the balance sheets to increase transparency.

In 2002, Securitization, Reconstruction of Financial Assets and Enforcement of Security Act were passed for providing satisfactory legal framework for the recovery of bank credit.

7.12.2 Evaluation of Economic Reforms

1. The trade regime has undergone massive change with the removal of quantitative restrictions along with rationalisation of the tariff structure. There has been a massive reduction in the number of tariff rates and the peak rate of tariff has been reduced from around 400 per cent to 12.5 per cent for non-agriculture products. Tariff reform for agriculture products has been constrained by the intransigence of developed countries in reducing their farm subsidies. Internationally, India has always participated actively in WTO negotiations. More recently, reflecting the hiccup in the achievement of consensus for further global trade reforms, India has also began to participate in a number of regional and bilateral trade agreements that are in the making.

   With the change in the exchange rate regime and accomplishment of trade reforms the current account is now open along with limited capital account convertibility. The exchange rate regime focuses on management of volatility without a fixed rate target and the underlying demand and supply conditions determine the exchange rate movements in an orderly way.

2. Massive deregulation of the industrial sector, in fact, constituted the first major package of reforms in July 1991.

   With this massive reform introduced in one stroke in 1991, the stage was set for a policy framework that encouraged new entry, introduced new competition, both domestic and foreign, which thereby induced the attainment of much greater efficiency in industry over a period of time. One area of industrial reform that has been sluggish has been the removal of restrictions that exist on investment in most labour using industries – known as small scale industry reservations. In 1991 as many as 836 industries were reserved for investment by only small firms, defined by the level of investment. The number of these industries has now come down to 326.

3. ***Infrastructure:*** A number of measures have been initiated in the development of infrastructure since 1996. Many of these reforms emanated from the recommendations of the India Infrastructure Report of the mid 1990s. We recognized that infrastructure investment had to be raised and suggested introduction of the private sector in infrastructure which had been restricted

earlier. This was part of a world wide move during the 1990s. This has also necessitated other wide ranging reforms including new legislations and formation of regulatory authorities.

With deregulation, introduction of the private sector and formation of the Telecom Regulatory Authority of India (TRAI), telecom is indeed a success story. The major reforms in roadways were: imposition of a fuel cess to finance highway construction; the commissioning of the National Highway Development Project and PMGSY (Prime Minister's Gram Sadak Yojana or the Rural Roads Programme). In case of ports private operators have been introduced and then the Tariff Authority of Major Ports (TAMP) formed; in civil aviation new private airlines, new private airports and the beginning of an open skies policy are in evidence. In all these cases the response has been positive.

In other infrastructure sectors, the reform process experience has been mixed. In the power sector, where some of the early efforts for reform were made in the early 1990s, problems continue to constrain its expansion. A comprehensive modern electricity act has been enacted, which has enabling features for encouraging private sector entry, enhanced competition, and rational regulation. However, despite the formation of a central regulatory authority and others at the state level, implementation of the tariff reform has not been found to be easy. State Electricity Boards continue to suffer from losses, arising both from inadequate tariff and from transmission and distribution losses (comprising important part of theft). Consequently, private sector investors in power generation face insecurity of payment and hence expansion of private investment in this sector has been constrained. Although the Act allows for private participation in distribution, practically it has not been found easy to privatize distribution systems. Thus, power reforms have some way to go, although the legislative and institutional pre-requisites are now in place.

Urban infrastructure is another area where reform has been inadequate and thinking has just begun. In transportation, considerable reforms have taken place in air and road transportation but railways have some way to go.

Although there has been noted improvement in financial performance of railways in the last couple of years, there is need for much greater structural reforms for this vital transportation system to be put in a sound sustained growth path.

4. ***Financial Sector:*** This gradual process of banking sector reforms has contributed significantly to the all round improvement in the financial health of the banking system. Among other segments of the financial sector, new private insurance companies have been introduced with limited foreign ownership.

   The introduction of new competition has led to the introduction of new products and new practices. A new regulator, the Insurance Regulation and Development Authority (IRDA) has been formed to govern the insurance industry.

   The capital market has been revived with both policy reforms and financial infrastructure development. The Securities and Exchange Board of India was formed as the capital market regulator; a new modern technology oriented stock exchange was formed (the National Stock Exchange, NSE); private sector mutual funds allowed and encouraged; along with the abolition of the Controller of Capital Issues (CCI) who controlled both issuance of securities and administered their price. A particular development has been the building of world class payment and settlement architecture in the stock market and government securities market. The one area that still needs considerable attention and development is the corporate bond market.

   There is a need to remember where India was at the time of its independence. Power capacity was just 1.1 per cent of what it is now. The country was literally

in darkness! With high mortality rates, the average Indian died at age 32. More than half of the country was under the poverty line. The income of an average household is now nearly Rs. 130,000. Poverty was down to 23-26 per cent in 1999-2000. Per capita growth has gone up from about 1.5 per cent per year in the first 30 years after independence to about 6.4 per cent per year now. This makes a palpable difference in peoples' standard of living (Tables 7.1, 7.2 and 7.3).

Table 7.1: Select Indicators of India's Progress

Year	Per Capita Income (at 1993-94 prices) (Rs.)	Poverty (Per cent)	Literacy (Per cent)	Life Expectancy (Years)	Power Capacity (MW)
1951	3,687	45	18	32	1,362
1961	4,429	45	28	41	4,653
1971	5,002	52	34	46	14,709
1981	5,352	43	44	50	30,214
1991	7,321	35	52	59	64,000
2001	10,308	26	65	65	102,000
2005	12.414	19.3*			118,419

* Projection for 2007

Table 7.2: Indian Growth Experience

(Per cent)

Sector	1951-52 to 1960-61	1961-62 to 1970-71	1971-72 to 1980-81	1981-82 to 1990-91	Crisis Year: 1991-92	1992-93 to 2001-02*	2002-03 to 2005-06*
Agriculture	3.1	2.5	1.8	3.1	-1.5	3.4	1.9
Industry	6.1	5.4	4.4	7.6	-1.2	6.1	8.3
Services	4.6	4.9	4.2	6.7	4.5	7.7	8.7
GDP	3.9	3.7	3.2	5.6	1.3	6.1	7.0
Per Capita National Income	1.9	1.3	0.8	3.2	-1.5	4.1	5.6

*Data up to 1999-2000 are at the base year 1993-94 and data from 2000-01onwards are at the base year 1999-2000

Source: Central Statistical Organisation

Table 7.3: Percentage of People below Poverty Line

(Per cent)

	1987-88	1993-94	1999-2000	Projection for 2007
Rural	39.1	37.3	27.1	21.1
Urban	38.2	32.4	23.6	15.1

Source: Economic Survey 2002-03

5. The step-up in the growth rate of the economy has been facilitated by increase in domestic investment to over 30 per cent of GDP, financed predominantly by domestic savings. Domestic savings increased to over 29 per cent of GDP by 2004-05 after some stagnation in the second half of the 1990s. The improvement in overall savings in recent years has particularly benefited from the turnaround in public sector savings. After turning negative between 1998-99 and 2002-03 owing to sharp deterioration in the savings of Government administration, public sector savings have turned positive again from 2003-04 onwards, mainly reflecting the ongoing fiscal consolidation. In 2004-05, the public sector savings rate was 2.2 per cent, but it was still less than a half of the peak of almost five per cent touched in 1976-77.

Improvement in corporate profitability since 2002-03 has also contributed to increase in domestic savings in the recent years. Household savings remain the predominant component of domestic savings, contributing almost three-fourths of overall domestic savings in 2004-05. For the Indian economy to achieve higher growth on a sustained basis, further improvement in overall savings is necessary and, in this context, public sector savings will have to play a significant role (Table 7.4).

Table 7.4: Aggregate and Public Sector Savings and Investment

(As percentage of GDP)

Year	Aggregate		Private Sector	
	Savings	**Investment**	**Savings**	**Investment**
1980-81	18.9	20.3	3.4	8.4
1981-82	18.6	20.1	4.5	10.1
1982-83	18.3	19.6	4.3	10.7
1983-84	17.6	18.7	3.3	9.7
1984-85	18.8	20.1	2.8	10.4
1985-86	19.5	21.7	3.2	10.8
1986-87	18.9	21.0	2.7	11.2
1987-88	20.6	22.5	2.2	9.5
1988-89	20.9	23.8	2.1	9.5
1989-90	22.0	24.5	1.7	9.5
1990-91	23.1	26.3	1.1	9.3
1991-92	22.0	22.6	2.0	8.8
1992-93	21.8	23.6	1.6	8.6
1993-94	22.5	23.1	0.6	8.2
1994-95	24.8	26.0	1.7	8.7
1995-96	25.1	26.9	2.0	7.7
1996-97	23.2	24.5	1.7	7.0
1997-98	23.1	24.6	1.3	6.6
1998-99	21.5	22.6	-1.0	6.6
1999-00	24.9	26.0	-0.9	7.5
2000-01	23.5	24.2	-1.8	6.9
2001-02	23.6	23.0	-2.0	6.9
2002-03	26.5	25.3	-0.7	6.2
2003-04	28.9	27.2	1.0	6.5
2004-05	29.1	30.1	2.2	7.2

Source: National Accounts Statistics, Central Statistical Organisation

6. Fiscal performance has still some way to go. The gross fiscal deficit has come down from 7 per cent in 1993-94 to 4.1 per cent in 2005-06. However, this needs to go to 3 per cent by 2009. Tax Revenue has just recovered to 10 per cent of GDP, about the 1991-92 level, and needs much greater growth (Table 7.5). Inflation is down from the 45 year average of 7-8 per cent to 4.5-5.0 per cent. So we have achieved some major macro and monetary improvements. However, growth needs investment and savings. Although the growth process stuttered somewhat in the late 1990s and early part of this decade, it has clearly recovered now and we seem to be on a sustainable path of annual GDP growth in excess of

8 per cent. After the award of the Pay Commission in 1997, public finances had come under strain and hence public savings had become negative. This was also accompanied by a business cycle slowdown and low profitability in the private corporate sector and low corporate savings. Both recoveries have now taken place: public sector savings are now again positive; and corporate profitability is also very healthy. With continuing growth in household savings, gross domestic savings are now 30 per cent plus and hence sustained investment rates in excess of 32 per cent are feasible. The sustenance of a higher growth now needs improvement in public investment and delivery of public services.

Table 7.5: Select Fiscal Indicators of the Central Government

(As percentage to GDP)

	Gross fiscal	Revenue Deficit	Direct Taxes	Indirect Taxes	Taxes Gross	Interest payments	Subsidies
1991-92	5.6	2.5	2.3	8.0	10.3	4.1	1.9
1992-93	5.4	2.5	2.4	7.5	10.0	4.2	1.4
1993-94	7.0	3.8	2.4	6.5	8.8	4.3	1..4
1994-95	5.7	3.1	2.7	6.5	9.1	4.4	1.2
1995-96	5.1	2.5	2.8	6.5	9.4	4.2	1.1
1996-97	4.9	2.4	2.8	6.6	9.4	4.3	1.1
1997-98	5.8	3.1	3.2	6.0	9.1	4.3	1.2
1998-99	6.5	3.8	2.7	5.6	8.3	4.5	1.4
1999-00	5.3	3.5	3.0	5.8	8.8	4.6	1.3
2000-01	5.6	4.0	3.2	5.7	8.9	4.7	1.3
2001-02	6.2	4.4	3.0	5.2	8.2	4.7	1.4
2002-03	5.9	4.4	3.4	5.4	8.8	4.8	1.8
2003-04	4.5	3.6	3.8	5.4	9.2	4.5	1.6
2004-05	4.0	2.5	4.3	5.5	9.8	4.1	1.4
2005-06	4.1	2.7	4.7	5.7	10.4	3.7	1.4
2006-07 (BE)	3.8	2.1	5.3	5.9	11.2	3.5	1.2

7. Financial sector reforms in general and banking reforms in particular have been a key ingredient of the Indian reforms process.

   As a result of these reforms, statutory pre-emptions of banks (in the form of high cash reserve and statutory liquidity ratio) got reduced to a great extent – so was the extent of financial repression. Interestingly the asset quality of the Indian banks has improved to a great extent with a distinct improvement in capital-to-risk adjusted assets ratio (CRAR) of banks which is much above the stipulated level (9 per cent), and drastic reduction in NPA levels, notwithstanding the transition to 90-day delinquency norm in 2004 (Table 7.6).

   The initial recapitalization by government in the public sector banks has been rather meagre (about 1 per cent of GDP) which was supported by equity issuance by the public sector banks. With public listing the public sector banks in India are now more subject to market discipline. Furthermore, there has been a distinct improvement in post-reform productivity as reflected in various indicators such as, business per employee, profit per employee and branch productivity. These productivity gains can be attributed to both technological improvement as well as peer pressure or catching up effect.

Table 7.6: Indicators of Indian Banking Reforms

(Per cent)

	Quality of Assets		Extent of Competition (Percentage share in Total Bank)		
	Gross NPL	Net NPL	Foreign Banks	Private Sector	Public Sector
1996-97	7.0	3.3	7.9	7.7	84.4
2000-01	4.9	2.5	7.9	12.6	79.5
2002-03	4.0	1.8	6.9	17.5	75.7
2003-04	3.3	1.2	6.9	18.6	74.5
2004-05	2.5	0.9	6.50	18.2	75.3
2005-06	1.9	0.7	7.2	20.4	72.3

Source: Reserve Bank of India

8. Let me briefly touch on the external sector now. The measures taken in respect of the external sector have clearly been very successful.

   Merchandise exports have increased from 6 to 13 per cent of GDP between 1990-91 and 2005-06; imports have also increased from 10 to 24 per cent of GDP over the same period; foreign exchange reserves increased from $ 1.5 billion to $ 165 billion.

   Industrial growth was very high during the 1992-97 period in the immediate exuberance of industrial policy reforms. However, there was a significant slowdown during 1997-2002. As tariffs were reduced, import controls were lifted, and domestic competitive threats emerged at the same time, the initial protective effects of the ex ante real devaluation of 1997 wore off and the Indian corporate sector, particularly in manufacturing, found itself in difficulty. The Indian corporate sector was therefore in the throes of significant technical restructuring, business process restructuring and financial restructuring, all at the same time. It can be said in retrospect that, though this process resulted in an industrial slowdown then, it has contributed to the industrial competitive resurgence that is now observed. There is a revival of manufacturing. A competitive company can be found in almost every sector industrial sector now. As indicators of this competitiveness, exports are growing more than 20 per cent; and the balance of payments with reference to China is almost even (Table 7.7).

Table 7.7: Some Indicators of India's Openness

(Per cent of GDP)

Year	Export of Goods	Import of Goods	Exports of Services	Import of Services	Receipts of Transfers & Incomes	Payments of Transfers & Incomes	Current Receipts	Current Payments	Current Account Balance
1990-91	5.8	8.8	1.4	1.1	0.9	1.3	8.2	11.2	-3.1
1991-92	6.9	7.9	1.9	1.4	1.7	1.5	10.5	10.8	-0.3
1992-93	7.3	9.6	1.8	1.5	1.8	1.5	10.9	12.6	-1.7
1993-94	8.3	9.8	1.9	1.7	2.2	1.3	12.4	12.8	-0.4
1994-95	8.3	11.1	1.9	1.7	2.9	1.3	13.1	14.2	-1.0
1995-96	9.1	12.3	2.1	2.1	2.9	1.3	14.1	15.8	-1.7
1996-97	8.9	12.7	1.9	1.8	3.6	1.2	14.4	15.6	-1.2
1997-98	8.7	12.5	2.3	2.0	3.4	1.3	14.4	15.8	-1.4
1998-99	8.3	11.5	3.2	2.7	3.0	1.3	14.5	15.5	-1.0
1999-00	8.3	12.3	3.5	2.6	3.2	1.2	15.0	16.1	-1.0

Contd....

2000-01	9.9	12.6	3.5	3.2	3.5	1.7	16.9	17.4	-0.6
2001-02	9.4	11.8	3.6	2.9	4.1	1.7	17.0	16.3	0.7
2002-03	10.6	12.7	4.1	3.4	4.2	1.5	18.9	17.6	1.3
2003-04	11.0	13.3	4.5	2.8	4.4	1.5	19.9	17.6	2.3
2004-05	12.2	17.1	6.2	4.0	3.8	1.5	22.2	22.6	-0.4
2005-06	13.1	19.6	7.6	4.8	3.9	1.5	24.6	26.0	-1.3

Source: Reserve Bank of India

8. The performance of the Indian corporate sector has been highly encouraging in the last three years. The previous occasion, when such a healthy performance was demonstrated by the corporate sector was in the early 1990s, i.e., during the initial period of exuberance immediately after the economic reforms programme was initiated in India. But during the latter part of the 1990s, around 1997, the momentum in the corporate sector slowed down in sync with the general economic slowdown. The recovery since then is remarkable in all important parameters: sales, gross profit, profit after tax, all have recorded robust growth rates during 2002-03, 2003-04 and 2004-05 implying that economic activity in the corporate sector has taken a full circle after three years of dull performance during 1999-2000, 2000-01 and 2001-02 (Table 7.8).

   The current exuberant run of corporate sector performance has continued well into its fourth year as evidenced by the corporate sector results for the first quarter of 2006-07. The strong sales performance has resulted in an improved bottom-line for the corporate sector as a whole. Powered by a strong top-line performance, gross profits of the Indian corporate sector grew at a sturdy rate of 34 per cent in the quarter ending in June 2006 on top of a 20 per cent growth recorded in the full fiscal year of 2005-06. The interest costs have been plummeting in the recent years due to an overall softening of interest rates and lower debt equity ratios, which is an outcome of conscious policy-driven measures.

Table 7.8: Select Indicators of Corporate Performance

(Per cent)

	Sales Growth (Year-on-Year)	PAT Growth (Year-on-Year)	Working Capital / Sales	Debt / Sales
1994-95	29.9	55.4	52.2	50.8
1995-96	19.4	22.7	53.2	47.7
1996-97	19.3	-0.5	54.8	47.8
1997-98	6.1	13.5	51.9	49.6
1998-99	13.8	-2.8	50.0	43.8
1999-2000	21.6	9.2	47.6	37.8
2000-01	22.9	23.6	42.2	31.8
2001-02	3.7	0.2	41.1	31.3
2002-03	16.2	51.8	43.2	27.1
2003-04	13.0	30.7	39.5	25.0
2004-05	18.5	28.4	24.7	52.6

Source: Prowess, Centre for Monitoring Indian Economy.

There is in fact a new confidence in the air. Let me give some random illustrations - TISCO is the lowest cost steel producer, Hindalco / Sterlite / NALCO are competitive aluminum producer, Reliance is a major petrochemical producer. We now have world class producers in most sectors and there are many more success stories. Moser Baer exports more than Rs.1000 crore; Hero Honda with 1.7 million motor cycles is the

largest producer of motor cycles; one now gets a wide range of automobiles in India such as Maruti, Tata, Hyundai, Toyota, GM, Ford; in Pharma there are Ranbaxy and Dr Reddy's among others; Bharat Forge exports castings and forgings to all main auto producers; Sundaram Clayton has been adjudged as Best GM supplier.

Let me sum up the broad contours of success of the overall economic reform programme. In general, the reform programme has achieved remarkable success. Annual GDP growth has averaged 6 to 6.5 per cent during the whole 15 year period since reforms began, and is now ascending to a higher trajectory of 8 per cent plus sustained growth. The external sector is comfortable: gone are the days of perpetual "shortage" of foreign exchange.

In contrast, some observers view India's foreign exchange as reserves as a problem of plenty. Industrial growth has been restored and the manufacturing sector has found a new level of competitiveness, quality and efficiency. There is a transformation in the external impression of the Indian economy: it is now viewed with a sense of some awe and confidence in its potential of sustainable high growth.

Finally, measured poverty has been reduced significantly. But we still have miles to go. The poverty ratio of 23-26 per cent is still too high, about a quarter billion people living in poverty are too many.

Employment growth is inadequate and we have an expanding young labour force, which will demand quality jobs. Public service delivery continues to be poor, with little sign of improvement.

7.12.3 Reform Process and Imperatives

After 1991, there was a two fold shift in the Indian economic policy - at the global level as also the national level.

At the global level, it sought to integrate the Indian economy with the world economy by allowing free movement of capital investment both into and from India. This exchange would also expose India to new technology.

Table 7.9: Foreign Direct Investment into India

(Rs. in Crores)

Year	Direct Investments	Portfolio (indirect Investments)
1993	1787	2595
1994	3289	6791
1995	6820	3854
1996	10389	10803
1997	16425	6207
1998	13340	(1480)
1999	16868	6697
2000	5908	7067
2001	4230	6950
2002	5410	7380
2003	7540	9080
2004	11300	10400

(1st four months)

Sources: Industry Ministry for foreign direct investment, SEBI for Portfolio Investment.

There has been a significant time lag between foreign direct investment approvals and actual inflows due to Government's failure to ensure a smooth single window clearance for projects. Other factors have been the Government's tendency to backtrack on its own policy and lack of congruity in centre-state clearance for FDI inflows.

At the national level, it envisages a decontrolled business environment where free market forces would be given more freedom to operate and state control would be reduced or eliminated. The omnipotent role of public sector corporations would be redefined, allowing disinvestments of their equity holdings by the Government.

7.12.4 Effect of the Reform Process

1. Major restructuring of economy leading to growth and generation of employment which would ultimately lead to more purchasing power for the common man?
2. The economy should have a skilled and educated workforce which can understand and cope with requirements of IT and other technologies in the manufacturing and service sectors leading to states heavy investments in education.
3. It has opened up the economy to a greater degree of international participation and investments. The service industry has taken significant strides in the areas such as tourism, hospitality, banking and financial services. Consequently, not only have more players come to India; but mergers and acquisitions of a large number of Indian companies have also taken place. This has compelled the Indian companies to renew their strategies and practices and also the type of business they are in, which is indeed a stark contrast to their attitude in the recent past where cornering a license mattered more than a company's product or competence.
4. The Indian market is changing from both marketing and sourcing angles. On the one hand, the market is large and expanding further and on the other, it is becoming an attractive source of inputs for Multi-national Companies (MNC's) The market is deeper and wider now. Customers' needs are changing and India's buyers' welcome new products and services. Many a successful product from abroad finds ready acceptance by Indian customers. The latter have become more demanding and their requirements of quality are increasingly stringent primarily because of the lowering of import duties on number of items, their easy availability at lower prices in India. Besides, exposure to international products and lifestyles through satellite TV also facilitated this change.
5. In terms of cost globalization drivers, India is increasingly becoming a major attraction for MNC manufacturing because of the high quality manpower and lower cost of production. Some MNCs have set up production bases here for markets in Asia while some have sub-contracting arrangements with Indian companies.
6. For many MNCs, it is the market attraction and Government requirements for local manufacturing that is influencing their current strategy. Some of the MNCs overcome their factor, supply related problems by developing in-house capabilities not only in terms of manpower training but also power supply and communication facilities. Some of the MNCs have high regard for India's pool of scientists and technologies and have set up R & D centres in the country. Several software companies also have R & D units located in India.
7. Another emerging challenge that Indian companies have had to perforce address is the infusion of the state-of-the-art technology and work practices. Consequently, many organizations including the PSU's have had to trim their bloated manpower and also think about empowering people down the line. This reversal of the earlier initiatives taken, where state-controlled industrialization was seen as an avenue for providing employment. However, the induction of

sheer numbers in the Indian workforce with lower level of productivity, education and skills in many cases has now created a new set of problems making many Indian companies globally in – competitive.

On a more positive note, many Indian Companies have taken steps in the right direction, albeit slowly, benchmarking the experience of Asian countries by adopting and modifying their strategies and bringing considerable changes by improving upon policies in key areas.

7.12.5 Consequences of Globalization on Different Companies

- Virtually all companies had started placing emphasis on the up-gradation of managerial and professional skills.
- A proper linkage between technology and management practices is being focused. Technology transfer affects the employment situation of an organization. Increased automation can lead to reduction of jobs and subsequently surplus of manpower. Hence the focus in such a situation will be on training and development as also on restraining, redeployment and restructure. On the other hand, liberalization has also created jobs requiring superior skills, which are associated with higher wages and opportunities.
- A flat organizational structure had resulted in fewer levels of hierarchy and enhanced empowerment. Empowerment to all categories, from shop floor workers to managers, had facilitated independent decision-making, flexibility and trust. This has led to empowered employee involvement and motivation.
- People at the middle levels of management were becoming more participative and result oriented. On the other hand, decision-making was increasingly being handled at the group level.
- Insecurity levels among employees had diminished and their sense of responsibility had increased.
- There was an emphasis in openness and transparency. An improvement in the communication channels within the organization had resulted in better interpersonal relations and net working among units. Month-end Floor meetings, open house and open sessions had greatly helped in this direction Communications had also been enhanced through notice boards, house journals, product sessions, etc.
- Changes in recruitment policy had led to:
  1. Induction of professionals with diverse technical, managerial and academic backgrounds.
  2. A fall in the average age of employees.
  3. Higher salaries and more responsibilities for young employees.
  4. The induction of human resource professionals at senior levels, implying increased recognition in this area.
- Meritocracy in personal policy which included performance based rewards for employees.
- Provision of VRS by companies to employees.
- A new culture that emphasized on employees' role of supporting rather than 'reporting' within the organization. Externally it emphasized employee commitment to customer satisfaction.
- Networking of various division or functions (marketing, manufacturing, vendor development, human resources management, etc.) within the organization with a view to create a responsive goal oriented and competitive organization.

Today, employees are recognized as the key to building a world-class organization. They are a finite resource for which organizations have to compete. Thus, proactive organizations have adopted strategic human resources management as a tool to position themselves in the business world. Further, the focus is linking the human resources management strategy with corporate plans i.e., to understand the corporate business objectives and to integrate various functions in an organization.

7.12.6 Restructuring the Organization

The impact of liberalization on Indian companies can be summed up in one world competition. The Indian corporate world is witnessing a modem day Darwinian phenomenon of the survival of the fittest where only, those companies can exist who are able to understand and rapidly adapt to changes. The following areas have been identified:

1. A corporate vision for the future and an appropriate strategy taking into account the growing competitive business environment and the aspiration of the individual employees. In the present age, future markets may bear no resemblance to the past. It therefore becomes necessary to forecast the future by examining the underlying forces of technological changes, customer preference, industry trends and macro level policies relevant to the business.
2. Examination of the existing organization structure, the levels, jobs, reporting relationships, authority and power assigned to each job role and so on. The findings are then reviewed against the backdrop of the current environment to see what changes are required. For instance, an organization could decide to change over to a flatter structure, empowered job roles and closely networked functional units. The creation of profit centre or Strategic Business Units (SBUs) can also be useful for certain organizations to enhance accountability and sense of ownership for different types of business activities. This restructuring would mean movement of people within the system or even out of it. Besides, such macro organizational changes, there are several processes or techniques that can be use to regenerate the organization to enhance effectiveness. Tools can be used e.g., business process re-engineering benchmarking practices, Kaizen, TQM, urgency motivation, human resources accounting, human resources audit.
3. Technology revolution has changed the old rules of the game. Transfer of technology means assimilation, adaptation and finally transmission of knowledge for the successful up-gradation of skills. Thus the recipient organization should develop sound technical infrastructure to absorb new technology with least possible resistance. Technology transfer affects the employment situation of an organization. e.g. Redundancy of jobs and subsequently surplus manpower. Thus the human resources policy will have to focus on training and development as also on retraining, deployment and retrenchment. Here the overall objective is to achieve higher productivity levels with fewer resources. Further due to manpower costs going up and the need to bring product prices down to meet competition, manpower productivity has become a central issue.
4. With rapid advancement in IT, routine transactional activities are being automated, streamlined, re-engineered and substituted by high powered information systems. This has resulted in efficient utilization of human resources.
5. An appropriate system and internal organizational and administrative processes.

   Businesses will have to respond positively, by re-designing its production processes to bring them in tune with market compulsions, by restructuring its internal structures to react quicker to competitive strategies, by redefining its markets to seek out the least crowded segments.

6. Organization need to change themselves by being more innovative, creative and by re-orienting themselves towards people based systems as opposed to "traditional hierarchical control based system." Here the emphasis is on employees sharing organizational goals through self-discipline. This shift is possible only if well-entrenched hierarchies are dissolved, internal political games are minimised, managers seek not to cover up their insecurities by using control mechanisms and organizations adopt a performance based paradigm where individual contribution is encouraged and rewarded. Furthermore, team organization and decentralization should be encouraged. Empowerment, thus helps to create autonomy for employees, allows the sharing of responsibility and power at all levels, builds employees' self-esteem and energises the workforce - all of which enable better performance. To achieve what is stated the following action plan is necessary.

   (a) Increased emphasis on training and retraining to tap latent talent.

   (b) Attention need to be focused on career growth and career planning.

   (c) Increased willingness to retain talent and re-deploy manpower when necessary.

   (d) Employee compensation is being linked with performance and performance based appraisal systems.

   (e) Contemporary practices, policies and programmes are becoming more focused, responsive and also reviewed against the external environment.

   (f) Effective monitoring of post empowerment initiative is necessary to gauge the change in performance standards, employee training, profitability and customer satisfaction as well as inter-personal relationships in the organisation. Monitoring allows for remedial action in case of wrong decisions.

7. With the increasing presence of trans-national corporations in India, managing employees from diverse background has emerged as a challenge, this includes managing cross-national diversity such as the inter-face between the people of two countries and the relationship between expatriates and local employees. It is also necessary to manage international diversity which is becoming more important with increasingly diverse stakeholders. This includes different ethnic background, physical handicaps, age groups, religious backgrounds and gender. It is important to value this diversity and exploit it positively. This requires an increased consciousness and awareness of cultures different from one's own and a sense of respect for them. It requires the deployment of specialized human resources instruments to develop communication competency, proficiency indifferent languages and negotiation skills.

   Thomas R R in (Managing Diversity, A Conceptual Framework in Diversity in the Work Place: Human Resources Initiative, Guilford Press, New York, 1992 PP 306-317) defines diversity in a broad context to include an infinite variety of dimensions other than merely race, gender, etc., the variables religion and so on. There are three fundamental ways to address diversity (i) taking affirmative action (ii) understanding diversity and valuing differences and (iii) managing diversity.

   De Luca and McDowell (Managing Diversity: A Strategic Grass roots Approach, in diversity in the workplace, Human Resources Initiatives, GuilFord Pries, New York 1992 PP 227 - 247) of Coopers and Lybrand, mention that managing diversity is not intended to replace existing affirmative action initiatives, rather it should be seen as part of the organizational culture. Here the mindset should be geared to new "differences" as opportunities. Therefore, strategic management of diversity may require the adoption of new initiatives that challenges the "one size fits all era of management".

Here one has to take a view that it is required to examine and emphasis aspects that are unique to India. The Indian population is divided under various categories or groups. Of these, groups like scheduled castes and tribes and other backward classes are eligible for statutory quotas. The country also has a highly pronounced ethnic on linguistic heterogeneity. Moreover differences between the North and the South and commercial sentiments (often politically ignited) are part of the present system. The basic principles of diversity management apply in the Indian context especially in light of its recent efforts to globalize its approach to business. What is required is an appreciation of local sensitivities while applying internationally tested diversity management formulae. India needs a fundamental attitudinal changes that will make it progressive, competitive and focused on achieving a national mission of integration. This will involve doing away long ushered discrimination against our own brethren, fragmenting the country on the basis of geography, religion, language and economic disparity which has led to lack of national pride and more' significantly, lack of self-esteem and self-confidence at the individual level. Many of the old Indian traditions and values such as tolerances, patience and acceptance of diversity need to be preserved and reinforced. In this context, at the organizational level, employees will have to learn to work in teams, closely networked and interlinked.

8. ***Other issues:*** Employment issues are of tremendous in pass for India. On one hand, the need for low skilled jobs will diminish and on the other, there will be a historic opportunity to leverage the vast pool of human resources available in the country, through proper training and skill-up-gradation programme.

The country's IT infrastructure and antiquated system of education are in urgent need of up-gradation. It would not be wrong to say that India has a long way to go, considering that it has not been able to build proper highway or road transport, leave aside building information highways.

In a world where innovation and the use of information determine the way business is conducted, intellectual property rights and their appropriate recognition and enforcement will become the price of entry into global business. It is high time the Government of India evolved a national consensus on these vital issues.

Check Your Progress

Mention the some of the steps taken by the Government of India in the area of trade and capital flows reform.

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7.13 LET US SUM UP

The political reality is that while many nations are nominally committed to free trade, they tend to intervene in international trade to protect the interests of politically important groups. When governments intervene, they often do so by restricting imports of goods and services into their nation, while adopting policies that promote exports.

Since July 1991 Indian Govt. has adopted comprehensive liberalization measures to improve supply side of the economy. The government had to set certain macro economic targets and initiated certain policy measures for bringing about structural changes in Indian Economy. These measures may be summarized as follows: (1) Trade and Capital Flows Reforms: These measures include (i) Devaluation of Rupee by 22% against currencies of the leading industrial countries. (ii) Introduction of the convertibility of rupee first on trade account and then for entire current account transactions. (iii) Liberalization of imports. (iv) Substantial reduction in customs tariff

rates and thrust on exports. (v) Liberation of capital flows in the form of foreign direct investment as a part of the package of external sector reforms. (2) In July, 1991 industrial policy emphasized deregulation of the industrial economy substantially and opening up a large number of industries for private sector. The requirement of industrial licensing has been limited to 6 product categories. These include alcohol, cigarettes, hazardous chemicals, industrial explosives, electronics-aerospace, drugs and pharmaceuticals. Even the number of industries reserved for public sector has been reduced to 3 from 17. Now core industries like iron and steel electricity and even strategic industry like defense production have been opened up for the private sector. (3) Public Sector Reforms and Disinvestments–The main objective of establishing public sector units was to make them work as an engine of self sustained economic growth and to control the commanding heights of the economy and promote technological progress at a faster rate. Under structural reforms the Govt. decided to give greater autonomy in management of these public sector units and to function more efficiently. In addition it was decided to increase private sector competition in areas where social considerations are important and to go for partial disinvestment of equity in selected enterprises. (4) In order to support the structural reforms effectively it is necessary to have an efficient and competitive financial system. The Govt. had set up committee on financial system in 1991 and on Banking sector Reforms (Narasimhan Committees). The committees recommendations include almost every aspect of the health of the financial sector. They deal with policy aspects, organizational issues, operational procedures, accounting practices etc. The main emphasis of Narasimhan Committee was on enhancing the inherent strength of the financial institutions and improving their advances portfolio qualitatively.

Consequences of globalization on different companies:

(a) Virtually all companies had started placing emphasis on the up-gradation of managerial and professional skills.

(b) A proper linkage between technology and management practices is being focused. Technology transfer affects the employment situation of an organization. On the other hand, liberalization has also created jobs requiring superior skills, which are associated with higher wages and opportunities.

(c) A flat organizational structure had resulted in fewer levels of hierarchy and enhanced empowerment. Empowerment to all categories, from shop floor workers to managers, had facilitated independent decision-making, flexibility and trust. This has led to empowered employee involvement and motivation.

(d) People at the middle levels of management were becoming more participative and result oriented. On the other hand, decision-making was increasingly being handled at the group level.

(e) Insecurity levels among employees had diminished and their sense of responsibility had increased.

(f) There was an emphasis in openness and transparency. An improvement in the communication channels within the organization had resulted in better interpersonal relations and net working among units. Changes in recruitment policy had led to (i) Induction of professionals with diverse technical, managerial and academic backgrounds. (ii) A fall in the average age of employees. (iii) Higher salaries and more responsibilities for young employees. (iv) The induction of human resource professionals at senior levels, implying increased recognition in this area. (v) Meritocracy in personal policy which included performance based rewards for employees. (vi) Provision of VRS by companies to employees. (vii) A new culture that emphasized on employees' role of supporting rather than 'reporting' within the organization. Externally it emphasized employee commitment to customers satisfaction.

(g) Networking of various division or functions (marketing, manufacturing, vendor development, human resources management, etc.) within the organization with a view to create a responsive goal oriented and competitive organization.

(h) Today, employees are recognized as the key to building a world-class organization. They are a finite resource for which organizations have to compete. Thus, proactive organizations have adopted strategic human resources management as a tool to position themselves in the business world. Further, the focus is linking the human resources management strategy with corporate plans i.e., to understand the corporate business objectives and to integrate various functions in an organization.

(i) Sum total of liberalization is building the new organization i.e. restructuring the organization

7.14 LESSON END ACTIVITY

Can you track changes in the global economy from classical trade theories of Smith, Ricardo, and Heckscher-Ohlin of free trade; intervention in international trade to protect the interests of politically important groups; to the Revised case for Free Trade; setting up of the WTO on January 1, 1995, the successor to the General Agreement on Tariffs and Trade (GATT).

7.15 KEYWORDS

Economic reforms: Deregulation–Removal of government restrictions concerning the conduct of a business.

Privatization: Privatization transfers the ownership of state property into the hands of private individuals, frequently by the sale of state assets through an auction.

7.16 QUESTIONS FOR DISCUSSION

1. Whose interests should be the paramount concern of government trade policy-interests of the producers (business and their employees) or those of consumers?
2. Given the arguments relating to the new trade theory and strategic policy, what kind of trade policy should business be pressuring government to adopt?
3. Why should the international manager care about the political economy of free trade or about the relative merits of arguments for free trade and protectionism?
4. What factors prompted-Globalization and internal reform process-Internal Structural Reforms Process in India: Since July 1991?
5. What were the effect of reforms on Indian economy?

Check Your Progress: Model Answer

- Devaluation of Rupee by 22% against currencies of the leading industrial countries
- Introduction of the convertibility of rupee first on trade account and then for entire current account transactions.
- Liberalization of imports.
- Substantial reduction in customs tariff rates and thrust on exports.
- Liberation of capital flows in the form of foreign direct investment as a part of the package of external sector reforms.

7.17 SUGGESTED READINGS

Cherenilan Francis, *International Business: Text and Cases*, 3rd Edition, Prentice-Hall of India Private Limited.

Charles W.L. Hill, *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Justin Paul, *International Business*, (3rd ed.), Prentice Hall of India.

LESSON

8

FOREIGN DIRECT INVESTMENT

CONTENTS

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8.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Describe the trends of global FDI
- Know different types of FDI
- Point out effects of FDI on national economy

8.1 INTRODUCTION

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

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

There is an important distinction between FDI and Foreign Portfolio Investment (FPI). Foreign portfolio investment is investment by individuals, firms or public bodies

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

8.2 FOREIGN DIRECT INVESTMENT IN THE WORLD ECONOMY

The flow of FDI refers to the amount of FDI undertaken over a given time period (normally a year). The stock of FDI refers to the total accumulation of foreign owned assets at a given time. We also talk of outflows of FDI meaning the flow of FDI out of the country and inflows of FDI, meaning the flow of FDI into a country.

The past 20 years have seen a marked increase in both the flow and stock of FDI in the world economy. The average outflow of FDI is increased from about $25 billion in 1975 to a record of $1.3 trillion in 2000, before slumping dramatically in 2001 to $735 billion to an estimated $534 billion in 2002. Between 1975 and 2001 the flow of FDI not only accelerated but also accelerated faster than the growth in world trade. For example, between 1990 and 2001, the total flow of FDI for all countries increased about 365 per cent while world trade grew by some 75 percent and world output by 26 percent. As a result of strong FDI flow, by 2001 the global stock of FDI exceeded $6.6 trillion. In total, 65,000 parent companies had 8, 50,000 affiliates in foreign markets that effectively produced an estimated $19 trillion in global sales, nearly twice as high as the value of global exports.

FDI is growing more rapidly than world trade and world output for several reasons.

1. Fear of protectionist pressure despite the general decline in trade barriers – Example, Much of the Japanese automobile companies' investments in the United States during the 1980's and early 1990's were driven towards reduction of exports from Japan, thereby removing trade tensions between nations.
2. Dramatic political and economic changes that have been occurring in many of the world's developing nations, the general shift towards democratic political institutions and for market economies has encouraged FDI Economic growth, economic deregulation, privatization programs that are open to foreign investors and removal of many restrictions on FDI have made Asia, Eastern Europe and Latin America more attractive to foreign investors.
3. Increase in the amount of bilateral investment treaties designed to protect and promote investment between two countries, has been reflected in the decrease to facilitate FDI.
4. The globalization of the world economy is also having a great impact on the volume of FDI.
5. Many firms believe, it is important to have production facilities base close to the major customers. This too is creating pressures for greater FDI.

Direction of FDI

Developed nations in general, and the United States in particular, account for the largest share of FDI inflows, there has been some increase of FDI into the world's developing nations. From 1985 to 1990, the annual inflow of FDI into developing nations averaged $27.4 billion, or 17.4 per cent of the total global flow. By 1997, the inflow into developing nations had risen to $149 billion, or 37 per cent of the total. However it fell back to 19 per cent of the total in 2000. In 2001, the flow into developing nations accounted for 27 per cent of the total and it rose to $185 billion and 35 per cent of the total in 2002. Most recent inflows into developing nations have

been targeted at the emerging economies of south, East, and Southeast Asia. Driving much of the increase has been the growing importance of china as a recipient of FDI. In 2000, China received direct investments valued at about 440 billion, and that investment increased in 2001 as China prepared to join the World Trade Organization. Latin America emerged as the next most important region in the developing world for FDI inflows.

Source of FDI

Since World War II, the United States has traditionally been by far the largest source country for FDI. During the late 1970s the United States still accounted for about 47 per cent of all FDI outflows from industrialized countries, while the second place United Kingdom accounted for about 18 per cent. US firms dominated the growth of FDI in the 1960s and 70s. By 1980, 178 of the world's largest 382 multi nationals were US firms and 40 of them were British. However, during 1985-90 the United States slipped to third place behind Japan and the United Kingdom. Since then the United States regained its dominant position in every year but 1999 and 2000,when the United Kingdom was the largest spurce country. However, as a percentage of total outward FDI flows, the US share declined to less than 20 per cent by 1998-2001. The source of FDI by country remains highly concentrated with five countries (such as United States, United Kingdom, Japan, Netherlands, France and Germany), generally accounting for more than two-thirds of all foreign direct investment outflows.

The high level of FDI outflows from the United States during 1990-2000 was driven by a combination of factors including a strong US economy; strong corporate profits and cash flow, which have given firms the capital to invest abroad; and a relatively strong currency, particularly since 1995. Similar factors explain the continued growth of FDI outflows from the United Kingdom during the 1990s.

8.3 THE FORM OF FDI: ACQUISITION VERSUS GREEN FIELD INVESTMENTS

FDI can take the form of a green-field investment in a new facility or an acquisition of or merger with an existing local firm. UN estimates indicate that in 2001 some 78 per cent of all FDI inflows were in the form of mergers and acquisitions. There is a marked difference, however between FDI flows into developed and developing nations. In the case of developing nations, only about one-third of FDI is in the form of cross-border mergers and acquisitions. The lower percentage of FDI inflows that is in the form of mergers and acquisitions may simply reflect the fact that there are fewer target firms to acquire in developing countries.

Firms prefer to acquire-existing assets rather than undertake green-field investments because of the following:

First mergers and acquisitions are quicker to execute than green-field investments. This is an important consideration. In the modern business world markets evolve very rapidly.

Second foreign firms are acquired because those firms have valuable strategic assets, such as brand loyalty, customer relationships, trademarks or patents, distribution systems, production systems, and the like. It is easier and perhaps less risky for a firm to acquire those assets than to build them from the ground up through green-field investment.

Third firms make acquisitions because they believe they can increase the efficiency of the acquired unit by transferring capital, technology, or management skills.

8.4 HORIZONTAL FOREIGN DIRECT INVESTMENT

Horizontal FDI is the investment in the same industry abroad as the firm operates at home. Other things being equal, FDI is expensive because the firm must bear the costs of establishing production facilities in a foreign country or of acquiring a foreign enterprise. FDI is risky because of the problems associated with doing business in another culture where the "rules of the game" may be very different. When a firm exports, it need not bear the costs of FDI, and the risks associated with selling abroad can be reduced by using a native sales agent. Similarly, when a firm licenses its know-how, it need not bear the costs or risks of FDI. Firms prefer FDI over either exporting or licensing because of the following factors that alter the relative attractiveness of exporting, licensing, and FDI: (i) Transportation costs (ii) Market imperfections (iii) Product Life Cycle (iv) Strategic behaviour and (v) Location advantages.

1. ***Transportation costs:*** When transportation costs are added to production costs, it becomes unprofitable to ship some products a long distance specially products that have a low value-to weight ratio and can be produced in almost any location (e.g. cement, soft drinks etc). For such products, relative to either FDI or licensing, the attractiveness of exporting decreases. Thus transportation costs alone can explain why Cemex, the largest cement manufacturer of Mexico has undertaken FDI rather than exporting. For products with a high value-to-weight ratio, transport costs are normally a very minor component of total landed cost (e.g. electronic components, personal computers, medical equipment, computer software etc.). In such cases, transportation costs have little impact on the relative attractiveness of exporting, licensing, and FDI.

2. ***Market imperfections:*** Market imperfections are factors that restrain markets from working perfectly. In the international business literature, the marketing imperfection approach to FDI is typically referred to as Internationalization theory. With reference to horizontal FDI, market imperfections arise in two circumstances: when there are impediments to the sale of know how (licensing is a mechanism for selling know-how). Impediments to the free-flow of products between nations decrease the probability of exporting, relative to FDI and licensing. Impediments to the sale of know-how increase the profitability of FDI relative to licensing. Thus, the market imperfections explanation predicts that FDI will be preferred whenever there are impediments that make both exporting and the sale of know-how difficult and/or expensive.

   (a) ***Impediments to exporting:*** Governments are the main source of impediments to the free flow of products between nations. By placing tariffs on imported goods, government increases the cost of exporting relative to FDI and licensing. Similarly, by limiting imports through the imposition of quotas, governments increase the attractiveness of FDI and licensing. For example, the flow of FDI by Japanese auto companies in the United States during the 1980s was partly driven by protectionists threats from Congress and by quotas on the import of Japanese cars. For Japanese auto companies, these factors have decreased the profitability of exporting and increased the profitability of FDI.

   (b) ***Impediments to sale of know-how:*** According to economic theory, there are three reasons that the market does no always work well as a mechanism for selling know how, or why licensing is not attractive as it initially appears. *First*, licensing may result in a firm's giving away its' know how to a potential foreign competitor. *Second*, licensing does not give a firm tight control over production, marketing, and in a foreign country that may be required to profitably exploit its advantage in know-how. With licensing, control over production, marketing and strategy is granted to a licensee in return for a royalty fee. However, for both strategic and operational reasons, a

sense for a firm to locate production facilities where the cost and skills of local labour are most suited to its particular production process

firm may want to retain control over these functions. For example, a firm might want its foreign subsidiary to price and market very aggressively, but the licensee may be unable to do this.

Third a firm's know-how may not be amenable to licensing. This is particularly true of management and marketing know-how, where the kinds of skills required are difficult to codify and cannot be written down in a simple licensing contract. They are organization wide and have been developed over years. They are not embodied in any one individual, but instead are widely dispersed throughout the company.

3. ***Product Life Cycle:*** The product life cycle holds that every product or line of business proceeds through four phases: development, growth, maturity and decline. During the first two stages, sales growth is rapid and entry is easy. As individual firms gain experience and as growth slows in the last two stages, entry becomes difficult because of cost advantages of incumbents. In the decline phase of the product line (as other product substitutes emerge) sales and prices decline, firms which have not achieved a favourable position on the experience curve become unprofitable and either merge or exit from the industry.

4. ***Strategic behaviour:*** Another theory to explain FDI is based on the idea that FDI flows are a reflection of strategic rivalry between firms in the global market place. An early variant of this argument was expounded by F.T. Knickerbocker, who looked at the relationship between FDI and rivalry in oligopolistic industries. An oligopoly is an industry composed of a limited number of large firms (e.g. an industry in which four firms control 80 per cent of a domestic market may be defined as an oligopoly). A critical competitive feature of such industries is interdependence of the major players. What one firm does can have an immediate impact on the major competitors, forcing a response in kind.

   Knickerbocker's theory can be extended to embrace the concept of multipoint competition. Multipoint competition arises when two or more enterprises encounter each other's moves in different markets to try to hold each other in check. The idea is to ensure that a rival does not gain a commanding position in one market and then use the profits generated there to subsidize competitive attacks in other markets. Kodak and Fuji Photo Film Co. for example compete against each other around the world. If Kodak enters a particular foreign market, Fuji will not be far behind.

5. ***Location advantages:*** The British economist John Dunning has argued that location specific advantage can help explain the nature and direction of FDI. By location-specific advantages, Dunning means the advantages that arise from using resource endowments or assets that are tied to a particular foreign location and that a firm finds value to combine with its own unique assets (such as the firm's technological, marketing, or management know-how). Dunning accepts the internalization argument that market failures make it difficult for a firm to license its own unique assets (know-how). Therefore he argues that combining location-specific assets or resource endowments and the firm's own unique assets often requires FDI. It requires the firm to establish production facilities where these foreign assets or resource endowments are located.

An obvious example of Dunning's arguments is natural resources, such as oil and other minerals, which are specific to certain locations. Dunning suggests that affirm must undertake FDI to exploit such foreign resources. This explains the FDI undertaken by many of the world's oil companies, which have to invest where oil is located to combine their technological and managerial knowledge with this valuable location-specific resource. Another example is valuable human resources, such as low-cost highly skilled labour. The cost and skill of labour varies from country to country. Since labour is not internationally mobile, according to Dunning it makes

sense for a firm to locate production facilities where the cost and skills of local labour are most suited to its particular production process.

8.5 VERTICAL FOREIGN DIRECT INVESTMENT

Vertical FDI takes two forms, there is backward vertical FDI into an industry abroad that provides inputs for a firm's domestic production processes. Historically, most backward vertical FDI has been in extractive industries (e.g. oil extraction, bauxite mining, tin mining, copper mining). The objective has been to provide inputs into a firm's downstream operations (e.g. oil refining, aluminium smelting and fabrication, tin smelting and fabrication). Firms such as Royal Dutch/Shell, British Petroleum (BP), RTZ, Consolidated Gold Field are among the classic examples of such vertically integrated multinationals.

A second form of vertical FDI is forward vertical FDI in which an industry abroad sells the outputs of a firm's domestic production processes. Forward vertical FDI is less common than backward vertical FDI. For example, when Volkswagen entered the US market, it acquired a large number of dealers rather than distribute its cars through independent US dealers.

The question may arise that why firms go to all the trouble and expense of setting up operations in a foreign country. There are two basic answers-the first is a strategic behaviour argument and the second draws on the market imperfections approach.

1. ***Strategic behaviour argument:*** According to economic theory, by vertically integrating backward to gain control over the source of raw material, a firm can raise entry barriers and shut new competitors out of an industry. Such strategic behaviour involves vertical FDI if the raw material is found abroad.

   Another stand of the strategic behaviour explanation of vertical FDI sees such investment not as an attempt to build entry barriers, but as an attempt to circumvent the barriers established by firms already doing business in a country. This may explain Volkswagen's decision to establish its own dealer network when it entered the North American auto market

2. ***Market imperfections approach:*** The market imperfections approach offers two explanations for vertical FDI. The first explanation revolves around the idea that there are impediments to the sale of know-how through the market mechanism. The second explanation is based on the idea that investments in specialized assets expose the investing firm to hazards that can be reduced only through vertical FDI.

   (a) ***Impediments to the sale of know-how:*** Oil refining companies such as British Petroleum and Royal Dutch/Shell pursued backward vertical FDI to supply their British and Dutch oil refining facilities with crude oil, in the early decades of this century when neither Great Britain nor the Netherlands had domestic oil supplies.

   Generalizing from this example, the prediction is that backward vertical FDI will occur when a firm has the knowledge and the ability to extract raw materials in another country and there is no efficient producer in that country that can supply raw materials to the firm.

   (b) ***Investments in Specialized Assets:*** In this context, a specialized asset is an asset designed to perform a specific task and whose value is significantly reduced in its next-best use. Consider the case of an aluminum refinery which is designed to refine bauxite ore and produce aluminum. Bauxite ores vary in context and chemical composition from deposit to deposit. Each type of ore requires a different type of refinery. Running one type of bauxite through a refinery designed for another type increases production costs by 20 to

100 per cent. Thus the value of an investment in an aluminum refinery depends on the availability of the desired kind of bauxite ore.

Check Your Progress

Consider the case of IBM and Mexico. IBM was in a fairly strong bargaining position, primarily because Mexico was suffering freedom a flight of capital out of the country during 1985 and 1986, which made the government eager to attract new foreign investment. But IBM's bargaining power was moderated somewhat by the following:

(a) Size of the proposed investment was unlikely to have more than a marginal impact on the Mexican economy.

(b) IBM was looking for a low-labour-cost most desirable location close to the United States.

(c) Before others move in IBM felt it needed to move quickly to establish its own low-cost production facilities.

(d) (a) and (b)

(e) (a), (b) and (c)

8.6 IMPLICATIONS OF FDI FOR BUSINESS

The implications of the theories of horizontal and vertical FDI for business practice are relatively straightforward. First, the location-specific advantages argument associated with John Dunning helps explain the direction of FDI, both with regard to horizontal and vertical FDI. From both an explanatory and a business perspective, the most useful theory is the market imperfections approach. With regard to horizontal FDI, this approach identifies with some precision how the relatives rates of return associated with horizontal FDI, exporting and licensing vary with circumstances. The theory suggests that exporting is preferable to licensing and horizontal FDI is more costly and more risky as long as transport costs are minor and tariff barriers are trivial. As transport cost and/or tariff barriers increase, exporting becomes unprofitable, and the choice is between horizontal FDI and licensing. Since horizontal FDI is more costly and more risky than licensing, other things being equal, the theory argues that licensing is preferable to horizontal FDI. Other things are seldom equal, however. Although licensing may work, it is not an attractive option when one or more of the following conditions exist: (a) the firm has valuable know-how that cannot be adequately protected by a licensing contract (b) the firm needs tight control over a foreign entity to maximize its market share and earnings in that country, and (c) a firm's skills and know-how are not amenable to licensing. Figure 8.1 represents these considerations as a decision tree.

Firms for which licensing is not a good option tend to be clustered in three types of industries:

1. High-technology industries where protecting firm-specific expertise is of paramount importance and licensing is hazardous.
2. Global oligopolies, where competitive interdependence requires that multinational firms maintain tight control over foreign operations so that they have the ability to launch coordinated attacks against their global competitors (as Kodak has done with Fuji).
3. Industries where intense cost pressures require that multinational firms maintain tight control over foreign operations (so they can disperse manufacturing to locations around the globe where factor costs are most favourable to minimize costs).

The majority of the limited evidence seems to support these conjectures. In addition, licensing is not a good option if the competitive advantage of a firm is based upon managerial or marketing knowledge that is embedded in the routines of the firm, and/or the skills of its managers, and is difficult to codify in a "book of blueprints". This would seem to be the case for firms based in a fairly wide range of industries.

Firms for which licensing is a good option tend to be in industries whose conditions are opposite to those specified above. Licensing tends to be more common (and more profitable) in fragmented, low-technology industries in which globally dispersed manufacturing is not an option. Licensing is also easier if the knowledge to be transferred is relatively easy to codify .A good example of an industry where these conditions seem to exist is the fast food industry. McDonalds has expanded globally by using a franchising strategy. Franchising is essentially the service industry version of licensing-although it normally involves much longer-term commitments than licensing. With franchising, the firm licenses its brand name to a foreign firm in return for a percentage of the franchisee's profits. The franchising contract specifies the conditions that the franchisee must fulfill if it is to use the franchisor's brand name. Thus, McDonald's allows foreign firms to use it's brand name as long as they agree to run their restaurants on exactly the same lines as McDonald's restaurants elsewhere in the world.

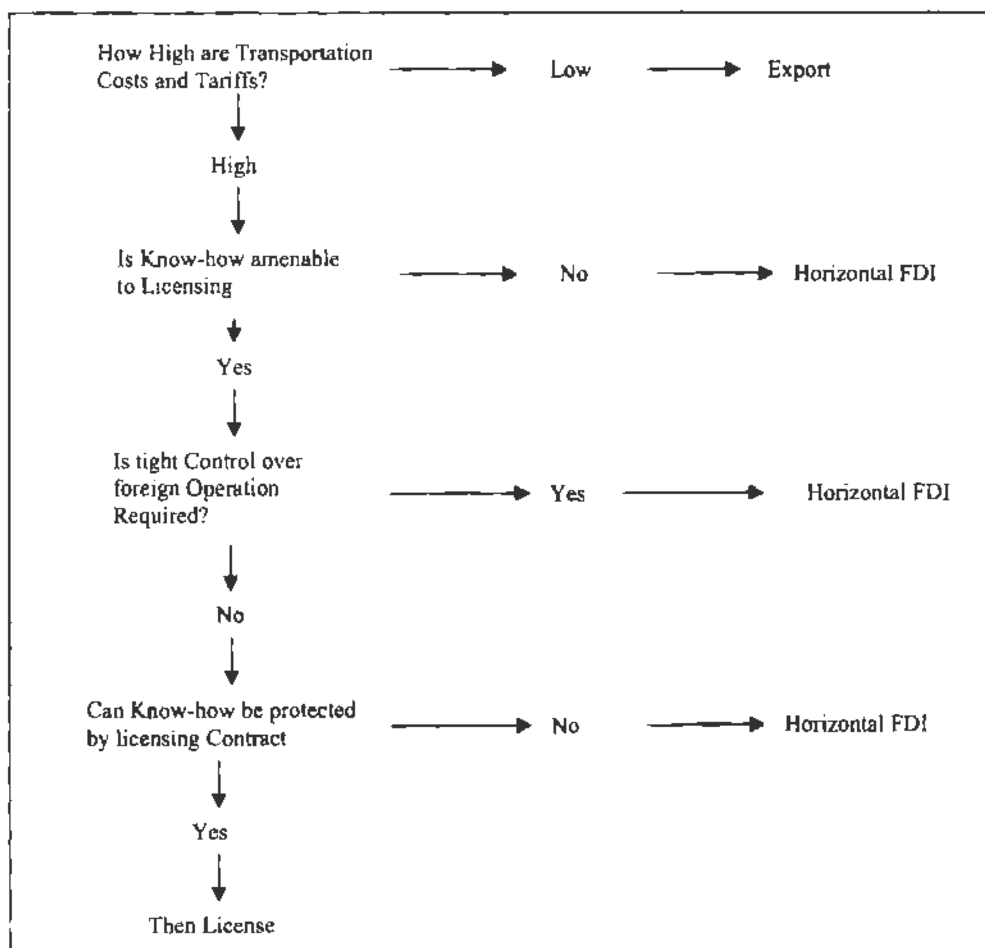

Figure 8.1: A Decision Framework

This strategy makes sense for McDonald's because:

(a) Like many services, fast food cannot be exported.

(b) Franchising economizes the costs and risks associated with opening foreign markets.

(c) Unlike technological, brand names are easy to protect using a contract.

(d) There is no compelling reason for McDonald's to have tight control over franchisees, and

(e) McDonald's know-how, in terms of how to run a fast-food restaurant, is amenable to being specified in a written contract e.g. the contract specifies the details of how to run a McDonald's restaurant).

It may be noted that McDonald's does undertake some FDI to establish "master franchisors" in each country in which it does business. These master franchisors are normally joint ventures with local companies and their task is to manage McDonald's franchisees within a particular country.

In contrast to the market imperfections approach, the product life-cycle theory and Knickerbocker's theory of horizontal FDI tend to be less useful from a business perspective. These two theories are descriptive rather than analytical. They do a good job of describing the historical pattern of FDI, but they do a relatively poor job of identifying the factors that influence the relative profitability of FDI, licensing and exporting. The issue of licensing as an alternative to FDI is ignored by both these theories.

Finally, with regard to vertical FDI, both the market imperfections approach and the strategic behaviour approach have some useful implications for business practice. The strategic behaviour approach points out that vertical FDI may be a way of building barriers to entry into an industry. The strength of the market imperfections approach is that it points the conditions under which vertical FDI might be preferable to the alternatives. Most importantly, the market imperfections approach points to the importance of investments in specialized assets and imperfections in the market for know-how as factors that increase the relative attractiveness of vertical FDI.

8.7 FDI IN INDIA

India has retained its position as the second most-preferred global location for foreign investment in 2008 and will continue to do so till 2010, lagging only behind China, the United Nations Conference on Trade and Development (UNCTAD) has said in World Investment Report 2008.

In the schema of classification of capital flows based on duration, FDI has been the most attractive type of capital flows for emerging market economies because of its lasting nature and also because it is considered a vehicle for transformation of the domestic production process through bridging the technological gap. Concerted efforts towards attracting FDI through an emphasis on policies of promoting non-debt creating capital inflows during the reform period did not yield results on the expected lines initially.

FDI in India has increased over the years due to the efforts that have been made by the Indian government. The increased flow of FDI in India has given a major boost to the country's economy and so measures must be taken in order to ensure that the flow of FDI in India continues to grow.

The total amount of FDI in India came to around US$ 42.3 billion in 2001, in 2002 this figure stood at US$ 54.1 billion, in 2003 this figure came to US$ 75.4 billion, and in 2004 this figure increased to US$ 113 billion.

With reform in policies, better infrastructure and a more vibrant financial sector, FDI inflows into India accelerated in 2006-07. On a gross basis, FDI inflows into India, after rising to a level of US$ 6.2 billion in 2001-02, fell to US$ 4.5 billion in 2003-04. After a recovery, the proportion has risen to reach US$ 23.0 billion in 2006-07. The trend continued in the current financial year with gross FDI flows at US$ 11.2 billion in the first six months. FDI inflows continued to be preponderantly of the equity

variety, broad-based and spread across a range of economic activities like financial services, manufacturing, banking services, information technology services and construction.

From April 2000 to November 2007, Mauritius remained the predominant source country for FDI to India accounting for 44.24 per cent share of the cumulative total, followed by the United States (9.37 per cent), the United Kingdom (7.98 per cent) and the Netherlands (5.81 per cent). During April-November 2007, the position of Mauritius remained still prominent (42.77 per cent). While the shares of the United States (5.45 per cent), the United Kingdom (2.19 per cent) and the Netherlands (4.51 per cent) were lower, those of Japan (5.72 per cent) and Singapore (8.73 per cent) were higher.

Sectoral Inflows of FDI in India

The major sectors of the Indian economy that have benefited from FDI in India are:

- Financial sector (banking and non-banking).
- Insurance
- Telecommunication
- Hospitality and tourism
- Pharmaceuticals
- Software and Information Technology.

Table 8.1: Sectors Attracting Highest FDI Equity Inflows

(In Rs. crore)

SECTOR	2005-06	2006-07	2007-08	2008-09 (April-July)	Cumulative (Apr.2000-July 2008)	% of total inflows*
Services (Financial & non-financial)	2399 (543)	21047 (4664)	26589 (6615)	6684 (1602)	62381 (14659)	20.97%
Computer Software & Hardware	6172 (1375)	11786 (2614)	(1410)	4642 (1092)	36809 (8370)	12.37%
Telecommunications	2776 (624)	2155 (478)	5103 (1261)	1295 (315)	18043 (4157)	6.065
Construction	667 (151)	4424 (985)	6989 (1743)	6224 (1483)	19606 (4646)	6.59%
Automobile	630 (143)	1254 (276)	2697 (675)	1792 (441)	11648 (2678)	3.92%
Housing and Real estate	171 (38)	2121 (467)	8749 (2179)	5480 (1315)	16642 (4026)	5.59%
Power	386 (87)	713 (157)	3875 (967)	2124 (520)	11754 (2725)	3.95%
Metallurgical	6540 (147)	7866 (173)	4686 (1177)	3208 (766)	10556 (2528)	3.55%
Chemicals (Other than fertilizers)	1731 (390)	930 (205)	920 (229)	1261 (301)	7401 (1686)	2.49%
Petroleum & Natural Gas	64 (14)	401 (89)	5729 (1427)	263 (62)	8509 (2043)	2.86%

Figures in bracket are in US$ million

* In terms of Rs.

Source: DIPP, Federal Ministry of Commerce and Industry, Government of India

8.8 LET US SUM UP

Foreign direct investment occurs when a firm invests directly in facilities to produce a product in a foreign country. It also occurs when a firm buys an existing enterprise in a foreign country.

Horizontal FDI is FDI in the same industry abroad as a firm operates at home. Vertical FDI is FDI in an industry abroad that provides inputs into or sells output from a firm's domestic operations.

Several factors characterized FDI trends over the past 20 years; (a) there has been a rapid increase in the total volume of FDI undertaken; (b) there has been some decline in the relative importance of the United States as a source for FDI, while several other countries have increased their share of total FDI outflows; (c) an increasing share of FDI seems to be directed at the developing nations of Asia and Eastern Europe, while the United States has become a major reeipient of FDI; and (d) there has been an increase in the amount of FDI undertaken by firms based in developing nations.

High transportation costs and/or tariffs imposed on imports help explain why many firms prefer horizontal FDI or licensing over exporting.

Impediments to the sale of know-how explain why firms prefer horizontal FDI to licensing These impediments arise when (a) a firm has valuable know-how that cannot be adequately protected by a licensing contract, (b) a firm needs tight control over a foreign entity to maximize its market share and earnings in that country, and (c) a firm's skills and know-how are not amenable to licensing.

Knickerbocker's theory suggests that much FDI is explained by imitative strategic behaviour by rival firms in an oligopolistic industry.

8.9 LESSON END ACTIVITY

Firms should not be investing abroad when there is a need for investment to create jobs at home. Discuss.

8.10 KEYWORDS

Foreign Direct Investment (FDI): Direct investment in business operations in foreign country

Horizontal foreign direct investment: Foreign direct investment in the same industry abroad as a firm operates in at home.

Vertical foreign direct investment: Foreign direct investment in an industry abroad that provides input into a firm's domestic operations, or foreign direct investment into an industry abroad that sells the outputs of a firm's domestic operations.

8.11 QUESTIONS FOR DISCUSSION

1. What are the advantages and disadvantages of FDI as compared to a licensing agreement with a foreign partner?
2. Recently, many foreign firms from both developed and developing countries acquired high tech US firms. What might have motivated these firms to acquire US firms?
3. Japanese MNCs such as Toyota, Toshiba and Matsushita made extensive investment in South East Asian countries like Thailand, Malaysia, Indonesia and India. In your opinion, what forces are driving Japanese investments in these regions?

4. Inward FDI is bad for (a) A developing economy and (b) A developed economy and should be subjected to strict controls! Discuss.

5. Compare and contrast these explanations of horizontal FDI: the market imperfections approach, Vernon's product life-cycle theory, and Knickerbocker's theory of FDI. Which theory do you think offers the best explanation of the historical pattern of horizontal FDI? Why?

6. Compare and contrast these explanations of vertical FDI: the strategic bahaviour approach the market imperfections approach. Which theory do you think offers the best explanation of the historical pattern of vertical FDI? Why?

Check Your Progress: Model Answer

(e)

8.12 SUGGESTED READINGS

Cherenilan Francis, *International Business: Text and Cases*, 3rd Edition, Prentice-Hall of India Private Limited.

Charles W.L. Hill, *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

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LESSON

9

GLOBAL MONETARY SYSTEM

CONTENTS

9.0 Aims and Objectives

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9.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- Institutional framework within which international payments are made
- The way movements of capital are accommodated
- Exchange rates among currencies are determined

9.1 INTRODUCTION

The lesson examines the international monetary system that is the overall financial environment in which global organisations operate.

The international monetary system can be defined as the institution framework within which international payments are made, movements of capital are accommodated and exchange rates among currencies are determined. It is a complex range of agreements, rules, institutions, mechanisms and policies regarding exchange rates, international payments and the flow of capital. The international monetary system has evolved over time and will continue to do so in the future as the fundamental business and political conditions underlying the world economy continue to shift.

9.2 EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM

The International Monetary System went through several distinct stages of evolution. These stages are summarized as follows:

1. Bimetallism
2. Gold standard
3. Bretton Woods System
4. Flexible Exchange Rate Regime

We will now examine each of the above stages in some detail:

9.2.1 Bimetallism before 1875

The international monetary system before the 1870's can be characterised as 'bimetallism' in the sense that both gold and silver were used as international means of payment and that the exchange rates among currencies were determined by either their gold or silver contents. Around 1870, for example, the exchange rate between the British pound, which was fully on a gold standard and the French franc, which was officially a bimetallic standard, was determined by the gold content of the currencies. On the other hand, the exchange rate between franc and the German Mark was determined by their exchange rates against the franc. It is also worth noting that due to various wards and political upheavals, some major countries such as limited states, Russia and Austria, Hungary had irredeemable currencies at one time or another during the period 1848-79. One might say that the international monetary system was less than fully systematic up until the 1870's.

9.2.2 Gold Standard

The gold standard had its origin in the use of gold coins as a medium of exchange, limit of account, and store of value – a practice that dates back to ancient times. When international trade was limited in volume, payment for goods purchased from another country was made in gold or silver. However, as the volume of international trade expanded in the wake of the Industrial Revolution, a more convenient means of financing international trade was needed. Shipping large quantities of gold and silver around the world to finance international trade seemed impractical. The solution was to arrange for payment in paper currency and for governments to agree to convert the paper currency into gold on demand at fixed rates.

Pegging currencies to gold and guaranteeing convertibility is known as the gold standard. By 1880, most of the world's trading nations including Great Britain, Germany, Japan and the United States had adopted the gold standard, given a common gold standard, the value of any currency in units of any other currency (the exchange rate) was easy to determine.

For example, suppose that the pound is pegged to gold at six pounds per ounce, whereas one ounce of gold is worth 12 francs. The exchange rate between the pound and the franc should be two francs per pound. To the extent that the pound and franc remain pegged to sell at given prices, the exchange rate between the two currencies will remain stable.

The strength claimed for the gold standard was that it contained a powerful mechanism for achieving balance of trade equilibrium by all countries. A country is said to be in balance of trade equilibrium when the income its residents earn from exports is equal to the money its residents pay to people in other countries for imports (the current account of its balance of payments is in balance). Suppose, under the gold standard, when Japan (its trade with United States) has a trade surplus, there will be

net flow of gold from the Unites States to Japan. This gold flow will reduce the money supply of US and swell Japan's money supply. We will see in subsequent chapters that there is a close connection between money supply growth and price inflation. An increase in money supply will raise prices in Japan, while a decrease in the US money supply will push US prices downward. The rise in the price of Japanese goods will decrease demand for these goods, while fall in prices of US goods will increase demand for these goods. Thus, Japan will buy more from the United States and the United States will buy less from Japan, until the balance of equilibrium is established.

The Gold standard worked reasonably well until the start of World War I in 1914. During the war, several governments financed part of their massive military expenditures by printing money. This resulted in all round inflation when the war ended in 1918. The United States returned to the gold standard in 1919, Great Britain in 1925 and France in 1928.

Great Britain returned to the Gold standard by pegging the pound to gold at the pre-war gold parity level despite substantial inflation during 1914-1925. This resulted in British goods being out of foreign markets resulting into a deep depression. When foreign holders of pounds lost confidence in Great Britain's commitment to maintain its currency value, they began converting their pound holdings into gold. The British government said it could not satisfy the demand of gold without seriously depleting its gold reserves, so it suspended convertibility in 1931.

The US followed suit and left the gold standard in 1933 but returned to it in 1934, raising the dollar price of gold by around 70%. Since more dollars were necessary to buy one ounce of gold than before, the dollar was worth less. This resulted in devaluation of the dollar relative to other currencies. By reducing the price of US exports and increasing the price of imports, the government was trying to create employment in the United States by boosting output. However a number of other countries adopted a similar tactic and in the cycle of competitive devaluation, no country could win.

The net result was the shattering of any remaining confidence in the system. Instead of holding onto another country's currency, people often tried to change into gold immediately lest the country devalue its currency. This put pressure on the gold reserves of various countries forcing them to suspend gold convertibility. By the start of World War II, the gold standard was dead.

9.2.3 Bretton Woods System

In 1944, when the World War II was at its peak, representatives from 44 countries met at Bretton Woods, New Hampshire, to design a new international monetary system. With the collapse of the gold standard and the great depression of the 1930's fresh in their mind, these statesmen wanted to have an enduring economic order that would facilitate post war economic growth. The general consensus was as follows:

1. Fixed exchange rates were desirable
2. The participants wanted to avoid the competitive devaluations of the 1930's

The agreement reached at Bretton Woods contained the following:

1. ***Two multinational institutions:*** The International Monetary Fund (IMF) and the World Bank were created. The IMF embodied an explicit set of rules about the conduct of international monetary policies and was responsible for enforcing these rules. The other institution, the International Bank for Reconstruction and Development (IBRD) better known as the World Bank was chiefly responsible for financing individual development projects.
2. Each country established a par value in relation to the US Dollar, which was pegged to gold at $ 35 per ounce. All participating countries agreed to try to

maintain the value of their currencies within 1 percent of the par value by buying or selling currencies (or gold) as needed. The US dollar was the only currency that was fully convertible to gold; other currencies were not directly convertible to gold. Countries held US dollars as well as gold, for use as an international means of payment.

3. A commitment by member countries not to use devaluation as a weapon of competitive trade policy. However, if a currency became too weak to defend, a devaluation of up to 10 percent would be allowed without any formal approval by the IMF. Larger devaluations require IMF approval.

Role of IMF

The aim of the Bretton Woods Agreement, of which IMF was the main custodian, was to try to avoid a repetition of that chaos through a combination of discipline and flexibility.

Discipline

1. The need to maintain a fixed exchange rate puts a break on competitive devaluations and brings stability to the world trade environment.
2. A fixed rate regime imposes monetary discipline on countries, thereby curtailing price inflation.

Flexibility

1. ***Lending facilities:*** The IMF was ready to lend foreign currencies to members tide them over during short period of balance of payments deficits, when a rigid tightening of monetary or fiscal policy would hurt domestic employment. A pool of gold and currencies contributed by IMF members' funds would buy time for countries to bring down their inflation rates and reduce their balance of payments deficits. The belief was that such loan would reduce pressures for devaluation and allow for a more orderly and less painful adjustment.
2. ***Adjustable parities:*** The system of adjustment parities allowed for the devaluation of a country's currency by more than 10 percent if the IMF agreed that a country's balance of payments was in "fundamental equilibrium". The Term "fundamental disequilibrium was not defined in the IMF's Articles of Agreement, but it was intended to apply to countries that had suffered permanent adverse shifts in the demand for their products.

Role of World Bank

The official name for the World Bank is the International Bank for Reconstruction and Development.

The bank lends money under two schemes:

1. Under the IBRD Scheme, money is raised through bond sales in the international capital market. Borrowers pay what the bank calls a market rate of interest. The bank's cost of funds plus a margin for expense. This "market rate" is lower than commercial banks' market rate. Under the IBRD Scheme, the bank offers low-interest loans to risky customers whose credit ratings are often poor.
2. The second scheme is overseen by the International Development Agency (IDA), an arm of the bank created in 1960. Resources to fund IDA loans were raised through subscriptions from wealthy members such as ULS, Japan and Germany. IDA loans go only to the poorest countries.

Failure

Under this system, the member countries had the option of pegging their currencies to either gold or to the dollar, the only reserve asset mentioned in the agreement establishing the system was gold. However as the gold stocks did not increase substantially in the year following the agreement, this provision acted as a bottleneck to the growth of international trade. Increase in trade necessitated increase in official reserves held by various countries in order to facilitate payment for these trades. To get around the problems, countries started holding dollar reserves. They held reserves in the firm of interest bearing securities issued by the U.S. Govt. This was encouraged by the US. Since US could pay for its increased imports just by printing additional money, without suffering a reduction in its reserves. Since other governments were ready to hold dollar reserves and not convert them into gold, the US started following a system of fractional reserves. The total number of dollars issued by the Federal Reserves (The American Central Bank) was far in excess of the value of the gold held by it. This created a paradox in the system known as Triffin paradox or the Triffin dilemma, after a Yale University Professor, Robert Triffin, who first spoke about it in 1960. According to him, it was necessary for the US to run Balance of Payments (BOP) deficit strategy to supply the world with the additional dollar reserves needed for increased international trade yet, as its deficit increased the volume of dollar reserves held by other countries grew without a simultaneous increase in US's gold reserves, its ability to honour its commitment (converting dollars into gold) would decrease. Such a situation would result in decreased confidence in the system and ultimately the system breaking down.

Another problem with the system was that it had become too rigid, despite the aim of the members being otherwise. As the system provided for realignment of exchange rates in case of fundamental disequilibrium, predicting exchange rate movements became very easy. This put currencies at the mercy of private speculation. If a country started facing regular BOP deficits, people would start facing regular BOP deficits, people would start experiencing a devaluation of its currency. Attempting to profit from such a scenario, private speculators would start selling the currency for gold or some other currency which was expected to remain strong in the hope of buying later at a reduced price with these capital outflows, the reserves of the country would go down, eventually forcing it to devalue its currency. These outflows could only be stopped by firm commitment by the concerned government at the very beginning of not devaluing such currency. After making such a commitment, the country would find it very difficult to go for devaluation, since the latter would make it lose its creditability and the possibility of controlling the market next time would be very bleak. The country cannot adopt other adjustment mechanisms which are generally not acceptable to them (which imply a contraction of the economy, thus resulting in increased unemployment), but to devalue it in a catch 22 situation. A country whose currency faces an upward pressure would also face a similar problem as the inflation resulting from an attempt to stop its currency from appreciating may not be acceptable and the only other option left would be to revalue the currency.

In the early 50's, the US was running the BOP surplus and there was shortage of dollars in the international markets. By the late 50s however, the US BOP situation had reversed and there was excess supply of dollars. So much so, that there was a considerable reduction in US. Gold holdings and the general belief that the dollar had become over valued and a connection in its value were due. This situation occurred due to two reasons:

1. Devaluation of other currencies vis-à-vis the dollar in the previous decade, which made American goods less competitive in the international markets and
2. High inflation rate prevailing in the US.

In 1960, the value of gold flared up in London where most of the private gold trading takes place. To prevent the markets from going too far off from the official price of $ 35 per ounce, the US arrived at a gold pool arrangement with 7 other countries, under which they sold gold in London. This helped in controlling the gold prices in the short run. At around the same time, US inflation started coming down and its BOP situation started improving. By the early 60's, US was enjoying a current account surplus. This was being balanced by capital flows out of US, mostly on account of US companies investing in Europe. In an attempt to reduce unemployment in the US, monetary tightening was not introduced despite the overall BOP figure remaining negative. Believing that the increasing trend in the current account balance would continue and the BOP deficit was a short-term phenomenon, the government looked at short-term arrangements for tiding over the BOP difficulties. It tried to persuade foreign governments not to convert their dollar holdings into gold, opened credit lines with foreign central banks, and drew small amounts from IMF. It also entered into the General Arrangements to Borrow (GAB), an agreement with 9 other major countries to form the Group of Ten (G – 10). The members of this group agreed to lend their currencies to IMF in case any one of them needed to draw a huge sum from it.

Despite all these steps, the BOP position did not turn positive as capital outflows continued. The main reason was the continuing high inflation rate in the US economy. With the US needing a lot of money to finance its commitments (to provide money for the reconstruction of the various war ravaged economies) under the Marshall Plan and its own expenses due to the Vietnam War, the money supply increased drastically, thus pushing the inflation to high levels. The US government then started imposing various restrictions on capital flows. An 'interest equalisation tax' was introduced on purchase of foreign securities by US citizens and its citizens were prohibited from holding gold either within the country or outside. In 1965, American banks and companies were told to voluntarily restrict loans to foreigners, and foreign direct investments respectively. In 1968, these controls were made compulsory. By then, however, the current account had also weakened. The pressure on the dollar started building up.

Other deficit countries were also facing problems. Britain started facing a BOP deficit in the early 60s and wanted to devalue the pound. The US objected as it felt that pound devaluation would fuel expectations of dollar devaluation and speculators would start taking positions against it, forcing it to be devalued. Due to the US objection, UK held on for some time, borrowing heavily from other governments and IMF to defend the pound's exchange rate. It finally gave up in 1967 and the pound was devalued. In 1968, capital started flowing out of France due to certain political disturbances there. In order to stop these disturbances, the French government had to increase wages, which resulted in making the French industry less competitive. This resulted in a pressure on the value of the French franc, especially vis-à-vis the DM. Neither France nor Germany took any action, as both of them wanted the other one to change the value of its currency with respect to the dollar. In 1969, the franc was finally devalued.

These problems put a lot of strain on the system. The pound devaluation did have the expected effect on the outlook for the dollar, and the pressures on that currency increased so much that even interventions by the gold pool group could not have the desired effect. In 1968, the sales by the gold pool in the private market were abandoned and the dollar was made non-convertible into gold for private market players. The Fed decided to convert only central bank's dollar holdings into gold.

After the franc's devaluation, there was increased speculation, especially regarding the DM. When the German authorities could no more stop their currency from appreciating, they let it float temporarily, rather than importing US inflation via the price adjustment mechanism. This was the first break in the Bretton Woods system after 1950, in which year the Canadian dollar was allowed to float. The German

authorities let the mark appreciate by 10% at which level they re-established the peg with the US dollar.

As the system started facing these problems and the pressure on the dollar increased, a new reserve asset was created by the IMF in 1967. Named SDRs (Special Drawing Rights), this international currency was allocated to the IMF member countries in proportion to their quotas. The biggest benefit of SDRs was that there would be a provision for international money to be created without any country needing to run a BOP deficit or to mine gold. Its value lay not in any backing by a currency or a real asset (like gold), but in the readiness of the IMF member countries to accept it as a new form of international money. Any member country, when facing payment imbalances arising out of BOP deficits, could draw on these SDRs, as long as it maintained an average balance of 30% of its total allocations. It could then sell these SDRs to a surplus country in exchange for that country's currency, and use it for settlement of international payments. Every member country was obliged to accept up to 3 times its total allocations as a settlement of international payments. It is an interest-bearing source of finance, i.e. countries holding their SDRs receive interest, and the ones drawing on them pay interest. This interest rate is determined on the basis of the average money market interest rates prevailing in France, Germany, Japan, the UK and the US. Only the member countries of IMF and specific official institutions are eligible to hold SDRs. SDR is also the unit of account for all IMF transactions.

The value of an SDR was initially determined as equal to that of the dollar, i.e., one ounce of gold was equalised to 35 SDRs. Later its value was revised and put equal to the weighted average value of 16 major currencies. Again, the basket of currencies was simplified and reduced to 5 currencies – US Dollar, Yen, Pound Sterling, DM and French Franc. Both the times, the weights were based on the importance of the respective countries in world trade. Both the basket and the weights are supposed to be revised every five years to reflect the changed scenario in international trade and the various countries' importance in it. An important advantage of the SDR is that its value is more stable than that of individual currencies. This happens because it derives its value from a number of currencies, whose values are unlikely to vary in the same direction and to the same extent. This feature makes it a better unit of account than a single currency.

Despite the introduction of SDRs, the crisis continued to deepen. By this time, US's gold holdings had reduced considerably (both as an absolute figure and as a proportion of its foreign liabilities). By 1979, its reserve position turned negative as the BOP deficit increased drastically. In the first three months of 1971, huge pressure built up against the dollar, especially with respect to the mark. A number of countries had to buy a lot of dollars to defend their exchange rates. Germany, not intending to increase its money supply to unmanageable proportions, once again floated its currency. In April 1971, the US suffered a trade deficit for the first time, but it could not follow contraction policies as it was simultaneously suffering from high unemployment. The only option left to it was to devalue. Even that it could not do on its own, as increasing the price of gold in terms of the dollar would not have had the desired effect due to other currencies being pegged to the dollar directly (rather than through gold prices). Also, an unexpected devaluation of the dollar would have penalised those countries, which were trying to help the US by holding on to dollars instead of converting them into gold. Most of the countries held on to dollars in the first half of 1971. In the beginning of August, France needed gold to repurchase francs from the IMF, which it had sold earlier in harder times. It fulfilled this need by converting its dollar holdings into gold. As gold reserves of the US fell and rumors spread about Britain also trying to follow the same route as France, panic spread in the international markets about US's ability to honour its commitment to convert all dollar holdings into gold. This caused a run on its gold reserves as all countries rushed

to get their dollar holdings converted when they could. This precipitated the matters so much that the US decided to stop converting dollars into gold and let its currency float on August 15, 1971. To improve its BOP position, it simultaneously imposed an additional 10% tariff on imports. Hence, the two most important pillars of the system were gone – fixing of prices of currencies in terms of gold and their convertibility into gold. As a reaction to this development, many of the countries let their currencies float.

The intention of the US behind these steps was not to shift from a pegged exchange rate system to a floating rate system, but to seek a realignment of exchange rates. Therefore, it called for a meeting of the 10 largest IMF member countries, which was held in December 1971, at the Smithsonian Institute in Washington, and considered the issue of realignment. As a part of the agreement, many of the countries revalued their currencies in terms of the dollar, while the dollar was devalued by raising the price of gold from $ 35 to $ 38 per ounce. The other part of the system, i.e. the facility of conversion of dollars into gold, however, was not re-established. The band around the parity rates was increased from one percent to 2.25 percent on each side, thus providing the central banks more flexibility in the management of exchange rate and monetary policy. It was also agreed to liberalise trade policies and to introduce more flexibility to exchange rates.

When the demand curve for exports is relatively inelastic, a devaluation of a country's currency does not immediately lead to an improvement in its current account balance. In the initial period, the reduction in the price of the exports is much more than the increase in the volumes and hence there is a net reduction in exports. In the long run, however, the volumes pick up and the net exports start rising. The current account curve, thus traces a J – shape. It first becomes worse than its position before the devaluation, and then improves. This is called the J – curve effect. The US's BOP behaved in a similar manner after the Smithsonian agreement. It was misinterpreted to mean that the devaluation of the dollar was smaller than it should have been. In mid 1972, the UK floated the pound as a response to BOP problems. This again fuelled speculation against the dollar, with dollar being abandoned in favour of the mark and yen. In February 1973, the dollar came under extreme selling pressure due to these factors and the high inflation rate, which continued to reign in the US. It was contemplating devaluing the dollar once again, but was pre-empted by Switzerland, which floated its currency. The dollar was, nevertheless, devalued by raising the price of gold to $41.22 per ounce. In mid March, 14 major industrial countries followed Switzerland by abandoning the system and floating their currencies. With this, the system came to an end.

9.2.4 Post Bretton Woods System (The Current System)

As the Bretton Woods System was abandoned, most countries shifted to floating exchange rates. This fact was finally recognised by the IMF and the articles were amended in its agreement. The amendment was decided upon in Jamaica in 1976 and became effective on April 1, 1978. This was the second amendment to IMF's articles. Under the new articles, countries were given much more flexibility in choosing the exchange rate system they wanted to follow and in managing the resultant exchange rates. They could either float or peg their currencies. The peg could be with a currency, with a basket of currencies or with SDRs. The only restriction put was that the pegging should not be done with gold. Neither was the member country allowed to fix an official price for gold. This was done to reduce the role of gold and to make SDRs more popular as a reserve asset. For the same reason, the value of an SDR was redefined in terms of a basket of currency (to make it more stable and hence preferable as a reserve asset), rather than in dollar terms. Also, the members were no longer required to deposit a part of their quota in gold, and IMF sold off its existing gold reserves. In order to make SDRs more attractive as a reserve asset, they were made interest bearing. It was allowed to be used for different types of international

transactions. The member countries were also left free to decide upon the degree of intervention required in the forex markets, and could hence make it compatible with their economic policies. Secondly, IMF was given increased responsibility for supervising the monetary system. As a part of these increased responsibilities, IMF was required to identify those countries which were causing such changes in the exchange rates through their domestic economic policies, which proved disruptive to international trade and investment. It could then suggest alternate economic policies to these countries; IMF was also responsible for identifying any country which was trying to defend an exchange rate which was inconsistent with the underlying economic fundamentals. This was to be done by a constant monitoring of the reserves position of various countries. Lastly, the new articles made it easier for countries facing short-term imbalances in their BOP accounts to access IMF's assistance.

While countries were free to determine their exchange rate policies, under Article IV of the Agreement, they were required to ensure that the economic and financial policies followed by them were such as to foster 'orderly economic growth and reasonable price stability'. They also had to follow principles of exchange rate management, adopted by IMF in April 1977. According to these principles:

- A member country neither should manipulate the exchange rates in such a way as to prevent a correction in the BOP position, nor should it use the exchange rates to gain competitive advantage in the international markets.
- A member country was required to prevent short-term movements in the exchange rates, which could prove disruptive to international transactions, by intervening in the exchange markets.
- While intervening in the forex markets, a member country was required to keep other countries' interests in mind, especially the country whose currency it chooses to intervene in.

These principles attempted to bring some stability in the forex markets and to prevent another bout of competitive devaluations.

Given the freedom, different countries chose different exchange rate mechanisms. While some of them kept their currencies floating, some of them pegged their currencies either to a single currency or to a basket of currencies. A peg was maintained by intervention in the foreign exchange markets and by regulating forex transactions. Table 9.1 shows the status of currencies as on March 31, 1995.

Floating of currencies was expected to make the exchange rate movements smoother. Instead, a lot of volatility has since been experienced. To remove a part of this volatility, sometimes a group of nations come together to form closer economic ties by co-operating with each other in the management of their exchange rates. One such group is the European Monetary Union (EMU).

Table 9.1: Exchange Rate Mechanisms followed by Various Countries as on March 31, 1995

Currencies pegged to	No. of currencies
The US dollar	23
French franc	14
SDR	3
Other currency baskets	28
Flexibility limited vis-à-vis single currency	4
Co-operation arrangements	10
Adjusted according to a set of indicators	3
Managed float	35
Independent float	59
	179

**Source:* Multinational Finance by Adrian Buckley

Check Your Progress

1. Which of the following countries has been worst affected by the Asian Currency Crisis:
   (a) Indonesia
   (b) Taiwan
   (c) Malaysia
   (d) Thailand
   (e) Philippines
2. The Asian Currency crisis was a result of:
   (a) Pegged exchange rate
   (b) Inefficient use of funds
   (c) Wrong pricing of capital
   (d) (a), (b) and (c) above,
   (e) Efficient use of funds

9.3 EUROPEAN MONETARY UNION

The basis of the European Monetary Union was the American desire to see a United Western Europe after World War II. This desire started taking shape when the Europeans created the European Coal and Steel Community, with a view to freeing trade in these two sectors. The pricing policies and commercial practices of the member nations of this community were regulated by a supranational agency. In 1957, the Treaty of Rome was signed by Belgium, France, Germany, Italy, Luxembourg and the Netherlands to form the European Economic Community (EEC), whereby they agreed to make Europe a common market. While they agreed to lift restrictions on movements of all factors of production and to harmonise domestic policies (economic, social and other policies which were likely to have effect on the said integration), the ultimate aim was economic integration. The European countries desired to make their firms more competitive than their American counterparts by exposing them to internal competition and giving them a chance to enjoy economies of scale by enlarging the market for all of them.

The EEC achieved the status of a customs union by 1968. In the same year, it adopted a Common Agricultural Policy (CAP), under which uniform prices were set for farm products in the member countries, and levies were imposed on imports from non-member countries to protect the regional industry from lower external prices. An important roadblock in the European unification was the power given under the treaty to all the member countries, by which they could veto any decision taken by other members. This hindrance was removed when the members approved the Single European Act in 1986, making it possible for a lot of proposals to be passed by weighted majority voting. This paved the way for the unification of the markets for capital and labour, which converted the EEC into a common market on January 1, 1993. Meanwhile, a number of countries joined EEC. Denmark, Ireland and the United Kingdom joined in 1973. By 1995, Austria, Finland, Greece, Portugal, Spain and Sweden had also joined, thus bringing the membership to 15.

The structure of the EEC consists of the European Commission, a Council of Ministers and a European Parliament. The Commission's members are appointed by the member countries' governments and its decisions are subject to the approval of the Council, where by convention, either the Finance Ministers or the heads of the Central Bank represent their respective countries. The Members of the Parliament are directly

elected by the voters of the member countries. In December 1991, the Treaty of Rome was revised drastically and the group was converted into the European Community by extending its realm to the areas of foreign and defence policies. The members also agreed to convert it into a monetary union by 1999.

As the Bretton Woods system was breaking down in 1973, six out of the nine members of the EEC jointly floated their currencies against the dollar. While Britain and Italy did not participate in the joint float, France joined and dropped out repeatedly. The currencies of the participating countries were allowed to fluctuate in a narrow band with respect to each other (1.125% on either side of the parity exchange rate), and the permissible joint float against other currencies was also limited (to 2.5% on either side of the parity, by the Smithsonian agreement). This gave the currency movements the look of a 'snake', with the narrow internal band forming the girth and the movements against other currencies giving the upward and downward wriggle. The external bank restricting the movement of these European currencies on either side, gave the impressions of a 'tunnel' thus giving rise to the term 'snake in the tunnel'. The idea of creating a monetarily stable zone started taking shape in 1978, which resulted in the creation of the European Monetary System in 1979. The system was quite similar to the Bretton Woods System, with the exception that instead of the currencies being pegged to the currency of one of the participating nations, a new currency was created for the purpose. It was named the European Currency Unit (ECU) and was defined as a weighted average of the various European currencies. Each member had to fix the value of its currency in terms of the ECU. This had the effect of pegging these currencies with each other. Since each currency could vary against the ECU and against other currencies with a certain band on either side of the parity rate (2.25% for others and 6% for Pound Sterling, Spanish peseta and Portuguese Escudo), a certain grid was formed which gave the limits within which these currencies could vary against each other. Whenever the exchange rate between two of the member currencies went beyond the permissible limit, both the countries had to intervene in the forex markets. This co-operation between the countries was expected to make the system more effective. Another important feature of this system was that the members could borrow unlimited amounts of other countries' currencies from the European Monetary Co-operation Fund in order to defend their exchange rates. This was expected to ward off any speculative activities against a member currency. Though the countries involved were also expected to simultaneously adjust their monetary policies, this burden was put more on the erring country. It was easier to fix the blame, as at the time of the fluctuation in the exchange rate of two members, the erring country's exchange rate would also be breaching its limits with respect to the ECU and other member currencies. When these parity rates became indefensible, they could be realigned by mutual agreement. The system was, thus, much more flexible than the Bretton Woods system.

The ECU also served as the unit of account for the EMS countries. It served another important purpose in that, loans among EMS countries (including private loans) could be denominated in the ECU. The ECU's value being the weighted average of a basket of currencies, it was more stable than the individual currencies. This made it more suitable for international transactions.

A number of realignments took place in the first few years of the system. However, the 1980's saw the system becoming more rigid. The German Central Bank, the Bundesbank, was committed to a low inflation rate, and hence to a tighter monetary policy. Some other countries (especially France and Italy, who had meanwhile joined the EMS) tried to control their domestic inflation by not realigning their currency's exchange rate with the DM and instead following the same monetary policy as the Bundesbank. The UK, which joined the EMS in 1990 also followed the same policy. This resulted in a high unemployment rate in such countries. This cost was acceptable to these countries, till the situation changed drastically with the effects of the 1990

German unification slowly becoming visible. As the erstwhile West Germany bore the expenses of the unification, its budget deficit started rising, increasing the German prices and wages. To keep inflation under control, the Bundesbank had to increase the interest rates to an even higher level. If the DM had been allowed to appreciate at that time, the Bundesbank would not have had to increase the interest rates too much, as German prices would have reduced in response to the higher DM. But as some other member countries of the EMS refused to let the DM appreciate, they had to increase their domestic interest rates in response. This happened at a time when many of the European countries were experiencing very high unemployment rates, and Britain was going through a recession.

The situation became worse with the decision of the EC countries to go ahead with monetary union. In 1989, the report of a committee chaired by the president of the European commission, Jacques Delor, was published. It recommended that the members of the EC abolish all capital controls and follow one common monetary policy. This monetary policy was proposed to be formulated by a European Central Bank (ECB), and followed by the central banks of all the member countries, which would become a part of the European System of Central Banks (ESCB). It also recommended the irrevocable locking of the EC Exchange Rates and the introduction of a common currency for the member nations. In the same year, the first stage of the process of economic integration began, and most of the recommendations of the Delor Committee report were accepted. However, it was decided that to make the integration long lasting, member countries were to achieve a high degree of economic convergence before being allowed to merge their economies with the rest of the group.

In December 1991, as a follow up to the Delor's report, the Treaty of Rome was revised extensively to provide for the monetary union. As these revisions were adopted in the Dutch town of Maastricht, they collectively came to be known as the Maastricht Treaty. The treaty laid down the timetable for the monetary union. According to the timetable, the union was to be completed by 1999, and the qualifying countries had to fulfil criteria regarding inflation rates, exchange rates, interest rates and budget deficits. As the markets believed these criteria to be too hard for some countries to achieve, speculative pressure against the currencies of these countries started building up. By September 1992, the pressure reached its peak. The first country to bear the brunt of the speculative attacks was Italy. Even as its Government announced a set of fiscal reforms to be able to meet the convergence criteria, pressures against the lira continued. Finally, Germany and Italy entered into a deal under which Italy devalued the lira and Germany reduced its interest rates. The UK was also facing a similar attack on its currency, and had to withdraw from the EMS soon after the Italian devaluation. Despite having already devalued its currency, Italy followed Britain and pulled its currency out of the EMS. Immediately afterwards, French voters approved the Maastricht Treaty. Yet, this approval could not stop an attack against the French franc. Even Bundesbank and the Banque de France (the French central bank) together could not postpone the inevitable for long. In July 1993, there was another attack on the franc as it became clear that the French and German interest rates would not converge. The French unemployment rates being very high and continuing to rise, it could be foreseen that a further possibility of interest rates rising there did not exist. At the same time, the German government could not be expected to reduce the interest rates as inflation was still not totally under control. It became clear that the franc had to be devalued as vis-à-vis the DM, but neither of the countries was ready to adjust the parity rates of their currency. Finally, the EMS countries decided to change the band from 2.25% to 15%. Germany and the Netherlands kept the band between their currencies at 2.25%. The band for peseta and the escudo continued at 6%. Though this change in the band successfully warded off the speculative attacks against the franc, the monetary convergence got a severe setback as there was no more need for

countries to converge their monetary policies. With the band becoming so wide, there was no real fixed exchange rate system left to talk about.

Despite these developments, the desire of the European countries to form a monetary union did not fade. After being ratified by all member countries, the Maastricht Treaty came into effect from November 1, 1993. Thus, the European and Monetary Union came into being. The first stage of the union continued up to the end of 1993. During this stage, capital flows and the financial sector were fully liberalised. The members were also required to keep their currencies within a 2.25% band of the parity rates. The second stage began in January 1994, with the establishment of the European Monetary Institute (EMI) in Frankfurt, which was the precursor to the ECB. Its job was to manage the EMS, co-ordinate national monetary policies, and to prepare for the creation of the ESCB. It's most important function was to monitor economic convergence among the member countries, a job to be shared by the EC, the Bundesbank and the Banque de France. In this stage, the governments were not allowed to borrow from their central banks at concessional rates and had to do so at market determined rates. They were required to systematically reduce their fiscal deficits and bring other economic indicators in line. In December 1995, a summit was held in Madrid, where the single European currency was named the euro, and a strict timetable for the EMU was finalised. In December 1996, the Dublin summit was held and it was decided to give full autonomy to the ECB. The rules which the ECB would have to follow for regulating monetary policy and to ensure exchange rate stability were also formulated. In May 1998, the heads of the member governments met in Brussels and were presented the reports of the various agencies responsible for monitoring the convergence of the various members. In accordance with the Maastricht Treaty, the member countries were required to fulfil the following criteria by the end of 1997:

- Fiscal deficit should be within 3% of GDP.
- Public debt should not exceed 60% of GDP.
- The inflation rate should not be more than 1.5% higher than that of three countries having the lowest inflation.
- The long term interest rates should not be exceeding the long term interest rates of the above mentioned 3 countries by more than 2%.
- The currency should have stayed within the ERM band for a minimum period of two years without any realignment.
- The central banks should be autonomous.

In line with the reports prepared by these agencies, the heads of states voted for selecting the countries which were eligible to join the EMU. 11 countries were allowed entry into the union, they being Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Britain, Denmark and Sweden opted out of choice despite being eligible and Greece was found ineligible. At the same time, the ECB was established. The day-to-day management of the ECB is the responsibility of an executive board. The board has a total of six members including a president and vice-president. These members are appointed by consensus and enjoy an eight year, non-renewable term. The managing body of the ECB is the governing council which consists of the executive board and the governors of the central banks of the EMU countries. The main functions of the ECB are to:

- Determine the monetary policy and to implement it.
- Support the member countries in implementing their economic policies, if that does not entail going against its main aim of maintaining price stability.
- Help the member countries in managing their forex reserves and to conduct forex operations.
- Ensure a smoothly operating interbank payments system.

The most significant development was the introduction of a single currency for the participants of the EMU – the euro. On January 1, 1999, the euro came into being. On this date, the exchange rates of the currencies of the participating nations with the euro were irrevocably fixed. There will be a transition period of three years during which these currencies will exist along with euro. However, from this date, all interbank payments will be in euros, there will be no interbank quotes between the dollar and local currencies, all new government debt will be denominated in euros, the ECB will conduct repo transactions in euros, and all stock exchange quotations for equities and trades and settlements of government debt and equity will be in euro. On the retail level, the bank statements and the credit card bills will be giving the euro equivalents of the national currency figure. Above all, from the same date, the ECB started formulating a common economic policy for the participating nations. Between January 1, 1999 and December 31, 2002 all retail transactions will be settled in the national currencies. As planned, euro notes and coins were introduced on January 1, 2002. The next 6 months will be the dual currency period in which both euro and the national currencies will be phased out and from July 2002, euro will be the only legal tender. As there will be a single European currency and hence no fluctuation of exchange rates, the introduction of euro is expected to result in a more efficient single market, and stimulate trade, growth and employment in the region. The single currency results in elimination of transaction costs, which results from the need to convert one currency into another.

9.4 EXCHANGE RATE MECHANISMS

The exchange rate can be formally defined as the value of one currency in terms of another. There are different ways in which exchange rates can be determined – fixed, floating or with limited flexibility. Different systems have different methods of correcting mismatch between international payments and receipts.

9.4.1 Fixed Exchange Rate System

As the name suggests, under the fixed (or pegged) exchange rate system, the value of a currency in terms of another is fixed. These rates are determined by the governments or the Central Banks of the respective countries. There is some provision for correcting these fixed rates in case of fundamental mismatch. The variations of the fixed rate system are:

1. Currency Bound system
2. Target Zone Agreement
3. Monetary Union

Under a Currency Bound System

A country fixes the rate of its domestic currency in terms of a foreign currency, and its exchange rate in terms of other currencies depends on the exchange rates between the other currencies and the currency to which the domestic currency is pegged. Due to the pegging, the monetary policies and economic variables of the country of the reference currency are reflected in the domestic economy. If the fundamentals of the domestic economy show a wide disparity from that of the reference countries, there is a pressure on the exchange rate to change. This may lead to a run on the currency, thus fixing the authorities to either charge or altogether abandon the peg. To prevent such an event, the monetary policies are kept in line with the reference country by the Central Monetary Authority, called the currency board. The currency board maintains reserves of the anchor currency up to 100% or more of the domestic currency in circulation. These reserves are kept in the form of low risk, interest bearing assets denominated in the anchor currency. An internationally accepted, relatively stable currency is generally selected as the anchor currency.

The currency board does not have discretionary powers over the monetary policy. The interest rates are determined by the market. If demand for the anchor currency rises people start converting more and more of the domestic currency for the anchor currency, the reserves with the currency board get depleted. As the domestic currency in circulation has to come down, this in turn will result in an increase in the domestic interest rates. A high interest rate increases the demand for the domestic currency and eliminates the pressure on the domestic currency. The opposite will happen in the case of an increase in the supply of the anchor currency. The interest rates thus, act as a force that brings back the forex markets to equilibrium.

Unlike a Central Bank, a currency board does not even have the power to print unlimited amounts of money (the domestic currency being backed by the reserves of the anchor currency). This prevents the board from lending to either the government or the domestic banks. The government's deficits are to be financed by either raising taxes or by borrowing in the market. Further, the Currency Board cannot act as the lender of the last resort.

Among the other drawbacks of the system, the foremost.is the loss of control over interest rates. The equilibrium in the forex markets is established at a point where the domestic interest rates in the economy are in accordance with the underlying economic fundamentals of the domestic and the anchor currency economy and the fixed exchange rate. A high inflation in the domestic markets can result in low or even negative interest rates. This may cause an asset price bubble as money is borrowed at low interest rates and part in financial and real assets. The excess demand for these assets makes their prices go up unrealistically high levels. Ultimately, the consequence is financial panic. Another effect of the inability of the board to set interest rates is that an important tool for controlling the level of economic activity becomes inoperative.

Target Zone Arrangement

Under this arrangement, a group of countries sometimes get together and agree to maintain the exchange rates between their currencies within a certain band around fixed countries' exchange rates. Convergence of chronic policies of the participating countries is a pre-requisite for the sustenance of this system. An example of this system is the European Monetary System under which twelve countries came together in 1979.

Monetary Union

This is the next logical step of target zone arrangement, under which a group of countries agree to use a common currency instead of their individual currencies. An independent common Central Bank is set up which has the sole authority to issue currency and to determine the monetary policy of the group as a whole.

Floating Exchange Rate System

Under this system, the exchange rates between currencies are variable. These rates are based on demand and supply for the currencies in the international market. These, in turn, depend on the flow of money between the countries, which may either result due to international trade in goods or services, or due to purely financial flows. Hence in the case of deficit or surplus in the balance of payments, (difference between the inflation rates, interest rates economic growth of the countries are some of the factors which result in such imbalances) the exchange rates get automatically adjusted and this leads to a correction in the imbalance.

Floating exchange rates may be of two types – Free Float and Managed Float.

Free float: The exchange rate is said to be freely floating when its movements are totally determined by the market. There is no intervention at all either by the governments or by the Central Bank.

Managed Float: The exchange rates do not depend on the Market but there is intervention by either the government or the Central Bank. The managed float can take three forms:

1. The Central Bank may occasionally enter the market in order to smoothen the transition from one rate to another, while allowing the market to follow its own trend.
2. Some events may have only a temporary effect on the markets. Here the intervention may take place to prevent these short-and medium-tenn effects, while letting the markets find their own equilibrium rates, in the long run.
3. Though officially, the exchange rate may be floating, in reality the Central Bank may intervene regularly in the currency market thus unofficially keeping it fixed.

Hybrid Mechanism

Hybrid Mechanism is a mix of fixed and floating exchange rate system.

Crawling Peg

A crawling peg system is a hybrid of the fixed and flexible exchange rate system. Under this system, while the value of the currency is fixed in terms of a reference currency, the peg itself keeps changing in line with economic fundamentals, thus letting the market forces play a role in the determination of the exchange rate. There are several bases, which could be used to determine the direction of the change in the exchange rate. One could be the actual exchange rate ruling in the market. Another base could be the recent figure for the difference between domestic inflation and the inflation rate in the anchor currency country. The other base can be on the balance of trade figures or changes in the external debt of the country. The advantages of a crawling peg is that, though it gives a relatively stable exchange rate (changes in which are fairly predictable), the rate is never too much out of line with the underlying fundamentals of the economy.

Basket of Currency

A selected group of currencies whose weighted average is used as a measure of the value or the amount of an obligation. A currency basket functions as a benchmark for regional currency movements – its composition and weighting depends on its purpose. A currency basket is commonly used in contracts as a way of avoiding (or minimizing) the risk of currency fluctuations. The European Currency Unit (which was replaced by the euro) and the Asian Currency Unit are examples of currency baskets. The use of a currency basket can be very important for investors who wish to deal with currency exchange as a way of increasing their net worth. In general, the process of evaluating one currency against a different currency is known as pegging. For example, an investor may choose to compare the current value of the United States dollar to the Euro. While this approach works well when considering an exchange that only involves these two currencies, it does not address the possible advantages in exchanging one base currency for several different currencies. With a currency basket, the comparison is broader and thus may yield two or more possible approaches to the execution of a Forex order.

A currency basket can also be an important factor for the countries who issue currency as well. Pegging the currency by comparing the current rate of exchange with several different prominent and desirable currencies can provide a lot of insight into all sorts of important aspects. Through the application of the currency basket approach, it is possible to get some perspective on the general opinion of a country, its political

situation, and the willingness of other countries to do business with the nation in question.

9.5 LET US SUM UP

A Gold standard involves the open offer by the central banks to exchange domestic paper money against gold at a fixed price. A deficit causes an outflow of gold. The reduction in gold reserves reduces the local money supply and puts downward pressure on prices in the deficit country. The fall in prices stimulates exports and lowers imports. In the surplus countries, the money supplies increase, raising prices in these countries. This causes a further reduction of relative prices in the deficit country. In addition, changes in relation to prices within each country help eliminate a deficit or surplus.

The classical gold standard was in effect for half a century before World War I and again from 1926 to 1931. The guarantees by governments to convert paper money to gold provided a creditable commitment that inflationary policy would not be provided.

Critics of the gold standard argue that prices in surplus and deficit countries showed parallel movement rather than the reverse implied by the gold standard. Downward price rigidity is responsible.

The Bretton Woods system of 1944 was a response to the conditions between the wars. Exchange rates were fixed to gold or the U.S. dollar and the International Monetary Fund, IMF, was established to administer the system.

The gold-exchange standard required the United States to fix its exchange rate to gold, and other countries to fix to gold or to the U.S. dollar. This system operated from 1944 to 1968. From 1968 to 1973, the U.S. dollar was not fixed to gold, but most other currencies were still fixed to the dollar. This was called the dollar standard.

To maintain the fixed exchange rate in terms of the dollar, central banks must purchase or sell their local currency at the support points on either side of the parity value.

Because deficit countries which run out of foreign exchange reserves are eventually forced to revalue, it is possible to identify which currencies face devaluation.

The European Monetary System (EMS) was a fixed-exchange-rate system in which countries cooperated to maintain exchange rates. Exchange rates were also maintained within limits vis-à-vis the European Currency Unit.

Alternatives to the fixed-rate system and flexible rate systems include fixed rate with a wide band, a crawling peg, fixed rate for some items and flexible for others and a dirty float with intervention to maintain orderly markets.

The creditable announcement of target zones helps to keep exchange rates within the zones.

9.6 LESSON END ACTIVITY

Once capital markets are integrated, it is difficult for a country to maintain a fixed exchange rate. Explain why this may he so.

9.7 KEYWORDS

Fixed exchange rate system: A system under which the exchange rate for converting one currency to another currency is fixed.

Floating exchange rate: A system under which the exchange rate for converting one currency into another is continuously adjusted depending on the laws of supply and demand.

Dirty float system: A system under which a country's currency is nominally allowed to float freely against other currencies, but in which the government will intervene, buying and selling currency, if it believes that the currency has deviated too far from its value.

International monetary system: Institutional arrangements countries adopt to govern exchange rates.

Gold Standard: The practice of pegging currencies to gold and guaranteeing convertibility.

Currency crisis: Occurs when a speculative attack on the exchange value of a currency results in a sharp depreciation in the value of the currency or forces authorities to expend large volumes of international currency reserves and sharply increase interest rates to defend the prevailing exchange rate.

Banking crisis: A loss of confidence in the banking system that leads a run on banks, as individuals and companies withdraw their deposits.

Foreign debt crisis: Situation in which a country cannot service its foreign debt obligations, whether private sector or government debt.

9.8 QUESTIONS FOR DISCUSSION

1. Discuss the advantages and disadvantages of the gold standard.
2. What are the main objectives of the Bretton Woods System?
3. Comment on the proposition that the Bretton Woods System was programmed to an eventual demise.
4. Why did the gold standard collapse? Is there a case for returning to some type of gold standard? What is it?
5. Do you think the standard IMF policy presumptions of the tight monetary policy and reduced government spending are always appropriate for developing nations experiencing a currency crisis? How might the IMF change its approach?
6. Debate the relative merits of fixed and floating exchange rate regimes.
7. Explain the arrangements and workings of the European Monetary System (EMS).
8. Which of the following system's collapse is related to the Triffin Paradox? (a) Gold standard, (b) Bretton Woods, (c) Exchange Rate mechanism in 1992, (d) Both (a) and (b) above, (e) None of the above
9. In general a currency crisis tends to occur when:

   (a) Economic fundamentals are weak

   (b) Currency of a country whose economic fundamentals are weak

   (c) Economic fundamentals are strong

   (d) Currency depreciates

   (e) None of the above
10. Which is the most important currency in the world after the collapse of Bretton Woods?

    (a) DM, (b) Yen, (c) Sterling, (d) FF, (e) US Dollar
11. Which of the following countries follow the currency Board System of exchange rate management?

    (a) India, (b) Pakistan, (c) Brazil, (d) Argentina, (e) Singapore

12. Which of the following institutions has international monetary corporation as its primary concern:
    (a) World Bank
    (b) Bank for International Settlements
    (c) International Monetary Fund
    (d) International Development Association
    (e) International Finance Corporation
13. The value of special drawing rights (SDR's) fluctuates in accordance with the following currencies except:
    (a) The Japanese Yen
    (b) The Swiss franc
    (c) The British Pound
    (d) The US Dollar
    (e) None of the above
14. Which exchange rate system is best suited as an exchange rate system where a home currency's value is fixed to a foreign currency but moves in line with that foreign currency against other currencies:
    (a) Fixed
    (b) Freely floating
    (c) Managed float
    (d) Pegged
    (e) None of the above
15. Devaluation of a currency means:
    (a) Government refixing the value of the local currency lower under the fixed exchange system
    (b) Market forces refixing the value of the local currency under the fixed exchange system
    (c) Market forces refixing the value of the local currency under the flexible exchange system
    (d) Government fixing the value of the local currency lower
    (e) Both (b) and (c) above

Check Your Progress: Model Answer

1. (a)
2. (b)

9.9 SUGGESTED READINGS

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LESSON

10

FOREIGN EXCHANGE MARKET

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10.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- The intricacies involved in the operations of the foreign exchange market within a regulatory environment

10.1 INTRODUCTION

In this lesson, the settlement of international payments will be discussed. The existence of a number of currencies gives rise to the need to transact in these currencies for settling international payments. We know that in international transactions, at least one of the parties would be dealing in a foreign currency. For example, if an Indian exporter sells some goods to someone in the US and the price is determined in dollars, the exporter would be dealing in a foreign currency. Similarly,

if an Italian resident makes an investment in the German Money Market, he would deal with the German currency Euro that would be a foreign currency to him. Sometimes, the transaction currency may be a foreign currency to both the parties involved. This fact resulted in the development of a market, which deals specifically in currencies, called the Foreign Exchange Market. This is an OTC (over the counter) market, i.e. there is no physical marketplace where the deals are made. It is a network of banks, brokers and dealers spread across various financial centres of the world. These players trade in different currencies through (and are linked to each other by) telephones, faxes, computers and other electronic networks. These traders generally operate through a trading room. The deals are mostly on an oral basis with written confirmations later.

10.2 STRUCTURE OF THE FOREX MARKET

Broadly defined "the foreign exchange" (FX or FOREX) market encompasses the conversion of purchasing power from one currency into another, bank deposits of foreign currency, the extension of credit denominated in a foreign currency, foreign trade financing, trading in foreign currency options and futures contracts and currency swaps.

The structure of the foreign exchange market is an outgrowth of one of the primary functions of a commercial banker, to assist clients in the conduct of international commerce. For example, a corporate client willing to import goods from abroad would need a source for foreign exchange, if the import was invoiced in the exporters' home currency. Alternatively, the exporter might need a way to dispose off foreign exchange if payment for the export was invoiced and received in the importer's home currency. Assisting in foreign exchange transactions of this type is one of the services that commercial banks provide for their clients and are of the services that bank customers expect from their bank.

10.3 FX MARKET PARTICIPANTS

The market for foreign exchange can be viewed as a two-tier market. One tier is the wholesale or interbank market and the other tier is the retail or client market. FX market participants can be categorised into five groups – international banks, bank customers, non-bank dealers, FX brokers and Central banks.

International banks provide the core of the FX market. Approximately 200 banks activity 'make a market' in foreign exchange i.e. they stand willing to buy or sell foreign currency for their own account. These international banks serve their retail clients, the bank customers in conducting foreign commerce or making international investment in fixed assets that require foreign exchange. Bank customers include MNC's, money managers and private speculators. Retail or bank client transactions account for approximately 15% of FX trading volume. The other 85% of trading volume is from inter-bank trades between international banks or non-bank dealers. Non-bank dealers are large non-bank financial institutions such as investment banks, where size and frequency of trades make it cost-effective to establish their own dealing rooms to trade directly in the inter bank market for their foreign exchange needs.

Part of the interbank trading among international bank involves adjusting the inventory positions they held in various foreign currencies. However, most interbank trades are speculative or arbitrage transactions, where market participants attempt to correctly judge the future direction of price movements in one currency versus another or attempt to profit from temporary price discrepancies in currencies between competing dealers. Market psychology is a key ingredient in currency trading and a dealer can often infer another's trading intention from the currency position being accumulated.

FX brokers match dealer orders to buy and sell currencies for a fee, but do not take a position themselves. Brokers have knowledge of the quotes offered by many dealers in the market. Consequently, inter-bank trades will use a broker primarily to disseminate as quickly as possible a currency quote to many dealers. In recent years, since the introduction and increased usage of automated dealing system, the use of brokers has declined.

The Central Bank (national monetary authority) of a particular country frequently intervenes in the foreign exchange market in an attempt to influence the price of its currency against that of a major trading partner, or a country that it "fixes" or pegs" its currency against. Intervention is the process of using foreign currency reserves to buy one's own currency in order to decrease its supply and thus increase its value in the foreign exchange market, or alternatively selling one's own currency for foreign currency in order to increase its supply and lower its price.

The inter bank market is a network of correspondent banking relationships, with large commercial banks maintaining demand deposit accounts with one another called correspondent banking accounts. The correspondent bank account network allows for efficient functioning of the foreign exchange market.

For example, if the Deutsche Bank sells dollars to the Global Trust Bank in exchange for French Francs, the Nostro account of the Deutsche Bank with a bank in the US will be debited and that of GTB will be credited with the amount of French Francs (Nostro account is the overseas account held by the domestic bank with a foreign bank or with its own foreign branch in that foreign country's currency). The same account is called a Vostro account from the holding bank's point of view). A currency's settlement always takes place in the country of origin of the currency. In the US, the Clearing House Interbank Payments System (CHIPS) is used for the settlement of forex transactions.

In India, all dealings in foreign exchange are required to comply with the Foreign Exchange Management Act, 1999 (FEMA). The Reserve Bank of India is the regulatory authority for the Act. According to FEMA, only those entities can deal in foreign exchange as authorised to do so by RBI. The Act provides for entities to be authorised either as authorised dealers or as money changers. Authorised dealers are generally commercial banks and form a large part of the interbank markets in India. Money changers can be either full-fledged money changers or restricted money changers. While the former are authorised to both buy and sell foreign currency from their customers, the latter can only buy the same. Money changers are allowed to deal only in notes, loans and travellers' cheques. Authorised dealers on the other hand are allowed to deal in all the items classified as foreign exchange by FERA. Thus, they are permitted to deal with all documents relating to exports and imports. The authorised dealers have to operate within the rules, regulations and guidelines issued by the Foreign Exchange Dealers Association of India (FEDAI) from time to time. The offices/branches of authorized dealers (AD's) are classified into three categories. These are:

- ***Category A:*** These are offices/branches which keep independent foreign currency accounts with overseas correspondent banks/branches in their own names.
- ***Category B:*** These are the branches which do not maintain independent foreign currency accounts but have powers to operate the accounts maintained abroad by their head office or the branches categorised as A.
- ***Category C:*** The branches, which fall in neither of the above categories and yet handle forex business through a category A or B branch, fall under Category C.

The Indian forex market consists of three tiers. The first tier consists of all the transactions between the authorised dealers and the RBI. The second tier is the interbank market referred to earlier i.e. the market in which the authorised dealers deal with one another. Money changers are required to offset, their positions created by

dealing with their customers, in this interbank market. The third tier is the retail segment, where authorised dealers and moneychangers deal with their customers.

10.4 FOREIGN EXCHANGE

Foreign exchange is defined in terms of section 2 of FEMA, 1999 as a foreign currency including:

1. All deposits, credits, balance payable in any foreign currency.
2. Any drafts, traveler's cheques, letters of credit and bills of exchange expressed or drawn in Indian currency and payable in foreign currency.
3. Any instrument giving anyone the option of making it payable either partly or fully in a foreign currency.

Here the term currency in "foreign currency" includes coins, bank notes, postal notes, postal orders and money orders.

In other words, foreign exchange includes all kinds of claims of the residents of a country to foreign currency payable abroad.

10.5 FUNCTIONS OF FOREIGN EXCHANGE MARKET

A foreign exchange market performs three important functions:

1. ***Transfer of Purchasing Power:*** The primary function of a foreign exchange market is the transfer of purchasing power from one country to another and from one country to another. The international clearing function performed by foreign exchange market plays a very important role in facilitating international trade and capital movements.
2. ***Provision of Credit:*** The credit function performed by foreign exchange markets also plays a very important role in the growth of foreign trade, for international trade depends to a great extent on credit facilities. Exporters may get pre-shipment, and post-shipment credit. Credit facilities are available also for importers.
3. ***Provision of Hedging Facilities:*** Hedging refers to covering of foreign trade risks, and it provides a mechanism to exporters and importers to guard themselves against losses arising from fluctuations in exchange rates.

10.6 METHODS OF AFFECTING INTERNATIONAL PAYMENTS

There are different methods of affecting international payments:

1. ***Transfers:*** Money may be transferred from a bank in one country to a bank in another part of the world by electronic or other means.
2. ***Cheques and Bank Drafts:*** International payments may be made by means of cheques and bank drafts. The latter is widely used. A bank draft is a cheque drawn on a bank instead of a customer's personal account. It is an acceptable means of payment when the person tendering is not known, since its value is dependent on the standing of a bank which is widely known and not on the credit worthiness of a firm or individual known only to a limited number of people.
3. ***Foreign Bill of Exchange:*** A bill of exchange is an unconditional order in writing, addressed by one person to another, requiring the person to whom it is addressed to pay a certain sum on demand or on a specified future date.

There are two important differences between inland and foreign bills. The date on which an inland bill is due for payment is calculated from the date it was drawn, but the period of a foreign bill runs from the date on which the bill was accepted The reason for this is that the interval between a foreign bill being drawn and its acceptance may be considerable, since it may depend on the time taken for the bill to pass from the drawer's country to that of the acceptor. The second important difference between the two types of bill is that the foreign bill is generally drawn in sets of three, although only one of them bears a stamp, and of course, one of them is paid.

4. ***Documentary (or reimbursement) Credit:*** Under this method, a bill of exchange is necessarily employed, but the distinctive feature of the documentary credit is the opening by the importer of a credit in favour of the exporter, at a bank in the exporter's country.

To illustrate let us assume that Mr. Menon of Cochin intends to purchase goods from Mr. Ronald of New York and that the terms of the deal have been agreed upon by them. Then the transaction swill be carried out as follows:

(a) Mr Menon the importer, instructs his bank, say State Bank of India (SBI) to open a credit in favour of Mr. Ronald, the exporter, at the New York branch of the SBI (or other bank to act as its agent there). The SBI will then inform Mr. Ronald that it will transfer him the specified sum in exchange for the bill of exchange and the shipping documents.

(b) Mr. Ronald may now dispatch the goods to Mr. Menon at cochin, draw a bill of exchange on the SBI and then present the documentary bill to the New York branch of the SBI. If all the documents are in order, the bank will pay Mr. Ronald. The bank will charge for its services, and will also charge interest if the bill is not payable at sight.

(c) The New York branch of the SBI then sends the documentary bill to its Cochin office for payment or acceptance, as the case may be, by Mr. Menon. When the bill is paid, Mr. Menon's account will he debited by that amount. Everything being in order, the banker will release the bill of lading from the bill to enable Mr. Menon to claim the goods on the arrival at the Cochin port.

Transactions in the Foreign Exchange Market: A brief account of certain important types of transactions conducted in the foreign exchange market is given below:

- ***Spot Market:*** The spot market involves almost the immediate or sale of foreign exchange. Typically cash settlements are made within one/two days.
- ***Forward Market:*** A forward contract (also called an outright forward) is one where the parties to the transaction agree to buy or sell a commodity (here, a currency) at a predetermined future date at a particular price. This future date may be any date beyond two business days. The price and the terms of delivery and payment are fixed at the time of entering into the contract. In the forex markets, forward contracts generally mature after 1, 2, 3, 6, 9 or 12 months.

A forward contract is normally entered into to hedge oneself against exchange risk (i.e. the uncertainty regarding the future movements of the exchange rate). By entering into a forward contract, the customer locks-in the exchange rate at which he will buy or sell the currency.

A currency is said to be at premium against another currency if it is more expensive in the forward market than in the spot market. In this case, its forward rate will be higher than its spot rate. This happens when the future spot rate is expected to be higher than the current spot rate. Conversely, a currency is said to be at a discount if it is cheaper in the forward market than in the spot market.

Futures

A future contract has been defined on "the simultaneous right and obligation to buy or sell a standard quantity of a specific financial instrument (or commodity or currency) at a specific future date and at a price agreed between the parties at the time the contract was signed." In short it is an exchange traded version of the traditional forward contract. As such the forward and future contract prices follow, the same basic principle that are derived from today's price, adjusted for the "cost of carry". The cost of carry can be defined as interest cost of buying the asset at today's price adjusted for income on the asset in the section. The major differences between futures and forward contracts are as follows:

1. ***Trading location:***

   Futures: traded comparatively on an organised exchange.

   Forward: traded by bank dealers via a network of telephones, fax machines and computerised dealing system.

2. ***Contractual Size:***

   Futures: Standardised amounts of underlying assets.

   Forward: tailor-made to the needs of the participant.

3. ***Settlement:***

   Future: daily settlement or marking to market, done by the future clearing house through the participants' margin account.

   Forward: participant buys or sells the contractual amount at the underlying asset from the bank at maturity at the forward contractual price.

4. ***Expiration Date:***

   Future: standardised delivery date.

   Forward: tailor-made delivery dates that meet the need of the investor.

5. ***Delivery:***

   Future: delivery of the underlying asset is seldom made; usually a reversing trade is transacted to exit the market.

   Forward: delivery of the underlying asset is commonly made.

6. ***Trading costs:***

   Futures: Bid–ask spread plus brokers' commission.

   Forward: Bid–ask spread plus indirect bank charges via company balance repayment

7. ***Counter Party Risk:***

   Future: practically none because of (a) mandatory margin requirements, (b) daily adjustment of margins–depending on price movements, and (c) the exchange itself is a party to every contract.

Options

An option is a contract giving the owner the right, but not the obligation, to buy or sell a given quantity of an asset at a specified price at some time in the future. Like a future or forward contract, an option is a derivative or contingent claims security. Its value is derived from its definite relationship with the underlying asset in this context foreign currency or some claimants.

An option to buy the underlying asset is a call and an option to sell the underlying asset is a put. Buying or selling the underlying asset via the option is known as exercising the option. The stated price paid (or received) is known as the exercise or

striking price. In option technology, the buyer of an option is frequently referred to as the long and the seller of an option is referred to as the writer of the option or short.

Because the option owner does not have to exercise the option if it is to his disadvantage, the option has a price or premium. There are two types of options- American and European. The names do not refer to the continents, where they are traded but rather to their exercise characteristics. A European option can be exercised only at the maturity or expiry date of the contract, whereas an American option can be exercised at any time during the contract.

There is one more option known as Bermudian option, an option exercisable only during a predetermined portion of its life.

Option or spot exchange are traded in the interbank over the counter markets as well as number of organised exchanges including the Philadelphia Stock Exchange (PHLX), the London Stock Exchange (LSE) Chicago Board Option Exchange (CBOE) and many others. Exchange traded options are standardised as to amounts of underlying currency and maturity dates. OTC options are tailor-made by banks to the specifications of their clients.

In the Indian market, the RBI has permitted banks to write cross currency options i.e. options between two foreign currencies since January, 1994. Options against the rupee will have to wait till Capital account convertibility is in place.

Call option: A call option gives the option buyer the right to purchase a currency Y against a currency X at a stated price say K units of X per unit of Y on or before a stated date. For exchange traded option, one contract represents a standard amount of the currency Y. The writer of the call option must deliver currency Y in exchange for X at the rate K, if the option buyer chooses to exercise his option.

Put option: A put option gives the option buyer the right to sell currency Y against a currency X at a specified price K on or before a specified date. The writer of a put option must take delivery of Y and deliver X if the option is exercised

Swap Operations

A swap is defined as a financial transaction in which two counter parties agree to exchange streams of payments, or cash flows, over time on the basis agreed at the beginning of the arrangement. It is quite clear from the definition that a swap is like a series of forward contracts. Under a forward exchange contract, the counter parties agree to exchange 'X' units of one currency for 'Y' units of another currency. We have also seen that under a Forward Rate Contract (FRA), future LIBOR is exchanged for a rate specified now. Swap involves a series of such exchanges, at specified future dates. Swaps can be broadly classified into two – interest rate swaps and currency swaps. In addition, commodity swaps and tax rate swaps are being introduced and gaining momentum.

Arbitrage

Arbitrage is the simultaneous buying and selling of foreign currencies with the intention of making profits from the difference between the exchange rate prevailing at the same time in different markets.

For illustration, assume that the rate of exchange in London is £1=$2 while in New York £1=$2.10.This presents a situation wherein one can purchase one pound sterling in London for two dollars and earn a profit of $ 0.10 by selling the pound sterling in New York for $ 2.10. This situation would hence, lead to an increase in demand for sterling in London and consequently, an increase in the supply of sterling in New York. Such operations, i.e. arbitrage, could result in equalizing the exchange rates in difference markets.

10.7 ECONOMIC THEORIES OF EXCHANGE RATE DETERMINATION

10.7.1 Introduction

At the most basic level, exchange rates are determined by the demand and supply of one currency relative to the demand and supply of another. For example, if the demand for dollar outstrips the supply and if the supply of Japanese yen is greater than the demand for it, the dollar – yen exchange rates will change. The dollar will appreciate against the yen (or the yen will depreciate against the dollar). However, the differences in relative supply and demand explain the determination of exchange rates to some extent but not fully.

If we understand how exchange rates are determined, we will be able to forecast exchange rate movements. Since future exchange rate movements influence export opportunities, the profitability of international trade and investment deals, and the price competitiveness of foreign imports, this is valuable information for an international business. The forces that determine exchange rates are complex, and no theoretical consensus exists, even among economists, who study the phenomenon everyday. Most economic theories of exchange rate movements seem to agree that three factors have an important impact on future exchange rate movements in a country's currency: (1) The country's price inflation, (2) Its interest rate and (3) Market psychology.

Prices and Exchange Rates

Here we will discuss an economic proposition known as the law of one price and then we will discuss the theory of Purchasing Power Parity (PPP) which links changes in the exchange rate between two countries currencies to changes in the countries' price levels.

10.7.2 Law of One Price

The law of one price states that in competitive markets free of transportation costs and barriers to trade (such as tariffs), identical products sold in different countries must sell for the same price when their price is expressed in terms of the same currency. For example, if the exchange rate between the British Pound and the US Dollar is £ 1 = 1.8 $, a jacket that is sold in the retail market for $ 72 in New York, should sell for £ 40 in London. Suppose, if the jacket costs £ 35 in London (corresponding to $ 63 in US Currency), it would pay a trade to buy jackets in London and sell them in New York (a process which is known as arbitrage). The trader can initially make a profit of $ 9 (buying £ 35 at London and selling at New York @ $ 72), (we are assuming no transportation costs and trade barriers). In this process, the increased demand for jackets in London would raise the price in London and the increased supply of jackets in USA will lower the price there. This would go on until prices are equalised.

10.7.3 Absolute Form of PPP

If the law of one price were to hold good for each and every commodity, then it will follow that:

$\frac{PA}{PB} = S\ (A/B)$ where PA and PB are the prices of same basket of goods and services in countries A and B respectively and S (A/B) = Exchange rate between two countries A and B.

Thus, if the basket of goods costs $ 200 in the United States and Y 20,000 in Japan, PPP theory provides that the dollar/yen exchange rate should be $ 200 /¥ 20,000 or $ 0.01 per Japanese Yen ($ 1 = ¥ 100).

Absolute PPP makes the same assumptions as the Law of One Price. It also makes a few additional assumptions.

- No transaction costs in the foreign currency markets
- ***Basket of Commodities:*** It also assumes that the same basket of commodities is consumed in different countries, with the components being used in the same proportion.

10.7.4 Relative Form of PPP

Here it is argued that the exchange rate will change if relative prices change. For example, imagine there is no price inflation in US while prices in Japan are increasing by 10 percent a year. In the example above, at the end of the year, the basket of goods still cost $ 200 in US but it costs ¥ 22,000 in Japan. The PPP theory provides that the exchange rate should change as a result. Thus, ¥ 1 = $ 0.0091 (or $ 1 = ¥ 110). Because of 10 percent price inflation, the Japanese Yen has depreciated by 10% against the dollar.

Reasons for PPP not holding good:

- Constraints on movement of commodities
- Price index construction is based on different baskets of commodities
- Effect of the statistical method employed by ignoring the fact that there is a two-way link between the spot rate and inflation rates.

10.7.5 Balance of Payments Theory

The balance of payments theory, also known as the Demand and Supply Theory and the General Equilibrium Theory of exchange holds that the foreign exchange rate, under free market conditions, is determined by the conditions of the demand and supply in the foreign exchange market. Thus, according to this theory, the price of a currency i.e. the exchange rate, is determined just like the price of any commodity is determined by the free play of forces of demand and supply.

The value of a currency appreciates when the demand for it increases and depreciates when the demand falls, in relation to its supply in the foreign exchange market.

10.7.6 Asset Approach to Exchange Rate

Exchange rates are relative prices of two assets: monies. The current values of an asset depend on what that asset is expected to be worth in the future. For example the more valuable a stock is expected to be worth, the more it is worth now. Similarly, the more a currency is expected to be worth in the future, the more it is worth now. It follows that today's exchange rate depends on the expected future exchange rate. In turn, the expected future exchange rate depends on what is expected to happen to all the factors reflected in future balance-of-payment accounts.

The asset approach to exchange rates, which has been articulated most clearly by Michael Musa, looks at the current spot exchange rate as a reflection of the market's best evaluation of what is likely to happen to the exchange rate in future. All relevant information about the future is incorporated into the current spot rate. Because new information is random, and could as easily be good as bad for one currency versus the other, the path of the exchange rate should contain a random component. This random component fluctuates around the expected change in the exchange rate.

The asset approach holds implications for the effect of fiscal policy as well as monetary policy. For example, it predicts that high fiscal deficits can result in an immediate depreciation. This would happen if the fiscal deficit caused people to expect future expansion of the money supply as the government printed money to make interest payments on the growing debt.

The asset approach offers an explanation for departure from PPP. Because expectation about the future is relevant to the current exchange rate, there is no necessity for the spot exchange to ensure PPP at every moment. For example if a country is expected to experience rapid inflation, poor trade performance, or something else leading to a depreciation, the current rate of that country's currency is likely to be below its PPP value.

10.7.7 Interest Rate Parity (IRP)

Interest rate parity is an arbitrage condition that must hold when international financial markets are in equilibrium IRP has an immediate implication for exchange rate determination.

$$\frac{F\,(A/B)}{S\,(A/B)} = \frac{1 + rA}{1 + rB}$$

Where F = Forward rate for B = foreign currency and A = domestic currency

rA = return on domestic deposits

rB = return on foreign currency denominated securities

Example: Spot Rs. 45/F; return on domestic deposits 14% return on dollar deposits 5%, ingestible funds = Rs. 1000

What will be the forward cover after 1 year?

Ans: If the investor invests in a rupee deposit, at the end of the year, he would have Rs. 1000 (1 + 0.14) = Rs. 1140

If instead he wants to invest in dollar deposits, he has to convert his investment in Dollar Deposit at spot rate i.e. $ 22.22. At the end of the year, this would fetch 22.22 (1 + 0.5) = $ 23.33. This has to be converted

$$\text{Hence forward rate of exchange} = \frac{1140}{23.33} = \text{Rs. } 48.86$$

Reasons for Deviations from Interest Rate Parity

Although IRP tends to hold quite well, it may not hold precisely all the time for the following reasons:

1. ***Transaction costs:*** It is basically transaction costs involved in money market operations i.e. the investment and borrowing rate.
2. ***Political risks:*** Risk of any change in the foreign country's laws or policies that affects the returns on the investment.

   It may take the form of a change in the tax structure or a restriction on repatriation of proceeds of the investment or a sudden confiscation of the foreign assets among other things.
3. ***Taxes:*** Taxes can affect the party in two ways - through withholding taxes and through differential tax rates on capital gains and interest income.
4. ***Liquidity preference:*** An asset's liquidity is measured by the quickness with which it can be converted into cash at the least possible cost.
5. ***Capital controls:*** Capital controls include restrictions on investing or borrowing abroad and as repatriation of investments made by foreign residents. It also includes restrictions on conversion of currencies. As a result of these controls, the interest rates in the euro market (where these regulations do not apply) are more in line with the parity than the domestic market rates in different countries.

10.7.8 International Fisher Effect

We know that the nominal interest rate comprises of a real interest rate and an expected rate of inflation. The nominal rate of interest adjusts when the interest rate is expected to change. It is finally expressed as follows:

1 + nominal interest rate = (1 + real int. rate) (1 + inflation rate)

That is $1 + r_n = (1 + r_r)(1 + i)$ where r_n = normal interest rate

r_r is real rate of interest and i is the inflation rate.

If the international capital markets are perfect, then the equivalent risk investments in two countries should offer the same expected real rate of return. This is ensured by arbitrage. Informal terms, the international Fisher effect states that the nominal interest rate differential must be equal to the expected inflation rate differential in two countries. Thus

Nominal interest differential = Expected inflation rate differential

$$\frac{1+rA}{1+rB} = \frac{E(1+iA)}{E(1+iB)}$$

where rA = interest rate in domestic currency

rB = interest rate in foreign currency

iA = inflation rate in domestic country

iB = inflation rate in foreign country

Check Your Progress

The Spot rate is Rs.45.00/$. Inflation rates in India and USA are expected to be 5.4% and 1.6% respectively. What is the expected rate of depreciation of the rupee by using purchasing Power Parity theory?

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10.8 LET US SUM UP

The foreign exchange market is a market in which foreign exchange transactions take place. In other words, it is a market in which national currencies are bought and sold against one another. A foreign exchange market performs three important functions; Transfer of purchasing power from one country to another and from one currency to another; provision of credit; and provision of hedging facilities. In the foreign exchange market, there exist Spot and Forward Exchanges. Spot exchange refers to the class of foreign exchange which requires the immediate delivery, exchange of currencies on the spot. The forward transaction is an agreement two parties requiring the delivery of some specified future date of a specified amount of foreign currency by one of the parties, against payment in domestic currency by the other party, at a price agreed upon in the contract.

With reference to its relationship with the spot rate, the forward rate may be at par, discount or premium. While a futures contract is similar to a forward contract, there are several differences between them. While a forward contract is tailor made for the client by its international bank, a futures contract has standardized features-the contact size and maturity dates. Futures can be traded only on an organised exchange and they are traded competitively.

An option is a contract or financial instrument that gives the holder the right, but not the obligation, to sell or buy a given quantity of an asset at a specified price at a

specified future date. An option to buy the underlying asset is known as a call option and an option to sell the underlying asset is known as a put option. Arbitrage is the simultaneous buying and selling of foreign currencies with the intention of making profits from the difference between the exchange rate prevailing at the same time in different markets.

There are some important theories which attempt to explain the mechanism of exchange rate determination, namely the purchasing power parity theory and balance of payments theory, also known as the demand and supply theory and the general equilibrium theory.

Interest rate parity is an arbitrage condition that mist hold when international markets are in equilibrium. IRP has an immediate implication, for foreign exchange determination.

10.9 LESSON END ACTIVITY

Study the Asian crisis of 1997 and find out the reasons. What will be the lesson for India?

10.10 KEYWORDS

Spot Market: The spot market involves almost the immediate or sale of foreign exchange. Typically cash settlements are made within one/two days.

Forward Market: A forward contract (also called an outright forward) is one where the parties to the transaction agree to buy or sell a commodity (here, a currency) at a predetermined future date at a particular price.

Futures: A future contract has been defined on "the simultaneous right and obligation to buy or sell a standard quantity of a specific financial instrument (or commodity or currency) at a specific future date and at a price agreed between the parties at the time the contract was signed."

Options: An option is a contract giving the owner the right, but not the obligation, to buy or sell a given quantity of an asset at a specified price at some time in the future.

Swap Operations: A swap is defined as a financial transaction in which two counter parties agree to exchange streams of payments, or cash flows, over time on the basis agreed at the beginning of the arrangement.

Arbitrage: Arbitrage is the simultaneous buying and selling of foreign currencies with the intention of making profits from the difference between the exchange rate prevailing at the same time in different markets.

Purchasing Power Parity (PPP): An adjustment in gross domestic product per capita to reflect differences in the cost of living.

Spot exchange rate: The exchange rate at which a foreign exchange dealer will convert one currency into another that particular day.

Forward exchange rate: The exchange rates governing forward exchange transactions.

Fixed exchange rates: A system under which the exchange rate for converting one currency to another is fixed.

Floating exchange rates: A system under which the exchange rate for converting one currency into another is continuously adjusted depending on the laws of supply and demand.

10.11 QUESTIONS FOR DISCUSSION

1. Which of the following is not a corporate function that makes exchange rate forecasting necessary?
   (a) Hedging decisions
   (b) Capital budgeting decisions
   (c) Exchange assessments
   (d) Demand – supply approach
   (e) None of the above
2. Which of the following is not a method of exchange rate forecasting?
   (a) Monetary approach
   (b) Asset approach
   (c) Portfolio balance
   (d) Demand – supply approach
   (e) None of the above
3. The predictions of the monetary approach are:
   (a) An increase in the real GNP of a country causes its currency to appreciate
   (b) An increase in the real money demand makes the currency appreciate
   (c) An increase in the money supply causes the currency to depreciate
   (d) An increase in the nominal interest rates causes the currency to depreciate
   (e) All of the above
4. Give a full definition of the market for foreign exchange
5. What is the difference between the retail or client market and the wholesale or interbank market for foreign exchange?
6. What are the market participants in the foreign exchange market?
7. What is meant by a currency trading at a discount or at a premium in the forward market?
8. Discuss the implications of the deviations from purchasing power party for countries' competitive positions in the world market.
9. Explain the conditions under which the forward rate will be an unbiased prediction of the future spot exchange rate.
10. Debate the relative merits of fixed and floating exchange rate regimes.
11. What does the monetary theory of exchange rates assume about the substitutability of different countries' monies and bonds?
12. What does the monetary theory of exchange rates imply for:
    (a) Relatively rapid growth in a country's money supply?
    (b) Relatively rapid growth in a country's national income?
    (c) An increase in a country's interest rates versus interest rates in another country?
13. Does the asset approach to exchange rates consider expectations about future exchange rates?

Check Your Progress: Model Answer

7.66%.

10.12 SUGGESTED READINGS

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LESSON

11

EXCHANGE RISK MANAGEMENT AND FEMA

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11.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- Fluctuations in Foreign Exchange/Foreign exchange exposure
- Designing and implementing appropriate hedging strategies
- The economic theories of exchange rate
- "The asset approach" which considers how expectations about the future affect today's exchange rates and "portfolio-balance approach" which considers bonds as well as money to be held
- Extension of the law of one price to goods and services in general and which gives rise to the PPP principle
- As a relationship over time rather than at a point of time, PPP becomes a link between changes in exchange rates and differences between inflation rates

11.1 INTRODUCTION

Foreign exchange exposure results in foreign exchange risk due to anticipated variability in exchange rates. As business becomes increasingly global, more and more firms find it necessary to pay careful attention to foreign exchange exposure and to design and implement appropriate strategies to handle such risks. Suppose for example that the US dollar substantially depreciates against the Japanese Yen, the change in exchange rate can have significant economic consequences for both US and Japanese firms. For example, it can adversely affect the competitive position of Japanese car makers in the highly competitive US market by forcing them to raise dollar prices of their cars by more than their US competitors do.

Changes in exchange rates can affect not only firms that are directly engaged in international trade but also purely domestic firms. For example a US bicycle manufacturer that sources only domestic materials and sells exclusively in the US market with no foreign currency receivables or payables in its accounting book, can be subject to foreign exchange exposure if it competes against imports say from a Taiwanese bicycle manufacturer.

11.2 HOW DISTINGUISHED FROM BUSINESS RISK

Doing any type of business is subject to risk. That distinguishes entrepreneurs willingness to take risks from other modes of investment. Broadly speaking, business risk can be divided into two categories – core business risk and environmental risk.

Core business risks are operational risks such as an unsuccessful new product launch, a new technology which does not perform up to expectations, interruption in raw material supplies, labour problems, cyclical demand fluctuations and so forth.

Environmental risks arise out of unpredictable fluctuations in financial variables such as exchange rates, interest rates and stock prices, macroeconomic shocks such as a sudden steep rise in prices of important commodities like crude oil, shifts in government policies. Financial risks are thus a subset of environmental risks.

While core business risks are peculiar to a particular firm, environmental risks are pervasive and affect all firms or at least all the firms in a given industry. However, the direction and magnitude of the impacts do vary from firm to firm. Thus a depreciation of the exchange rate might have a beneficial impact on the exporting firm while it hurts an importing firm.

11.3 DEFINING EXPOSURE AND RISK

The impact of fluctuation in financial prices can be illustrated by a number of situations:

- An appreciation of the value of a foreign currency (or equivalent, a depreciation of the domestic currency) increases the domestic currency value of a firm's foreign currency assets and liabilities such as foreign currency receivables and payables, bank deposits and loans, etc.
- It will also change domestic currency cash flows from exports and imports.
- An increase in interest rates reduces the market value of a portfolio of fixed rate bonds and may increase the cash outflow on account of interest payments.
- Acceleration in the rate of inflation may increase the value of sold stocks, the revenues from future sales as well as the future costs of production.

The above demonstrates that the firm is "exposed" to unforeseen exchange in a number of variables in its environment. These variables are also called Risk factors.

Uncertainties arising out of fluctuations in exchange rates, interest rates and relative prices of key commodities such as crude oil, copper, etc. create strategic exposure and risk for a firm.

The long term response of the firm to these risks can involve significant changes in the firm's strategic posture. Choice of product – market combinations, souring of inputs, choice of technology, location of manufacturing activities, strategic alliances and so forth.

We have seen that exchange rates, interest rates and inflation rates are intimately interrelated and in turn relate to a whole complex of macroeconomic variables. In many cases it is difficult to locate the effect of changes in any of them on the firm's assets, liabilities and cash flow.

The terms exposure and risk though often used interchangeably are not identical. Exposure is a measure of the sensitivity of the firm's performance, however measured to fluctuation in the relevant risk factor. While risk is a measure of the extent of variability of the performance measure attributable to the risk factor.

Note the following important points about the definition of exposure and risk:

1. Value of assets and liabilities or operating income is denominated in the functional currency of the firm. This is the primary currency of the firm in which its financial statements are published. For most firms it is the domestic currency of the firm.

2. Exposure is defined with regard to the real values i.e. values adjusted for inflation. While theoretically this is the correct way of assessing exposure, in practice due to the difficulty of dealing with an uncertain inflation rate, this adjustment is often ignored i.e. exposure is estimated with reference to changes in nominal value.

3. The definition stresses that only anticipated changes in the relevant risk factor are to be considered. The reason is that markets have already considered allowance for anticipated changes. For example, an exporter invoicing a foreign buyer in the buyer's currency will build an allowance for the expected depreciation of that currency into the price. A lender will adjust the rate of interest charged in the loan to incorporate an allowance for the expected depreciation.

4. From the operational point of view, how do we separate given change in exchange rate or interest rate into anticipated and unanticipated components since only the actual change can be observed. One possible option of estimating what will be the exchange rate after 3 months from the transaction date is to consider a firm which has a 90 day payable amounting to US$ 500,000, arising out of a raw material import transaction. The current spot rate is Rs. 43.60 per dollar and the three months forward rate is Rs. 43.80. Three months later, the spot rate turns out to be Rs. 44.00. Thus the unanticipated depreciation of the rupee is 44 – 43.80 or Rs. 0.20 per dollar. The loss on account of the increase in the rupee value of the payable is Rs. 100,000.

Now let us introduce the concept of risk:

Suppose a financial consulting firm gives the following "forecast" of the value of spot exchange 3 months from now. In our view, the most likely value of the spot rate three months from now is Rs. 44.0, but it could be shooting as high as Rs. 44.50. There is a very small probability that the dollar could fall to Rs. 43.40.

Given this view, the best scenario for the firm would be dollar falling to Rs. 43.40 (since the company has to pay in US$ after 3 months) and the worst case would be dollar shooting up to Rs. 44.50. The rupee outlay on settling the payable could be as high as Rs. 24/75 million or as low as Rs. 24.20 million. Exchange rate risk is a measure of variability of the value of an item attributable to the fluctuations in the underlying exchange rate. It depends upon the size of the exposure (transaction) and the extent of fluctuation expected in the underlying exchange rate. Exchange rate risk can be captured by analysing the "best case" and "the worst case" scenarios to gauge the maximum possible variation in the value of the item under consideration. In the most formal way, we must use the statistical concept of variance or standard deviation to measure financial risk.

In the above example, the value of the item in the foreign currency was contractually fixed.

Consider another example:

A firm exports denim jeans to the US, selling a pair of jeans at USD 50. The exchange rate is Rs. 44.00, its operating costs are Rs. 1600 per pair of jeans. Thus its operating margin on export sales is Rs. 2200 – Rs. 1600 = Rs. 600 per pair. Over the next year, US inflation is expected at 5% pa, Indian inflation is at 10% per annum and by the year end, the exchange rate depreciates to Rs. 45/-. Assume that it raises its price in the US market by 5% (based on inflation rate of 5%) to Rs. 52.50 and its operating costs go up by 10 % (the Indian rate of inflation) to Rs. 1760. Its operating margin per unit is now (52.50 × 45) – 1760 = 2362.50 – 1760 = 602.50.

In real terms adjusted for inflation at 10%, the operating margin has shrunk from Rs. 600 to (602.50/1.1) Rs. 547.72.

Thus it will be observed that in the present case the impact of exchange rate fluctuations in the operating cash flow depends upon several factors:

1. Change in price
2. Quantity response to price change
3. Changes in unit costs and
4. Changes in exchange rate

Unlike the case of contractually fixed items like a foreign currency receivable or payable, we cannot access the impact of exchange rate fluctuations on the firm's future, cash flow and profitability unless we know the structure of the market in which the firm sells, price sensitivity of demand, currency composition of its operating cost and the structure of the market in which it buys its inputs. These in turn will have a bearing on the firm's competitive position in the output markets.

In the above situation precise, assessment of exposure of future cash flow and profit is possible by:

1. Constructing an alternative scenario in which the relevant risk factor e.g. exchange rate takes specific values and alternate future cash flows for each scenario. This will give an estimate as to how sensitive future cash flows are to fluctuations in the exchange rate. This requires a thorough understanding of the firm's business including its competition, customers and cost structure.
2. Alternatively, one can adopt a statistical approach using past data to access the influence of the relevant risk factor on a target performance variable such as cash flow.

11.4 CLASSIFICATION OF CURRENCY EXPOSURE

Figure 11.1 presents a schematic picture of currency exposure. The first group of exposures known as accounting exposures relate to items that currently appear in the balance sheet and income statement of the firm.

Within this group we have two further categories, e.g. transaction exposure and translation exposure.

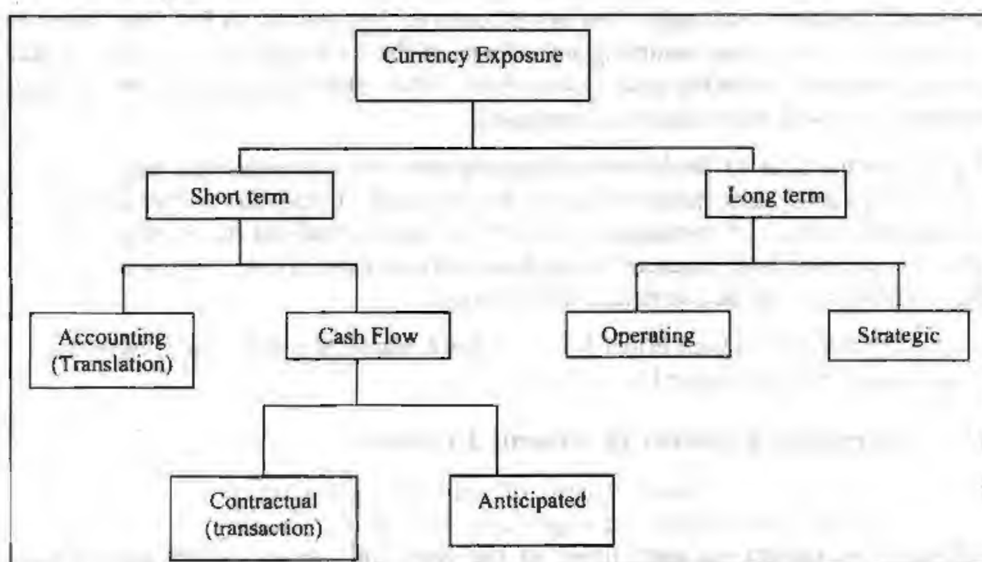

Figure 11.1: Schematic Picture of Currency Exposure

11.4.1 Transaction Exposure

This is a measure of the sensitivity of the home currency value of assets and liabilities which are denominated in foreign currency, to unanticipated changes in the exchange rates, when the assets or liabilities are liquidated. The foreign currency values of these items are contractually fixed i.e. they do not vary with exchange rate. You may recall the example above of a firm with USD 100,000 payable. This is also known as contractual exposure.

Some examples that lead to transaction exposure are:

1. A currency has to be converted in order to make or receive payment for goods and services.
2. A currency has to be converted to repay a loan or make an interest payment (for foreign currency loan) or receive a repayment of loan or an interest on loan and advances (denominated in foreign currency).
3. A currency has to be converted to make a dividend payment, royalty payment (to overseas shareholders or overseas collaborators).

In all the cases, the foreign currency value of the item is fixed, the uncertainty pertains to home currency value. For example, if a firm has entered into a contract to sell cars to foreign customers at a fixed price denominated in foreign currency, the firm would be exposed to exchange rate movements till it receives the payment and converts the receipts into the domestic currency. The exposure of a company in a particular currency is measured in net terms i.e. after netting of potential cash inflows with outflows.

The important points to be noted are:

1. Translation exposures usually have short term horizons and
2. Operating cash flows are affected.

11.4.2 Translation Exposure

Translation exposure arises from the need to "translate" foreign currency assets or liabilities into the home currency for the purpose of finalising the accounts for the given period. A typical example of a translation exposure is the treatment of foreign currency loan (medium term) to finance. The import of capital goods worth US $ 1 million. When the import materialised, the exchange rate was Rs. 43/- per $. The imported fixed asset was capitalised in the books of the company at Rs. 430/- lakhs. In the ordinary course and assuming no change in the exchange, the company would provide depreciation on the asset values at Rs. 430/- lakhs for finalising the accounts for the year in which the asset was purchased.

Suppose at the time of finalisation of the accounts, the exchange rate has moved to Rs. 440 involving a translation loss of Rs. 10 lakhs. Under the earlier accounting standards the effect of translation, gain or loss was capitalised by altering the book value of the fixed asset financed by the loan and consequently the provision of higher depreciation was required to reduce the net profit.

As per IAS (certified) with effect from 1/4/2004, translation differences have now to be accounted in the profit and loss account.

11.4.3 Operating Exposure (Economic Exposure)

The second group of exposure consists of contingent and competitive exposures and together also known as operating exposures. The principal focus is on items which will have an impact on cash flows of the firm and whose values are not (yet) contractually fixed in foreign currency terms.

Of the two categories, contingent resources have a much shorter time horizon. Typical situations giving rise to such exposure are:

1. An import or export deal is being negotiated. Quantities and prices are to be finalised. Fluctuation in exchange rate will probably influence both and then it will be converted into transaction exposure.
2. The firm has submitted a tender bid on an equipment supply contract. If the contract is awarded, transaction exposure will arise.
3. A firm imports a product from abroad and sells it in the domestic market. Supplies from overseas are received continuously but for marketing convenience the firm publishes selling price in home currency which holds good for six months. While the sales proceeds in domestic currency may be more or less certain, costs measured in home currency are exposed to currency fluctuations.

In all the cases, currency movement will affect future cash flows.

Competitive exposure is the most crucial dimension of currency exposure. Its home horizon is longer than that of transaction exposure, say around three years. The focus is on future cash flows and hence a long run survival and value of the firm. We have already discussed this kind of exposure in our example of the denim jeans exporter.

11.4.4 Strategic Exposure

Competitive exposure is often referred to as "Statistic Exposure" because it has significant implications for some strategic business decisions. It influences the firm's choice of markets, products, source of inputs, location of manufacturing activity and decisions as to whether foreign operation should be started.

A number of examples from recent history clearly bring out the nature of operating exposure:

1. The increase in dollar during the 1st half of 1980's eroded the competitive position of many US firms where the costs were dollar denominated. E.g. Kodak found that their sales were spread all over the world whereas the costs were dollar denominated. They faced stiff competition from Japanese firms such as Fuji both in the US market as well as third country markets.
2. Further when the dollar started falling against the yen and deutsche mark around mid 1985 and continued to fall for over two years, Japanese and German car makers found their operating margins being squeezed. They responded by starting manufacturing in the US and partly by moving up into premium priced luxury cars where consumer sensitivity to price increases is relatively less.
3. At home, Indian manufacturers of cars and two wheelers with significant import content denominated in Yen found that strengthening of Yen resulted in cost increase which they would not allow to pass on to the consumer because of depressed demand conditions and competitive consideration.
4. US pharmaceuticals multinationals like Merck found that during the period of strong dollar, their cash flows denominated in dollars tend to shrink while most of their R&D expenditures are denominated in dollars. A shortage of internally generated cash tends to have an adverse impact in their R&D budgets which is a crucial factor in their long run competitiveness.
5. The significant fall in south Asian currencies starting mid 1997 has hurt Indian exports in the western markets as some of these countries are India's competitors in these markets.

In all these cases, exchange rate changes coupled with concomitant changes in relative cost had a significant impact on the firm's ability to compete effectively in particular

product market segments, to undertake good investment projects and thus to enhance their long run growth potential.

Check Your Progress

Multiple choice/options:

1. An Indian company's cost of production is Rs. 20/- per unit while its export price is $1/- unit. If the dollar appreciates by 10% and the spot today is Rs. 40/- $, what is the impact of transaction exposure:
   (a) Increase in profit by the Rs. 4/- Per unit
   (b) Decrease in profit by Rs. 4/- per unit
   (c) No change in profit
   (d) Insufficient data
   (e) None of the above
2. Which of the following features influence the extent of translation exposure faced by a multinational company?
   (a) Accounting methods used
   (b) Location of foreign subsidies
   (c) Degree of foreign movement by foreign subsidies
   (d) Account of (a), (b) and (c) above
   (e) None of these

11.5 MANAGEMENT OF EXCHANGE RISK

Transaction exposure: A firm is subject to transaction exposure when it faces contractual cash flows that are fixed in foreign currencies. Suppose that a US firm sold its product to a German customer on three month credit terms and invoiced in Euro. When the US firm receives Euro in three months, it will have to convert (unless it hedges) the Euro into Dollar at the spot exchange rate prevailing on the maturity date, which cannot be known in advance. As a result the Dollar receipt from this export sale becomes uncertain; should the Euro appreciate (depreciate) against the dollar, the dollar receipt will be higher (lower).

The above example suggests that whenever the firm has foreign currency denominated receivables or payables, it is subject to transaction exposure and their settlements are likely to affect the firm's cash flow position. The various ways of hedging transaction exposure are as follows:

Financial Contracts

- Forward market hedge
- Future market hedge
- Option market hedge
- Money market hedge

Operational Techniques

- Exposure netting
- Heading and lagging
- Hedging by choosing the currency of invoice
- Hedging through sourcing

11.5.1 Forward Market Hedge

This is the most direct and popular way of hedging transaction exposure. Generally speaking the firm may sell (buy) its foreign currency receivables (Payables) forward to eliminate its exchange risk exposure. Let us consider a business situation:

Suppose Boeing Corporation exported a Boeing 747 to British Airways and billed pound million payable in one year. The money market interest rate and foreign exchange rates are given as follows:

The US interest rate	6.10% pa
The UK interest rate	9.00% pa
The spot exchange rate	$1.50/pound
The forward exchange rate	$1.46/pound (1 year maturity)

In the above situation, in order to hedge foreign exchange exposure, Boeing may supply sell forward its pounds receivables, 20 Million pounds for delivery in one year, in exchange for a given amount of US dollar. On the maturity date of the contract Boeing will have to deliver 20 million pounds to the bank, which is the counter party of the contract and in return take delivery of $29.2 million ($1.46 × 20 million) regardless of the spot exchange rate that may prevail on the maturity date. Boeing will use the 20 million pounds that it is going to receive from British Airways to fulfil the forward contract. Under this method, Boeing pound receivable is exactly offset by the pound payable (created by the forward contract, the company's net pound exposure becomes zero.

Suppose that on the maturity date of the forward contract, the spot rate turns out to be $1.40/pound which is less than the forward rate $1.46/pound. In this case, Boeing would have received $28.0 million rather than $29.2 million had it not entered into the forward contract. Thus one can say that Boeing gained $1.2 million from forward hedging. If the spot rate is say $1.50/pound on the maturity date, then Boeing could have received $30.0 million by not hedging. Of course forward hedging costs Boeing $0.80 million. The gains and losses from forward hedging at different spot exchange rates on the maturity date are given below:

Spot Exchange Rate On the Maturity Date	**Receipts from British Sale**		
(1)	**Unhedged Portion (2) = (1) × 20,000,000**	**Forward Hedge (3) = 1.46 × 20,000,000**	**Gain or loss from hedge (4)=(3)-(2)**
$1.30	$26,000,000	29,200,000	3,200,000
$1.40	$28,000,000	29,200,000	1,200,000
$1.46	$29,200,000	29,200,000	0
$1.50	$30,000,000	29,200,000	(-) 800,000
$1.60	$32,000,000	29,200,000	(-) 2800,000

From the above one can observe that the gain will be positive as long as forward exchange rate is greater than the spot rate on the maturity date.

It is important to note that the above analysis is ex-post in nature, and no one can guess what the future spot rate will be beforehand. The firm has to decide whether to hedge or not to hedge ex-ante (earlier). To help the firm decide, it is necessary to consider the following three alternative scenarios.

1. Sr = F
2. Sr < F
3. Sr > F

Under the first scenario, where the firms expected future spot rate (Sr) is about the same as forward rate (F). The expected gains of loss are approximately zero. But forward hedging eliminates exchange exposure. Under this scenario the firm would be inclined to hedge so long as it is averse to risk.

Under the second scenario, where the firms expected future spot exchange rate is less than the forward rate, the firm expects a positive gain from forward hedging. Since the firm expects to increase the dollar proceeds, while eliminating exchange exposure, it would be even more inclined to hedge under this scenario.

Under the third scenario, where the firms expected future spot exchange rate is more than the forward rate, the firm can eliminate exchange exposure via the forward contract only at the cost of reduced expected dollar proceeds from the foreign sale. Thus the firm would be less inclined to hedge under this scenario, other things being equal. Whether the firm actually hedges or not depends upon the degree of risk aversion, the more risk averse the firm is, the more likely it is to hedge.

11.5.2 Hedging through Futures

The second way to hedge exposure is through futures. The rule is the same as in the forward market.

Example: A British firm orders farm equipment worth USD 5 million from a US supplier. The payment is due in three months. The market rates are:

Pound/USD spot 1.7225, 90 days forward 1.7165

LIFFE September Pound Future 1.7170

The firm decides to hedge by selling 47 sterling contracts (this is equivalent to buying dollar futures) with a total value of Pound 2937,500 = USD 5043687.5 at USD 1.7170/Pound. It pays a brokerage fee of 50 pound per contract or Pound 2350 for the total amount.

On the maturity date, the following prices rule:

USD/Pound spot 1.6680 September futures 1.6650. The firm buys USD 5 million at the ruling spot and closes out its future position.

Sterling outflow on spot purchasing USD 5 million = 50,000,000/1.6680 = Pound 2,997,601.9.

Gain on future	= USD (1.7170 – 1.6650)(2937500)
	= USD52750 = Pound 91576.74 at $1.6680/Pound
Total sterling outlay	= 2997601.90 + 2350.00$ – 91576.74)
	= Pound 2908,375.20

Affective USD/ Pound rate obtained by the firm is = 50,000,000/2908375.20 = 1.7191

The hedge through future turns out to be better than a forward hedge. The effective rate with the latter would have been 1.7165. This is despite the adverse basis movement (as usual we have ignored the effect of marking to market).

11.5.3 Money Market Hedge

Transaction exposure can also be hedged by lending and borrowing in the domestic and foreign markets. Generally speaking the firm may borrow (lend) in foreign currency to hedge its foreign currency receivables (payables), thereby matching its assets and liabilities in the same currency. Again using the same situation of Boeing it can eliminate the exchange exposure arising from the British sale by first borrowing in pounds, then converting the loan proceeds into dollars which then can be converted at the dollar interest rate. On the maturity date of the loan, Boeing is going to use the

pound receivables to pay off the pound loan. If Boeing borrows a particular pound amount so that the maturity value of this loan becomes exactly equal to the pound receivable from the British sale, Boeing's net pound exposure is reduced to zero and Boeing will receive the future maturity value of dollar investment.

The first important step in money market hedging is to determine the amount of pounds to borrow. Since the maturity value of borrowing should be the same as the pound receivable, the amount to borrow can be computed as the discounted present value of the pound receivable that is pound 10 million/(1.09) (rate of interest @ 9%) = £9174,312. The step by step procedure of money market hedging can be illustrated as follows:

Step 1: Borrow £ 9174, 312 in the UK

Step 2: Convert £ 9174,312 into $ 13761.468 at the current spot exchange rate of $ 1.50 /£

Step 3: Invest $13,761,468 in the US

Step 4: Convert £ 10 million from British Airways and use it to repay the pound loan

Step 5: Receive the maturity value of the dollar investment i.e. $14,600,918 = $13761, 468 (1.061) which is the guaranteed dollar proceed from the British sale.

The following table shows that the net cash flow is zero at the present time, implying that apart from possible from transaction costs, the money market hedge is fully self-financing. The table also clearly shows how the £ 10 million receivable is exactly offset by the £ 10 million payable (created by borrowing) leaving a net cash flow of $ 14,600,918 on maturity date.

Transaction	Current Cash Flow	Cash Flow at Maturity
1. Borrow pounds	£ 9174,312	- £10,000,000
2. Buy dollar spot with pounds	$13,761,468 £ -9174,312 -$ 13,761,468	
3. Invest in the US		$14,600,918
4. Convert pound receivable net		£ 10,000,000
5. Net cash flow	0	$14,600,918

The maturity value of dollar invested from the money market hedge turns out to be nearly identical to the dollar proceeds from forward hedging. This is due to the fact that the interest rate parity condition is approximately holding in our example.

11.5.4 Option Market Hedge

One shortcoming of both forward and money market hedge is that these methods completely eliminate exchange exposure. Hence the firm cannot take the opportunity of benefiting from favourable exchange rate change. To elaborate this point, let us assume that the spot rate turns out to be $1.60 / £ at the time of maturity date of the forward contract. As already seen, the forward hedging would cost the firm $ 1.4 million in terms of foreign dollar receipts. With its pound receivable, Boeing ideally would like to profit itself only if the pound weakens; while retaining the opportunity to benefit if the pound strengthens. Currency option provides such a flexible "optional" hedge against exchange exposure. Generally speaking, the firm may buy a foreign currency call (or put) option to hedge its foreign currency payables (receivables).

It shows how the option works, suppose that in the over-the-counter market, Boeing purchased a put option on £ 10 million with an exercise price of $ 1.46 and one year expiration. Assume that the option premium (price) was $0.02 per pound. Boeing thus paid $ 200,000 (= $0.02 × 10 million) for the option. This transaction provides Boeing

with the right but not the obligation, to sell up to £ 10 million for $1.46/ £ regardless of the future spot rate.

Now assume that the spot rate turns out to be $1.30 on the expiration date. Since Boeing has the right to sell each pound for $1.46, it will certainly exercise its put option on the pound and convert £ 10 million into $14.6 million. The main advantage of option hedging is that the firm can decide whether to exercise the option based on the realised spot exchange rate on the expiration date. Boeing has paid $ 200,000 up front for the option. Considering the time value of money, this is equivalent to $ 200,000 × 1.61 i.e. $212,200 as on the expiration date. Thus under the option hedge, the net dollar proceeds from the British sale becomes $14600,000 – $212,000 = $14387,800.

Since Boeing is going to exercise its put option whenever the future spot exchange rate falls below the exercise rate of $ 1.46, it is assured of "minimum dollar receipt" of $ 14,387,800 from the British sale.

Next, let us consider a; alternative scenario where the pound appreciates against the dollar and the spot exchange rate on the date of maturity works out to be $1.60 per pound. Boeing in that case would have no incentive to exercise the option. It will let the option expire and convert £ 10 million into $ 16 million at the spot rate. Subtracting $ 212,200 from the cost of option the net proceeds will become $15,787,800 ($ 16 million - charges $ 212,200).

As seen, the option hedge allows the firm to limit the downside risk while preserving the upside potential with a change of option premium.

The break-even spot rate, which is useful for choosing the hedging method can be determined as follows:

£ 10,000,000 × break-even spot rate – $ 212,200 = $ 14,600,000

Solving the equation, we get break-even spot rate $ 1.48 / £. The break-even analysis suggests that if the firm's expected future spot rate is greater (less) than the break-even rate, then the option (forward) hedge might be preferred.

Note: A call option gives the option buyer the right to purchase a currency Y against a currency X at stated price K units of X per unit of Y on or before a stated date. The writer of a call option must deliver currency Y in exchange of X at the rate K if the option is exercised.

A put option: A put option gives the option buyer the right to sell a currency Y against a currency X at a specified price K on or before a specified date. The writer of the put option must take delivery of Y and deliver X if the option is exercised.

11.5.5 Hedging Recurrent Exposure with Swap Contracts

Firms often have to deal with a "sequence" of account payable or receivable in terms of a foreign currency. Such recurrent cash flows in a foreign currency can best be hedged using a currency swap contract, which is an agreement to exchange one currency for another at a predetermined exchange rate, i.e. the swap rate on a sequence of future dates. As such, a swap contract is like a portfolio of forward contracts with different maturities.

Suppose that Boeing is scheduled to deliver an aircraft to British Airways at the beginning of each year for the next five years, British Airways in turn is scheduled to pay £ 10,000,000 to Boeing on December,1 of each year for five years. In this case, Boeing faces a sequence of exchange risk exposures. As previously mentioned, Boeing can hedge this type of exposure using a swap agreement by which Boeing delivers £ 10,000,000 to the counter party of the contract in December of each year for 5 years and takes delivery of the predetermined dollar amount each year. If the agreed swap exchange rate is $ 1.50 / £, then Boeing will receive $ 15 million each year,

regardless of the future spot and forward rates. Note that a sequence of five forward contracts would not be priced at uniform rate \$ 1.50 / £, the forward rate will be different for different maturities. In addition, longer term forward contracts are not readily available.

11.5.6 Exposure Netting

Exposure netting involves creating exposure in the normal course of business which offsets/balances the existing exposures. The exposures so created may be in the same currency as the existing exposures or in any other currency but the effect should be that any movement in exchange rates that results in a loss on the original exposure that should result in a gain on the new exposure. This may be achieved by creating an opposite exposure in the same currency or a currency, which moves in tandem with the currency of the original exposure. It may also be achieved by creating a similar exposure in a currency which moves in the opposite direction to the currency of the original exposure.

11.5.7 Hedging via Lead and Lag

Hedging and lagging can also be used to hedge exposures in "lead: means to pay or collect early whereas to "lag" means to pay or collect late. The firm would like to lead soft currency receivables and lag hard currency receivables to avoid the loss from depreciation of the soft currency and benefit from the appreciation of the hard currency. For the same reason, the firm will attempt to lead the hard currency payable and lag soft currency payables.

The lead/lag strategy can be employed more effectively to deal with intra firm payables and receivables such as material cost, rents, royalties, interests and dividends among subsidiaries of the same multinational corporation. Since managements of various subsidiaries of the same firm are presumably working for the good of the entire firm, the lead/lag strategy can be applied more aggressively.

11.5.8 Hedging through Invoice Currency

The firm can shift, share or diversify exchange risk by choosing the currency of invoice. In our example, if Boeing invoices \$ 15 million rather than £ 10 million for the sale of the aircraft, then it does not face exchange exposure anymore. Note however that, the exchange exposure has not gone; it has merely shifted to the British importer. British Airways now has an account payable in US dollars. Instead of shifting exchange exposure entirely to British Airways, Boeing can share the exposure with British Airways by invoicing half of the bill in US dollars and the remaining half in British pounds that is \$ 7.5 million and £ 5 million.

Another way of using the choice of invoicing currency as a hedging tool relates to the outlook of the firm about various currencies. This means invoicing exports in a hard currency and imports on soft currency. The currency so chosen may not be domestic currency for either of the parties involved and may be selected because of its stability (like the dollar, which serves as an international currency).

11.5.9 Demonstration Problem

1. (a) An Indian exporter has an ongoing order from USA for 2000 pieces per month at a price of \$100. To execute the order, the exporter has to import Yen 6000 worth of material per piece, Labour costs are Rs. 350/- per piece while other variable overheads add up to Rs. 700 per piece. The exchange rates are currently Rs. 35/\$ and Yen 120 /\$. Assuming that the order will be executed after three months and payment is obtained immediately on shipment of goods, calculate the loss/gain due to transaction exposure of the exchange rate change to Rs. 36/\$ and Yen 110/\$.

(b) If the contracted export price is Rs.3500, calculate losses/gains due to transaction exposure and economic exposure. Assume that elasticity of demand of product is –2 in USA. Assume that the exporter has supplied unutilised capacity to meet the additional demand (if, any).

Solution:

(a) At the existing level of exchange rates we can calculate profit as follows:

Revenue	2000 × 100 × 35	Rs.70, 00,000
Material	6000 × 2000 × (35/120)	Rs.35, 00,000
Labour	2000 × 350	Rs. 7,00,000
Overhead	2000 × 700	Rs. 14,00,000
		Rs. 56,00,000
	Hence profit	Rs.14,00,000

After the change in exchange rates:

Revenue	2000 × 100 × 36	Rs.72,00,000
Material	6000 × 2000 × (36/110)	Rs.39,27,272
Labour	2000 × 350	Rs. 7,00,000
Overhead	2000 × 700	Rs. 14,00,000
		Rs. 60,27,272
	Hence profit	Rs.11,72,728

So loss due to transaction exposure 1400000 – 1172278 = 227,272

(b) Transaction exposure:

Existing level of profits Rs. 14,00,000

After the exchange rates change, we have the following revenues and costs:

Revenue	2000 × 3500	Rs.70,00,000
Material	6000 × 2000 × (36/110)	Rs. 39,27,272
Labour	2000 × 350	Rs. 7,00,000
Overhead	2000 × 700	Rs. 14,00,000
		Rs. 60,27,272
	Hence profit	Rs. 9,72,728

So decline in profits Rs. 14,00,000 – 972,728 = 427,272

Economic exposure:

Current price 3500/35 = $ 100 / piece

After the change in exchange rate $ piece = 3500 / 36= $ 97.22 per piece

Hence reduction in price (100 – 97.22) = 2.78 %

So increase in demand 2 × 2.78 = 5.56 %

Hence size of the order changes to 2000 × (1 + 0.0556) = 2111

Revenue	2111 × 3500	Rs.73, 88,500
Costs		
Material	6000 × 2111 × (36/110)	Rs.41, 45,236

Labour	2111 × 350	Rs. 738,850
Overhead	2111 × 700	Rs. 1477,700
		Rs. 6361,786
Profit		Rs. 1026,714
Existing level of profits so decline in profits		Rs. 1400,000
		Rs. 373,286

2. You are planning to hedge a payable exposure in dollars and have calculated the following information.

Spot Rs. /$	42.50 / 42.60
3 months forward (Rs. /$)	43.50 / 43.70
Interest rate	$ 6%
	Rs. 15%

If the exposure matures in 3 months and there are no restrictions on trading in forward/money market instruments, which cover you would prefer – forward cover or money market cover? Show necessary calculations.

Solution:

Suppose we need $ 1000 after 3 months

Forward cover out flow 1000 × 43.70 = Rs.43, 700

Money market cover $\frac{\$1000}{1+0.06/4} = \$985.22$

Investment today $\frac{\$1000}{1+0.06/4} = \$985.22$

Rupee needed today $ 985.22 × 42.60 = Rs.41970

Rupee outflow after 3 months = 41,970 × (1 + 0.15/4) = 43544

Money market is better as it involves lesser rupee out flow at the end of 3 months when exposure will mature.

3. M/s Windfall Ltd has to import raw material in three consignments at the rate of one consignment every month in the rest 3 months. Payment will have to be made at the end of each month. The company has the option to invoice the consignment either in US $ or Euro. The terms are as under:

	US $	**Euro**	**To be paid after**
First consignment	150,000	157,000	1 month
Second consignment	300,000	312,000	2 months
Third consignment	250,000	262,000	3 months

You as the finance manager of the company have the following forecast for the exchange rates:

	After 1 month	**After 2 months**	**After 3 months**
US $ / Euro	1.0455 / 56	1.0418 / 09	1.0400 / 01
Rs. / US $	43.25 / 35	43.45 / 58	43.75 / 85

The current forward quotes in the market are as under:

	After 1 month	After 2 months	After 3 months
US $ / Euro	1.0465 / 67	1.0426 / 29	1.0415 / 19
Rs. / US $	43.45 / 50	43.65 / 75	43.80 / 95

Suggest the currency in which you invoice for each of the consignment

1. If the exposure is hedged
2. If the exposure is left conserved

Solution: The Rs. / Euro rate can be calculated as follows:

Forward rates:

Rs. / Euro bid [(Rs. / $) bid × ($ / Euro bid)]

1 month = 43.45 × 1.0465

2 months = 43.65 × 1.0426

3 months = 43.80 × 1.0415

Rs. / Euro ask (Rs. /$) ask × ($/Euro) ask

1 month = 43.50 × 1.0467 = 45.53

2 months = 43.75 × 1.0429 = 45.63

3 months = 43.95 × 1.0419 = 45.79

Expected rates:

Rs. / Euro ask (Rs. /$) ask × ($/Euro) ask

1 month = 43.35 × 1.0456 = 45.33

2 months = 43.58 × 1.0409 = 45.36

3 months = 43.85 × 1.0401 = 45.61

Consignment	Invoicing	Hedged / Not Hedged	Rate	Outflow in Foreign currency	Outflow in Rs.
First	$	Hedged	Rs.43.50 /$	$ 150,000	6525,000
	Euro	Hedged	Rs.45.53 / Euro	Euro 157,000	7148,210
Second	$	Hedged	Rs.43.75 /$	$ 300,000	13125,000
	Euro	Hedged	Rs.45.65 / Euro	Euro 312,000	14236,560
Third	$	Hedged	Rs.43.95 /$	$ 250,000	10,987,500
	Euro	Hedged	Rs.45.79 / Euro	Euro 262,000	11,996,980
First	$	Unhedged	Rs.43.35 /$	$ 150,000	6502,500
	Euro	Unhedged	Rs.45.33 / Euro	Euro 157,000	7116,810
Second	$	Unhedged	Rs.43.58 /$	$ 300,000	13074,000
	Euro	Unhedged	Rs.45.36 / Euro	Euro 312,000	14152,320
Third	$	Unhedged	Rs.43.85 /$	$ 250,000	13962,500
	Euro	Unhedged	Rs.45.61 / Euro	Euro 262,000	11949,820

All these 3 consignments have to be invoiced in $ and left uncovered.

11.6 EXCHANGE RATE FORECASTING

A plethora of factors affect the level of and movements in exchange rates, often in a conflicting manner. A number of theories were developed to explain these effects. Though a consistent prediction of the exact level of future exchange rates is impossible, these theories help in forecasting the possible direction of the movements.

The following modes of exchange rate forecasting are being covered below:

Forward rate as an unbiased predictor of future spot rates.

11.6.1 The Demand – Supply Approach

A currency's exchange rate is determined by the overall supply of and demand for that currency. According to this, new changes in exchange rates can be forecast by analysing the factors that affect the demand and supply of a currency. However very few currencies in the world float freely without any government intervention. Most are managed to some extent, which implies that government needs to make political decisions about the value of their currencies. Managers of multinational organisations need to monitor the following factors the government follows, in order to try to protect values.

11.6.2 The Institutional Setting

- Does the currency float, or is it managed, and if so, is it pegged to another currency, to a basket, or to some other standard?
- What are the intervention practices? Are they credible? Sustainable?

11.6.3 Fundamental Analysis

- Does the currency appear undervalued or over valued in terms of PPP, balance of payments, foreign exchange reserves or other factors?
- What is the cyclical situation in terms of employment growth, savings, investments and inflation?
- What are the prospects for government, monetary, fiscal and debt policy?

11.6.4 Confidence Factors

What are the market views and expectations with respect to the political environment, as well as to the credibility of the government and Central Bank?

11.6.5 Expected Theory of Forward Rates

What is the relationship between the forward rates and the expected spot rates in the future? Suppose you are an exporter who is expecting to receive US dollars in the future, you have two choices. You can either wait until you receive dollars and then covert them into rupees. The second alternative to that you fix the price of the dollar today and sell the US dollars forward. You are thus able to avoid the risk of a possible fall in the value of the dollar. In the case of an importer, who is required to make payment in US Dollars in the future, the situation is just the opposite. He will buy the US dollars forward to avoid the risk of possible appreciation in the value of the dollar in the future. If both the exporters and the importers are in large numbers, the forward rate of US dollars relative to the Indian rupee will be very close to the expected future spot rate. This is the expectation theory of exchange rates.

The expected future spot rate depends on the expectations of the forex market participants. If they can hedge their forex risk or if they are risk neutral, then the forward rate must be equal to the expected future spot rate.

Thus: Forward and current spot rate differential = Expected and current spot Rate differential

i.e. $$\frac{fA/B}{sA/B} = \frac{E(sA/B)}{sA/B}$$

Where E (S A/B) is the expected future exchange rate (unit of domestic currency per unit of foreign currency) and

F A/B is the forward rate.

In simple terms, the forward rate must be equal to the expected future spot rate. Thus,

Forward rate = Expected future spot rate

F A/B = E (S A/B)

11.6.6 Events

Are there national or international incidents in the news; the possibility of crisis or emergencies; governmental or other important meeting coming up (such as that of the G7 for example?

11.6.7 Technical Analysis

- What trends do the charts show? Are these signs of trend reversals?
- At what rates do there appear to be important buy and sell orders? Are they balanced? Is the market overbought? Oversold?
- What are the thinking and expectations of other market players and analysts?

11.6.8 Fundamental and Technical Forecasting

Managers can forecast exchange rates by using either of the two approaches: fundamental forecasting or technical forecasting. Fundamental forecasting uses past trends in exchange rates themselves to spot future trends in rates. Technical forecasters, assume that if current exchange rates reflect all facts in the market, then under similar circumstances, future rates will follow the same patterns.

However, all forecasting is imprecise.

Good treasurers and bankers develop their own forecasts of what will happen to a particular currency and use fundamental or technical forecasts of outside forecasters to incorporate them. Doing this helps them to determine whether they are considering important factors and whether they need to revise their forecasts in the light of outside analysis.

It is hard to predict what will happen to currencies and to use those predictions to forecast profits and establish operating strategies.

Technical analysis uses price and volume data to determine past trends, which are expected to continue into the future. This approach does not rely on a consideration of economic fundamentals. Technical analysis is based on the premise that there are analysable market trends and waves and that previous trends and waves can be used to predict future trends and waves.

11.6.9 The Monetary Approach

This theory assumes that PPP holds good i.e. an increase in the price level results in the depreciation of a country's currency and vice versa.

11.6.10 Portfolio Balance Approach

This approach states that the value of a currency is determined by two factors – The relative demand and supply of money and the relative demand and supply of bonds. According to this approach, people can hold assets across different countries,

denominated in different currencies (mainly in the form of currencies and bonds). Hence any change in exchange rates, changes the wealth of the balance of these assets, which becomes an instrument for maintaining equilibrium in money and bond markets.

As per this theory, interest rates and exchange rates are linked in the manner shown in the following Figure:

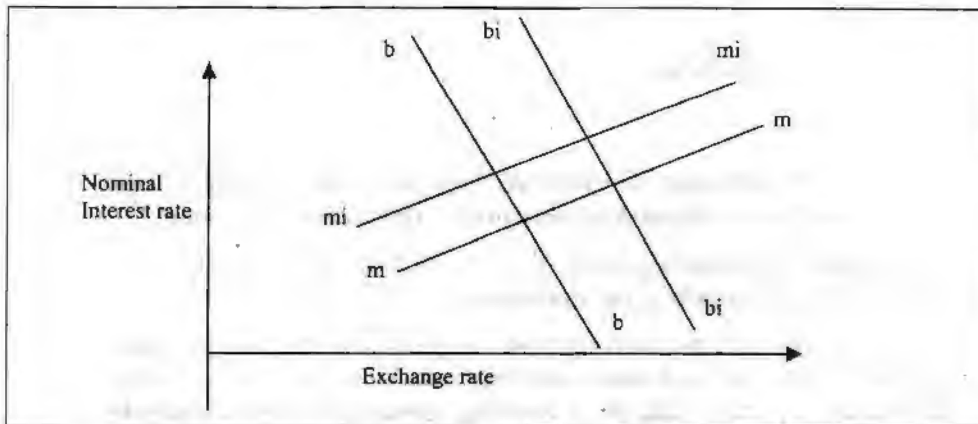

Figure 11.2

In the above, interest rates are shown on the Y axis and the exchange rate on the X axis, with a movement towards the right reflecting depreciation of the home currency. Curve bb represents the combination of interest rates and exchange rates for which the bond market is in equilibrium and curve mm representing combination of interest rates and exchange rates for which the money markets are in equilibrium. As interest rates rise, the demand for bonds increases, with the supply of bonds not changing, this results in excess demand. This demand can be reduced by reducing the wealth of the portfolio holders. A reduction in the wealth would induce portfolio holders to demand loss of everything, including bonds. This is achieved through an appreciation of the domestic currency. The appreciation reduces the real wealth of the portfolio holders in domestic currency terms. Hence, appreciation of the domestic currency is accompanied by an increase in interest rates in order to maintain equilibrium in the bond market. This makes curve bb downward sloping. Similarly an increase in interest rates means a lower demand for money with money supply being constant, this results in excess supply of money. To bring the money market back to equilibrium, the demand for money needs to be increased. This can happen if the real wealth of portfolio holders increases through a depreciation of the domestic currency. Hence depreciation of the domestic currency accompanies an increase in interest rates, to maintain the equilibrium in the money markets. This makes the curve more upward sloping.

The equilibrium level of interest rates and exchange rates are determined by the interplay of money market and bond markets and the intersection of two curves. The theory assumes that any change in money supply is effected via open market operations by the government (or the Central Bank), thus changing the supply of bonds. Suppose there is a reduction in the money supply which would be done by the government selling bonds in the market, the reduced money supply would shift the mm curve upwards, since the interest rate would increase for every level of exchange rate. The increase in bond supply would shift curve bb to the right since at every level of exchange, portfolio holders would require increased interest rate. The reduction in the money supply will definitely result in an increase in interest rates, the effect on exchange rates would depend upon the degree to which the two curves would shift and hence could be in any direction. If curve bb shifts more than curve mm, then there would be a depreciation of the currency.

The theory provides an explanation for a change in the value of currency arising from a change in the real GNP. A higher real GNP results in a higher demand for both money and bonds. The higher demand for money increases interest rates and hence shifts the mm curve upwards. The higher demand for bonds reduces the interest rates and hence shifts curve bb to the left. Both the shifts result in an appreciation of the currency, which is higher than that predicted by the monetary theory. But there, the effect on interest rates is ambiguous and depends on the quantum by which the two curves shift.

1. Several theories of exchange rates have been advanced which have been advanced which are based on the stocks of countries' monies the demand to hold these monies.
2. The monetary approach to exchange rates is based on links between money supplies and price levels and between price levels and exchange rates.
3. The monetary approach predicts that an exchange rate will depreciate by the excess of money growth in one country over another.
4. The asset approach to exchange rate suggests that the current exchange rate depends on the expected future exchange rate. Since the expected future rate can depend on expected inflation or anything appearing in the balance-of-payments account, the asset approach is consistent with other theories of exchange rates.
5. The portfolio-balance approach assumes different countries' bonds are not perfect substitutes. As a result, changes in preferences for bonds of one country over another, or changes in bond supplies, can affect exchange rates.
6. The principle of purchasing-power parity (PPP) is the extension of the law of one price to prices of a basket of goods. In its absolute form, PPP says that the dollar price of a basket of goods in the United States is the pound price of the basket in Britain, multiplied by the exchange rate of dollars per pound.
7. In its relative form, PPP says that the rate of change of the exchange rate is approximately equal to the difference between inflation rates.
8. An investor should be indifferent with respect to investing in domestic or foreign currency when the domestic-currency interest rate equals the foreign-currency rate plus the annualised forward exchange premium or discount on the foreign currency. The investor should invest in domestic currency when the domestic currency interest rate exceeds the foreign currency interest rate plus the forward foreign exchange premium or discount.

11.7 FOREIGN EXCHANGE MANAGEMENT ACT (FEMA)

Foreign exchange transactions were regulated in India by the Foreign Exchange Regulations Act (FERA), 1973. This Act sought to regulate certain aspects of the conduct of business outside the country by Indian companies and in India by foreign companies.

The main objective of FERA framed against the background of severe foreign exchange problems and the controlled economic region, was conservation and proper utilization of the foreign exchange reserves of the country.

There was lot of demand for a substantial modification of FERA in the light of the ongoing economic liberalization and improving foreign exchange reserves of the country Accordingly, a new Act, the Foreign Exchange Management Act (FEMA), 1999 replaced the FERA.

The FEMA which came into effect from January 1, 2000, extends to the whole of India and also applies to all branches, offices, and agencies outside India, owned or controlled by a person resident in India.

Objectives

The objectives of FEMA are:

- To facilitate external trade and payments.
- To promote the orderly development and maintenance of foreign exchange market.

Dealings in Foreign Exchange

Section 3 of FEMA imposes restrictions on dealings in foreign exchange and foreign security and payments to and receipts from any person outside India. Accordingly, except as provided in terms of the Act, or with the general or special permission of the RBI, no person shall:

(a) Deal in any foreign exchange or foreign security with any person other than an authorized person;

(b) Make any payment to or for the credit of any person resident outside India in any manner;

(c) Receive otherwise through an authorized person, any payment by order or on behalf of any person resident outside India an any manner; and

(d) Enter into any financial transaction in India as a consideration for or in association with acquisition or creation or transfer of a right to acquire, any asset outside India by any person.

Further, save as otherwise provided in this act, no person resident in India shall acquire, hold, own, possess or transfer any foreign exchange, foreign security or any immovable property situated outside India.

Holding of Foreign Exchange: Save as otherwise provided in this Act, no person resident in India shall acquire, hold, own, possess or transfer any foreign exchange, foreign security or nay immovable property situated outside India.

Current Account Transactions: FEMA permits dealings in foreign exchange through authorized persons for current account transactions. However, the central government can impose reasonable restrictions in public interest.

Capital Account Transactions: Any person may sell or draw foreign exchange to or from an authorized person for a capital account transaction permitted by the Reserve Bank in consultation with the central Government.

The Reserve Bank may, however, without prejudice to the generality of this, prohibit, restrict or regulate the following:

(a) Transfer or issue of any foreign security by a person resident in India;

(b) Transfer or issue of any security by a person resident outside India;

(c) Transfer or issue of any security or foreign security by any branch, office or agency in India of a person resident outside India;

(d) Any borrowing or lending in foreign exchange in whatever form or by whatever name called;

(e) Any borrowing or lending in rupees in whatever form or by whatever name called between a person resident in India and a person resident outside India;

(f) Deposits between persons resident in India and persons resident outside India;

(g) Export, import or holding of currency or currency notes;

(h) Transfer of immovable property in India, other than a lease note exceeding five years, by a person resident in India;

(i) Acquisition or transfer of immovable property in India, other than a lease not exceeding five years by a person resident outside India;

(j) Giving of a guarantee or surety in respect of any debt, obligation or other liability incurred:

- By a person resident in India and owed to person resident outside India; or
- By a person resident outside India.

A person resident in India may hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India if such currency, security or property was acquired, held or owned by such person when be was resident outside India or inherited from a person who was resident outside India.

A person resident outside India may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency, security or property was acquired, held or owned by such person when he was resident in India or inherited from a person who was resident in India.

The Reserve Bank may prohibit, restrict, or regulate establishment in India of a branch, office or other place of business by a person resident outside India, for carrying on any activity relating to such branch, office or other place of business.

The Reserve Bank shall not impose any restriction on the drawal of foreign exchange for payments due on account of amortization of loans or for depreciation of direct investments in the ordinary course of business.

Export of Goods and Services

Every exporter of goods shall:

(a) Furnish to the Reserve Bank or to such other authority a declaration as specified, containing true and correct material particulars, including the amount representing the full export value or, if the full export value of the goods is not ascertained at the time of export, the value which the exporter having regard to the prevailing market conditions, expects to receive on the sale of the goods in market outside India;

(b) Furnish to the Reserve Bank such other information as may be required by the Reserve Bank for the purpose of ensuring the realization of the export proceeds by such exporter.

For the purpose of ensuring that export value o goods is received without any delay, the Reserve Bank may direct any exporter to comply with such requirements as it deems fit.

Every exporter of services shall furnish to the reserve Bank or to such other authorities a declaration as specified, containing the true and correct material particulars in relation to payment for such services.

Realization and Repatriation of Foreign Exchange: Where any amount of foreign exchange is due or has accrued to any person, he shall take all reasonable steps to realize and repatriate it to India within the time and in the manner prescribed by the RBI. Several exemptions are however granted to this clause.

Contravention and Penalties: Any kind of contravention under this Act is liable to a penalty to thrice the amount involved where it is quantifiable or up to Rs. 2 lakhs where it is not quantifiable and where such contravention is continuing one. Further penalty which may extend to five thousand rupees for every day after the first day during which tbe contravention continues. This provision is in total contrast to the respective provision of the erstwhile FERA which provided for imprisonment and no limit of fine Under FEMA, a person will be liable to civil imprisonment only if he

does not pay the fine within 90 days from the date of notice and that too after the formalities of show cause notice and personal hearing. If he does not respond to the notice, a warrant of arrest can be issued against him.

Administration of the Act: The FEMA has assigned an important role to the Reserve Bank of India in the Administration of this Act. The rules, regulations and norms pertaining to several sections of the Act are to be laid down by RBI, in consultation with the Central Government.

The Act requires the Central Government to appoint as many officers of the central Govt. as adjudicating authorities for holding inquiries pertaining to contravention of the Act. There is also provision for appointing one or more Special Directors (Appeals) to hear appeals against the order of the Adjudicating Authorities. The Central Govt. shall also establish an Appellate tribunal for foreign exchange to hear appeals against the orders of the Adjudicating Authorities and the Special Director (Appeals).

The FEMA provides for the establishment, by the Central Govt., of a Director of Enforcement with a director and such other officers or class of officers as it thins fit for taking up investigation for the contravention under this act.

FERA and FEMA- A Comparison

1. In FEMA only the specified acts relating to foreign exchange are regulated, while in FERA, anything and everything that has to do with foreign exchange was controlled Also, the aim of FEMA is facilitating trade as against that of FERA which was to prevent misuse.
2. FEMA is a much smaller enactment-only 49 sections as against 81 sections of FERA.
3. In the process of simplification, many of the 'laid downs' of the erstwhile FERA have been withdrawn.
4. Many provisions of FERA like the ones relating to blocked accounts, Indians taking up employment abroad, employment of foreign technicians in India, contracts in evasion of the Act, vexatious search, culpable mental state etc. have no appearance in FEMA.

11.8 FINANCIAL CRISES IN THE POST BRETTON WOODS ERA

A number of financial crises have occurred over the last quarter of a century, many of which had IMF interference and involvement.

- A currency crisis occurs when a speculative attack on the exchange value of the currency forces authorities to spend large amounts of international currency reserves and sharply increase rates to defend the prevailing exchange rate.
- A banking crisis refers to the loss of confidence on the banking system that leads to a run on banks, as companies and individuals withdraw their deposits.
- A foreign debt crisis is a situation in which a country can service its foreign debt obligation whether private sector or government debt.

These crises tend to have common micro-economic causes:

1. High relative price inflation rates
2. A widening current account deficit
3. Excessive expansion of domestic borrowing
4. Asset price inflation such as sharp rise in share and property prices.

At times, elements of currency, banking and debt crisis may occur simultaneously, as in the 1997 Asian crisis or in 1999 - 2001 Turkish crises.

To assess the frequency of financial crisis, the IMF reviewed the macro economic performance of a group of 53 countries from 1975 to 1997 (22 of these countries were developed nations and 31 were developing countries). The IMF found that there were 158 currency crises, including 55 episodes in which a country's currency declined by more than 25 percent. There were 54 banking crises.

Four crises have been of particular significance in terms of IMF involvement, the third world debt crisis of the 1980s, the crisis experienced by Russia which moved towards a market based economic system, the 1995 Mexican currency crisis and the 1997 Asian financial crisis. All four of these crises were the result of excessive foreign borrowings, a weak or poorly regulated banking system and high inflation rates. These resulted in simultaneous debt and currency crises.

11.8.1 Third World Debt Crisis

The Third World Debt Crisis can be traced back to the OPEC oil price hike of 1973 and 1979. There was a huge flow of funds from major oil importing countries like Germany, Japan and the United States to the oil producing nations of OPEC. Commercial banks stepped in to recycle the money, by borrowing from OPEC countries and lending to governments and businesses around the world. The commercial banks on the basis of optimistic assessments of the growth prospects lent a lot of money to various Latin America and African nations. This did not materialise. Rather third world economic growth slowed down in the early 1980's due to high inflation, rising short term interest rates (which increased the cost of servicing the debt) and recession condition in industrialised nations (which were the market for third world goods).

The consequence was a third world debt crisis of huge proportion. At one point of time, commercial banks had more than $ 1 billion of had debts on their books (debts which the debtor nations had no hope of paying off). Against this backdrop, Mexico announced in 1982 that it could no longer service its $ 80 billion international debt without a bail off new loan of $ 3 billion. Brazil followed suit, revealing that it could not meet the required payments on its borrowed $ 87 billion loan. Then Argentina and several other dozen countries followed suit. Thus the international monetary system faced a crisis of enormous dimensions.

IMF together with several Western Governments stepped in to resolve the debt crisis. The deal with Mexico contained three aspects:

1. Rescheduling of Mexico's old debt
2. New loans from the IMF, the World Bank and Commercial Banks
3. Mexico government's agreement to comply by a set of IMF dictated macroeconomic prescriptions for its economy, which included tight control over the growth of the money supply and major cuts in government spending.

The IMF's solution to the debt crisis was based on the assumption that there will be rapid resumption of growth in member countries; with the result that the capacity to pay will improve and the crisis would be resolved. By the mid 1980s it became clear, that this was not going to happen. The IMF's dictated macro chronic policies did bring down the trade deficits and inflation rates of many debtor nations under control, but the chronic growth rates did not go up.

By 1989, it became clear that the debt problem was not going to be solved merely by rescheduling of debts. In April of that year, the IMF has come up with a new approach, that debt reduction was a necessary part of the solution. The essence of the plan was that IMF and World Bank would assume lead role in financing it and that

IMF, the World Bank and the Japanese government would each contribute 10 billion towards debt reduction. To get these funds, the debtor nation has to agree to follow imposed conditions for macro chronic policy management and debt repayment. The first application was the Mexican debt reduction of $15 billion (out of $107 billion) in 1989. Till 1995 this action was widely regarded as a success.

11.8.2 Mexican Currency Crisis of 1995

The Mexican Peso had been pegged to the dollar from early 1980's as part of the condition of IMF while lending money to the Mexican Government to bail the country out of the 1982 financial crisis. The peso had been allowed to trade within a tolerance band of plus or minus 3 percent against the dollar. The band was also permitted "crawl" down daily, allowing for an annual peso depreciation of about 4 percent against the dollar. The IMF believed that the need to maintain the exchange rate within a fairly narrow trading band would force the Mexican government to adopt stringent financial policies to limit growth in the money supply and contain inflation.

Until the early 1990's, it looked as if the IMF policy had worked. However, the strains were beginning to show by 1994. Since the mid 1980's till the period, Mexican producer prices had risen 45 percent more than prices in US, and yet there had been no adjustment in the exchange rate. By late 1994, Mexico was running a trade deficit of $ 17 billion, which amounted to 6% of the country's gross domestic product and there had been rapid expansion in the country's public and private sector debt. In spite of the pressures, Mexican government officials had been stating publicly that they would support the peso's dollar peg at around $ 1 = 3.5 pesos by adopting appropriate monetary policies and by intervention in the currency markets. Encouraged by such public statements, $ 64 billion of foreign investment money poured into Mexico between 1990 and 1994 as corporations and mutual fund money transfer sought to take advantage of the booming economy.

However, currency traders began to dump peso on the foreign exchange market. The government tried to bide the time by buying pesos and selling dollars but it didn't have the foreign currency reserves to halt the speculative tide. In mid December 1994, the Mexican government announced devaluation abruptly. Immediately many of the short-term investment money that had flowed into Mexico in shares and bonds during the year, reversed its course. This enhanced the sale of peso and contributed to a rapid 40 percent drop in value.

The IMF together with the US government and the Bank for International Settlements promised nearly $ 50 billion to help Mexico stabilise the peso and to redeem $ 47 billion of public and private sector debt that was set to mature in 1995. As usual, the IMF insisted on tight monetary policies and further cuts in public spending, both of which pushed the country into a deep recession. However, the recession was short-lived and by 1997 the country was once more on the growth path, had reduced its debt and had paid back the $ 20 billion borrowed from the US government ahead of schedule.

The future outlook of Mexico will depend not only on the performance of the US economy but also on the progress of the Mexican banking system. The volume of bank credit in 1998 was much below the pre-crisis level of 1994. Hence additional support was announced to bank debtors in 1998. The congress in late 1998 agreed to the establishment of a deposit insurance agency for dealing with the non-performance loans taken off bankbooks in recent years. It is expected that this agreement will lead to the expansion of credit and equity in the banking industry.

11.8.3 The Brazilian Crisis

Brazil is the largest country in South America and fifth largest in the world covering 3.3 million square miles with a population of 151 million people of Portuguese

heritage. Brazil is strategically located with borders touching most of the nations in South America.

The 1980-decade started with inflation at an average rate of 200 percent. It began with the country under military rule but civilian leadership was re-established in 1985.

Brazil's economic strife is a puzzle because the country has huge deposits of natural resources, large investment opportunities and a vast pool of managerial talent. In spite of all these, the nation has to face chronic crises one after another.

The main handicap of the Brazilian economy is the existence of mostly a planned economy, through which bureaucracy operates more than 60% of the country's industrial output through ineffective public sector units.

In 1992, Brazil was Latin America's largest debtor nation with excessive foreign debt of $ 118 billion. The IMF agreed to extend a $ 2.1 billion standby loan on the conditions that Brazil should adopt strict macro economic measures to control inflation and stabilise its economy. President Fernando Collor de Mello introduced economic and trade reforms, overhauling the monetary system, reducing government spending, opening Brazilian international bonds to meet margin calls elsewhere, contributed significantly to the financial crisis and thus capital outflows were accelerated.

In 1997, partial moratorium by the state government increased the pressure and the authorities abandoned the long standing exchange rate regime.

The government attempted limited and controlled devaluation with a large stock of foreign exchange reserves and an international support programme already in place. Secondly the corporate and banking sectors were not highly exposed as they had hedged their positions against sudden changes in interest rates and exchange rates. A major weakness was the vulnerability of the government deficit, to devaluation coupled with high interest rates, given the large stock of dollar linked and floating treasury bills and the central bank's short position in the exchange rate futures and forward markets. Under these circumstances, the real depreciated by 40% within the period of two months following the adoption of the floating regime.

In the context of devaluation two issues were important. Firstly, internal debt GDP ratio was to be lowered. Hence, in order to prevent continuous downward pressure in the currency and upward pressure on interest rates, strict corrective action in the fiscal area was announced in March 1999. In addition to the measures already agreed with the IMF, further restraint on spending and tax increases were adopted to bring the public sector primary surplus to over 3% of GDP in 1999.

The second concern was to control inflation. So the authorities tightened monetary policy and interest rates were allowed to rise from 30% in 1998 to 45% in 1999 to reverse the weakening of the exchange rate and to limit the impact of inflation. As exchange rates strengthened, the central bank was allowed to lower interest rates from March 1999 onwards and inflation levelled at 1.3% in March 1999, it attracted foreign investment.

11.8.4 Argentina

Argentina is one of the Latin American countries with 1.1 million square miles having a population of over 32.3 million. Most of its wealth originates from land – agriculture, minerals and oil. Argentina's economy flourished in the beginning of the twentieth century, growing at an annual rate of 5 percent for three years. It attracted a flood of British and Spanish capital and was rated as one of the world's richest countries – even ahead of France and Germany. However, it has been downhill since then. When Juan Peron ruled the country from 1946 to 1955, he instituted protectionist measures and printed money to finance generous benefits for workers. State intervention in all sectors led to poor productivity and structural weakness in the

economy. Inflation plagued the country; there were two bouts of hyperinflation in the 1980s and two banking collapses. As a result, Argentines lost trust in the peso and invested in US dollars or shipped their capital abroad.

In 1989, Carlos Menem took control of the country and set out to implement free market reforms and to restructure monetary and economic policies. He privatised many state-run companies, tightened fiscal management, and opened up the country's borders to trade. Probably the most important policy he established was the Convertibility Law, which pegged the Argentine peso 1:1 with the US dollar and restricted the money supply to its hard dollar currency reserves. This monetary arrangement was called a currency board and was established to impose discipline on the central bank. The new currency board accomplished what it set out to do: It halted inflation and attracted investment. Investors felt that there was little risk anymore in investing in the peso, since it was pegged to the dollar. The sentiment that "the peso is as good as the dollar" was strong throughout the country. Because there was a stable money supply, this reduced inflation to nearly 0 percent through the rest of the 1990s and kept the exchange rate at a constant value. Real GDP grew by 6.1 per cent from 1991 to 1997 compared to 0.2 per cent from 1975 to 1990.

In spite of these positive developments, the currency board also had its drawbacks. It reduced the Argentine government's ability to respond to external shocks by allowing its exchange rate and monetary policy to be determined de facto by the United States. Interest rates were in reality set by the U.S. Federal Reserve; plus there was a risk-margin for investing in Argentina. This arrangement was put to the test in 1995, when the Mexican peso devalued. Investors got nervous about Latin America in general and pulled investments out of Argentina. Its economy shrank by 4 percent, and many banks collapsed. The government responded by tightening bank regulation and capital requirements, and some of the larger banks took over weaker ones. Argentina increased exports and investment, and the country returned to 5.5 per cent growth.

Unfortunately, the government wasn't so lucky with its results at the end of the 1990s. Commodity prices, which Argentina relied heavily on, declined; the U.S. dollar strengthened against other currencies; Argentina's main trading partner, Brazil, devalued its currency; and emerging economies' cost of capital increased. Argentina soon fell into a recession, with GDP falling to 3.4 percent in 1999 and unemployment increasing into the double digits. Argentina, because of its hard link to the dollar, was unable to compete internationally, especially in Brazil, because of its high prices. One way to correct this problem would be to devalue the currency to bring the value closer to its fundamental value. Argentina couldn't devalue unless it cancelled the currency board's popularity and past success. The only way for Argentina to become more competitive was for prices to fall. As deflation set in, the government (and some private companies) found it difficult to pay its debt because it was not collecting as much revenue. Banks had been lending dollars at 25 percent interest rates even though the risk was supposed to be low.

Argentina was acquiring a burgeoning public debt. When the recession hit, tax revenue fell and spending increased to pay for such things as higher unemployment. Tax evasion is extremely high in Argentina; but government did little to tackle the problem. The budget went from a surplus of 1.2 percent of GDP in 1993 to a deficit of 2.4 percent in 2000. Increased interest rate payments also added to the increasing budget deficit. From 1991 to 2000, the amount of interest rate payments increased from $ 2.5 billion to $ 9.5 billion annually. This drained the economy more as most of this money went to overseas investors. This currency "mismatching", meaning most of the debt is taken out in one currency but assets are held in another, were large in Argentina and would later prove disastrous.

Politicians found little they could do to help the struggling economy. They fiddled with tariffs and finally the currency board. They pegged the peso half to the dollar and

half to the euro for exporters. The idea of devaluation scared investors and caused interest rates to rise even more. Unable to pay its interest payments and unwilling to declare a debt default, the government turned to the banks. The Menem government had strengthened the banking system, particularly the central bank, but his successor, Fernando de la Rua, sent a crushing blow to the sector. He strong-armed the banks into buying government bonds. This triggered a bank run, and Argentines withdrew over $ 15 billion between July and November 2001. In a desperate attempt to save the industry, Mr. De la Rua imposed a ceiling of $ 1,000 a month on bank withdrawals on December 1. Within days, the country defaulted on $ 155 million in public debt, the largest such default in world history. As rioters and looters took to the streets, Mr. De la Rua resigned.

Argentina struggled to find a president who was fit for the job; it went through a total of five presidents in four months ending finally with Eduardo Duhalde. The government abandoned the currency board in January 2002 and let the peso float against the dollar. The peso began falling quickly, so the government spent around $ 100 million a day – to a total of $ 1.2 billion – to prop up the value. More money was leaking out of the banking system too (around $ 50 million a day) –, because the courts had overturned the freeze on withdrawals.

In March 2002, Mr. Duhalde imposed new restrictions on the foreign exchange market. Individuals could buy no more than $1000 a day and companies no more than $10,000 a day. Bank businesses had restrictions on the number of dollars they could hold and how much money could be shipped abroad. Currency exchanges could only operate three to four hours each day – versus typical seven hours. However, the courts kept overturning policies set by the government and had police arrest bank managers who didn't follow their rulings. Still unable to prevent the increasing flow of money out of the system, Duhalde closed all banks for a week. In the meantime, he proposed to forcibly convert billions of dollars in bank deposits into low-interest bonds. The senate refused the president's bond proposal, thus sending him back to the drawing board.

As Argentina tries to repair its economy, it is waiting for help from the International Monetary Fund (IMF). However, the IMF continues to turn down Argentina's requests for help until it implements some sweeping changes in its exchange rate policy, fiscal policy banking system. In an attempt to find someone to blame it started criticising foreign owned banks for not infusing more cash into the system from their headquarters. The central bank has been printing pesos to keep banks solvent, but this led to increased inflation. The national and provincial government is also using bond notes, quasi-currency, to pay many of their debts. This note is being swapped in everyday transactions and has surprisingly held its value against the peso. Officials promise Argentina that once a deal is signed with the IMF; they will gather up this currency and swap it for pesos at face value.

Progress is slow with the IMF. Many of the measures required by the IMF are extremely unpopular with the provincial government and the courts. As a result, Duhalde has had to abandon some of his required cost cutting in order to please the country. One of the last measures Duhalde has implemented is that of pacification which turned bank's dollar assets and liabilities into devalued pesos. This again has put a severe strain on the banking system. People do not trust the banks anymore. They blame the banks for the bank freezes even though the government ordered them. Two foreign banks left the country, and others are threatening to do the same.

Argentina's economy, though still deeply damaged, is beginning to stabilise. The peso was trading around 27 cents in the latter half of 2002, inflation declined and the central bank's reserves increased a little partly due to the fact that the nation's banks aren't paying their debts. Some economists believe that Argentina should go with full dollarisation of its currency, not at 1:1 but more like 4:1. This would be even more

binding than its previous policy, but it would bring confidence back to the economy. Others argue for a system of managed floating plus at that would give the government flexibility to alter its monetary policy but still stay within certain targets and reduce its currency mismatching. The world is waiting to see what the IMF will do to support the country and what Argentina's next move will be.

11.8.5 The Asian Crisis of 1997

The seeds of this crisis were sown in the previous decade when these countries were experiencing unprecedented economic growth. Exports had long been the engine of economic growth in these countries. From 1990 to 1996, the value of exports from Malaysia had grown by 18 percent annually. Thai exports 16 percent per year, Singapore by15 percent, Hong Kong by 14 percent and those of South Korea and Indonesia by 12 percent annually. The nature of these exports had also shifted from basic materials and products such as textiles to complex and increasingly high technology products, such as automobiles, semi conductors and consumer electronics.

The wealth created by export led growth helped find an investment boom in commercial and residential property, industrial assets and infrastructure. The value of commercial and residential real estate in cities like Hong Kong and Bangkok started to soar. This led to a building boom, which had never been seen in Asia. Heavy borrowing from banks financed much of the construction. As for industrial assets, the success of Asian exporters encouraged them to make bolder investments in industrial capacity. This was demonstrated most clearly by South Korea's giant diversified conglomerates, or Chaebol, many of which had ambitions to build a major position in the global automobile and semi conductor industries.

An added factor behind the investment boom in most South East Asian economies was the government. Since in many cases, governments had embarked on huge infrastructure projects. In Malaysia, a new government administrative centre was constructed in Putrajaya for M $ 20 billion (U.S. $ 8 billion at the pre-July 1997 exchange rate) and the government was funding the development of a massive high technology communications corridor and the huge Bakun dam (most expensive power generation plant of M $ 13.6 billion). Throughout the region, the government also encouraged private businesses to invest in certain sectors of the economy in accordance with "national goals" and "industrialisation strategy". In South Korea, the government urged the Chaebol to invest in new factories as a way of boosting economic growth. South Korea enjoyed an investment led economic boom in the 1994–95 periods, but at a cost. The Chaebol always reliant on heavy borrowings, built up massive debts that were equivalent, on average to four times their equity.

In Indonesia, President Suharto had long supported investments in a network of an estimated 300 business owned by his family and friends with a system known as "crony capitalism". Many of these businesses were granted lucrative monopolies by the President. To support the ventures, a consortium of Indonesian banks was "ordered" by the government to offer almost 700 million in startup loan to the companies.

By the mid of 1990's, South East Asia was in the midst of an unprecedented investment boom, much of it financed with borrowed money. Between 1990 and 1995, gross domestic investment grew by 16.3 percent annually in Indonesia, 16 per cent in Malaysia, 15.3% in Thailand and 7.2% in South Korea. By comparison investment grew by 4.1 percent annually over the same period in US and 0.8% in all high income economies.

In subsequent years many of these investments declined significantly since some of the investments were made on the basis of unrealistic projections about future demand conditions. This has resulted now in significant excess capacity e.g. DRAM manufacturers (dynamic random access memory chips). Another example, a building boom in Thailand resulted in excess capacity in residential and commercial property.

By early 1997, what was happening in the South Korean semi conductor industry and the Bangkok property markets, was being repeated elsewhere in the region. To make matters worse, much of the borrowing had been in US dollars as opposed to local currencies. Throughout the region, local currencies were pegged to the dollar and interest rates on dollar borrowings were generally lower than rates on borrowings in domestic currency. Thus, it often makes economic sense to borrow in dollars if the option was available. However, if governments could not maintain the dollar peg and their currencies started to depreciate against the dollar, this would increase the quantum of debt burden, when measured in local currency. Currency depreciation would raise borrowing costs and could result in companies defaulting on their debt obligations.

The final complicating factor was that by the mid 1990s, although exports were still expanding across the region, imports were too. The investments in infrastructure, industrial capacity and commercial real estate were sucking in foreign goods at unprecedented rates. To build infrastructure, capital equipment and materials were brought from America, Europe and Japan. Many South East Asian states saw the current accounts of their balance of payments shift strongly into the red during the mid 1990's. By 1995, Indonesia was running a current account deficit that was equivalent to 3.5 percent of its GDP, Malaysia's 5.9 percent and Thailand's 8.1 percent. With deficits like these, it was increasingly difficult for the governments of these countries to maintain their currencies against the US Dollar.

The Asian melt down began in mid 1997 in Thailand when it became clear that several key Thai financial institutions were on the verge of default. These institutions had been borrowing dollars from international banks at low interest rates and lending Thai Baht at higher interest rates to local property developers. However, due to speculative overbuilding, these developers could not sell their commercial and residential property, forcing them to default on their debt obligations. In turn, the Thai financial institutions seemed increasingly likely to default on their dollar denominated debt obligations to international banks. Sensing the crisis, foreign investors fled the Thai Stock market, selling their positions and converting them into US Dollars. The increased demand for dollars and increased supply of Thai baht pushed down the dollar Thai baht exchange rate and the stock market plunged.

Further, foreign exchange dealers and hedge funds started speculating against the baht, selling it short. For the previous 13 years, the Thai Baht had been pegged to the US Dollar at an exchange rate of about $ 1 = Bt 25. The Thai government tried to defend the peg but only succeeded in depleting its foreign exchange reserves. On July 2, 1997, the Thai government abandoned its defence and allowed the Baht to freely float against the dollar. By January 1998, $ 1 = Bt 55 i.e. 55 percent decline in the value of the baht against the dollar doubled the amount of baht required to serve the dollar denominated debt commitments taken on it by Thai financial institutions and businesses. This increased the probability of corporate bankruptcies and further pushed down the stock market. The Thailand Stock market index declined from 787 in January 1997 to a low of 337 in December of that year, as top of 45 percent decline in 1996.

With its foreign exchange reserves depleted, Thailand lacked the foreign currency needed to finance its international trade and service debt commitments and therefore approached IMF help. It also needed to restore international confidence in its currency. The IMF agreed to provide Thai Government with $ 172 billion in loans but with some conditions. The conditions were to increase taxes, cut public spending, privatise several state owned businesses and raise interest – all steps needed to cool Thailand's overheated economy. The IMF also required Thailand to close illegal financial institutions. In December 1997, the Government closed 56 financial institutions, laying off 16,000 people and further deepening the recession that now gripped the country.

Following the devaluation of the Thai Baht, wave after wave of speculation hit other Asian currencies. The Malaysian ringgit, Indonesian rupiah, and the Singapore dollar were all marketed lower. With its foreign exchange reserves down to $ 28 billion, Malaysia let the ringgit float on July 14, 1997 before the devaluation the ringgit was trading at $ 1 = 2.525 ringgit, 6 months later it had declined to $ 1 = 4.15 ringgit. Singapore followed on July 17 and the Singapore dollar quickly dropped in value from $ 1 = 1.495 before the devaluation to $ 1 = S $ 2.68 a few days later. Next was Indonesia, where the rupiah was allowed to float from August 14. The currency fell from $ 1 = 2400 rupiah in August 1997 to $ 1 = 10,000 rupiah in January 6, 1998, a loss of 75 percent.

With the exception of Singapore, whose economy is probably the most stable in the region, these devaluations were driven by identical factors of that of Thai – combination of excess investment, high borrowings much of it in dollar denominated debt and a declining balance of payments position. Though Malaysia and Singapore were able to halt the slide in their currencies and stock markets without the help of IMF, Indonesia could not. Indonesia was struggling with a private sector, dollar denominated debt of close to $ 80 billion.

On Oct. 31, 1997, the IMF announced a rescue deal for $ 37 billion for Indonesia in conjunction with World Bank and Asian Development Bank. In return the government agreed to a number of restrictions e.g. close a number of troubled banks, reduce public spending, remove government subsidies on basic food stuffs and energy, balance the budget and unravel the irony capitalism that was so widespread in Indonesia. But the government of President Suharto backtracked several times on commitments made to the IMF. This precipitated decline in the Indonesian currency and stock markets. Ultimately, Suharto agreed and removed costly government subsidies, only to see the country dissolve into chaos as the population took to the streets to protest the resulting price increases. This led to a chain of events and Suharto's removal from power in May 1998.

The final axe fell on South Korea. During the 1990's South Korean companies had built up a huge debt as they invested in developing new industrial capacity. They found that the industrial capacity that was built up could not generate revenue to service their debt. Here also South Korean Banks and companies borrowed in dollars and that too in the form of short-term debt that would become due within one year. Thus, when the South Korean Won started to decline in 1997 in sympathy with the problem elsewhere in Asia, debt obligations ballooned. Several large companies were forced to file for bankruptcy. This triggered a decline in the South Korean currency and stock market that was difficult to stop or halt. The Central Bank tried to keep the dollar/Won exchange rate above $ 1 = 1,000 but found that it only depleted its foreign exchange reserves. On November 17, the Central Bank gave up the defence of the Won, which quickly fell to $ 1 = 1500.

With its economy on the verge of collapse, the South Korean government on November 21, requested $ 20 billion in standby loans from the IMF. Among other problems, the country's short term foreign debt was found to be twice as large as previously thought at close to $ 100 billion while the country's foreign exchange reserves were down to less than $ 6 billion. On December 3, the IMF and South Korean Government reached a deal to lend $ 55 billion to the country. The agreement put some conditions: (1) Opening up the economy and banking system to foreign investors. (2) Pledged to restrain the Chaebol by reducing their share of bank financing and requiring them to publish consolidated financial statements and undergo annual independent external audits. (3) Comply with its commitments to the World Trade Organisations to eliminate trade related subsidies and restrictive import licensing and would streamline its import certificates procedures, so as to open the economy to greater foreign competition.

11.8.6 Lessons from the Asian Currency Crisis

Generally speaking, liberalisation of financial markets when combined with a weak, underdeveloped domestic financial system tends to create an environment susceptible to currency and financial crises. Interestingly both Mexico and Korea experienced a major currency crisis within a few years after joining the OECD, which required a significant liberalisation of financial markets. It seems safe to recommend that countries first strengthen their domestic financial system and then liberalise their financial markets.

A number of measures should be taken to strengthen a nation's domestic financial system. Among other things, the government should strengthen its system of financial sector regulations and supervision. In addition, banks should be encouraged to base their lending decisions solely on economic merits rather than political considerations. Furthermore, firms, financial institutions and the government should be required to provide the public with reliable financial data in a timely fashion. A higher level of disclosure of financial information and the resultant transparency about the state of the economy will make it easier for all the concerned parties to monitor the situation better and mitigate investor panic, accentuated by the lack of reliable information.

Even if a company decides to liberalise its financial markets by allowing cross border capital flows, it should encourage foreign direct investments and equity and long-term bond investments, it should not encourage short term investments that can be reversed overnight, causing financial turmoil.

A fixed but adjustable exchange rate is problematic in the face of integrated international financial markets. Such an arrangement often invites speculative attack at the time of financial vulnerability. Countries should not try to restore the same fixed exchange rate system unless they are willing to impose 'capital controls'. According to the so-called "trilemma" that economists talk about, a country can attain only two of the following three conditions: (1) a fixed exchange rate (2) free international flows of capital and (3) an independent monetary policy. If a country would like to maintain monetary policy independence to pursue its own domestic economic goals and still would like to keep a fixed exchange rate between its currency and other currencies, then the country should restrict free flows of capital. China and India were not noticeably affected by the Asian currency crisis because both countries maintain capital controls, segmenting their capital markets from the rest of the world. Hong Kong and Argentina were less affected by the crisis because they have fixed their exchange rates permanently to the US Dollar via currency boards and allowed free flows of capital, in consequence, they gave up their monetary independence. A currency board is an extreme form of the fixed exchange rate regime under which local currency is "fully" backed by the dollar (or another chosen standard currency). Hong Kong and Argentina have essentially dollarised their economies. To avoid a currency crisis, a country can have a really fixed exchange rate or flexible exchange rate but not a fixed yet adjustable exchange rate, when international capital markets are integrated.

11.9 HISTORY OF EURO

Euro, the common currency of European Union, was launched by 11 of the 15 members of the Union, on January 1, 1999. The exchange rates for Euro determined at the time of the euro launch were about US $1.17; British pound 0.70, yen 133; and German Mark 1.96. One euro was equivalent to about Rs. 49.

The Maastricht treaty of 1991, which set the stage for the Monetary Union laid down certain eligibility criteria for member countries to join the EMU, such as maintaining budget deficit, public debt, inflation, long-term interest rates and exchange rate within defined limits.

Greece could not join the Euro launch as she could not satisfy these criteria. Britain, Denmark and Sweden opted out, although they satisfied the eligibility criteria, due to domestic political reasons. The parties to the Euro at the beginning were, thus, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Greece joined the Euro in January 1, 1999. The National currencies of the Euroland nations continued in circulation until July, 2002, the deadline for the withdrawal of national currencies and coins.

At the time of the launch of Euro, its conversion ratio against other currencies-internal and external-were also decided. Internal conversion rates are the rates at which participating currencies would be converted into the Euro during the transition period, i.e. until the euro would completely replace the national currencies of the Euroland, while the external exchange rates are the exchange rates against currencies outside the Euroland. A key distinction was that the internal rates were irrevocably fixed while external values of the euro will be market determined.

The monetary policy decisions for the Euro area are made by the European Central Bank (ECB),which along with the national Central Banks (NCBs) of all EU members, comprises the European System of Central Banks (ESCB). The ECB is controlled by a governing council consisting of an Executive Board (with six members appointed by the heads of State or governments of countries in the Euro area), and the governors of the NCBs of the Euroland. In designing the EMU, the architects laid great emphasis both on the independence of the ECB and on the simplicity and severity of its ant-inflation objective. The Maastricht Treaty directs the ECB to support the general economic policies of the Community, but critically, without prejudice to the objective of price stability.

Benefits of Euro: The single currency will bring a single interest rate, eliminate currency risk and give equity and bond markets the necessary scope and liquidity to attract big investors. Europe will rank alongside the US as the deepest and most liquid market in the world.

Consumers will be benefited in several ways. The single currency will impart price transparency throughout the Euroland-when there were many currencies price, comparisons were not so easy. Prices now will tend to be equal throughout the Euro area.

The single currency saves a lot on the cost of hedging against exchange rate risks. Companies in the Euroland benefit from the ease of outsourcing, relocation of production bases, mergers and takeovers, transportation procedures, marketing, etc., besides the savings on hedging costs. These will also improve their global competitiveness.

11.9.1 Euro vs Dollar

It is felt that dominance of US dollar in the Global economy will gradually decline in several spheres. Before the launch of the Euro, about 60 per cent of the foreign exchange reserves held by Central banks and Governments was in US dollars, whereas the corresponding share of the European currency was about 20 per cent (mostly D Mark). The share of the euro would rise in future and that of dollar will fall. The EMU and Euroland would expand in size with more countries joining both. The Euro will also be accepted as a currency of peg by several nations. The dominance of dollar will also decline in the securities with the increasing presence of the Euro.

11.9.2 Implications of Euro for India

The Euro has important implications for India. Euroland accounts for large share of India's foreign trade. Further, the EU is an important source of aid and foreign investment. Indian companies have significant investment interests in Europe and they also tap the European capital market.

Indian businessmen benefit, like their counterparts in the other countries, from a single currency instead of many. Further it is observed that dollar in gradually going down as compared to Indian Rupees, whereas the EURO is strengthening or kept within a range. This helps that export transactions are to be denominated in Euro rather than US dollar.

11.10 LET US SUM UP

Exposure is a measure of the sensitivity of the firm's performance. However, measured to fluctuation in the relevant risk factor while risk is a measure of the extent of variability of the performance measure attributable to the risk factor. Currency Exposure can be divided into short term and long term. Short term can be divided into translation/Accounting and Cash Flow exposure. Cash Flow exposure can be Contractual (Transaction based) and anticipated. Long-term exposure can be Operating and Strategic.

An importer or exporter faces exposure and risk because of delay between agreeing on a foreign –currency price and settling the transaction.

The expected cost of hedging is the difference between the forward exchange rate and the expected future spot rate. The decision to use forward hedging does not depend on their bearing a forward risk premium. However, if the bid – ask spread on forward transactions exceeds that of spot transactions, there is an expected cost of forward hedging.

Futures – Market hedging achieves essentially the same result as forward hedging. However, with futures the foreign exchange is bought or sold at the spot rate at maturity, and the balance of receipts from selling a foreign currency or the cost of buying a foreign currency is reflected in the margin account. Because interest rates vary, the exact receipt of payment with futures is uncertain.

Foreign currency accounts payable can be hedged by buying a call option on the foreign currency, and accounts receivable can be hedged by buying a put option on the foreign currency. Options set a limit on the worst that can happen from unfavourable exchange rate movements without preventing enjoyment of gains from favourable exchange rate movements. An importer can hedge with a swap by borrowing in the home currency, buying the foreign currency spot and investing in the foreign currency. Exporters can hedge with a swap by borrowing in the foreign currency, buying in the home currency spot and investing in the home country. Foreign exchange exposure can be eliminated by invoicing in domestic currency. Exposure can be reduced by invoicing in a mixture of currencies or by buying inputs in the currency of exports.

Several theories of exchange rates have been advanced which have been advanced which are based on the stocks of countries' monies the demand to hold these monies. The monetary approach to exchange rates is based on links between money supplies and price levels and between price levels and exchange rates. The monetary approach predicts that an exchange rate will depreciate by the excess of money growth in one country over another. The asset approach to exchange rate suggests that the current exchange rate depends on the expected future exchange rate. Since the expected future rate can depend on expected inflation or anything appearing in the balance-of-payments account, the asset approach is consistent with other theories of exchange rates.

The portfolio-balance approach assumes different countries' bonds are not perfect substitutes. As a result, changes in preferences for bonds of one country over another, or changes in bond supplies, can affect exchange rates.

The principle of Purchasing-power Parity (PPP) is the extension of the law of one price to prices of a basket of goods. In its absolute form, PPP says that the dollar price of a basket of goods in the United States is the pound price of the basket in Britain, multiplied by the exchange rate of dollars per pound. In its relative form, PPP says that the rate of change of the exchange rate is approximately equal to the difference between inflation rates. An investor should be indifferent with respect to investing in domestic or foreign currency when the domestic-currency interest rate equals the foreign-currency rate plus the annualised forward exchange premium or discount on the foreign currency. The investor should invest in domestic currency when the domestic currency interest rate exceeds the foreign currency interest rate plus the forward foreign exchange premium or discount.

The objectives of the Foreign Exchange Management Act (FEMA) 1999 are to facilitate external trade and payments and to promote the orderly development and maintenance of foreign exchange market.

11.11 LESSON END ACTIVITY

An Indian firm has a 90 day receivable of Euro 1000,000. The spot and forward rates are as follows:

USD/INR spot 48.95/49.00	90 Days swap	10/12
EUR/USD spot 0.9050/55	90 Days swap	15/10

The firm thinks that the USD is undervalued against the EUR in the forward market.

(a) What will be its cash flow if its sells EUR forward against INR? The EUR / INR core rate would be calculated from the rates given above.

(b) Can it use third currency forward? How much will be the cash flow, if at settlement, the rates are EUR/USD 0.8750/55 and EUR /INR 45.00/55?

11.12 KEYWORDS

Foreign exchange exposure: The risk that future changes in a country's exchange rate will hurt the firm.

Foreign exchange risk: The risk that changes in exchange rates will hurt the profitability of a business deal.

11.13 QUESTIONS FOR DISCUSSION

1. How would you define economic exposure to exchange risk?
2. Suppose that your company has an equity position in a French firm. Discuss the conditions under which Rs./franc exchange rate uncertainty does not constitute exchange exposure for your company.
3. Explain the competitive and conversion effects of exchange rate changes in the firm's operating cash flow.
4. Discuss the advantages and disadvantages of maintaining multiple manufacturing sites as a hedge against exchange rate exposure.
5. General Motors export cars to Spain. But the strong dollar against the peseta hurts rates of G M cars in Spain. In the Spanish market, GM faces competition from Italian and French car makers such as Fiat and Renault, whose currencies remain stable relative to be peseta. What kind of measures would you recommend so that GM can maintain the market share in Spain.
6. Exchange rate uncertainty may not necessarily mean that firms face exchange risk exposures. Explain why this may be the case.

7. An industrial unit in Chennai exports washing machines to Dubai at a price of $150 per unit. The company executed an order for the supply of 1200 units in December 2005. The company uses Japanese motors for washing machines and the cost of each motor is $ 50. Its other variable costs per unit are Rs. 4200/-. The allowances fixed cost of the company is Rs.1222,222. The spot rate of dollar in December 2005 is Rs. 48/-. If rupee appreciates to Rs. 47/$, you are required to find out by how many units should the company increase its sales, so as to maintain the correct profit.

8. A UK MNC has a surplus of $ 1 million and repayment of US dollar 1.44 million both for 3 months.

The spot $ / L	1.4400/20
3 months forward	0.0070 /0.0060

9. It can borrow the dollar at a rate of 4% pa and convert pounds at 3% p.a. You are required to determine the net cost of borrowing in dollars, by evaluating the following two alternatives:
   (a) Borrow dollar and convert pound
   (b) Swap pounds into dollar for 3 months

10. An Indian company has an outward order for supplying brakes at the rate of $100 per piece. The exporter will have to import parts worth $ 50 per piece. In addition, variable cost of Rs. 200 will be incurred per piece. Explain the impact of the following if the exchange rate which is currently Rs. 36/$ moves to Rs. 40 /$.
    (a) Transaction exposure
    (b) Economic exposure if invoicing is done in rupees, price elasticity of demand is 1.5 and the current order quantity is 1000 units

Check Your Progress: Model Answer

1. (a)
2. (d)

11.14 SUGGESTED READINGS

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LESSON

12

STRATEGIC CHOICES IN INTERNATIONAL BUSINESS

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12.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- Strategic choices available to international firms
- Role of strategy in global expansion of businesses
- Implications of culture on international business

12.1 INTRODUCTION TO STRATEGY CHOICES

We have described in earlier lesson that the environment in which international business competes include the different political, economic and cultural institutions found in nations. Our focus now shifts from the environment to the firm itself and in particular to the actions managers take to compete more effectively as an international business. We discuss how firms can increase their profitability by expanding their operations in foreign markets. We discuss different strategies that firms pursue when competing internationally, pros and cons of these strategies, the various factors that affect firms choice of strategy and what practice firms adopt across various national markets.

12.2 STRATEGY AND THE FIRM

A firm's strategy can be defined as the actions that managers take to adopt the goals of the firm for most firms the goal is to maximize long term profitability. A firm makes a profit if the price it can charge for its output is greater that the cost of producing that output, profit (II) is defined as the difference between total revenue (TR) and total cost (TC) or

$$II = TR - TC$$

Total Revenue (TR) are equal to price (P) times the number of units sold by the firm (Q)

Or $TR = P * Q$

Total cost (TC) are equal to cost per unit (C) times the number of units sold or

$$LTC = C*Q$$

Total profit (II) is equal to profit per unit (II) times the number of units sold or

$$II = II * Q$$

Profitability is a ratio or a rate of return concept. A simple example would be rate of return on sales (ROS) which is defined as profit (II) over Total Revenue (TR) or

$$ROS = II / TR$$

Thus a firm might operate with a goal of maximizing its profitability as defined by its return on sales (ROS) and its strategy would be the actions that its managers take to attain this goal. A more common goal is to maximize the firms return on investment (ROI) which is defined as ROI = II / I where I represents the total capital invested in the firm.

12.3 VALUE CREATION

Two basic conditions determine firms profit (II):

1. The value customers place on the firms goods or services and
2. The firms cost of production

In general the more value customers place on a firms products, the higher price the firm can charge for those products. However the price a firm charges for goods and services is typically less than the value placed by the customer on those goods and services. This is because the customer captures some of the value in the form of what economists call 'consumer's surplus'. The customer is able to do so because the firm is competing with other firms for the customer's business so the firm must charge a lower price than it could if it was a monopoly supplier. Also, it is normally impossible to segment the market to such a degree that the firm can charge each customer a price that reflects individual's assessment of the value of a product which economist's refer as 'customer's reservation price'.

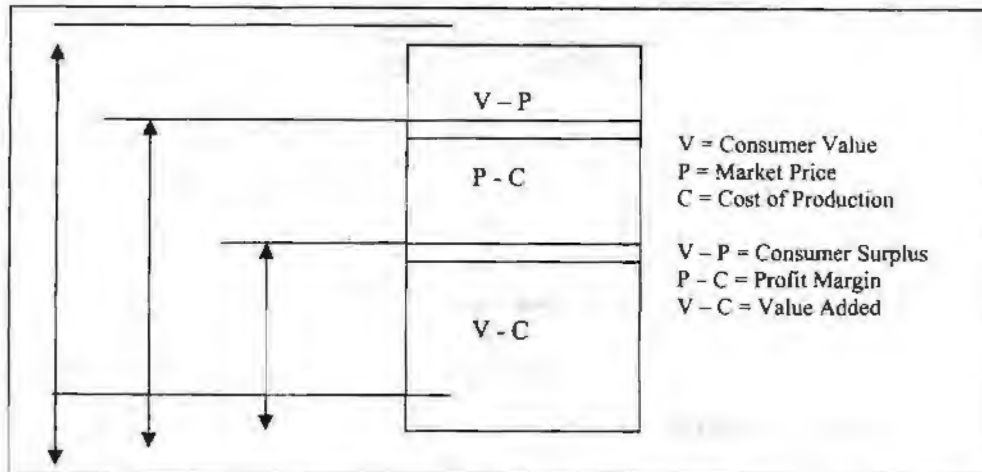

Figure 12.1: Illustrates these Concepts

The value of product to a consumer is (V), the price that the firm can charge for that product given competitive pressures and its ability to segment the market is (P) and the cost of producing the product are (C).

The firms profit per unit sold (II) is P – C while the consumer's surplus is V – P. The firms make a profit so long as P>C and its profit will be greater the lower C is related to P.

The difference between V and P is determined by the intensity of competitive pressure in the market place. The lower the intensity of pressure the higher the price that can be charged relative to V.

The value created by a firm is measured by the difference between V and C (V-C); the company creates value by converting inputs that cost (C) into a product on which consumer's place a value of V. A company can create more value for its customers either by lowering production cost (C) or making the product more attractive through superior design, functionality, quality and the like so that consumer's place a greater value on it and consequently are willing to pay a high price. This discussion suggests that a firm has high profits when it creates more value for its customers and does so at lower costs. Strategy can be referred to as that which focuses on lowering production costs as a low cost strategy. Similarly, strategy that focuses on increasing the attractiveness of the product can be called as a differential strategy. Michael Porter has argued that low cost and differential are two basic strategies for creating value and attaining a competitive advantage in an industry. According to Porter superior profitability is earned by those firms that can create superior value and the way to create superior value is to drive down the cost structure of the business and/or differentiate the product in some way so that consumers value it more and are prepared to pay a premium price. Superior value creation as compared to rivals does not necessarily require a firm to have a lowest cost structure in an industry or to create the most valuable product in the eyes of the consumers.

12.4 FIRM AS A VALUE CHAIN

Firm can be treated as a value chain composed of series of value creation activities including production, marketing, sales, materials management, R&D, human resources, information systems and the firms infrastructure. We can categorize their value creation activities as primary and support activities (see Figure 12.2).

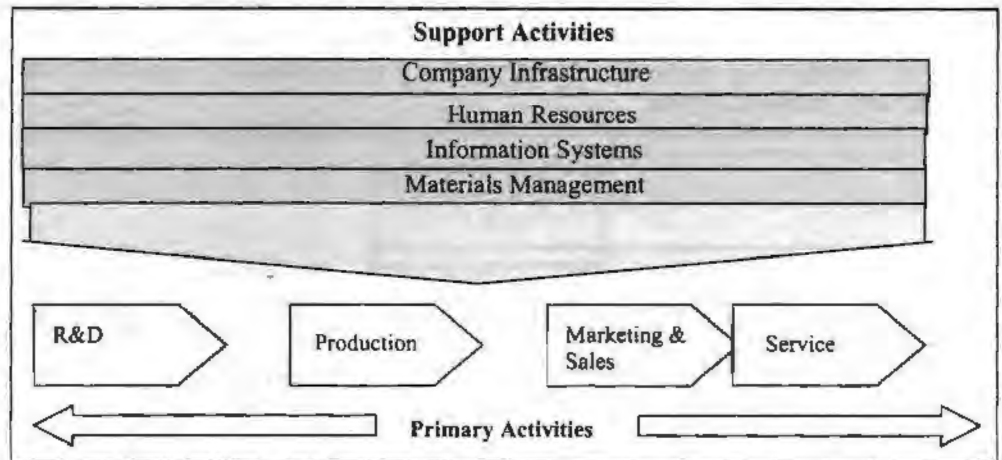

Figure 12.2

12.4.1 Primary Activities

Primary activities have to do with the design, creation and delivery of the product; its marketing; its support and after sales service. In the value chain illustrated in Figure 12.2 the primary activities are broken into 4 functions; R&D, production, marketing and sales and service.

Research & Development (R&D) is concerned with the design of products and production process. Although we think of R&D as being associated with the design of physical products and production process in manufacturing enterprises, many service companies also undertake R&D. For example, banks compete with each other by developing new financial products and the new ways of delivering those products to customers. Online banking and smart debit cards are two recent examples of new product development in the banking industry.

Through superior product designs, R&D can increase the functionality of products which makes them more attractive to consumers (raising V). Alternatively R&D may result in more efficient production process thereby lowering production costs (lowering C). Either way the R&D function and create value.

Production is concerned with the creation of good or service. For physical products production generally mean manufacturing. For services such as banking or retail operations production occurs when the service is delivered to the customer (for example, when a bank originates a loan for a customer it is engaged in the production of the loan). The production activity of a firm creates value by performing its activities efficiently with lower costs (lower C) or by performing them into a more reliable and higher quality product (which results in higher V).

The marketing and sales function of a firm can create value in several ways. Through brand positioning and advertising the marketing function can increase the value (V) that consumers perceive in a firms product. If these create a favourable impression of the firms product in the minds of consumers they increase the price that can be charged for the firms product. For e.g. In the 1980s the French Company Perrier did a wonderful job of US consumers that slightly carbonated bottled water was worth US $ 1.50 per bottle rather than price closer to US $ 0.50 that it cost to physically collect, bottle and distribute the water. Perrier's marketing function increased the

perception of value (V) that consumer's ascribed to the product. Marketing and sales can also create value by discovering consumer needs and communicating back to the R&D function of the Company which can design products to match those needs.

The role of service activity is to provide after – sales services and support. This can create a perception of superior value (V) in the minds of consumers by solving customer problems and supporting customers after they have purchased the product. This is an extremely valuable capability in an industry where down time is very expensive. For example Caterpillar the US based manufacturer of heavy earth moving equipment can get spare parts to any point in the world within 24 hours thereby minimizing the amount of downtime its customer's have to suffer if their Caterpillar equipment malfunctions.

12.4.2 Support Activities

The support activities of the value chain provides inputs that allow the primary activities to take place (see Figure 12.2). The materials management (or logistics) function controls the transmission of physical materials through the value chain, from procurement through production and into distribution. The efficiency with which this is carried out can significantly lower cost (lower C), thereby creating more value.

Similarly, the human resources function can help create more value in a number of ways. It ensures that the company has the right mix of skilled people to perform its value creation activities effectively. The Human resources function also ensures that people are adequately trained, motivated, and compensated to perform their value creation tasks.

Information systems refer to the normally electronic systems for managing inventory, tracking sales, pricing products, dealing with customer service inquiries, and so on. Information systems, when coupled with the communications features of the Internet, can alter the efficiency and effectiveness with which a firm manages its other value creation activities.

The final support activity is the company infrastructure. By infrastructure we mean the context within which all the other value creation activities occur. The infrastructure includes the organizational structure, control systems, and culture of the firm. Because top management can exert considerable influence in shaping these aspects of a firm, top management can exert shape the infrastructure of a firm and through that the performance of all other value creation activities within it.

12.5 ROLE OF STRATEGY

To be profitable in international markets, a firm must both reduce the costs of value creation (lower C) and differentiate its product offering so that consumers value that product more (raise V) and are willing to pay more for the product than it costs to produce. Thus strategy is often concerned with identifying and taking actions that will lower the costs of value creation and/or will differentiate the firm's product offering through superior design, quality, service, functionality and so on.

12.6 PROFITING FROM GLOBAL EXPANSION

Expanding globally allows firms to increase their profitability in ways not available to purely domestic companies. Firms that operate internationally are able to:

1. Realize location economies by dispersing individual value creation activities to those locations around the globe where they can be performed most efficiently and effectively.

2. Realize greater cost economies from experience effects by serving an expanded global market from the central location, thereby reducing the costs of value creation.

3. Earn a grater return from the firm's distinctive skills or core competencies by leveraging those skills and apply them to new geographic markets.
4. Earn a grater return by leveraging any valuable skills developed in foreign operations and transferring them to other entities within the firm's global network of operations.

However, a firm's ability to increase its profitability by pursuing these strategies is to some extent constrained by the need to customize its product offering, marketing strategy, and business strategy to differing national conditions; that it, by the imperatives of localization.

12.7 LOCATION ECONOMIES

We have seen that countries differ along a range of dimensions, including the economic, political, legal, and cultural, and that these differences can either raise or lower the costs of doing business in a country. The theory of international trade also teaches us that due to differences in factor costs, certain countries have a comparative advantage in the production of certain products. Japan might excel in the production of automobiles and consumer electronics; the United States in the production of computer software, pharmaceuticals, biotechnology products, and financial services; Switzerland in the production of precision instruments and pharmaceuticals; and South Korea in the production of steel.

For a firm that is trying to survive in a competitive Global market, it means that, trade barriers and transportation costs permitting, the firm will benefit by basing each value creation activity it performs at that location where economic, political, and cultural conditions, including relative factor costs, are most conducive to the performance of that activity.

Firms that pursue such a strategy can realize what we refer to as location economies, the economies that arise from performing a value creation activity in the optimal location for that activity, wherever in the world that might be transportation costs and trade barriers permitting. Locating a value creation in the optimal location for that activity can have one of the two effects. It can lower the costs of value creation and help the firm to achieve a low cost position, and/or it can enable a firm to differentiate its product offering from the offerings of competitors. In terms of Figure 12.1, it can lower C or increase V, which in general supports higher pricing (P).

12.7.1 Creating a Global Web

One can think of a creation of a global web of value creation activities, with different stages of the value chain being dispersed to those location around the globe where perceived value is maximized or where the costs of value creation are minimized. Consider the case of General Motors'. Marketed primarily in the United States, the car was designed in Germany; key components were manufactured in Japan, Taiwan and Singapore; assembly was performed in South Korea; and the advertising strategy was formulated in Great Britain. The car was designed in Germany because GM believed the designers in its German subsidiary had the skills most suited to the job at hand. (They were most capable of producing a design that added value). Components were manufactured in Japan, Taiwan and Singapore because of favourable factor conditions – relatively low cost, skilled labour – suggested that those locations had a comparative advantage in the production of components (which helped the costs of value creation). The car was assembled in South Korea because GM believed that due to its low labour costs, the costs of assembly could be minimized there (also helping to minimize the costs of value creation). Finally the advertising strategy was formulated in Great Britain because GM believed a particular advertising strategy there was able to produce an advertising campaign that would help sell the car. (This decision was consistent with GM's desire to maximize the value added).

In theory, a firm that realizes location economies by dispersing each of its value creation activities to its optimal location should have a competitive advantage vis-à-vis a firm that bases all of its value creation activities at a single location. It should be able to better differentiate its product offering (thereby raising perceived value, V) and lower its cost structure (C) than its single location competitor. In a world where competitive pressures are increasing, such a strategy may become an imperative for survival.

If transportation costs and trade barriers are introduced, the situation is somewhat complicated. Due to favourable factor endowments, New Zealand may have a comparative advantage for automobile assembly operations, but high transportation costs would make it an uneconomical location from which to serve global markets.

Check Your Progress

Fill in the blanks:

Due to favourable ...., New Zealand may have a .... for automobile assembly operations, but high .... would make it an uneconomical location from which to serve ....

12.8 EXPERIENCE EFFECTS

The experience curve refers to systematic reductions in production costs which occur over the life of a product. A number of studies have observed that a product's production costs decline by some characteristic about each time accumulated output doubles.

12.9 LEARNING EFFECTS

Learning effects refer to cost savings that occur from learning by doing. Labourer, for example, learns by repetition how to carry out a task such as assembling airframes. Labour productivity increases over time as individual learn the most efficient ways to perform particular tasks. In new production facilities, management typically learns how to manage the new operation more efficiently over time. Hence, production costs eventually decline due to increasing labour productivity and management efficiency.

Learning effects tend to be more significant when a typically complex task is repeated, since there is more that can be learned about the task. Thus, learning effects will be more significant in an assembly process involving 1000 complex steps than in one of only 100 simple steps.

12.10 ECONOMIES OF SCALE

Economies of scale refer to the reduction in unit cost achieved by producing a large volume of a product. Economies of scale have a number of sources. For example, the ability to spread fixed costs over a large volume. Fixed costs are the inputs required to set up a production facility and develop a new product.

Another source of scale economies arises from the ability of large firms to employ increasingly specialized equipment or personnel.

12.11 STRATEGIC SIGNIFICANCE

The strategic significance of the experience curve is clear. Moving down the experience curve allows a firm to reduce its cost of creating value. The firm that moves down the experience curve most rapidly will have a cost advantage vis-à-vis its competitors.

Many of the underlying sources of experience-based cost economies are plant based. Because global markets are larger than domestic markets, a firm that serves a global

market from a single location is likely to build accumulated volume more quickly than a firm that serves only its home market or that serves multiple markets from multiple locations. Thus, serving a global market from a single location is consistent with moving down the experience curve and establishing a low cost position (i.e. lowering the costs of value creation, C).

12.12 LEVERAGING CORE COMPETENCIES

The term core competence refers to skills within the firm that competitors cannot easily match or imitate. These skills may exist in any of the firm's value creation activities – production, marketing, R&D, human resources and general management. Such skills are typically expressed in product offerings that other firms find difficult to match or imitate, and thus the core competencies are the bedrock of a firm's competitive advantage. They enable a firm to reduce the costs of value creation(C) and/or create perceived value (V) in such a way that premium pricing is possible. For example, Toyota has a core competence in the production of cars. It is also able to produce high quality, well designed cars at a lower delivered cost than any other firm in the world.

The potential for creating value from such strategy is greatest when the skills and products of the firm are most unique, when the value placed on them by consumers is great, and when there are very few capable competitors with similar skills and/or products in foreign markets. Firms with unique and valuable skills can often realize enormous returns by applying those skills, and the products as they produce, to foreign markets where indigenous competitors lack similar skills and products.

12.13 LEVERAGING SUBSIDIARY SKILLS

In the discussion of core competencies it is implicit that skills are developed first at home and then transferred to foreign operations. However for mature multinationals that have already established a net-work of subsidiary operations in foreign markets, the development of valuable skills can just as occur in foreign subsidiaries. Skills can be created anywhere within a multinational's global network of operations, wherever people have the opportunity and incentive to try new ways of doing things. The creation of skills that help to lower the costs of production, or to enhance perceived value and support higher product pricing, are not the monopoly of the corporate centre. For example, McDonald's increasingly is finding that its foreign franchisees are a source of valuable new ideas.

12.14 PRESSURES FOR COST REDUCTIONS AND LOCAL RESPONSIVENESS

Firms that compete in the global marketplace typically face two types of competitive pressure. They face pressures for cost reductions and pressures to be locally responsive. These competitive pressures place conflicting demands on a firm. Responding to pressures for cost reductions requires that a firm try to minimize its unit costs. Offering a standardized product enables the firm to attain other scale operations and ride down the experience curve as quickly as possible. In contrast, responding to pressures to be locally responsive requires that a firm differentiate its product offering and marketing strategy from country to country in an attempt to accommodate the diverse demands that arise from national differences in consumer tastes and preferences, business practices, distribution channels, competitive, and government policies. Because customize product offerings to different national requirements can involve significant duplication and a lack of product standardization, the result may be to raise costs.

12.14.1 Pressures for Cost Reductions

Pressure for cost reduction requires a firm to try to lower the costs of value creation by mass producing a standardized product at the optimal location in the world, wherever that might be, in order to realize location and experience curve economies. Cost reduction pressures can be intense in industries producing commodity-type products where meaningful differentiation on non-price factors is difficult and price is the main competitive weapon. This is the case for conventional commodity products such as bulk-chemicals, petroleum, steel, sugar and the like. It also tends to be the case for many industrial and consumer products; for example, handheld calculators, semiconductor chips, personal computers and liquid crystal display screens. Pressures for cost reductions are also intense in industries where major competitors are based in low-cost locations, where there is persistent excess capacity, and where consumers are powerful and face low stitching costs.

12.14.2 Pressures for Local Responsiveness

Pressures for local responsiveness arise from a number of sources including. (i) differences in consumer tastes and preferences, (ii) differences in infrastructure and traditional practices, (iii) differences in distribution channels, and (iv) host government demands.

1. ***Differences in consumer tastes and preferences:*** Strong pressures for local responsiveness emerge when consumer tastes and preferences differ significantly between countries, as they may for historic or cultural reasons. In such cases, product and/or marketing messages have to be customized to appeal to the tastes and preferences of local consumers. This typically creates pressure to delegate production and marketing functions to national subsidiaries.
2. ***Differences in infrastructure and traditional practices:*** Pressures for local responsiveness emerge when there are differences in infrastructure and/or traditional practices between countries. In such circumstances, the product may need to be customized to the distinctive infrastructure and practices of different nations. This may necessitate the delegation of manufacturing and production function to foreign subsidiaries. For example, in North America, consumer electrical systems are based on 110 volts, while in some European countries 240-volt systems are standard Thus, domestic electrical appliances have to be customized for this difference in infrastructure.
3. ***Differences in distribution channels:*** A firm's marketing strategies may have to be responsive to difference in distribution channels between countries. This may necessitate the delegation of marketing functions to national subsidiaries. In Germany, for example, a handful of food retailers dominate the market, but the market is very fragmented in neighboring Italy.
4. ***Host government demands:*** Economic and political demands imposed by host-country governments may necessitate a degree of local responsiveness. For example, the politics of health care around the world requires that pharmaceutical firms manufacture in multiple locations. Pharmaceutical firms are subject to local clinical testing, registration procedures, and pricing restrictions, all of which require that the manufacturing and marketing of a drug should meet local requirements. Because governments and government agencies control a significant proportion of health care budget in most countries, they can demand a high level of local responsiveness.

Implications

Pressures for local responsiveness imply that it may not be possible for a firm to realize the full benefits from experience curve and location economies. The need to customize the product offering to local conditions may work against implementation of such a strategy. For example automakers have found that Japanese, American and

European consumers demand different kinds of cars, and that this necessitates producing products that are customized for local markets. In response, Honda, Ford, and Toyota are establishing top-to-bottom design and production facilities in each of these regions to better serve local demands.

In addition, pressure for local responsiveness imply that it may not be possible to leverage the skills and products associated with a firm's core competencies wholesale from one nation to another.

12.15 STRATEGIC CHOICES

Firms use four basic strategies to enter and compete in the international environment: an international strategy, a multi-domestic strategy, a global strategy, and a transnational strategy. Each of these strategies has its advantages and disadvantages. The appropriateness of each strategy varies with the extent of pressures for cost reduction and local responsiveness.

International Strategy

Firms that pursue an international strategy try to create value by transferring valuable skills and products to foreign markets where indigenous competitors lack those skills and products. Most international skills hence created value by transferring differential product offerings developed at home to new markets overseas Accordingly, they tend to centralize product development functions at home (e.g. R&D). However they tend to establish manufacturing and marketing functions in each major country in which they do business. But while they may undertake some local customization of product offering and marketing strategy, this tends to be limited. In most international firms, the head office retains tight control over marketing and product strategy.

An international strategy makes sense if a firm has a valuable core competence that indigenous competitors in foreign markets lack and if the firm faces relatively weak pressures for local responsiveness and cost reductions (as is the case for Microsoft).

Multi-domestic Strategy

Firms pursuing a multi-domestic strategy orient themselves toward achieving maximum local responsiveness. The key distinguishing feature of multi-domestic firms is that they extensively customize both their product offering and their marketing strategy to match different national conditions. Consistent with this, they also tend to establish a complete set of value creation activities, including production, marketing and R&D, in each major national market in which they do business.

A multi-domestic strategy makes some sense when there are high pressures for local responsiveness and low pressure for cost reductions.

Global Strategy

Firms that pursue a global strategy focus on increasing profitability by reaping the cost reductions that come from experience curve effects and location economies. That is, they are pursuing a low cost strategy. The production, marketing, and R&D activities of firms pursuing a global strategy are concentrated in a few favourable locations. Global firms tend not to customize their product offering and marketing strategy to local conditions because customization raises costs (it involves shorter production and the duplications of functions). Instead, global firms prefer to market a standardized product worldwide so they can reap the maximum benefits from the economies of scale that underlie the experience curve. They may also use their cost advantage to support aggressive pricing in world markets.

This strategy makes most sense where there are strong pressures for cost reductions and where demands for local responsiveness are minimal e.g. semi-conductor industry.

Transnational Strategy

Christopher Bartlett and Sumantra Ghoshal have argued that in today's economic environment, competitive conditions are so intense that to survive in the global marketplace, firms must exploit experience-based cost economies and local economies, they must transfer core competence within the firm, and they must do all of this while paying attention to pressures for local responsiveness. Bartlett and Ghoshal maintain that the flow of skills and product offerings should not be all one way, from home firm to foreign subsidiary, as in the case of firms pursuing an international strategy. Rather, the flow should also be from foreign subsidiary to home country, and from foreign subsidiary-a process they refer to as global learning.

A transnational strategy makes sense when a firm faces high pressures for cost reductions, high pressures for local responsiveness, and where there are significant opportunities for leveraging valuable skills within a multinational's global network of operations. In some ways, firms that pursue a transnational strategy are trying to simultaneously achieve cost and differential advantages. In terms of framework they are trying to simultaneously lower C and increase V.

The advantages and disadvantages of each of the four strategies are given below:

Table 12.1: Advantages and Disadvantages of each of the Four Strategies

Strategy	Advantages	Disadvantages
Global	Exploit experience curve effects Exploit location economies	Lack of local responsiveness
International	Transfer core competencies to foreign markets	Lack of local responsiveness. Inability to realize location economies Failure to exploit experience curve effects
Multi-domestic	Customize product offerings and marketing in accordance with local responsiveness	Inability to realize location economies Failure to exploit experience curve effects Failure to transfer core competencies to foreign markets
Transnational	Exploit experience curve effects Exploit location economies Customize product offerings and marketing in accordance with local responsiveness Reap benefits of global learning	Difficult to implement due to organizational problems

12.16 CULTURE AND THE WORKPLACE

For an international business with operations in different countries, of considerable importance is how a society's culture affects the values found in the workplace. Management process and practices may need to vary according to culturally determined work-related values. For example, if the cultures of the United States and France result in different work-related values, an international business with operations in both countries should vary its management process and practices to take these differences into account.

Probably the most famous study of how culture relates to values in the workplace was undertaken by Geert Hofstede. As part of his job as a psychologist working for IBM, Hofstede collected data on employee attitudes and values for more than 100,000 individuals from 1967 to 1973. This data enabled him to compare dimensions of culture across 40 countries. Hofstede identified four dimensions that summarized different cultures-power distance, uncertainty avoidance, individualism versus collectivism, and masculinity versus femininity.

Hofstede's power distance dimension focused on how a society deals with the fact that people are unequal in physical and intellectual capabilities. According to Hofstede,

high power distance cultures were found in countries that let inequalities of power and wealth. Low power distance cultures were found in societies that tried to play down such equalities as much as possible.

The individualism versus collectivism dimension focused on the relationship between the individual and his or her fellow. In individual societies, the ties between individuals were loose and individual achievement and freedom was highly valued. In societies where collectivism was emphasized, the ties between individuals were tight. In such societies, people were born into collectives, such as extended families, and everyone was supposed to look after the interest of his or her collective.

Hofstede's uncertainty avoidance dimension measured the extent to which different cultures socialized their members into accepting ambiguous situations and tolerating uncertainty. Members of high uncertainty avoidance cultures placed a premium on need for rules and regulations; the manager was expected to issue clear instructions, and subordinates' initiatives were tightly controlled. Lower uncertainty avoidance cultures were characterized by a greater readiness to take risks and less emotional resistance to change.

Hofstede's maseulinity versus femininity dimension looked at the relationship between gender and work roles. In masculine cultures, sex roles were sharply differentiated and traditional "masculine values" such as achievements and the effective exercise of power, determined cultural ideas. In feminine cultures, sex roles were less sharply distinguished, and little differentiation was made between men and women in the same job.

Hofstede created an index score for each of these four dimensions that ranged from 0 to 100 and scored high for high individualism, high power-distance, high uncertainty avoidance and high masculinity. He averaged the sore for all employees from a given country. Table 12.2 summarises this data for 20 selected countries.

Table 12.2

	Power Distance	Uncertainty Avoidance	Individualism	Masculinity
Argentina	49	86	46	56
Australia	36	51	90	61
Brazil	69	76	38	49
Canada	39	48	80	52
Denmark	18	23	74	16
France	68	86	71	43
Germany (F.R.)	35	65	67	66
Great Britain	35	35	89	66
Indonesia	78	48	14	46
India	77	40	48	56
Israel	13	81	54	47
Japan	54	92	46	95
Mexico	81	82	30	69
Netherlands	38	53	80	14
Panama	95	86	11	44
Spain	57	86	51	42
Sweden	31	29	71	5
Thailand	64	64	20	34
Turkey	66	85	37	45
United States	40	46	91	62

Western nations such as the United States, Canada and Britain score high on individualism scale and low on the power distance scale. At the other extreme are a group of Latin American and Asian countries that emphasize collectivism over individualism and score high on the power distance scale. The above Table also reveals that Japan's culture has strong uncertainty avoidance and high masculinity. This characterization fits the standard stereotype of Japan as a country that is male dominant and where uncertainty dominant and where uncertainty avoidance exhibits itself in the institution of lifetime employment.

Hofstede's results are interesting for what they tell us in a general way about differences between cultures. Many of the Hofstede's findings are consistent with standard Western stereotypes about cultural differences.

Hofstede's results has been criticized on a number of points. First, Hofstede assumes there is one-to-one correspondence between culture and the nation-state, but many countries have more than one culture. Second, the research may have been culturally bound. The research team was composed of Europeans and Americans, hence Hofstede's results confirm Western stereotypes.

Third, Hofstede's information worked only within a single industry and also within one company. At that time IBM was renowned for its own strong corporate culture and employee selection procedures, making it possible that the employees' values were different in important respects from the values of the cultures from which those employees came. Also, certain social classes such as unskilled manual workers were excluded from Hofstede's sample. A final caution is that cultures do not stand still, they evolve, albeit slowly. What was a reasonable characterization in the 1960s and 1970s may not be so today.

12.17 CULTURAL CHANGE

Culture is not a constant; it evolves over time. Change in value systems can be slow and painful for a society. In the 1960s, for example, American values toward the role of women, love, sex and marriage underwent significant changes. Change, however, does occur and can often be quite profound. For example, at the beginning of the 1960s, the idea that women might hold senior management positions in major corporations was not widely accepted. Today, it is reality and few in the mainstream of American society question the development or the capability of women in the business world. Similarly, the value systems of many ex-Communist states, such as Russia, are undergoing significant changes as those countries move away from values that emphasize collectivism and toward those that emphasize individualism.

The culture of societies may also change as they become richer because economic progress affects a number of other factors, which in-turn impact on culture. For example, increased urbanization and improvements in the quality and availability of education are both a function of economic progress, and both can lead to declining emphasis on the traditional values associated with poor rural societies.

12.18 CULTURE IMPLICATIONS FOR BUSINESS

International business is different from national business because countries and societies are different. Societies differ because their cultures vary. Three important implications for international business flow from these differences. The first is the need to develop cross-cultural literacy. A second implication looks at the connection between culture and ethics in decision making. A third implication for international business centres on the connection between culture and national competitive advantage.

Cross-cultural Literacy

To combat the danger of being ill-informed, international business should consider enjoying local citizens to help them do business in a particular culture. They must also ensure that home-country executives are cosmopolitan enough to understand how differences in culture affect the practice of international business. Transferring executives overseas at regular intervals to expose them to different cultures will help build a cadre of cosmopolitan executives. An international business must also be constantly on guard against the dangers of ethnocentric behaviour. Ethnocentrism is a belief in the superiority of one's own ethnic group of culture. Hand in hand with ethnocentrism goes a disregard or contempt for the culture of other countries. Unfortunately, ethnocentrism is all too prevalent; many Americans are guilty of it, as are many French people, Japanese people, British people, and so on. Ugly as it is, ethnocentrism is a fact of life, one that international businesses must be on continual guard against.

Culture and Business Ethics

A certain level of faith that agreements will be honoured-, that parties to a transaction will do the ethical thing-is required to encourage economic activity no matter what the culture. In the West, the legal system and particularly our systems of contract law, evolved to help assure people that agreements will be honoured but it is important to recognize that the legal system is designed to deal only with the exceptions to the general rule (which is embedded in our culture) that one should honour agreements. In nations that lack a similar legal tradition, other institutions have emerged to help assure people that the business agreements will be honoured.

Although many ethical principles are universal, some are culturally bound. When this is the case, international businesses may be confronted with difficult ethical dilemmas.

One response to such a dilemma is to argue that because customs vary from country to country, businesses should adopt the customs of the country in which it is currently doing business.

Culture and Competitive Advantage

The value systems and norms of a country influence the costs of doing business in that country. The costs of doing business in a country influence the ability of firms to establish a competitive advantage in the global market place. We have seen how attitudes toward cooperation between management and labour, toward work, and toward the payment of interest are influenced by social structure and religion. It can be argued that the class-based conflict between workers and management found in British society, when it leads to industrial disruption, raises the costs of doing business in that culture.

For the international business, the connection between culture and competitive advantage is important for two reasons. First, the connection suggests which countries are likely to produce the most viable competitors.

Second, the connection between culture and competitive advantage has important implications for the choice of countries in which to locate production facilities and do business. Consider a hypothetical case when a company has to choose between two countries, A and B, for locating a production facility. Both countries are characterized by low labour costs and good access to world markets. Both countries are of roughly the same size (in terms of population) and both are at a similar stage of economic development. In country A, the education system is undeveloped, the society is characterized by a marked stratification between the upper and lower classes, the dominant religion stresses the importance of reincarnation and there are three major linguistic groups. In country B, the education system is well developed, there is a lack of social stratification, group identification is valued by the culture, the dominant

religion stresses the virtue of hard work, and there is only one linguistic group. Which country makes the best investment site?

Country B does. The culture of country B is supportive of the capitalist mode of production and social harmony, whereas the culture A is not.

12.19 LET US SUM UP

A firm's strategy can be defined as the actions that mangers take to attain the goals of the firm. For most firms, the pre-eminent goal is to maximize long-term profitability. Maximizing profitability requires firms to focus on value creation. Due to national differences, it may pay a firm to base each value creation activity it performs at that location where factor conditions are most conducive to the performance of that activity. This strategy is referred to as focusing on the attainment of local economies. By rapidly building sales value for a standardized product, international expansion can assist a firm in moving down the experience curve. International expansion may enable affirm to earn greater returns by transferring the skills and product offerings derived from its core competencies to markets where indigenous competitors lack those skills and product offerings.

A multinational firm can create additional value by identifying valuable skills created within its foreign subsidiaries and leveraging those skills within its global network of operations. The best strategy for a firm to pursue often depends on a consideration of the pressure for cost reductions and for local responsiveness.

Pressures for cost reductions are greatest in industries producing commodity-type products where price is the main competitive weapon. Pressures for local responsiveness arise from differences in consumer tastes and preferences, national infrastructure and traditional practices, distribution-channels and from host-government demands. Firms pursuing an international strategy transfer the skills and product derived from distinctive competencies to foreign markets, while undertaking some limited local customization. Firms pursuing a multi-domestic strategy customize their product offering, market strategy, and business strategy to national conditions. Firms pursuing a global strategy focus on reaping the cost reductions that come from experience curve effects and location economies.

Many industries are now so competitive that firms must adopt a transnational strategy. This involves a simultaneous focus on reducing costs, transferring skills and products, and boosting local responsiveness. Implementing such a strategy a may not be easy. Geert Hofstede studied how culture relates to values in the work place. Hofstede summarized four dimensions – power distance, uncertainty avoidance, individualism versus collectivism and masculinity versus feminity. Culture is not a constant; it evolves over time. Economic progress and globalization seem to be two important engines of cultural change.

To develop cross-cultural literacy, international businesses need to employ host-country nationals, build a cadre of cosmopolitan executives, and guard against the dangers of ethnocentric behaviour.

12.20 LESSON END ACTIVITY

From the internet scanning the company's site, find out the marketing strategy followed by Proctor &Gamble (P&G), the large US, consumer products company, has a well earned reputation as one of the world's best marketers. What comments you can offer.

12.21 KEYWORDS

First-mover advantages: Advantages accruing to the first to enter a market.

Global strategy: Strategy focusing on increasing profitability by reaping cost reductions from experience curve and location economies.

Economies of scale: Cost advantages associated with large scale production

International strategy: Trying to create value by transferring core competencies to foreign markets where indigenous competitors lack those competencies.

Multi-domestic strategy: Emphasizing the need to be responsive to the unique conditions prevailing in different national markets.

Trans-national strategy: Plan to exploit experience-based cost and local economies, transfer core competencies with the firm, and pay attention to local responsiveness.

12.22 QUESTIONS FOR DISCUSSION

1. In a world of zero transportation costs, no trade barriers and nontrivial differences between nations with regard to factor conditions, firms must expand internationally if they are to survive. Discuss.
2. Are the following global industries or multi-domestic industries: bulk chemicals, pharmaceuticals, branded food products, moviemaking, television manufacture, personal computers, airlines travel?
3. Discuss how the need for control over foreign operations varies with the strategy and core competencies of a firm? What are the implications of this for the choice of entry mode?
4. What do you see as the main problems likely to be associated with implementation of a transnational strategy?

Check Your Progress: Model Answer

Factor endowments, comparative advantage, transportation costs, global markets

12.23 SUGGESTED READINGS

Cherenilan Francis, *International Economics*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Levi Maurice D., *International Finance*, 3rd Edition, McGraw-Hill, Inc.

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LESSON

13

INTERNATIONAL MARKET ENTRY STRATEGIES

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13.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- How firms choose which foreign markets to enter and at the factors that are important in determining the best timing and scale of entry
- The choice of entry mode

13.1 INTRODUCTION TO BASIC ENTRY DECISIONS

The choice for entering foreign market is another major issue with which international business must wrestle. The various modes for serving foreign markets are exporting, licensing or franchising to host country firms, establishing joint ventures with a host country firms, setting up a new wholly owned subsidiary in host country to serve its

market, or acquiring an established enterprise in the host nation to serve the market. The optimal entry mode varies by situation depending on factors like transport costs, trade barriers, political risks, economic risks, and firm strategy.

13.2 BASIC ENTRY DECISIONS

In this lesson we discuss three basic decisions that a firm contemplate while making foreign expansion (a) which markets to enter (b) when to enter those markets, and (c) on what scale.

13.2.1 Which Foreign Markets?

There are number of nation- states in the world and all of then do not hold the same profit potential for a firm entering foreign market. The choice must be based on an assessment of a nation's long run profit potential. This potential is a function of several factors such as:

1. Detail of the economic and political factors that effect the potential attractiveness of a foreign market.
2. Balancing of benefits, costs, and risks associated with doing business in that country.

   With regard to political factors the cost of doing business in a country can be increased by a need to pay off the politically powerful to be allowed by the Government to do business. With regard to economic factors, one of the most important variables is the sophistication of a country's economy. It may be more costly to do business in relatively primitive or undeveloped economies because of the lack of infrastructure and supporting businesses. At the extreme, an international firm may have to provide its own infrastructure and supporting business, which raises costs.

   As for legal factors, it can be more costly to do business in a country where local laws and regulations set strict standards with regard to product safety, safety in the work place, environmental pollution, and the like. It can be more costly to do business in a country that lacks well-established laws for regulating business practice. Similarly, local laws that fail to adequately protect intellectual property can lead to the "theft" of an international business's intellectual property and lost income.

   As with costs, the risks of doing business in a country are determined by a number of political, economic and legal factors. Political risk has been defined as the likelihood that political forces will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a particular business enterprise. Political risks tend to be greater in countries experiencing social unrest and disorder or in countries where the underlying nature of the society increases the likelihood of social unrest. Social unrest typically finds expression in strikes, demonstrations, terrorism and violent conflict.

   Economic risks can be defined as the likelihood that economic mismanagement will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a particular business enterprise. One visible indicator of economic mismanagement may be the country's inflation rate, another may be the level of business and government debt in the country. Economic risks are not independent of political risk. Economic mismanagement may give rise to social unrest and hence political risk.

   The legal risks may be defined as the likelihood that a trading partner will opportunistically break a contract or expropriate property rights. When legal risks in a country are high, an international business might hesitate entering into a long-term contract or joint-venture agreement with a firm in that country.

The overall attractiveness of a country as a potential market and/or investment site for an international business depends on balancing the benefits, costs and risks associated with doing business in that country. Generally the costs and risks associated with doing business in foreign country are typically lower in economically advanced and politically stable democratic nations and greater in less developed and politically unstable nations.

3. Study of factors such as the size of the market (in terms of demographics), the present wealth (purchasing power) of consumers in that market, and the likely future wealth of consumers. While some markets are very large when measured by number of consumers (e.g. China and India), low living standards may imply limited purchasing power and relatively small market when measured in economic terms. Further the costs and risks associated with doing business in a foreign country are typically lower in economically advanced and politically unstable nations.
4. Potential long-run benefits bear little relationship to a nation's current stage of economic development or political stability. Long-range benefits depend on likely future economic growth rates, and economic growth appears to be a function of a free market system and a country's capacity for growth (which may be greater in less developed nations).
5. By following the above process a firm can rank countries in term of their attractiveness and long run profit potential. Preference is then given to entering markets that rank highly. In the case of ING, its latest international ventures in the financial services business has been focused in Europe and North America. These regions have large financial services markets and exhibit relatively low political and economic risks, so it makes sense that they would be attractive to ING. The company should be able to capture a large enough share of the market in each country to justify its investment in setting up business there.

13.2.2 Timing of Entry

Once attractive markets have been identified, it is important to consider the timing of entry. The advantages frequently associated with entering a market early are commonly known as first-mover advantages. One first mover advantage is the ability to preempt rivals and capture demand by establishing a strong brand name. A second advantage is the ability to build sales volume in that country and ride down the experience curve ahead of rivals, giving the early entrant a cost advantage over later entrants.

There can be disadvantages associated with entering a foreign market which are often referred to a first-mover disadvantages. These disadvantages may give rise to pioneering costs that an early entrant has to bear that a later entrant can avoid. Pioneering costs arise when the business system in a foreign country is so different from that in a firm's home market that an enterprise has to devote considerable effort, time, and expense to learning the rules of the game e.g. costs of business failure due to ignorance of the foreign environment, certain liability associated with being a foreigner, the costs of promoting and establishing a product offering including the costs of educating customers, change in regulations in a way that diminishes the value of an early entrant's investments.

13.2.3 Scale of Entry and Strategic Commitments

Another issue that an international business needs to consider when contemplating market entry is the scale of entry. Entering a market on a large scale involves the commitment of significant resources. For example, ING had to spend several billion dollars to acquire its US operations. Not all firms have the resources necessary to enter on a large scale, and even some firms prefer to enter foreign markets on a small scale and then build slowly as they become more familiar with the market.

13.3 ENTRY MODES

Firms can use six different modes to enter foreign markets: exporting, turnkey projects, licensing, franchising, establishing joint ventures with a host-country firm, or setting up a new wholly owned subsidiary in the host country. Each entry mode has advantages and disadvantages. Managers need to consider these carefully when deciding which to use.

13.3.1 Exporting

Using domestic plant as a production base for exporting goods to foreign markets is an excellent initial strategy for pursuing international sales.

Advantages

1. It minimizes both risk and capital requirements and it is conservative way to test the international waters. With an export strategy the manufacturer can limit its involvement in foreign markets by contracting with foreign wholesalers experienced in importing to handle the entire distribution and marketing function in their countries or regions of the world. If it is more advantageous to maintain control over these functions, a manufacturer can establish its own distribution and sales organizations in some or all of the target foreign markets. Either way, a firm minimizes its direct investments in foreign countries because of its home-based production and export strategy.
2. Exporting may help a firm achieve experience curve and location economies. By manufacturing the product in a centralized location and exporting to other national markets, the firm may realize substantial economies from its global sales volume. This is how Sony came to dominate the global TV market.

Disadvantages

1. Exporting from the firm's home base may not be appropriate if there are lower-cost locations for manufacturing the product abroad (i.e. if the firm can realize location economies by moving production elsewhere.)
2. High transport costs can make exporting uneconomical, particularly for bulk products. One way of going around is to manufacture bulk products regionally.
3. Tariff barriers can make exporting uneconomical. Similarly the threat of tariff barriers by the host-country government can make it very risky.
4. Exporting through local agent may not be good proposition since foreign agents often carry the products of competing firms and so have divided loyalties.

13.3.2 Turnkey Projects

Firms that specialize in the design, construction, and start-up of turnkey plants are common in some industries. In a turnkey project, 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 handled the "key" to a plant that is ready for full operation-hence the term turnkey. This is a means of exporting process technology to other countries. Turnkey projects are most common in the chemical, pharmaceutical, petroleum refining, and metal refining industries, all of which use complex, expensive production technologies.

Advantages

1. Turnkey projects are a way of earning great economic returns from the asset. The strategy is particularly useful where FDI is limited by host-government regulations. For example, the governments of many oil-rich countries have set out

to build their own petroleum refining industries, so they restrict FDI in their oil and refining sectors. But because many of these countries lacked petroleum technology; they gained it by entering into turnkey projects with foreign firms than had the technology.

2. A turnkey strategy can also be less risky than conventional FDI. In a country with unstable political and economic environments, a longer-term investment might expose the firm to unacceptable political and/or economic risks (e.g., the risk of nationalization or of economic collapse).

Disadvantages

1. The firm that enters into a turnkey deal will have no long-term interest in the foreign country. This can be a disadvantage if that country subsequently proves to be a major market for the output of the process that has been exported.
2. The firm that enters into a turnkey project with a foreign enterprise may inadvertently create a competitor.
3. 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.

13.3.3 Licensing Strategies

Licensing makes sense when a firm with valuable technical know-how or a unique patented product has neither the internal organizational capability nor the resources to enter the foreign markets.

Advantages

1. Licensing has the advantage of avoiding the risks of committing resources to country markets that are unfamiliar, present considerable economic uncertainty or are politically volatile. By licensing the technology or the production rights to foreign-based firms, the firm does not have to bear the costs and risks of entering foreign markets on its own, yet it is able to generate income from royalties.
2. Licensing is often used when a firm wishes to participate in a foreign market but is prohibited from doing so by barriers to investment.
3. Licensing is frequently used when a firm possesses some intangible property that might have business applications, but it does not want to develop those applications itself.

Disadvantages

1. The big disadvantage of licensing is the risk of providing valuable technological know-how to foreign companies and thereby loosing some degree of control over its use; monitoring licenses and safeguarding the company's proprietary know-how can prove quite difficult in some cases.
2. Competing in a global market may require a firm to coordinate strategic moves across countries by using profits earned in one country to support competitive attacks in another. By its very nature, licensing limits a firm's ability to do this. A licensee is unlikely to allow a multinational firm to use its profits (beyond those due in the form of royalty payments) to support a different licensee operating in another country.
3. Technological know-how constitutes the basis of many multinational firms' competitive advantage. Most firms wish to maintain control over how their know-how is used, a firm can quickly lose control over its technology by licensing it.

13.3.4 Franchising Strategies

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

While licensing works well for manufacturers, franchising is often suited to the global expansion efforts of service and retailing. McDonald's, Tricon Global Restaurants (the parent of Pizza Hut, Kentucky Fried Chicken, and Taco Bell), and Hilton Hotels have all used franchising to build a presence in foreign markets.

Advantages

Franchising has much the same advantages as licensing. The franchisee bears most of the costs and risks of establishing foreign locations; the franchiser has to expend only the resource to recruit, train, and support franchisees. Thus using a franchising strategy, a service firm can build a global presence quickly and at a relatively low cost and risk, as McDonald's has.

Disadvantages

The big problem a franchiser faces is maintaining quality control; foreign franchisees do not always exhibit strong commitment to consistency and standardization, perhaps because the local culture does not stress or put much value on the same kinds of quality concerns.

13.3.5 Joint Ventures

A joint venture entails establishing a firm that is jointly owned by two or more otherwise independent firms. Fuji-Xerox for example, was set up as a joint venture between Xerox and Fuji Photo. Establishing a joint venture with a foreign firm has long been popular mode for entering a new market. The most typical joint venture is a 50/50 venture, in which there are two parties, each of which holds a 50 percent ownership stake and contributes a team of mangers to share operating control.

Advantages

First, a firm benefits from a local partner's knowledge of the host country's competitive conditions, culture, language, political systems and business systems. Second, when the development costs and/or risks of opening a foreign market are high, a firm might gain hy sharing these costs and/or risks with a local partner. Third, in many countries, political considerations make joint ventures the only feasible entry mode.

Disadvantages

1. As with licensing, a firm that enters into a joint venture risks giving control of its technology to its partner.
2. A joint venture does not give a firm the tight control over subsidiaries that it might need to realize experience curve or location economies. Nor does it give a firm the tight control over a foreign subsidiary that it might need for engaging in coordinated global attacks against its rivals.
3. Shared ownership arrangements can lead to conflicts and battles for control between the investing firms in their goals and objectives change or if they take different views as to what the strategy should be.

13.3.6 Wholly Owned Subsidiaries

In a wholly owned subsidiary, the firm owns 100 per cent of the stock. Establishing a wholly owned subsidiary in a foreign market can be done in two ways. The firm can

either set-up a new operation in that country often referred to as a green-field venture, or it can acquire an established firm in that host nation and use that firm to promote its products.

Advantages

1. When a firm's competitive advantage is based on technological competence, a wholly owned subsidiary will often be the preferred entry mode, because it reduces the risk of losing control over that competence. Many high-tech firms prefer this entry mode for overseas expansion (e.g. firms in a semi-conductor, electronics, and pharmaceutical industries).
2. A wholly owned subsidiary gives a tight control over operations in different countries. This is necessary for engaging in global strategic coordination (i.e. using profits from one country to support competitive attacks in another).
3. A wholly owned subsidiary may be required if a firm is trying to realize location and experience curve economies.

Disadvantages

Establishing a wholly owned subsidiary is generally the most costly method of serving a foreign market. Firms doing this must bear the full costs and risks of setting up overseas operations. The risks associated with learning to do business in a new culture are less if the firm acquires an established lost-country enterprise. However, acquisitions raise additional problems, including those associated with trying to marry divergent corporate cultures. These problems may more than offset any benefits derived by acquiring an established operation.

Selecting an Entry Mode

Advantages and Disadvantages associated with all the entry modes are summarized in Table 13.1 below:

Table 13.1

Entry Mode	Advantages	Disadvantages
Exporting	Ability to realize location and experience curve economies	High transport costs Trade barriers Problems with local marketing agents
Turnkey contracts	Ability to earn returns from process technology skills in countries where FDI is restricted	Creating efficient competitors Lack of long-term market presence.
Licensing	Low development costs and risks	Lack of control over technology. Inability to realize location and experience curve economies. Inability to engage in global strategic coordination.
Franchising	Low development costs and risks	Lack of control over quality. Inability to engage in global strategic coordination.
Joint ventures	Access to local partner's knowledge. Sharing development costs and risks Politically acceptable	Lack of control over technology Inability to engage in global strategic coordination. Inability to realize location and experience economies.
Wholly owned subsidiaries	Protection of technology Ability to engage in global strategic coordination. Ability to realize location and experience economies	High costs and risks.

Due to this advantages and disadvantages, trade-offs are inevitable when selecting an entry mode.

13.4 CORE COMPETENCIES AND ENTRY MODE

The optimal entry mode for the firms depends to some degree on the nature of their core competencies. A distinction can be drawn between firms whose core competency is in technological know-how and those whose core competency is in management know-how.

When technological know-how constitutes a firm's core competence, wholly owned subsidiaries are referred, since they best control technology.

When management know-how constitutes a firm's core competence, foreign franchise controlled by joint ventures seem to be optimal. This gives the firm the cost and risk benefits associated with franchising, while enabling it to monitor and control franchisee quality effectively.

Check Your Progress

Fill in the blanks:

1. The optimal entry mode for the firms depends to some degree on the nature of their core competencies. A distinction can be drawn between firms whose core competency is in .... and those whose core competency is in ....
2. When .... constitutes a firm's core competence, wholly owned subsidiaries are referred, since they best control technology.
3. When .... constitutes a firm's core competence, foreign franchise controlled by joint ventures seem to be optimal.

13.5 ESTABLISHING A WHOLLY OWNED SUBSIDIARY

13.5.1 Green-Field Venture or Acquisition

A firm can establish a wholly owned subsidiary in a country by building a subsidiary from the ground up, the so called green-field strategy or by acquiring an established enterprise in the target market. The volume of cross border acquisitions has been growing at a rapid rate for two decades. Some 80 per cent of the world's FDI flows is now in the form of mergers and acquisitions. The value of cross-border acquisitions grew at an average rate of 42 per cent a year compounded between 1980 and 1999 and exceeded $2.3 trillion in 1999 when over 24,000 cross-border acquisitions occurred.

Pros and Cons of Acquisitions

Acquisitions have three major points in their favour:

1. They are quick to execute. By acquiring an established enterprise, affirm can rapidly build its presence in the target foreign market. When the German automobile company Daimler-Benz decided that it needed a bigger presence in the US automobile market, instead of building new factories that would have taken years, instead it acquired us automobile company Chrysler and merged the two operations to form Daimler/Chrysler.
2. In many cases firms make acquisitions to preempt their competitors. The need for preemption is particularly great in markets that are rapidly globalizing, such as telecommunications.
3. Managers may believe acquisitions to be less risky than green-field ventures. When a firm makes an acquisition, it buys a set of assets that are producing a known revenue and profit stream. In contrast, the revenue and profit stream that a green field venture might generate is uncertain.

Despite the arguments in favour of acquisitions, acquisitions often produce disappointing results.

Pros and Cons of Green-field Ventures

The big advantage of establishing a green-field venture in a foreign country is that it gives the firm a much greater ability to build the kind of subsidiary company that it wants. For example, it is much easier to build an organization culture from scratch than it is to change the culture of an acquired unit. Similarly, it is much easier to establish a set of operating routines in a new subsidiary than it is to convert the operating routines of an acquired unit. This is a very important advantage for many international businesses, where transferring products, competencies, skills, and know-how from the established operations of the firm to the new subsidiary are principle ways of creating value.

Set against this significant advantage are the disadvantages of establishing a Greenfield venture. Green-field ventures are slower to establish. They are also risky. As with any new venture, a degree of uncertainty is associated with future revenue and profit prospects. Also, green-field ventures are less risky than acquisitions in the sense that there is less potential for unpleasant surprises. A final disadvantage is the possibility of being preempted by more aggressive global competitors, who enter via acquisitions and build a big market presence that limits the market potential for the green-field venture.

Green-field Venture or Acquisition?

In general, the choice will depend on the circumstances confronting the firm. If the firm is seeking to enter a market where there are already well-established incumbent enterprises and where global competitors are also interested in establishing a presence, it may pay the firm to enter via an acquisition. In such circumstances, a green field venture may be too slow to establish a suitable presence. However, if the firm is going for acquisition route its management should we aware of the risks associated with acquisition when determining the firms to purchase. It may be better to opt for the slower route of a green-field venture than to make a bad acquisition.

If the firm is considering entering a country when there are no incumbent competitors to be acquired, then the green-field venture may be the only mode. Even when incumbents exist, if the competitive advantage of the firm is based on the transfer of organizationally embedded competencies, skill, routines, and cultures, it may still be preferable to enter via a green-field venture. Things such as skills and organizational culture, which are based on significant knowledge that is difficult to articulate and codify, are much easier to embed in a new venture than they are in an acquired entity, where the firm may have to overcome the established routines and culture of the acquired firm.

13.6 STRATEGIC ALLIANCES AND JOINT VENTURES WITH FOREIGN PARTNERS

Strategic Alliances and cooperative agreements of one kind or another with foreign companies are a favourite and potentially fruitful means for entering a foreign market or strengthening a firm's competitiveness in world market. Historically export-minded firms in industrialized markets sought alliances with firms of less-developed countries to import and market their products locally-such arrangements were often necessary to win approval from the host country's government to enter its market. More recently, companies from different parts of the world have formed strategic alliances and partnership arrangements to strengthen their mutual ability to serve whole continents and move toward more global market participation.

Strategic alliances can help companies in globally competitive industries strengthen their competitive positions while still preserving their independence.

Advantages of Strategic Alliances

First, strategic alliances may facilitate entry into a foreign market. For example, Motorola initially found very difficult to gain access to the Japanese cellular telephone market. The turning point for Motorola came in 1987 when it allied with Toshiba to build microprocessors. As part of the deal, Toshiba provided Motorola with marketing help, including some of its best managers. This helped Motorola in the political game of securing government approval to enter the Japanese market and getting radio frequencies assigned for its mobile communication systems.

Second, strategic alliances also allow to share fixed costs and associated risks of developing new products or processes.

Third, an alliance is a way to bring together complementary skills and assets that neither company could easily develop on its own. For example, AT&T gave NEC Corporation of Japan in 1990 through a deal by which NEC was given some of its computer-aided design technology and NEC gave AT&T access to the technology underlying its advanced logic computer chips.

Fourth, it makes sense to form an alliance that will help the firm establish technological standards for the industry that will benefit the firm.

Disadvantages of Strategic Alliances

Despite the advantages arising out of strategic alliances some commentators have criticized strategic alliances on the grounds that they give competitors a low-cost route to new technology and markets.

Alliances have risks. Unless a firm is careful, it can give away more than what it receives.

13.7 LET US SUM UP

The lesson addresses two related topics: the optimal choice of entry mode to serve a foreign market and strategic alliances. Basic entry decisions include identifying which markets to enter, when to enter those markets, and on what scale. The most attractive foreign markets tend to be found in politically stable developed and developing nations that have free market systems and where there is not a dramatic upsurge in either inflation rates or private-sector debt. There are six modes of entering a foreign market: exporting, creating turnkey projects, licensing, franchising, establishing joint ventures, and setting up a wholly owned subsidiary. Each mode has relative advantages and disadvantages. The optimal choice of entry mode depends on the firm's strategy. Relative to green-field ventures, acquisitions are quick to execute, may enable a firm to preempt its global competitors and involve buying a known revenue and profit stream. The big advantage of establishing a green-field venture in a foreign country is that it gives the firm a much greater ability to build the kind of subsidiary company that it wants. Strategic alliances are cooperative agreements between actual or potential competitors. The advantages of alliances are that they facilitate entry into foreign markets, enable partners to share the fixed costs and risks associated with new products and processes, facilitate the transfer of complementary skills between companies, and help firms establish technical standards. The disadvantage of a strategic alliance is that the firm risks giving away technological know-how and market access to its alliance partner in return for very little.

13.8 LESSON END ACTIVITY

A small Canadian firm that has developed some valuable new medical products using its unique biotechnology know-how is trying to decide how best to serve the European Community market. Its choices are:

(a) Manufacture the product at home and let foreign sales agents handle marketing.

(b) Manufacture the products at home and set up a wholly owned subsidiary in Europe to handle marketing.

(c) Enter into a strategic alliance with a large European pharmaceutical firm. The product would be manufactured in Europe by the 50/50 joint venture and marketed by the European firm.

The cost of investment in manufacturing facilities will be a major one for the Canadian firm, but is not outside its reach. If these are the firm's only options, which one would you advise it to choose? Why?

13.9 KEYWORDS

International Strategy: Trying to create value by transferring core competencies to foreign markets where indigenous competitors lack those competencies

Multipoint Strategy: Emphasising the need to be responsive to the unique conditions prevailing in different national markets.

13.10 QUESTIONS FOR DISCUSSION

1. What kinds of companies stand to gain the most from entering into strategic alliances with potential competitors? Why?

2. Discuss how the need for control over foreign operations varies with firms' strategies and core competencies? What are the implications for the choice of entry-mode?

3. Whose interests should be the paramount concern of government trade policy (the interests of producers, business and their employees) or those of consumers?

4. Discuss the merits and demerits of the following strategies to enter international business: (i) Licensing (ii) Strategic Alliance (iii) Joint Venture.

Check Your Progress: Model Answer

1. Technological know-how; management know-how;
2. technological know-how;
3. management know-how.

13.11 SUGGESTED READINGS

Cherenilan Francis, *International Economics*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

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LESSON

14

INTERNATIONAL MARKETING

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14.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Describe meaning and features of international marketing
- Discuss reasons behind going international
- Distinguish between various types of international management orientation
- Segment international market

14.1 INTRODUCTION

One can observe rapid changes in the world markets which are resulting in the emergence of new markets across the world. In this century China, India and Latin America and the emerging market-based economies of Eastern Europe promise new opportunities for global trade.

The growing internationalization of business induces changes in the positioning of competitors and appropriate competitive strategies. As companies attain gradual success in expanding their business geographically and effectively performing international operations, they will reach critical point and will be able to synchronize the proximity to the oversea markets and customer needs. The global companies at this point blue print their success business systems in the emerging markets by creating relatively decentralized operations in production, marketing and sales.

Key Aspects of International Marketing

The term 'international marketing' may be defined as the process of trade exchanges cross national boundaries for the satisfaction of human needs and wants. The pursuit of foreign markets is a function of commitment and the extent of involvement of the company overseas. The foreign involvement of a company may be categories into one of the following depictions:

- Domestic marketing, where the enterprises operate exclusively within a single country may be termed as native country.
- The agencies or individuals operating within the predefined region may be described as regional exporters. In this kind of operation, the markets served are economical and culturally homogeneous and turn optimistic if the activities fall outside the home region.
- Exporters deal with the finished goods and operate from their home country office to various destination markets across national frontiers and geographies.
- A firm's international involvement is reflected in such regional operations as are of a partially autonomous nature. However, key decisions are made at the corporate office with the top-down control strategy. In the process, both the manufactured and intermediate or semi-processed products are exported outside the home region.
- On the other hand, truly global companies operate with total autonomy through their independent subsidiaries in a cluster of countries. Some key functions such as research and development, outsourcing, promotions and finance functions are managed locally in view of volatile customer preferences and market-driven needs.

14.2 PROBLEMS IN INTERNATIONAL MARKETING

The important special problems in international marketing are given below:

1. ***Political and legal differences:*** The political and legal environment of foreign markets are different from that of domestic. The complexity generally increases as more number of countries are included in the Company's business portfolio
2. ***Cultural differences:*** This is the most difficult area in international marketing. Many domestic markets, however, are also not free from cultural diversities.
3. ***Economic differences:*** The economic environment may change from country to country.
4. ***Differences in the currency unit:*** The currency unit varies from country to country. This may sometimes cause problems of currency convertibility, besides the problems of exchange rate fluctuations. The monetary system and regulation may also vary.
5. ***Differences in the language:*** An international marketer often problems arising out of the differences in the language. Even when the same language is used in different countries, the same words or terms may have different meanings or connotations.

invest in foreign countries. Sometimes as was the case with India companies may be obliged to earn foreign exchange to finance their imports and to meet certain

6. ***Differences in marketing infrastructure:*** For example, and advertising medium that is very effective in one market may not be available or may be underdeveloped in another market.
7. ***Trade restrictions:*** Trade restrictions particularly import controls, is a very important problem which an international marketer faces.
8. ***High cost of distance:*** When markets are far removed by distance, the transport cost becomes high and the time required for effecting the delivery tends to become longer .Distance tends to increase certain other costs also.
9. ***Differences in trade practices:*** Trade practices and customs may differ between markets.

14.3 WHY GO INTERNATIONAL?

The factors that motivate firms to go international may be broadly divided into two groups:

- ***The pull factors:*** Most of which are proactive reasons, are those forces of attraction which pull the business to the foreign markets. Such attractiveness include, broadly, the relative profitability and growth prospects.
- ***The push factors:*** Refer to the compulsions of the domestic market, like saturation of the market, which prompt companies to internationalize. Most of the push factors are reactive reasons.

Important reasons for going international are given below:

- ***Profit advantage:*** International business could be more profitable than the domestic. Even when international business is less profitable than the domestic, it could increase the total profit. Further in certain cases international business can help increase the profitability of the domestic business. One of the important motivations for foreign investment is to reduce the cost of production (by taking advantage of cheap labour, for example).
- ***Growth opportunities:*** MNCs are getting increasingly interested in a number of developing countries as the income and population are rapidly rising in these countries. Foreign markets in both developed country and developing country provide enormous growth opportunities for firms of the developing country too.
- ***Domestic market constraints:*** The market for a number of products tend to saturate or decline in the advanced countries. This often happens when the market potential has been almost fully tapped. In the United States, for example the stock of several consumer durables like cars, TVs etc. the total number of household. Further the technological advances have increased the size of the optimum scale of operation substantially in many industries making it necessary to have foreign market, in addition to domestic market to take advantage of scale economies. Again when the domestic market is very small, internationalization is the only way to achieve significant growth. For example Nestle derives only about 2 per cent of its total sales from its home market Switzerland. Similarly with only 8 per cent of the total sales coming from the home market, Holland, many different national subsidiaries of the Philips have contributed much larger share of the total revenues than the parent company.
- ***Competition:*** Competition may become a driving force behind international-ization. A protected market does not normally motivate companies to seek business outside the home market. Many companies also take an offensive international competitive strategy by way of counter-competition.
- ***Government Policies and Regulation:*** Many governments offer a number of incentives and other positive support to domestic companies to export and to

invest in foreign countries. Sometimes as was the case with India companies may be obliged to earn foreign exchange to finance their imports and to meet certain other foreign exchange requirements like payment of royalty, dividend etc. Further in India permission to enter certain industries by the large companies and foreign companies was subject to specific export obligation. Some companies also move to foreign countries because of certain regulations, like the environmental laws in advanced countries.

- ***Monopoly power:*** Monopoly power may arise from such factors as monopolization of certain resources, patent rights, technological advantage, product differentiation, etc. Exclusive market information as knowledge about foreign customers, market places, or market situations not widely shared by other firms.
- ***Spin-off benefits:*** International business improve the image of the company. There is white skin advantage associated with exporting-when domestic consumers get to know that the company is selling a significant portion of the production abroad, they will be inclined to buy from such company.

14.4 STRATEGIC VISION

The stimulus for internationalization comes from the urge to grow, the need to become more competitive, the need to diversify and to gain strategic advantages of internationalization.

14.5 SWOT ANALYSIS

It has been observed that no product marketing is effective in the long run unless modifications in marketing approaches are properly carried out. Self-appraisal mechanisms have to be developed within the product marketing system to acquaint oneself with the existing Strengths, Weaknesses, Opportunities and Threats (SWOT) of the product and the market. Such an analysis has to be done with reference to prevailing market conditions for the product. Table 14.1 explains the areas of SWOT analysis for achieving better marketing efficiency. Companies may restructure the production and marketing design for their products on the basis of weaknesses and threats in order to explore better opportunities and gain more strength in the product market.

Table 14.1: SWOT Analysis

Strengths	Weaknesses	Opportunities	Threats
*Production recognition *Long standing in market (image) * Consistency in price, quality and supply * Effective distribution network * Strong Market Information System(MIS) and Consumer Awareness System (CAS)	* Production recognition * Short span * Pricing mismatch * Product design * Product transformation system * Risk * Low market investment * Poor accessibility to market	* Uninterrupted entry * Weak competition * Few Substitutes and/or complementary products * Access for MIS and CAS. * High density and marketing area	* Neck and neck competition * Fashion advertisements * Contemporary marketing mechanism * Frequent shifts in demand * High cost of marketing * Political and technological threats

Product marketing has a tertiary environment comprising the Social, Technological, Economic and Political Sectors (STEP) which affect the marketing of products indirectly. These factors, together with vested interests, offer scope for developing a capitalist environment by interrupting the inflow of products to potential markets which in turn provides an opening for the products to capture these markets through

the STEP PUSH approaches. The STEP effect is common for the new product entries that often put the customers in a state of indecisiveness. The power structure of capitalist industries operates with a strong resistance in competitive markets and even dilutes state intervention to a large extent. It would help to protect the consumer system within the framework of STEP to avoid marketing interruption at the pre-mature and mature stage of product cycle.

14.6 INTERNATIONAL ORIENTATIONS

The EPRG framework identifies four types of attitudes or orientation towards internationalization that are associated with successive stages in the evolution of international operations. These four orientations are:

- Ethnocentrism (home country orientation)
- Polycentrism (host country orientation)
- Regiocentrism (regional orientation)
- Geocentrism (world orientation)

Table 14.2: Comparison of Different International Operations

Characteristics	Ethnocentrism	Polycentrism	Regiocentrism	Geocentrism
Management Orientation	Home country orientation	Host country orientation	Regional orientation	Global orientation
Perception of the market	Domestic market is superior Opportunities are similar between the home and foreign markets Foreign markets are extensions of home market	Each national market is distinctive. The differences between the home and foreign markets are decisive.	Markets can be differentiated and delineated on the basis of common regional characteristics.	The entire world is a single market that can be effectively tapped by standardized marketing strategy.
Marketing strategy	Extension of domestic strategy to foreign markets	Localization	Trade-off between localization and standardization	Global standardisation.
Merits	No cost and effort of localization. An easy route to internationalization when foreign markets/ niches exist With characteristics similar to domestic market exist	Adaptations to the market characteristics which helps better exploitation of the market potentials.	Some of the advantages of both the localization and standardization strategies.	Economics of scale and lower costs. Advantages of pace.
Demerits	Limits the scope of exploitation of international business opportunities.	High costs of adaptation. Delays associated with adaptation.	Neglect of intra-regional differences in the business environment.	Standardization will not be successful in many cases.

Check Your Progress

A company with polycentrisim orientation of international business is required to have marketing strategy as:

(a) Extension of domestic strategy to foreign markets

(b) Localization

(c) Trade-off between localization and global standardization

(d) Global standardization

(e) None of the above

14.7 THE GLOBAL MARKET PLACE

In the highly competitive global marketplace of today, the pressure on organizations to find new ways to create and deliver value to customers is intense. The global market place has been segmented geographically, comprising a triad market: Pacific-rim, post/communist countries, Latin America, China and India. In the last two decades, technological innovations, logistics and supply chain have moved center stage. There is a growing recognition that it is through an effective management of the logistics function and the supply chain that the goal of cost reduction and service enhancement can be achieved. The global marketplace may be described as a spatial network of market across countries, comprising homogenous and customized segments.

Determinants of International Trade

With a view to ease the complexities of the global market place in terms of competition and socio-economic conflicts, international business houses generally cluster the countries by common attributes such as political systems, social structures, economic development and accessibility. The cultural and economic geography that affects the international trade and investment includes proximity to the market place, common heritage, income levels and ownership of natural resources.

14.8 THE TRIAD MARKET

The new global marketplace accelerates competition, thereby reducing the lead time for companies with new products, services or technologies to reach and service their target market. To survive and grow in this type of economic environment, a business will need strategic markets where it can expand its sales and be competitive. Businesses, both large and small, are turning to niche markets where competition is reduced. Economic globalization is a new worldwide economic order, in which a majority of nations prescribe to the free enterprise system

The triad market refers to the United States and Canada, Japan and Western European countries. This group of countries accounts for approximately 14 per cent of the global populations and represents about 70 per cent of the world gross product while absorbing the major proportion of capital and consumer products. Since 1980, three major international trading areas have emerged in the world economy in the form of the triad, that aim at developing uniformity in the markets, and currency parity differences across countries. One of the appealing characteristics of the triad markets is the globalization of needs. There are striking similarities in the demand and lifestyle patterns of triad consumers.

The triad power may be described as a group of countries performing business operations in a predetermine framework. A Japanese triad power is operative in the United States of America, European community and in Southeast Asia with Japan as the focal point of business operations. Likewise, the American triad power consists of the NAFTA countries (United States, Canada and Mexico), European community and Japan. The triad powers essentially function in the countries of their spatial spread and the other regions become less important for survival and are considered as marginal or less opportunistic .In the triad market, time and distance play a major role in helping the executives to make quick and appropriate strategic decisions.

14.9 GLOBAL MARKET SEGMENTATION

A market segment refers to a group of countries that are alike in respect to their responsiveness to some aspect of marketing strategy. Market segmentation may be defined as a technique of dividing different countries into homogeneous groups. The concept of segmentation is based on the fact that a business cannot serve the entire

world with a single set of policies because there are disparities among countries-both economic and cultural. An international market should pick one or more countries as target markets. A company may not find it feasible to do business immediately with the entire spectrum of countries forming a segment.

Market segmentation is one of the pre-requisites for planning marketing activities for any product. Segmenting, Targeting, and Positioning (STP) are the three basic components of strategic marketing in modern times. Segmentation of market is a process of identifying the agglomeration of buyers, their wants, purchasing power, geographical locations, their buying attitudes and behaviour, to facilitate the targeting and positioning of the product

It is essential to identify the segmentation variables and developing profiles of the resulting segmentation for making decisions and also for marketing planning. There are many bases for segmenting the consumer markets, of which some are exhibited below:

Table 14.3: Bases and Variables for Segmenting Consumer Markets

Geographic	Demographic	Psychographic	Behavioural
Territory	Density of population	Nationality	Product usage pattern
Habitual identity	Age	Race	Derived product benefits
Population size	Sex	Social class and clan	User status
Climate	Household patterns	Livelihood systems	Usage frequency
Flora and fauna	Income level	Personality groups	Brand loyalty
	Occupation	Influencing cultures	State of readiness
	Education		Attitude towards product
	Population categories		Personal preferences

Besides the above variables, the lifestyles of consumers and their personalities also provide ample information for segmenting consumer markets. In the behavioural variable category, apart from other variables, personal preferences have a substantial impact when it comes to identifying the consumer segments for the products. Personal preference can be categorized in the following three patterns:

- Homogeneous preferences for products or brands.
- Diffused preferences showing greater variations for the brands across the regions.
- Clustered preferences indicating localized preferences of consumers for the brands available.

Conducting exploratory interviews and focus group analysis-in order to gain insights into consumer motivation, attitudes and behaviour is another way of collecting information on the above-listed variables for purposes of market segmentation. The data may be collected through structured questionnaires broadly covering the issues related to consumer behaviour, brand awareness and brand rating, product usage patterns, product-mix behaviour, demographic and psychographic variables.

The procedure for segmenting industrial markets is different from that used for consumer markets. However, the selected industrial market can be further segmented in terms of consumer goods. The major variables that need to be considered for the segmentation of industrial markets are listed in Table 14.4.

Table 14.4

Physical	Operational	Purchase	Situational	Personal
Type of industry Size of industry Location	Technology Status of production Customer target Logistics policy	Purchase policy Lobby status Continuing relationship with supplier Purchasing criteria	Immediate need Specific order Size of the order Legal binding New markets Substitute or complementary products need	Risk factor Brand loyalty Marginal difference in the product

Above all, the risk factor in penetrating into such market segment, involving the factor of brand loyalty among users, is also an important variable when it comes to decision-making for segmenting the market for industrial consumers. In a given operational area for the company, the market for consumer goods and services can be segmented in five different forms as given below:

- ***One product in one market:*** micro consumer segmentation;
- ***Different products in different markets:*** diffused segmentation;
- ***All products in one market:*** specialized market segmentation;
- ***One product in all markets:*** product specialized market segmentation; and
- ***All products in all markets:*** absolute market segmentation or total coverage.

The companies that are proposing for the global expansion may utilize these steps of segmentation determining the criteria for classifying the countries for its product and services, particularly those countries or regions that show high market potential

14.9.1 Reasons for Market Segmentation

1. Accurate market segmentation helps a multinational company to better perform its marketing activities. It is easier to address the needs of smaller groups of customers, particularly they have many characteristics in common (e.g. seeking the same benefits, same age, gender etc.).
2. Using 'niche marketing' segmentation can allow a new company or new product to target less contested buyers and help a mature product seek new buyers. The companies, may make more efficient use of marketing resources by focusing on the best segments for offering-product, price, promotion, and place (distribution).
3. Segmentation helps in various ways to avoid sending the wrong message, or sending one's message to the wrong people.

Functional steps to be considered by multinational companies to determine the segmentation criteria are:

- A market taxonomy for classifying the world markets should be developed by the companies in reference to the SLEPT (i.e. marketing environment- social, legal, economic, political and technical) considerations in the host country.
- The countries to be clustered into homogeneous groups having common characteristics with reference to the dimensions of the market taxonomy.
- Most efficient method of serving each group should then be determined methodologically.
- The group in which the marketer's own perspective (its product/service, strengths) is in line with the requirements of the group may further be chosen.

Corporate strategy to implement the segmentation process.

Table 14.5: Constituents of Market Segmentation Process

Constituents	Attributes of Market Segmentation
Large size	Market must be large enough to warrant segmenting. Don't try to spilt a market that is already very small.
Differences	Differences must exist between members of the market and these differences must be measurable through traditional data collection approaches (i.e. surveys)
Responsive	Once the market is segmented, you must be able to design marketing communications that address the needs of the desired segments. If you can't develop promotions and advertising that speak to each segment, there is little value in knowing that those segments exist.
Accessibility	Each segment must be reachable through one or more media. If one-eyed, green aliens are your best marketing opportunities, make certain there is a magazine, cable programme or some other medium that targets these people (or be prepared to create one)
Multiple benefits	Segments must not only differ on demographic and psychographic characteristics, they must also differ on the benefits sought from the product. If everyone ultimately wants the same things from your product, there is no reason to segment buyers.
Profitability	The expected profits from expanding your markets and more effectively reaching buyer segments must exceed the costs of developing multiple marketing programmes, re-designing existing products and/or creating new products to reach those segments.

Table 14.4 presents the corporate strategy to implement the segmentation process. A key factor in competitive success is focusing on little differences that give a marketing edge and are important to customers. Market segmentation matches consumer differences with potential or actual buying behaviour. It may prove more profitable to develop smaller market segments into a target segment. Primary market-research is used to collect classification and descriptor variables for members of the target market. Segments are not defined until after collection and analysis of all relevant information. Multivariate analytical techniques are used to define each segment and develop a scoring algorithm for placing all members of the target market into segments. The classification variables are used to classify survey respondents into market segments. Almost any demographic, geographic, psychographic or behavioural variable can be used to classify people into segments. Age, gender, income, ethnicity, marital status, education, occupation, household size, length of residence, type of residence, etc., constitute the demographic variables used for segmenting the market. The territorial determinants comprise city, state, pin code, census tract, district, region, metropolitan or rural location, population density, climate etc. The psychographic variables include attitudes lifestyle, hobbies, risk aversion, personality traits, leadership treats, magazines read, television programmes watched, and the brand loyalty, usage level, benefits sought, distribution channels used, reaction to marketing factors, may be defined as behavioural variables that influence the market segmentation process by the multinational companies. The descriptors are used to describe each segment and distinguish one group from the others. Descriptor variables must be easily obtainable measures or linkable to easily obtainable measures that exist in or can be appended to customer files.

14.9.2 Grouping of Countries

The following methods are commonly used by multinational companies to group countries for developing appropriate business strategies:

- Economic status grouping
- Geographic grouping
- Political grouping

- Cultural classification
- Portfolio approach
- Multiple variable grouping
- Inter-market segmentation
- Grouping by religion

14.9.3 Market Segmentation through Perceptual Mapping

Perceptual mapping is one of the important tools for segmenting the markets in reference to the products or brands that are perceived to be close together in the behaviour of the consumers. The market segmentation through perceptual mapping approach can be done by adopting the following steps:

- Select product market area to be segmented.
- Identify which brands compete in the market.
- Collect buyer's perception about the current brands.
- Analyze data to cluster one or more composite attribute dimensions, independent of each other.
- Map the attributes of consumers in reference to special and temporal data.
- Plot consumer's preferences and locate sub groups, if any.
- Evaluate the mapping results
- Interpret the results of market segmentation and product positioning.

14.9.4 Niche Marketing

The niche strategy would be profitable to those firms with low shares of the total market. The main reason is that the niche strategy provides total knowledge about the customer segment to the company to enable it to serve better through value addition. As a result, the niche company can charge a substantial mark up over cost, because of value addition. The niche marketing strategy provides high margin to the company, while the mass marketing strategy may provide the advantage of high volume to the company. The niche marketer should consider the following factors while deciding strategies:

- Adequate size of the product.
- Purchasing power of the segment to the tune of profitability.
- Potential for growth.
- Negligible interest to the competing companies.
- Appropriate skills and resources to serve the niche in a superior fashion.
- Well-knit defensive strategy to counter competitors' attacks.

14.10 LET US SUM UP

International marketing can be defined as "finding out what customers want around the world and then satisfying these wants better than other competitors, both domestic and international".

Problems in International Marketing international are Political and legal differences, cultural difference, economic difference, currency difference, language difference, difference in marketing infrastructure, trade restrictions, high cost of distance, differences in trade practices.

The factors that motivate firms to go International are two the pull factors and the push factors. Important reasons for going international are profit advantage, growth opportunities, domestic market constraints, competition, Government policies and regulation, monopoly powers, spin-off benefits.

The stimulus for internationalization comes from the urge to grow, the need to become more competitive, the need to diversify and to gain strategic advantages of internationalization.

The EPRG framework identifies four types of attitudes or orientation towards internationalization that are associated with successive stages in the evolution of international operations Ethnocentrism (home country orientation), Polycentrism (host country orientation), Regiocentrism (regional orientation), Geocentrism (world orientation).

In the highly competitive global marketplace of today, the pressure on organizations to find new ways to create and deliver value to customers is intense. The global market place has been segmented geographically, comprising a triad market: Pacific-rim, post/communist countries, Latin America, China and India.

Since 1980, three major international trading areas have emerged in the world economy in the form of the triad, that aim at developing uniformity in the markets, and currency parity differences across countries. One of the appealing characteristics of the triad markets is the globalization of needs. There are striking similarities in the demand and lifestyle patterns of triad consumers.

Self-appraisal mechanisms have to be developed within the product marketing system to acquaint oneself with the existing Strengths, Weaknesses, Opportunities and Threats (SWOT) of the product and the market. Such an analysis has to be done with reference to prevailing market conditions for the product.

Market segmentation may be defined as a technique of dividing different countries into homogeneous groups. The concept of segmentation is based on the fact that a business cannot serve the entire world with a single set of policies because there are disparities among countries both economic and cultural. An international market should pick one or more countries as target markets. Market segmentation is one of the pre-requisites for planning marketing activities for any product. Segmenting, Targeting, and Positioning (STP) are the three basic components of strategic marketing in modern times. Segmentation of market is a process of identifying the agglomeration of buyers, their wants, purchasing power, geographical locations, their buying attitudes and behaviour, to facilitate the targeting and positioning of the product. The lesson has also discussed—Components of strategic marketing, reasons for market segmentation, functional steps to determine the segmentation criteria, Grouping of countries, Market segmentation through Perpetual Mapping, Niche Marketing.

14.11 LESSON END ACTIVITY

Compare four types of attitudes or orientations towards internationalization that are associated with successive stages in the evolution of international operations.

14.12 KEYWORDS

SWOT analysis: It is self-appraisal mechanisms within the product marketing system to acquaint oneself with the existing Strengths, Weaknesses, Opportunities and Threats (SWOT) of the product and the market. Such an analysis has to be done with reference to prevailing market conditions for the product.

Segmentation of international markets: Market segmentation may be defined as a technique of dividing different countries into homogeneous groups. Segmentation of

market is a process of identifying the agglomeration of buyers, their wants, purchasing power, geographical locations, their buying attitudes and behaviour, to facilitate the targeting and positioning of the product.

14.13 QUESTIONS FOR DISCUSSION

1. Why firms go international? What are the problems inherent in international marketing?
2. Explain the areas of SWOT analysis for achieving better market efficiency.
3. How can you describe the global market place of a multinational company? What are the factors that influence the decision process of multinational companies while identifying opportunities for global business?
4. What is Global Market Segmentation? What are the bases and variables for segmenting consumer markets?
5. What are the reasons for Market Segmentation? What are the functional steps to be considered by multinational companies for segmentation criteria? What corporate strategy needs to be followed to implement the segmentation process?

Check Your Progress: Model Answer

(b)

14.14 SUGGESTED READINGS

Cherenilan Francis, *International Economics*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Charles W.L. Hill *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited

Rajagopal, *International Marketing*, 1st Edition, Vikas Publishing House Pvt. Ltd.

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LESSON

15

PRODUCT AND PRICING STRATEGIES IN INTERNATIONAL MARKETING

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15.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Get acquainted with pricing concepts and their relevance in strategic marketing
- Know the product strategies in contemporary situations

15.1 INTRODUCTION

Pricing goods and services is critical to maximizing the profit of business organizations. Price is the one element of the marketing-mix that generates revenue:

the rest are costs. Pricing in markets is a controversial issue involving legal, economic, and political factors both in the practice of differential pricing as well as uniform pricing. Some international marketers argue for uniform pricing while others, however, observe that the obvious differences in the markets of various countries favour the use of an internationally differential pricing policy.

15.2 PRICING STRATEGY

International pricing strategy is an important component of the overall international marketing mix:

- ***Price discrimination:*** Price discrimination exists whenever consumers in different countries are charged different prices for the same product. Price discrimination can help a company maximize its profits. Two conditions are necessary for profitable price discrimination.
  - ❖ First, the firm must be able to keep its national markets separate. If it cannot do this, individuals or business may undercut its attempt at price discrimination by engaging in arbitrage. For example, many automobile firms have long practiced price discrimination in Europe. A Ford Escort once cost $2,000 more in Germany than it did in Belgium. This policy broke down when car dealers bought Escorts in Belgium and drove them to Germany, where they sold them at a profit for slightly less than Ford was selling Escorts in Germany.
  - ❖ The second necessary condition for profitable price discrimination is different price elasticities of demand in different countries. Demand is said to be elastic when a small change in price produces a large change in demand; it is said to be inelastic when a large change in price produces only a small change in demand.
- ***Strategic Pricing:*** The concept of strategic pricing has three aspects as predatory pricing, multipoint pricing and experience curve pricing.
  - ❖ Predatory pricing is the use of price as a competitive weapon to drive weaker competition out of a national market. Once the competitors have left the market, the firm can raise price and enjoy high profits. For such a pricing strategy to work, the firm must normally have a profitable position in another national market, which it can use to subsidize aggressive pricing in the market it is trying to monopolize. Many Japanese firms have been accused of pursuing such a policy.
  - ❖ *Multipoint Pricing Strategy:* This pricing becomes an issue when two or more international businesses compete against each other in two or major national markets. For example, multipoint pricing is an issue for Kodak and Fuji Photo because both companies compete against each other in different national markets for film products around the world.
  - ❖ *Experience Curve Pricing:* Learning effects and economies of scale underlie the experience curve. Price comes into the picture because aggressive pricing (along with aggressive promotion and advertising) can build accumulated sales volume rapidly and thus move production down the experience curve. Firm further down the experience curve bave a cost advantage vis-à-vis firms further up the curve.
- ***Regulatory Influence on Prices:*** The ability to engage in either price discrimination or strategic pricing may be limited by national or international regulations. Most important, a firm's freedom to set its own prices is constrained by antidumping regulations and competition policy.

- Damping occurs whenever a firm sells a product for a price that is less than the cost of producing it. Most regulations, however define dumping more vaguely for example, a country is allowed to bring antidumping actions against an importer under Article 6 of GATT as long as two criteria are met: sales at 'less than fair value' and 'material injury to a domestic industry'. The problem with this methodology is that it does not indicate what is a fair value. The ambiguity has led some to argue that selling abroad at prices below those in the country of origin, as opposed to below cost, is dumping.

  Example: The European Commission found Japanese exporters of dot-matrix printers to be violating dumping regulations. To correct what they saw as dumping, the EU placed a 47 per cent import duty on imports of dot-matrix printers from Japan and required that the import duty be passed on to European consumers as a price increase.

- *Competition Policy:* Most industrialized nation have regulations designed to promote competition and to restrict monopoly prices. These regulations can be used to limit the prices a firm can charge in a given country. For example, during the 1960s and 70s, the Swiss pharmaceutical manufacturer Hoffmann-LaRoche had a monopoly on the supply of Vitamin and Librium tranquilizers. The British Monopolies and Mergers Commission, which is responsible for promoting fair competition in Great Britain found that the company was overcharging for its tranquilizers and ordered the company to reduce its prices 35 to 40 percent.

15.3 CONFIGURING THE MARKETING MIX

A firm might vary aspects of its marketing mix from country to country to take into account local differences in culture, economic conditions, product and technical standards, distribution systems, government regulations, and the like. Such differences may require variation in product attributes, distribution strategy, communications strategy and pricing strategy. The cumulative effect of these factors makes it rare for a firm to adopt the same mix worldwide. For example financial services is often thought of as an industry that global standardization of the marketing mix is a norm, however while a financial services company such as American Express may sell the same basic card service worldwide, utilize the same basic fee structure for that product and adopt the same basic global advertising message (Never leave home without it) differences in national regulation still mean that it has to vary aspects of its communication strategy from country to country.

However, there are often significant opportunities for standardization along one or more elements of the marketing mix. Firms may find that it is possible and desirable to standardize their global advertising message and/or core product attributes to realize substantial cost economies. They may find it desirable to customize their distribution and pricing strategy to take advantage of their local differences.

15.4 NEW PRODUCT DEVELOPMENT

Firms that successfully develop and market new products can earn enormous returns. Examples include: DuPont, which has produced a steady stream of successful innovations such as cellophane, nylon, frelon, teflon (non-stick pans); Sony, whose successes include the Walk-man and the compact disc.

In today's world competition is about technological innovations. The pace of technological change has accelerated since the industrial revolution in the 18th century and continues to do so today. The result is shortening the product life cycles. Technological creations are both creative and destructive and innovation can make established products obsolete overnight and an innovation can also make a host of

new products possible. Witness recent changes in electronics industry for 40 years before the early 1950's, vacuum valves were a major component in radios and then in record players and early computers. The advent of transistors destroyed the market for vacuum bulbs but at the same time created new opportunities connected with transistors. Transistors took up far less space than vacuum bulbs creating a trend towards miniaturization that continues today. Microprocessors replaced transistors in the 1970's and the market for transistors declined sharply. The microprocessor created a another set of new product opportunities – pocket calculators, compact disc players, personal computers to name a few.

15.4.1 Location of R&D

Other things being equal the rate of new product development seems to be greater in countries where:

- More money spent on basic applied research and development
- Underlined demand is strong
- Consumers are affluent
- Competition is intense

Basic and applied research and development discovers new technologies and then commercializes them. Strong demand and affluent consumers create a potential market for new products. Intense competition among firms stimulates innovation as the firms try to beat their competitors and reap potentially enormous first – mover advantages that result from successful innovation.

For example United States devoted a greater proportion of its GDP to R&D than any other country did. Its scientific establishment was the largest and most active in the world. US consumers were the most affluent and the market was large and competition among US firms was brisk. Due to these factors, US was a market were most new products were developed and introduced. Accordingly, it was the best location for R&D activities.

Over the past 20 years, things have been changing fast, risk monopoly or new product development has weakened though US firms are still at the leading edge of many new technologies. Japanese and European firms are also strong players with companies such as Sony, Sharp, Ericsson, Nokia and Philips NV driving product innovation in their respective industries.

15.4.2 Integrating R&D, Marketing and Production

Tight cross functional integration between R&D, production, marketing can help a company to ensure that:

- Product development projects are driven by customer needs
- New product designed for ease of manufacturing
- Development costs are kept in check
- Time to market is minimized

Close integration between R&D and marketing is required to ensure that product development projects are driven by the need of customers.

Integration between R&D and production can help a company to design products with manufacturing requirements in mind. Designing for manufacturing can lower costs and increase product quality. Integrating R&D and production can also help lower development costs and speed products to market. Minimizing time to market and development cost may require simultaneous development of new products and processes.

15.4.3 Cross Functional Teams

One way to achieve cross functional integration is to establish cross functional product development teams composed of representatives from R&D, marketing and production. Because these functions may be located in different countries, the team will sometimes have a multinational membership. The objective of the team should be to take a product development project from the initial concept development to market introduction. A number of attributes is important for a product development team to function effectively and meet all its development milestones.

The team should be led by heavy weight project managers who has high status within the organization and who has the power and authority required to get the financial and human resources the team needs to succeed. The leader should also be able to act as an advocate of the team to senior manager.

The team should be composed of at least one member of each key function and have a number of attributes including ability to contribute functional expertise, high standing within their function, willing to share responsibility for team results and an ability to put functional and national advocacy at sight.

The team member should be if physically, if possible co-located to create a sense of camaraderie and to facilitate communication.

The team should have a clear plan and goal, particularly with regard to critical development milestones and development budgets.

Each team needs to develop its own process for communication and conflict resolution.

15.5 PRODUCT STRATEGY

Introduction

A product is a good, a service, or an idea consisting of a bundle of tangible and intangible attributes that satisfies consumers and is received in exchange for money or some other unit of value. Each product includes a bundle of attributes capable of exchange and use. Product Planning refers to the systematic decision-making related to all aspects of the development and management of the products of a company, including branding and packaging.

Levels of the Product: A product is closely associated with the need and level of satisfaction of the customers. It may be defined as an article introduced in the market that grabs attention, arouses a desire for acquisition and an image of being able to satisfy a want or need of a customer. Obviously, the hierarchy of products is based on their utility and intensity of customer satisfaction. In developing a useful product, a planner has to look upon its levels. They are core products, tangible products or augmented products. A core product or service that meets the basic need or service may be defined as the product that provides a core benefit to a customer e.g. it may be a piece of cloth, a food item or a drinking substance, irrespective of its taste, colour, aesthetic appeal etc. The product planner has to make the core product tangible to introduce it in the competitive market, allowing the customer to exercise his franchise, rationally, considering competitive advantage.

The product augmentation is asset of approaches, followed by a company in promoting its product through effective delivery and service, incentives to customers and dealers warranty-to instill customers' confidence in the product and maintain a product-oriented relation of customers with the company.

Table 15.1: Exhibits the Nature and Levels of the Product

Levels of product	Marketing variables	Orientation	
Core product	Basic need Basic service Core benefits	Customer	'company-customer' oriented relationship in the market. The product levels also determine the selling process to a large extent. The core products play an important role in product planning while the tangible products initiate the sales management process. The augmented products drive the concept of extended sales mechanism for marketing expansion and product diversification.
Tangible product	Quality Features, Style, Design, Brand packaging	Market and customer	
Augmented product	Delivery and service	Company and customer	

15.5.1 Product Hierarchy

The product hierarchy is the intra-level characteristics of the three broad levels of products-core, tangible and augmented. In order to recognize core product, marketers must first define what core benefits the product will provide to the customer. The actual product must be built around the core product. The product has four characteristics:

- Quality level
- Features
- Brand name
- Packaging

All these attributes combined together carefully deliver the core benefit(s) of the product. The augmented offers additional consumer benefits and service such as warranty and customer training.

The product hierarchy is exhibited in Table 15.2 in reference to its attributes.

Table 15.2

Product Hierarchy	Nature
Need family	Basic need that contributes product family
Product family	All the product classes that satisfy the basic need with varying degrees of satisfaction
Product class	A group of products within the product family having utility advantages
Product-line	Types of products in product class and number of items pertaining to specific size, colour, quality, etc., in each type
Product type	Different forms of product in terms of quality and usage
Brand	an associated name of items in product-line for identification of particular items and quality A certification of federation or group of companies manufacturing similar products to certify quality.
Item	A particular product passed through all above hierarchical stages

15.5.2 International Product-Line Analysis

Product line analysis is a component of product mix which a company offers to the customers exhibiting the length and width of the range of products. The analysis of product-line depends on two important information sources. These are (i) volume of sales and profit on each item and (ii) competitors' product-line in the same market or

segment. The product line manager of the company should be aware that each item of the product-line contributes considerably to gross sales and profit.

Table 15.3 presents the different components of the product-line analysis and tasks involved thereof.

Table 15.3

Analysis components	Task	Approach
Sales and profit	Identifying vulnerable items on product-line	Quantitative and time-series data on variables
Market profile	Product positioning	Competitive product profiles analysis-physical and monetary
Line length	Optimal length comprising a number of items	Analysis of stretching and filing options
Stretching	Increasing product line	Downward/Upward
Filling	Adding new/missing items	Lowering the product price or re-launch
Featuring	Increasing profit and volume of sales	Customer orientation to me made at high end of line with a matching price
Pruning	Scanning items on the product line to optimize profit and reduce marketing expenditure.	Cost-effective decision-making, eliminating low sales items.
Modernization	Product diversification and new product-line	Market segmentation, demand analysis and pricing strategies.

Adding New Products Line

An international firm should develop country-specific product-lines in order to be successful in the overseas market. To achieve this viability, the composition of the product-line needs to be periodically reviewed and changed. Such environmental changes as customer preferences, competitors' tactics, host country legal requirements, and a firm's own prescriptive including its objectives, cost structure, and spill over of a demand from one product to another, can all render a product-line inadequate. Thus it may become necessary to add new products or eliminate existing products from the product-line to customize the product-line specific to each country. Alternatively, certain specific products may be added for a particular foreign country, or in the home country. The extension of domestic products to foreign markets follows the logic of the concept of the international product life cycle. Such product extension into the market of host country is generally adopted through a process wherein the products are developed first for the home market that may prove successful and lead to some export orders. As exports grow, the firm may consider setting up a warehouse, a sales branch, or a service centre in the foreign locate.

15.5.3 Product Design Strategy

The product and business strategies of a foreign firm should be developed in reference to the macroeconomic conditions of the host country. In other words, the definition of the product objectives should emerge from business definitions developed in accordance with the macroeconomic requirements of the host country. Foreign firms need to analyze whether the success of their product or product-line can be replicated in a new market destination abroad and explore the factors that may lead the product approach In the host country success. A decision must be made about which is more appropriate of two product design strategies-*standardization* or *customization*. *Standardization* refers to offering a common product on a national, regional, or world-wide basis, while *customization* signifies adopting a product by making appropriate changes in it, to match the local prescriptive.

15.5.4 Product Life Cycle Management (PLC)

The international markets are not always homogeneous and markets in different countries for a given product display different stages of development at the same time. The phenomenon may be explained through the product life cycle concept wherein products go through several life cycle stages over a period of time, and in each stage different marketing strategies are appropriate. There are four stages usually identified with the process: introduction, growth, maturity, and decline, even for the products distributed in markets overseas.

At the introduction stage of the product in the segmented, profit remains almost non-existent and product sales can be slow. Heavy expenditure is incurred in pushing the product into the market. The product then passes into the next stage i.e. growth-with improved sales and profit conditions mirroring the rapid acceptance of the product in the market. The product remains in the growth stage till the competition increases and negatively affects the sales of the existing product. At this juncture, the product moves into the stage of maturity where it faces setback of the volume of sales but succeeds in sustaining the profit level. Then comes the stage of decline, the product faces a downward trend in both the volume of sales and profit, reaching the point where it doesn't make any sense in retaining it in the product-line up.

Check Your Progress

Fill in the blanks:

Major Strategies at the Growth Stage:

1. Rationalizing the ....
2. Innovative ....
3. Identifying ....
4. Evolving the comprehensive ....

15.5.5 New Product Development

It is necessary to understand and accommodate the needs of consumers, counter competitive threats, ensure ability of post sales services and take into account the cost of marketing the product. Despite the risks involved, however, new product development is essential and companies need to make continuous efforts to develop new products, in order to beat competitors. It must be noted that new product failures are quite high (80%) in case of products and about 75% in case of services.

Factors that obstruct the growth of new products are:

- Limited creativity and paucity of new (and eminently useful) products ideas.
- Fragmented markets
- Social, economical and technological limitations
- Government policies and restrictions
- Cost effectiveness of the process of new product development
- Resource crisis at various levels in the process, extending from the state of product development to launching in the market
- Overly extended product development and launching time. and
- Short product life cycle-meaning rather rapid technological obsolescence or being displaced by better copy-cat versions.

The companies should strengthen their marketing network simultaneously while launching the new products. It has been observed that the failure of new products is

often due to lack of organizational teamwork. Thus it is required to inculcate team behaviour in developing the new products and popularizing them in the test market segment. The results of the test markets may be further tested in larger segments.

15.5.6 Product Planning Strategy

The product must be capable of earning substantial revenues to recover the full investment that the company has put into it, i.e. the cost of design, manufacturing and inventory, market research, sampling and logistics and physical distribution. The product manager has to ensure that the marketing programs are designed to attain faster recovery of investments. It is therefore necessary to enter the global market in the existing era of competition with proper product planning. The following also needs to be considered:

- The product launch must be carried out in an energetic and creative style with effective promotional packages.
- This may provide the marketer opportunity for wide coverage of the market at low margins, which helps it to become the market leader as no competitors may be able to sustain at low margins, due to economic problems associated with economies of scale.
- It is necessary to position the new products in the new segments carefully by building image of the brand, by means of a pre-launch publicity blitz, swamping the competitive pricing strategy would help the product to penetrate into the market against competing brands in the new segment.
- At the same time, it is required of the marketer to refresh the consumer behavioiur periodically and reorient brand image in tune with the existing consumer segment by constantly building better communication strategies. The success stories of the product would help in carrying out such a process.

Figure 15.1 Exhibits the product planning strategy in the new and existing consumer segments.

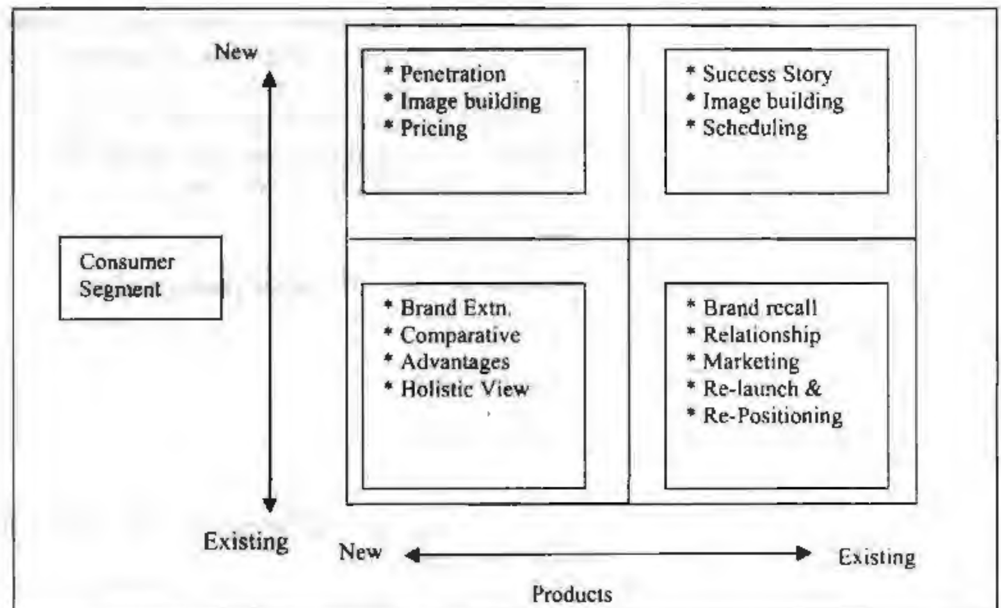

Figure 15.1

15.5.7 Product Portfolio Matrix

A good planning system must guide the develop of strategic alternatives for the current businesses and new business possibilities of the company. It must also provide

for management's review of these strategic alternatives and for the corresponding resource allocating decisions. The result is a set of approved business plans that represent the direction of the firm. The top management can and should establish a conceptual framework within these alternatives can be developed. One such framework is the portfolio matrix associated with the Boston Consulting Group (BCG). Briefly the portfolio matrix is used to establish the best mix of businesses in order to, maximize the long-term earnings growth of the firm. The portfolio matrix represents a real advance to strategic planning in several ways:

- It encourages top management to evaluate the prospects of each of the company's businesses individually and to set tailored objectives for each business based on the contribution it can realistically make to corporate goals.
- It stimulates the use of externally focused empirical data to supplement managerial judgment in evaluating the potential of a particular business.
- It explicitly raised the issue of cash flow balancing as management plans for expansion and growth.
- It gives mangers a potent new tool for analyzing competitors and for predicting competitive responses to strategic moves.
- It provides not only a financial but also a strategic context for evaluating acquisitions and divestures.

The portfolio matrix approach has given top management the tools to evaluate each business in context of its environment and its unique contribution to the goals of the company as a whole. It has enabled them to weigh the entire array of business opportunities available to the company against the financial resources required to support them. The portfolio matrix concept addresses the issue of the potential value of a particular business for the firm. This value has two variables; the potential for generating attractive earnings levels now and second, the potential for growth i.e. for significantly increased earnings levels in the future.

15.5.8 Dimensions of Product Strategies

Product strategies specify market needs that may be served by different product offerings. The product strategies of the company are duly related to market strategies that eventually come to dominate both the overall strategy and the spirit of the company. Product strategies deal with matters such as number and diversity of products, product innovation, product scope, and product design.

The implementation of product strategies requires cooperation among different groups: finance, research and developments, the corporate staff, and marketing. This level of integration makes product strategies difficult to develop and implement. In many companies, to achieve proper coordination among diverse business units, product strategy decisions are made by top management. In some companies the overall scope of product strategy is laid out at the corporate level, whereas actual design is left to business units. The different product strategies that a company should develop at an appropriate time are listed below:

- Product-positioning strategy
- Product-repositioning strategy
- Product-overlap strategy
- Product-scope strategy
- Product-design strategy
- Product-elimination strategy
- New product strategy

- Diversification strategy
- Value-marketing strategy

Each strategy is examined from the point of view of a business unit or profit centre. The term 'positioning' refers to placing a brand in that part of the market where it will receive a favourable reception compared to competing products. The product should be positioned so that it stands apart from competing brands. Positioning tells what the product stands for, what it is, and how customers should evaluate it. Positioning is achieved by using marketing-mix variables, especially design and communication. Although differentiation through positioning is more visible in consumer goods, it is equally true of industrial goods. With some products, positioning can be achieved on the basis of tangible differences (e.g. product features); with many others, intangibles are used to differentiate and position products.

15.5.9 Types of Positioning Strategies

The type of positioning strategies may be identified as single-brand strategy and multiple-brand strategy. A company may be identified as single-brand strategy and multiple-brand strategy. A company may have just one brand that it may place in one or more chosen market segments, or, alternatively, it may have several brands positioned in different segments simultaneously.

15.5.10 Types of Product Strategy

The product overlap strategy may be understood as competing against one's own brand through introduction of competing products, use of private labelling, and selling to original-equipment manufacturers.

The product scope strategy (PPS) deals with the perspectives of the product mix of a company. The product scope strategy is determined by taking into account the overall mission of the business unit. The company may adopt a single-product strategy, a multiple-product strategy, or a system-of-products strategy. To increase economies of scale by developing specialization for the single product a company may focus the PSS.

The product-design strategy deals with the degree with the degree of standardization of a product. The company has a choice among the following strategic options, viz. standard product, customized product, and standard product with modifications. To develop the standard product, the company should aim to increase economies of scale while it focuses the strategy for customized product to compete against mass producers of standard products through product design flexibility.

A new product strategy is difficult to implement if a 'new product development system' does not exist within a company. Five components of this system should be assessed: (a) corporate aspirations towards new products, (b) organizational openness to creativity, (c) environmental favour towards creativity, (d) screening method for new ideas, and (e) evaluation process.

The product diversification strategy is developed for developing unfamiliar products and markets through (a) concentric diversification (products introduced are related to existing ones in terms of marketing or technology) (b) horizontal diversification (new products are unrelated to exiting ones but are sold to the same customers), and (c) conglomerate diversification (products are entirely new).

The value marketing strategy concerns delivering on promises made for the product or service. These promises involve product quality, consumer service, and meeting time commitments. Value-marketing strategies are directed toward seeking total consumer satisfaction. It means striving for excellence to meet customer expectations.

15.6 LET US SUM UP

International pricing strategy is an important component of the overall international marketing mix. Price discrimination exists whenever consumers in different countries are charged different prices for the same product.

The concept of strategic price has three aspects as predatory pricing, multipoint pricing and experience curve pricing. The ability to engage either in price discrimination or strategic pricing may be limited by national or international regulations.

A firm might vary aspects of its marketing mix from country to country to take into account local differences in culture, economic conditions, product and technical standards, distribution systems, government regulations, and the like. Such differences may require variation in product attributes, distribution strategy, communications strategy and pricing strategy.

Other things being equal the rate of new product development seems to be greater in countries where: (i) More money spent on basic applied research and development (ii) Underlined demand is strong (iii) Consumers are affluent (iv) Competition is intense.

A product is closely associated with the need and level of satisfaction of the customers. It may be defined as an article introduced in the market that grabs attention, arouses a desire for acquisition and an image of being able to satisfy a want or need of a customer.

The product hierarchy is the intra-level characteristics of the three broad levels of products-core, tangible and augmented.

The definition of the product objectives of a foreign firm should emerge from business definitions developed in accordance with the macroeconomic requirements of the host country.

The international markets are not always homogeneous and markets in different countries for a given product display different stages of development at the same time. The phenomenon may be explained through the product life cycle concept wherein products go through several life cycle stages over a period of time, and in each stage different marketing strategies are appropriate.

Despite the risks involved, new product development is essential in international market and companies need to make continuous efforts to develop new products, in order to beat competitors. The product must be capable of earning substantial revenues to recover the full investment that the company bas put into it, i.e. the cost of design, manufacturing and inventory, market research, sampling and logistics and physical distribution.

The portfolio matrix approach has given top management the tools to evaluate each business in context of its environment and its unique contribution to the goals of the company as a whole.

The product should be positioned so that it stands apart from competing brands. Positioning tells what the product stands for, what it is, and how customers should evaluate it. Positioning is achieved by using marketing-mix variables, especially design and communication.

15.7 LESSON END ACTIVITY

Formulate a new product development strategy for BMW Z38 series. Study the attributes of the products, company profile, service strategy and approaches for customer delight. Visit the website of BMW for more information (*website:*www.bmw.com)

15.8 KEYWORD

Product Life Cycle: Products go through several life cycle stages over a period of time, and in each stage different marketing strategies are appropriate. There are four stages usually identified with the process: introduction, growth, maturity, and decline, even for the products distributed in markets overseas.

15.9 QUESTIONS FOR DISCUSSION

1. How can you describe the global marketplace of a multinational company? What are the factors that influence the decision process of multinational companies while identifying opportunities for global business?
2. Is it necessary for companies to develop appropriate segmentation techniques for conducting business in their host countries? Discuss the different approaches by which multinational companies segment global markets.
3. Discuss the process of perpetual mapping approach of market segmentation. How can a multinational company attain long-term benefits of deriving consumer segments through perpetual mapping methods?
4. Which is the most appropriate strategy for grouping countries with a view to develop effective logistics and communication networks by multi-domestic companies? Discuss the corporative advantages and losses in reference to the rest of the grouping approaches.
5. What is a product line? How can the product-line be managed for optimum business results?
6. Critically examine the different product strategies and discuss their relevance in reference to the product life cycle.
7. Discuss the factors affecting firms in product-line management in the overseas market. What care must be taken by the firms for adding new product-line specific to each market overseas?
8. What is the importance of the product portfolio matrix and how can it be explained for the company that is in the stage of introduction and decline?

Check Your Progress: Model Answer

1. product-line and width
2. promotional approaches
3. new market segments
4. distribution strategy

15.10 SUGGESTED READINGS

Cherenilan Francis, *International Economics*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Charles W.L. Hill, *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited

Rajagopal, *International Marketing*, 1st Edition, Vikas Publishing House Pvt. Ltd.

Justin Paul, *International Business*, (3rd ed.), Prentice Hall of India.

LESSON

16

INTERNATIONAL DISTRIBUTION

CONTENTS

16.0 Aims and Objectives

16.1 Introduction to International Distribution

16.2 International Channel System

16.3 Channel(s) for the Distribution

16.4 Marketing Environment and Internal Distribution

16.4.1 Factors Influencing Channel Selection

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16.6 Let us Sum up

16.7 Lesson End Activity

16.8 Keyword

16.9 Questions for Discussion

16.10 Suggested Readings

16.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Describe various channels of international distribution
- Identify factors that affect channel selection

16.1 INTRODUCTION TO INTERNATIONAL DISTRIBUTION

Effectiveness of marketing depends, among other things, on making the product available at the right places and at the right time at the minimum possible distribution cost.

A distribution channel may be defined as "the path traced in the direct or indirect transfer of title to a product as it moves from a producer to ultimate consumers or individual users." A distribution channel, in other words, is "the set of firms and individuals that take title, or assist in transferring title, to the particular good or service as it moves from the producer to the consumers".

16.2 INTERNATIONAL CHANNEL SYSTEM

Where international marketing involves exporting, two categories of marketing channels are involved, viz. channels between the nations and channels within the foreign market.

The international distribution system consists of two subsystems, namely, the domestic system and the foreign system. The nature of channel system is affected by

among other things, by the method of exporting. There are broadly two ways of exporting, namely, direct exporting and indirect exporting.

- ***Indirect exporting:*** Here the manufacturer uses the services of various types of independent international marketing middlemen or cooperative organizations. The indirect method is more popular with firms which are just beginning their exporting activities and that with those whose export business is not considerable. The main disadvantage of the indirect method of exporting is that the development of overseas market depends to a very large extent on the middlemen and not on the firm producing the export goods.
- ***Direct exporting:*** In this case the responsibility for performing international selling activities rests on the producer. These activities are carried out by so called dependent organizations that are administratively a part of the manufacturer's company organization.

Broadly, two alternative channels are available for indirect exporting-international marketing middlemen and co-operative organizations.

1. ***International Marketing Middlemen:*** There are two important middlemen-merchants and agents. The basis distinction between the merchant and the agent is that the merchant takes title to the product he sells while the agent does not.
   (a) *Export merchants:* The domestic based export merchant buys the manufacturer's product and sells it abroad on his own. When this type of middlemen is used in an international marketing channel, the marketing job of the manufacturer is reduced to essentially domestic marketing and except for certain modifications in the product mix which are sometimes required to suit the international market, all aspects of the international marketing task are handled by this merchant.
   (b) *Export/Trading houses:* India there area number of merchant exporters including export houses and different categories of trading houses who export products procured from many manufacturers. Some companies have established their own export marketing subsidiaries.
   (c) *Trading companies:* Unlike an export house which concentrates on exports, a trading company is active both in exports and imports. In Japan, the general, trading companies are known as sogo shosba and include well known MNCs as Mitsubishi, Mitsui and Itochu.
   (d) *Export drop shipper:* In some countries, there is a special kind of export merchant known by such names are export drop shipper, desk jobber or cable merchant. Upon receipt of an order from overseas, the export drop shipper in turn places an order with the manufacturer, directing the manufacturer to deliver the product directly to the foreign huyer. The manufacturer collects payment from the drop shipper who in turn is paid by the foreign buyer. Export drop shippers are common in the international marketing of bulky products of low unit value like coal and construction materials.
   (e) *Agents/Brokers:* The second type of marketing middlemen in the indirect exporting is the domestic based agent. Unlike the marketing middlemen, the agent does not take the title to the goods; he simply seeks overseas buyers for a commission. In this case the manufacturer assumes all the financial risks.
2. ***Co-operative Organizations:*** The co-operative exporting organizations, which represents a cross between indirect and direct export, carries on exporting activities on behalf of several producers, and is partly under the administrative control of the manufacturers.

There are two distinct types of co-operative international marketing organizations:

1. Piggyback marketing
2. Exporting combinations

Under Piggyback marketing, also known as mother-henning or allied company arrangement, one manufacturer uses its overseas distribution facilities to sell the products of one or more other company/companies as well as his own.

As exporting combination is more or less a formal association of independent and competitive business firms which are organized for the purpose of export marketing for the mutual benefit.

- ***Direct Export:*** As the name indicates, direct export refers to the sale in the foreign market directly by the manufacturer. The manufacturer may make the sale directly to the foreign customers or to a middlemen located in the overseas market. In both the cases, the export is direct-manufacturer does not use any independent middlemen in the channel between the home country and the overseas market.

Firms with considerable export business usually resort to direct exporting. Of course, the investment and risk involved in direct exporting are great; but so are the potential returns.

A number or organizational arrangements are available to a company for carrying on direct exporting:

(a) The export business may be conducted by a domestic based export department or division. There are four important types of domestic-based export organizations.

(i) built-in export department; (ii) Separate export department; (iii) export sales subsidiary; and (iv) export combination, or co-operative export company.

(b) The company may establish overseas sales branches or subsidiaries in addition to, or instead of, a domestic marketing department. An overseas sales branch enables a company to carry out the marketing activities in the foreign market more effectively.

(c) A company may employ traveling salesmen for the overseas market. These traveling salesmen may be home-based or may be attached to the foreign branches or subsidiaries.

(d) Direct exporting may also be carried out by establishing contacts worth foreign-based distributors or agents. The distributors would buy the goods from the manufacturer and sell them in the overseas market, whereas the agents would sell on the manufacturer's behalf on commission basis.

16.3 CHANNEL(S) FOR THE DISTRIBUTION

Channel(s) for the distribution of a product may be different in different countries. A channel which is effective in one country may not be effective or available in another country. Let us take a general look at the common distribution channels or channel levels.

The channel levels refer to the number of intermediaries involved in the channel. The following are the channel levels.

Zero level channel also called direct marketing channel, is essentially characterized by the producer making a direct sales to the ultimate buyer. Three important ways of direct selling are (1) Door to door; (2) Mail order and (3) Manufacturer-owned stores.

One level channel is characterized by one selling intermediary like the retailer or agent.

Two-level channel contains two intermediaries, e.g. wholesaler/distributor and retailer.

Three-level channel has three intermediaries, i.e. agents, wholesalers and retailers.

There are also higher level channels.

Types of Foreign Intermediaries

The important foreign subsidiaries are given below:

Importers: The term importer refers to one who imports the product in large quantities either as an agent for a foreign buyer or for resale. Such importers include, among others, large import houses and trading houses like the Japanese trading companies. The importers who buy on their own account may sell the product to the distributors, industrial and other institutional customers, wholesalers etc.

Distributors: A distributor who buys directly from the exporter and holds large stocks of a product has an exclusive right to sell the product in a particular area or to a particular type of customer.

Wholesalers: Although wholesalers often buy from the importers or distributors, there are also wholesalers who buy directly from the exporters.

Retailers: Large retailers may buy directly from the exporters. Department stores, supermarkets or other types of chain stores are among the most important direct retail buyers. Other retailers may depend on distributors or wholesalers.

Multiple channels: In some cases, an exporter may use multiple channels, i.e. more than one channel for a product. For example, an exporter may sell directly to the wholesalers, large retailers and institutional consumers, even while having distributors.

Government departments: In some countries government departments buy large quantities of certain goods, often on a long-term basis. These are generally essential goods of mass consumption or for use in government departments.

State buying organizations: In some countries the imports of goods are done by the government organizations, like state trading organizations. This was the case until recently in the centrally planned economies. In India, imports of several commodities are canalized, i.e. only designated government agencies can import these goods.

Joint-ventures and licensees/Franchisees: A very important export marketing channel that is growing in popularity is the collaborative arrangement between exporter and foreign firm.

Joint ventures i.e. enterprises in which both ownership and participate in the equity in joint ventures in developing countries. The collaboration with the developed country firm becomes very helpful in marketing the product in the foreign countries.

Another type of international collaboration is the licensing or franchising.

16.4 MARKETING ENVIRONMENT AND INTERNAL DISTRIBUTION

Though the basic factors which influence the choice of distribution channels within the foreign markets are the same as in the domestic market, the distribution strategy for a market should be based on, among other things, the relevant environmental factors as given below:

- A particular distribution channel best suited for a product in one market may be inappropriate in another market. Sometimes, the exporter will have to take the existing distribution system in the foreign market for granted. For instance, when

customers are accustomed to buying a particular product from a particular source, it is not easy to switch them to a different source.

- Within-country channels of distribution vary considerably from country to country for consumer goods. For example, food channels in the USA are dominated by the large supermarket channels; in France, supermarkets are progressing, but food retailing is still dominated by small merchants with modest stores; in India food is sold mainly through thousands of individual tradesmen squatting in open markets or selling in tiny shops.
- The services provided by retailers vary considerably, with much more personal attention and bargaining in countries such as India than in western countries. As against this, in the high income countries like the USA, self-service is the dominant pattern.
- The assortment of goods handled by retailers varies, tending toward greater specialization in lower-income economies.
- The retailing system tends to be stratified in levels that parallel the class structure of society. There will be exclusive stores that cater to the wealthy, others that serve the middle class, and still others, usually open markets and "hole-in the wall shops" that sell goods to the low-income groups.
- While super market and chain stores play a dominant role in certain markets like the US and Japan, in Europe that are not so well developed and in many countries they are either absent or are insignificant.
- Mass merchandisers as the US giants Sears and K-mart place huge orders with suppliers and keep large inventories. In Europe, however, there are not so many huge chain operations. So exporters who are accustomed to selling the US giants encounter a different situation in Europe.
- The international retailing firms. i.e. firms operating in two or more countries have been growing in importance. These include both general merchandise retailers and specialized retailers. There has also been a growth of international mail order business. Sears, F.W. Woolworth, K. Mart and Marks and Spenser are among the important general merchandise retailers. International specialized retailers include Mothercare (clothes and related items), Roche and Bobois (furniture), etc. There are also fast-food franchisers like McDonald's, Pizza Hut, Burger King and Kentucky Fried Chicken.
- The distribution system of a country may have some other peculiarities too. For example, the trade in one or other product in several countries is characterized by ethno-domination which is defined as a situation where an ethnic group occupies a majority position in a channel of distribution with respect to the ownership and control of physical and financial resources, or through the familiar coercive and collusive practices such as price setting (in both product and factor markets), exclusive dealing arrangements and discrimination among customers or suppliers. In many cases of ethno-domination, it would be beneficial for the international marketer to co-opt rather than compete with the dominant ethnic group.
- Many foreign affiliated companies failed in the Japanese market due to the difficulty of getting their goods out to the retailers. It is therefore felt that choosing a right partner for a joint venture arrangement can have a major impact on a firm's competitiveness. The right partner can serve as a cultural bridge between the manufacturer and the market. Nabisco is a good example of a company that has dealt appropriately with cultural differences in country like Japan.

16.4.1 Factors Influencing Channel Selection

The important factors influencing the choice of channels are the following:

- ***Product characteristics:*** Product characteristics like, unit value, perishability, bulk, degree of product standardization, complexity and service requirements, determine, to some extent, the way the product should be distributed.
- ***Market and customer characteristics:*** Such as the size and location of the market, the number and geographical dispersal of the customers, the frequency of purchase and the typical size of the purchase, customers' buying habits and susceptibility to different selling methods are important factors to be considered in the choice of the channel.
- ***Middlemen characteristics:*** Middlemen differ in their ability and willingness to carryout promotional activities and to push the product. The margin or commission for the middlemen is another important issue. The type of product dealt with by a middlemen is another important issue. The type of product dealt with by a particular intermediary should also be an important consideration. Further, the marketer may be restricted in his choice of channel by the non-availability of particular middlemen
- ***Company characteristics and objectives:*** This includes such factors as the company's size, financial strength, product mix, past channel experience, overall marketing policies and channel objectives.
- ***Competitors' characteristics:*** Some times it may be appropriate to adopt a channel policy similar to that of the competitor, but sometimes it may be more profitable to design quite a different channel policy.
- ***Environmental characteristics:*** These include environmental factors such as the economic situation, social and cultural factors, the physical environment and government policies and regulations.

16.5 SIX Cs IN INTERNATIONAL MANAGEMENT

Creation of Value

Two basic conditions determine firms profit (II):

1. The value customers place on the firms goods or services and
2. The firms cost of production

In general the more value customers place on a firms products, the higher price the firm can charge for those products. However the price a firm charges for goods and services is typically less than the value placed by the customer on those goods and services. This is because the customer captures some of the value in the form of what economists call 'consumer's surplus'. The customer is able to do so because the firm is competing with other firms for the customer's business so the firm must charge a lower price than it could if it was a monopoly supplier. Also, it is normally impossible to segment the market to such a degree that the firm can charge each customer a price that reflects individual's assessment of the value of a product which economist's refer as 'customer's reservation price'.

Cost

The value created by a firm is measured by the difference between V and C (V-C); the company creates value by converting inputs that cost (C) into a product on which consumer's place a value of V. A company can create more value for its customers either by lowering production cost (C) or making the product more attractive through superior design, functionality, quality and the like so that consumer's place a greater value on it and consequently are willing to pay a high price. This discussion suggests

that a firm has high profits when it creates more value for its customers and does so at lower costs. Strategy can be referred to as that which focuses on lowering production costs as a low cost strategy. Similarly, strategy that focuses on increasing the attractiveness of the product can be called as a differential strategy. Michael Porter has argued that low cost and differential are two basic strategies for creating value and attaining a competitive advantage in an industry. According to Porter superior profitability is earned by those firms that can create superior value and the way to create superior value is to drive down the cost structure of the business and/or differentiate the product in some way so that consumers value it more and are prepared to pay a premium price. Superior value creation as compared to rivals does not necessarily require a firm to have a lowest cost structure in an industry or to create the most valuable product in the eyes of the consumers.

Channels of Distribution

Place, i.e., placing the product, is one of the four P's of marketing and it refers to the distribution of the product covering channels of distribution and physical distribution. Effectiveness of marketing depends, among other things, on making the product available at the right places and at the right time at the minimum possible distribution cost.

A distribution channel may be defined as "the path traced in the direct or indirect transfer of title to a product as it moves from a producer to ultimate consumers or individual users." A distribution channel, in other words, is "the set of firms and individuals that take title, or assist in transferring title, to the particular good or service as it moves from the producer to the consumers."

Where international marketing involves exporting, two categories of marketing channels are involved, viz. channels between the nations and channels within the foreign market.

The international distribution system consists of two subsystems, namely, the domestic system and the foreign system. The nature of channel system is affected by among other things, by the method of exporting. There are broadly two ways of exporting, namely, direct exporting and indirect exporting.

Communication or Promotion

Marketing communication or promotion, plays a very important role in marketing, both domestic and international.

Communication performs one or more or all of the following function-

1. Making the potential consumers aware of the product.
2. Persuading the consumers to buy the product.
3. Motivating the consumers to buy the product by special incentives.
4. Reassuring the consumers and helping to overcome the post-purchase dissonance.
5. Informing the channels to handle the product.
6. Promoting the image of the company.
7. Promoting the image of the country.

Control Strategies

Control is necessary to achieve international objectives. It is much more than just the ownership of some voting share to direct company policy. Control is management planning, implementation, evaluation and correction of performance to ensure that the organization meets its objectives. The top management's toughest challenge is to balance the company's global needs with its need to adapt to country level differences.

Control keeps a company's decisions or strategy on track. Control is also needed so that individuals cannot make decisions that may endanger the entire company.

Country Image

The overall attractiveness of a country as a potential market and/or investment site for an international business depends on balancing the benefits, costs, and risks associated with doing business in that country. Generally, the costs and risks associated with doing business in a foreign country are typically lower in economically advanced and politically stable democratic nations and greater in less developed and politically unstable nations. The calculus is complicated, however, by the fact that the potential long-run benefits are not only dependent upon a nation's current stage of economic development or political stability. Rather, the benefits depend on likely future economic growth rates.

16.6 LET US SUM UP

The international distribution system consists of two subsystems, namely, the domestic system and the foreign system. There are broadly two ways of exporting, namely, direct exporting and indirect exporting.

Broadly, two alternative channels are available for indirect exporting-international marketing middlemen and co-operative organizations.

The channel levels refer to the number of intermediaries involved in the channel. Channel(s) for the distribution–Zero level, One level, Two level, Three level.

The important types of foreign subsidiaries are–importers, distributors, wholesalers, retailers, multiple channels, Government departments, state buying organizations, joint venture and licenses/franchises.

Though the basic factors which influence the choice of distribution channels within the foreign markets are the same as in the domestic market, the distribution strategy for a market should be based on, among other things, the relevant environmental factors.

The important factors influencing the choice of channels are the following: product characteristics, market and customer characteristics, middlemen characteristics, company characteristics and objectives, competitors characteristics, environmental characteristics

Six 6Cs in international management are creation of value, cost, channels of distribution, communication or promotion, control strategies, country image

16.7 LESSON END ACTIVITY

Though the basic factors which influence the choice of distribution channels within the foreign markets are the same as in the domestic market, the distribution strategy for a market should be based on, among other things, the relevant environmental factors. Discuss them in detail.

16.8 KEYWORD

Distribution channel: It is the path traced in the direct or indirect transfer of title to a product as it moves from a producer to ultimate consumers or individual users.

16.9 QUESTIONS FOR DISCUSSION

1. Where international marketing involves exporting, two categories of marketing channels are involved-what are they?

2. Channel(s) for the distribution of a product may be different in different countries. A channel which is effective in one country may not be effective or available in another country. What are the channels referred here?
3. What are the important factors influencing the choice of channels?
4. Discuss 6Cs in International Marketing.

16.10 SUGGESTED READINGS

Cherenilan Francis, *International Business: Text and Cases*, 3rd Edition, Prentice-Hall of India Private Limited.

Charles W.L. Hill, *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Justin Paul, *International Business*, (3rd ed.), Prentice Hall of India.

LESSON

17

INTERNATIONAL PROMOTION AND ON-LINE MARKETING

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17.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- Why marketing communication or promotion, plays a very important role in marketing, both domestic and international

17.1 INTRODUCTION

The word communication in marketing simply means the transmission of a message, to the buyer or the consumer or the channel of distribution, in which the supplying company aims to tell each one of those receiver why they should buy or handle the product.

1. Communication performs one or more or all of the following function.
2. Making the potential consumers aware of the product.
3. Persuading the consumers to buy the product.

4. Motivating the consumers to buy the product by special incentives.
5. Reassuring the consumers and helping to overcome the post-purchase dissonance.
6. Informing the channels to handle the product.
7. Promoting the image of the company.
8. Promoting the image of the country.

17.2 MARKETING ENVIRONMENT AND PROMOTION STRATEGIES

Because of the differences in the marketing environment, promotion is often a very complex problem in international, particularly in multinational marketing. Even when the same product is marketed in other countries without any modification, sometimes it is necessary to modify the promotional theme. Hence the promotion strategy will have to be tailor-made to suit the particular marketing environments.

17.3 MAJOR DECISIONS IN INTERNATIONAL MARKETING COMMUNICATION

The important steps in developing an effective communication are the following:

1. ***Identifying the Target Audience:*** Even for the same product the target audience may be different in different countries. For example, bicycles are basic means of transportation in countries like India and the important category of consumers are small farmers, blue-collar workers and students. In some of the advanced countries, bicycles are used for sporting and exercising and hence the target audience is different.
2. ***Determining the Communication Objectives:*** The communication objective may be different in some cases. For example, when the product is in the introduction stage in a market the emphasis of communication could be on consumer education and creation of primary demand. In a market where the product is at other stages of the life cycle, the communication objectives would be different.
3. ***Determining the Message:*** Kotler points out that "formulating the message will require solving four problems: what to say (message content), how to say it logically (message structure), hot to say it symbolically (message format), and who say it (message source)."
4. ***Budget Decisions:*** The common methods used to set promotion budgets are the following:
   - Affordable method
   - Percentage of sales method
   - Objective and task method-involves determining the communication objectives and the tasks involved in achieving the objectives and estimating the expenditure requirements for performing these tasks.
   - Competitive parity method i.e. in line with the competitors.
5. ***Communication Mix Decision:*** Difference in the marketing environment may necessitate variations in the communication mix because a channel or medium that is very effective in one market may not be so effective in another market.

17.4 COMMUNICATION MIX

The communication mix , also called promotion mix has four major tolls or channels, viz. advertising, sales promotion, personal selling and public relations. Which

communication tool or tools should be used is determined by the marketing environment and the company's objectives and resources.

Advertising: Advertising is defined as any paid form of non-personal presentation and promotion of ideas, goods or services by an identified sponsor.

Advertising regulations differ between countries. The relative effectiveness of different media may be different in different countries. Similarly, media availability and efficiency may also vary.

Sales Promotion: Sales promotion is defined as short-term incentives to encourage purchase or sale of a product or service. Sales promotion includes many things like trade fairs and exhibitions, samples, gifts, contests, games, lotteries etc.

Personal Selling: Personal selling is defined as oral presentation in a conversation with one or more prospective purchasers for the purpose of making sales. Personal selling may be preferable when the product is technical in nature, is of high value, and the number of customers is limited

Public Relations: Public relations include a variety of programs designed to improve, maintain, or project a company or product image.

An important form of public relations is getting positive news and reports about the product or company released through media. This is of particular significance to new products.

The export promotion organizations in India e.g. Export Promotion Councils (EPCs), Export Development Authorities, Commodity Boards, India Trade Promotion Organization (ITPO), EXIM Bank etc., can playa very important role in promoting Indian products abroad.

17.5 PROBLEMS IN INTERNATIONAL MARKETING COMMUNICATION

Important problems or factors those, make the development of international communication difficult are the following:

1. ***Differences in regulations:*** An exporter has to understand regulations governing promotion and ensure that the promotion programs are in conformity with such varying regulations of each country.
2. ***Cultural differences:*** The cultural factors are very complex and difficult to understand and play an important role in designing the advertising strategy, particularly the message design. The differences in consumer behaviour and consumption habits are also very important factors to be considered in designing the communication strategy.
3. ***Media factors:*** The effectiveness of media, the availability of media, the cost of media, etc. differ between countries and this may call for different promotional media strategies in different countries.
4. ***Infrastructure:*** These include the availability and equality of advertising agencies, marketing research firms, etc.
5. ***Cost factors:*** The cost of promotion, particularly advertising, in advanced countries is often prohibitively costly for Indian exporters who, in general, are of small means. The advertisement outlay should normally be very large if it should have any impact.
6. ***Language factors:*** There are many instances of the language causing problems in international marketing communication. Word by word translation of Ad slogans and the like into certain foreign languages sometimes give different or distorted

meanings. Even some of the English words mean different things in different English speaking countries.

7. ***Home country regulations:*** There may be some home country regulations which affect promotion. For example, Indian exporters are confronted with certain Government of India/Reserve bank of India regulations regarding promotion abroad like the restrictions on expenditure abroad for promotion.

17.6 ADVERTISING

Advertising may be defined as the strategy of communicating a sales message to potential customers. Advertising plays crucial role in international business and is critical factor in achieving sales goals in a tough, competitive environment. In the globalization era, national and multinational companies are increasingly considering successful advertising as a prerequisite to profitable global operations. Advertising is one segment of a well-organized, continuous marketing plan.

17.6.1 Developing International Advertising Strategy

It has been observed that advertising objectives vary in each country. Though advertising of products and services do not lead directly to sales, it can be crucial when it comes to transferring the customer from one phase to the next. Advertising only attempts to bridge the gap between awareness of a product or service to awareness among the consumers, which further leads to comprehension, conviction and finally action towards buying the products.

It is complex issue for multinational companies to opt for advertising strategy between standardization and localization. Among many factors that help the firms to decide on the type of advertising strategy to be adopted, the analysis choice criteria, advertising transferability and organizational support may be useful. The choice criteria comprises the factors associated with environmental factors, advertising objectives of the company and target markets where the advertisement needs to be delivered.

17.6.2 Advertising Environment

As with marketing environment, advertising also works in an environment that may be understood by studying the conditions under which it functions.

Environmental Factors Affecting Advertising

- Social and cultural factors
- Market competition related factors
- Legal factors
- Economic factors related to business and consumer.

There are many other factors which have a stake in the advertising environment and play a significant role in determining policies for effective advertising as a communication and marketing tool. These factors are:

- Technology development
- Growth in per capital income
- Increase in disposable income
- Higher purchasing power of consumer
- Growth of popular consumer clusters
- Development of infrastructure
- Increase in education standards of consumer

- Use of research and development results
- Growth of service sector
- Specialization in advertising techniques
- Growth in marketing finance
- Growth of brands and variety of trade

Advertising Process

Advertising is closely associated with marketing variables. Hence, the process of advertising depends largely on the market environment. The marketing plan enables the advertiser to set objectives, budget and the time plan for scheduling the advertisement. In an advertising strategy, the important determinants are communication strategy and media strategy. The strategy for communication includes the type of message to be released, its length, contents, audience interest, product characteristics and frequency of message dissemination. The process of advertising is illustrated in Figure 17.1.

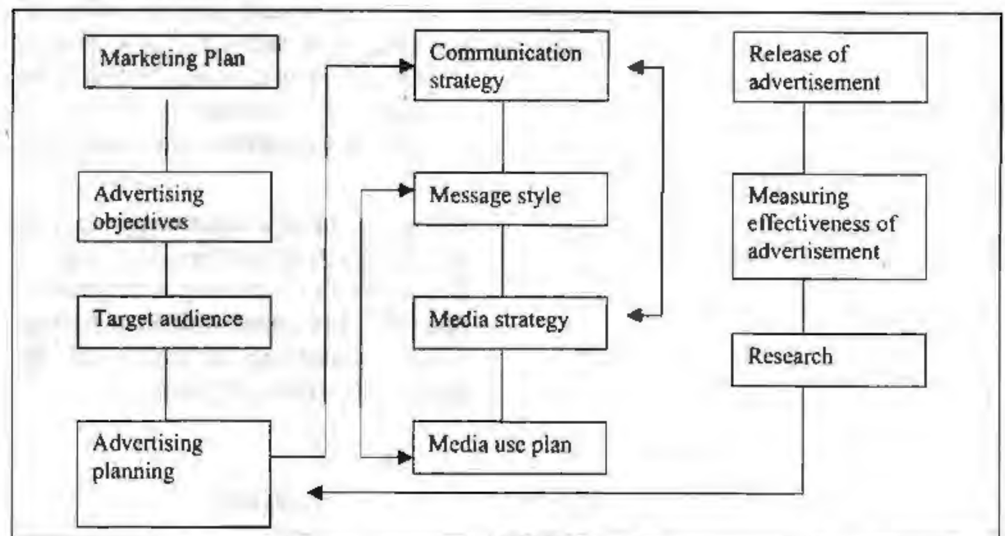

Figure 17.1: Advertising Process Model

Advertising Categories

Advertising is creative task and varies according to the need and taste of the target group. It can be categorized into audiences, types of advertiser, mass media and functions. There are three sets of audience in advertising-business, professionals and consumers. The business-to-business advertising is directed towards processors, wholesalers and professionals. Similarly when an advertisement is directed towards a group of professionals like engineers or doctors, it is called professional advertising. The advertising audience may also be categorized as a mass or a class. An example of advertising for biscuits may be planned for the mass audience while an expensive canned food such as Kraft cheese or Caviare may be directed towards a high class audience.

The volume of the business of a company and the geographical coverage of the product would be another consideration for classifying advertising strategies. The companywide coverage of a product such as automobiles, television sets, refrigerators and the like is known as general advertising. Advertising for a product limited to regional markets for local consumption is defined as local advertising. Advertising can be also classified with reference to the medium used to deliver the message like national TV network, cable TV network, radio, newspaper and magazines of national and regional status.

Advertising Styles

The different styles of advertising are an art form and cannot be limited to theoretical boundaries. The advertising manager is always at liberty to design the message in an appropriate manner for achieving the best results. Some common techniques of Product Advertising are:

- Comprehensive advertisement
- Positive advertisement
- Negative advertisement
- Social-theme based techniques
- Future project-based techniques
- Entertaining and family oriented
- Gender sensitive
- Product-customer age cohesive
- High frequency insertion-drive.
- Average frequency insertion cue
- Scientific message
- Abstract message
- Indicative and symbolic for segment customer
- Influence leader oriented
- Comparative product profit oriented

These techniques change according to the behavioural changes in the customers towards products.

17.7 ON-LINE MARKETING-E-BUSINESS ENTERPRISE

With the emergence of Internet, business organization of 20th century has undergone structural, cultural and qualitative change, and a new organization structure has emerged known as E-business enterprise. E-business enterprise enables employees, professionals, teams, groups, vendors, customers to perform business operations through electronic exchange of data and information anywhere at any time. The business operations are performed through E-communication and E-collaboration initiatives. Therefore, E-business has a global market, reach, source and global competition.

Due to internet capabilities and web technology, traditional business organization definition has undergone a change where the scope of the enterprise now includes other company locations, business partners, customers and vendors. It has no geographic boundaries as it can extend its operations where internet works. E-business enterprise is open twenty-four hours, and being independent managers, vendors, customers transact business any time from anywhere.

Internet capabilities have given E-business enterprise a cutting edge capability advantage to increase the business value. It has opened new channels of business as buying and selling can be done on Internet. It enables to reach new markets across the world anywhere due to communication capabilities. It has empowered customers and vendors/supplies through secured access to information to act, wherever necessary. The cost of business operations has come down significantly due to the elimination of paper driven processes, faster communication and effective collaborative working. The effect of these radical changes is the reduction in administrative and management

overheads, reduction in inventory, faster delivery of goods and services to the customers.

In E-business enterprise traditional people organization base on 'Command Control' principle is absent. It is replaced by people organizations that are empowered by information and knowledge to perform their role. They are supported by information systems, application packages, decision supported systems. It is no longer functional, product, and project or matrix organization of people but E-organization where people work in network environment as a team or work group in virtual mode.

E-business enterprise is more process driven, technology enabled, and uses its own information and knowledge to perform. It is lean in number, flat in structure, broad in scope and a learning organization. In E-business enterprise most of the things are electronic, use digital technologies and work on data base, knowledge bases, directories and document repositories. The business processes are conducted through enterprise software like ERP, SCM, and CRM supported by data warehouse, decision support, and knowledge management systems.

Managing the E-enterprise

Today most of the business organizations are using Internet technology, network, and wireless technology for improving the business performance measured in terms of cost, efficiency, competitiveness and profitability. They are using E-business, E-commerce solutions to reach faraway locations to deliver product and services. The enterprise solutions like ERP, SCM, and CRM run on Internet (Internet/Extranet) & Wide Area Network (WAN). The business process across the organization and outside run on E-technology platform using digital technology. Hence today's business firm is also called E-enterprise or Digital firm. The paradigm shift to E-enterprise has brought four transformations, namely:

- Domestic business to global business.
- Industrial manufacturing economy to knowledge based service economy.
- Enterprise Resource Management to Enterprise Network Management.
- Manual document driven business process to paperless automated electronically transacted business process.

This paradigm shift has added new challenges for management to tackle. It has opened larger market but not without severe competition from more competitors'. Market and business risks have increased, then differentiating factors in manufacturing process and products are no longer competitive advantage. What is critically important is service to the customer and customer satisfaction. Customer satisfaction and high level customer service is possible using knowledge based proactive management systems.

In E-enterprise, business is conducted electronically. Buyers and sellers through Internet drive the market and Internet based web systems. Buying and selling is possible on internet. Books, CDs, computer, white goods and many such goods are bought and sold on Internet. The new channel of business is well known as E-commerce. On the same lines, banking, insurance, healthcare are being managed through Internet E-banking, E-billing, E-audit, & use of credit cards, Smart card, ATM, E-money are the examples of the E-commerce application.

Organization of Business in an E-enterprise

Essentially Internet and networks enable integration of information, facilitate communication, and provide access to everybody from anywhere. And software solutions make them faster and self-reliant as they can analyze data information, interpret and use rules and guidelines for decision making. These enabling capabilities

of technology have given rise to four business models that together work in an E-enterprise organization they are:

- E-business
- E-commerce
- E-communication
- E-collaboration

These models work successfully because Internet technology provides the infrastructure for running the entire business process of any length. It also provides e-mail and other communication capabilities to plan, track, monitor and control the business operations through the workers located anywhere. It is capable of kinking to disparate systems such as logistics, data acquisition, and radio frequency used systems and so on. Low cost connectivity physical & virtual and universal standards of Internet technology make it a driving force to change conventional business model to E-business enterprise model.

The basic capabilities of Internet have given rise to number of business models. Some of them are given below:

Table 17.1: Business Models

Business Model	Description	Example
Virtual Store	Provides information about product, and sells and deliver directly to customer or business organization	Amazon.com, rediff.com, ebay.com
Information store	Provides information of interest and earns revenue from sharing and advertising	Yahoo.com, msn.com, rediff.com, satyaminfoway.com
Transaction Process	Process bills for payment: telephone, electricity, money transfer & banking transactions, membership for club registration	Icici.com, Billjunction.com Seekandsource.com
Online marketing	Provides a marketing platform where buyers and sellers can meet to exchange information, negotiate and place order for delivery. Examples are shoes, commodities	Eanction.com Seekandsource.com
Content Selling	News, music, photos, articles, pictures, greetings are stored and sold at a price	Timesofindia.com Gartner.com Aberdeen.com
Online Service	Offers services to individuals and business at large and generates revenue. Examples: Tours and travels, manpower recruiting and maintenance services	Railway, restaurant, airlines booking, Online maintenance service. Online examination
Virtual Communities	Provides platform to meet people of common interests. Software user groups, professional groups like doctors, managers, user groups	Linux Group New groups Application Package User Groups Community Groups
E-Learning	Provides contents, E-books, CDs, lessons, conduct test and offers certification	Sifylearning.com

We now discuss in detail how E-business enterprise model, and E-business process adds value in management process. Such E-business enterprise model is shown below:

The internet and networks provide platform and various capabilities whereby communication, collaboration, and conversion has become significantly faster, transparent and cheaper. These techniques help to save time, resource and enable faster decision-making. The technology adds speed and intelligence in the business process improving quality of service to the customer.

The business process of serving the customer to offer goods, products or services is made of following components:

- Enquiry Processing
- Order Preparation
- Order placement
- Order Confirmation
- Order Planning
- Order Scheduling
- Order Manufacturing
- Order Status Monitoring
- Order Dispatching
- Order Billing
- Order Receivable Accounting
- Order Payment Processing

The entire process in parts or full can be handled through these technologies and software solutions. It provides important strategic, competitive advantage. Further the technology is flexible and capable of handling any business models such as

- Retailing, Trading, auctioning
- Manufacturing, Distribution & Selling
- Outsourcing, Subcontracting
- Servicing, training, Learning, consulting

The resultant effect is the reduction in cost of business operations, improved customer loyalty and retention and better quality offer to the customer.

Four major applications make this achievement possible. These are discussed one by one.

E-business

The scope of E-business is limited to executing core business process of the organization i.e. procurement, manufacturing, selling, distribution, delivery and accounting. These processes would have external interface like suppliers, customers, contractors, consultants and so on. These core processes are best run by application packages like Enterprise Resource Planning (ERP). If enterprise definition is made wider including customer, suppliers and distributors, application package like Supply Chain Management (SCM) is best suited for planning and execution of entire business process.

In addition to these core processes, organizations use Internet enabled systems and other technologies to handle these processes more effectively. The following table gives such Internet enabled systems.

Table 17.2

Application	Illustration	Technology
Transaction Processing	Order booking from remote location Receipt processing at warehouse	Wireless, PDAs bar code reading, RFID Data Processing, LAN,WAN, Database
Workflow	Insurance claim Leave application Travel advance payment	Intranet, Client / server Use of stored procedures and intelligent trigger
Work Group	Engineering design Employees database for pay roll, tax applications	DBMS capabilities of Data and Information sharing through Internet/ Intranet
Process Control	Shop floor applications to run machines To control process based output Automated Go / No Go Quality / Checking applications	Embedded technology Use of intelligent chips and sensors Use of programmable logic controllers

Transaction processing, workflow, work group and process control applications are the backend support systems to main ERP/SCM enterprise management systems.

For example, when a supplier sends goods, it is received in the warehouse. This event is processed E-way using E-business systems suite. The receipt, documents and packages are read by bar coding systems or RFID. Then receipt processing is done to confirm the validity of dispatch by the supplier, confirmation of quality, acknowledging the receipt, updating the inventory, communication of receipt to manufacturing, updating the purchase order, effecting material accounts and supplier accounts, creating a liability ion payables and posting it into cash flow projections. You will observe that receipt of processing is first done at locations like warehouse, and 'Procurement' module of ERP takes over to effect seamlessly all updates and changes.

In this event processing, workflow system is used where quality of goods is checked, confirmed and certified in stages by three agencies in the organization. This event is processed by a work group, which includes receiver at the warehouse, QA inspector, and warehouse manager playing their respective role in the receipt of processing as specified in the workgroup application. Having accepted the goods, automated and process controlled goods movement, warehouse system takes over, and reads the receipt record to move the goods physically to assign him in a rack.

E-business systems use internet/intranet/extranet capabilities to process an event in seamless manner covering all technical, commercial, business aspects and implications of an event. They perform internal business operations and interface with external agencies.

17.8 E-COMMERCE AND E-COMMERCE BUSINESS MODELS AND STRATEGIES

E-commerce is a second big application next to ERP. It essentially deals with buying and selling of goods. With the advent of internet and web technology, E-commerce today covers an entire commercial scope online including design and developing, marketing, selling, delivering, servicing, and paying for goods. Some E-commerce applications add order tracking as a feature for customer to know the delivery status of the order. Figure 17.2 shows the E-commerce process model.

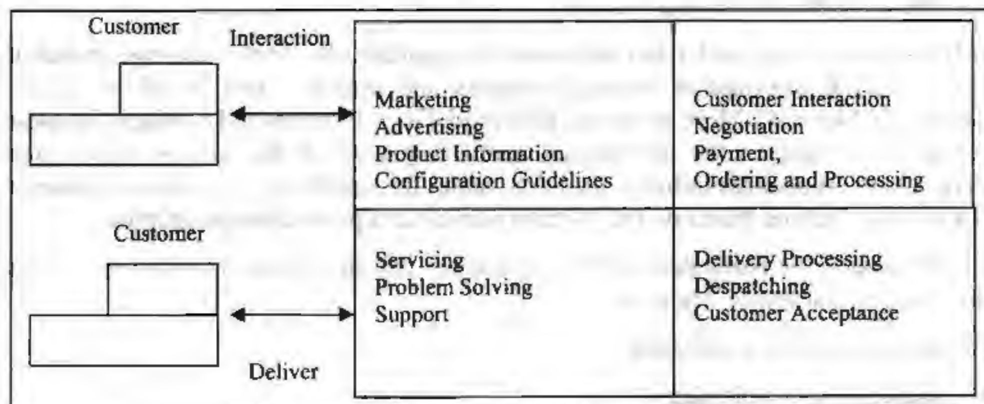

Figure 17.2: E-commerce Process Model

The entire model successfully works on web platform and uses Internet technology-commerce process has two participants, namely buyer and seller, like in traditional business model. And unique and typical to E-commerce there is one more participant known as 'merchant Server'. Merchant server role in E-commerce ensures payment to seller by authorization and authentication of commercial transaction.

E-commerce process model can be viewed in four ways and categories:

- B2C: Business Organization to Customer
- B2B: Business Organization to Business
- C2B: Customer to Business Organization
- C2C: Customer to Customer

In B2C model, business organization uses websites or portals to offer information about product, through multimedia clippings, catalogs, product configurations guidelines, customer histories and so on. A new customer interacts with the site and uses interactive order processing system for other placement. On placement of order, secured payment systems come into operation to authorize and authenticate payment to seller. The delivery system then takes over to execute the delivery to customer. In B2C model, the participants in E-business are an organization, and customer as an individual. The E-business applications in B2C are the following:

Information delivery and sharing application

- Organization manual
- Database of knowledge
- Business information

Transaction processing application

- Payments to employee
- Issue of shares/bonds
- Delivery through courier

In B2C, messaging and information downloading is a big application. Inter organization communication application, like news bulletin, communicating change of rules, announcements, price revision are very common in B2C. In the case of bank, announcing new interest rates, financial products, opening of mew branch, and so on is a communication application.

Crediting interest on fixed deposits, dividend on shares, refund of unused share amount are applications that fall in domain of B2C, where partner 'C'-an individual in B2C model-is outside the organization.

In B2B model, buyer and seller are business organizations. They exchange technical & commercial information through websites and portals. Then model works on similar line like B2C. More advanced B2B model uses Extranet and conducts business transactions based on the information status displayed on the buyers' application server. Auto component industry uses this model for supplying parts and components to auto manufacturer based on the inventory levels and production programme.

In B2B model, the participants in E-business are two organizations with relations as buyer-seller, distributor-dealer and so on.

Information delivery application:

- Issuing business circular
- Product catalogues publications
- News clippings
- Messaging

Transaction processing application:

- Order processing

- Order execution
- Payment processing
- Money transfer

In more specific terms, ERP/supply chain management is a typical B2B model where information is shared and business is transacted between two organizations. The organizations could be a manufacturer and a vendor, a manufacturer and a courier service partner, or a manufacturer and ad is built on trust and confidence. Hence information is shared with confidence and business is transacted on the basis of agreed rules and regulations. In B2B model, procurement, inventory, distribution and payments are managed using e-business technology.

In C2B model, customer initiates actions after logging on to seller's website or to server. On the server of the selling organization of the selling organization. E-commerce applications are resent for use of the customer. The entire Internet banking process works on C2B model where holders of the bank account transacts number of requirements such as seeking account balance, payment, money transfer and so on.

In C2B, the customer/consumer deal with business organization in individual capacity.

Information delivery and sharing application:

- Downloading of information from website/portal
- Viewing the bank balance
- Seeing manuals/drawings/pictures/images, and so on.

Transaction processing application

- Requesting an item
- Obtaining travel advance
- Inquiry processing
- Credit card payment
- Cash withdrawal through ATM

In C2B model, a customer interacts with information databases such as product catalogues, price information, configures the product, compares the cost, places the order and have it delivered after the electronic payment process. The products like computers, books, CDs music systems and different services are punched through E-commerce application. Bill payments are a big application of C2B model. The electronic mail, video conferencing and news groups are other big applications where information is shared through electronic communications.

In C2C model, customer participates in the process of selling and buying through the auction website. In this model, website is used for personal advertising of products or services-newspaper website is an example of advertising and selling of goods to the customer.

In C2C, both the parties are individuals and play the role of buyer/seller as the case may be.

Information delivery and sharing application

- Messaging e-mail
- Reports
- News groups
- Interests groups

Transaction processing application

- Payment approvals
- Memos
- Sanctions and confirmations
- Issues and receipts

In C2C model, E-business revolves around two individuals who deal with each other in their individual capacities and play a designated role as buyer/seller, teacher/ student, manager/officer, brother/sister. E-mailing, sending E-greetings, payments, ordering and sending gifts are the C2C model applications.

General: Broadly, information delivery and sharing applications is built on back-end systems, which collect data and process it to create information databases. The users of these databases could be organization or individuals in the capacity of buyer or seller. The participants have an authorized access to information and have rights to read, write or use it in any of the application. In transaction processing applications, participants draw the information, use the business rules and follow a process to achieve the results. Information or material is transacted using electronic process using information and business rules. There is a well defined input to produce the predefined output based on business rules and on satisfying certain conditions.

In all models, basic business and communication processes are executed through electronic documents. The following table shows some of the documents:

Table 17.3: Paper Document vs. E-document

Information on paper	Information on E-document
Product information brochure	Product catalogue document database
Order on paper	Electronic order
Confirmation letter	E-mail
Payment cheque	Electronic cash, credit card, E-cheque

All transactions are paperless hence, confirmations, approvals, signatures are electronically carried out and the participant is informed through E-communications.

It should be noted that B2B business models actually run with the help of B2C, C2B and C2C models. The execution process using these models is assisted by portals, websites, E-mail, web directories, Internet Service Providers (ISP). Each organization in E-business environment has its web-site and E-mail address and they are linked from portals, which provide basic information. The portal is a website dedicated to specified class of items where focus is on information about the items and not so much on who makes it? They essentially are information providers to users to transact through e-business models. Some portals have scope of buying and selling besides information sharing. Search engines like Yahoo, Alta Vista and Lycos are higher-level portals. Which help you find web address of buyers and sellers for you to choose your E-business partner?

In E-business models, we have considered two parties who engage in business activity. But to perform these activities certain intermediaries are required to handle the communication traffic between the two parties in B2B, B2C, C2B and C2C.

17.9 E-COMMUNICATION

In E-business world, E-communication system is a backbone of all processes whose role is to share information by messages or store information to download on access by the customer. This is done though many applications and systems. Most popular

and widely used messaging system is e-mail and voice-mail. Through these systems both parties communicate on ongoing basis. It provides facilities to store delete and search mails supporting the reference need of the user. This system is popular when one to one communication is needed.

When there is a need of communication in real time, systems available are voice conferencing, video conferencing and electronic meeting systems. Voice conferencing is conducted on telephone network using speaker phones or networked PCs with Internet telephone connectivity. Video conferencing provides capabilities of video and audio for participants situated at different locations. Video conferencing also becomes an interacting and effective communication system when it has a feature of white boarding and document sharing. In electronic meeting system, participants sit in a meeting room with networked PCs and online screen projections to discuss the meeting agenda. PC network is chosen fro communication, and access databases and processing and projecting on the screen for common viewing. This system is useful to solve some problems and communication within small groups.

Another E-communication system which is a kind of offline is known as web publishing. Web publishing uses websites and portals for storing documents, catalogues, drawings, pictures and so on for sharing. Such information is stored on documents. In this system user searches, navigates, selects and downloads document for self-use. Web publishing is popular amongst research organizations, educational bodies, government organizations, and large business and commercial bodies. These organizations have large information set and document to share with the community.

E-communication systems are capable of sending messages, documents and files in any format over Internet. The communication could be online in offline mode and online in real time mode. All E-communication systems have sufficient safeguards, which make them secured for use. Internet and web technologies are used for forming different interest groups to communicate and share the information. these groups are popularly known as 'user groups' who have common interest in subject, technology or tool, and come together with the objective of improving the quality of subject of interest by sharing the experience.

Enterprise information portal is another tool used for information posting and communication to users or customers. Portal is a web-based interface on an integrated internet/intranet/extranet platform allowing customers to use application and other services. It provides secured access to all users/consumers to search information analyze the situation and communicate. The difference between a website and a portal is that the latter is a comprehensive multipurpose repository of information, applications, and tools to serve the consumers. Most of the information needs are met at one place like portal eliminating excessive surfing, quick access to various resources and application. Relatively, website is a much focused platform with limited objective of sharing and communicating the information.

17.10 E-COLLABORATION

Every business has a number of work assignments where group of people work together to complete the tasks and achieve a common objective. The groups could be teams or virtual teams with different member strength. They come together to perform a task to achieve results. The process is called collaboration. The collaboration now is possible with e-technologies, which put these teams in network with Internet support for communication, access to different databases and servers. These capabilities help to create collaborative work systems and allow members to work together cooperatively on projects and assignments. The biggest advantage of E-collaboration is that it taps the collective wisdom, knowledge and experience of the memhers. The collaboration team or group could be within the organization and between the organizations as well.

Since, E-collaboration works on an Internet platform and uses web technology, work group/team need not be at one physical location. They can be at different locations and form a virtual team.

E-collaboration uses E-communication capabilities to perform collaborative tasks, or project assignments. Its effectiveness is increased by software 'Group Ware' that enables the members of the group to share information, invoke an application and work together to create documents and share them and so on. Group Ware is a collaboration software. For example; Lotus Notes, Novell Group Ware, Microsoft exchange and Netscape communicator are Group Ware tools. These tools are designed to make communication and coordination between members of the group more easily, disregarding their physical location.

E-collaboration helps work effectively on applications like calendaring and scheduling tasks, event, project management, workflow application, work group application, document creation and sharing and knowledge management.

E-collaboration system components are Internet, Intranet, Extranet and LAN; WAN networks for communication through Group Ware tools, browsers, Application packages are software suit, which help process customer requirements. It is supported by databases present on various servers like mail server, material database, knowledge server, document server and so on.

17.11 LET US SUM UP

Promotion, being one of the four Ps of the marketing mix, to be successful, should be consistent with the other three ingredients of the mix.

The promotion strategy will have to be tailor-made to suit the particular marketing environments.

The important steps in developing an effective communication are identifying the target audience, determining the communication objectives, determining the message, budget decisions, communication of mix decision.

Relevant communication tools depending on marketing environment and the company's objectives and resources are Advertising, Sales promotion, Personal Selling.

Problems in International Marketing Communication are differences in regulations, cultural differences, media factors, infrastructure, cost factors, language factors, home country regulation.

Advertising is one segment of a well-organized, continuous marketing plan. Among many factors that help the firms to decide on the type of advertising strategy to be adopted, the analysis choice criteria, advertising transferability and organizational support may be useful. The choice criteria comprises the factors associated with environmental factors, advertising objectives of the company and target markets where the advertisement needs to be delivered. Advertising is creative task and varies according to the need and taste of the target group. It can be categorized into audiences, types of advertiser, mass media and functions. The different styles of advertising are an art form and cannot be limited to theoretical boundaries. The advertising manager is always at liberty to design the message in an appropriate manner for achieving the best results.

The lesson also discusses on line marketing strategies for different business models like B2C, B2B, C2B, C2C.

17.12 LESSON END ACTIVITY

Develop a promotion-expenditure strategy for a household computer to be marketed through a large retail chain.

17.13 KEYWORDS

International promotions are concerned with the planning, implementation and control of persuasive communication with customers in the international arena. Promotion includes advertising, personal selling, sales promotion and publicity of goods and services.

Advertising in foreign markets may be defined as the strategy of communicating a sales message to potential customers internationally. Advertising plays a crucial role in international business and is crucial factor in achieving sales goals in a tough competitive environment.

E-business Enterprise: E-business enterprise enables employees, professionals, teams, groups, vendors, customers to perform business operations through electronic exchange of data and information anywhere at any time. The business operations are performed through E-communication and E-collaboration initiatives. Therefore, E-business has a global market, reach, source and global competition.

17.14 QUESTIONS FOR DISCUSSION

1. Because of the differences in the marketing environment, promotion is often a very complex problem in international, particularly in multinational marketing, why?
2. What are the important steps in developing an effective international marketing communication?
3. The international communication mix, also called promotion mix has four major tolls or channels. What are they? Under what situations these communication tool or tools should be used?
4. What are the important problems or factors those, make the development of international communication so difficult?
5. What are the problems faced in developing International Advertising Strategy?
6. Discuss the environmental factors affecting advertising in international arena.
7. Discuss the Advertising Process in international marketing. What are the Advertising styles commonly used in international Marketing?
8. What do you mean by E-Learning and its evolution?
9. What are the advantages and disadvantages of E-Learning?
10. How E-Learning can be compared with Brick and Mortar Schools? How does the growing trend fit into the corporate world?
11. Define E-organization, E-business, E-communication, E-Commerce, E-collaboration and their role in E-enterprise.
12. Compare and contrast E-enterprise Business Model with traditional business organization model.
13. What is the value addition in E-enterprise business model going e-way for managing business?
14. Explain how in E-enterprise, managers role and responsibilities are changed? Explain how manager is a knowledge worker in e-Enterprise?
15. Explain how going E-Way for managing business has affected the organization? It is said that E-organizations are lean, flat, learned, agile, and knowledge driven.

17.15 SUGGESTED READINGS

Cherenilan Francis, *International Business: Text and Cases*, 3rd Edition, Prentice-Hall of India Private Limited.

Charles W.L. Hill, *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Justin Paul, *International Business*, (3rd ed.), Prentice Hall of India.

LESSON

18

GLOBAL HUMAN RESOURCES MANAGEMENT

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18.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to:

- Understand HRM activities such as human resource strategy, staffing, performance evaluation, management development, compensation and labour relations in international business

18.1 INTRODUCTION

Human Resources Management refers to the activities of an organization that carries out to use its human resources effectively. The activities include:

- determining the firm's human resource strategy on staffing, performance evaluation, management development, compensation and labour relations
- these need to be linked to the strategy of the firm since HRM has an important strategic component. Through its influence on the character, development, quality and productivity of the firm's human resources, the HRM function can help the firm to achieve its primary strategic goals of reducing the costs of value creation and adding value by better serving customer needs.

The strategic role of HRM is complex in a purely domestic firm, but it is more complex in an international business where staffing, management development, performance evaluation and compensation activities are complicated by profound differences between countries in Labour markets, culture, legal systems, economic systems, and the like.

In this lesson, we will look closely at the role of HRM in an international business.

We turn our attention to four major tasks of the HRM function:

1. staffing policy
2. management training and development
3. performance appraisal, and
4. compensation policy.

18.2 STRATEGIC ROLE OF INTERNATIONAL HRM

The four strategies pursued by international business-the multi-domestic, the international, the global and the transnational. Multi-domestic firms try to create value by emphasizing local responsiveness; international firms, by transferring core competencies overseas; global firms, by realizing experience curve and location economies; and transnational firms, by doing all these things simultaneously. Table 18.1 below summarizes the relationships between international strategies, structures, and controls.

Table 18.1: International Strategy

Structure and Controls	Multi-domestic	International	Global	Transnational
Centralization of operating decisions	Decentralized	Core competency centralized Rest decentralized	Some centralized	Mixed centralized and decentralized
Horizontal differentiation	Worldwide area structure	Worldwide product division	Worldwide product division	Informal matrix
Need for coordination	Low	Moderate	High	Very High
Integrating mechanism	None	Few	Many	Very Many
Performance ambiguity	Low	Moderate	High	Very High
Need for cultural controls	Low	Moderate	High	Very High

18.3 STAFFING POLICY

Staffing policy is concerned with the selection of the employees for particular jobs.

- At one level, this involves selecting individuals who have the skills required to do particular jobs.
- At another level, staffing policy can be a tool for developing and promoting corporate culture Corporate culture means the organisation's norms and value systems 'Cultural Controls' in business help the firm pursue its strategy. Firms pursuing transnational and global strategies have high needs for a strong unifying culture, and the need is somewhat lower for firms pursuing an international strategy and lowest of all for firms pursuing a multi-domestic strategy.

In case of firms pursuing transnational and global strategies, we might expect the HRM function to pay significant attention in selecting individuals who not only have the skills required to perform particular jobs but who also 'fit' the prevailing culture of the firm. The belief is that if employees are predisposed toward the organisation's norms and value systems by their personality type, the firm which has significant need for integration will experience fewer problems with performance ambiguity.

The need for integration is less in a multi-domestic firm.

18.3.1 Types of Staffing Policy

There are three types of staffing policy in international business – the Ethnocentric approach, the polycentric approach, and the geocentric approach.

An Ethnocentric staffing policy is one in which all key management positions are filled by parent-country nationals. Such a practice was wide spread at one time in firms such as Procter& Gamble, Philips NV, and Matsushita.

A polycentric staffing policy requires lost-country nationals to be recruited to manage subsidiaries, while parent–country nationals occupy key positions at corporate headquarters.

A geocentric staffing policy seeks the best people for key jobs throughout the organization, regardless of nationality.

Table 18.2: Comparison of Staffing Approaches

Staffing Approach	Strategic Appropriateness	Advantages	Disadvantages
Ethnocentric	International	1. Overcomes lack of qualified managers in host nation. 2. Unified culture 3. helps transfer core competencies	1. Produces resentment in host country. 2. Can lead to cultural myopia
Polycentric	Multi-domestic	1. Alleviates cultural myopia. 2. Inexpensive to implement	1. Limits career mobility. 2. Isolates headquarters from foreign subsidiaries
Geocentric	Global and transnational	1. Uses human resources efficiently. 2. Helps build strong culture and informal management of network.	1. National immigration policies may limit implementation. 2. Expensive

18.3.2 Expatriate Managers

Two of the three staffing policies-the ethnocentric and the geocentric-rely on extensive use of expatriate managers. Expatriates are citizens of one country who are working in another country. Sometimes the term impatriates is used to identify a subset of expatriates who are citizens of a foreign country working in the home country of their multinational employer.

Expatriate Failure represents a failure of the firm's selection policies to identify individuals who will not thrive abroad. The cost of expatriate are high. The reasons for failure are:

- Inability to cope with larger overseas responsibilities.
- Difficulties with new environment
- Personal or emotional problems
- Lack of technical competence
- Inability of spouse to adjust

Expatriate Selection

One way to reduce expatriate failure rates is by improving selection procedures to screen out inappropriate candidates. For Foreign assignments five important factors are important in assignee Success and their components are given below:

1. ***Job Knowledge and Motivation***
   - Managerial ability
   - Organizational ability
   - Imagination
   - Creativity
   - Administrative skills
   - Alertness
   - Responsibility
   - Industriousness
   - Initiative and energy
   - High motivation
   - Frankness
   - Belief in mission and job
   - Perseverance
2. ***Relational skills***
   - Respect
   - Courtesy and fact
   - Display of respect
   - Kindness
   - Empathy
   - Non-judgmentalness
   - Integrity
   - Confidence

3. ***Flexibility/Adaptability***
   - Resourcefulness
   - Ability to deal with stress
   - Flexibility
   - Emotional stability
   - Willingness to change
   - Tolerance for ambiguity
   - Adaptability
   - Independence
   - Dependability
   - Political sensitivity
   - Positive self-image
4. ***Extra-cultural openness***
   - Variety of outside interests
   - Interest in foreign cultures
   - Openness
   - Knowledge of local language(s)
   - Outgoingness and extraversion
   - Overseas experience
5. ***Family Situation***
   - Adaptability of spouse and family
   - Spouse's positive opinion
   - Willingness of spouse to live abroad
   - Stable marriage

18.4 TRAINING AND MANAGEMENT DEVELOPMENT

Selection is just the first step in matching a manager with a job. The next step is training the manager to do the specific job. The intensive training program might be used to give expatriate managers the skills required for success in a foreign posting. Management development is a much broader concept, it is intended to develop the manager's skills over his career with the firm. Hence as a part of management development program, a manager might be sent on several foreign postings over a number of years to build his cross-cultural sensitivity and experience.

18.4.1 Training for Expatriate Managers

Two most common reasons for expatriate failure were the inability of a manager's spouse to adjust to a foreign environment and the manger's own ability to adjust to a foreign environment. Training can help the manager and spouse to cope up with these problems. Cultural training, language training and practical training all seem to reduced expatriate failure.

- ***Cultural training:*** Understanding a host country's culture will help the manager empathize with the culture, which will enhance his effectiveness in dealing with host-country nationals.

- ***Language training:*** English is the language of world business, it is possible to conduct business all over the world using only English.
- ***Practical training:*** It is aimed at helping the expatriate manager and family ease day-to-day life in the host country. The sooner a routine is established, the better are the prospects that the expatriate and their family will adapt successfully. One critical need is for a support network of fiends for the expatriate.

Check Your Progress

Statement which one is true or false:

1. An ethnocentric approach in staffing policy can result in cultural myopia.
2. A geocentric staffing policy may not be possible because on immigration policies of national governments.
3. A polycentric staffing policy cannot minimize the dangers of cultural myopia.
4. Expatriate failures seem to be those who do not have high self-esteem and self-confidence.
5. Firms success requires HRM policies to be congruent with the firm's strategy.

18.4.2 Repatriation of Expatriates

A largely overlooked but critically important issue in the training and development of expatriate mangers is to prepare them for reentry into their home-country organization. Repatriation should be seen as the final link in an integrated, circular process that connects good selection and cross-cultural training of expatriate managers with completion of their term abroad and reintegration into their national organization. However, instead of having employees come home to share their knowledge and encourage other high-performing managers to take the same international career track, expatriates too often face a different scenario.

Often when they return home after a stint abroad-where they have typically been autonomous, well-compensated, and celebrated as a big fish in a little pond-they face an organization that doesn't know what they have done for the last few years, doesn't know how to use their new knowledge, and doesn't particularly care. In the worst cases, reentering employees have to scourge for jobs or firms will create standby positions that don't use the expatriate's skills and capabilities and fail to make the most of the business investment the firm has made in that individual.

The key to solving this problem is a good human resource planning. Just as the HRM function needs to develop good selection and training programs for its expatriates, it also needs to develop good programs for reintegrating expatriates back into work life within their home-country organization, for preparing them for changes in their physical and professional landscape, and for utilizing the knowledge they acquired while abroad.

18.4.3 Managing Development and Strategy

Management development programs are designed to increase the overall skill levels of managers through a mix of ongoing management education and rotation of managers through a number of jobs within the firm to give them varied experiences. They are attempts to improve the overall production and quality of the firm's management resources.

International business increasingly are using management development as a strategic tool. This is particularly true in firms pursuing a transnational strategy, as increasing numbers are. Such firms need a strong unifying corporate culture and informal

management networks to assist in coordination and control. In addition, transnational firm managers need to be able to detect pressures for local responsiveness, and that requires them to understand the culture of a host country.

Management development programs help build a unifying corporate culture by socializing new managers into the norms and value systems of the firm. In-house company training programs and intense interaction during off-site training can foster spirit de corps-shared experiences, informal networks, perhaps a company language or jargon-as well as develop technical competencies.

18.5 PERFORMANCE APPRAISAL

A critical issue in many international business is how to evaluate its expatriate managers' performance.

18.5.1 Performance Appraisal Problems

In most cases, two groups evaluate the performance of expatriate managers-host-nation managers and home-office managers-and both are subject to bias. The host-nation managers may be biased by their own cultural frame of reference and expectations.

Home-country managers' appraisals may be biased by distance and by their own lack of experience working abroad. Home-office manager are often not aware of what is going on in a foreign operation. Accordingly, they tend to rely on hard data in evaluating an expatriate's performance, such as the subunit's productivity, or market share. Such criteria may reflect factors outside the expatriate manager's control. Also hard date do not take into account many less-visible "soft" variables that are also important, such as an expatriate's ability to develop cross-cultural awareness and to work productivity with local managers.

Due to such biases, many expatriate managers believe that headquarters management evaluates them unfairly and does not fully appreciate the value of their skills and experience. This could be one reason many expatriates believe a foreign posting does not benefit their careers.

18.5.2 Guidelines for Performance Appraisal

Several things can reduce bias in the performance appraisal process.

- More weight should be given to an on-site manager's appraisal, than to an off-site manager's appraisal.
- When the policy is for foreign on-site managers to write performance evaluations, home-office managers should be consulted before an on-site manager completes a formal terminal evaluation. This gives the home-office manager the opportunity to balance what could be very hostile evaluation based on a cultural misunderstanding.

18.6 COMPENSATION

Two issues are involved:

1. How compensation should be adjusted to reflect national differences in economic circumstances and compensation practices.
2. Other issue is how expatriate managers should be paid

18.6.1 National Differences in Compensation

The question arises, should the firm pay executives in different countries according to the prevailing standards in each country, or should it equalize pay on global basis?

The problems does not arise in firms pursuing ethnocentric or polycentric staffing policies. In ethnocentric firms, the issue can be reduced to that of how much home-country expatriates should be paid. As for polycentric firms, the lack of mangers' mobility among national operations implies that pay can and should be kept country-specific.

However, this problem is very real in firms with geocentric staffing policies. A geocentric staffing policy is consistent with a transnational strategy. One aspect of this policy is the need for a cadre of international managers that may include many different nationalities. Should all members of such a cadre be paid the same salary and the same incentive pay?

18.6.2 Expatriates Pay

The most common approach to expatriate pay is the balance sheet approach. This approach equalizes purchasing power across countries so employees can enjoy the same living standard in their foreign posting that they get at home .In addition this approach provides financial incentives to offset qualitative differences between assignment localities. Figure 18.1 shows atypical balance sheet. It may be noted that home-country outlays for the employees can be designated as income taxes, housing expenses, expenditure for goods and services (food, clothing, entertainment etc.), and reserves (savings, pension contribution etc.). Thus the balance sheet approach attempts to provide expatriates the same standard of living in their host countries as they enjoy at home plus a financial inducement (i.e. premium, incentive) for accepting an overseas assignment.

The components of an expatriates compensation package are a base salary, a foreign service premium, allowances of various types, tax differentials and benefits.

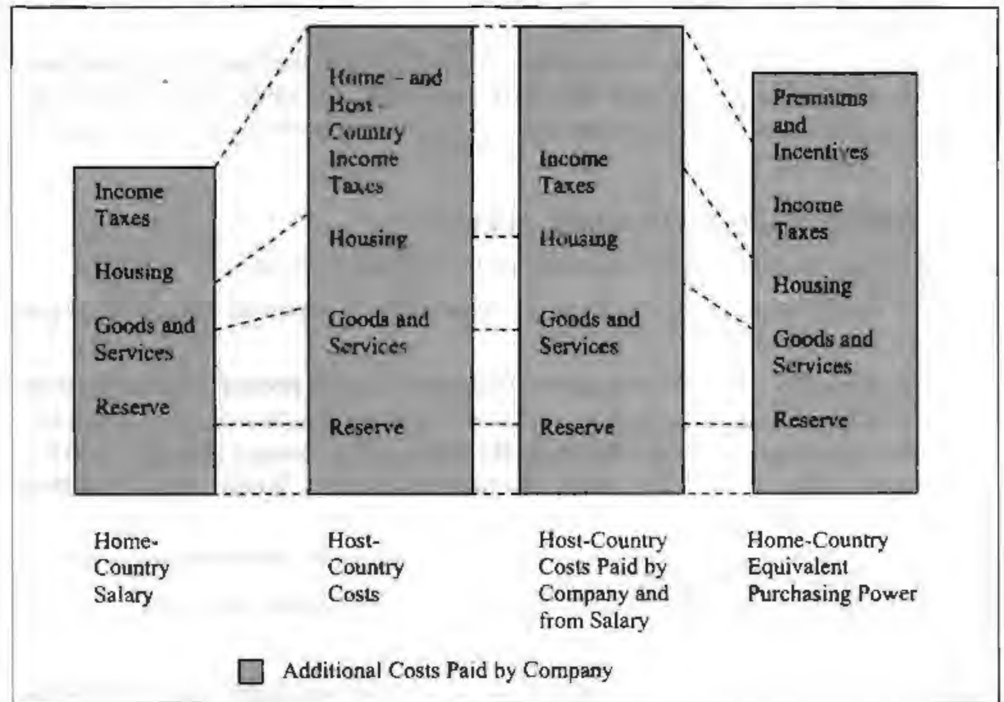

Figure 18.1

Base Salary

An expatriate's base salary is normally in the same range for a similar position in the home country. The base salary is normally paid in either the home currency or in the local currency.

Foreign Services Premium

It is the extra pay the expatriates receive for working outside his country of origin as an inducement to accept foreign postings, to compensate for living in an unfamiliar country isolated from friends and relations, to deal with new culture and language and to adapt to new work habits and practices. It is observed that the foreign premium works from 10 to 30 percent after tax with average of 16 percent on base salary.

Allowances

Four types of allowances are often included in expatriates compensation package: hardship allowances, housing allowances, housing allowances, cost of living allowances and education allowances. A hardship is normally paid when the expatriates is sent to a difficult location where such basic amenities as health care, schools and retail stores are grossly deficient by the standards of the expatriate's home country. Other allowances are self explanatory.

Taxation

Unless a host-country has a reciprocal tax treaty with the expatriate's home country, the expatriates may have to pay income-tax in both the host country and home country. In case the reciprocal tax treaty is not there, the firm pays the income tax in the host country. In addition, firms make up the difference where a higher income tax rate in a host country reduces an expatriates take-home pay.

Benefits

Many firms ensure that the expatriates receive take same level of medical and pension benefits abroad that they receive at home. This can be costly for the firm since the benefits that are tax deductible.

18.7 INTERNATIONAL LABOUR RELATIONS

The HRM function of an international business is typically responsible for international labour relations. From a strategic perspective, the key issue in international labour relations is the degree to which organized labour can limit the choices of an international business.

One task of the HRM function is to foster harmony and minimize conflict between the firm and organized labour. This section is divided into three parts-First, we review organized labour's concerns about multinational enterprises. Second, we look at how organized labour has tried to deal with these concerns. And, third, how international businesses manages their labour relations to minimize labour disputes

18.7.1 Concerns of Organized Labour

Labour unions try to get better pay, greater job security and better working conditions for their members through collective bargaining with management. Union's bargaining power is derived largely from their ability to threaten to disrupt production either by strike or some other form of work protest. This threat is possible since the management has no other option but to employ union labour.

Principal concerns of domestic unions about multi-national firms are as follows:

- The company can counter its bargaining power with the option of moving production to another country. Ford, for example, very clearly threatened British Unions with a plan to move manufacturing to Continental Europe unless British workers abandoned work rules that limited productivity, showed restraint in negotiating for wage increases and curtailed strikes and other work disruptions.
- The international business will keep highly skilled tasks in its home country and farm out only low-skilled tasks to foreign plants. Such practices makes it

relatively easier for an international business to switch production locations from one place to another as economic conditions warrant

- When an international business imports employment practices and contractual agreements from its home country. When these practices are new to the host country, the labour union fears that the change will reduce their influence and power.

18.7.2 Strategy of Organized Labour

Organized labour has responded to the increased bargaining power of multinational corporations by taking three actions:

1. trying to establish international labour organizations,
2. lobbying for national legislation to restrict multinationals, and
3. trying to achieve international regulations on multinationals through such organizations as the United Nations. These efforts have not been successful.

A further impediment to co-operation has been the wide variation in union structure. Trade unions developed independently in each country, the structure and ideology of unions tend to vary significantly from country to country as does the nature of collective bargaining. The ideological gap between union leaders in different countries has made cooperation difficult. Divergent ideologies are reflected in radically different views about the role of a union in society and the stance unions should take towards multinationals.

Organized labour has also met with only limited success in its effort to get national and international bodies to regulate multinationals. Such international organizations as the International Labour Organization (ILO) and the Organization for Economic Cooperation and Development (OECD) have adopted codes of conduct for multinational firms to follow in labour relations. However these guidelines are not as far-reaching as many unions would like. They also do not provide any enforcement mechanism.

18.7.3 Approaches to Organized Labour

Approaches to international labour relation differ from one international business to other. The main difference is the degree to which labour relations activities are centralised or decentralized. Historically most international businesses have decentralised international labor relations activities to their foreign subsidiaries because labour laws, union power and the nature of collective bargaining varied so much from country to country.

The general rise in competitive pressure in industry has made it important for firms to control their costs. Labour costs account for a large percentage of total costs, many firms are now using the threat to move production to another country in their negotiations with unions, to change work rules and limit wage increases. Because such a move would involve major new investments and plant closures, this bargaining tactic requires the input of headquarters management. Thus the level of centralized input into labour relations is increasing.

In addition, the realization is growing that the way work is organized within a plant can be a major source of competitive advantage. Much of the competitive advantage of Japanese auto makers has been attributed to the use of self-managing teams, job-rotation, cross-training and the like. To replicate their domestic performances in foreign plants, the Japanese firms have tried to replicate their work practices there. This often brings them into direct conflict with traditional work practices in those countries, as sanctioned by the local labour unions, so the Japanese firms bargains directly with local unions to get union agreement to changes in work rules before committing to an investment.

18.8 LET US SUM UP

The lesson focus on human resource management in international business. HRM activities include human resource strategy, staffing, performance evaluation, management development, compensation, and labour relations. All these activities must be appropriate to firm's strategy.

18.9 LESSON END ACTIVITY

What is Coca-Cola's staffing policy for managerial positions: ethnocentric, polycentric, or geocentric? Check from the internet site.

18.10 KEYWORDS

An expatriate manager: A national of one country appointed to a management position in another country.

Ethnocentric staffing: A staffing approach within the MNE in which all key management positions are filled by parent country nationals

Polycentric staffing: A staffing policy in an MNE in which host-country nationals are recruited to manage subsidiaries in their own country, while parent-country nationals occupy key positions at corporate head-quarters.

Geocentric: A staffing policy where the best people are sought for key jobs throughout an MNE, regardless of nationality.

18.11 QUESTIONS FOR DISCUSSION

1. What are the main advantages and disadvantages of the ethnocentric, polycentric and geocentric approaches to staffing policy? When is each approach appropriate?
2. What is the link between an international business strategy and its human resource management policies particularly with regard to the use of expatriate employees and their pay scale?
3. It has been observed that many expatriate employees encounter problems that limit both their effectiveness in a foreign posting and their contribution to the company when they return home. What are the main causes and consequences of these problems, and how might a firm reduce the occurrence of such problem?
4. In what ways can organized labour constrain the strategic choices of an international business? How can an international business limit these constraints?
5. A prominent issue in the international staffing is expatriate failure, defined as the premature return of an expatriate manager to his home country. What can be possible reasons for such an eventuality? How such failures can be prevented?

Check Your Progress: Model Answer

1. T, 2. T, 3. F, 4. F, 5. T

18.12 SUGGESTED READINGS

Cherenilan Francis, *International Business: Text and Cases*, 3rd Edition, Prentice-Hall of India Private Limited.

Charles W.L. Hill, *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Justin Paul, *International Business*, (3rd ed.), Prentice Hall of India.

LESSON

19

OUTSOURCING CHALLENGES

CONTENTS

19.0 Aims and Objectives

19.1 Introduction

19.2 IT-Enabled Services

19.3 Business Process Outsourcing (BPO)

19.4 IT-Enabled Services (ITES) or Business Process Outsourcing (BPO)

19.5 Why Business Process Outsourcing – BPO

19.6 Why India-SWOT Analysis

19.7 Let us Sum up

19.8 Lesson End Activity

19.9 Keywords

19.10 Questions for Discussion

19.11 Suggested Readings

19.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- Types of outsourcing
- Reasons of outsourcing
- Advantages of India in global outsourcing

19.1 INTRODUCTION

Sourcing is the set of business processes required to purchase goods and services. Managers must first decide which tasks will be outsourced and those that will be performed within the firm. For each outsourced task, the manager must decide whether to source from a single supplier or a group of suppliers. If a portfolio of suppliers is to be carried, then the role of each supplier must be clarified. The next step is to identify the criteria of selection and the performance parameters. Managers then select suppliers and negotiate contracts with them. Once suppliers and contracts are in place, procurement processes that facilitate the placement and delivery of orders play a major role.

19.2 IT-ENABLED SERVICES

Information technology enabled services, or ITES, is a form of outsourced service which has emerged due to involvement of IT in various fields such as banking and finance, telecommunications, insurance, etc. Some of the examples of ITES are medical transcription, back-office accounting, insurance claim, credit card processing and many more.

Firms usually from developed countries outsource such services to countries like India, China and Philippines in order to gain from large talent pool and low labor cost.

19.3 BUSINESS PROCESS OUTSOURCING (BPO)

Business Process Outsourcing (BPO) can be defined as the transfer of an organization's entire non-core but critical business process/function to an external vendor who uses an IT-based service delivery. By doing so, BPO helps an organization concentrate on its core competencies, improve efficiency, reduce cost and improve shareholders' value. Though IT outsourcing has been happening for so many years, an increased momentum has been witnessed since the late 1990s due to the rise of Internet and Communication technologies. Several global giants from various industries have begun to realize the importance of Business Process Outsourcing (BPO) and have started outsourcing their non-core business functions. This has given rise to many specialized BPO vendors across the globe, with India being a major hub owing to its large computer-literate English-speaking population, low billing rates, strategically favorable time zone and high quality. The Business Process Outsourcing (BPO) market in India is expected to grow exponentially in the coming years.

19.4 IT-ENABLED SERVICES (ITES) OR BUSINESS PROCESS OUTSOURCING (BPO)

IT-Enabled Services (ITES) or BPO (Business Process Outsourcing) as it is better known holds tremendous potential for India. Though ITES in India has become almost synonymous with call centers in public perception, it encompasses much more. The term ITES can be defined as outsourcing of such processes that can be enabled with information technology and covers areas as diverse as finance, HR (human resource), administration, healthcare, telecommunication, manufacturing etc.

ITES/BPO service includes a scenario wherein one company hands over part of its work to another company, making it responsible for the design and implementation of the business process through the telecom and Internet medium under strict guidelines regarding requirements and specifications from the outsourcing company.

Till 1994, the Indian telecom sector was under direct governmental control and the state owned units enjoyed a monopoly in the market. In 1994, the government announced a policy under which the sector was liberalized and private participation was encouraged. With New Telecom Policy announced in 1999 and introduction of IP telephony ended the state monopoly on international calling facilities. This brought about a drastic reduction and this heralded the golden era for the ITES/BPO industry.

One of the first outsourced services was medical transcription, but outsourcing of business processes like data processing, billing, and customer support began towards the end of the 1990s when MNCs established wholly owned subsidiaries which catered to the process off-shoring requirements of their parent companies.

The ITES or BPO industry is a young and nascent sector in India and has been in existence for a little more than five years. Despite its recent arrival on the Indian scene, the industry has grown phenomenally and has now become a very important part of the export-oriented IT software and services environment. Today, Indian companies are offering a variety of outsourced services ranging from customer care, transcription, billing services and database marketing, to Web sales/marketing, accounting, tax processing, transaction document management, telesales/ telemarketing, HR hiring and biotech research.

The ITES – BPO industry, which contributes 25% to the total IT Software and Service exports from India, witnessed a growth of 53.3% to reach US$ 2.3 bn in financial year

2003. According to Nasscom, the industry is expected to grow by around 57% to touch US$ 3.6 bn in the current fiscal. Going by the long-term projection of Nasscom, the industry is estimated to touch a size of US$ 21-24 bn by 2008. This would imply an estimated compound annual growth rate of 58%, making it one of the fastest growing sectors in India. Looking at the success of India's IT/software industry, the central government identified ITES/BPO as a key contributor to economic growth prioritized the attraction of FDI in this segment by establishing 'Software Technology Parks' and 'Export Enterprise Zones'.

In the last financial year, ITES-BPO companies were the largest recruiters in the IT/ITES sector, adding about 70,000 jobs. Nasscom estimates that the sector would add roughly about 300,000 people every year and would be employing 2 million people by 2008.

19.5 WHY BUSINESS PROCESS OUTSOURCING – BPO

BPO is important because it links to shareholder value: As customers have become more sophisticated, they have come to realize that the goal is to link business performance to shareholder value. Business Process Outsourcing or BPO has gained prominence because people have asked, "When do I get the business result?" BPO is about optimizing business performance to drive value creation.

Executives want shareholder value from investments: This is an important shift in management thinking with respect to IT and shared services. They want to know how your shared services and world-class processes are creating shareholder value for the firm. They are likely to ask, "What about partnering with a supplier to sell our capabilities to the outside?"

BPO has emerged as a repeatable model for reducing costs while increasing service quality: Businesses have worked for decades to use alliances to combine and leverage their unique skills and access to markets. The building of core functions, while outsourcing non-core functions, has moved from theory to practice. This trend has become increasingly important as globalization expands the range of competitors and innovation rapidly raises the bar in many non-core areas.

Business Process Outsourcing (BPO) is often the next step after shared services: Companies that have centralized services and created a shared services organization have already handled some of the change management issues that arise from Business Process Outsourcing or BPO. They also often see the next step as BPO.

19.6 WHY INDIA-SWOT ANALYSIS

Comparing India with other BPO Destinations (Why India?)

The abundant skilled manpower has made India a target destination for multinationals to back end their operations in India. India ranks high in areas such as qualifications, capabilities, quality of work, linguistic capabilities and work ethics, and thus is ahead of competitors such as China, Philippines, Ireland, Australia, Canada etc. Indian companies have unique capabilities and systems to set measure and monitor quality targets.

In specific BPO categories, Indian centers have achieved higher productivity levels-for example, the number of transactions per hour for back office processing, than their Western counterparts. Also, India is able to offer a 24 × 7 services and reduction in turnaround times by leveraging time zone differences. India's unique geographic positioning makes this possible. Many state governments in India are offering incentives and infrastructure to set up IT enabled services.

About 100,000 engineers graduate from India every year. Many of these engineers are employed with call centers for troubleshooting and providing technical support at salaries that are dramatically lower compared to the pay scales in the US. The average monthly salary in India is $400 – 700 compared to $2,700 – 2,800 in the US.

Table 19.1: India - SWOT Analysis

Strengths	Weaknesses (Challenges)
• Solid history in software development	• Positioning & Brand management
• English proficiency	• Infrastructure
• Government Support	• Cultural differences
• Cost advantage	• Sales & marketing
• Strong tertiary education	• Leverage expertise for higher-value education
• Process quality focus	• Business process experience
• Skilled workforce	• Distance from US
• Expertise in new technologies	• Fear/Uncertainty from Pakistan
• Entrepreneurship	• Legal system
• Reasonable technical innovations	• Poor globalization skills
• Reverse brain drain	• Internal competition for resources
• Existing long term relationships	• Over-promise / Under-deliver
• Creation of global brands	• Regional geopolitical uncertainty
• BPO & Call center offerings	• Rising labor costs
• Expansion of existing relationships	• Competition from other countries
• Chinese domestic & export market	• Sometime blinding nationalism
• Leverage relationships in West to access APAC/Middle East markets	• Government blocking reform/deals
• Indian domestic-market growth	• Corruption/piracy/trust
	• Political & religious instability-war

Check Your Progress

What do you understand by the term "business process outsourcing"?

....

....

19.7 LET US SUM UP

Sourcing is the set of business processes required to purchase goods and services. Managers must first decide which tasks will be outsourced and those that will be performed within the firm. Information technology enabled services, or ITES, is a form of outsourced service which has emerged due to involvement of IT in various fields such as banking and finance, telecommunications, insurance, etc. IT-Enabled Services (ITES) or BPO (Business Process Outsourcing) as it is better known holds tremendous potential for India. The abundant skilled manpower has made India a target destination for multinationals to back end their operations in India. India ranks high in areas such as qualifications, capabilities, quality of work, linguistic capabilities and work ethics, and thus is ahead of competitors such as China, Philippines, Ireland, Australia, Canada etc. Indian companies have unique capabilities and systems to set measure and monitor quality targets.

19.8 LESSON END ACTIVITY

Identify and discuss the challenges facing Indian business process outsourcing industry.

19.9 KEYWORDS

BPO: Business Process Outsourcing

ITES: Information Technology Enabled Services

19.10 QUESTIONS FOR DISCUSSION

1. What is Business Process Outsourcing (BPO) and how it is related to IT enabled services?
2. Why BPO has emerged and what are the areas where BPO has prospered in recent years.
3. BPO services in India-Can you prepare a SWOT analysis.
4. BPO Service in India-what are the strengths-opportunities?

Check Your Progress: Model Answer

Business Process Outsourcing (BPO) can be defined as the transfer of an organization's entire non-core but critical business process/function to an external vendor who uses an IT-based service delivery.

19.11 SUGGESTED READINGS

Cherenilan Francis, *International Business: Text and Cases*, 3rd Edition, Prentice-Hall of India Private Limited.

Charles W.L. Hill, *International Business Competing in the Global Marketplace*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

Justin Paul, *International Business*, (3rd ed.), Prentice Hall of India.

LESSON

20

EXPORT-IMPORT POLICY GUIDELINES

CONTENTS

20.0 Aims and Objectives

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20.2 Trade Regulations Governing Imports

- 20.2.1 Import Licenses
- 20.2.2 Categories of Licenses
- 20.2.3 Transferability of Licenses
- 20.2.4 Endorsement of Import License

20.3 Trade Regulations Governing Exports

20.4 Government Assistance in Exporting

20.5 Exim Bank

20.6 Forfaiting

20.7 Maturity Factoring by ECGC

20.8 Export Credit Risk Insurance

20.9 Foreign Exchange Dealer's Association of India (FEDAI)

20.10 Let us Sum up

20.11 Lesson End Activity

20.12 Keywords

20.13 Questions for Discussion

20.14 Suggested Readings

20.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- The genesis of trade restrictions as they evolved in the last five or six decades in our country
- Government assistance in exporting

20.1 INTRODUCTION

The exim policy announced by the Commerce Minister lays down various trade regulations governing exports and imports. These regulations have to be mandatorily complied with, by exporters, importers, authorised dealers and all other market players engaged in the business of exports/import transactions. Hence, it is necessary for these players to familiarise themselves with the trade regulations. Moreover, they are also required to keep a constant watch on any modifications/amendments to trade

regulations effected by the concerned authorities from time to time in order to ensure strict compliance.

Given this fact, we shall now discuss trade regulations governing both exports and imports in detail.

20.2 TRADE REGULATIONS GOVERNING IMPORTS

FEMA defines 'import' as bringing into India, any goods or services. Imports to India can be classified into two categories:

(a) ***Freely Importable Items or the Open General License (OGL):*** The OGL includes those items which are freely importable and do not require import licenses.

For instance the following items does not require import license:

- Microfilm Camera
- Paraffin Wax
- Video Echo Sounder
- Collator Machine
- Asbestos Fibre, etc.

(b) ***The Negative List:*** Import of those items, which are not regulated by the OGL fall under the negative list category. These categories of items are broadly grouped under three heads: Prohibited, Restricted and Canalised.

1. Banned or prohibited items are not permitted to be imported at all. They include tallow fat, animal rennet and unprocessed ivory.
2. Restricted items are generally those for which demand can be adequately satisfied, in normal circumstances, by local production in India. These are permitted to be imported only against a license, and include certain categories of consumer goods, precious stones, seeds, animals, insecticides, certain electronic items, drugs and chemicals.
3. Canalised items are those items, which are importable only by government trading monopolies. They are mostly commodity imports and any import of these items must be channeled through these agencies. Some of the canalised items include petroleum products to be imported only by the Indian Oil Corporation, Nitrogenous Phosphates, potassic and complex chemical fertilisers by the Minerals and Metals Trading Corporation and cereals by the Food Corporation of India.

The Director General of Foreign Trade functioning under the Ministry of Commerce exercises import trade control. Some of the trade regulations governing imports are discussed below:

20.2.1 Import Licenses

Import license means a license granted specifically for the import of goods, which are subject to import control. Items which require a license, can be imported only by an actual user, unless the actual user condition is specifically dispensed with by the licensing authority.

The Export-Import Policy defines "Actual User" as an actual user who may be either industrial or non-industrial user. "Actual User (Industrial)" is defined as "a person who utilises the imported goods for manufacturing in his own unit or manufacturing for his own use in another unit including a jobbing unit." "Actual User (Non-Industrial)" is defined as "a person who utilises the imported goods for his own use in (i) any commercial establishment carrying on any business, trade, or profession;

or (ii) any laboratory, Scientific or Research and Development (R&D) institution, university of other educational institution or hospital; or (iii) any service industry."

Every license has a validity period, which is specified therein. For example, the validity of the Export Promotion Capital Goods license (EPCG) is 24 months. Only those items or category of items mentioned on the license can be imported under that license. A license is issued subject to the provisions of the policy applicable as on date of issue of the license. Every license bears the security seal of the office of issue as well as the signature of the issuing authority. As per the present rules, import licenses issued under various provisions of the policy indicate the value in Indian rupees and in foreign currency at the exchange rate prevailing on the date of issue of the license.

20.2.2 Categories of Licenses

There are different categories of licenses.

Regular License

These are licenses issued for the import of goods, which fall under the normal import policy. These can be issued to anybody entitled for issuance as per the policy provision.

Advance License

Advance licenses are issued under the duty exemption scheme. Under advance licenses, duty free imports of inputs are permitted on fulfilment of value addition and export obligation within a certain time frame. Such licenses (other than those for deemed exports) are exempted from payment of basic customs duty, surcharge, and additional customs duty, anti dumping duty and safeguard duty, if any.

Under a value based advance license, any of the inputs specified in the license may be imported within the total GIF value indicated for those inputs, except inputs specified as sensitive items. Under such a license, both the quantity and the FOB value of the exports to be achieved shall be specified. It shall be obligatory on the part of the license holder to achieve both the quantity and FOB value of the exports specified in the license.

In case of quantity-based license, each item of input for import will be restricted in terms of quantity (or value where restrictions cannot be put in quantity terms). The exim policy 1997-2002 has done away with value based advance licenses. However, quantity based advance licenses will continue to remain in force.

Quantity based advance licenses indicate the individual item, along with quantity and the aggregate GIF value of imports.

Licenses with Export Obligations

Certain licenses are issued with a rider, like 'export obligation' which means importers of capital goods are required to export to a place outside India, a certain proportion of goods manufactured by the use of imported capital goods. In case of importers rendering services, export obligation means receiving payments in freely convertible foreign currency for services rendered through the use of such capital goods. License where export obligation is imposed indicates value of export obligation both in free convertible currency and Indian Rupees equivalent thereof at the exchange rate prevailing on the date of issue of the license. It also indicates exchange rate used for arriving at the rupee value of license. Value indicated on import licenses is always for CIF (Cost, Insurance and Freight) value of goods authorised to be imported.

Special Import License

A Special Import License (SIL) may be used to import, among other items, certain consumer goods. The SIL is like an import permit and is traded in the market at a premium on its value. It is issued to Indian exporters as an export incentive, and its value is tied to export earnings. SIL licenses are freely transferable and thus can be easily procured in the market by any prospective importer. The Special Import License shall be valid for import of items appearing in the ITC (HS) classification of Export and Import items. ITC (HS) refers to Indian Trade Classification (Harmonised System). The ITC (HS) classification of export and import items contains 99 chapters and each chapter covers information in five columns: the 8-digit code i.e. the exim code, the item description, the applicable policy (prohibited, restricted, canalised or free); any conditions relating to the Export and Import Policy (these conditions appear either indicated with the particular item or in licensing notes at the end of the HS Chapter or section thereof); and an indication of whether the product can be imported under a Special Import License. The eight-digit code can be interpreted as follows: the first two digits represent the chapter number, the next two digits the heading of goods in that chapter, and the last four digits refer to the sub heading. Each chapter is divided into various headings depending on different types of goods belonging to the same class of products. For instance, raw cotton has a code of 5201, while soft cotton waste/hard cotton waste has a code of 5202 and cotton yarn has a code of 5205. This means that the said items are in chapter 52 and occupy the first, second and fifth place respectively in that particular group. Similarly, the code for exotic birds is 0106 indicating that it falls under chapter one and occupies the sixth place in that chapter. The policy applicable to exotic birds is "Prohibited" and the nature of restriction is "Not permitted to be exported". Another example would be calcium ammonium nitrate. The code for calcium ammonium nitrate is 31029009. The first two digits represent the chapter number, the next two digits the place it occupies in the chapter and the remaining four digits the sub classification under that chapter.

Import licenses are issued in duplicate. One copy is marked for "Customs Purposes" and has to be presented to the customs authorities at the time of clearance of goods. The other copy is marked for "Exchange Control Purposes" and has to be presented by the importer to the authorised dealer while opening a Letter of Credit (L/C) or making payment for import of goods.

20.2.3 Transferability of Licenses

After the fulfilment of export obligation and other conditions laid down, the holder of a transferable license may transfer it to a third party. However, a request for endorsement of transferability should be made to the licensing authority within 36 months of the date of issuance of license. When the import license is so endorsed, the license holder may transfer the license in full in case he has not made any imports or where imports have already been made, the license may be transferred in part excluding the value and quantity of imports already made or the materials or the balance already imported.

Issue of duplicate license, increase in the C.I.F value or any other amendments will not be permitted once the endorsement of transferability is made on the license.

The license transferred will be valid for the balance period of its validity or six months from the date of endorsement whichever is later.

20.2.4 Endorsement of Import License

Where a license is transferable, the fact of transferability will be indicated on the body of the license. In such case the license holder may affect part or full transfer of the license to other eligible importers in conformation with the various provisions of the policy.

Validity of Import License / Certificates / Permission / CCPS

The above shall be valid as follows from the date of its issue:

1. Advance license DFRC and Replenishment License for Gem & Jewellery as per Chapter 4 of the Policy	18 months
2. EPCG License (other than spares)	24 months
3. Spares under EPCG License	Validity of EO period
4. Others including CCP and Duty Entitlement Pass Book Scheme, unless otherwise specified.	12 months
5. Advance License for project / turnkey project	18 months or Co-terminus with the contracted duration of execution of the project whichever is later.

Duty Entitlement Pass Book Scheme (DEPB)

The objective of Duty Entitlement Passbook Scheme is to neutralise the incidence of customs duty on the import content of the export product. The neutralisation shall be provided by way of grant of duty credit against the export product.

Under the Duty Entitlement Passbook Scheme (DEPB), an exporter may apply for credit, as a specified percentage of FOB value of exports, made in freely convertible currency. DEPB credit is available on export of goods. However, only those goods specified in the list of goods notified by the Director General of Foreign Trade by way of a public notice issued in this behalf will be eligible for credit. It thus becomes clear that unless the item is specified in the list notified by the DGFT, no DEPB credit can be availed of. The exim policy 1997-02 had introduced a new duty entitlement passbook scheme in place of the old passbook scheme.

Under this scheme, the exporter is issued a passbook, which has validity for a period of 12 months from the date of its issue. The holder of DEPB shall have the option to pay additional custom duty, if any, in cash as well and the DEPB and/or the items imported against it are freely transferable.

Diamond, Gem and Jewellery Export Promotion Scheme

To give a boost to exports of diamonds, gems and jewellery in which India enjoys a special advantage of skilled labour, exporters under these sectors have been offered two special schemes viz:

- Replenishment (REP) licenses and
- Diamond Imprest Licenses for importing their inputs like raw/cut and polished diamonds, gold, etc. A brief summary of the provisions under these schemes is discussed hereunder.

Replenishment License

Eligibility: The exporter of gem and jewellery products listed in Appendix-26 of the handbook (Vol. I) shall be eligible to import and replenish their input.

Procedure for Obtaining REP Licenses:

- The Gem REP licenses are available as per the scale given in Appendix-26A.
- An application for the Gem REP license may be given to the license authority in Appendix 25 in the form given in Appendix-ISA along with the documents prescribed therein.
- In case EP copy of the shipping bill and custom attested invoice is submitted to the nominated agencies, the exporter shall furnish a self certified photocopy of the same along with a certificate from the nominated ageney certifying the carat/value of studding in case of studded jewellery and excess value addition achieved in the case of plain jewellery and articles.

- Such applications are to be made within 6 months following the month/quarter in which export proceeds were realised.
- A consolidated application is to be made for all the exports realised in a month/quarter.
- To claim REP licenses against third party exports, the EP copy of the shipping bill must show the names of both i.e. the name of the manufacturer and the 3rd party through whom it was exported. Secondly, a disclaimer should be furnished from the third party.

Diamond Imprest License

Under this scheme, diamond exporters can obtain Diamond Imprest License in advance, for import of rough diamonds from any source. Such licenses, however, carry an export obligation, which the licensee has to fulfil.

Eligibility: An exporter of cut and polished diamonds who is a status holder may be issued a license for the import of cut and polished diamonds up to 5% of the export performance of the preceding year of cut and polished diamonds.

Procedure for obtaining a Diamond Imprest License:

- Application has to be made in the prescribed format to the Regional licensing authority along with name and address of his banker and banker's certificate to the effect that there are no overdue export bills beyond a period of six months.

Export Obligation: The export obligation against each consignment shall be fulfilled within a period of five months from the date of clearance of such consignment through customs.

Bank Guarantee and Legal Undertaking (LUT)

The licensee is required to execute a bank guarantee/legal undertaking before the first consignment of import is cleared. However, this requirement will be waived in case the export obligation is fulfilled before any imports are made.

LUT/Joint LUT limits for different categories of exporters are indicated in the table below:

Table 20.1

No.	Type of Exporter	Limits
1.	Super Star Trading House and Units within the same group/ public sector undertaking and units within the same group	Unlimited
2.	Export House / Trading House / Star Trading House and units within the same group	Up to five times of FOB value of exports affected in the preceding licensing year / current year
3.	Exporters having performance of past exports but not covered under Sl. 1 and 2 above	Up to two times of FOB value of exports made during the preceding licensing year
4.	Any overseas company with its branch office in India with an annual average turnover in diamonds during preceding three licensing years not less than Rs. 150 crore	Up to 50% of annual average turnover of the preceding three licensing years

If a licensee does not have the LUT limit, he is required to execute Bank Guarantee for 50% of the CIF value of the license in the prescribed form.

Extension of Export Obligation Period

The licensing authority shall allow one extension for a period of six months from the date of expiry of the original export obligation period to the licensee subject to payment of composition fee of 1% of the unfulfilled FOB value of export obligation

with reference to CIF value of imports made, for which extension is being sought. The request for further extension may be considered by the authorities, subject to payment of composition fee of 5% of the unfulfilled FOB value of export obligation with reference to CIF value of imports made for which extension is being sought. Such extension shall however not exceed a period of six months from the date of expiry of earlier extension.

Diamond Dollar Account

Diamond exporters enjoy several benefits including the right to open diamond dollar accounts, which were introduced in the Exim Policy 1997-2002. Diamond dollar accounts allow exporters to retain their proceeds in dollars. However, opening of this account is optional, and diamond exporters can continue to use their rupee accounts if required.

The criteria specified by RBI for operating diamond dollar accounts include:

- Firms/companies should be dealing in the purchase/sale of rough or cut and polished diamonds
- A track record of at least 3 years in import or export of diamonds
- An average annual turnover of Rs. 5 crore or above during the preceding three licensing years

Firms and companies maintaining foreign currency accounts, excluding Export Earners' Foreign Currency (EEFC) accounts with banks in India or abroad, are not eligible to maintain Diamond Dollar Accounts. Eligible firms or companies may be allowed to open not more than 5 Diamond Dollar accounts with their banks.

20.3 TRADE REGULATIONS GOVERNING EXPORTS

FEMA defines 'export' as the taking or sending out of goods by land, sea or air, on consignment or by way of sale, lease, hire purchase, or under any other arrangement by whatever name called, and in the case of software, also includes transmission through any electronic media.

Exports may be of different types. They could be:

Cash Exports: Cash exports are those exports where the proceeds are realised within 6 months from the date of shipment or the due date for payment whichever is earlier. As per FEDAI rules, the normal transit period and the notional due date of the bill will be taken into consideration to determine the due date of payment.

Project Exports: Export of engineering goods on deferred payment terms and execution of turnkey projects and civil construction contracts abroad are collectively referred to as 'Project Exports'. These contracts are usually of very high value.

Deemed Exports: Goods under this kind of export do not leave the shore of the country. Any such supply to be eligible for labelling as deemed exports should comply with the following:

(a) Supply of goods is to a project that is funded by multilateral / bilateral agencies like IBRD/ADB/OPEC, etc. and any other such projects notified by the government of India from time to time.

(b) Goods are supplied against an order received under international competitive bidding and to this effect the supplier of goods should submit a certificate from his buyer.

The central idea of this arrangement is that supply of goods has indeed facilitated inflow/retention of forex into/within the country.

The current trade policy allows for the free export of all goods, except to the extent such exports are regulated by the ITC (HS) classification of export and import items or any other provisions of the policy or any other law for the time being in force. Exports from India are categorised into two (i.e. the open general license and the negative list) on the same lines as imports. The negative list consists of those goods, which are (a) Permitted for export under license (restricted) or (b) Canalised, or (c) Prohibited.

Some of the goods which are included under the restricted list are cattle, de-oiled groundnut cakes containing more than 1% oil, fur of domestic animals excluding lamb fur skin, fodder including wheat and rice straw, etc. Canalised exports include export of petroleum products, mica waste, mineral ores, onions, etc. The prohibited list includes all forms of wild life, exotic birds, human skeletons, etc.

The Director General of Foreign Trade lays down conditions according to which certain items may be exported without licenses. Such terms and conditions generally include minimum export price, registration with specific authorities, quantitative ceilings and compliance with other laws. A person wishing to export an item on the negative list of exports must have a registration and membership certificate from the relevant export promotion council. He should also be in possession of a license issued by the licensing authority for the said purpose. An export license contains all the terms and conditions laid down by the licensing authority. Some of the details which are included in an export license are the quantity, description and value of the goods, actual user condition, export obligation, value addition to be achieved by the exporter, and the minimum export price. It should be noted that an export license couldn't be claimed as a right. The licensing authority has the power to refuse, grant or renew a license as per the provisions of the Act. All export contracts must be denominated in freely convertible currencies.

In addition to possessing an export license, exporters are also required to register themselves with anyone of the Export Promotion Councils (EPCs) and obtain Registration and Membership Certificate (RCMC). Export promotion councils help in promoting and developing the exports of the country. Each council is responsible for the promotion of a particular group of products, projects and services. EPCs are non-profit organisations registered under the Indian Companies Act or the Societies Registration Act as the case may be and are supported by financial assistance from the Government of India. An exporter who wishes to avail various Exim benefits will have to mandatorily register with the export promotion council. The RCMC issued by the Export Promotion Council is valid for a period of 5 licensing years.

Prior to any export, an exporter is required to give a declaration that the full export value of the goods or if the value is not ascertainable at the time of export, the value which the exporter expects to receive from the export has been or will be paid within the stipulated time and in the prescribed manner.

Also, the export of goods to countries other than Nepal and Bhutan can be made only if a declaration in the prescribed form is furnished to the prescribed authority.

However, declaration forms are not required in certain cases. Exports where the declaration form is not required are:

(a) Trade samples supplied free of payment.

(b) Personal effects of travellers, whether accompanied or unaccompanied.

(c) Ships stores, transshipment cargo and goods shipped under the orders of the Central Government or of such officers as may be appointed by the Central Government on this behalf or of the military, naval or air force authorities in India for military, naval or air force requirements.

(d) Goods or software accompanied by a declaration by the exporter that they are not more than twenty five thousand rupees in value.

(e) By way of gift of goods accompanied by a declaration by the exporter that they are not more than one lakh rupees in value.

(f) Aircraft or aircraft engines and spare parts for overhauling and/or repairs abroad subject to their re-import into India after overhauling/repairs/within a period of six months from the date of their export.

(g) Goods imported free of cost on re-export basis.

(h) Goods not exceeding US$ 1000, or its equivalent in value per transaction exported to Myanmar under the Barter Trade Agreement between the Central Government and the Government of Myanmar.

(i) The following goods which are permitted by the Development Commissioner of the Export Processing Zones or Free Trade Zones to be re-exported namely:

1. Imported goods found defective for the purpose of their replacement by the foreign suppliers/collaborators.
2. Imported goods, which were imported from foreign collaborator on loan basis.
3. Surplus goods, which were earlier imported from foreign suppliers or collaborators free of cost, after production operations.

(j) Replacement goods exported free of charge in accordance with the provisions of the Exim policy in force, for the time being.

20.4 GOVERNMENT ASSISTANCE IN EXPORTING

Success in international trade is fundamentally important for the country. To be successful in international trade, the country's export oriented firms have to be good marketers i.e. to be competitive in terms of product offerings, promotion, price, delivery capability and service provided to importers. Equally important is for firms to be competitive in terms of extending credit to importers.

Because of the benefits that accrue from exporting, the governments of most countries offer competitive assistance to domestic exporters in the form of subsidised credit that can be extended to importers. Also, credit insurance programmes that guarantee financing extended by private financial institutions.

Check Your Progress

1. Which of the following is included in the prohibited list of exports?
   (a) Cattle
   (b) All forms of wild life
   (c) Petroleum products
   (d) Onions
   (e) Mineral ores
2. The export policy is announced for a period of:
   (a) 1 year
   (b) 2 years
   (c) 3 years
   (d) 4 years
   (e) 5 years

20.5 EXIM BANK

The Export Import Bank of India, set up in 1982, by an Act of Parliament, for the purpose of financing, facilitating and promoting foreign trade of India, is the principal financial institution in the country for co-ordinating the working of institutions engaged in financing exports and imports.

The Exim Bank is fully owned by the Government of India and is managed by a Board of Directors, which has representatives from the Government, Reserve Bank of India, Export Credit Guarantee Corporation of India, a financial institution, public sector banks and the business community.

Mission: Exim Bank's mission is to facilitate globalisation of Indian Business. The mission statement: to develop commercially viable relationships with externally oriented companies by supporting their internationalisation efforts, through a diverse range of products and services.

Objectives:

The objectives of the Exim Bank are:

1. To translate national foreign trade policies into concrete action points.
2. To provide alternate financing solutions to the Indian exporter, aiding him in his efforts to be internationally competitive.
3. To develop mutually beneficial relationships with the international financial community.
4. To initiate and participate in debates on issues central to India's international trade.
5. To forge close working relationships with other export development and financing agencies, multilateral funding agencies and national trade and investment promotion agencies.
6. To anticipate and absorb new developments in banking, export financing and information technology.
7. To be responsive to export problems of Indian exporters and pursue policy resolutions.

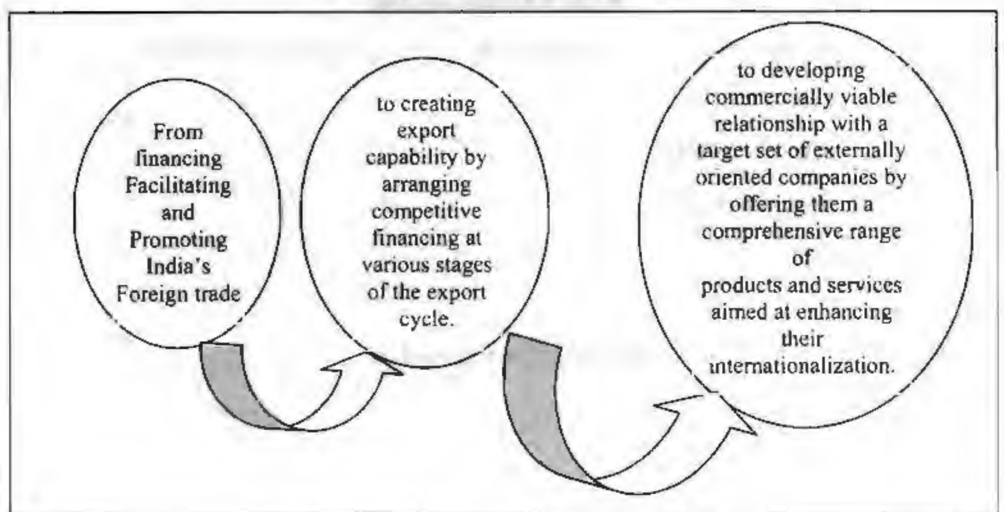

Figure 20.1: Evolving Role of Exim Bank

Global Networking

Exim Bank is quite unique in its global and national network of institutional and professional linkages. Its several overseas offices in places such as Budapest, Johannesburg, Milan, Singapore and Washington, D.C. have forged strategic institutional linkages for the Bank with multilateral agencies such as World Bank, Asian Development Bank, etc, Export Credit Agencies; Trade & Investment Promotion Agencies abroad; and Trade & Industry Associations in India.

The Bank's extensive global network, supported by the Indian Missions abroad makes it uniquely capable of offering advisory services to Indian companies looking for market opportunities, buyer information, technology suppliers and partners for overseas and domestic joint ventures. Further, our overseas offices enable us to garner economic and commercial intelligence on countries, companies and projects, assess credit risks, review competitive export practices and provide alerts on new export opportunities.

The domestic offices of the Bank in several places are intended to help to respond to regional developmental activities in the export sector. They are expected to identify special needs of the export business through close interaction with existing and prospective clients and suggest innovative instruments appropriate to the region's potential. They also regularly interact with commercial/developmental/government agencies, and strengthen the Bank's policy mechanism with their critical inputs on market perceptions and the export environment.

Functional Organisation

The Bank's functions are segmented into four major operating groups:

1. Overseas Investment Finance which handles a variety of financing programmers for Export Oriented Units (EOUs), importers and overseas investment by Indian companies.
2. Project Finance/Trade Finance: handles the entire range of export credit services such as supplier's credit, pre-shipment credit, lines of credit, buyer's credit, and finance for export of projects and consultancy services, guarantees, forfeiting, etc.
3. Export Services Group offers a variety of advisory and value added information services aimed at investment promotion.
4. Agri Business Group which has been put in place to spearhead the initiative to promote and support Agri exports. The Group handles projects and export transactions in the agricultural sector for financing.

Apart from these, there are the Support Services groups, which include Planning and Research, Corporate Finance, Management Information Services, Information Technology, Legal, Human Resources Management and Corporate Affairs.

Assistances: Exim Bank plays a four-pronged role with regard to India's foreign trade: those of a coordinator, a source of finance, consultant and promoter.

The Exim Bank operates a wide range of financing and promotional programmes. The Bank finances exports of Indian machinery, manufactured goods, and consultancy and technology services on deferred payment terms. It also seeks to co-finance projects with global and regional development agencies to assist Indian exporters in their efforts to participate in such overseas projects.

The Bank is involved in promotion of two-way technology transfer through the outward flow of investment in Indian joint ventures overseas and foreign direct investment flow into India. The Bank is also a partner Institution with the European Union and operates for facilitating promotion of joint ventures in India through technical and financial collaboration with medium sized firms of the European Union.

The Exim Bank thus, extends both funded and non-funded assistance for promotion of foreign trade.

The funded assistance programme of the Bank includes direct financial assistance to exporters; rediscounting of export bills, technology and consultancy services, financing, refinancing of export credit and re-lending facility to banks abroad.

Financing Services: Exim Bank offers a diverse range of financing services for the Indian exporter, including a variety of Export Credit Facilities, and Finance for Export Oriented Companies.

Export Credits: Exim Bank offers the following Export Credit facilities, which can be availed of by Indian Companies, commercial banks and overseas entities.

For Indian Companies Executing Contracts Overseas

Pre-shipment credit: Where the manufacturing cycle of the export contract exceeds six months. Exim Bank's Pre-Shipment Credit facility provides access to finance at the manufacturing stage – enabling exporters to purchase raw materials and other inputs.

Pre-Shipment Rupee Credit is extended to finance temporary funding requirements of export contracts. This facility enables provision of rupee mobilisation expenses for construction/turnkey projects. Exporters could also avail of pre-shipment credit in foreign currencies to finance cost of imported inputs for manufacture of export products to be supplied under the projects. Commercial banks also extend this facility for definite periods.

Supplier's credit: At the post-shipment stage, this facility enables Indian exporters to extend term credit to importers (overseas) of eligible goods. Exim Bank offers Supplier's Credit in Rupees or in Foreign Currency at post-shipment stage to finance export of eligible goods and services on deferred payment terms. Supplier's Credit is available both for supply contracts as well as project exports; the latter includes construction, turnkey or consultancy contracts undertaken overseas.

Exporters can seek Supplier's Credit in Rupees/Foreign Currency from Exim Bank in respect of export contracts on deferred payment terms irrespective of value of export contracts.

For project exporters: Indian project exporters incur Rupee expenditure while executing overseas project export contracts. Exim Bank's facility helps them meet these expenses. These would generally include costs of mobilisation/acquisition of materials, personnel and equipment, payments to be made in India to staff, sub-contractors and consultants, and project related overheads in Indian Rupees.

For exporters of consultancy and technological services: Exim Bank offers a special credit facility to Indian exporters of consultancy and technology services, so that they can, in turn, extend term credit to overseas importers. The services covered include providing personnel for rendering technical services, transfer of technology/know-how, preparation of project feasibility reports, maintenance and management contracts, etc.

Guarantee facilities: Indian companies can avail of these to furnish requisite guarantees to facilitate execution of export contracts and import transactions.

Forfaiting: Forfaiting is a financing mechanism that enables a company to convert credit sale to cash sale, on 'without recourse' basis. Exim bank acts as a facilitator for the Indian exporter, enabling him to access the services of an overseas forfaiting agency.

Other facilities for Indian companies: Indian companies executing contracts within India, but which are financed by multilateral funding agencies, can avail of credit

under the Bank's Finance for Deemed Exports Facility, aimed at helping them meet cash flow deficits.

For Overseas Entities

Buyers Credit: Overseas buyers can avail of Buyer's Credit from Exim Bank for import of eligible goods from India on deferred payment terms.

Lines of credit: Exim Bank extends Lines of Credit to overseas financial institutions, foreign governments and their agencies, enabling them to lend term loans to finance import of eligible goods from India.

The lines of credit are extended by the Bank to overseas governments/agencies nominated by them or financial institutions overseas to enable buyers in those countries to import capital/engineering goods, industrial manufacturers and related services from India on deferred payment terms. This facility enables importers in those countries to import from India on deferred credit terms as per the terms and conditions already negotiated between Exim Bank and the overseas agency. The Indian exporters can obtain payment of eligible value from Exim Bank against negotiation of shipping documents, without recourse to them.

The lines of credit are denominated in convertible foreign currencies or Indian Rupees and extended to sovereign governments/agencies nominated by them or financial institutions. Such governments/agencies/institutions are the borrowers and Exim Bank, the lender. Terms and conditions of different lines of credit are varying and details in respect of each line of credit can be obtained from the Exim Bank. It would need to be ascertained from time to time that the lines of credit have come into effect and uncommitted balance is still available for utilisation. Indian exporters also need to ascertain the quantum of service fees payable to Exim Bank on account of pro rata export credit insurance premium and/or interest rate differential cost that they can then pay up in their prices to their importers.

Finance for Export Oriented Units (EOUs): For the purpose of financing, an Export Oriented Company is defined as any company with a minimum export orientation of 10% of net sales, or annual export sales of Rs. 5 crores, whichever is lower.

Project Finance

For setting up EOUs: Exim Bank offers term loans for setting up new projects and for acquisition of assets for modernisation/upgradation/expansion of existing units. The Bank also extends 100% refinance to commercial banks, for term loans sanctioned by the lending bank to an EOU.

For textile and jute industries: The Bank also extends finance to eligible units in textile and jute industries under the Technology Upgradation Fund Scheme, to enable them to upgrade their manufacturing facilities.

For software industry: The Bank offers a comprehensive financing/services package for the software industry. These include project/equipment finance, working capital finance, overseas investment finance, besides support for obtaining product/process certification, export marketing and export product development.

The Exim Bank extends term loans to software exporters for the establishment expansion of software training institutes. Further, the Bank also facilitates setting up of Software Technology Parks (STPs).

For Indian companies involved in port development and related activities: Exim Bank extends term loans to Indian companies involved in the construction of ports/ jetties, and for the acquisition of fixed assets for stevedoring, cargo handling, storage and related activities like dry docks and ship breaking.

Equipment Finance

Finance for production equipment: To cater to the non-project related capital expenditure of EOUs, Exim Bank offers a line of credit for the acquisition of imported/indigenous equipment for packaging, pollution control, etc.

For vendors of EOUs: Under the Export Vendor Development Finance facility, Exim Bank offers term loans to vendors of EOUs, to enable them to acquire plant and machinery and other assets required for increasing export capability.

Working capital finance: Exim Bank provides term loans (of 1 year, 1-2 years, and up to 5 years tenure) to eligible EOUs, to help them meet their working capital (loan component) requirements.

Other Facilities

Finance for R&D and export product development: Exim Bank offers term loans to EOUs for the development of new technology to satisfy domestic and international environment and standards, and to help them develop and/or commercialise new product/process applications.

Underwriting: Exim Bank extends underwriting commitment to Indian exporters, to help them raise finance from capital markets through public/rights issues of equity shares/debentures.

Export marketing finance: Exim Bank offers term loans to Indian companies, to aid them in their efforts to penetrate and retain their presence in overseas markets, particularly in developed countries.

Import loans: Exim Bank finances bulk imports of consumable inputs and canalised items undertaken by manufacturing companies.

Guarantee facility: Exim Bank issues different kinds of guarantees for EOUs. These include: (a) export obligation guarantees; (b) deferred payment guarantees; and (c) guarantees in favour of commercial banks/lending institutions abroad on behalf of Indian exporters.

For JVs between Indian and East Asian companies: Under the Asian Countries Investment Partners Programme, Exim Bank provides finance at various stages of a joint venture project cycle viz., sector study, project identification, feasibility study, prototype development and technical, managerial assistance.

Finance for Ventures Overseas: Exim Bank offers term loans to Indian companies, both for equity investment in their ventures overseas as well as for on lending purposes.

Besides, Exim Bank also undertakes Direct Equity Stake in Indian ventures abroad, to enable Indian companies to supplement their equity with Exim Bank's equity contribution.

For Commercial Banks

Exim Bank offers Rediscounting facility to commercial banks, enabling them to rediscount export bills of their SSI customers, with usance not exceeding 90 days. It also offers Refinance of Suppliers Credit, enabling commercial banks to offer credit to Indian exporters of eligible goods, who in turn extend term credit over 180 days to importers overseas.

Authorised Dealers in foreign exchange can obtain from Exim Bank, hundred percent re-finance of deferred payment loans extended for the export of eligible Indian goods.

Export Services: Exim Bank offers a diverse range of information, advisory and support services, which enable exporters to evaluate international risks, exploit export opportunities and improve competitiveness.

For Multilateral Agencies Funded Projects Overseas (MFPO): Exim Bank offers value added information and support services to Indian companies seeking business in projects funded by multilateral agencies such as the World Bank, Asian Development Bank, African Development Bank, European Bank for Reconstruction and Development, and other official Development Agencies like the Overseas Economic Co-operation Fund of Japan. Services offered include identification of business opportunities in funded projects; details on specific projects of interest; information on procurement guidelines, policies and practices of multilateral agencies; assistance for registration with multilateral agencies: advice on preparation of Expression of Interest, Capability Profile, etc; advice on bids, with regard to bid evaluation, review of bid documents, etc.

Apart from these, the Bank also offers support services, such as liaising with Indian missions, monitoring bid performance, aids in prequalification, etc.

Commercial services: Exim Bank undertakes customised research on behalf of interested companies in areas such as establishing market potential defining marketing arrangements and specifying distribution channels. We also assist companies in developing export market entry plans, obtaining quality certifications and display of their products in our overseas offices.

Country profiles: Exim Bank also undertakes country profiles, which assess the economic, political currency and credit risks involved, along with the export opportunities in the country concerned.

Financial counselling: Exim Bank offers advice on how to access foreign currency finance from multilateral institutions and import lines of credit, trade finance alternatives, collection/payment systems, as well as on the credit- worthiness of business entities and banks.

Internationalisation support: Exim Bank helps in identifying technology, suppliers, partners, and in consummation of domestic and overseas joint ventures, through its network of alliances and its overseas offices. It also advises companies on regulatory clearances, and facilitates tying up finance for equity and working capital.

Building export capability: The Bank's Eximius Learning Centres in Bangalore and Ahmedabad organise training programmes, workshops and seminars for exporters. These programmes on sector specific issues are conducted by international experts from trade promotion organisations and multinational companies.

The Bank also carries out research on issues related to international trade, economics, and sector/product/country studies, which it publishes in the form of Occasional Papers.

The Bank disseminates information on export opportunities and highlights developments that have a bearing on Indian exports, through its periodicals.

International merchant banking services: The Exim Bank provides advisory services to Indian exporters to enable them to offer competitive financial packages when they bid for exports.

Joint Ventures

Global Procurement Consultants Limited (GPCL) is a successful consultancy company, promoted by Exim Bank in 1996, in partnership with leading private and public sector consultancy firms in India. GPCL provides procurement related services to multilateral agencies such as World Bank, Asian Development Bank and African Development Bank.

Global Trade Finance Private Limited (GTF): Joint Venture promoted by Exim Bank with Westdeutsche Landesbank Girozentrala (West LB), Germany and International Finance Corporation (IFC), Washington, commenced business in

September 2001. GTF offers, for the first time in India, structured foreign trade financing products such as forfeiting and factoring.

Promotional Programmes: Award for Business Excellence, Exim Bank in association with the Confederation of Indian Industry (CII), presents an Annual Award for Business Excellence for the best TQM practices adopted by an Indian company. The high performance standards set down in order to qualify for the Award serve to foster strong commitments to TQM in the company's journey towards Business Excellence.

Grants to Indian Consultants for undertaking services abroad, under the Project Preparatory Services Overseas (PPSO) Programme. Exim Bank provides loan / grant finance to enable Indian consultancy firms to take up project preparatory studies in developing countries.

Under an arrangement with International Finance Corporation (IFC), Washington, Exim Bank is a participant in the trust funds set up by the IFC in different parts of the world. As a result of this arrangement, Indian consultants can avail of grant finance for undertaking specific assignments in select countries in Africa, Eastern Europe, and the Mekong delta region.

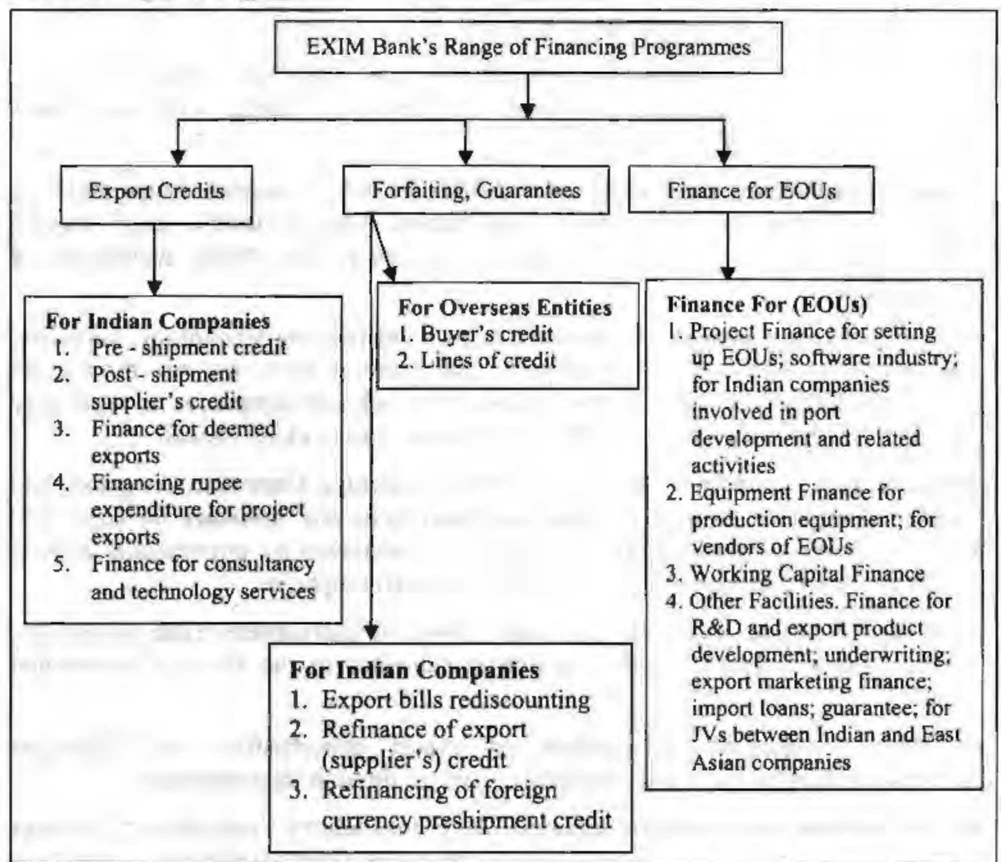

Figure 20.2: Scope of EXIM Bank's Financing Programmes

20.6 FORFAITING

The word 'forfait' is derived from the French word 'a forfait' which means the surrender of rights. Simply put, forfaiting is the non-recourse discounting of export receivables. In a forfaiting transaction, the exporter surrenders, without recourse to him, his rights to claim for payment on goods delivered to an importer, in return for immediate cash payment from a forfaiter. As a result, an exporter in India can convert a credit sale into a cash sale, with no recourse to the exporter or his banker.

Forfaiting in short is a mechanism of financing exports:

1. By discounting export receivables
2. Evidenced by bills of exchange or promissory notes
3. Without recourse to the seller (viz. exporter)
4. Carrying medium to long-term maturities
5. On a fixed rate basis (discount)
6. Up to 100 percent of the contract value

All exports of capital goods and other goods made on medium to long-term credit are eligible to be financed through forfaiting.

Receivables under a deferred payment contract for export of goods, evidenced by bills of exchange or promissory notes can be forfaited. Bills of exchange or promissory notes, backed by co-acceptance from a bank (which would generally be the buyer's bank) are endorsed by the exporter, without recourse, in favor of the forfaiting agency in exchange for discounted cash proceeds. The banker's co-acceptance is known as validation. The co-accepting bank must be acceptable to the forfaiting agency.

Exim Bank has been authorized by the Reserve Bank of India to facilitate export financing through forfaiting.

The role of Exim Bank will be that of a facilitator between the Indian exporter and the overseas forfaiting agency. On a request from an exporter, for an export transaction which is eligible to be forfaited. Exim Bank will obtain indicative and firm forfaiting quotes – discount rate, commitment and other fees – from overseas agencies. The Bank will receive availed bills of exchange or promissory notes, as the case may be, and send them to the forfaiter for discounting and will arrange for the discounted proceeds to be remitted to the Indian exporter. It will issue appropriate certificates to enable Indian exporters to remit commitment fees and other charges.

To be eligible for forfaiting the export contract can be executed in any of the major convertible currencies e.g. US Dollar, Deutsche Mark, Pound Sterling, and Japanese Yen.

The duration of receivables eligible for forfaiting is normally between 1 year and 5 years.

The minimum value of an export contract eligible for forfeiting and acceptable to a forfaiting agency will generally be the equivalent of US $ 1, 00,000.

Eligibility of an export transaction for forfeiting can be determined when the forfaiting agency is approached for a forfait quote. The availability of a forfaiting quote for a particular country will depend on the forfaiting agency's perception of risk quality of export receivables from that country. The forfaiting agency will indicate the maximum amount and the period of discount while giving quote for forfeiting.

A forfaiting transaction has typically three cost elements: commitment fee; discount fee; and documentation fee. Exim Bank will charge a service fee for facilitating the forfaiting transaction which will be payable in Indian rupees.

Benefits of Forfaiting:

1. Converts a deferred payment export into a cash transaction, improving liquidity and cash flow.
2. Frees the exporter from cross border political or commercial risks associated with export receivables.
3. Finance up to 100 percent of the export value is possible as compared to 80 - 85 percent financing available from conventional export credit programmes.

4. As forfaiting offers without recourse finance to an exporter, it does not impact the exporter's borrowing limits. Thus, forfaiting represents an additional source of funding, contributing to improved liquidity and cash flows.
5. Provides fixed rate finance; hedges against interest and exchange risks arising from deferred export credit.
6. Exporter is freed from credit administration and collection problems.
7. Forfaiting is transaction specific. Consequently, a long-term banking relationship with the forfaiter is not necessary to arrange a forfaiting transaction.
8. Exporter saves on insurance costs as forfaiting obviates the need for export credit insurance.
9. Simplicity of documentation enables rapid conclusion of the forfaiting arrangement.

(More details about forfeiting are available on the www.eximindia.com)

20.7 MATURITY FACTORING BY ECGC

Factors in general offer their clients bill discounting, credit protection, ledger maintenance and receivable management in respect of approved customers.

Maturity factoring facility offered by the Export Credit Guarantee Corporation of India Ltd. (ECGC) provides the following viz., credit protection, ledger maintenance, receivable management, enables client to avail discounting facility from bank by guaranteeing the advances granted against the bill.

Thus, the facility offered by ECGC allows you the benefits of the traditional factoring without disturbing your existing banking arrangement. Apart from this, it also provides for sharing of losses where the goods/documents are not accepted due to insolvency or financial condition of the buyer.

The following are the benefits to exporters: 100 percent risk protection in respect of transactions where the buyer accepts the bills/documents without recourse to the exporter; sharing of loss in case of non-acceptance of goods/documents due to insolvency or financial difficulty; receivable management and sales ledger maintenance; enables the exporter to avail bank finance on easier terms. The exporter can avail of the above benefits without disturbing existing system of banking arrangements.

20.8 EXPORT CREDIT RISK INSURANCE

The Export Credit Guarantee Corporation of India Ltd. (ECGC), a company wholly owned by Government of India and which functions under the administrative control of the Ministry of Commerce, has a number of schemes to cover several risks which are not covered by general insurers.

The primary role of ECGC is to support and strengthen the export development of India by:

1. Providing a range of credit risk insurance covers to exporters against loss in of goods and services.
2. Offering guarantees to banks and financial institutions to enable export obtain better facilities from them.

In other words, the objectives of ECGC are:

1. To provide insurance cover to exporters against political and commercial risks.
2. To provide insurance cover to exporters against the risk of exchange rate fluctuations in respect deferred payments.

3. To provide insurance cover to banks against export credit and guarantees extended by them.
4. To provide insurance cover to Indian investors abroad against political risks.

Insurance Covers

The covers issued by ECGC may be broadly divided into the following four groups:

1. Standard policies issued to exporters to protect them against payment risks involved in exports on short term credit.
2. Specific policies designed to protect Indian firms against payment risks involved in exports on deferred terms of payment, services rendered to foreign parties construction works and turnkey projects undertaken abroad.
3. Financial guarantees issued to banks in India to protect them from risks of loss involved in their extending financial support to exporters at the pre-shipment as well as post shipment stages.
4. Special schemes

Transfer Guarantee: To safeguard banks in India against losses on account of failure of foreign banks to reimburse it with the amount paid to an exporter, when Indian bank has added information to a letter of credit opened by the foreign bank.

Overseas Investment Insurance: To cover the risk on account of war, appropriation or restriction on remittances to Indian investments made by way of equity capital or united loan for the purpose of setting up or expansion of overseas projects.

Exchange Fluctuation Risk Cover: To provide protection for exchange rate fluctuation to exporters of capital goods, and engineering contractors and consultants who have to receive payments over a period of 4 years for their exports construction work or services.

20.9 FOREIGN EXCHANGE DEALER'S ASSOCIATION OF INDIA (FEDAI)

Foreign Exchange Dealer's Association of India (FEDAI) was set up in 1958 as an Association of banks dealing in foreign exchange in India (typically called Authorized Dealers – Ads) as a self regulatory body and is incorporated under Section 25 of the Companies Act, 1956. Its major activities including framing of rules governing the conduct of inter-bank foreign exchange business among banks vis-à-vis public and liaison with RBI for reforms and development of forex market.

Presently some of the functions are as follows:

- Guidelines and Rules for Forex Business
- Training of Bank Personnel in the areas of Foreign Exchange Business
- Accreditation of Forex Brokers
- Advising/assisting member banks in settling issues/matters in their dealings.
- Represent member banks on government/Reserve Bank of India/Other Bodies.
- Announcement of daily and periodical rates to member banks.

Due to continuing integration of the global financial markets and increased pace of de-regulation, the role of self-regulatory organizations like FEDAI has also transformed. In such an environment, FEDAI plays a catalytic role for smooth functioning of the markets through closer co-ordination with the RBI, other organizations like FIMMDA, the Forex Association of India and various market participants. FEDAI also maximises the benefits derived from synergies of member

banks through innovation in areas like new customized products, benchmarking against international standards on accounting, market practices, risk management systems, etc.

20.10 LET US SUM UP

Countries have started realising the benefits of free trade and are slowly moving away from quotas and embargo towards positive and growth oriented economic policies to encash one's own unique potential/competency vis-a-vis the treading partners. Our recent EXIM Policy is a pointer in that direction.

The major thrust of the new Exim policy for the period 2002-07 is the acceleration of India's exports through a wide range of measures to restructure the various export promotion schemes and to advocate simplification and streamlining of procedures so as to inject greater transparency into the system, besides ensuring 'speed' in carrying out transactions.

The Exim policy also issues trade regulations governing exports and imports. It lays down the trade procedures to be followed by exporters and importers.

Because of the benefits that accrue from exporting, the Government of most countries offer competitive assistance to domestic exporters in the form of subsidised credit that can be extended to importers. Also, credit insurance programmes that guarantee financing extended by private financial institutions. The programme available to Indian exporters. Assistance through EXIM Bank, forfaiting facility, Maturity Factoring by Export Credit Guarantee Corporation of India Ltd. (ECGC) and Foreign Exchange Dealer's Association of India (FEDAI).

20.11 LESSON END ACTIVITY

Do you think that a country's government should assist private business in the conduct of international trade through direct loans, loan guarantees and/or credit insurance?

20.12 KEYWORDS

Regular license: These are licenses issued for the import of goods, which fall under the normal import policy.

Advance licenses: Advance licenses are issued under the duty exemption scheme.

Special Import License: A Special Import License (SIL) may be used to import, among other items, certain consumer goods.

DEPB: Duty Entitlement Pass Book Scheme

20.13 QUESTIONS FOR DISCUSSION

1. What are the objectives of EXIM Policy 2002-07 and what are the highlights of Exim Policy 2002-07 (as amended up to 31.3.2003)?
2. What is the purpose of the Export-Import Bank?
3. What is the profile of Foreign Exchange Dealers Association of India (FEDAI)?
4. What is a forfaiting transaction?

Check Your Progress: Model Answer

1. (b), 2. (e)

20.14 SUGGESTED READINGS

Apte P.G., *International Financial Management*, 4th Edition, Tata McGraw-Hill Publishing Company Limited.

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LESSON

21

EXPORT AND IMPORT FINANCING

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21.0 Aims and Objectives

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21.0 AIMS AND OBJECTIVES

After studying this lesson, you should be able to understand:

- The intricacies of international trade transactions in comparison to domestic trade
- The structuring of foreign trade transactions and various financing options available in international trade

21.1 INTRODUCTION

International trade is important for a country. In modern times it is virtually impossible for a country to produce domestically everything its citizens need or demand. Even if it could, it is unlikely that it could produce all items more efficiently than producers in other countries. Without international trade, scarce resources are not put to effective use.

International trade is more difficult and risky, however, than domestic trade because of financing. Mechanisms for financing exports and imports have evolved over the centuries in response to a problem that can be particularly critical in international trade i.e. the lack of trust that exists when one must place faith in a stranger. Firms engaged in international trade have to find someone that may have never seen, who lives in a different country, one who speaks a different language, one who abides by (or does not abide by) a different legal system, and who could be very difficult to track down in case of default in fulfiling its delegation. For example, consider a US firm exporting to a distributor in UK. The US businessman may be concurred that if

he ships the produce to UK before he receives the payment; the UK businessman may take delivery of the products and not pay. Conversely, the UK Businessman may think that if he pays for products before they are shipped, the US firm may keep the money and never ship the products or might ship defective products. This lack of trust again increases because of distance between the two parties – in space, language and culture – and due to an underdeveloped international legal system to enforce contractual obligation.

Due to lack of trust between the two parties, each party will have its own preferences for the transaction to be configured. To make sure that the firm gets paid, the US firm would prefer the UK distributor to pay for the products before these are shipped. Alternatively the UK firm, to be sure that it receives the products wants to make payment only after satisfactory receipt of the products. Thus, each party has a different set of preferences. Unless there is some way of establishing terms between the two parties, the transaction might never take place.

This problem is solved by using a third party trusted by both – normally a reputable bank – to act as an intermediary. The process can be summarised as follows:

First the importer obtains a bank's promise to pay on its behalf knowing the exporter will trust the bank. This promise is known as a letter of credit. Having seen the letter of credit, the exporter ships the products. Title to the products is given to the bank in the form of a document called a bill of lading. In return the exporter asks the bank to pay for the products and the bank pays. The document for requesting this payment is referred to as a draft. The bank, having paid for the products, now passes tbe title of the goods to the importer whom the bank trusts. At that time or later, depending on their agreement, the importer reimburses the bank. The process is shown below:

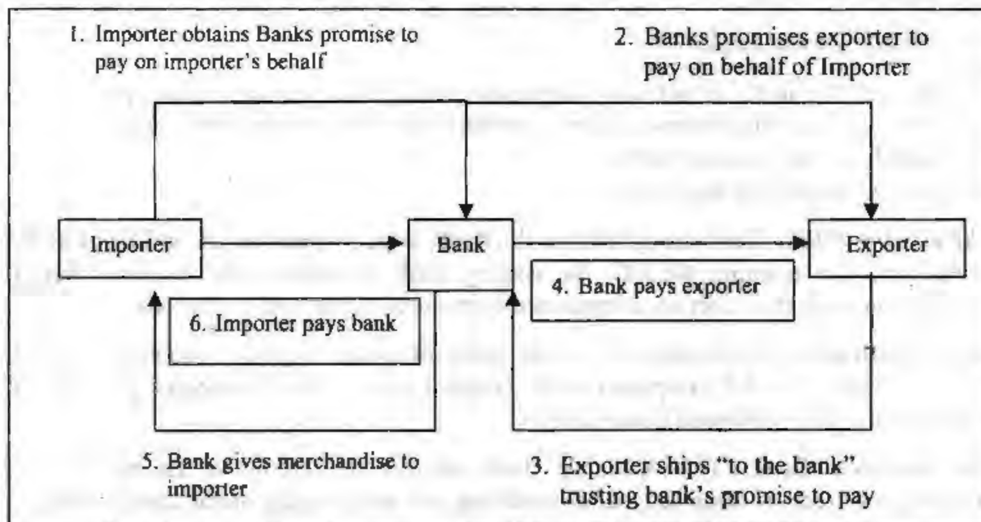

Figure 21.1: Use of a Third Party for Export-Import

In the remainder, we examine how the above system works in greater detail.

21.2 WHAT IS A LETTER OF CREDIT?

A documentary/letter of credit may be defined as "an arrangement by means of which a bank (Issuing Bank) acting at the request of a customer (Applicant), undertakes to pay to a third party (Beneficiary) a predetermined amount by a given date according to agreed stipulations and against presentation of stipulated documents." In simple terms, an LC may be defined as an arrangement where payment is made against documents. Under documentary credits, all the parties concerned deal with documents and not with goods, services or performances to which the documents may relate.

The Uniform Customs and Practice for Documentary Credits (UCPDC) guidelines which govern the operations of letters of credit defines documentary credit as any arrangement, however named or described, whereby a bank (the "Issuing Bank"), acting at the request and on the instructions of a customer (the "Applicant") or on its own behalf:

1. Is to make a payment to or to the order of a third party (the Beneficiary), or is to accept and pay bills of exchange ("Draft" (s) drawn by the Beneficiary), or
2. Authorises another bank to effect such payment, or to accept and pay such bills of exchange (Draft(s)), or
3. Authorises another bank to negotiate against stipulated documents, provided that the terms and conditions of the credit are complied with.

21.3 PARTIES TO A LETTER OF CREDIT

From the definition given above it can be deduced that the principal parties to a letter of credit are:

- The Applicant (Opener of the LC/Importer)
- The Issuing Bank (The bank which opens the LC)
- The Beneficiary (Who is the Seller/Exporter) of the underlying LC
- The Advising Bank
- Confirming Bank
- Nominated Bank
- Reimbursement Bank

The applicant of an LC is normally the buyer of the goods who is to make payment to the seller. It is at his request and instructions that the issuing bank opens the LC. Incidentally, an LC issuing bank could itself be an applicant (For its own use, it can be an applicant, as well as an issuer).

The Issuing Bank: The Issuing Bank is the bank, which opens the LC in favour of the beneficiary. By opening the LC, the issuing bank undertakes the responsibility to make payment to the seller on compliance of required terms and conditions.

The Beneficiary: The Beneficiary is the seller of goods who is to receive payment from the buyer. The LC is opened in his favour to enable him to receive payment on submission of the stipulated documents.

The Advising Bank: The Advising Bank advises the credit to the beneficiary. Advising of credit is done only after verifying the authenticity of the credit. When a bank advises a credit, it implies that it authenticates the signatures of the issuing bank. The advising bank is usually situated in the country of the beneficiary.

Confirming Bank: The advising bank or any other bank so authorised by the issuing bank may assume the role of a confirming bank and add its confirmation to the LC opened by an issuing bank. The bank which has been asked to confirm an LC is under no obligation to confirm it. It can independently choose either to confirm or not, but it should advise its decision to the issuing bank. A confirming bank, for all practical purposes enters into the shoes of the issuing bank and assumes primary responsibility of effecting payment under the LC to the beneficiary, upon his complying with the terms of the LC.

Nominated Bank: Nominated bank is the bank that is nominated and authorised by the issuing bank to:

- Pay if the LC is a payment LC

- Incur a deferred payment undertaking
- Accept drafts, if the credit stipulates so
- Negotiate

Where a credit is specified as freely negotiable, any bank can negotiate the documents under such an LC. However, where credit is restricted for negotiation, the issuing bank specifies the banks which are the nominated banks and to whom documents have to be presented for negotiation, etc. Bills under an LC with "restricted for negotiation" clause cannot be negotiated by any bank other than the nominated bank in the LC.

Reimbursement Bank: Reimbursement bank is the bank, which is authorised to honour the reimbursement claim in settlement of negotiation/acceptance/payment lodged with it by the paying, negotiating or accepting bank. It is normally the bank with which the issuing bank has an account, from which payment is to be made.

21.4 DUTIES AND RESPONSIBILITIES OF PARTIES TO AN LC

The rights and responsibilities of every party associated with an LC have been defined in the UCPDC 500. It is necessary that every party dealing with an LC keeps himself informed about these responsibilities. A brief summary of these rights is as under:

- All parties dealing with an LC are dealing only with documents and not with goods / services, or performances to which the documents may relate.
- Exporter / Beneficiary of LC has a right to receive payment against submission of prescribed documents under the LC. It is the exporter's duty to ship the goods as per the LC and submit the documents within the stipulated time for registration.
- ***Negotiating Bank:*** Once documents under the LC are submitted, the negotiating bank has to ascertain that they appear on their face to be in accordance with the terms and conditions of the credit and if found agreeable, should effect payment as per the LC terms and dispatch documents to the opening bank as instructed. Once the amount under the LC is paid to the beneficiary, the negotiating bank is entitled to get reimbursement from the opening bank for the payment, provided documents are in conformity with LC terms.
- ***Opening Bank:*** Once documents under the LC are received from the negotiating bank, it should scrutinise them within 7 days from the date of receipt. If it finds any discrepancy in the documents, it must convey the same to the negotiating bank through the fastest means available, advising that it is holding documents in want of disposal instructions.
- ***Advising Bank:*** Once LC opening instructions are received from the opening bank, the advising bank should if it so desires to, act as advising bank, verify the veracity of the LC and advise the beneficiary about the LC and its terms. It is entitled to receive advising charges for having advised the LC from the LC opening bank.
- ***Confirming Bank:*** If, at the request of the issuing bank, the advising bank chooses to add its conformity to the LC, it is taking upon itself, the responsibility of paying the beneficiary against presentation of stipulated documents. Upon payment, it is entitled to receive reimbursement from the issuing bank. It is also entitled to receive confirmation charges.
- ***Applicant to the LC:*** The importer is responsible for making payment under the LC, against release of stipulated documents, to the opening bank.

21.5 HOW A LETTER OF CREDIT OPERATES

In order to make payment to the overseas supplier, the buyer of goods approaches his bank for opening a letter of credit in favour of the supplier.

After considering the request of the buyer and fulfilment of the necessary formalities, the issuing bank (i.e. the buyer's bank) opens the letter of credit in favour of the supplier.

The letter of credit is transmitted to the advising bank (usually an intermediary bank located in the supplier's country) with a request to advise the credit to the beneficiary. After being satisfied with the authenticity of the credit, the advising bank advises the credit to the beneficiary (i.e. the supplier).

The beneficiary verifies the letter of credit and checks for any discrepancies vis-à-vis the sale contract. If any discrepancies are noticed, the buyer is asked to incorporate the necessary changes/amendments to the LC. The supplier then proceeds to ship the goods.

Shipment of goods is followed by submission of the necessary documents by the supplier to the negotiating bank in order to obtain payment for the goods. The negotiating bank, upon receipt of commercial documents and the bill of lading from the exporter, scrutinises the documents in relation to the LC and if found to be in order, negotiates the bill and makes payment to the supplier.

The negotiating bank then claims reimbursement from the issuing bank by mailing the documents to it or any other bank authorised for the said purpose.

The commercial invoice and other documents are presented by the issuing bank to the buyer of goods, who, on receipt of the same, checks the documents and accepts/pays the bill. On acceptance/payment, the shipping documents covering the goods purchased are handed over to him.

21.6 DIFFERENT KINDS OF LETTERS OF CREDIT

Various types of LCs are in operation depending upon the need. Based on the nature and function, LCs may be categorised as under:

Based on Scope for Cancellation

(a) ***Revocable Letter of Credit:*** A revocable letter of credit is one, which can be revoked (either cancelled or amended), by the issuing bank without giving notice to any of the parties concerned. Here the issuing bank reserves the right of revocation. A revocable letter of credit is disadvantageous from the exporter's point of view. By opening a revocable letter of credit, the issuing bank does not make a definite undertaking to effect payment to the exporter. However, if a nominated bank has made payment to the beneficiary, prior to receipt of the notice of cancellation or amendment, then the issuing bank will be responsible to reimburse the claim that has been presented to it.

    Every letter of credit should clearly specify whether it is revocable or irrevocable. According to the UCPDC guidelines, if no such indication is observed, the credit will be deemed to be an irrevocable letter of credit.

(b) ***Irrevocable Letter of Credit:*** Almost all LCs opened in the course of international trade are irrevocable letters of credit. Cancellation or any amendment to such an LC cannot be made without the prior acceptance of all the parties to the said LC like the applicant, the confirming bank, if any and the beneficiary. It is important to note that cancellation or amendment can be made only if all the parties consent to the same. An irrevocable letter of credit is more desirable from the exporter's point of view.

(c) ***Confirmed Letter of Credit:*** Here, in addition to the issuing bank, another bank will add its confirmation to the LC. In other words, a confirmed letter of credit will have the guarantee of not only the issuing bank but also of the confirming bank. It should be noted that only irrevocable letters of credit could be confirmed. The confirming bank will add its confirmation only if requested by the issuing bank. Confirming banks are usually located in the country of the beneficiary.

This works to the convenience of the beneficiary, as he will have to deal with a local bank rather than a bank situated in another country. A confirmed letter of credit is slightly costlier, owing to the charges that will have to be paid to the confirming bank for confirmation.

Based on Mode of Payment

(a) ***Payment Credit:*** Under this credit, payment will be made to the beneficiary on submission of the required documents provided they are in compliance with the LC terms. Payment credits do not usually call for drawing of bills. Under payment credit, the issuing bank nominates a bank in the exporter's country to effect payment on its behalf if the documents are in conformity with the LC. The bank, which paid the amount under the LC, gets reimbursement from the issuing bank.

(b) ***Deferred Payment Credit:*** This type of credit is a usance credit, where payment is made on the due dates specified in the credit. The beneficiary may or may not be required to draw drafts. However, under this credit, the maturity dates at which payment has to be made and how much maturity should be determined should be clearly indicated. The drawer bank itself may draw promissory notes and pass on to the beneficiary for claiming payments on due date.

(c) ***Acceptance Credit:*** This credit is a usance credit, where it is mandatory for the beneficiary to draw a draft on the drawer/specified tenor. The drawer bank will accept such drafts and make payment on the respective due dates on presentation of the relevant bill of exchange.

(d) ***Negotiation Credit:*** This credit may be a slight credit or a usance credit. Under a sight credit, payment is made immediately, while under a usance credit payment is made after a specified tenor. A negotiation credit may be freely negotiable in which case the beneficiary may approach any bank for the presentation of documents. This implies that when a credit is freely negotiable, any bank is a nominated bank.

On the other hand, when a credit is restricted for negotiation, the issuing bank authorises certain specified banks as the nominated banks. In such a case, the beneficiary is required to present the stipulated documents only to such banks as they alone are authorised to negotiate the documents under LC.

When a bank nominated to make payment refuses to do so, and then it is the responsibility of the issuing bank to make such payment. Hence, in a negotiation credit, under all circumstances, it is the responsibility of the issuing bank to pay, and it cannot avoid its responsibility by stating that the negotiating bank is required to pay. A nominated bank, which effectively negotiates documents, buys the same from the beneficiary, thus becoming a holder in due course.

Based on Tenor

(a) ***Sight Credit:*** Where payment is made on sight (either on demand or presentation), such credit is called a sight credit. Drawing of drafts is not compulsory under sight credit. Under a sight payment credit (if drawing a draft is not required) payment can be made against submission of stipulated documents.

(b) ***Usance Credit:*** Also referred to as Term Credit, this credit requires drafts to be drawn on the drawee/specified bank indicating the tenor. Such drafts will be accepted by the drawee and paid for at the end of the usance period.

Based on Availability Style

(a) ***Revolving Credit:*** A letter of Credit whereby the credit available to the beneficiary gets reinstated to the original amount once a drawing is made is called revolving credit. The amount under this credit may revolve in relation to time or value. Revolving credit may be of two types. In the first type, the amount gets reinstated immediately when the beneficiary makes a drawing. In the second type, the amount will be revived only when the issuing bank gives a confirmation. This may take place after the issuing bank receives documents and payment is made, or the issuing bank confirms the fact of receipt of documents.

(b) ***Instalment Credit:*** It stipulates that shipments may be made in instalments at specified periods of time. Instalment credit differs from simple credit, which permits partial shipments in the sense that under instalment credit, the time as well as the quantity is stipulated. On the other hand, under a simple credit, which permits partial shipments, there is no stipulation as to the time and quantity.

While availing credit under an instalment letter of credit, the exporter should be aware of the implications of Article 41 of the UCPDC guidelines. As per this article, if for any reason, the beneficiary is not able to ship the goods within the stipulated period and does not draw the instalment on time, then the LC ceases to be available not only for that instalment but also for any subsequent instalments. This can be prevented only if the beneficiary sees to it that a provision specifically stipulating that credit will be available for subsequent instalments despite any failure of earlier shipment or drawings is incorporated in the text of the LC. This credit calls for shipment of full value of goods.

(c) ***Deferred Credit:*** This credit is mostly used in those trades where a portion of goods is paid for by the buyer after verification of goods or after assessing the value of the goods, taking into account the quality, shortages, etc. The date for payment of the undrawn balance may or may not be specified. Hence such type of credit is called deferred credit.

(d) ***Transit Credit:*** Normally, when an LC is opened, it will be advised to the beneficiary by a bank that is based in the beneficiary's country. However in transit credit, the services of a bank situated in a third country will be used. In such credit, the advising bank will be situated in a country other than the beneficiary's. Such a requirement may be called for in cases where the opening bank has no corresponding relations with any bank in the beneficiary's country. Transit credit may also be opened by countries whose credit may not be readily accepted in the beneficiary's country. In such a case, a bank in a third country may be requested to open the LC.

(e) ***Reimbursement Credit:*** When credit is denominated in the currency of a third country, such credit is termed as reimbursement credit. This is in contrast to the normal letters of credit, which are denominated in the currency of either the applicant's country or the beneficiary's country. Sometimes, credits where a paying/accepting/negotiating bank is reimbursed in a manner other than by debit to the Vostro Account of the opening bank or by credit to the Nostro Account of the paying/accepting/negotiating bank is reimbursed in a manner other than by debit to the Vostro Account of the opening bank or by credit to the Nostro Account of the paying/accepting/negotiating bank held with the opening bank are also referred to as reimbursement credits.

(f) ***Anticipatory Credit:*** Payment under a letter of credit is usually made at the post shipment stage (i.e. on submission of relevant shipping documents). However, under anticipatory credit, payment is made to the exporter at the pre-shipment stage in anticipation of export of goods and submission of bills at a later stage. The advances so made will be recovered from the proceeds of bills to be

submitted under the letter of credit. Where the bills are not presented, recovery will be made from the opening bank.

Anticipatory credits are of two types:

- Red clause credit
- Green Clause Credit

Under the red clause credit, advance payment is made to the beneficiary for purchasing raw materials/processing and/or packing the goods.

In addition to the purpose specified under the red clause credit, the green clause credit provides for payment of advance towards warehousing and insurance charges at the port where the goods are stored pending availability of ship/shipping space.

These two types are, as of now, outdated and are rarely being used.

Others

(a) ***Stand by Letter of Credit:*** In a standby letter of credit, the credit is payable upon certification of a party's non-performance of the agreement, of course upon adducing evidence to the effect that payment has indeed been defaulted. Standby LC is mostly used in countries where financial guarantees are prohibited by law, like in the USA.

(b) ***Transferable Credit:*** A transferable credit is one, which can be transferred (i.e. from the First Beneficiary to a Second Beneficiary). It should be noted that such credit can be transferred only once. The second beneficiary cannot in turn transfer the same to a third beneficiary. A transferable credit will be subject to the original terms and conditions of the credit, excepting the amount of credit, unit prices, percentage of insurance terms, period of validity and shipment.

According to Article 48(b) of the UCPDC, a credit will be rendered as transferable, only if it is specifically stipulated as such in the credit.

(c) ***Back to Back Credit:*** This credit is one that is opened against the security of another credit called the main credit. Under this credit, an LC is opened by the buyer in favour of his actual supplier/manufacturer against the security of the main credit. By doing so, .the first beneficiary can obtain reimbursement by presenting documents received under back to back credit under the main LC.

Situations where the need for back-to-back letters of credit arises are:

- Where the buyer is not willing to open a transferable letter of credit.
- Where the beneficiary does not want to reveal the source of supply to the buyer.
- Where the actual supplier wants payment against documents for goods but the beneficiary of credit is short of funds.

Bankers may not find a back-to-back credit as safe as a transferable credit. This is because there is likelihood that once payment is made against the documents received under the back to back LC, the opener of the back-to-back LC may not be able to submit the same documents under the main LC to obtain reimbursement leading to credit risk to the opening bank of the back to back LC. Hence, bankers should exercise due caution while opening a back-to back letter of credit.

21.7 DOCUMENTS UNDER A LETTER OF CREDIT

In case of shipment under Letter of credit, the supplier should prepare documents strictly in accordance with the terms and conditions of the Letter of credit and submit them to his bank for negotiation. The negotiating bank will examine these documents and if found in order, negotiate the same.

If there are any discrepancies in the documents presented by the exporter, the negotiating bank:

- May return the documents to the exporters for rectification of defects,
- May refuse to negotiate the documents and advise the exporter to send them on collection basis, or
- Contact the issuing bank for authorisation for negotiation in case of minor discrepancies, or
- Make payment 'under' reserve against the exporter's indemnity and send the bills to the issuing bank.

The documents to be submitted by the exporter to his banker would include a commercial invoice, transport document which is usually the bill of lading (or seaway bill or airway bill), insurance document, certificate of inspection, packing list and in some cases a certificate of origin of goods as well.

Before submitting the documents to the bank, the exporter should follow certain safeguards, which are indicated below:

- Documents called for should be submitted and in the requisite number.
- Documents should be issued by the persons required to issue.
- Documents should be dated wherever required.
- Documents should be manually signed wherever stipulated.
- Any material alterations to the documents should be properly authenticated.
- Documents should be consistent with each other.
- Shipment should take place within the time stipulated in the LC. In case of instalment credit, the requisite quantity should be shipped within the stipulated time.
- If partial shipment is effected, the same should be permitted under the LC.
- Documents should be presented at the place stipulated.
- Documents should be presented within the expiry date of the LC.
- Documents should be presented within the time stipulation indicated in the LC or the provisions of the UCPDC.

Guidelines to be kept in mind with respect to individual documents are enumerated below:

Invoice

A commercial invoice is prima facie evidence of the contract of sale and purchase. It is a document made by the exporter on the importer indicating details like description of the goods consigned, consignor's name, consignee's name, name of the steamer, number and date of bill of lading, country of origin, price, terms of payment, amount of freight, etc.

- The invoice should be made out in the name of the applicant.
- It should be signed by the maker. Description of goods specified in the invoice should correspond to the description given in the letter of credit. Similarly, other conditions like quantity of goods, unit price, delivery terms, etc. should conform to those stipulated in the Letter of Credit.
- The invoice should be drawn in the same currency of LC unless otherwise specified.

- The invoice should not include any charges not stipulated in the LC. Also, the gross value of invoice should not exceed the credit amount.
- Final amount of invoice or the percentage of drawing as permitted in the LC hold corresponds with the draft amount.
- If partial shipments are effected, amount of drawings should preferably correspond to proportionate quantities shipped (where only quantity is mentioned without unit price).
- If invoice is issued for an amount in excess of the amount permitted by the credit, the drawings should not exceed the amount of credit.
- Details stated on the invoice should correspond to details specified in all other documents. Also, the invoice should certify to facts like origin of goods, etc. as stipulated in the LC.

Bill of Lading

A bill of lading is a document issued by the shipping company or its agent, acknowledging the receipt of goods for carriage which are deliverable to the consignee or his assignee in the same condition as they were received.

There is a close relationship between bills of lading and the letter of credit. The possession of the original bill of lading enables the holder to claim the goods from the carrier.

The bill of lading must satisfy certain requirements. Every bill of lading must:

- Show the name of the carrier and must be issued by a named carrier or his agent. The bill of lading must also be signed by the named carrier or his agent.
- Bear a distinct number.
- Indicate the date and place of issuance.
- Indicate the name of consignor and consignee.
- Indicate a brief description of goods being carried.
- Indicate port of loading or taking in charge (in case of marine bill of lading it must show a definite port of loading and in other cases it can be shown as an "intended" port).
- Indicate port of discharge (in case of a marine bill of lading it must indicate a definite port of discharge and in other cases it can be shown as an intended port).
- Be presented in full set of originals (full set comprises of two or more originals issued to consignor of goods, all of which are made as "originals" and signed. The number of copies of originals is indicated on the bill of lading itself).
- Meet all other stipulations of the credit.
- Must indicate whether freight is prepaid or is payable.

A bill of lading should not unless otherwise specified by the terms of the LC:

- Be a chartered party bill of lading.
- Indicate that the carrying vessel is propelled only by sails.
- Be issued by a freight forwarder (unless he himself is acting as a carrier or agent).
- Indicate that the goods are or will be loaded on "DECK".
- Be a claused bill of lading.

A bill of lading can (unless otherwise prohibited):

- Bear title such as "combined transport B/L" "Combined Transport Document or Combined Transport B/L" or "Port to Port B/L."

- Be a short form or blank backed bill of lading.
- Indicate a place of taking in charge different from the port of loading and or place of final destination as different from the port of discharge.
- Indicate that the goods are carried in containers, pallets, etc.
- Be a FIATA Combined Transport B/L known as FIATA FBL approved by ICC issued by the freight forwarder.
- Be issued by a freight forwarder provided it is issued in his capacity as a carrier or his agent.
- Contain a notation that the goods may be carried on deck provided it does not specifically state that they are or will be loaded on deck.
- Indicate that the goods will be trans shipped provided the same B/L covers the entire carriage.
- Be a "freight payable" bill of lading.
- Evidence freight prepayment by a stamp or otherwise on bill of lading to the effect like "Freight Prepaid."
- Bear a reference by stamp or otherwise to cost additional to freight charges.
- Show clauses such as "shippers load and count" or "said by shipper to contain", etc. with reference to goods covered by bill of lading.
- Show shipper as third party other than the beneficiary.
- Be deemed as "clean on board" if it is an on board bill of lading without any superimposed clauses or notations expressed in declaring the defective conditions of the goods and or the packaging.

Other Aspects of Bill of Lading

If a bill of lading is issued as an "on board" bill of lading, it must indicate the name of the carrying vessel.

A charter party bill of lading need not show the name of the carrier.

A FIATA FBL can be accepted as a "Marine Bill of Lading" provided it meets with all the requirements of a marine bill of lading.

A bill of lading issued by even a Non-Vessel Owning Common Carrier (NVOCC) can be accepted as "Marine B/L" provided NVOCC has issued the B/L in his capacity as a carrier or his agent and all other requirements of "Marine B/L" are met with.

Bill of lading received for shipment can be treated as an "on board" bill of lading; if received for shipment. Bill of Lading is affixed with "on board" notation duly signed or initialed and dated by the carrier or his agent.

If LC calls for a "marine B/L" without specifying whether it should be "on board" or "received for shipment" only "on board B/L" will be accepted.

Date of issue of B/L or "on board" notation should be dated prior to the shipment date permitted under the L/C.

Shipping marks, gross/net weight, etc., specified on bill of lading must correspond to those specified in other documents.

Insurance Document

In international trade, when goods are in transit they are exposed to marine perils. Insurance is effected to protect the insured against risk of loss or damage to goods due to marine perils.

Insurance documents should be issued and signed only by insurance companies or underwriters or their agents.

Cover notes issued by brokers will not be accepted unless specifically authorised by the credit.

The insurance document should be signed by the issuer and dated. Date of the issuance must be on or before the date of shipment or it must be evidenced by specific notation that the cover is effective from the date of shipment.

The insurance document must be expressed in the same currency as the letter of credit.

The insurance document must indicate the name of the assured and also give brief details of the goods insured.

The mode of conveyance of goods should also be indicated. Further, it should also indicate the nature of risks covered, which should be those specified in the LC.

The insurance document should be in a negotiable form.

Unless otherwise specified, it should be issued for an amount of 110% of CIF/CIP value of the goods. If such value is not determinable from the documents on their face, it should be for a minimum amount of negotiation requested for or the amount of invoice value whichever is higher.

If the insurance document is issued in more than one negotiable copy, all copies must be submitted.

The document should be endorsed in blank by the assured if required as per the terms of the LC.

It should indicate the port of shipment and destination or point of insurance coverage and point of termination of insurance.

It should not contain any clause affecting the interest of the assured/assignees.

It must cover all the additional risks as specified in the LC.

If the goods are on "DECK", deck shipment should be covered.

Other Documents

In addition to the above mentioned documents, a letter of credit may call for additional documents like bill of exchange, health certificate, pre-shipment inspection certificate, packing list, shipping company's certificate, beneficiary's declaration/ undertaking, etc. Whenever such documents are called for under LC the following aspects should be taken care of:

- The documents called for should be issued by the person or authority specified in the credit. If no such person is specified or authorised, the banker may accept documents issued by any person.
- The documents should be dated and signed by the person/authority concerned.
- The documents should certify the facts required as per the LC.
- It should be checked whether or not the documents contain wordings or data content as specified in the LC.
- Bankers should check whether the details mentioned in such certificates/ documents are consistent with other documents.

Certificate of Origin

Many countries require a certificate from the supplier of goods stating the origin of the goods and certified by the Chamber of Commerce or any other recognised authority in the exporter's country. Certificate of origin is an important document in

case of imports into India to determine the origin of goods for methods of payment purpose as required by the Exchange Control Authorities.

- It must be issued and signed by an independent authority such as chamber of commerce, etc., indicating the origin of goods.
- The country of origin certified must be as per the LC requirement and consistent with the declaration given by the beneficiary in his invoice/other documents.
- It must indicate the description of goods and should be consistent with other documents.
- It must indicate the name of the consignor/seller and name of consignee/buyer.

Details appearing in the documents must be consistent with the details in other documents.

Incoterms: An acronym for International Commercial Terms – are a series of 13 trade terms used in international sales contracts to clearly divide the risks and responsibilities of buyers and sellers with regard to the movement of goods between both parties. They were first introduced in 1936 in Europe to prevent misunderstandings and disputes that may arise because of different trading practices among countries. They have been revised periodically to reflect current trading practices and the most recent is the Incoterms 2000.

EXW Ex Works (… named place)

It means that the seller has delivered if he places the goods at the disposal of the buyer either at the seller's premises or any other named place (works, factory, warehouse, etc.). This term represents the minimum obligation for the seller. All the expenses and risks involved in taking the goods from the seller's premises will have to be borne by the buyer.

FCA Free Carrier (… named place)

"Free Carrier" (FCA) means that the seller fulfils his obligation to deliver when he has handed over the goods, cleared for export, into the charge of the carrier named by the buyer at the named place or point. If no precise point is indicated by the buyer, the seller may choose within the place or range stipulated where the carrier shall take the goods into his charge.

FAS Free Alongside Ship (… named port of shipment)

Free Alongside Ship means that the seller delivers when the goods are placed alongside the vessel at the named port of shipment. This means that the buyer has to bear all costs and risks of loss of or damage to the goods from that moment. Free alongside ship does not include charges for loading the goods on board the vessel. It also does not include ocean freight charges and marine insurance premium. The FAS term requires the seller to clear the goods for export. This is in contrast to the earlier requirement where the buyer was required to arrange for clearance of the goods.

FOB Free on Board (… named port of shipment)

The seller is said to have delivered once the goods cross the ship's rail at the named port of shipment. From that point onwards all the risks and expenses are to be borne by the buyer. The FOB price is inclusive of ex works price, packing charges, transportation charges up to the place of shipment, wharfage and portage, customs dues, export duties, cost of checking of quality measure, weight or quantity, if any which an exporter incurs while delivering the goods to the buyer on board the ship.

CFR Cost and Freight (... named port of destination)

"Cost and Freight" (CFR) means that the seller must pay the costs and freight necessary to bring the goods to the named port of destination but the risk of loss of or damage to the goods, as well as any additional costs due to events occurring after the time the goods have been delivered on board the vessel, is transferred from the seller to the buyer when the goods pass the ship's rail in the port of shipment.

CIF Cost, Insurance and Freight (... named port of destination)

"Cost, Insurance and Freight" (CIF) means that in addition to the obligations under Cost and Freight (CFR), the seller has to procure marine insurance against the buyer's risk of loss of or damage to the goods during the carriage. The seller contracts for insurance and pays the insurance premium.

CPT Carriage Paid to (... named place of destination)

"Carriage Paid To..." (CPT) means that the seller pays the freight for the carriage of the goods to the named destination. The risk of loss of or damage to the goods as well as any additional costs due to events occurring after the time the goods have been delivered to the carrier, are transferred from the seller to the buyer when the goods have been delivered into the custody of the carrier.

"Carrier" means any person who, in contract of carriage, undertakes to perform or to procure the performance of carriage, by rail, road, sea, air, inland waterway or by a combination of such modes.

If subsequent carriers are used for the carriage to the agreed destination, the risk passes when the goods have been delivered to the first carrier.

CIP Carriage and Insurance Paid to (... named place of destination)

"Carriage and Insurance Paid to ..." (CIP) means that the seller has the same obligations as under CPT (Carriage Paid To), but with the addition that the seller has to procure cargo insurance against the buyer's risk of loss of or damage to the goods during the carriage. The seller contracts for insurance and pays the insurance premium. The buyer should note that under CIP terms, the seller is only required to obtain insurance on minimum coverage. The CIP terms require the seller to clear the goods for export. This term may be used for any mode of transport including multimodal transport.

DAF Delivered at Frontier (... named place)

"Delivered at Frontier" (DAF) means that the seller fulfils his obligation to deliver when the goods have been made available, cleared for export, at the named point and place at the frontier, but before the customs border of the adjoining country. The term "frontier" may be used for any frontier including that of the country of export. Therefore, it is of vital importance that the frontier in question be defined precisely by always naming the point and place in the terms. The terms are primarily intended to be used when goods are to be carried by rail or road, but may be used for any mode of transport.

DES Delivered Ex Ship (...named port of destination)

"Delivered Ex Ship" (DES) means that the seller fulfils his obligation to deliver when the goods have been made available to the buyer on board the ship uncleared for import at the named port of destination. The seller has to bear all the costs and risks involved in bringing the goods to the named port of destination. This term can only be used for sea or inland waterway transport.

DEQ Delivered Ex Quay (... named port of destination)

"Delivered Ex Quay (duty paid)" (DEQ) means that the seller fulfils his obligation to deliver when he has made the goods available to the buyer on the quay (wharf) at the named port of destination, cleared for importation. The seller has to bear all risks and costs including duties, taxes and other charges of delivering the goods thereto.

DDU Delivered Duty Unpaid (... named place of destination)

"Delivered Duty Unpaid" (DDU) means that the seller fulfils his obligation to deliver when the goods have been made available at the named place in the country of importation. The seller has to bear the costs and risks involved in bringing the goods thereto (excluding duties, taxes and other official charges payable upon importation as well as the costs and risks of carrying out customs formalities). The buyer has to pay any additional costs and to bear any risks caused by his failure to clear the goods for import in time.

DDP Delivered Duty Paid (... named place of destination)

"Delivered Duty Paid" (DDP) means that the seller fulfils his obligation to deliver when the goods have been made available at the named place in the country of importation. The seller has to bear the risks and costs, including duties, taxes and other charges of delivering the goods thereto, cleared for importation. While the EXW (ex works) term represents the minimum obligation for the seller, DDP represents the maximum obligation.

Further Information on the Procedure

The readers can refer to the following guidelines issued by the International Chamber of Commerce so as to ensure uniformity across the trading partners and which are accepted by the local courts in settling trade disputes.

1. Uniform customs and practices for documentary credits 1993 Revision ICC Publication No. 500 is applicable to all Documentary Credits (including to the extent in which they may be applicable, standby Letter(s) of Credit where they are incorporated into the text of the credit.
2. The Uniform Rules for Collection 1995 Revision ICC Publication No. 522 is applicable to all collections as defined in Article 2 where such rules are incorporated into the text of the collection instructions referred to in Article 4 and are binding on all parties thereto unless otherwise expressly agreed or contrary to the provisions of a natural state or local law and/or regulation which cannot be departed from.
3. The Uniform Rules for bank-to-bank Reimbursement under Documentary Credit ICC Publication 525 is applicable to all reimbursements' applicability transaction between the using bank, reimbursing bank and claiming bank. It provides step-by-step guidance to each party and includes detailed explanation of the principles behind each part of a reimbursement transaction.

21.8 OTHER FINANCING MECHANISMS

1. ***Cross border leasing:*** Equipment such as aircraft, ships, oil drilling rigs, etc. are leased by international leasing firms. There are some merchant hanks, which specialise in cross border leasing. Foreign banks of importers usually specialise in such leasing activities.
2. ***Forfaiting:*** It is a specified form of trade finance, which helps exporter to offer extended credit to the importer. Under forfaiting, the importer gives the exporter a bundle of bills of exchange or promissory notes covering the principal amount and interest. Each transaction of the notes falls due at different points of time in the

future e.g. every six months, extending up to several years (For instance importers in India may be able to avail credit extending up to 7 years). The notes are backed by a guarantee provided by a reputed bank in the importer's country. The exporter can then discount these notes without recourse to banks that specialise in the forfaiting business to generate immediate cash flow. The forfeiter in turn, may hold the notes in his own portfolio or sell different trenches in the secondary market. Figure 21.2 shows a schematic picture of the forfaiting mechanism. Forfaiting tends to be a specialised business each underlying export import transaction generally has unique features.

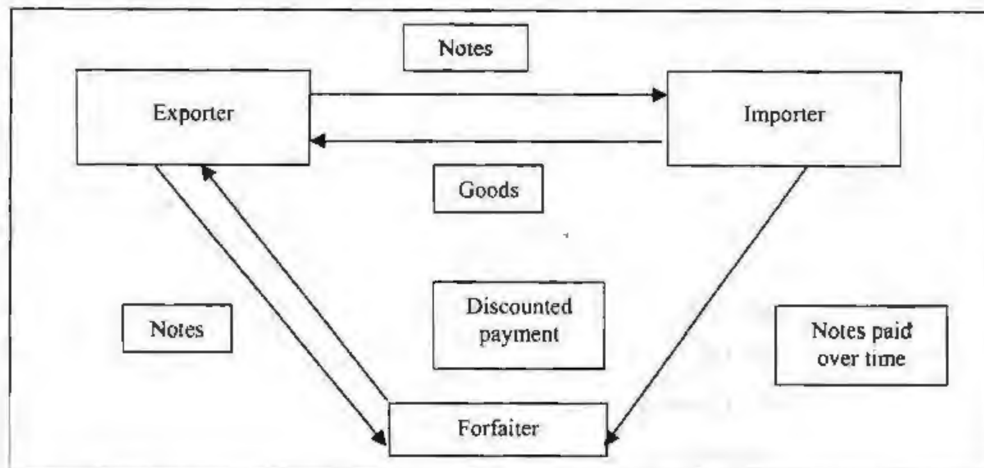

Figure 21.2: Forfaiting Mechanism

3. ***Buyers' Credit:*** It is a form of euro currency loan designed to finance a specific transaction involving imports of goods and services. Under this arrangement, lending bank(s) pay the exporter on presentation of shipping documents. The importer works out a deferred payment arrangement with the leading bank, which the bank treats as a loan. Large loans are club loans or syndicated loans. Many provisions in the loan agreement are quite similar to a general-purpose syndicated credit. A number of formalities have to be completed before the exporter can draw funds. Interest rate is linked to a market index such as LIBOR. In some cases a state export credit agency from the exporter's country may pay a subsidy to the banks so that an attractive finding list can be offered to the importer.

4. ***Line of Credit:*** Lines of credits are like buyers' credits but much wider in scope. A typical buyer's credit involves one transaction between one supplier and one buyer. A line of credit may lower several purchase transactions with the buyer importing different items from different suppliers. Many buyers may be involved if the ultimate credit risk is that of a single buyer or guarantor.

5. ***Suppliers Credit:*** Under supplier's credit arrangements, the exporter extends credit to the importer by allowing it to pay on the basis of deferred payment. Promissory notes issued by the importer evidence the credit. The supplier can discount the paper with a bank. The payments made by the buyer under the promissory notes are assigned to the lenders and may be routed to them directly or through the supplier. The supplier may have to share the responsibility of pursuing payment on the bank's behalf in the case of default by the buyer.

6. ***EXIM Bank:*** The EXIM Bank of India set up in 1982, is the principal institution in the country for co-ordinating the working of institutions engaged in trade finance. It has a variety of programmes designed to provide long term and short term finance to foreign buyers of Indian goods and services, enabling Indian exporters to extend credit to their overseas customers. It also assists commercial banks in providing export finance and finance for import of bulk goods and imports of raw materials for export production. Apart from finance it also

provides information and advisory services to exporters to assess international opportunities and risks.

Counterparts of EXIM India in other countries such as EXIM USA are an important source of finance, including term credits for importers in India.

Check Your Progress

1. Which of the following is prima facie evidence of purchase and sale?
   (a) Commercial Invoice
   (b) Shipping bill
   (c) Mate's receipt
   (d) Import Manifest
   (e) Bill of entry
2. Which of the following document is a document of title of goods?
   (a) Shipping bill
   (b) Bill of lading
   (c) Mate's receipt
   (d) Commercial Invoice
   (e) Bill of exchange

21.9 LET US SUM UP

Special procedures have evolved for dealing with extra risks of international trade and national and international institutions have been established to finance and regulate international trade.

Before shipping goods to foreign buyers, many exporters require a letter of credit from a reputable bank. This is a guarantee that the exporter will be paid if the goods are supplied in good order.

Payment is made by a bill of exchange, or draft, which is sent by the exporter to the importer or to the importer's bank. The importer or importer's bank signs the draft. If the draft is payable on presentation, it is a sight draft. If it is payable at a future date, it is a time draft.

The shipper gives the exporter a bill of lading, the original copy of which is required for collection of the goods. The bill of lading is forwarded to the importer for the goods to be released.

When an exporter is confident an importer will pay, goods may be sold on an open account, and a bill presented after shipment. When an exporter suspects that the importer may not pay, cash may be demanded before shipment occurs.

When an exporter lacks trust in the importer's bank or country, the exporter can have the importer's letter of credit confirmed. A confirmed letter of credit is one way of avoiding country risk.

Export credit insurance is an alternative to letters of credit for avoiding commercial and/or country risks. Export insurance, however, typically involves a deductible portion of coverage and differs from letters of credit in other ways that are sometimes important.

Official export financing agencies often provide direct buyer credits, as well as guarantees on credits to buyers granted by domestic or financial institutions.

When an exporter's time draft is accepted by the bank, the resulting accepted draft is called a banker's acceptance.

Banker's acceptance are a means of short-term trade financing typically up to 6 months. Forfaiting is a means of medium-term trade financing, with a typical term of 5 years.

Forfaiting involves the sale by an exporter of promissory notes issued by an exporter and usually availed by the importer's bank. The forfaiter has no recourse to the exporter in the event that for whatever reason, the forfaiter is not paid.

Forfaiting is a particularly useful means of financing the sale of capital goods. The exporter is paid immediately while the importer can make payments out of revenue generated by the products of the capital goods.

The majority of trade occurs between countries which are members of customs unions or free-trade agreements The trend toward the establishment of trading blocs could threaten globally free trade.

21.10 LESSON END ACTIVITY

You are required to write a letter to your Banker for opening letter of credit for importing capital goods worth $90,000 from XYZ Ltd as per pro forma invoice attached.

21.11 KEYWORDS

Bill of Exchange: An order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time.

Bill of Lading (or draft): A document issued to an exporter by a common carrier transporting merchandise. It serves as a receipt, a contract, and a document of title.

Export-Import Bank (EXIM Bank): Agency of the Central Govt. whose mission is to provide aid in financing and facilitate exports and imports.

Letter of Credit: Issued by a bank, indicating that the bank will make payment under special circumstances.

Sight draft: A draft payable on presentation to the drawee.

Time draft: A promise to pay by the accepting party at some future date.

21.12 QUESTIONS FOR DISCUSSION

1. Discuss some of the reasons why international trade is more difficult and risky from the exporter's perspective than is domestic trade.
2. What three basic documents are necessary to conduct a typical foreign commerce trade? Briefly discuss the purpose of each.
3. How does a time draft become a banker's acceptance?
4. Explain different methods of payment in International Trade. How does FCGC help the firm to cover the credit risk?
5. What is the role played by EXIM Bank in International Finance?
6. Which of the following statements are true?
   (a) When an ex-works price is quoted, the risk and cost to bring the goods from the exporters place to the desired location will be to the exporters account.
   (b) FOB price is inclusive of ex-works price, transportation charges up to the place of shipment but exclusive of other costs involved.

(c) C&F price covers FOB value of goods plus freight charges of transporting goods to the port of destination.

(d) When a CIP price is quoted, the responsibility of arranging and paying for insurance lies with the buyer of goods

(e) Both (b) and (d) above.

7. The bank which opens the LC in favour of the beneficiary is the

   (a) Issuing bank

   (b) Advising bank

   (c) Confirming bank

   (d) Nominated bank

   (e) Reimbursing bank

8. A letter of credit is opened in favour of the

   (a) Applicant of LC

   (b) The importer of goods

   (c) The exporter of goods

   (d) The exporters bank

   (e) Advising bank

9. Which of the following is not true?

   (a) The term negotiation means giving value

   (b) Where a credit is freely negotiable, any bank may be a nominated bank

   (c) A credit which is restricted for negotiation will have a specific bank as a nominated bank

   (d) The advising bank is usually situated in the country of the buyer of goods

   (e) None of the above

10. Which of the following is not true?

   (a) In a letter of credit transaction, the negotiating bank becomes the holder in due course.

   (b) The bank which has opened the letter of credit has the right to refuse documents submitted to it in case they contain discrepancies.

   (c) The letter of credit is not independent from the sale contract or any other contract on which it is based.

   (d) Both (a) and (c) above

   (e) None of the above.

11. Which of the following is the best form of credit available to the exporter?

   (a) An acceptance credit

   (b) A negotiation credit

   (c) A confirmed irrevocable credit

   (d) A revocable credit

   (e) A payment credit

12. Confirmation of the credit will be made by the advising bank only on the request of the

    (a) Importer

    (b) Exporter

    (c) Exporter's bank

    (d) Opening bank

    (e) Nominated bank

13. A revolving letter of credit:

    (a) Is one in which the limit under the credit is renewed as and when bills drawn under it are paid, to the extent of such bills.

    (b) Is one in which the limit is reduced permanently to the extent of bills drawn under the credit.

    (c) Is useful where continuous transactions between the exporter and the importer are expected.

    (d) Both (a) and (c) above

    (e) Both (b) and (c) above

14. Which of the statement is correct – Standby credit

    (a) Is widely used in USA

    (b) Is a substitute for bank guarantee

    (c) Is a credit that is payable upon adding evidence of a party's non-performance of the agreement

    (d) Both (b) and (c) above

    (e) All of (a), (b) and (c) above

15. Which of the following is the most risky form of payment from the point of view of the exporter?

    (a) Advance remittance

    (b) Open Account

    (c) Consignment sale

    (d) Documentary collections

    (e) Letter of credit

16. Bank B bas been asked to add its confirmation to an irrevocable letter of credit by the issuing bank. How will Bank B deal with such a request?

17. Midland Bank has been requested to add its confirmation to a revocable letter of credit by the beneficiary of the LC. How would the bank deal with such a request?

18. As a negotiating banker should B accept the following bill of lading? Bill of lading is dated 19th January whereas the letter of credit calls for shipment towards the ending of January.

19. Bank B issued an irrevocable letter of credit in favour of an Australian exporter through one of its branches in Australia, which confirmed the letter of credit. The goods underlying the LC were computers. The beneficiary of the credit refused to accept it, on the ground that the LC is not confirmed by another bank but by a branch of the issuing bank. Discuss.

20. Bank B has received a bill drawn under an irrevocable letter of credit opened by it on behalf of customer 'A' covering shipments of diamonds from Australia to Mumbai. On scrutiny of documents, Bank B finds that the certificate of specification and fineness has not been submitted to the supplier. Discuss the position of Bank B in such a case, in the light of VCP 500.

Check Your Progress: Model Answer

1. (a), 2. (b)

21.13 SUGGESTED READINGS

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