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School of Social Sciences

BECE-002
Indian Economic Development: Issues and Perspectives

Block

6

EXTERNAL SECTOR

Course Editor

Dr. V.R. Panchamukhi
Managing Editor
Indian Economic Journal
New Delhi

Course Coordinator

Dr. B.S. Prakash
School of Social Sciences
IGNOU
New Delhi

Block Coordinator

Dr. B.S. Prakash
School of Social Sciences
IGNOU
New Delhi

Block Preparation Team

Unit No.	Unit Writer	Unit Editor
20	Sh. I.C. Dhingra	Dr. B.S. Prakash
21	Sh. I.C. Dhingra	Dr. B.S. Prakash
22	Sh. I.C. Dhingra	Dr. B.S. Prakash
23	Sh. I.C. Dhingra	Dr. B.S. Prakash

Material Production

Mr. Arvind Kumar
Mr. Sunil Kumar

Cover Design

HD Computer Craft

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BLOCK 6 EXTERNAL SECTOR

Introduction

The present block, the sixth in the course, is on External Sector. The block consists of four units.

Unit 20 is on Trade and Development. Outlining the rationale behind the important theories of trade, the case for free trade versus protection is discussed. The trade policy and strategy adopted in India, beginning from the early plan period to the present, is then explained. The issue of export subsidies is briefly touched upon.

Unit 21 discusses the empirical aspects of trade with a focus on the volume, composition and direction of India's foreign trade. The issue of balance of payment and the problem of deficits are then outlined. The exchange rate regime prevailing in India and the reforms introduced therein, with a focus on convertibility of current and capital accounts, is discussed in detail. Finally, the meaning and implications of full convertibility of rupee is presented.

Unit 22 focuses on regional trading arrangements. Outlining the features, benefits and limitations of regional trading agreements (RTAs), major RTAs in which India is a member is discussed. The concept of free trade area (FTA) and the implications of establishing an FTA between India and China are also discussed.

Unit 23 is on WTO and challenges of new trading and financial systems. Outlining the background in which the WTO came to be set up, it reviews the functioning of the WTO as it has evolved over the last fourteen years of its existence. In the light of recent turmoil in the international economic environment, due to which a global recession is being experienced, the unit suggests the elements of a new international financial architecture considered vital to cope with the emerging challenges in the world economies.

UNIT 20 TRADE AND DEVELOPMENT

Structure

20.0 OBJECTIVES

After reading this unit you will be able to:

- state the reasons for foreign trade in terms of different theories of trade;
- explain how foreign trade promotes economic growth and its relationship with issues like unemployment, growth and environmental protection;
- distinguish between free trade and protection examining why barriers are placed on the free flow of goods, and with what consequences;
- describe the current global environment in which the developing nations have to conduct their trade operations;
- examine the different forms of trade policy and strategy underlying the rationale behind each of them; and
- explain the role of subsidies, specially agricultural subsidies, in foreign trade and why they should or should not continue.

20.1 INTRODUCTION

Foreign trade has worked as an 'engine of growth' in the past (e.g. Great Britain in the 19th Century and Japan in the 20th century, besides others). Even in more recent times, the success of the 'miracle' newly industrialised countries (NICs) of south-east Asia or of the 'miracle-in-making' economies of China and India can be attributed to a large measure to the growing integration of these economies with the global economy. Trade, both exports and imports, contribute to economic growth and welfare in different ways. Although the trading partners may enjoy different degrees of gains from the transactions, trade is positively a win-win situation for each i.e. there are no losers in this game. However, this observation can be questioned when one finds that free and unobstructed flow of goods are not permitted as a rule across the borders. In other words, trade barriers are imposed. Sovereign nations impose these barriers for their own reasons, although efforts have been made in recent years to institute arrangements that help the smooth flow of goods across borders. In this unit, we analyse these aspects and examine the evolution of trade policy and strategy over the years.

20.2 THEORIES OF TRADE

In pursuit of the question, 'Why do nations trade?' economists have come out with varied explanations. But before we visit the different theories of trade, it is useful to ask a more general question as to what are the necessary and sufficient conditions for 'two countries not to trade'? These are the following:

a) they have identical factor endowments;

b) they have identical production functions;

c) they have no scale economies;

d) they have identical demand conditions, including similar tastes and preference for their population;

e) there are no tariffs/subsidies, quotas or other governmental interventions;

f) there are no transport costs; and

g) there is no mobility of factors of production between the countries.

Thus, there is no need for inter-country trade, when the above conditions are fulfilled. However, when one or more of the conditions are not fulfilled, then there is scope for some trade to take place. The different theories of trade conform to the framework of deviations from these conditions. For instance, the Hecksher-Ohlin theory of factor endowments, is the theory based on the deviation of the first of the above assumptions on identical factor endowments. Most of the other theories of trade also could be conceived in this light. We will now take a brief look on the other theories of trade in the chronology of their development in this section.

The earliest of these trade theories is known as *mercantilism*. According to mercantilists, a nation's wealth and prosperity depended on its stock of precious metals which, in turn, depends first on international trade and thereby on 'trade surplus'. To gain trade surplus, a nation should strive to maximise exports and minimise imports.

The basic flaw of mercantilism was that trade was regarded as a zero-sum game (i.e. one nation's gain was another's loss). In other words, mercantilists took a static view of the world economy believing that the world's economic pie is of a constant size.

Adam Smith (in Wealth of Nations, 1776) and David Ricardo (in Principles of Political Economy and Taxation, 1817) took a dynamic view and postulated that trade first expands the scope of division of labour which then increases productivity and output. They thus viewed that trade is actually a positive sum game, in which all the trading nations gain.

In *Adam Smith's* view, the basis of trade was absolute cost advantage. According to his theory, trade between two countries would be mutually beneficial if the country could produce one commodity at an ***absolute advantage*** (over the other country) and the other country could, in turn, produce another commodity at an ***absolute advantage*** over the first.

David Ricardo further demonstrated that trade would be beneficial to nations if a country enjoyed ***comparative advantage***, and not necessarily absolute advantage. Ricardo's doctrine of comparative costs maintains that if trade is left free, each country, in the long run: (i) tends to specialise in the production and export of those commodities in which it enjoys a comparative advantage in terms of real costs, (ii) obtains by import those commodities which could be produced at home at a comparative disadvantage in terms of real costs, and (iii) such specialisation works to the mutual advantage of the countries participating in trade.

The ***opportunity cost theory*** put forward by *Gottfried Ven Haberler* (The Theory of International Trade, 1933) improved upon one of the main drawbacks of the Ricardian cost theory, viz. labour cost theory of value. It gave a new life to the comparative cost theory by restating it in terms of opportunity costs. The opportunity cost of anything was defined by Haberler as the value of the alternatives or other opportunities which have to be foregone in order to obtain a particular thing. Thus, according to the opportunity cost theory, the basis of international trade is the difference between nations in the opportunity costs of production of commodities.

The factor-endowment theory, developed by *Eli Heckscher* and *Bertil Ohlin*, (in Interregional and International Trade, 1933) establishes that trade, whether national or international, takes place because of the ***differences in the factor endowments*** of the various regions. Trade is expected to eventually lead to commodity and factor prices equalisation internationally.

There is a significant portion of the international trade that is not explained by the basic Heckscher-Ohlin (H-O) model. Some theories have been propounded to explain different patterns or reasons for trade which are not explained by the basic H-O model. These theories are known as complementary trade theories or extensions of the H-O trade model.

The Stolper-Samuelson Theorem (vide 'Protection and Real Wages', Review of Economic Studies, 9, 1941) which explains the effect of change in relative product prices on factor allocation and income distribution, postulates that an increase in the relative price of a commodity raises the return on the factor used intensively in the production of that commodity. That is, if the relative price of labour intensive commodity rises, that will cause an increase in the wages. Similarly, an increase in the relative price of capital intensive product will raise the return on capital. Free trade will raise the return to the factor used intensively in the rising price industry and lower the returns to the factor used intensively in the falling price industry. This implies that free trade would raise the returns to the ***abundant factor*** and reduce the returns to the ***scarce factor***.

20.3 FOREIGN TRADE AND GROWTH

Foreign trade has been the driving force behind economic growth. For instance, in the nineteenth century, exports were the leading sector that propelled the economies into rapid growth and development. Workers with skills and capital moved from the highly regulated areas of Europe to the mostly empty and natural-resource rich lands in the 'new world'. This, together with a very rapidly growing demand for food and raw materials, particularly from industrialising but resource-poor England, resulted in rapid and sustained export-led growth in the economies of these new lands. Thus, international trade acted as an 'engine of growth' in these new lands in the nineteenth century. Even in more recent times the 'outward-oriented growth strategy' adopted by the Newly Industrialising Economies of Asia (viz. Hong-Kong, Singapore, Taiwan, Malaysia, Thailand and South Korea), has enabled them to overcome the constraints of small, resource-poor, and less developed economies.

20.3.1 Contribution of Foreign Trade to Economic Growth

Foreign trade contributes to economic growth in a number of ways. Some of the important among these are the following:

i) The primary function of foreign trade is to explore means of procuring imports of capital goods, without which no process of development can start;

ii) Trade provides for flow of technology which allows for increases in productivity, and also result in short-term multiplier effect;

iii) Foreign trade generates pressure for dynamic change through (a) competitive pressure from imports, (b) pressure of competing export markets, and (c) a better allocation of resources;

iv) Exports allow fuller utilisation of capacity resulting in achievement of economies of scale, separates production pattern from domestic demand, and increases familiarity with absorption of new technologies;

v) Foreign trade increases most workers' welfare. It does so at least in four ways: (a) Larger exports translate into higher wages; (b) because workers are also consumers, trade brings them immediate gains through products of imports; (c) it enables workers to become more productive as the goods they produce increase in value; and (d) trade increases technology transfers from industrial to developing countries resulting in demand for more skilled labour in the recipient countries.

vi) Increased openness to trade has been strongly associated with reduction in poverty in most developing countries. As the historian Arnold Toynbee said 'civilisation' has been spread through 'mimesis' i.e. emulation or simply copying.

In short, trade promotes growth enhancing economic welfare by stimulating more efficient utilisation of factor endowments of different regions and by enabling people to obtain goods from efficient sources of supply.

20.3.2 Trade, Employment and Poverty

Notwithstanding all that has been said above, there is no unanimity among economists about the impact of trade on employment and poverty. Empirical evidence presents a mixed picture, with positive impacts on some countries and negative on some others with no clear indication in others.

Positive Side

On the positive side, theoretically, it has been established that trade liberalisation can lead to reduction of unemployment and poverty. The possible impacts of trade liberalisation on poverty are explained in terms of the following:

1. The expansion of the export sector following trade liberalisation will increase the demand for labour. Developing countries are assumed to export principally labour-intensive products. This will create new demand for labour. Unemployed labour will gain productive employment. In a situation where there is no unemployment, labour will gain by way of higher wages. Labour will also gain by way of movement from low-wage occupations to relatively high-wage occupations.

2. Expansion of the export sector will result in an increase in demand for other factor-inputs. This will result in higher prices of factor-inputs. Owners of these factor-inputs will gain by increased prices.

3. The acceleration of economic growth caused by export growth will benefit the economy in general. Southeast Asian economies bear witness to the success of export-led-growth strategy.

4. Trade liberalisation reduces the cost of living by providing access to cheaper imports of food and essential consumer goods, and by keeping domestic prices under check because of the global competition.

5. Expansion in the level of economic activity normally yields larger revenue for the government. It enables the government to undertake more social sector programmes with focus on welfare of the poor.

6. Trade can contribute to long-term poverty reduction by enhancing production and resource allocation efficiencies. It helps in the spread of economic activities in areas where greater economic gains are possible.

Negative Side

Trade in actual practice is, however, not fair but biased to serve the vested interests of the developed countries. For instance, exports of developing countries face high tariff and non-tariff barriers. Developing countries are losing market share even in traditional commodities. Their efforts to move away from commodity dependence have generally been frustrated by restrictive trade rules/bias against agricultural commodities. Some of the other negative influences are in terms of the following:

1. Developing countries, particularly the least developed countries (LDCs), are characterised by large subsistence sector which can hardly withstand the global competition.

2. Multinational corporations (MNCs) with their marketing strategies change the consumption habits of people causing significant damage to the traditional economic activities. In due course of time, such changes also cause damage to the very wellbeing of the consumers.

3. With the secular deterioration (i.e. adverse conditions persisting over long period) in the terms of trade, more openness can lead to growth with increase in poverty for developing countries.

Hence, a more reasonable conclusion to the debate can be that while trade can help a country to reduce poverty, it can not take it out of poverty. For that to happen, more important orientation is needed in terms of government expenditure on education, health and nutrition.

20.3.3 Trade and Environment

As with the relationship between trade and poverty, no definite patterns can be observed on the effect of foreign trade on environment. There is however a fear that as a consequence of rapid growth related tendencies, massive and irreversible environmental problems can take place. This situation can be avoided provided right policies and institutions to address such trends are initiated at the right time. Three patterns that have emerged in this regard are as follows:

1. *Some environmental problems get reduced in intensity as income increases:* This is because increasing income provides the resources for public services such as sanitation and rural electricity. When individuals no longer have to worry about their day-to-day survival, they can devote resources to profitable investments in conservation. The positive relationship between economic growth and environment quality can not be underestimated.

2. *Some problems initially worsen but then improve as incomes rise:* Most forms of air and water pollution fit into this category, as do some types of deforestation and encroachment on natural habitats. These is however nothing automatic about this improvement as such improvements occur only when governments deliberately introduce policies to ensure that additional resources are devoted to dealing with environmental problems.

3. *Some indicators of environmental stress worsen as incomes increase:* Emissions of carbon and nitrogen oxides and municipal wastes are examples for this. In these cases, abatement is relatively expensive and the costs associated with the emissions and wastes are not yet perceived as high - often because they are borne by someone else. The key, once again, is policy and institutions. More generally, individuals and firms have few incentives to cut back on wastes and emissions, and until such incentives are put in place - through regulation, charges, or other means - damage will continue to increase. The experience with the turnarounds achieved in some other forms of pollution, however, shows that once a policy commitment is made results can be achieved albeit slowly.

A recent study on the subject puts forward a practical and persuasive set of arguments to conclude that it is the economic growth that will help set up a sustainable ecosystem. Considerable economic growth has been accompanied by a substantial decline in a number of pollutants in the developed countries.

Environmental protection is an international issue and needs global intervention. The existing formal international agreement, known as Kyoto Protocol, came into force in 2005. The protocol has set legally binding targets for member-nations to reduce their greenhouse gas emission. The Protocol is due to expire in 2012. A new set of principles signed by 190 countries in 2007, known as the 'Bali Roadmap', is expected to become operational for the post-2012 years.

Check Your Progress 1

1. State in brief the central idea behind each of the theories of foreign trade.

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2. How does foreign trade contribute to economic growth? Outline in 50 words.

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3. Does foreign trade help to reduce unemployment and poverty? Briefly outline in 50-60 words.

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20.4 FREE TRADE AND PROTECTION

Free trade refers to trade that is free from all artificial barriers to trade like tariffs, quantitative restrictions, exchange controls, etc. Protection, on the other hand, refers to the government policy of providing protection to the domestic industries from foreign competition.

20.4.1 Case for Free Trade

The principal arguments in favour of free trade can be briefly stated as follows:

1. Free trade leads to the most economic utilisation of the productive resources of the world. Under free trade, each country will specialise in the production of those goods for which it is best suited, and will import from other countries those goods which can only be produced domestically at a comparative disadvantage.

2. Free trade results in international division of labour, leading to greater specialisation, efficiency and economy in production.

3. Under the pressure of competition, inefficient producers are forced either to improve their productivity or close down.

4. Free trade helps to break domestic monopolies benefiting the consumers from exploitation.

5. Free trade makes available large varieties of goods to the consumers. Free trade, thus, benefits the consumers by enabling the consumers to obtain goods from the cheapest source.

However, free trade does not mean that the gains from trade would be equitably distributed among trading nations. The distribution of gains from trade is largely influenced by the terms of trade that each nation gets to face. The determination of terms of trade, in turn, depends on the elasticity of demand and supply for tradable goods, both in the domestic and foreign markets.

But the prevailing market conditions may be viewed as unfavourable by a country. It may therefore seek to put barriers in the way of foreign trade, i.e. it may put restrictions on trade. This type of policy is known as 'protection'.

20.4.2 Case for Protection

The main arguments in support of protection can be briefly summarised as follows:

i) *The Infant Industry Argument:* There are many industries in a country that are in their infancy, but have a potential to grow. In the short term, these industries may be too small to gain economies of scale. Without protection, these infant industries will not survive competition from abroad. Protection will allow such industries to grow and become more efficient. Once they have achieved a comparative advantage, the protection can be removed to enable them to compete from a level playing field.

ii) Protection is required to prevent dumping and other unfair trade practices by foreign producers.

iii) Protection is required to prevent the establishment of a foreign-based monopoly so as to prevent mis-utilisation of resources.

iv) Protection helps to reduce reliance on goods with little dynamic potential. Many countries have traditionally exported primary commodities. The world demand for these commodities is income inelastic and thus grows relatively slowly. In such cases, free trade is not an engine of growth.

v) Protection is required to spread the risks of fluctuating markets. Greater diversity and greater self-sufficiency can reduce these risks.

vi) Trade restrictions are imposed to reduce the influence of trade on consumer tastes. Some restrictions on trade may be justified in order to reduce 'producer sovereignty' of the MNCs.

vii) Restrictions are required to prevent the import of harmful goods.

viii) Protection is required to take account of externalities. Free trade tends to reflect private costs ignoring the associated externalities. Trade restrictions could be designed to deflect these externalities.

ix) Trade restrictions also help a country to improve its terms of trade by exploiting its market power.

20.4.3 Case Against Protection

Protection, however, imposes costs on a nation. This may be outlined as follows.

i) Protection to achieve some objective may be at a very high opportunity cost. Other things being equal, there will be a net loss in welfare from restricting trade. Due to this reason, any gain in government revenue or profits to firms would be outweighed by a loss in consumer's surplus.

ii) Restricting trade is unlikely to be a first-best solution to the problem, since it involves costs of side-effect.

iii) Restricting trade may have adverse world multiplier effects.

iv) Protection may encourage retaliation.

v) Protection may allow inefficient firms to remain inefficient.

vi) Restrictions may involve considerable bureaucracy and possibly even corruption.

20.4.4 Methods of Protection

The policy of protection can be employed through the use of various methods. A few of these are as follows:

1. ***Tariffs (custom duties)***: These are taxes on imports. These are usually ad-valorem i.e. these are levied as a percentage of the price of the import. Other features of tariff are:
   - Tariffs that are used to restrict imports will be most effective if demand is elastic.
   - Tariffs can also be used as a means of raising revenue. They will be more effective if demand is inelastic.
   - Tariffs can also be used to raise the price of imported goods to prevent 'unfair' competition for domestic producers.
2. ***Quotas***: It implies fixing of a maximum limit on the quantity of a good that can be imported.
3. ***Exchange Controls***: These include limits on the amount of foreign exchange made available to the residents for effecting transactions with rest of the world.
4. ***Import Licensing***: Importers may be required to obtain prior permission from the government in the form of a license which may state the quantity of a good that can be imported.
5. ***Embargoes***: This is a measure used by the government to completely ban certain imports or exports to certain countries.
6. ***Export Taxes***: These can be used to increase the price of exports when the country has monopoly power in their supply.
7. ***Subsidies***: These can take two forms. **One**, subsidies can be given to domestic goods to prevent competition from otherwise lower-priced imports. Two, subsidies on exportable goods are expected to increase the competitiveness of the subsidised exports in the international markets.

8. ***Administrative Barriers***: Regulations may be designed in such a way as to target imports. Taxes may be exempted for local products or ingredients favouring domestic production.

9. ***Procurement Policies***: This refers to government purchases to favour domestic producers.

10. ***Support for Investment***: Domestic production and investments may be encouraged through different measures like lower interest rates, export credit facilities and import credit facilities, etc.

20.4.5 International Protectionism

After the Second World War, there had been a progressive liberalisation of trade by the developed countries. This gets reflected in successive cuts in tariffs effected by almost all the countries. Average tariffs on trade in manufactured goods used to be about 40 percent in 1947. These were down to only about 3 percent in 2008.

Even though the process of elimination of the tariff barriers continued, around the mid-1970s, the liberalisation trend in developed countries was replaced by growing protectionism. A number of problems like the currency crisis, oil crisis, debt crisis, recession and high rate of unemployment created an atmosphere all over the world in which demands for protection increased dramatically. Added to these there was growing competition from newly industrialising countries. As a response to this, the developed countries have been increasingly resorting to non-tariff barriers (NTBs), although tariffs have been systematically lowered.

Types of NTBs: Some of the important forms of NTBs are as follows: (i) health and safety provisions, (ii) ban on the use of certain chemicals in select manufactured goods, (iii) insistence on appreciation of currency of the supplying country (which creates automatic market constraint due to loss of competitiveness), (iv) insistence on special information with reference to certain items in addition to normal information supplied in the customs invoice, (v) insistence on satisfying special specifications, (vi) insistence on shipment through designated vessels, (vii) insistence on inspection of products by designated agencies, (viii) insistence on the use of local materials up to a specified percentage, (ix) fixation of minimum floor prices, (x) restrictions on import of inflammable products (xi) insistence on use of specific materials and also ban on the use of certain specific materials etc.

The NTBs can be classified into two categories: (a) technical and (b) non-technical. Technical NTBs include such measures as a higher standard of processed food industry products, food safety, non-use of certain chemicals and child labour. Non-technical NTBs include anti-dumping duties and pre-shipment inspection. The non-technical NTBs can be contested at the WTO.

20.5 TRADE ENVIRONMENT FOR DEVELOPING COUNTRIES

Current trade environment has features that are favourable for developing countries. However, it also poses some constraints.

20.5.1 Conditions Favourable for Trade

In the present juncture of the twenty-first century, we can identify the following conditions as favourable for developing countries in employing foreign trade as an instrument in promoting their economic growth.

i) Increasing spread of globalisation translates into larger movement of goods and services across the nations.

ii) Continuing reallocation of manufacturing activities from industrial economies to developing economies offers ample opportunities to expand trade not only in goods, but also in services, which are becoming increasingly tradable.

iii) Trade is intertwined with another element of globalisation i.e. the spread of international production networks.

iv) Growth of trade is firmly supported by international institutions. In particular, the world trade organisation (WTO) has aimed at creating an environment conducive to the multilateral exchange of goods and services.

v) Recent years have seen substantial changes in trade policy and in the barriers inhibiting developing country participation in world trade. Lower trade barriers have contributed to a perceptible shift in the pattern of developing country trade shifting them away from dependence on commodity exports to reliance on manufactures and services. In addition, exports to other developing countries have assumed importance.

vi) Information infrastructure plays a crucial role in promoting trade.

20.5.2 Constraints

Most of the non-oil producing developing countries including India are finding themselves facing a number of difficulties in benefiting from foreign trade as an engine of growth. Among these we may specifically mention the following:

1. *Slow Growth of Demand for Primary Commodities (PCs)*: The demand for PCs which form the principal exports of a developing country has not helped in keeping pace with the growth of world trade or with income levels in different countries. The world trade in PCs has been declining for the last five decades. Four possible factors can explain this.

a) The increasing tendency of the market economies to protect their agriculture by imposing tariffs and non-tariff barriers.

b) An inadequate increase in the demand for PCs in the developed market economies in the wake of industrialisation.

c) Development of synthetic substitutes.

d) In real terms, prices of PCs are presently at their lowest compared to the last century and a half. Growth rates are now at or near the replacement level so that little expansion can be expected from this source.

2. *Slow Growth of Exports from Developing Countries*: Exports of developing countries as a group have been slow to develop. As a result, the share of developing countries in the total world trade has maintained a downward trend. The decline has been caused by factors like the emergence of trade blocs, restrictive commercial policies and the growth of monopolies. These trends are indicative of the fact that the UDCs have to face foreign trade with barriers, to overcome which they have to strive hard.

3. *Deteriorating Terms of Trade*: The declining demand for primary commodities in the developed markets has given rise to the problem of worsening terms of trade for developing countries. Whereas prices of manufactured goods, especially capital goods, have been rising in the world markets, there has been a gradual decline in the prices of primary goods.

4. *Increasing Concentration of Foreign Trade*: With international trade in agricultural commodities becoming more concentrated, fewer companies increasingly control commodity supply chains, including activities ranging from production, grading, processing and distribution to retail. Small producers are edged out of high income activity for not being able to compete or meet the certification requirements of buyers.

5. *WTO and Trade Policies of Developed Countries*: These have the following effects:

i) Protectionist trade policies adopted by industrialised countries affect prospects for developing countries' export of manufactures.

ii) When developed countries indulge in dumping of their commodities, price environment for the importing countries is adversely affected for the domestic producers.

iii) Increased emphasis in recent years on 'fair' trade by industrialised countries is a development which has made it more difficult for developing countries to depend on international trade and foreign investment.

In short, developing countries face many difficulties in their foreign trade operations. Although numerous multilateral initiatives have been mounted to tackle these problems, they have left them largely unresolved. Therefore, in the given circumstances, the developing countries have to evolve a suitable trade policy-mix that create export outlets while also assuring supplies of essential imports.

Check Your Progress 2

1. Briefly state the arguments for and against free trade.

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2. State the arguments in brief for and against protection.

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3. Mention the principal features of the global environment in which developing countries have to operate.

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20.6 TRADE POLICY AND STRATEGY

The term ‘trade policy’ refers to all the policies that have either direct or indirect bearing on the trade behaviour of a country. The details of these policies depend upon the broad trade strategy adopted, which in turn, depends upon the developmental strategy adopted by the countries.

20.6.1 Inward-Orientation and Outward-Orientation

In a broader framework, inward-looking strategy refers to policies which discourage reliance on foreign resources. Under this, in its extreme form, no foreign aid is permissible, no movement of factors of production to or from outside is allowed, multinational corporations are not allowed to function, and freedom in international communications too is not entertained. In the present world economy, such an extreme form of inward orientation hardly exists in any economy.

The opposite of this extreme form of inward orientation is the extreme form of outward-orientation. In this, free movement of capital, labour, goods, multinational enterprises and open communication are permitted.

Arguments for outward-orientation: Advocates of outward-orientation argue that openness is useful to bring about good educational effects, new ideas and new techniques, growth of new forms of organisation, etc. They believe that free trade encourages learning and makes possible achievements of dynamic transformation of the economy yielding higher standards of living. Free trade is thus considered a win-win situation, in which all the trading partners stand to gain through productivity improvements, notwithstanding diversities in their domestic institutions and policies.

Quotas and other quantitative restrictions, on the other hand, interfere with the price mechanism, involve allocative and X-inefficiencies (i.e. failure to minimise costs), create distortions and impede the progress of competitive firms and industries.

Arguments for inward-orientation: As against the above arguments, the advocates of inward-orientation argue that inward-looking policies encourage indigenous talent by learning to do things by one self, domestic technological development with suitable range of products, avoid the ill-effects of demonstration from the outside world, etc. Given the gaps of development between the developing and developed countries, inward-orientation is advocated as an inevitable policy.

Effects of these two types of strategies on growth of output, employment, income generation and income inequalities could also be of diverse nature, and no general inference can be drawn in this context.

20.7 TRADE POLICY AND STRATEGY IN INDIA

Two important elements of trade policy and strategy pursued in India have been: (i) import substitution, and (ii) export promotion.

20.7.1 Import Substitution

Import substitution implies indigenous production of raw materials, intermediate goods and final consumer and capital goods. Import substitution was the major plank of India's foreign trade policy during the early years of economic planning. Later, however, it was realised that large imports of capital goods and equipment would help the country build up domestic production capacity and help meet the domestic requirements. The presumption was in-built in the Mahalanobis strategy of heavy-industry-led growth. A further assumption of the strategy was that once the production capacity within the country was built up, it would be possible to give up imports to a large extent. Working on this assumption, our plans provided for the required imports, financed largely by external assistance.

The progress of import substitution in the country was quite satisfactory. For instance, in the sphere of consumer goods, we acquired the capacity to produce exportable surplus in which we are competing effectively in the international markets. Likewise, indigenous production of capital goods also expanded fast with the country gradually becoming self-sufficient in their production too.

But all this does not mean that the country's requirements of imports have decreased or show signs of falling. On the contrary, India's imports have been mounting. As a percentage of national income they are about 22.3 percent presently, thus falsifying the Mahalanobis assumption that these would fall after a certain stage of development.

The approach of 'import and adapt', continuously fell short of global advancement in technology. More importantly, imports keep our industry on its toes in terms of price, quality and technology. Hence, our policies and efforts should be geared to develop ways and means with which to finance the rising needs of imports in the country. That takes us to the sphere of export promotion.

20.7.2 Export Promotion

The terms 'export promotion', 'outward-orientation', and 'export-led growth' have all been used interchangeably to describe the policies adopted in the successful developing countries. Note that import substitution and export promotion are not competitive, but each requires a different set of policies to be pursued. Three distinct phases can be seen in India's approach and policy towards exports.

a) The early phase, which lasted up to about 1972-73, was one of extreme export pessimism with a fear that exports are subject to low growth in demand, high fluctuations in prices and lead to economic dependency.

b) The second phase began in 1973 after the first oil crisis and lasted for about ten years. In this phase, although it was not explicitly stated, it was recognised that policies of import substitution by themselves could not bring about viability in India's BOP.

c) In the third and more recent phase, exports are being seen as an integral part of industrial and development policy. The anti-export bias of the policy has paved way for pro-export policy.

The policy has emphasised technological up-gradation, increase in the size of plants, freer imports and domestic and international competition for the entire industrial sector as being essential for export promotion.

Import Liberalisation and Export Promotion: The 'import substitution' strategy of industrialisation relied on encouraging domestic production to cater to the domestic market. This was sought to be realised by high tariffs and a high degree of protection granted to the domestic industry. The major drawback of this strategy was that it led to an inefficient and high cost industrial structure, which also adversely affected the prospects for export growth. Thus, it worked as a 'bias' against exports.

The argument for import liberalisation rests on the need to reduce the protection granted to the domestic industry for domestic production, thereby reducing the 'bias' against exports.

20.7.3 Recent Reform Measures

In the wake of shift in strategy, changes have been gradually introduced in the foreign trade sector. These include transition to a market determined exchange rate regime, removal of quantitative restrictions (QRs), tariffication (i.e. replacing QRs by tariffs), substantial reduction in the tariff rates, removal of negative list of exports and imports, substantially reducing licensing, introduction of current account convertibility, liberalisation of capital inflows, simplification of procedures, broadening the reach of export incentives, extending the benefits of various export-promotion schemes to a large number of non-traditional and non-manufactured exports, strengthening the export promotion base, etc.

Simultaneously, while removing QRs, the Government has taken several safeguard measures (e.g. adjustment of tariffs, imposition of temporary QRs, safeguard duties, anti-dumping duties, restricting the import of certain agricultural products, etc.) in order to guard against any surge in imports on account of dumping.

The import duty levels have been substantially reduced. The peak rate of duty on non-agricultural imports has been gradually reduced from as high as 150 percent in 1991-92 to 10 percent in 2008-09. However, the weighted average import duties on various goods, even though reduced from the high levels prevailing earlier, are still higher than that of some of the East Asian countries. The Government is committed to reduce tariffs to levels compatible with those prevailing in most East Asian countries.

It is expected that these measures will make domestic industry cost-efficient by enhancing efficiency in resource use. Under international competition, this is expected to lead to a better export performance in the long-run. Consumer welfare is expected to improve because of the availability of better quality products at globally competitive prices and by providing greater freedom of choice to residents to undertake current transactions on a global scale.

Check Your Progress 3

1. What is meant by import substitution? Briefly indicate with rationale.
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2. What is the rationale for export promotion? Outline briefly.
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20.8 EXPORT SUBSIDIES AND WTO

As a part of export promotion strategy, besides various other measures, various types of export incentives have been evolved. These have been altered and modified from time to time to meet varying conditions. Broadly, these incentives can be classified into three categories, viz. (i) fiscal incentives, (ii) financial incentives, and (iii) special incentive schemes.

i) **Fiscal Incentives**: Under fiscal incentives, the important measures that have been in vogue are income tax concessions, customs draw-backs, refund of excise duty, exemption from sales tax, provision for export undertaken, and facility for manufacture under bond.

ii) **Financial Incentives**: These incentives refer to the provision of cash assistance for specified export promotional efforts and export facilities.

iii) **Special Incentive Schemes**: Besides the recent reforms in the export incentive structure, export profitability was sought to be improved through a variety of fiscal concessions, and explicit and implicit subsidies. These measures were considered necessary to neutralise the negative financial impact of high administered prices of inputs and differential tax incidence that exporters suffer vis-a-vis 'across the border' competitors.

Advance license, export promotion of capital goods (EPCG) scheme, duty exemption pass book (DEPB), duty free import authorisation scheme and the draw-back scheme are a few important schemes currently in operation.

These schemes were attractive when the customs duty levels were high, but they are losing their attraction in view of the continuous reduction in import duty. In the light of this, the current policy reforms have initiated corrective steps towards making the export-incentive mechanism more market-determined, as mandated by the WTO Agreement on Subsidies and Countervailing Measures (SCM)

20.8.1 WTO Agreement on Subsidies and Countervailing Measures (SCM)

The SCM Agreement applies to non-agricultural products. It follows the traffic lights approach and classifies subsidies in three categories.

- **Red:** Subsidies with high trade-distorting effects, such as export subsidies, and those that favour the use of domestic over imported goods are prohibited. Developing countries with a per capita income of less than $1,000 have been exempted from this prohibition on export subsidies.

- **Green:** Subsidies that are not specific to an enterprise or industry or a group of enterprises or industries are non-actionable.

- **Amber:** Subsidies that are neither red nor green belong to the amber category. They are actionable by the trading partners if their interests are adversely hit. The affected country can seek remedy through the dispute-settlement procedures or go for countervailing duties.

20.8.2 Issues of Agricultural Subsidies

Agriculture is subsidised in all countries, developed or developing. The US reportedly provides $30 billion of annual subsidies to its farmers, i.e. about Rs. 1,50,000 crore. India budgeted Rs. 63,676 crore as subsidies on food and fertilisers during 2008-09. The subsidy per european cow is $750 per year. In recent years, the US exported cotton at 53 percent, wheat at 72 percent and rice at 84 percent of their cost of production. The EU's export prices were 34 percent for dairy products and 75 percent for sugar.

Agriculture is far more heavily subsidised in rich developed countries than in poor developing countries for two reasons:

a) Rich countries can afford larger amounts in subsidies.

b) Agriculture typically ceases to be competitive as a country industrialises. This has been the case in much of Europe and the US.

In developing countries, subsidies are provided simply to ensure self-reliance and self-sufficiency. In India, agricultural inputs like fertilisers, water and electricity are subsidised. The issue of these subsidies has come in for much debate in more recent times. This has happened essentially because of two reasons:

a) The rising burden of these subsidies has been questioned by policy makers trying to correct fiscal imbalance.

b) The issue of agricultural subsidies was brought to the centre stage with the establishment of WTO.

Rationale for Subsidies

The rationale for subsidising agricultural inputs is to be traced to the role that these subsidies play in stimulating development of any country through increased agricultural production, employment and investment. However, there are arguments being advanced on both the sides.

Arguments in Favour of Subsidisation

1. Subsidised inputs sell at lower prices. When subsidies are withdrawn their prices would rise. This would affect their sale and use of agricultural inputs resulting in lower agricultural production, particularly food production. This would compel the country to import food-grains. Importing fertilisers and subsidising their use has proved cheaper than buying and importing food-grains from abroad.

2. The subsidisation of inputs and credit has influenced (and does influence) the acceptance of new technology.

3. Subsidies, particularly in developing countries, must be construed more as an instrument for protecting the risk-taking function of the farmers than anything else.

4. Input subsidisation also prevents rising of food and raw material prices, thus avoiding the plausible adverse effects of growing industrial sector on large mass of poor living in the developing countries. This has come to be known as the 'cheap-input–cheap-output' policy.

5. Value added by subsidised inputs far exceeds the cost of subsidy.

Arguments Against the Continuation of Subsidies

a) Fertiliser and irrigation subsidies have widened regional disparities to some extent.

b) The maximum benefit of subsidisation of inputs is reaped by large and medium farmers, who possess the capacity to buy inputs at higher prices.

c) Input subsidies tax the budgetary capacity of the government. Fiscal imbalance pave the way for macroeconomic imbalances that create inflation, lower growth and increases inability to finance imports. Growth, in order to be sustainable, has to be efficient, and subsidies of the kind that Indian agriculture has been used to make for enormous wastage of power, water, fertiliser and pesticides.

d) Heavy fiscal burden of subsidy on inputs is also responsible for stagnation, if not decline, in public investment in agriculture.

e) Subsidy on irrigation through electricity and canal water causes distortion in cropping pattern in favour of water-intensive crops like paddy in Punjab and sugarcane in Maharashtra. These practices have led to a sharp decline in underground water resources.

f) Where the prices of inputs do not reflect their scarcity value, there is very little incentive for farmers to adopt methods which could make more efficient use of scarce resources. A rise in subsidies where prices do not reflect the scarcity value will increase their inefficiencies. This inhibits the growth of water-saving or energy-saving devices, discouraging investment in those industries which could manufacture these input-saving devices.

g) Provision of subsidised inputs results in their inefficient and unbalanced use. This, in turn, affects productivity adversely.

What is the Way Out?

The limits or constraints of the present subsidies, either from the financial, social, nutritional or environmental point of view, are well-recognised. But it is not possible to replace the present system by any other mechanism of incentives and redistribution. At least the following three things are clear:

1. Any fiscal approach to this problem is destined to fail as one cannot politically or reasonably ask a sector that is poorer than others to make bigger sacrifices.

2. Any reforms that are introduced should be presented as an effort to better utilise subsidies for the greater benefit of farming communities.

3. The fact at 2 above calls for the active involvement and participation of the concerned communities.

The sequencing of reforms in the agricultural subsidies must start from liberalising the output markets, opening them to exports and thereafter involving farmers in carrying out reforms in input markets particularly for non-tradable inputs like canal water, electricity and rural credit. It is only through such a comprehensive package of reforms that transformation towards accelerated and sustainable growth of Indian agriculture can be achieved.

WTO and Agricultural Subsidies

In the WTO Agreement on Agriculture (AOA) the approach adopted has been to encourage gradual reduction of trade distorting subsidies. The AOA specifically deals with (i) providing market access, (ii) containing of export subsidies, and (iii) regulating domestic support (also see unit 23 for more details).

Under the AOA, an index known as 'Aggregate Measurement of Support' (AMS) has been introduced. The AMS consists of two parts: (i) product specific support, and (ii) non-product specific support. The product specific support is the difference between domestic support prices (procurement prices in India) and external reference prices times (i.e. multiplied by) the quantity of production which gets such support. Non-product specific support is the sum total of subsidies on inputs like power, irrigation, fertiliser and credit.

The AMS provides an overall permitted measure of subsidies allowed as a percentage of gross agricultural production. Under the agreement, product specific and non-product specific supports as measured by the AMS, would have to be reduced if they exceed 5% of the value of production. For developing countries, this percentage is 10%. However, the following are exempted:

a) Government measures which encourage agricultural and rural development like subsidies for low income producers in developing countries.

b) Government service programmes like research, pest and disease control, training, extension and advisory services, inspection, marketing and promotion of infrastructural services.

India and AOA

In India, quantitative restrictions on agricultural imports imposed for BOP considerations have been removed and these imports are placed in the open general licence (OGL) list. In order to provide adequate protection to domestic producers in case of a surge in imports, India can raise the tariffs within the bound ceilings.

India can take suitable measures under WTO Agreement on Safeguards if there is a serious injury to domestic producers due to surge in imports or if there is any such threat.

India's domestic support to agriculture is well below the limit of 10 percent of the value of agricultural produce and therefore India is not required to make any reduction in it at present. The subsidies given for PDS are basically the consumer subsidies and are exempt from WTO discipline. India's system of minimum support price (MSP) as also the provision of input subsidies to agriculture are not constrained by the agreement. Thus, the agricultural sector schemes can be continued under AOA.

India in many cases, in fact, has actually been taxing her farmers by not allowing them to export their produce freely at international prices which are higher than the domestic prices. So when the likes of the US and the EU reduce support levels, the international prices will increase. India whose prices will then become competitive, will stand to gain out of the provision that the countries with BOP problems are not required to provide minimum market access.

But by the same logic, large subsidies given to cotton, sugarcane and oilseeds will have to be reduced. This is because the aggregate measurement support (AMS) given by the government by way of high procurement prices for these products is above the limit of 10 percent permitted for the developing countries under the WTO-AOA.

Assessment

Experience during the last decade and a half or so has shown that WTO has no visible agenda for the resource poor farming families. It is clear that rich nations are not prepared to phase out trade distorting subsidies and provide increased market access to predominantly agricultural developing nations. For this to happen, we may suggest as follows:

1. All boxes may be abolished; the do's and don'ts with reference to trade distortion and unfair trade practices may be spelt out in more clear and unambiguous terms.

2. As an alternative, a fourth box relating to sustainable livelihoods (livelihood security box) may be introduced. This should empower developing nations facing the challenge of providing livelihoods to their poor rural population. By this, restrictions on agricultural imports should be imposed whenever there is convincing evidence that they erode the job/livelihood opportunities of poor in their countries.

3. A range of domestic support measures like those relating to infrastructure development, and many other forms of public provisioning, are non-trade distorting and hence non-actionable. Support for sustainable farming and rural livelihoods, on the other hand, merits subsidy. This concern of developing economies should be duly recognised by the international institutions. The approach adopted in classifying actionable and the non-actionable types of activities should take due cognisance of this in the interest of financial help needed by the large number of small farmers/producers in the developing economies.

20.9 LET US SUM UP

Foreign trade is a win-win situation for all trading partners as it promotes economic welfare. Based on comparative advantage theory, foreign trade promotes global specialisation, efficiency and better use of resources.

However, very often, the free flow of goods across borders is restrained due to other considerations, among which, the most important is to protect domestic industry from foreign competition. Protection is an international phenomenon in which all nations, big and small, rich and poor, impose barriers on free flows of goods. These barriers may be tariff barriers or non-tariff barriers. The height and strength of these barriers is determined by the growth, and the corresponding trade strategy pursued by a nation. Those nations which pursue import-substitution strategy raise higher barriers. Nations pursuing outward-oriented strategy of growth normally place only nominal barriers. Nations, including India, also provide incentives and other subsidies to their producers, both agricultural and non-agricultural. Subsidies amount to interference with the free operation of market forces. The WTO has put in place international arrangements that regulate them.

20.10 KEY WORDS

Opportunity cost	:	The value of the alternatives or other opportunities which have to be foregone in order to obtain a particular thing.
Free trade	:	refers to trade that is free from all artificial barriers to trade like tariffs, quantitative restrictions, exchange controls, etc.
Protection	:	refers to the government policy of providing protection to the domestic industries from foreign competition.
Inward-looking strategy	:	refers to policies which discourage reliance on foreign resources.
Outward-orientation or Outward-looking strategy	:	Refers to an environment in which free movement of capital, labour, goods, multinational enterprises, open communication, etc. are permitted.
Agreement on Agriculture (AOA)	:	Refers to the approach adopted to encourage gradual reduction of trade distorting subsidies.

20.11 SOME USEFULL BOOKS

1. Asian Development Bank, Trade Policy, Industrial Performance, and Private Sector Development in India, Oxford University Press (OUP), New Delhi, 2009.

2. Kaushik Basu (ed.), The Oxford Companion to Economics in India, OUP, New Delhi, 2008.

3. Ashok Gulati and Tim Kelley, Trade Liberalisation and Indian Agriculture, OUP, New Delhi, 2007.

4. Deepak Nayyar, Trade and Liberalisation, OUP, New Delhi, 2008.

20.12 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1. See Section 20.2 and answer.

2. See Section 20.3 and answer.

3. See Section 20.3.2 and answer.

Check Your Progress 2

1. See Section 20.4.1 and answer.

2. See Section 20.4.2 and answer.

3. See Section 20.5 and answer.

Check Your Progress 3

1. See Section 20.7.1 and answer.

2. See Section 20.7.2 and answer.

UNIT 21 EMPIRICAL ASPECTS OF TRADE AND BALANCE OF PAYMENTS

Structure

21.0 OBJECTIVES

After reading this unit you will be able to:

- outline the empirical dimensions of India's foreign trade;
- explain the changes in the different aspects of the structure of India's foreign trade in terms of volume, composition and direction;
- describe the concept and significance of balance of payments;
- discuss the role of balance of payment deficits in the growth process;
- explain the trends in India's balance of payments since the early 1950s;
- outline the importance of different exchange rate regimes and the broad changes in the exchange rate management system; and
- describe the meaning and implications of the full convertibility of rupee.

21.1 INTRODUCTION

As stated in Unit 20, foreign trade worked as an engine of growth in UK (18th & 19th centuries), Japan, South Korea, Taiwan and other East Asian Countries (20th century), and more recently, in China, by generating impulses that had strong forward and backward linkages with many sectors of the economy. These countries also gained by opening up their economies to foreign capital and enterprise. Since the 1990s, India too has adopted similar policies. Liberalisation of trade and opening up of the economy has dramatically transformed the profile of India's foreign trade and balance of payments scenario. The present unit discusses the principal features of India's foreign trade and balance of payment profiles.

21.2 EMPIRICAL DIMENSIONS OF FOREIGN TRADE

An analysis of a country's foreign trade can be made in terms of its three main profiles: (i) volume, (ii) composition, and (iii) direction.

21.2.1 Volume of Trade

It relates to the size of international transactions. Since a large number of commodities enter in international transactions, the volume of trade can be measured only in terms of money value. The trends in the value of trade over time help us to identify the basic forces that may be operating at different periods in the economy.

However, mere absolute changes in the value of trade is not a satisfactory guide. Hence, it is necessary to find the changes in the value of trade by relating them to two variables, viz.

- Share of exports/imports in GDP, and
- Share of exports/imports in world trade.

The share of exports/imports in GDP indicates the degree of outward-orientation or openness of an economy in regard to its trade. This, in a broad way also reflects the nature of trade strategies adopted in the country. The ratio of exports to GDP could also be interpreted to reflect the average supply capability of the economy in terms of its exports. It can therefore be called as ***average propensity to export***. A similar ratio between imports and GDP gives the ***average propensity to import***. However, the relative share of exports in output under an efficient allocation of resources will be less in bigger economies than in smaller economies. This is in the sense of developed economies being more self-contained as compared to the situation of the developing economies. Such economies have to also import, sometimes in large numbers, all types of goods and services required in the process of development e.g. capital goods, intermediate goods, consumer goods, etc. To finance such imports, these economies have to focus on exports to establish balance of trade.

The share of exports in the world trade indicates the importance of the country as a nation in the world economy. It reflects the market thrust that the country is able to realise in the presence of the various competitors in the world market. Changes in this ratio, thus, indicate the shift in the position of the comparative advantage of the country.

Further, changes in the value of exports may be compared to the changes in the value of imports. It is the relationship between these two variables which is known as the *terms of trade (TT),* i.e. the terms at which exports exchange for imports. Terms of trade can be defined in respect of (i) net barter terms of trade, (ii) gross barter terms of trade, and (iii) income terms of trade.

i) **Net Barter Terms of Trade**: Also called as the commodity terms of trade, this measures the relative changes in the import and export prices. This is expressed as:

$$N = P_x / P_m$$

Where P_x and P_m are price index numbers of exports and imports respectively. A rise in N indicates that a larger volume of imports could be received in exchange for a given volume of exports. However, the net barter terms are relevant only when nothing enters into the trade between countries except sales and purchases of merchandise.

ii) **Gross Barter Terms of Trade**: This is the ratio of the physical quantity of imports to physical quantity of exports. This is expressed as:

$$G_t = Q_m/Q_x$$

where Q_m and Q_x are the quantity or volume index numbers of imports and exports respectively. A rise in G_t is regarded as a favourable change in the sense that more imports are received for a given volume of exports (in the i^{th} year than in the base year).

iii) **Income Terms of Trade**: This is expressed as:

$$I = P_x \cdot Q_x / P_m$$

A rise in I indicates that the nation's capacity to import, based on exports, has increased i.e. it can obtain a larger volume of imports from the sale of its exports.

21.2.2 Composition of Trade

It is indicative of the structure and level of development of an economy. For instance, most of the underdeveloped countries (UDCs) [a term not used any longer having since been replaced by the term developing countries for long] depend for their export earnings on a few primary commodities (PCs). These countries export raw materials of agricultural origin and import manufactured industrial products, thus, denying themselves the benefits of value added. As an economy develops, its trade gets diversified. It no more remains dependant on a few primary commodities for its exports as it begins to export more of manufactured industrial goods importing industrial raw materials, capital equipment and technical know-how.

Manufactured exports create greater value addition than the PCs as they go through more stages of processing. The manufacturing sector has greater linkages with the rest of the economy and, hence, the downstream effect on exports from these sectors are likely to be greater than primary exports.

The commodities entering trade could also be classified by various other criteria such as value added per unit of output, productivity of labour, capital intensity in production, the strength of backward and forward linkages, etc. The shifts in the commodity composition of trade in these categories would bring out the nature of structural changes in regard to income generation, employment effect and overall industrialisation through linkage effects, etc. The following questions need to be analysed in this regard:

- What is the degree of concentration in the composition of exports/ imports? Has there been any change in the degree of concentration over time?
- Is there any shift in the shares of the primary products and manufactured products in the total export or import traded?

21.2.3 Direction of Trade

The direction of trade is indicative of the structure and level of economic development. As a country develops and its trade gets diversified, it has to seek new outlets for its exports. Its horizon of choice in terms of imports also gets widened. The country begins to trade with an increasingly large number of countries. One could therefore ask whether there has been a concentration or a dispersion of the markets for exports and sources of supply for imports.

It is in terms of these components that we have to study the trends in India's foreign trade during the course of economic planning.

21.3 VOLUME OF INDIA'S FOREIGN TRADE

As envisaged in our development strategy, the volume of merchandise trade has been on the rise; the trade to GDP ratio has gone up from 13 percent in the 1980 to about 25 percent presently. The increase has been shared both by exports and imports.

21.3.1 Exports

India's total exports have increased manifold, from Rs. 606 crores in 1950-51 to over Rs. 6,25,064 crores in 2007-08. However, the increase has not been uniform over the years. Whereas the exports hardly showed any variation during the first decade and a half of our getting independence, i.e. between 1950-51 and 1965-66, it multiplied manifold during the next four decades, i.e. between 1966-67 and 2007-08. We can, therefore, conveniently divide the whole period into two sub-periods, with 1965-66 serving as the year of divide. We shall now identify the trends and the forces that have been at work during each of these sub-periods.

Before 1965-66

India's exports were slow to grow during the first fifteen years of economic planning, notwithstanding the fact that this period has been described as the *Golden Era* for world exports.

This fact can be established with the help of two comparisons, viz.

- A comparison with the growth in total world exports.
- A comparison with the growth of net national product (NNP).

The total exports formed as much as 6.8 percent of the NNP in 1950-51 and 8.0 percent in 1951-52. This share fell to 3.9 percent in 1965-66 indicating that the growth in the *exports sector lagged behind the growth in other sectors of the economy.*

India's share in the total world exports was 2.2 percent in 1951. It came down steeply to 1.3 percent in 1958, and further to 1.1 percent in 1965.

After 1965-66

In 1966, the Indian rupee was devalued to bring domestic prices in alignment with external prices. After this devaluation, initially, exports were slow to pick up. But in 1972-73, a real breakthrough in exports occurred. This was mainly due to a substantial growth in the exports of sugar, iron and steel, fruits and vegetables and food products. A considerable growth was also recorded by engineering goods, leather goods, apparel, handloom cloth, chemicals and allied products, and various handicrafts, especially gems and jewellery.

A second major change in the trend in exports occurred in 1986-87, and has continued since, with evidence of a new dynamism of India's export performance brought about by a more supportive domestic industrial policy. This policy emphasised on competition, efficiency, scale economies and technological up-gradation. Further, a more liberal import policy ensured greater and easier access to imported inputs of raw materials and components as also technology. The pursuit of a realistic exchange rate also helped in preserving a competitive edge in exports. As a result, exports increased at an annual average rate of more than 25 percent in rupee terms.

In view of these factors, over the last twenty years i.e. 1987-2007, the upward trend in exports has been consistently maintained, except for some occasional dips. Currently, the export sector is poised for a major break-through, notwithstanding the serious uncertainties and instabilities caused by financial turmoil in the developed world. This shows that Indian exporters are successfully exploiting the scope of productivity gains that exist today. For instance, major emphasis is laid on improving the infrastructure in the country. Falling interest rates have also helped considerably to maintain competitiveness. This trend should strengthen India as it progressively gets greater market access, especially in services within the framework of WTO.

Relative Position

As already stated, changes in the value of trade may not be much useful in assessing the export performance. *We must study the relative position*. We can employ, presently, three types of comparisons for this purpose.

i) **Comparison with the First Decade and a-half of Planning:** As to this, the conclusion is obvious i.e. India's exports have picked up and continued to maintain an upward trend.

ii) **Comparison with the Growth of GDP:** The share of exports in GDP too has increased over the years. Whereas it was a mere 3.1 percent in 1965-66, it was 13.0 percent in 2007-08. The aggregate exports of all high-income countries combined are 15 percent of their aggregate GDP whereas the average for all low-income economies (including China) is 18 percent.

iii) **Comparison with the Growth of World Exports:** India's exports, as compared to the world exports, have been slow to grow. Consequently, India's share in the world exports fell to a low of 0.42 percent in 1980-81. This is in spite of the country's comparative advantages like: low wages, educated workforce, etc. During the 1980s and the 1990s, there has been some improvement in this ratio, varying between 0.50 and 1.00 percent, indicating improvement in the export sector.

In short, India's exports shows a mixed trend. Whereas the rate of growth as measured in terms of past performance (or in terms of its share of national income) shows a rise, its performance when measured in terms of the share in world exports is very low.

21.3.2 Imports

India's total imports have increased from Rs. 608 crores in 1950-51 to an estimated Rs. 9,49,134 crores in 2007-08. It is estimated that 1 percent increase in national income requires imports to grow by 1.2 percent. This would mean that to achieve the targeted 9.0 percent per annum rate of growth, the import bill would rise by about 10.8 percent per annum. The overall trend of imports has been that of an increase right since 1954-55, with some dips now and then. While exports have been mainly dependent on world demand and availability of exportable surpluses, imports have been largely a matter of government policy.

Till 1980s, the government had adopted an import control policy. This included measures like licensing, quotas, bans, etc. of imports and tariff measures for providing protection to domestic units. The degree of control varied depending on the circumstances obtaining in the economy. Initially, the objective of the import trade control was to save foreign exchange. Over the years, the import trade control acquired a more positive and wider role in the economic development and industrial growth of the economy. It sought to facilitate the availability of such imported inputs crucially needed to broaden the base of industrial production and growth, especially for promoting exports.

21.4 COMPOSITION OF INDIA'S FOREIGN TRADE

21.4.1 Exports

The picture that emerges from the aggregate behaviour of export values, volumes and prices gets reflected in the performance of individual commodities. There are two marked features of the composition of exports as they have emerged during the last five and a-half decades.

Till 1965-66

During the first decade and a-half, i.e. till 1965-66, India's export efforts leaned heavily on three principal commodities, viz. tea, jute and cotton goods. These three commodities among themselves commanded between 45 and 50 percent of the total export earnings. Other principal items of export during this period were manufactured tobacco, cashew kernels, leather and iron ore.

Since 1965-66

Since 1965-66, the commodity composition of India's exports has undergone a total transformation, which, in turn, has also contributed to a rapid expansion of India's exports during this period. The diversification in exports largely reflects the growth and industrialisation of the economy. It is also indicative of India's resolve to realise the goal of self-reliance. Important new commodities that have been added to the export basket and have acquired considerable significance in terms of their export value realisations are engineering goods, leather manufactures, cotton apparels, pearls and precious stones, chemicals and allied products, woollen carpets, iron and steel, etc.

Economic Reforms and Stimulus to Exports

The on-going economic reforms characterised by trade liberalisation (brought about by the reduction of tariff and non-tariff barriers) is expected to bring about following effects:

- It will stimulate production of labour intensive items and bring about more efficient use of resources as country specialises in production of goods where it has a comparative cost advantage.

- The growth in output will allow the buoyant sectors to reap the advantages of large-scale production.

- Competitive pressures will induce firms to raise production achieving more efficient plant sizes and lower per unit costs. Firms will also become quality-conscious.

- The termination of multi-fibre agreement (MFA) is expected to offer opportunities for larger exports of textiles, although the competitive pressures from other competing developing countries' low-cost producers may rise.

21.4.2 Imports

Imports, as already mentioned, have been largely governed by the import trade control policy of the government although the composition of imports has been changing in response to the needs of the economy.

India's imports can be classified into three parts viz. (i) consumer goods, (ii) raw materials and intermediates, and (iii) capital goods. While the import of consumer goods have been totally restricted, permitted only when required to meet domestic shortages, imports of raw materials, intermediate goods and capital goods have increased.

Consumer Goods

The import of consumer goods, as already stated, have been allowed only when they are required to meet domestic shortages. Among these, the more important have been cereals, especially wheat and pulses. Hence, these imports do not show any systematic pattern. They have been usually high in the year succeeding the bad crop year. Since 1976-77, these imports have been negligible primarily because of large food-grains production during the period 1976-2008.

Capital Goods

The import of capital goods (e.g. machinery and other industrial equipment) shot up rapidly between 1955-56 and 1965-66, which correspond to the period covered by the Second and Third Plans.

Subsequently, there was a significant slow-down in imports of capital goods whereby domestic investment activity had slowed down. Imports of capital goods which formed as much as 29.5% of total imports during 1960-61 came down to only 15.0% in 1990-91.

With the on-set of the economic reforms programme, technological improvement and efficiency became the keywords for industrial survival in the emerging competitive environment.

Import of capital goods increased during the decade of 1990s and after. This increase could be attributed to the following three reasons:

- Indian manufactures introduced advanced technology to meet international competition.
- Import duties were reduced and regulations on import of capital goods were relaxed.
- Inflow of FDI rose. When joint venture companies are set up, they are likely to result in the import of capital goods from the partner countries.

Intermediate Goods

The group of commodities which has been growing in importance over the years consists of raw materials and intermediate goods most of which are in the nature of 'maintenance imports'. As the growth process moved, shortages and scarcities of different types of raw materials and intermediate goods began to be felt. These shortages would adversely affect the utilisation of capital goods, but for the import of required intermediate goods. Hence, the large imports of these commodities have been allowed. Among these imports, the most significant have been crude oil and petroleum products, fibres, fertilisers, chemical products, iron and steel, and non-ferrous metals. In short, the product profile of India's imports shows a strong push towards modernisation of Indian industry.

The composition of India's foreign trade reflects the structural changes that the Indian economy has undergone over the period of last five decades. It is no longer an exporter of primary commodities and an importer of manufactured goods. It exports manufactured goods and imports raw materials, intermediate goods and capital goods.

21.5 DIRECTION OF INDIA'S FOREIGN TRADE

21.5.1 Exports

The relative importance of the U.K. and the U.S.A. as outlets for our exports has declined over the years. Whereas in 1950-51, these countries together accounted for more than 40 percent of India's exports, this share came down in 2007-08 to less than 23 percent. The U.S.A., all the same, continues to be our principal buyer. It has, however, to contend with EU member-nations who as a group offer us a very rich market. The economic conditions in industrial countries significantly determine the demand for India's exports.

More Recent Development

Over the last decades, in wake of Look East Policy, India's exports to Asia and Oceania markets, with which ethnically, culturally and economically India is closer, have shown a sharp jump. In fact, the current boom in exports is sustained largely by what officials see as an unexpected and healthy rise in exports to the Asia and Oceania countries, which include the ESCAP countries like Australia, Iran, Japan, Korea, Malaysia, Singapore, Thailand, Hong-Kong, Bangladesh and Nepal. The shift in favour of these countries implies that Indian exporters have begun concentrating in markets closer home to capitalise on the advantages from lower freight cost. It is also an evidence of the outward orientation being imparted to the economy by reforms.

However, the expansion of trade within Asia is inevitably going to be constrained by the fact that many countries, particularly the fastest growing ones, have similar resource endowments. For instance, they are commonly competitive in labour-intensive products. And as they will find it difficult to sell these goods in each others' markets, their aim is to compete for a share in the American and European markets.

21.5.2 Imports

The direction of imports has been largely influenced by the development of the economy. In the initial stages of growth, a large part of the development process was financed through foreign aid, which was primarily in the form of tied aid. As a result, a large part of imports originated from the aid-giving counties.

- In 1965-66, more than 35 percent of India's total imports came from the U.S.A. Since then the share of the U.S.A. has declined although it continues to be our largest supplier, accounting for about 8 percent of our total imports.
- The share of the U.K. in India's imports has also sharply declined although it continues to be a principal supplier. Among the other major countries that have made inroads into our import trade are Belgium, Canada, France, Germany and Japan. The EU as a group accounts for about 24 percent of our imports.
- A more significant development has been the emergence of oil-producing countries as a significant purchasing centre for us. Sharp increase in the unit value of petroleum and its products have led to higher oil import bill. The OPEC accounts for about 22 percent of our total imports.
- Since the liberalisation in more recent years a glut of imports has been taking place from China and East Asian countries. These imports, presently, are limited to low-price consumer goods.

Diversification or Concentration?

Nine countries, viz. the U.S., the U.K., Germany, the erstwhile USSR, Japan, Iran, Iraq, Australia and Canada had a lion's share ranging between 51 to 62 percent of our exports and 56 to 75 percent of imports during the three decades from 1951-52 to 1979-80. In 1990-91, their share of exports was as high as 56.7 percent while their share in imports had declined to 47.6 percent. More recently, in 2004-05, 51.7 percent of our total exports had their destination in the EU, the USA and the UAE. Likewise, about 40.5 percent of our total imports originated from the EU, the USA and Japan. It is therefore clear that India's foreign trade is not diversified. By implication this means that India would have to explore new sources of imports and new markets for its products in a fast globalising world.

To sum up, during the last five decades, significant changes have been observed in the volume, composition and direction of India's foreign trade. Although most of these changes have been in consonance with the development needs of the economy, following problems need immediate attention.

- Problems of deficits in the balance of trade. Growing trade deficits had posed problems of resource mobilisation for the Indian planners till the recent past. This, therefore, needs to be monitored continuously.

- Our share in world trade (which is presently less than 1 percent) needs to be increased if India is to play its rightful role in the international division of labour.

- The expansion of trade within Asia is inevitably going to be constrained by the fact that many countries, particularly the fastest ones, have similar resource endowments. To go beyond mere diversification and act as a genuine engine of growth, Asian trade will have to be driven by forces similar to those in Europe. Gains can come from increasing efficiencies as production relocates across borders to take advantage of scale economies and other factors.

Check Your Progress 1

1. What major changes have taken place in the volume of India's foreign trade during the last three decades?

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2. How has the composition of India's exports been affected by economic reforms?

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3. Highlight the important changes in the direction of India's foreign trade in recent times

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21.6 BALANCE OF PAYMENTS AND PROBLEM OF DEFICITS

The principal tool for the analysis of the monetary aspects of international trade is the balance of international payments settlement. This statement, also simply known as the 'balance of payments' (BOP), is a systematic record of all international economic transactions, visible and invisible, of a country during a given period, usually a year. In other words, the statement is a device for recording all the economic transactions within a given period between the residents of a country and the residents of other countries. The BOP of each of the individual countries, technically speaking, always *'balances'*. Such equality in the debit and credit sides of the BOP, known as equilibrium, has no economic significance. It simply results from the double entry bookkeeping procedure, which is used to record the transactions.

The analysis of the BOP can be done in terms of its two major sub-divisions: (a) Current Account, and (b) Capital Account.

21.6.1 Current Account

The *Current Account* can be broken down into two parts, viz. (i) balance of trade and (ii) balance on invisibles. The *Balance of Trade* (BOT) deals only with exports and imports of merchandise (i.e. visible items). The *Balance on Invisibles* (BOI) shows net receipts on account of invisibles. These include the remittances, net service payments, etc. It is not necessary that the BOT should always balance; more often than not, it will show either a surplus or a deficit. Similarly, the BOI will always show either a surplus or a deficit. A surplus on BOT may be matched with a surplus or deficit on BOI. If the surplus on BOI equals the deficit on BOT, the current account will show a net balance. However, there is no reason why these two balances should always be equal; as a matter of fact, the balance on current account always shows a deficit or a surplus. A surplus on current account leads to an acquisition of assets or repayment of debts previously contracted, and a deficit involves withdrawal of previously accumulated assets or is met by borrowings.

21.6.2 Capital Account

The *Capital Account* presents transfers of money and other capital items and changes in the country's foreign assets and liabilities resulting from the transactions recorded in the current account. The deficit on the current account and on account of capital transactions can be financed by external assistance (e.g. loans and grants drawn from the International Monetary Fund) and allocation of the Special Drawing Rights.

The BOP accounts provide a link between the increase in gross external debt and the portfolio and spending decisions of the economy.

Thus, increase in gross external debt = Current account deficit (CAD)

– direct and long-term portfolio capital inflows

\+ official reserve increase

\+ other private capital outflows

21.6.3 Balance of Payments and Developing Economies

It is well known in development economics that UDCs invariably start of as debtor economies. In the process of development itself, these economies have to import a great deal of capital goods, food and raw materials and spares and components. They also have to import new technologies. Hence, the total exchange outgo cannot be matched by export earning. It is, however, expected that in a decade or two, as the new capital goods and technologies become effective with their products directed towards exports, the volume of exports expand and, in due course, overtake imports. A developing economy at that stage moves on from being a debtor economy to a more balanced one in terms of BOP and, finally, becomes a creditor economy, when its exports are more than its imports. Thus, from being a net debtor in the beginning, it becomes a net creditor in the end and, in fact, begins to invest abroad rather than have others lending to and investing in it.

21.6.4 Current Account Deficit (CAD)

A current account deficit, as seen from the above, is nothing but a measure of a country's savings gap, i.e. the excess of investment over savings. It represents the net transfer of resources from the rest of the world to the country running the deficit. Therefore, in a developing country, with huge needs for funds for investment, a CAD is unavoidable as it represents investment which would otherwise be beyond its potential to finance from its own savings. In view of this, CADs are best when financed by foreign capital inflows.

The right CAD for any country, therefore, depends on its ability to absorb and service the capital inflows. If these resources can be deployed productively and in ways that enhance its ability to repay, a high CAD to GDP ratio is nothing to worry about. But if they cannot, then it is inviting trouble. Too high a ratio can prove unsustainable in the long run as it did in East Asian economies in 1998 and in Mexico earlier. To that extent low CAD to GDP ratio has its advantages. However, a very low ratio carries with it an opportunity cost - of not being able to benefit from resources that could be drawn from outside.

21.7 TRENDS IN INDIA'S BALANCE OF PAYMENTS

India has faced pressures on BOP from time to time either due to certain domestic compulsions or due to external factors. In this context, the whole period, covering nearly five decades, can be divided into five sub-periods, depending on: (i) the nature of the BOP problem, (ii) the overall macro-economic environment, and (iii) the external situation.

Period I (up to 1975-76): A Period of Deterioration

The period was very difficult for India's BOP, partly because of slow growth of exports in relation to import requirements and partly because of adverse external factors. Despite tight import controls (through quantitative restrictions) and foreign exchange regulations, the CAD was 1.8 percent of the GDP. Foreign exchange reserves were at a low level, generally less than necessary to cover three months' imports. Almost the entire CAD (92 percent) was financed by inflows of external assistance on highly concessional terms.

Period II (1976-77 to 1979-80): A Period of Transition and Improvement

These few years stand out as the golden years for India's BOP. India had a small current account surplus (0.6 percent of the GDP on an average) and foreign exchange reserves equivalent to about seven months' imports. Export growth was good but the primary reason for the improvement in BOP was the dramatic improvement in net invisibles (by way of large remittances from the middle east from Indian emigrants). Net invisibles increased from Rs. 193 crores in 1974-75 to Rs. 2,486 crores in 1979-80.

Period III (1980-81 to 1989-90): Emergence and Persistence of Structural Imbalances

This period corresponds to the Sixth and the Seventh Plan periods. The Sixth Plan was launched when the economy was faced with severe BOP difficulties. In 1981, India entered into an arrangement with the IMF for a loan of *SDR 5 billion* under the Extended Fund Facility. The amount was to be disbursed over a three-year period. India, however, drew only SDR 3.9 billion and the arrangement was terminated in early 1984 at India's request because of the improvement in the BOP position in 1983-84.

The deficit on external trade and payments suddenly jumped from the first year of the Seventh Plan and was particularly acute during the last two years of the plan. The CAD more than trebled over the plan period as a whole. The deficit was as high as 2.2 percent of the GDP, as compared to 1.3 percent during the Sixth Plan.

Period IV (1990-91 to 1995-96): Stabilisation and Strengthening

The BOP crisis reached its climax during 1990-91 - CAD reached a high of 3.3 percent of the GDP during this year.

A comprehensive strategy to deal with the BOP situation was put in practice. The principal elements of the BOP strategy were as follows:

- **Preference to Non-Debt Creating Capital Flows:** The most important element of strategy has been the paradigm shift in the attitude towards inflow of capital from abroad. Capital inflow from abroad was earlier treated more generally as a device to finance CAD. Now non-debt creating capital inflows, especially FDI, is being encouraged on account of their positive impact both in terms of technology and the stabilising role in external sustainability. The policy has, therefore, been to gradually liberalise capital account.

- Recognising that liberalisation of capital account needs to be treated as a continuous process, the approach is being based on a careful and continuous monitoring of certain preconditions/signposts such as monetary and fiscal discipline, exchange rates, structural reforms, etc.

- Stabilisation and strengthening of strict fiscal and monetary discipline to control aggregate demand in place of monetary policy aimed at slowing down the growth of money supply.

- **Exchange Rate Policy:** The exchange rate policy was progressively liberalised in the successive union budgets of early 1990s. For instance:

  - A dual exchange rate system, called liberalised exchange rate management system (LERMS), was introduced in the union budget of 1992-93. Under this system, 40 percent of foreign exchange earnings were to be surrendered at the official exchange rate. Remaining 60 percent could be converted at a market-determined rate.

  - The budget for 1993-94 introduced another scheme viz. the unified exchange rate system (UERS) in which rupee was convertible at a unified market determined rate of exchange. Under this, all payments and receipts of foreign exchange were to be converted in rupees at market-determined rate of exchange.

  - The budget for 1994-95 introduced full convertibility on current account making many trade transactions relatively more free of controls.

Further, import restrictions on capital goods, raw materials and components were virtually removed. With this, excess import-demand would be reflected in a higher market exchange rate with which a self-correcting mechanism was expected to operate keeping the trade deficit in check.

Period V (1996 to 2008)

Over the last decade or so, two prominent features on the BOP front can be indicated as follows:

1. On the current account front:

   i) **Firstly**, trade deficits have been widening. Both exports and imports have multiplied fast, but imports have risen at a faster rate than exports. Expanding exports, in turn, reflect (a) the impact of liberalisation measures, and (b) increasing manufacturing activity in the domestic economy.

   ii) **Second,** there has been a phenomenal increase in the net surplus on account of invisibles. This, in turn, is principally due to (a) buoyancy in private transfers (i.e. inward remittances), and (b) fast expansion in exports of services, especially software. India is unique among emerging economies to have a sizeable invisible surplus that substantially offsets the merchandise trade deficit. As a result, although India has been running a current account deficit (except during 2002-04 when India experienced a current account surplus), the deficit has been conveniently managed, largely because of huge surplus on capital account as the following point clarifies.

2. On the capital account front, India has been running a big surplus. The size of the surplus has been much more than what is required to finance the current account deficit. As a result, India has been rapidly building up its foreign exchange surplus. The capital account demonstrates features like:

   i) Increased inflows and outflows of capital especially since 2003.

   ii) The composition of capital flows has undergone change by way of:

      a) Official external assistance gradually losing out its significance;

      b) FDI and portfolio investment have surged, with the FDI inflows being much more than portfolio investment; and

      c) Easing of controls resulting in external commercial borrowings in a prominent manner.

Overall, therefore, India's balance of payments (both current account and capital account) has been in surplus, resulting in rapid build-up of foreign exchange reserves. However, it should also be noted that the acceleration in India's growth momentum since 2003 owes partly to the exceptionally easy global liquidity conditions. This has increased the scope for risk-taking contributing to an increase in the volume of capital inflows into India.

21.7.1 Long-run Perspective

Our long term strategy should aim at enhancing the economy's absorptive capacity to achieve higher levels of real investment. At the same time, we must ensure that we do not become dependent on external capital, for if it dries up, our currency loses its value. Speculators anticipate this by betting against the currency, which puts pressure on it. When this happens, the value of investments drop. The flight of capital increases the pressure on the currency, and such a situation might warrant the assistance of the central bank. Therefore, no country must let its CAD go beyond 3 to 4 percent of GDP which in India's case works out to about $ 45 billion. Also, the composition of its reserves and the vulnerability of its capital inflows to short-term uncertainties must be minimised. This implies that as the economy grows up, outside influences will increasingly impact and constrain policy-making along with domestic imperatives. This requires that imports must be constantly monitored for its composition, and capital goods imports must be encouraged as compared to consumer goods. Exports should always be a priority and to the maximum extent possible, the trade deficit should be narrowed. With a large service sector and huge stock of service professionals, a big push in multiple directions is required for exploiting the market potential in this area. Short-term debts should not be allowed to reach a level where its refinancing could create a crunch. Direct investments are more important than portfolio investments in that they represent more stable and committed flows.

Check Your Progress 2

1. What is meant by balance of payments? Distinguish between current account and capital account.

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2. Outline the significance of balance of payments in a developing economy in about 50 words.

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3. Do current account deficits need to be avoided in all situations?

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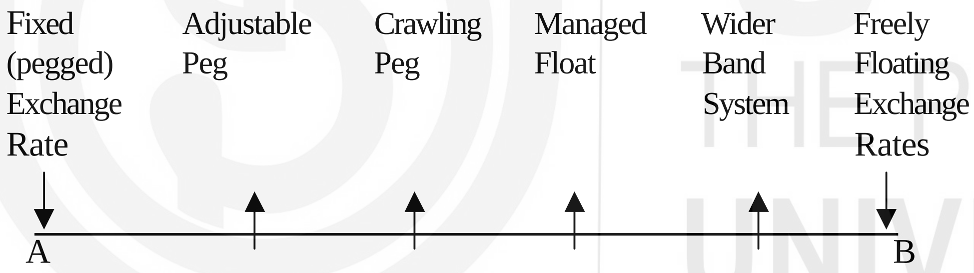
21.8 EXCHANGE RATE REGIME

Exchange rate regime refers to the way in which a country manages its currency is respect of other foreign currencies and the foregin exchange market. Between the two limits of fixed and freely floating exchange regimes, there can be several other types of regimes as shown in Fig. 21.1. In their operational objective, it is closely related to monetary policy of the country with both depending on common factors of influence and impact. Exchange rate regime has a big impact on world trade and financial flows. The volume of such transactions and the speed at which they are growing make the exchange rate regime a central piece of any national economic policy framework.

Figure 21.1: Types of Exchange Rate Regime



In Fig. 21.1, as one moves from point A on the left to point B on the right, both the frequency of intervention by domestic monetary authorities and required level of international reserves tend to be lower. Under a pure fixed-exchange-rate regime (point A), authorities intervene so that the value of the domestic currency vis-à-vis the currency of another country, say the US dollar, is maintained at a constant rate. Under a freely floating exchange-rate regime, authorities do not intervene in the market for foreign exchange and there is minimal need for international reserves.

21.8.1 Exchange Rate System in India

India was among the original members of the IMF when it started functioning in 1946. As such, India was obliged to adopt the Bretton Woods system of exchange rate determination. This system is known as the par value system or pegged exchange rate system. Under this system, each member country of the IMF was required to define the value of its currency in terms of gold or the US dollar and maintain (or peg) the market value of its currency within ± percent of the defined (par) value.

The Bretton Woods system collapsed in 1971. Consequently, the rupee was pegged to pound sterling for four years after which (since September 1975) it was initially linked to the basket of 14 currencies but later reduced to 5 currencies of India's major trading partners. This system continued through the 1980s; though the exchange rate was allowed to fluctuate in a wider margin and to depreciate modestly with a view to maintaining competitiveness. However, the need for adjusting exchange rate became precipitous in the face of the external payments crisis of 1991. As a part of the overall macro-economic stabilisation programme, the exchange rate of the rupee was devalued in two stages by 18 percent in terms of the US dollar in July 1991. With that, India entered into a new phase of exchange rate management.

21.8.2 Objectives of Exchange Rate Management

The main objectives of India's exchange rate policy is to ensure that the economic fundamentals are truly reflected in the external value of the rupee. Subject to this predominant objective, the conduct of exchange policy is guided by the following:

1. Reduce volatility in exchange rates, ensuring that the market correction of exchange rates is effected in an orderly and calibrated manner;

2. Help maintain an adequate level of foreign exchange reserves;

3. Prevent the emergence of destabilisation by speculative activities; and

4. Help eliminate market constraints so as to assist the development of a healthy foreign exchange market.

Exchange Rate Reforms

Exchange rate reforms have proceeded gradually beginning with a two-stage cumulative devaluation of rupee by about 20 percent effected in July 1991. Subsequently, as mentioned earlier, the Liberalised Exchange Rate Management System (LERMS) was introduced in 1992 which was later replaced by the Unified Exchange Rate System (UERS) in 1993. The net result was an effective devaluation of the rupee by around 35 percent in nominal terms and 25 percent in real terms between July 1991 and March 1993.

21.8.3 Features of the Current Regime

The principal features of the current exchange rate regime in India can be briefly stated as follows:

1. The rates of exchange are determined in the market.

2. The freely floating exchange rate regime continues to operate within the framework of exchange control.

3. Current receipts are surrendered (or deposited) to the banking system, which in turn, meets the demand for foreign exchange.

4. RBI can intervene in the market to modulate the volatility and sharp depreciation of the rupee. It effects transactions at a rate of exchange which could change within a margin of 5 percent of the prevailing market rate.

5. The US dollar is the principal currency for the RBI transactions.

6. The RBI also announces a Reference Rate based on the quotations of select banks in Bombay at twelve noon every day. The Reference Rate is applicable to SDR transactions and transactions routed through the Asian Clearing Union.

In short, the Indian rupee has matured to a regime of the floating exchange rate from the earlier versions of a 'managed float'.

21.8.4 Convertibility on Current Account

The current regime of exchange rate has been accompanied by full convertibility on current account with effect from August 20, 1994. Accordingly, several provisions like remittances for services, education, basic travel, gift remittances, donation, and provisions of the Exchange Earners' Foreign Currency Account (EEFCA) were relaxed. In a further move, announced in 1997, the RBI liberalised the existing regulations in regard to payments for various kinds of feasibility studies, legal services, postal imports and purchases of designs and drawings. With this, India acquired a status called as the IMF Article VIII Status. By attaining the Article VIII status, India has reached a position by which it can instil confidence among the international investor community, paving the way for further inflow of foreign capital. Further, India is also committed to allowing free outflow of current account payments (like interest) even if there is a serious foreign exchange crisis.

Notwithstanding the above, the government still retains many controls on current account. Among these, the following may be specifically mentioned:

i) Repatriation of export proceeds within six months;

ii) Caps on the amounts spent on the purchase of services abroad;

iii) Restrictions on the repatriation of interest on rupee debt;

iv) Dividend-balancing for FDI in some consumer goods industries;

v) Restrictions on the repatriation of interest on NRI deposits;

vi) Rupee is not allowed to be officially used as international means of payment. Indian banks are not permitted to offer two-way quotes to NRIs or non-resident banks.

With the help of these controls the governments can significantly alter the flow of foreign exchange and the exchange rate of rupee. Additionally, the RBI can influence the exchange rate through direct purchase and sale of foreign exchange in the market.

21.8.5 Convertibility on Capital Account

Drawing on the experience of the past decade and a half, the extent and timing of capital account liberalisation is sequenced with other reforms like strengthening of banking systems, fiscal consolidation, market development and integration, trade liberalisation, etc. all of which are in tune with the changing domestic and external economic environment. A hierarchy is thus established in the sources and types of capital flows. The priority has been to liberalise inflows relative to outflows, but all outflows associated with inflows have been totally freed. Among the types of inflows, FDI is preferred for its stability, while short-term external debt is avoided. A differentiation is made between corporates, individuals and banks.

For outflows, the hierarchy for liberalisation has corporates at the top, followed by financial intermediaries and individuals. Restrictions have been eased for corporates seeking investments and acquisitions abroad which strengthen their global presence. Banks and financial intermediaries are considered a source of greater volatility as their assets are relatively illiquid and their liabilities are demandable. They are thus susceptible to self-fulfilling crisis of confidence leading to a contagion effect. In view of this, liberalisation for outflows in this sector has been tied to financial sector reforms. For individuals, residents are treated differently from non-residents, and non-resident Indians are accorded a well-defined intermediate status between residents and non-residents.

21.8.6 Intervention By RBI

In the current exchange rate regime, introduced in 1993, the RBI has been actively intervening in the foreign exchange market with the objective of maintaining the real effective exchange rate (REER) stable. The RBI uses two types of intervention in this regard:

1. **Direct Intervention**: It refers to purchases and sales in international currency (i.e. US dollars and euro) both on-spot and also in forward markets.

2. **Indirect Intervention**: It refers to the use of reserve requirements and interest rate flexibility to smoothen temporary mismatches between demand and supply of foreign currency.

Intervention by the RBI has raised a question as to whether or not there should be an exchange rate band within which the central bank should allow the currency to fluctuate. The Tarapore Committee in its report on Capital Account Convertibility had, while suggesting transparency in the exchange rate policy of the central bank, recommended a band within which it would allow the currency to move. The RBI has been, in contrast, saying that there cannot be such rigidities in exchange rate policy, and, therefore, the bank should have the right to intervene at its discretion. Such interventions are considered necessary till the rupee is made fully convertible.

21.9 FULL CONVERTIBILITY OF RUPEE

Meaning of a Convertible Currency

A convertible currency is one, which can be converted into foreign currencies and can be used freely for payment of goods and services, including travel, without any constraints or limitations imposed on it. This is to be contrasted with a controlled currency, which cannot be converted into foreign currencies without prior authorisation because of exchange controls imposed in that country.

The convertibility can be for current account transactions (with restrictions on capital flows) or capital account transactions or for both the current and the capital accounts. Each has its benefits while posing certain risks and challenges to the economy.

Convertibility requires an appropriate and credible economic environment. In the absence of such environment providing the much required confidence in macro-economic stability and the competitiveness of domestic enterprises, establishment of capital account convertibility entails the risks of capital flight and greater volatility in exchange rates. It is because of this that many countries have maintained various restrictions on different types of capital flows until their economies are well advanced.

21.9.1 Changeover to Full Convertibility

Indian rupee was made fully convertible on current account in 1994. Following this, several provisions relating to flows of foreign exchange were relaxed. Further, as stated before, in 1997, the RBI liberalised the existing regulations in regard to payments in foreign exchange thereby according India the status of IMF Article VIII.

On the capital account, liberalisation measures has kept in tune with other reforms. The extent and timing of capital account liberalisation is sequenced with other reforms and the changing domestic and external economic environments. As such, rupee is not fully convertible on capital account.

Having made rupee convertible on current account and partially convertible on capital account, full convertibility of rupee should be the next logical step. There are, however, reasons to weigh both the pros and cons before this step is undertaken.

21.9.2 Gains From Full Convertibility

Capital account convertibility can yield many efficiency gains. These are:

i) By setting the prices right, it enables the aggregate savings and investment to be optimised, giving both allocative efficiency and competitive discipline to the economy.

ii) By providing the opportunity of using the world markets for achieving diversification, it permits both savers and investors to protect the real value of their assets.

iii) By exposing the financial sector to global competition, capital account convertibility stimulates efficiency, stabilisation and innovation.

iv) By symbolising the economy's openness and freedom, it will not only attract foreign capital but also encourage foreigners to take large and more permanent ownership positions in domestic enterprises, and persuade them to be less inhibited about sharing technologies, management practices and markets. A free forex regime thus acts as a strong magnet to the riches of the world.

v) Once the capital account is freed, the Indian stock market, foreign exchange, bond and commodity markets will become more linked to the global markets and the Indian markets will be truly part of an international economy. Interest rates in India will then be more closely aligned with global rates assuring our industry and agriculture adequate credit at reasonable rates.

vi) Under a free forex and full convertibility atmosphere, asset switching possibilities will bring about a greater degree of efficiency; just like 'arbitrage' possibilities of an insular market will disappear.

vii) Capital account convertibility provides resident Indians with investment opportunities overseas.

viii) A non-convertible rupee insulates the Indian economy from global crises, but keeps its poor.

21.9.3 Costs of Full Convertibility

There are no free lunches in real life for macroeconomic management. Among the important costs associated with capital account convertibility the following are important:

i) Convertible rupee would encourage capital flight.

ii) The capital outflows would have to be neutralised, at least by an equal volume of inflows in the form of investments by foreigners or a matching increase in export earnings. The former would require their confidence, not just in economy's potential but also in the government that it would not panic and reintroduce capital controls. The latter is an uphill task. In other words, both will take time.

iii) Total capital decontrol in the present situation is premature, as trade sector reforms are not yet complete. A trade sector that is still in the process of adjustment emits faulty signals about the relative profitability of various sectors. Capital will more likely flow into sectors that will not eventually survive international competition. The differing speeds with which asset and goods markets adjust can make a crucial difference in this regard.

iv) Fiscal consolidation, which is basic to our reform strategy, can be eroded by premature capital decontrol. In the event of net inflows, the fiscal costs of monetising them can be heavy. Further, because of volatile exchange rate movements, it could be uncertain too. Likewise, in the event of outflows, the domestic tax base will shrink, with its obvious fiscal repercussions. In either case, RBI will lose control over the money base and the monetary policy will become largely ineffective in inflation management.

v) If immediate full convertibility also means full-scale trade convertibility, it would play havoc with the Indian industry and stock markets. The slowdown in domestic industrial growth under the impact of greater foreign competition would bring adverse influence on the corporate profitability sending the stock market into a tailspin. Under these circumstances, it would be impossible to have a vibrant, attractive and lucrative capital market.

vi) From the point of view of attracting foreign capital, we would be sending less positive signals by premature capital account convertibility than by robust macroeconomic adjustment . In other words, the advantages of capital account convertibility cannot be derived until fiscal consolidation is complete.

One may not fully agree with Prof. Jagdish Bhagwati, the internationally acknowledged champion of free trade, when he says that 'he will avoid full convertibility like plague'. This may appear a harsh judgement, but not wrong. It finds support from Paul Krugmen when he remarks that 'it is an extremely dangerous world out there. The risks of getting caught in the pinball game are too high'.

21.9.4 Adjustment Measures

Before the decision on full convertibility is finally taken, it must be preceded by a number of adjustment measures. To recapitulate, these measure are:

- Fiscal consolidation of a stable and robust order;
- Achieving a strong and sustainable BOP adjusted position;
- Achievement of low and stable level of inflation;
- Completion of the trade and financial sector reforms;
- Establishment of globally competitive interest rates; and
- Establishment of efficient infrastructure and streamlined production procedures for achieving high productivity and quality consciousness.

In short, controls over outward capital movements and foreign borrowing should ge retained until at least the domestic financial system has been strengthened and economic conditions are so stable that the movement of money from India to the United States matters as little as its movement from Mumbai to Delhi. We should not show any haste. There are lessons in patience we can emulate. The first country to industrialise, the United Kingdom, lifted controls as recently as in 1979. Most developed countries have removed capital controls only in the last two decades. South Korea, the success story of the twentieth century, still maintains extensive capital controls. So are the vast majority of developing countries who continue to impose capital controls. No country that has gone in haste for total convertibility has managed to sustain itself when faced with continued fiscal deficits and structural disequilibrium. The issue of full convertibility therefore relates more to the right sequencing of reforms than to their speed.

21.10 LET US SUM UP

The unit presents a profile of India's foreign trade and balance of payments. During the early phase of economic planning, the foreign trade sector was relegated to the background with import substitution, rather than export promotion, forming the core of development strategy pursued in India. The balance of payments difficulties made it imperative to bring about changes in this strategy and adopt export promotion as an independent goal of growth strategy. The ensuing opening up of the economy and liberalisation resulted in dramatic changes in the structure of India's foreign trade. Balance of payments situation improved with large inflows of foreign capital. In this fast changing situation, rate of exchange has come to play an important role. There is a need to pursue a growth-friendly exchange rate regime. A diligent sequencing and focused pursuit of reform measures is called for.

21.11 KEY WORDS

Terms of Trade : Refers to the relationship between exports and imports. It is the relative price of country's exports to imports.

Multi-Fibre Agreement : Also known as Agreement on Textile and Clothing (ATC), MFA governed the world trade in textiles and garments from 1974 to 2004 i.e. till it expired in 2005. It imposed quotas on the amount 'developing countries' could export to 'developed countries'.

Balance of Payment (BoP) : It is a systematic record of all international economic transactions (both visible and invisible) of a country during a given period like a year.

Special Drawing Rights (SDRs) : Created to replace gold, SDRs are used as a unit of account by the IMF. They are potential claims on the freely usable currencies of IMF members.

Arbitrage : Refers to the simultaneous buying and selling of assets in different markets or in derivative forms taking advantage of the differing prices.

21.12 SOME USEFUL BOOKS

Asian Development Bank, *Trade Policy, Industrial Performance and Private Sector Development in India*, Oxford University Press (OUP), New Delhi, 2009.

Kaushik Basu (ed.), *The Oxford Companion to Economics in India*, OUP, New Delhi, 2008.

Suparna Karmakar, Rajiv Kumar and Bibek Debroy (eds.), *India's Liberalisation Experience*, Sage, New Delhi, 2008.

Deepak Nayyar, *Liberalisation and Development*, OUP, New Delhi, 2008.

Arvind Panagariya, *India: The Emerging Giant*, OUP, New Delhi, 2008.

Ishwar C. Dhingra, *The Indian Economy, Environment and Policy*, Sultan Chand, New Delhi, 2009.

21.13 ANSWERS OR HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1. See Section 21.3
2. See Section 21.4
3. See Section 21.5

Check Your Progress 2

1. See Section 21.6
2. See Sub-section 21.6.3
3. See Sub-section 21.6.4

UNIT 22 REGIONAL TRADING ARRANGEMENTS

Structure

22.0 OBJECTIVES

After reading this unit you will be able to:

- explain the recent trends in global trading environment;
- analyse the factors underlying the growing tendency towards regionalism;
- state the nature of regional trading arrangements and their significance;
- describe the need for RTAs for developing countries;
- explain the contours and rationale of India's Look East Policy;
- outline the bilateral arrangements such as ASEAN and SAARC; and
- identify India's position with regard to FTAs, and analyse the prospects of FTAs with countries like China.

22.1 INTRODUCTION

Efforts at reaching agreements through multilateral trade negotiations and those towards region-centric initiatives are two major developments in the global trading environment witnessed in the past two decades. Both these developments are interrelated in a substantive sense. The former aims at integrating national markets through the process of globalisation. It is intended to improve efficiency by removing barriers and thus promoting a competitive environment. This thrust has motivated countries to take greater interest in regional groupings that facilitate larger market access, which in turn, enables them to enjoy scale economies and thus provide a competitive edge in the global market.

The above developments, would have far-reaching implications on economic ties between countries. The former would result in a larger world trade while the latter would enhance the role of trading blocks in it. This implies that prominent trading blocs and their member states would play an increasingly important role in the emerging global economic order. This would pose many challenges to the developing countries, particularly those which are outside the major blocs, necessitating changes in their policies and perceptions.

It is in this background that the present unit focuses on providing a discussion on the regional trading arrangements in terms of their contours, directions and implications.

22.2 REGIONAL TRADING ARRANGEMENTS (RTAs)

The global trading system has always been a witness to some form of economic integration between countries, across continents or within a region. The different forms of such economic integration are known as regional trading arrangements (RTAs). There are different degrees or levels of economic integration. Five different levels can be visualised as follows.

Free Trade Area	Free trade among members				
Common Market	Free trade among members	Common external commercial policy			
Customs Union	Free trade among members	Common external commercial policy	Free factor mobility within the market		
Economic Community	Free trade among members	Common external commercial policy	Free factor mobility within the market	Harmonised economic policies	
Economic Union	Free trade among members	Common external commercial policy	Free factor mobility within the market	Harmonised economic policies	Super-national organisa-tional structure

It would be seen that at each succeeding stage, members surrender a greater measure of their national sovereignty.

With globalisation, regionalism is on the rise. This is in fact ironical and inconsistent with the spirit of multilateralism. Hence, initially, the DG of WTO was opposed to the proliferation of regional arrangements, after WTO was launched in 1995. The number of regional trading agreements (RTAs) notified to the WTO stands at about 200. An estimated 70 percent of the world trade is now covered by RTAs. For instance, the Americas - North and South, all of Europe, including the transition economies of the eastern part, most of Africa, Asia, Australia and New Zealand are signatories to free trade areas, customs unions and partial scope agreements. The new trends in regionalism, however, can be accepted as a supplement to globalisation.

22.2.1 Features of RTAs

The major features of the RTAs are as follows:

1. Almost all RTAs show an inherent dynamism towards greater liberalisation and open market. For instance:

   - The best example is the European Union (EU) where a single market and a common currency have been introduced to strengthen internal competition and external competitiveness. The origins of the EU are usually traced to the European Coal and Steel Community (1952). Heavy regulated coal and steel industries of Germany and France were to be administered by a supranational authority. The 1957 Treaty of Rome created the European Economic Community (EEC). The EEC abolished internal tariffs and quotas and established a customs union. The treaty made provisions for the eventual liberalisation of movement of labour, services and capital. In 1986, growing global competition caused the signing of the Single European Act (SAC) and the creation of the European Common Market (ECM). The SEA liberalised restrictions on merchandise transport, government movement and movement of services, capital and labour. The ECM gradually developed into the European Union (EU). On January 1, 1999, eleven members of the EU replaced their national currencies with a single currency, the EURO. The monetary policies of the Eurozone members then ceased to be autonomous and are now set by the European Central Bank (ECB). Another European project involves adoption of the European Constitution. The ratification of the constitution is uncertain, in part because of its rejection in the French and Dutch referenda.

- In the Americas, trade has increased significantly between the USA, Mexico and Canada under NAFTA (North American Free Trade Agreement). Negotiations to create the free trade zone for the Americas aim at progressively eliminating barriers to trade in goods, services and investment.

- The four members of the MERCOSUR (South American Free Trade Area comprising Brazil, Argentina, Uruguay, and Paraguay) have decided to introduce a common external tariff.

- In Asia, members of the Association of South-East Asian Nations (ASEAN) are accelerating trade liberalisation within the ASEAN Free Trade Area (AFTA). They have agreed to set up a full economic community by 2015.

- Nearer home, the greater Mekong Sub-region (consisting of China, Myanmar, Thailand, Vietnam, Laos and Cambodia) has set an example in regional co-operation.

- The targets of Asia Pacific Economic Co-operation (APEC) to open their markets in trade and investments are very ambitious.

- The initiatives of the South African Customs Union (SACU), the common market for Eastern and Southern Africa (COMESA) and the progress towards regional integration in the West African Economic Monetary Union (WAEMU) show the growing significance of regional co-operation.

2. The new regionalism brings with it an increase in the size of regional groupings. Once again, the best example of the enlargement dynamics can be seen in the European Union (EU). EU started off as a coal and steel community in 1952. The European Common Market (ECM) initially consisted of six countries and European Free Trade Area (EFTA) consisted of seven countries. They were hence known as inner six and outer seven. The composition of EU initially encompassed Spain, Portugal, France, Belgium, Netherlands, Luxembourg, Germany, Denmark, Sweden, Austria, Italy, Greece, Finland, Ireland, U.K. It was subsequently expanded to include ten more countries in 2007. These are Poland, The Czech Republic, Hungary, Slovakia, Slovenia, Estonia, Latvia, Lithuania, Malta and Cyprus, Romania and Bulgaria. As an yet another major block a group of 34 countries, called the Western Hemisphere countries, have agreed to set up a Free Trade Zone from Arctic to Argentina.

3. There is emergence of overlapping regionalism. Countries belong to more than one RTA. There is an inherent scope that these RTAs may turn the world trade system into what Jagdish Bhagwati calls a 'noodle blow' of overlapping and potentially inconsistent and unmanageable RTAs.

4. In the current practice, regionalism covers many issues beyond the removal of barriers to trade in goods and services, such as social policy, environmental policy and competition policy.

5. RTAs thus exist in all regions of the world. They follow a strategy that combines internal liberalisation with external agreements.

Thus, in general, currently regionalism is a benign and dynamic initiative compatible with the overall aims of the multilateral trade order.

22.2.2 Benefits of RTAs

The motivation for forming regional trading blocs differs from region to region, and even from country to country within a bloc, but a few factors play a key role. These are:

i) members see economic benefits from a more efficient production structure by exploiting economies of scale. In addition to spreading fixed costs over larger regional markets, it enhances economic growth from foreign direct investment, and research and development.

ii) members value non-economic benefits such as strengthening political ties and managing migration blocs.

iii) smaller countries seek increased security of market access by forming regional trading blocs and joining with associations of larger countries.

iv) countries may want to lock-in unilateral domestic policy reforms.

v) Members' bargaining power in multilateral trade negotiations is improved where they can more effectively express in pursuance of their regional interests.

vi) Members can promote industries that are not viable without a protected regional market – e.g. regional infant industries – the idea being that they would be internationally competitive if given sufficient time and scope to develop.

vii) open regionalism – i.e. agreements with low external trade barriers, service markets and a dominant focus on reducing transaction costs at borders, help get around the complexity of the international trading system.

22.2.3 Limitations of RTAs

Formation of regional blocs invariably implies that the constituent members are keen on promoting their economies. However, quite often what is good for individual nations may not be good for the global economy. Most economists agree that the emergence of regional blocks diverts trade to less efficient producers, thereby preventing the global economy from growing as fast as it can. Nonetheless, when seen from a purely national perspective, it would suit a country to create and protect a regional market. There has thus been a clear movement towards the regionalisation of trade.

Check Your Progress 1

1. What do you mean by regional trading arrangements (RTAs)?

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2 Enumerate the benefits of regional trading agreements?.

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3. State in brief the limitations of regional trade agreements.

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22.3 REGIONAL TRADING ARRANGEMENTS (RTAs) AND WTO

Increased emphasis on regionalism is a prominent feature of international economics since the mid-1990s. Currently, there are more than 200 active Regional Trade Agreements in force and majority of these agreements are north-south RTAs or RTAs between developed and developing countries.

RTAs represent an important exception to the WTO's principle of non-discrimination through the most-favoured nation (MFN) rule. According to the MFN rules, WTO members must extend the same market access conditions to all WTO members. However, as an exception to MFN, WTO allows countries with a RTA (i.e. members of a RTA) to trade among themselves using *preferential tariffs* and easier market access conditions than what is applicable to other WTO member countries. Such RTAs are, however, permitted under WTO only when they have a clause to move towards global Free Trade Area without discrimination, in a time bound manner. The advantage to the RTA members thus come from the preference margins i.e. the gap between MFN rates and preferential tariff rates. As a result, WTO member countries that are not a part of the RTA lose out in these markets. Also, trading within the regional trading blocks does not come under the purview of WTO.

22.4 RTAs AND DEVELOPING COUNTRIES

The basic principles embodied in the GATT/WTO, viz. open markets, non-discrimination and global competition are unexceptionable. These are designed to foster a non-discriminatory, competitive and unified world market. Developing countries have, however, attempted to integrate their national economies with the world economy at a varying pace.

In the process of integration, developing countries have encountered several adverse consequences. For instance, easy market access, liberalised merger and acquisition laws, permitting majority to full foreign ownership and liberalised foreign exchange regulations, financial liberalisation etc. that come in the course of integration process have facilitated large scale entry of global economic players into developing countries. This has led to many local entrepreneurs surrendering their ventures to the global giants or assuming a position of joint partnership, if at all, in the re-structured collaborative ventures. In the face of such threat to their survival, particularly for the small-scale sector, local entrepreneurs in developing countries have started demanding a level playing field and protection.

Another adverse consequence of globalisation is that the emerging order would provide significant growth opportunities to only a few of the developing countries while for others it could result in several risky exposures. Some studies have brought out that many of the developing countries would be worse off as a result of WTO agreements. This is expected to widen inter-country disparities, as visualised by the centre-periphery doctrine of Samir Amin and Andre Gunder Frank: developing countries, except a few, would be placed in a disadvantageous position (on periphery) while the system would work well for a few mighty developed countries and fast growing developing countries.

22.4.1 Options for Developing Countries

Basically, there are two options for the developing countries:

- to join one or the other prominent bloc so as to remain within the mainstream of RTAs, or
- to strengthen economic ties among developing countries themselves on bilateral basis so as to provide a cushion to export growth.

The problem with regard to the first option is that membership of regional trading blocs is not easily available. There are usually too many restrictive qualifying criteria. For instance, India was denied membership of ASEAN for not being a south-east Asian nation.

These problems have motivated developing countries to come together and form a bloc of their own. In fact, developing countries from Asia, Africa and Latin America have made several attempts at bloc formation. In Asia, for instance, five south-east Asian countries established the ASEAN in 1967; to which five more countries joined subsequently. Likewise, seven south Asian countries formed South Asian Association of Regional Co-operation (SAARC) in 1985. Again, two of the ASEAN states (viz. Thailand and Myanmar) and three SAARC states (viz. India, Bangladesh and Sri Lanka) came together in 1997 to promote economic co-operation under the name of Bangladesh, India, Myanmar, Sri Lanka and Thailand Co-operation (BIMST-EC).

While the role of a bloc in promoting economic ties is widely recognised, attempts at bloc formation by developing countries have rarely met with big success. ASEAN is one rare example of a successful attempt of bloc formation by the developing countries. In contrast, SAARC, of which India is a founding member, is a classic case to demonstrate how difficult it is to promote effective co-operation even after more than two decades of its existence.

Following the spirit of regionalism, some of the south and south-east

Asian countries introduced schemes of sub-regional co-operation, primarily to strengthen economic relations based on complimentarities among the geographically/economically/historically/culturally adjoining nations, but administratively detached sub-regions. In south-east Asia, they are also viewed as inter-governmental efforts to accelerate private sector led economic growth in less developed pockets.

In addition, developing countries have also taken interest in acting together for their mutual benefits. There are many examples of such initiatives. The Non-Aligned movement (1961) and G-77 (1964) aimed at promoting common interests of developing countries through collective actions. The scheme of global system of trade preferences (GSTP) of 1987 provided a 10 percent across–the–board tariff concession on intra-developing country trade flows.

Also, developing countries took specific initiatives to strengthen bilateral economic ties. India's Look East Policy is a good example of such initiatives.

Check Your Progress 2

1. How are regional arrangements treated by WTO?

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2. Write a note on the significance of RTAs for developing countries

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3. Write a note on options for developing countries under the new global trade environment.

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22.5 INDIA'S LOOK EAST POLICY

In the process of globalisation, India has attempted to strengthen trade and investment relationship with the rest of the world. It has laid a special emphasis on strengthening ties with the south-east and north-east Asian countries within the framework of Asianisation of its economy. India's policy of strengthening economic ties with this part of the world is commonly known as Look-East policy. As part of this policy, it has targeted member states of the Association of South East Asian Nations (ASEAN) as a priority region for promoting co-operation and taken several initiatives to establish close ties with them.

The Look-East policy was officially launched in 1992. It was expected to: (i) contribute significantly to India's efforts towards globalisation and integration with the world economy, (ii) fill the void caused by the collapse of the Soviet Union, its major trading partner, and (iii) help the country in overcoming its isolation from world-wide phenomenon of joining regionalism.

22.5.1 Rationale

The rationale for Look-East policy can be seen in the following:

One, India has made serious efforts for getting an entry into the trading blocs of the region, notably the ASEAN and the Asia Pacific Economic Co-operation (APEC) forum. Stronger economic ties with ASEAN states would stand in good stead in view of all ASEAN states being members of APEC.

Two, the economic dynamism that south-east and east Asian economies have displayed since the 1970, partly from their outward oriented development strategies. Their growth performance has been far higher than that in most developed regions, including USA, European Union, other European countries and Japan. In some of the East Asian countries, share of value added manufacturing in GDP has surpassed the level found in USA and Europe. Most of the so-called 'miracle' economies are concentrated in this part of the world.

Three, India enjoys a geographical proximity with this region though it does not belong to it. Its bilateral relationship with these countries would benefit from low transport costs and shorter delivery schedules. This is particularly important in the case of Indian exporters, since longer delivery schedules of Indian exporters in view of severe and wide-ranging domestic supply constraints, have been considered as one of the major hindrances by the European importers.

Four, it also makes an important geographical sense, since the south-east Asian countries are situated in the main inter-continental routes between Europe, America, East Asia and Australia thus providing scope to act as important stopovers for Indian exporters.

Five, a sizeable population of Indian origin, which played an important role in the industrialisation and trade-promotion of these countries, can act as a vital link in developing mutually beneficial commercial ties between India and south-east Asian countries. The new class of Indian migrants that include software engineers, financial analysts, management professionals could play an more important role in promoting Indo-ASEAN economic relations. The age-old cultural ties between India and these countries are thus viewed as a favourable factor in strengthening the bilateral economic relations.

Six, India may also derive benefits from the growing ASEAN economic co-operation, more specifically the ASEAN Free Trade Area (AFTA). Given the considerable outward orientation of these economies, the AFTA is expected to be substantially outward oriented. It would, therefore, provide ample scope for mixing ASEAN and Indian materials and labour to produce competitive consumables and exportables. This may also offer opportunities for relocating some of the labour intensive activities from the ASEAN states to India enabling them to maintain their competitive edge, which are otherwise getting phased out in several lines of production owing to rising wages.

22.6 ASSOCIATION OF SOUTH EAST ASIAN NATIONS (ASEAN)

The ten-member ASEAN was formed in 1967 by five south-east Asian countries (Indonesia, Malaysia, the Philippines, Singapore, and Thailand), to begin with, but were joined later by the other five viz. Brunei (1984), Vietnam (1995), Laos and Myanmar (1997); and Cambodia (1999). As a result, the ASEAN has become an organisation of about 500 million people with $950 billion of income of which an estimated $900 billion are out of external trade. Apprently, the reach of the association in economic co-operation is very wide.

22.6.1 Objectives of ASEAN

Objectives of the ASEAN include acceleration of economic growth, social progress, and cultural development as well as regional peace and stability through joint endeavours in the spirit of equality and partnership.

ASEAN was initially slow to take off the ground. It was in the second half of the 1980s, following the liberalisation policies in Indonesia, Malaysia, Thailand and the Philippines, that much bolder steps were initiated towards strengthening economic co-operation. ASEAN investment area co-operation in services and intellectual property, industrial co-operation, etc. were introduced in the 1990s.

22.6.2 ASEAN Free Trade Area (AFTA)

The framework of agreement on enhancing economic co-operation (1992) made a decisive move towards economic co-operation by proposing AFTA to increase ASEAN's competitive advantage as a single production unit in the world market. With this, greater economic efficiency, productivity, and competitiveness were expected to emerge out of the elimination of tariff and non-tariff barriers. Towards this objective, foreign firms were allowed to team up with the local firms by using as much as 60 percent of the imported materials from outside the ASEAN world.

A scheme of trade liberalisation, called as the common effective preferential tariff (CEPT) Scheme, was adopted to effect a lower targeted tariff level (in the range of zero to five percent) to be achieved within a short time-framework of ten years i.e. by January 1, 2003. New ASEAN members were, allowed longer time to meet this deadline e.g. Vietnam up to 2006, Laos and Myanmar up to 2008, and Cambodia up to 2010. The CEPT also provides for the elimination of non-tariff barriers in five years' time. The implementation of CEPT is expected to facilitate: (i) harmonisation of standards, (ii) reciprocal recognition of tests and certification procedures, (iii) removal of barriers to foreign investments, (iv) macroeconomic consultations, (v) promotion of venture capital, etc.

22.6.3 Asia-Pacific Economic Cooperation (APEC) Forum

The Asia-pacific economic co-operation (APEC) forum was launched in 1989. With almost two-fifths of the world population, more than half of the world GDP and more than two-fifths of global international reserves, the APEC forum has all the potentials of emerging as one of the most powerful regional blocs in the world.

22.6.4 India and ASEAN: Towards a Free Trade Agreement (FTA)

Since the Look East policy adopted in the early 1990s, India's engagement with ASEAN has been on the rise. In 1992, India became a sectoral dialogue partner of ASEAN and in 1996 it became a member of the ASEAN regional forum. In 2003, India and ASEAN signed the bilateral framework agreement, which spelt out the broad parameters of an agreement on trade in goods. On 28th August 2008, India and ASEAN concluded a Trade in Goods (TIG) which will operationalise the free trade agreement (FTA). Implementation of the agreement will begin from 1 April, 2009 and will be completed by 2018.

The TIG agreement forms an important milestone in India's economic relationship with ASEAN. It is notable that among the ASEAN members, India has preferential trade agreements with Thailand, Myanmar and Singapore. India, Myanmar and Thailand are also part of the Bay of Bengal initiative for multi-sectoral technical and economic co-operation trade group. India and Singapore have also separately signed a comprehensive economic co-operation agreement (CECA) few years back.

The major features of the proposed FTA are as follows:

- Reduce tariff to zero percent in over 4,000 out of 5,000 goods that are traded, in a phased manner over a period of six years;
- Effect partial reduction in import tariffs on highly sensitive farm goods;
- Effect partial duty cuts for 606 items in a list of goods called 'sensitive list of goods'; and
- Have also a 'negative list' with no duty cuts.

22.7 SOUTH ASIAN ASSOCIATION FOR REGIONAL COOPERATION (SAARC)

The SAARC, is an economic and political organisation of eight countries in southern Asia. In terms of population, its sphere of influence is the largest of any regional organisation: almost 1.5 billion combined population of its member states. It was established on December 8, 1985 by India, Pakistan, Bangladesh, Sri Lanka, Nepal, Maldives and Bhutan. In April 2007, Afghanistan became its eighth member.

22.7.1 Objectives of SAARC

The objectives of SAARC, as defined in its charter, are as follows:

- promote the welfare of the peoples of South Asia and improve their quality of life;
- accelerate economic growth, social progress and cultural development in the region by providing all individuals the opportunity to live in dignity and realise their full potential;
- promote and strengthen collective self-reliance among the countries of South Asia;
- contribute to mutual trust, understanding and appreciation of one another's problems;
- promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields;
- strengthen co-operation with other developing countries;
- strengthen co-operation among themselves in international forums on matters of common interest; and

- co-operate with international and regional organisations with similar aims and purposes.

22.7.2 SAARC Preferential Trading Agreement (SAPTA)

SAPTA which came into operation in 1995 heralds a new chapter of economic co-operation among the SAARC countries. It concretises the first step towards creation of a trade bloc in the South Asian Region. Under the SAPTA mechanism, the SAARC countries, to begin with, have identified 226 items for exchange on tariff concessions ranging from 10 percent to 100 percent. India has agreed to extend tariff concessions on 106 items, while Bangladesh has agreed to offer tariff concession on 12 items, Maldives on 17, Nepal 14, Pakistan 35, Sri Lanka 31 and Bhutan 11. Out of 106 items offered by India for tariff concessions, 62 items would be for the least developed countries in the SAARC.

22.7.3 SAPTA TO SAFTA

The South Asia Free Trade Area (SAFTA) agreement came into force from July 1, 2006. With this, the earlier SAPTA established in 1995 has paved the way to SAFTA. The South Asian developed countries are well-endowed with labour and natural resources. Further, with growing openness among themselves, higher production and expansion of labour, intensive exports, increased employment, increased wages and thereby helping in reducing poverty, the region is poised to play an important role in the growing international trade relations.

22.8 INDIA AND FTAs

India has signed FTAs with many countries including SAARC nations. A brief account of these is presented in Table 22.1. This is followed by a set of points indicating the factors that needs to be taken into account while signing any FTA with a country.

Table 22.1: Map of India's RTAs

Operational	Sri Lankan FTA, SAFTA, Singapore CECA, Thailand-Bhutan Treaty, Indo-Nepal Treaty, Asia Pacific Trade Agreement, Global system of Trade Preferences, Indo-Afghanistan PTA, Indo-China PTA
Advanced Negotiation Stage	ASEAN, Korea, BIMSTEC, Thailand, Sri Lanka CECA, Mauritius CECPA
Early Negotiation Stage	EU, Japan
Negotiation likely to start	Indonesia, Russia, Israel, Malaysia, India – Brazil – South Africa, India – MEROSUR – SACU

While negotiating/signing an FTA, India needs to take due care of the following factors:

a) ensure that the FTA permits only those items that are wholly manufactured in the concerned country;

b) discourage items that are highly subsidised;

c) discourage items that badly hurt the Indian industry and farmers while drawing up 'the agreed list' for FTAs;

d) ensure that any such agreement does not violate the WTO guidelines;

e) undertake detailed analysis of the positive effects of FTA on sectors and economy as a whole prior to signing an agreement;

f) address all trade facilitation concerns, including mutual recognition agreements on standards, customs collaboration agreements, and expansion of transport links so as to remove all NTBs with each other;

g) reflect services prominently in all agreements so as to feature India's dynamic comparative advantage in services;

h) ensure high-level political attention to induce institutional improvements, such as commitments to tariff reduction, customs co-operation, etc.

Check Your Progress 3

1. What is India's 'Look East Policy'?

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2. Explain in brief the rationale for India's 'Look East Policy'.

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3. State in brief the composition of ASEAN.

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4. Mention in brief the objectives of ASEAN.

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5. What is SAARC? What are its objectives?

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22.9 INDIA AND CHINA

The global economy has been growing strong at about 5 percent per annum over the last few years. The growth has been led by two major Asian countries, China and India. In more recent years, China has been growing at over 9 percent per year, while India's economic growth has been at a little over 8 percent per annum. The rise of India and China may be seen (as articulated by Dr. Manmohan Singh) as 'global public good' which will benefit the whole world.

India and China, both, cover a large landmass, both have more than a billion people, and both are engaged in the reform process and moving towards a market-oriented economy, in the firm belief that this would enable them to confront the challenges of a globally integrating world. On present trends, in 20 years, their collective share of the global economy will match their percentage of the global population, which is roughly where they were in the 18th century, before Europeans engulfed them.

These two nations share some common features but also differ in some respects. Both are large countries and, coincidentally, underwent substantial political and economic changes at about the same time. India gained its independence in 1947 and initiated the experiment of planned economic development with the First Five Year Plan in 1951. Following the 1949 communist revolution, China embarked on a new economic development path at the beginning of the 1950s. Thus, both countries experienced profound political and economic reforms in the past 60 years.

There are, however, at least three crucial differences that need to be recognised. **One**, following independence, India adopted a mixed economic system characterised by the presence of both the public and private sectors. China, on the other hand, embarked on an economic development path with a socialist economic framework characterising, at least until recently, control over the agricultural and industrial resources by the state.

Two, compared to India, China has been functioning with a reasonable degree of control in terms of raising and allocating financial resources for public investments.

Three, China initiated the process of economic development with greater equality than India in terms of people's access to income sources and social needs.

All these similarities and dissimilarities have had different impacts on the patterns of government spending, and therefore, have led to different growth paths and poverty reduction programmes

22.9.1 Free Trade Area Between India and China

An FTA between India and China had been a subject of intense debate in recent years in both academic and policy-formation groups. We can approach the issue from the perspective of both China and India.

For China, an FTA focused on trade in goods would enable them to best leverage their comparative advantage. **For India**, on the other hand, an agreement restricted to or focused on merely free movement of goods across borders would not be advantageous. While it would give Chinese manufacturers ready access to Indian markets, India has less to gain from such an FTA. This is because Chinese tariffs are already lower in most areas as China was forced to lower them in return for its late entry into the WTO. FTAs, however, need not be restricted to goods alone; it could extend to services as well. But, as the historical experience globally has shown, genuinely free trade in services is rather more difficult to achieve than free movement of goods. The experience after the dismantling of quantitative restrictions on imports suggests that fears about Chinese goods swamping India were exaggerated. But Indian industry continues to be wary of taking on China's manufacturing prowess in a no-holds-barred contest. The government, of course has to factor this while responding to China's overtures on the FTA.

In the circumstances, it is better that we set our house in proper order by increasing the competitiveness of our manufacturing, instead of rushing headlong into an FTA with China at this juncture.

22.9.2 Preparing For an FTA

A move towards an FTA with China should be preceded by a number of preparatory stages. These can hardly be bypassed.

The **first** step towards this would be for India to diversify its trade basket. If we examine the two-way trade flows, the most obvious characteristic of trade pattern is that our exports to China are basically raw material, ores and steel (accounting for 57% of exports) while China's exports to India are primarily manufactured goods (like electric machinery, electronic and audio-video equipment). Since manufactured goods have a much higher level of duty compared to raw materials, free trade will mean we give away our advantages more than gaining from them. Besides, unless our exports become more diversified, trade will not be sustainable in the long-term.

Second, the two countries must resolve to scrap a whole range of barriers to free trade. These have been identified in which NTBs are a major hindrance to trade. It has been emphasised that the rules of origin should be examined and reframed so that these do not have 'any restricting, distorting or disruptive effects on bilateral trade.' Yet another area which calls for immediate attention is the need for harmonisation of the standards, certification and regulatory practices of the two countries. In this context, both India and China should work towards mutual recognition agreements to achieve this.

Thus, it is only when these two areas have been duly sorted out, and when the trade flow path is smoothened, should we look into the prospects of an economic co-operation agreement. Economic co-operation envisages not only trade, but also investment and collaboration in various areas, like energy security, development of small and medium enterprises, water resources management, space research, remote-sensing techniques, urban management, city development and disaster management.

Underlying all these, is the mutual promotion of investment. China is emerging as a major overseas investor. India can profit from its investment in areas like white goods. Similarly, Indian firms are also investing increasing amounts overseas and some parts of it could go into providing Chinese facilities.

22.10 LET US SUM UP

With the setting up of the WTO in 1995, multilateralism reached its zenith. One difficulty with the WTO system has been the problem of maintaining and extending the liberal world trading system in recent years. Recent negotiations, such as the Doha Development Round, have run into problems and their ultimate success is uncertain. Many countries have turned away from the multilateral process toward bilateral or regional trade agreements. The advantage of such regional trade agreements is that they promote greater trade among the parties to the agreements. However, by excluding certain countries, these agreements may shift the composition of trade from low-cost countries that are not a party to the agreement to high-cost countries which are. Regional arrangements may also undermine and supplant, instead of supporting and complementing, the multilateral WTO approach. Whatever the arguments, nations of the world, both developed and developing, are seeking safe sanctuaries in regional arrangements. India too has been no exception to this global trend. India needs to remodel its trade policy and strategy to get the benefits of regional trading arrangements.

22.11 KEY WORDS

Regional Trade Arrangements (RTAs)	:	Agreement between any two or more of sovereign nation of geographical proximity for the purpose of economic and trade promotion.
BIMST-EC	:	A RTA of economic cooperation covering the countries of Bangladesh, India, Myanmar, Sri Lanka and Thailand.
Global System of Trading Preferences (GSTP)	:	A scheme launched in 1987 providing a 10 percent across-the-board tariff concession on intra-developing country trade flows.
Look East Policy	:	A policy of India to strengthen its ties with the South-East and North-East Asian countries in which its trade ties with the ASEAN countries are targeted for improvement.
Association of South East Asian Nations (ASEAN)	:	A 10-country association comprising of Indonesia, Malaysia, Philippines, Singapore, Thailand, Brunei, Vietnam, Laos, Myanmar and Cambodia. India is a member of the ASEAN regional forum since 1996.
Asia Pacific Economic Cooperation (APEC) Forum	:	A significant forum in the sense that it covers two-fifths of world's population and global international reserves. Also covers more than half of world's GDP.
South Asian Association for Regional Cooperation (SAARC)	:	Established in 1985, it is an economic and political organisation of 8 countries in the South Asia region. Its members are: India, Pakistan, Bangladesh, Sri Lanka, Nepal, Maldives, Bhutan and Afghanistan.

South Asian Preferential Trading Agreement (SAPTA) : An agreement of economic cooperation among the SAARC countries launched in 1995.

South Asia Free Trade Area (SAFTA) : An agreement which came into effect in 2006, replacing the SAPTA of 1995.

22.12 SOME USEFUL BOOKS

Kaushik Basu and Ravi Kanbur (eds.), *Arguments for a Better World*, Oxford University Press (OUP), New Delhi, 2009.

Sunanda Sen, *Globalisation and Development,* NBT, New Delhi, 2008.

Kaushik Basu (ed.), *The Oxford Companion to Economics in India OUP*, New Delhi, 2008.

Adityta Bhattacharya and Sugata Marjit (eds.), *Globalisation and the Developing Economies: Theory and Evidence*, Manohar, New Delhi, 2004.

Ramesh Chand, *Free Trade Area in Asia*, Academic, New Delhi, 2005.

Ashok Gulati and Shenggen Fan (eds.), *The Dragon and the Elephant*, John Hopkins University, 2007.

22.13 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1. See sub-section 22.2 and answer.
2. See sub-section 22.2.2 and answer.
3. See sub-section 22.2.3 and answer.

Check Your Progress 2

1. See section 22.3 and answer.
2. See Section 22.4 and answer.
3. See sub-section 22.4.1 and answer.

Check Your Progress 3

1. See section 22.5 and answer.
2. See sub-section 22.5.1 and answer.
3. See section 22.6 and answer.
4. See sub-section 22.6.1 and answer.
5. See section 22.7 and answer.

UNIT 23 WTO AND CHALLENGES OF NEW TRADING AND FINANCIAL SYSTEMS

Structure

23.0 OBJECTIVES

After reading this unit you will be able to:

- explain the different international economic institutions that have moulded international economic relations during the last six decades since 1950;
- outline the background in which the World Trade Organisation came to be set up;
- state the objectives, principles and functions of the WTO;

- describe the principal agreements in trade in goods, services etc. that the WTO administers;
- review the functions of WTO as it has evolved over the last fourteen years;
- identify the factors due to which a new international financial institution capable of responding to the changing international economic environment is needed; and
- suggest a new international financial architecture.

23.1 INTRODUCTION

In the wake of the unprecedented destruction caused to the global economic structure by the Second World War, and the accompanying instabilities and uncertainties that arose in the economies world over, a group of nations met at Bretton-woods for a conference in 1944. Their principal objective was to prepare a framework for economic co-operation and co-ordination between sovereign nations having the right to pursue independent policies. The Bretton-woods conference, as it has since come to be known as, addressed itself to three broad issues of interest in international economic relations, viz. (i) trade in goods, (ii) flow of capital for development, and (iii) stability of exchange rates and provision for assistance to members who get confronted with short-term imbalance in their balance of payments. In seeking to find a solution to the problems arising out of these, the Bretton-woods conference reached an agreement to set up three multilateral institutions, viz. (a) International Monetary Fund, (b) International Bank for Reconstruction and Development (IBRD), and (c) International Trade Organisation (ITO).

The two institutions, IMF and the IBRD which were set up and started functioning since 1946 came to be identified as Bretton-woods twins. While the IMF was entrusted with the task of ensuring exchange rate stability and providing short term financial assistance to member countries faced with balance of payments difficulties, the IBRD was to arrange long-term finance for developmental programmes in member nations. The agreement relating to the setting up of the ITO was not ratified by the US and hence the ITO could not be established. Instead, the US, UK and a few other countries, set up in 1947 an interim organisation called General Agreement on Tariffs and Trade (GATT). The GATT, in its functioning, was biased in favour of the developed countries and hence began to be informally dubbed as the 'rich men's club'.

Owing to the persistent insistence of the developing countries for setting up the ITO, which move was continually opposed by the US, the United Nations (UN) appointed a committee in 1963 to resolve the issue. The committee recommended the alternative of setting up a United Nations Conference on Trade and Development (UNCTAD). The UNCTAD was thus set up in 1964 with its principal functions outlined as follows:

- promote international trade with a view to accelerate economic development;
- formulate principles and policies on international trade and related problems of economic development;
- assist developing countries in the negotiations in the international fora and facilitate market access for the goods of developing countries and encourage technology transfer to them;
- assist developing countries to improve their terms of trade vis-à-vis the developed countries;
- negotiate multilateral trade agreements; and
- make proposals for putting its principles and policies into effect.

The UNCTAD could manage to get some concessions for the developing countries, more important among which was the General System of Preferences (GSP). GSP provided for preferential access to markets in the developed countries for the manufacturing goods originating from the developing countries. Having functioned for many years in its originally charted out functions as outlined above, the vision and structure of UNCTAD began experiencing the need for a significant change in the 1990s. This was triggered mainly, once again, by the decision of the developed world to de-link the UNCTAD from the discussions of the Uruguay round of negotiations on GATT. The Uruguay round thus became controversial as it sought to expand the scope of GATT by including under its purview areas like services, investment and intellectual property rights (IPR). The Uruguay round proposals were accepted by all the members of the GATT in December 1993 at the official level and in March 1994 at the ministerial level. This set the ground for the setting up of what came to be later known as the World Trade Organisation (WTO).

23.2 WORLD TRADE ORGANISATION (WTO)

The Uruguay round of agreement provided for the setting up of an international trade organisation by the name of World Trade Organisation (WTO). The WTO started functioning from January 1, 1995. At present, the WTO has 153 countries as its members.

23.2.1 Objectives of the WTO

The agreement establishing WTO reiterated the objectives of the GATT. More specifically, the WTO outlined its objectives to include the following under its scope.

a) Raise standard of living and incomes by ensuring: (i) full employment, (ii) expanding production and trade, and (iii) optimal use of world's resources;

b) Adopt the idea of sustainable development in relation to the optimal use of world's resources i.e. reinforce the need to protect and preserve the environment in a manner consistent with the various levels of national economic development; and

c) Recognise the need for positive efforts to ensure that developing countries secure a better share of growth in international trade.

23.2.2 Principles of the WTO

In its broad perspective, the WTO was to strive at creating a liberal and open trading environment by which business enterprises could trade under conditions of fair and undistorted competition. Towards the achievement of this, the four principles that were laid down to guide the trading rules of its members are as follows:

1. **Most Favoured Nation (MFN) Treatment:** The principle of MFN treatment laid that tariffs and regulations must be applied to imports or exports without discrimination among members. In other words, no member country was to be accorded a treatment of 'a favoured nation';

2. **National Treatment:** It prevents discrimination between imported products and equivalent domestically produced goods, especially in levying internal taxes and domestic regulations;

3. **Protection Through Tariffs:** While advocating liberal trade, the WTO recognises that some members may need to protect their domestic production against foreign competition. The underlying principle was, however, that such protections through tariffs must be kept at low levels in what was called as 'bound tariff framework';

4. **Bound Tariffs:** The principle of 'bound tariff' advises the member countries to reduce and gradually eliminate protection to domestic production. By seeking to reduce tariffs and eliminating non-tariff barriers, the principle requires the member countries to commit in their respective national schedules against further increase of tariff levels at later points of time. In other words, the reduction and ultimate phase-outs of tariffs was meant to provide the cushion time required for gaining competitive strength and the tariffs were to be phased out firmly in a committed time frame.

23.2.3 Functions of the WTO

The WTO is meant to perform the following functions:

1. Administer through various councils and committees, the 29 agreements contained in the final Act of the Uruguay round of world trade talks, plus a number of plurilateral agreements, including those on government procurement;

2. Oversee the implementation of the significant tariff cuts (average 40 percent) and reduction of non-tariff measures agreed to in the trade negotiations;
3. Act as a watchdog of international trade by regularly examining the trade regimes of individual members;
4. Ensure that members notify in detail various trade measures and statistics, which are to be maintained by the WTO in a large database;
5. Provide several conciliatory mechanisms for arriving at an amicable solution to trade conflicts among members;
6. Resolve trade disputes that cannot be solved through bilateral talks by adjudication in the WTO dispute settlement court;
7. Act as a management consultant for world trade by having its economists keep a close watch on the pulse of the global economy and provide inputs to WTO by studies conducted on the main issues of the day; and
8. Assist developing countries through its secretariat to implement the Uruguay round agreements through a newly-established development division and a technical co-operation and training division.

The WTO is, thus, a forum where countries continuously negotiate the exchange of trade concessions and trade restrictions all over the world. The WTO has a substantial agenda for further negotiations in many areas, notably certain services sectors.

23.2.4 Structure of the WTO

The WTO secretariat is headed by a Director General with a three-tier system of decision making. The decisions are made at three levels: (i) Ministerial Conference, (ii) General Council and other councils, and (iii) Heads of Delegations. The principal decision-making body is thus the ministerial conference which can take decisions on all matters under any of the multilateral trade agreements. It meets once in two years.

In the intervening period, the General Council of the WTO, together with the other councils for Trade in Goods, Trade in Services and Intellectual Property, performs the WTO functions. These councils are responsible for overseeing the implementation of the WTO agreements in their respective areas of specialisation.

The third-tier of decision-making, at the Heads of Delegation level, is most effective in overcoming inherent impediments for reaching consensus on a trade-related issue. This level is usually represented by different sets of people depending on the need of the hour with the required expertise and experience. The usual process is to hold a meeting in which select countries are interested in participating in a particular issue. Such meetings are termed as ***Green Room meetings***.

23.2.5 WTO Agreements

WTO administers a set of agreements, among which the more important are the following:

1. GATT 1994

The cornerstone of trade relations is the area of goods. Differential and most favoured treatment (MFT) to UDCs and LDCs is permitted under the 1979 enabling clause with respect to tariffs and non-tariff measures. This is notwithstanding the MFN treatment principle which prohibits such favoured treatment to any country as a rule.

2. Agreement on Agriculture (AOA)

The approach adopted here is to encourage gradual reduction of trade distorting subsidies. The AOA specifically deals with: (i) providing market access, (ii) containing of export subsidies, and (iii) regulating domestic support.

i) **Market Access:** The AOA requires tariffication of all NTBs, and a reduction of those tariffs by an average of 36 percent for developed countries and 24 percent for UDCs. Developed countries were given 6 years to bring about these reductions, while developing countries are given 10 years. The time counting has begun from 1995.

ii) **Export Subsidies :** Export subsidies have to be reduced by 36 percent in budgetary terms and 21 percent in volume over a six-year period. The developing countries have been given lower reduction targets of 24 and 14 percent respectively over a longer period of 10 years.

iii) **Domestic Support:** A distinction has been made between subsidies that did not distort trade and those that do. Only the trade distorting subsidies have to be reduced, if they are above the permissible level. The following have been exempted from this provision.

- **Green Box:** Subsidies with no, or minimally trade distorting, effect have been put in this box. These are not subject to any reduction commitments. It includes all government service programmes.

- **Blue Box:** It contains those subsidies whose continuation is subject to a limitation on production.

- **White Box:** It includes such subsidy practices in developing countries like investment subsidies, agricultural input subsidies available to low-income or resource-poor farmers and measures to encourage diversification from growing illicit narcotic crops.

All other domestic support measures are subject to reduction commitment.

3. Agreement on Sanitary and Phyto-Sanitary (SPS) Measures

SPS measures are those applied to protect human, animal or plant life from certain risks. These risks are those arising from the entry, establishment or spread of pests, diseases and disease-carrying or diseases causing organisms. The risks also include risks arising from additives, contaminants or toxins. Disease causing organisms in food, beverages and foodstuffs and from risks arising from diseases carried by animals, plants and products are also covered under this agreement.

SPS measures include all relevant laws, decrees, regulations, requirements and procedures, including end-product criteria, processes and production methods, testing, inspection, certification and approval procedures, quarantine treatments, provisions on relevant statistical methods, sampling procedures and methods of risk assessment, packaging and labelling requirements directly related to food safety.

SPS measures must be based on international standards, guidelines or recommendations where they exist. It is open to a country to adopt a level of SPS protection higher than that of the relevant international standards, if there is a scientific justification or if it is needed by the appropriate level of SPS protection in that country.

Members are allowed to provisionally adopt such SPS measures which, on the basis of available pertinent information and relevant scientific evidence are the best possible measures at the current juncture, although they fall short of the standards set by the WTO. Such provisional measures need to be reviewed within ‘a reasonable period of time’.

4. Agreement on Anti-Dumping (ADA)

The objective of this agreement is to provide the right to the contracting parties to apply anti-dumping measures. These are measures against imports of a product if such imports cause injury to a domestic industry in the territory of the contracting party.

The ADA allows member-nations to apply anti-dumping measures on a unilateral basis after elaborate investigations. The anti-dumping investigation determines whether:

- an imported product has been dumped;
- it has caused material injury to the domestic industry of a like product; and
- there is a causal link between dumped imports and the injury.

If the investigations establish these three factors, the government is allowed to levy anti-dumping duty on imports. This duty could be levied on imports either from a specific country or a group of countries.

The ADA provides that all countervailing duties should be terminated within five years of their imposition unless a review determines otherwise.

5. Agreement on Technical Barriers to Trade (TBT)

The objective of this agreement is to ensure that mandatory product standards should not be so applied to countries as to cause 'unnecessary obstacles to international trade'. It visualises that mandatory product standards do not create such barriers if based on internationally agreed standards. It also recognises that countries have a right to establish protection, at levels they consider appropriate (concerning the human, animal or plant life or health of the environment), and that countries should not be prevented from taking such measures as are necessary to ensure that those levels of protection are met.

Technical regulations and standards cover product characteristics, process and production characteristics, terminology and symbols and packaging and labelling requirements as they apply to the products.

The TBT encourages countries to use international standards where appropriate, but does not require change in the level of protection as a result of standardisation.

It recognises right of member countries to adopt technical regulations and standards as well as conformity assessment procedures for the purpose of: (i) national security requirements, (ii) prevention of deceptive practices, (iii) protection of human health or safety, animal or plant life or health of the environment.

6. Agreement on Trade-Related Investment Measures (TRIMs)

Beginning 1995, GATT's inconsistent agreement on TRIMs were required to be notified and eliminated within a transition period of two years (for developed countries), five years (for developing countries) or seven years (for least-developed countries). A further extension may be requested by developing and least-developed countries. The agreement on safeguards prohibits the use of 'grey-area measures' such as voluntary restrains or orderly marketing arrangements, and requires that such measures are both notified and eliminated within a time frame.

7. Agreement on Textiles and Clothing

This provides for the eventual elimination of the multi-fibre arrangement (MFA) after a ten-year transition period. In place since 1973, The MFA has since been terminated with effect from January 1, 2005.

8. General Agreement on Trade in Services (GATS)

It is the first multilateral agreement on trade that has as its objective the progressive liberalisation of trade in services. The GATS covers trade in all service sectors and the supply of service in all forms. Every member is bound to open up its service sector, with exceptions only in (i) non-commercial services like health-care and education, (ii) measures affecting air-traffic rights and services, and (iii) other services for which a country has sought partial or full exemption before signing the treaty (for example, India sought exemptions for legal and accounting services).

9. Agreement on Trade-Related Intellectual Property Rights (TRIPs)

The main features of this agreement are as follows:

- minimum standards of protection to be provided by each member;
- domestic procedures and remedies for the enforcement of intellectual property rights to be evolved and put in place;
- dispute settlement mechanisms for the WTO member countries to be instituted.

TRIPs agreements cover the following areas: copyright and related rights, trademarks including service marks, geographical indications including appellations of origin, industrial designs, patents including the protection of new varieties of plants, the lay-out designs of integrated circuits and undisclosed knowledge including trade secrets and test dates.

10. Agreement on Government Procurement (GPA)

The GPA provides a vehicle for the progressive opening of markets to international competition through legally enforceable provisions of non-discrimination which apply to procurements 'covered' by the agreement. In addition, various provisions of the agreement relating to the provision of information to potential suppliers, contract awards, qualification of suppliers and other elements of the procurement process aim at ensuring transparency and non-discriminatory conditions of competition among suppliers. India, as yet is not a signatory to GPA, although other major developing countries such as China and Saudi Arabia have made commitments to eventually seek accession to it.

Check Your Progress 1

1. State in brief the objectives of the WTO.

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2. What are the principles on which the WTO has been set up?

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3. State in brief the functions of the WTO.

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4. Outline in brief the structure of the WTO.

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5. State in brief the features of the WTO agreement on agriculture.

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6. What are TRIPs and TRIMs ?

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7. State in brief the features of GATS.

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23.3 DISPUTE SETTLEMENT MECHANISM (DSM) OF WTO

The Dispute Settlement Mechanism (DSM) of the WTO is a central element in providing security and predictability to the multilateral trading system. WTO members have committed themselves not to take unilateral actions against perceived violations of the trade rules. In fact, they have pledged to take recourse to the DSM, and abide by its rules and procedures.

Under the WTO, there is a dispute settlement body (DSB) which is the custodian of the DSM. The DSB has been empowered to establish panels which are bodies set up for a specific investigation. The DSB is also empowered to constitute appellate bodies and exercise surveillance for compliance of rules and recommendations. It can also authorise retaliatory measures in cases of non-implementation of recommendations.

Stages in Dispute Settlement

The settlement of disputes passes through different stages as follows:

The **first** stage of settling disputes is the holding of consultations between the members concerned. Such consultations aim at evolving a solution of the dispute in a mutually acceptable manner.

If no solution is found, in the **second** stage, the complainant can ask the DSB to establish a panel. The panel is set up by the DSB in consultation with the disputing parties. The panel examines the complaint. Its report contains findings and recommendations. The DSB adopts the panel report after its submission.

In the **third** stage, any party to the dispute can appeal a panel's decision to the WTO appellate body. A standing appellate body (SAB) is set up by the DSB to hear all appeals. Prompt compliance with recommendations or ruling of the DSB is essential in order to ensure effective resolution of disputes to the benefit of all members. Members are given time to implement the recommendations but if a member fails to act, it is obliged to enter into compensation negotiations with the complainant. If no satisfactory compensation is agreed, the complainant may request authorisation from the DSB to suspend concessions or obligations against the other party. The suspension of concession is thus the last resort which an aggrieved member can call upon in retaliation.

WTO and GATT

DSM of the WTO is a significant improvement over GATT. Under GATT, dispute settlement was fragmented between the council and various committees. Under the WTO, there is one DSB which has the sole authority to establish panels and appellate bodies.

Besides, under the WTO, there has to be consensus against the establishment of panels or for the adoption of panel reports, whereas the opposite was true for the GATT. Thus, parties to the dispute in the present system can no longer block these decisions. Another new feature is the possibility of appeal against panel decisions to a SAB. And in line with the integrated nature of the WTO mechanism, complainants may take retaliatory action as a last resort against a nation which has not implemented the adopted panel recommendations.

23.4 EVALUATION OF WTO

WTO has been in operation for about a decade and a half now. During this short time, the WTO has proved that it is very different from its predecessor, GATT. For instance:

- While GATT was toothless, WTO with its DSM is able to bring to book even the mighty US in several cases.
- GATT's negotiating rounds took place once in a decade or so. But, at Singapore, just two years after the conclusion of the Uruguay round, the WTO virtually concluded an Information Technology Agreement, and launched studies on investment, competition policy, transparency in government procurement and trade facilitation. There is enormous pressure to compress into next five years what used to take decades to complete before.
- WTO is democratic in the sense that one country-one vote principle is adopted;
- For enforcing trade liberalisation, WTO has brought into its framework, many new areas, such as agriculture, textiles, technology and investment; and
- Induction of services, in the agenda of liberalisation, has been an extremely important feature of WTO.

23.4.1 Achievements of WTO

In the short period the WTO has been in existence it is being credited with the following achievements:

i) Greater market orientation has become the general rule;

ii) Tariff-based protection has become the norm rather than the exception;

iii) Use of restrictive measures for BOP problems has declined markedly;

iv) Services trade has been brought into the multilateral system and many countries, as in goods, are opening their markets for trade and investment either unilaterally or through regional or multilateral negotiations;

v) Many UDCs have undertaken radical trade, exchange and domestic reforms which have improved the efficiency of resource use, opened up new investment opportunities, and, thus, promoted economic growth;

vi) Bilateralism has been, to a great extent, placed under control by the extension of WTO provisions to services, TRIPs and TRIMs. Further, under the unified DSM, the possibility of any country unilaterally blocking the adoption of panel decisions no longer exists;

vii) The trade policy review mechanism has created a process of continuous monitoring of trade policy developments. Also, by promoting greater transparency, it has assisted the process of liberalisation and reform;

viii) It has been agreed to reduce import tariffs on industrial goods, based on Swiss Formula. A Swiss formula is a non-linear formula where tariff-cuts are proportionally higher for tariff which are initially higher. For instance, a country which has an initial tariff of 30% on a product will have to undertake proportionally higher cuts than a country which has an initial tariff of 20% on the same product.

23.4.2 Limitations of WTO

The WTO, however, has still to make any progress or become more sensitive on the following issues:

i) The trade reform process is incomplete in many countries. For instance, some high tariffs still remain on which negotiations are still proceeding at various levels, notably in the areas of basic telecommunications and financial services;

ii) There appears to have been at least some reversals in the overall liberalisation process in some developing countries. Examples are of increasing anti-dumping measures, selective tariff increases and investment related measures. The developed countries are also blocking the process of liberalisation by adopting many neo-protectionist measures;

iii) Concerns have been raised that the combination of globalisation and technological change creates a premium on high-skill as against low-skill with growing social divisions;

iv) The major share of the benefits of the WTO has gone to the countries of the North. The WTO has opened up the world economy more rapidly in areas that benefit the developed world. Where the benefits of free trade accrue primarily to the UDCs, progress has been much slower;

v) The WTO has also not been sensitive enough to the development of non-tariff barriers to imports from the UDCs, such as anti-dumping duties;

vi) The multilateral trade rules are increasingly becoming a codification of the policies, perceptions, laws and regulations of the industrialised countries. The policies and rules appropriate or advantageous to the industrialised world are getting established as common rules to be obeyed by the developing world as well. As a result a 'one size fits all' approach is increasingly getting embedded in the WTO rules and disciplines;

vii) The interests of international trade, which are primarily the intrests of transnational corporations, take precedence over local concerns and policies even if such a course exposes the local population to serious health and security risks;

viii) The implementation-related issues are becoming a source of serious concern. These issues cover a whole range of demand to correct while asymmetries in TRIPS, TRIMS, anti-dumping, movement of people, etc. remain. Other issues requiring WTO attention relate to agriculture, textiles, industrial tariffs including peak tariffs, and services. In addition, there are what are described as Singapore issues. These relate to: (i) rules to protect investments, (ii) competition policy, (iii) transparency in government procurement, and (iv) trade facilitation.

WTO has now become a forum for perpetual negotiations on newer and newer subjects and for using trade rules to establish standards and enforce compliance even in non-trade areas. Everything now seems to require the hand of WTO, be it foreign investment, environmental or labour standards, child labour, good governance, or human rights.

However, a word of caution need to be sounded. WTO should not be expanded into a sort of world government, covering every economic subject under the sun, and then using the threat of trade sanctions to bring about a new world order.

23.5 DOHA ROUND OF NEGOTIATIONS

At the ministerial meeting at Doha (Qatar, UAE), in November 2001, the WTO held a new round of trade negotiations. This round has been temporarily named as the Doha Development Round. This round began in January 2002 and was expected to end by January 1, 2007. It has, however, not concluded till January, 2009.

The Doha round of trade negotiations mandated negotiations on agriculture, industrial products, services, intellectual property, WTO rules, trade and environment. The negotiations at WTO reached a dead-end in July 2006 and were temporarily suspended. Since then, some attempts have been made to revive them, but these have not been successful.

Due to unrelenting pressure by the developed countries, the Doha negotiations veered from their proclaimed 'development-orientation' towards a 'market access' direction in which developing countries are pressurised to open up their agricultural, industrial and service sectors. In short, developed countries are out to seek exclusive benefits for themselves, alone. This goes against the spirit of bilateralism. The demise of multi-lateralism will set in a two-pronged movement towards increased bilateralism and regionalism. This will mean short-term gains for the vested interests, and medium and long-term welfare losses for everyone.

23.5.1 India's Response

India has a strong interest in a successful conclusion of the Doha round and should aim at the successful ending of negotiations even if the impasse may need to be prolonged to accomplish such an outcome. India should not be deterred by the fear that the trend towards regional arrangements would strengthen and trade conflicts would intensify. The geographical dynamics which drives regional arrangements will remain unaltered as it is. There is no doubt a distinct possibility of increased trade disputes, especially in agriculture after the demise of the peace clause, remains. But, India should not be daunted as the major subsidising countries are likely to face disputes and trade friction which could eventually prove to be a tonic for the trading system. In other words, it might help create a sense of urgency among the major players and a required political will to emerge effecting deep reforms in agriculture.

Check Your Progress 2

1. Enumerate in brief the major achievements of the WTO.

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2. Enumerate in brief the major limitations of the WTO.

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3. What is Doha round of negotiations?

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23.6 NEW INTERNATIONAL FINANCIAL ARCHITECTURE

The global economy has entered a new phase during the first decade of the twenty-first century. Momentous changes have been taking place, whose pace and force have both been unprecedented. Among these changes, a few important ones can be enumerated as follows:

1. **Emergence of China, etc.:** Emergence of China, India and others as economic powers has been a major factor of the present international economic dispensation. The global economy had witnessed the all-powerful hold of US and Europe for preceding close to two centuries or so. These economies served as the locomotive for the global economy. Twenty-first century is a witness to a tilt in this power-balance. Growth rate in China have been stupendous; India and other Asian nations have been fast catching up with this trend. This cannot leave the global economy unaffected. Already China is being touted as the locomotive economy for the world.

2. **Groups of Developing Economies:** Fast emerging developing economies have already tasted the flavour of their strength and ability to dictate their demands to the developed world. They have successfully stopped the developed world in their mission at Doha round of negotiations. They have presented a voice of unity in the form of groups of nations, like G20. India and other fast emerging economies have provided leadership to such efforts.

3. **Capital Flows:** Unprecedented capital flows, in different forms of investment, has taken place throughout the globe. Aided by advances in technology, both the developed and developing nations have gained from these flows.

4. **Growing Uncertainties and Instabilities:** While mushrooming foreign capital flows lubricated the growth engine throughout the

> globe, it suffered from in built weaknesses of growing uncertainties and instabilities. These flows have been fickle and have demonstrated keenness to take flight at the first sign of trouble.

That these instabilities can cause trouble throughout the world, and there is no system in place to check and regulate them, became clear when the whole of the globe got engulfed in what came to be known as the '***sub-prime crisis***' that originated in US (see Unit 28 on this). Even earlier, the Latin American Crisis of 1987-88 and the East Asian and South East Asian Crisis had sounded the warning bubbles which were not adequately heeded. In wake of sub-prime crisis, however, the all-powerful, steel-strengthened, highly robust and the energetic financial structure of the US came down like a house of cards, putting the whole economy in a state of recession. This turmoil soon spread throughout the globe, bringing distress and misery for the masses.

23.6.1 Need for a New International Financial Architecture

The world now (2009) needs a new international financial architecture, including a new global economic institution for several reasons. These are:

One, the existing international financial institutions have been inefficient in dealing with the present economic crisis. They were set up in a different political and economic context from what prevails today. The IMF was set up with a view to maintaining an international monetary system that would promote exchange rate stability. The World Bank was set up to help build war ravaged nations. The prevailing global economic conditions have little or no similarity to the conditions at that time.

Two, prospects for enhancing the effectiveness of the existing international financial institutions are bleak. There is little or no indication thus far that these institutions have been able to gear themselves adequately for the magnitude of the task that the world economy currently faces, be it in the developed or the developing world. On the contrary, there have been indications of delays and failures, not to talk of the role with respect to 'surveillance' that the IMF is mandated to perform.

Three, in the wake of the international financial crisis in 2008, at the G-20 Summit towards the end of 2008, an Action Plan has been formulated to meet the situation. The plan consists of both short-term and medium term measures. It, however, appears unlikely that either the IMF or the World Bank is geared to perform this task.

Four, a new international financial architecture, including a new global economic institution is required to enable the global economy to become more fair and equitable, and thereby also more sustainable. Present day globalisation has created tremendous potential for creating prosperity and for reducing global inequalities with growth rates of developing countries far outpacing those of the developed world. However, globalisation has been accompanied by accentuation of income inequalities across nations and within nations. This has happened because globalisation, as reflected in flows of finance, investment, capital, and knowledge between nations, has taken place across a less than level playing field, thereby enabling the already prosperous nations to get greater benefits, and become even more prosperous, while others have been partly or totally left out of the growth process.

In short, action to build a fair and inclusive globalisation through a new financial architecture is urgently required.

23.6.2 Suggestions for a New International Financial Architecture

As stated above, it is imperative to design a new international financial architecture. For this purpose, a few suggestions can be advanced as follows.

1. **The process and institutional design that the new architecture develops must be inclusive:** The new institution should give adequate attention and support to both industrial and developing countries, and to both large and small countries. Its governance system must be based on representative institutions, not on any adhoc grouping of countries (e.g. a G-8, a G-13 or a G-20). There is a need for a deeper involvement of the United Nations (UN) in any reform process, as it is the most representative of global institutions.

2. **The regulatory deficit of global finance must be corrected:** The crisis in the international financial system is closely associated with inadequate regulation and supervision of financial activities. Since the Asian crisis of the 1990s, it became an established criterion that financial liberalisation must be accompanied by stronger prudential regulation and supervision. This principle has been applied in many parts of the developing world but was entirely disregarded in the US, where further liberalisation was accompanied by deregulation and weak supervision of financial inter-mediation.

It is important, in this context, to follow the following **basic regulatory principles**.

One, regulations must be comprehensive, to avoid the massive loopholes through non-banking inter-mediation that led to the 2008 turmoil. This will include regulating the types of transactions that led to this crisis, particularly securitisation and derivatives, and force all the markets to be open and transparent thus limiting the over-the-counter operations.

Two, regulations should have strong counter-cyclical focus which would avoid excessive indebtedness and force the accumulation of increasing capital and provisions during booms.

Three, when pricing assets according to their market value to maintain transparency, the system must have mechanisms to avoid asset price bubbles from feeding into the credit expansion, and asset price busts from feeding into the credit squeeze.

Four, reliance on the internal models of financial institutions should be discarded. It has already shown how perilous it can be, and how the use of similar risk models by financial institutions can lead to greater instability. The new models should focus on: restricting monopoly power, encouraging diversification and avoiding unsafe financial products.

Five, any system that is designed in this area should be based on a well-functioning network of national and regional authorities and include truly international supervision of financial institutions with a global reach. The IMF should not be at the centre of the regulatory system. The Bank of International Settlements and the Basle Committee are better placed, but this will require a fundamental reform to broaden their membership and avoid the two major problems that the Basle Committee faced in recent years viz. (i) the lack of representation of developing countries, and (ii) excessive influence over regulation by large international banks. Alternatively, building on these institutions, a new 'Global Financial Regulatory Authority' could be considered.

3. **The IMF should be revamped:** Four essential reforms of the IMF should be part of the reform agenda.

   The **first** is the creation of a meaningful and truly global reserve currency, which could be based on the IMF special drawing rights. This would overcome both the inequities and the instability that is inherent in a global reserve system based on a national currency.

   The **second** issue is the need to place the IMF at the centre of global macroeconomic co-ordination, not the G-7 or in fact any group. This is the only way to give developing countries a voice on the issue.

   The **third** issue is the need for the IMF to lend during BOP crisis rapidly and without overburdening conditionalities, particularly when the sources of the crisis are a rapid reversal of capital flows and a sharp deterioration in the terms of trade. This means putting in place a preventive credit line for capital account crises and making active use of the Compensatory Financing Facility and of the Poverty Reduction and Growth Facility to manage the adverse terms of trade shocks faced by low income countries. This implies that the IMF would act more like a central bank, providing liquidity in an agile way, the way central banks have actually been providing funds in industrial countries on a massive scale in recent months.

   As a **fourth** issue, the IMF should encourage and advice countries on what regulations to impose under given circumstances. Indeed, the regulatory structure that must be developed to manage financial stability in the global era should include provisions that apply to cross-border capital movements such as: generalised reserve requirements on cross-border flows, minimum stay periods, and prohibitions to lend in foreign currencies to economic agents that do not have revenues in those currencies.

4. **A co-ordinated global macro-economic policy package must be urgently adopted:** Both developed and developing countries should form part of such an effort.

5. **An international debt count must be created:** The lack of a regulatory institutional framework to manage debt (i.e. a court similar to those created to manage bankruptcies in national economies, the decisions of which are legally binding) is one of the major deficiencies of the current international financial architecture. The system has relied in the past on ad-hoc mechanisms, or on traumatic individual debt renegotiations. The problem of all these mechanisms has been that they generally come too late, after high indebtedness has had devastating effects on countries. Conditionalities have also been a significant source of problem for several poor countries and must be immediately lifted to allow these countries to benefit from these initiatives. The new international financial architecture should solve these problems by creating an international debt court, which would serve both as mediator and eventual arbitrator of both public and private sector international loans.

6. **The system must rely more broadly on regional institutions:** In all areas of reform, the IMF should make more active use of regional institutions and support their creation in other parts of the developing world. Indeed, the IMF of the future should be seen as the apex of a network of regional reserve funds.

The developing countries are in an excellent position to contribute to this task, given their large foreign exchange reserves. Using those reserves more actively for swap arrangements among central banks, pooling them in reserve funds, or using them to support the development of regional bond markets are all mechanisms to be used in expanding the scope to plan the new financial architecture. These reserves and existing sovereign wealth funds could also be used for creating the multilateral development banks owned by developing countries, and by investing in the capital bonds issued by such institutions.

Check Your Progress 3

1. Mention the factors which indicates the need for a new international financial architecture.

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2. State the essential features (by way of suggestions) for a new international financial architecture.

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3. Mention the lines (by way of your suggestions) on which a revamping of the International Monetary Fund is called for.

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23.7 LET US SUM UP

Bretton-woods conference, 1944, gave birth to two international institutions, viz. the IMF and the IBRD. Interim arrangements were made to regulate trade in goods through an institutional structure called GATT. GATT, however, did not live up to the expectations and requirements of newly developing countries. The continuous pressure exerted by these countries resulted in the setting up of the UNCTAD. The Uruguay round of negotiations on GATT culminated in the setting up of the WTO, which became operational from January 1, 1995. During the period since the WTO has been in existence, it has broadly lived up to the expectations of majority of countries.

However, the response of the WTO to the fast changing global situation has also been found inadequate. This can be seen from the slow progress made by the Doha round of negotiations. Simultaneously, international financial system has come under deep stress with the turmoil having its origins in the US and in the highly volatile large capital movements across the globe. This has brought out the need for a new international financial architecture.

23.8 KEY WORDS

Bretton-woods Institutions : Refers to the two institutions of IMF and World Bank following their establishment as a result of a conference held in a place called Bretton-woods in 1944 as a sequel to the need felt for extending economic support following the end of II World War.

General Agreement on Tariffs and Trade (GATT) : An organisation set up by the rich developed countries in 1947. It was biased in favour of the rich countries and hence was dubbed as the 'rich men's club'.

World Trade Organisation (WTO) : An international organisation set up in 1995. This organisation too came up as a result of the initiative and support of the members of GATT. However, its functioning was more democratic mainly in view of the change in the economic atmosphere which had seen the coming up of many newly industrially advanced countries since GATT.

Most Favoured Nation (MFN) Treatment : One of the four principles of WTO, which advocates no preferential treatment be given to any country. However, the other two principles of the remaining three provisions for such a treatment to some countries by 'protection through tariffs' based on the 'bound tariffs' approach.

TRIPs and TRIMs : Two agreements under WTO for protection of 'intellectual properties' and 'trade related investment measures'.

Doha Round : An inconclusive and continuing round which became controversial in view of its agenda on items like agriculture, services, environment, and other issues in which the views and situation of developing countries are different from those of developed countries.

23.9 SOME USEFUL BOOKS

Kaushik Basu (ed.), The Oxford Companion to Economics in India, Oxford University Press (OUP), New Delhi, 2008.

Ishwar C. Dhingra, The Indian Economy, Environment and Policy, Sultan Chand, New Delhi, 2009.

Ashwini Deshpande (ed.), Globalisation and Development, OUP, New Delhi, 2007.

Basudeb Guha (ed.), The WTO, Developing Countries and the Doha Development Agenda, Palgrave, New York, 2004.

K.S. Jomo (ed.), Globalisation Under Hegemony, Uneven Development and Global Inequality, OUP, New Delhi, 2005.

23.10 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1. See Section 23.2.1 and answer.
2. See Section 23.2.2 and answer.
3. See Section 23.2.3 and answer.
4. See Section 23.2.4 and answer.
5. See Section 23.2.5 and answer.
6. See Section 23.2.5 and answer.
7. See Section 23.2.5 and answer.

Check Your Progress 2

1. See Section 23.4.1 and answer.
2. See Section 23.4.2 and answer.
3. See Section 23.5 and answer.

Check Your Progress 3

1. See Section 23.6.1 and answer.
2. See Section 23.6.2 and answer.
3. See Section 23.6.2 and answer.