Uttarakhand Open University, Haldwani

MS 111

School of Management Studies and Commerce

International Business

Block I International Business: An Overview

Block II International Trade and Environment

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Block – I

Block Title- International Business: An Overview

Block – II

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ISBN : **978-93-85740-17-6**

Edition : **2020 (Restricted Circulation**
(Pre-Publication Copy; Subject to Changes before Final Version)

Published by : **Uttarakhand Open University, Haldwani, Nainital – 263139**
Printed at : **(Name of the Printer)**

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Course Code- MS 111

Course Objective: The objective is to impart knowledge and skill of analysis of operational processes of business between two or more nations.

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Suggested Readings:

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Block I
International Business: An Overview

UNIT 1 INTERNATIONAL BUSINESS: INTRODUCTION, EVOLUTION AND DRIVERS

1.1 INTRODUCTION

International Business is performing trade between two or more countries. When an enterprise expands its business operation in more than one Nation with an objective of targeting and serving the global customer it is called International Business. In other words International Business is conducting business between two or more countries. Companies all over the globe are undergoing an elementary movement from independent to dependent on other nations for procuring raw material as well as supplying their products and services.

International Business deals in different Culture, Social, Political and Economical environment. Now most of the countries are reforming their economy including India by introducing an open entry strategy, reducing the rigidity in licensing process.

The unavoidability of globalisation is very well explored by Management Guru Peter Ducker in his Book "*Management Challenges for the 21st Century:* All institutions have to make global competitiveness a strategic goal. No institution, whether a business, a university or hospital, can hope to survive, let alone to succeed, unless it measures up to the standards set by the leaders in its field, any place in the world." As there is mounting trend towards a borderless business and due to increasing Privatisation, liberalisation, WTO mandated, gradually diminishing barriers to cross-border business. And, "Globalisation, for better or worse, has changed the way the world does business... it (globalisation) is all but unstoppable. The challenge that individuals and business face is learning how to live with it, manage it, and take advantage of the benefits it offers."

Globalisation has taken a high momentum in the last couple of decades which promotes Internationalisation. International businesses have become mandatory because if a company doesn't accept and enter into global environment then there will be a risk of sustainability as well as losing business in the domestic market.

During late 1960's and early 1970's Arabian countries recognised that they had rich source of crude oil but they were not having sufficient technology for extracting it. And there were certain countries which were searching for sources of raw material around the world. Some countries were rich in resources and other was having technology, in this way the interdependence generated companies to enter into International business. The companies searching for raw material were called Raw material seekers.

After some time the companies were engaged in mass production in order to reduce the cost, which created a need of potential market to dispose the excess production, these types of countries were called Market seekers. Market seekers were searching for potential market in different regions of world. Internationalisation of business means there is high level of Inter-dependence, Inter-relatedness and there is high degree of involvement of different nations around the world. International Business is an activity that involves the transfer of resources, goods & services, specialisation and information across national borders. Globalisation has created lot of new opportunities for the growth and development of International Business. We are living in an environment with cross-border business with fewer obstacles, where the economy of different nation is integrated into world economy and no doubt to say world has become global platform and global market.

The main objective behind studying International business is that three decades ago very few companies ventured into international field and most of them restricted themselves to physical movement of goods and services i.e. exports and imports. Restrictions, regulations and other barriers did not allow them to take risks. Presently, the world has become an open market. Duties, license quotas, restrictions and other investment limitations have gradually been eliminated. Anyone can do business in any part of the globe. Risk factors are properly analyzed and evaluated and most of information about them is easily accessible. The aspirant entrepreneur can go to anywhere and explore opportunities. Most of the companies are entering into international business which provides them abundant opportunities for development and improved returns.

Factors like finance flow or investment plays significant role in International trade. Right technology is a pre-requisite to manage business internationally to manufacture goods. There should also be substantial market to generate revenue. To manufacture goods in any country, raw material, components, consumables and capital items are required. Easy access to all resources is easy as domestic procurement today. Hence scope of international business is widened.

In this unit, attempts are made to familiarise with the basic concepts of International trade; history and Evolution, scope of International Business, objectives of International business, importance and factors effecting International business, types and strategy of International business. International business has become an important aspect for success of a company, which serves its global markets in a unique and better way in this competitive world.

1.2 LEARNING OBJECTIVES

After studying this chapter you should be able to understand:

- International business; Introduction, meaning, objective, scope.
- Evolution of International Business.
- Motives of international business from companies and nations.
- Globalisation
- Factor effecting International Business.
- Fundamental differences between Domestic and International business
- Few successful organizations in Domestic and International business.

1.3 CONCEPT OF INTERNATIONAL BUSINESS

A business operation between two or more countries is called International Business. Export of goods & services from one nation to another is not sufficient to identify it as International business. Business operations within the geographical territory of a nation are known as domestic business. International business has a wide spectrum of activities beyond simple exports. A commercial transaction among two or more companies of different countries with diverse environment is called International business. International business is that trading which opens a cross border transactions between two countries. No matters if these countries are developed, developing or underdeveloped. These all transactions take place with the collaboration of highly skilled labour, capital, technology, transportation etc. In the other words it is an activity which increases foreign investment. Such Multinational Enterprises (MNE) involves themselves in such transactions for revenue, profit and prosperity of society.

International business has a wide range of business activities beyond just exports. Presently Indian corporate acquires and takeover companies in different part of globe. They make huge investment to find an optimisation of resources and most suitable location for production. The growth of company will depend upon its business activities in many other countries not only on the revenue generated but also through investment, manufacturing and marketing.

Enterprises operating in International business enjoy autonomy and encourage entrepreneurial spirit which is essential for gaining expanding markets in different countries are also called Multinational Organisations. While doing business at globe level the company must ensure that activities of all the subsidiaries are integrated according to global market. As each country is economically, politically and socially discrete, the fact remains that a multinational is a single organization which attempts to attach diverse national units.

According to Roger Bennett

“International Business involves commercial activities that cross national frontiers”.

According to Michel R. Czinkota

“International Business consists of transactions that are devised and carried out across national borders to satisfy the objectives of the individuals, companies and organisations. These transactions take on various forms which are often interrelated”.

According to International Business Journal

“International business is a commercial enterprise that performs economic activity beyond the bounds of its location, has branches in two or more foreign countries and makes use of economic, cultural, political, legal and other differences between countries.”

The primary reason behind the international business because the natural resources are not equally distributed and companies are searching for the cheap and easy availability of raw material which creates dependency over other countries. Enterprises are engaged in international business to import the resources that are available at lower prices from other countries, and export goods to those international markets where they can obtain better prices for their goods and services. Other than, price considerations there are several other advantages which nation and enterprise get from international business. Simultaneously, it provides momentum to nation’s growth.

All most every one of us consumes products designed and offered by Multinational organisation in every day of life, which plays important role in our life. At present most of the enterprises are moving towards International Business, which is more complex than domestic business.

International business includes performing business operations at different countries with resources arranged from all over the globe and offered to global customers. Executives play an important role in shaping the competitiveness of organisations as per the prevailing conditions in various countries at the global arena.

1.4 FEATURES OF INTERNATIONAL BUSINESS

Following are some of the features of International Business.

a) Integration of economies of different nation.
   Dependency for resources over other nation is one of the causes for international businesses. This dependency creates economic relation as well as new business

alliances between countries. There is high level of economic integration of nations engaged in international business.

b) Large level/scale business operations

Companies engaged in International Business performs all production, sales, marketing and other business related operation at International level by crossing the boundaries of their home nation. The companies are targeting the customer of different territory and the strategies are prepared by keeping the world as global village.

c) International Business is controlled by Developed countries.

As in International Business there is involvement two or more Nations, the advance nation are having dominance over the companies of growing nation. The companies of developed countries are rich in resources and favoured by the condition. The companies of developed country are having control over the various decisions and influencing role in strategic policy making.

d) Favourable to participating countries

International business creates growth and new options for both domestic nations as well as host nation. Every country entering into international trade identifies opportunities then involves themselves in trade relations. International trade include exchange of resources and also provides healthy ecosystem to participating nations.

International business creates employment opportunities, effective utilisation of resources, future growth option and generating national income in one nation and provides market to another nation.

e) Perfect Competition

International business crosses the national boundary of their home nation by targeting and serving two or more countries customer as one customer. It tries to eliminate the negative effect of monopoly and protecting the customer interest of general public. International business promotes customer oriented approach and by provide better alternative for the customer.

f) Dynamic in nature

The companies participating in International businesses have to work in very diverse environment which is dynamic in nature, where each nation is having different political, socio-economic, cultural and demographic features.

g) Headquarter in Home Country

The company involved in International business have one headquarter in home nation and multiple business operation in rest of the world. All Multinational enterprise has their controlling office at country of origin and performs diverse functions in different part of world.

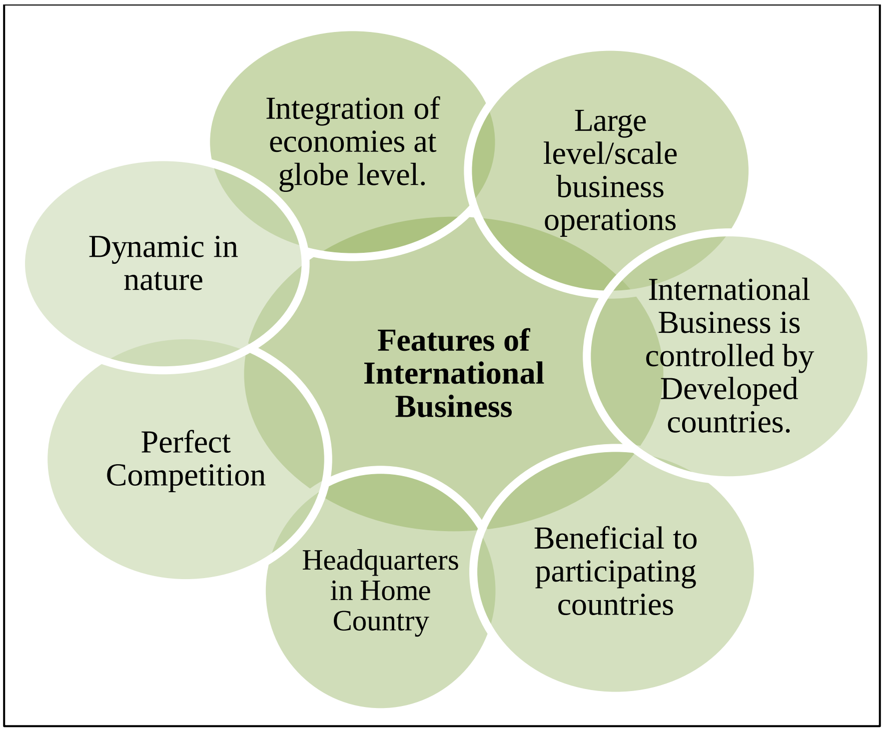

Figure 1.1: Features of International Business

1.5 IMPORTANCE OF INTERNATIONAL BUSINESS

International business benefits all its stakeholders which include domestic company, home nation, host nation, other subsidiary companies. The following are some of the benefits of International business.

a) Market/ Business Expansion.
International business creates and develops the new growth opportunities for the existing business setup. Once business enterprise successfully established, international business serves new avenue. There is always a scope of business growth for the companies in International business.

b) Nominal cost of procurement.
The basic concept behind International Business is procurement of resources at low price. As it is very difficult to have all resources at one place and it is not possible that to a nation will be rich in required resources. International Business creates an ease to get that at very fair prices.

c) Generates employment opportunities.
International Business generates lot of employment opportunities in the host nation. International Business contributes in development of human capital and new job avenues.

d) Healthy International relationship.
International Business builds the relation between nations which increases the dependency between the nations. It develops the long and strong relations.

International Business creates a healthy environment to work which bring international peace and harmony. International Business builds sound relation between nations involved international business

e) Improves the living standard.
International business increases the foreign investments which contribute in infrastructural development and development of services. With the development of an economy, there is increase in per capita income and it results in high spending or investments. It creates facilities for the development of living standard. The countries with high involvement in international business have better living standard as comparison to low involved countries in International business operation. So there is strong association of standard of living and International Business.

f) To fulfil the industrial need of industry.
International business fulfils the regular needed material by supplying the required goods and services. Companies are in need of specialized services while operating International trade. Technological Merger and funding are some of the need of industry. International business creates lot of Growth Avenue for small scale sector and promotes tiny enterprises that supplies raw material to large sector.

g) Fast economic growth
International business facilitates higher rate of economic growth. Studies have proved that the companies engaged in International business are growing as faster pace than other companies. The transformations of the underdeveloped and developing countries are being contributed by international organizations.

h) Superior quality goods at minimum prices
The MNE (Multinational Enterprise) crosses the domestic boundary and expands their business operation in more than one nation. In such situation the company compete with companies of host nation. It creates perfect competition where they offer quality product at nominal prices to customer.

i) Increase national Income
International business helps in generating income for the country by increasing exports, technology transfer and by supplying other specialised services. International business always promotes exchange of resources between two or more nations. Export generates national income, which also help a country have positive Balance of Payment (BOP) by earning foreign exchange.

j) Eliminate monopoly
International Business allows a company to enter into the territory of another country to explore their domestic market. The multinational enterprise enters into the market of other nation with nominal prices and superior quality goods.

1.6 EVOLUTION OF INTERNATIONAL BUSINESS

The International trade practised around the world for thousands of years, since ancient time and it is not a new phenomenon, although form business, its methods, and significance are gradually sprouting. In ancient times, the Phoenicians, Mesopotamians, and Greeks traded along routes established in the Mediterranean. The trade and commerce constantly grew through different types, facilitating the movement of goods and services and other resources between two or more nations. The establishment of credit and pooling of resources during the Renaissance period were trade activity which further encouraged by colonization activities during 1700’s and 1800’s centuries which provided the maritime nations with rich resources of raw materials as well as enormous business opportunities.

International business is encouraged by the Industrial Revolution by providing mass production techniques, sufficient and easy sources of raw material through efficient methodology. The flow of capital, technological development due to Industrial revolution leveraged the mobility of goods and services between countries.

Industrial Revolution was at peak in 1880’s in Europe and the US. Due to advancement in science and technology, the domestic and International transportation became new sources of energy for development. It created a platform for the emergence of MNC’s in the business world.

Over a period of time the development of Information and Communication Technology (ICT) raised the expectation of customer at global level. As the increasing interdependence and interrelatedness has created high rate of transactions at global level.

In the 21st century, in the business world, large and diversified business operations are covering maximum regions of globe. As commercial activities are crossing the territory of a nation, there has been significant need of banks and financial institutions to support the trade between two or more nation smoothly. Without the involvement of financial institutions, performing business transactions would be a very complicated. Financial markets have also become intricately linked, for example fluctuations in the US market have a direct impact on equity markets in other parts of the globe.

At present, only mature businessmen can understand that International business is the key of growth and success of any enterprise rather limiting the business in the domestic territory of a nation. There has been growing inclination towards internationalisation of business, territory expansion and multination business operations. People, product, technology and services are moving across the domestic boundaries in amazing figures. Many enterprises from different nations are expanding exports, creating franchising arrangements, entering into ventures with foreign companies and establishing foreign subsidiaries. The concept of global expansion is not only for large corporations but also medium-sized, family-owned business. Many of such enterprises have experienced profitability in exporting and new business avenue for future. In today’s scenario enterprises must be aware about threats and opportunities, as international business is becoming increasingly intricate and complex. The international business environment is extremely dynamic which creates new challenges and scope for growth. Enterprises engaged in international business to import resources that are available at low price in other countries and export goods to other nations from where they may fetch better prices for the products.

1.7 CHALLENGES IN INTERNATIONAL BUSINESS

With the previous discussion we may easily understand the contribution of International Business on the countries development in various areas like its infrastructure, employment status, living standard etc. There are some challenges faced by the countries entering into International business and they must take preventive measures to mitigate the adverse effect and to achieve the objective. Some of the obstacles are discussed below;

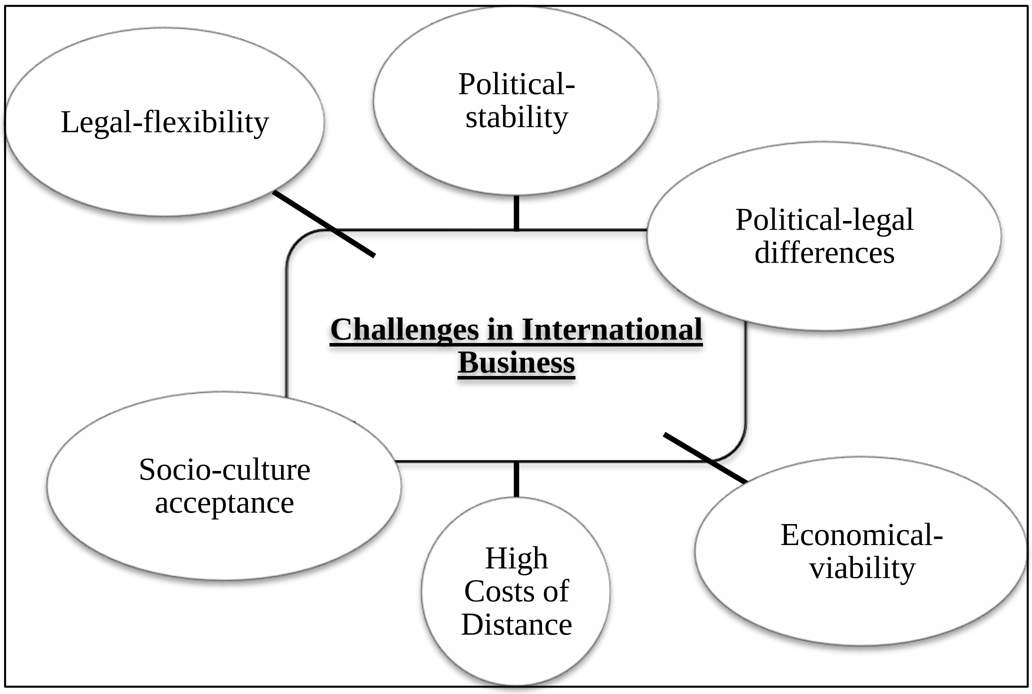

Figure 1.2: Challenges in International Business

1. Political stability
   Political stability is very important prerequisite for establishing business operations in any country. Government activity and set of political factor may either facilitate or act as obstacles for new companies in the country. Political stability helps in building healthy environment for healthy business, growth and long lasting business operations. Countries vulnerable to invasion are less favorable for International business.
2. Political-legal differences
   The political and legal environment of foreign markets is different from that of the domestic. The complexity generally increases as the number of countries in which a company does business increases. It should also be noted that the political and legal environment is not the same in all provinces of many home markets. For example, the political and legal environment is not exactly the same in all the states of India.
3. Economical-viability
   Economic factors play very vital role for decisions related to International businesses. Interest rates, Exchange rates, Recession, Inflation, Taxes, Demand / Supply are

important element of the economic environment. Different countries are having different currency that sometimes cause problems of currency conversion; in addition there is problem of fluctuations in exchange rate. The monetary system as well as regulations of two nations doesn't match.

4. Socio-culture acceptance:

   Differences in socio-culture factor of two nations are one of the most complicated problems in International market. Socio-cultural factors of any country are of most important for the company in making decisions to enter into International Business. Until and unless the company doesn't fulfil the cultural need of society it will be difficult establish their business operation in any nation.

   Secondly, International Business encounters inconvenience arising out of language differences between different nations. Even sometimes same words have different meanings in different countries. India is best example.

5. Legal-flexibility

   Legal flexibility is the degree to which the legal policies can be changed as per the nature and convenience of companies. Trade restrictions creates problem. The level of flexibility in legal policy creates favourable environment assists in identifying the level of involvement in International Business. More flexibility policy attracts International Business.

6. High costs of distance

   When there is large distance between the countries, the cost of transport cost is very high and the time required for completion become larger. Distance tends to increases certain other costs.

1.8 ADVANTAGES AND DISADVANTAGES OF IB

Despite of complexities, risks, and dynamic environment, international business is important for enterprise and nation both. IB creates numerous advantages. Gradual expansion of trade and investment between companies of different nations created global economy resulting globalisation. The following are some of the advantage of international business to the companies and the nation.

Advantage to Company

i) **Growth of higher returns:** International business is more profitable than the domestic business. When the price of domestic company product is lower than the other nation's product, the enterprise can, earn business can earn higher profits by selling their products in other countries.

ii) **Increased capacity utilisation:** In international business the firms may produce more than the consumption in domestic nation. Many times the capacity of company is more than the demand in home nation. In order to dispose that excess product the company search for market in different parts of the world. With the overseas expansion planning and procuring orders from other countries the company improves their profitability. Larger scale Production leads to economies of scale, which improves per unit profit margin and reduces production.

iii) **Growth prospects:** It is very embracing for an enterprise when they find that product of their companies is saturated in the country of origin. The company can increase their avenues by jumping into overseas markets. This is how the Multinational enterprise of developed nation enters into market of developing nation.

iv) **Deal with situation of intense competition in domestic market:** When there is tough competition in the domestic market, internationalisation helps companies to identify the potential market. Many companies adopt to go international market in the search of markets for their products. International business thus acts as a stimulator for firms facing tough market conditions on the domestic turf.

v) **Superior business vision:** The growth and development of international business in many companies is essentially a part of their business policies or strategic.

Advantage to Nations

i) **Generating foreign exchange:** With International business a country can earn foreign exchange which helps country for meeting its imports of capital goods, pharmaceutical products, technology, petroleum products and fertilisers and a host of other consumer products which otherwise might not be available domestically.

ii) **Optimum utilisation of resources:** As it is being discussed that *the core concept international business is "produce what your country can produce more efficiently, and trade the surplus production to procure what they can produce more efficiently*". If such an improved pool of goods and services is distributed fairly between nations, it benefits all the trading nations.

iii) **Enhancing employment opportunity and growth prospects:** Production of product only for domestic consumption restricts growth and employment in a country. International business helps in improving their growth prospects, but also provides opportunities for employment in these countries.

iv) **Developing standard of living:** International business encourages the trade activity between the nations, which facilitates the consumer of different countries. By offering better options of goods and services citizen enjoys a higher standard of living.

Disadvantages of International Business.

i) **International Business destructs Cottage and village Industries:**

International business is having many benefits and simultaneously it also effect the growth and development of cottage and small business by increasing the competitors. It is difficult for the village level enterprise to compete with Multinational enterprise with sound resources. In such situation either small enterprise need certain protection policy or they must be equipped with sound resources.

ii) **High level of dependence on Foreign business creates difficulties in times of need:**

International business encourages high level of participation in foreign market which creates high dependency of MNE on host nation. Technical dependency, accessories & equipments and R&D.

iii) The countries exporting raw materials and imports finished goods in return have loses and difficulty in improving the country economy:

The country which are selling raw materials and purchasing finished goods have to bear losses because the cost of raw material is always less than the finished products. The country exporting goods to another country because lack of technology they import the same goods in finished form and face lots of difficulty in improving economic status.

iv) International business exhaust host nation's irreplaceable natural resources like coal and oil:

International business exploits scarce natural resources of host nation's resources. The host nation will have to suffer losses in the long run, as their source will be dried up entirely.

1.9 DIFFERENCE BETWEEN DOMESTIC BUSINESS AND INTERNATIONAL BUSINESS

i) Nationality of buyers and sellers:

Nationality of the involved company (i.e., buyers and sellers) to the business differs between domestic and international businesses. In the domestic business, both the buyers and sellers are from the same country. It is easy to operate for both the enterprise to trade with each other and enter into business deals. But this is not same in international business where both the buying and selling company comes from different countries. There is difference of languages, attitudes, social customs, business goals and legal aspect, it becomes comparatively more difficult for both the nation to transact with one another and finalise business transactions.

ii) Citizenship of other stakeholders:

Domestic and international businesses also differ in terms of the nationalities of the other stakeholders such as employees, distributer, marketers, shareholders and customers who interact with business firms. In domestic business all resources belong to one country, and therefore decision making in international business becomes much more complicated than domestics business. The enterprises have to take decisions on different dimensions of the stakeholders belonging to different nations in international business.

iii) Movement of factors of production:

The degree of mobility of resources is low in International business. But movement of resources is high in domestic business. As a nation is favoured by same economic and socio-cultural conditions it allows free movement of man, machine material and money within the country. While the conditions are different in International business and important thing is legal restriction between the nations restrict free flow of material.

iv) Customer heterogeneity:

In domestic business there is homogeneity in customer's socio-cultural environment. In International business customer hail from different countries, they differ in their socio-cultural background. Their tastes, fashions, culture, languages, beliefs and customs, attitudes and product preferences create variations in demand for different products and purchase behaviours.

v) Differences in business systems and practices:

The differences in business systems and practices are considerably much more among countries than within a country. Countries differ from one another in terms of their socio-economic development, availability, cost and efficiency of economic infrastructure and market support services, and business customs and practices due to their socio-economic milieu and historical coincidences. All such differences make it necessary for firms interested in entering into international markets to adapt their production, finance, human resource and marketing plans as per the conditions prevailing in the international markets.

vi) Political system:

The type of government, political ideology, political risks have an intense impact on business decisions. In domestic business the business man is aware about political environment of his country and can well understand as well as predict it. But in case of International business it varies from country to country. In this way international businesses have to deals with diverse political risk and need to do lot of homework before any business transaction whereas it is very easy to operate in domestic market.

vii) Currency used:

In performing domestic business it is very comfortable for any company to deal in home nation as it is based on the concept of "One Country, One Currency". But in case of International Business it is difficult as different country have different currency and if any country imports some material then they have to make payment in selling countries currency. So in case of International business the country must have foreign of that nation from whom material is purchased. Secondly, the exchange rate keep on fluctuating, it increases the problems of international business firms in fixing prices of their products and hedging against foreign exchange risks.

S No.	**Basis**	**Domestic Business**	**International Business**
1.	Environment	The political, economic, legal, socio-cultural, competitive and technology conditions are familiar.	There is high rate of speculation in international business environment.
2.	Plan and	Both Short terms and long term planning in done. Business	Only long term planning and strategy will work.

	strategy	strategies are made on the basis of home country.	Strategic inputs are required in multiples. Business strategies are made on the basis of different countries environment conditions.
3.	Currencies and their movements	Single currency is used for all domestic business transactions. All Costing, pricing, revenue and margins are calculated in a single currency. There is low impact of volatility on business in short term and it is easy to overcome.	In International Business all payment is done in the selling countries' currency. And there is a high fluctuation in the exchange rate of currency, which varies from country to country.
4.	Business risks	In domestic business situations can be predicted as the entrepreneur are aware of domestic countries environment.	It is relatively difficult to predict the future as International business is very dynamic. An enterprise in International business has to deal in diverse situation which is very risky.
5.	Research	It is practical and simple to perform business research, demand analysis and market surveys. It is also reliable.	Capital intensive and complex. Validity and reliability depend on individual countries and there is no similarity in the output.
6.	Human resources	Domestic business have human resource from one nation with limited knowledge and specialization	Here human resources are hired from different nation with Multilingual, multi-strategic and multi-cultural sills.
7.	Organizational vision, mission and objective	Visions are designed as per single country with growth objective. It is easy to create vision as per the home nation conditions.	Visions are broadened in International business where the strategies are created with perspective different countries, and

			their cultural diversity.
8.	Product and usage	Products are designed as per the need of the domestic customer's taste, affordability, preference, nature, customs, values and buying behavior.	Products are designed as per the need and demand of different country, which varies from country to country as per the different culture and customs.
9.	Legal aspects	The legal aspect of home nation is considered and it is convincing and flexible.	In International business trade policy of home nation with respective to different country and host country regulations are considered.
10.	Investment and Sourcing	Can be easily started on the basis of size of the business with a minimum investment. The fund is determined on the basis of Individual ability and repayment terms.	Heavy investments are needed for setting up and expanding the business in multiple countries.
11.	Pricing strategy	In domestic business majority of companies uses cost plus margin pricing or competitive pricing.	In International business companies are using marginal cost pricing or transfer pricing or competitive pricing.
12.	Distribution channels	The company in domestic business use channels of distribution as per their convenience and nature of product.	Government policy and market practice governs the distribution channel. Exporters are used while selling product at initial stage.
13.	Promotion	Advertising, personal selling and other promotional activities are very flexible.	Different countries have different language and culture. Product promotion and selling is done on the basis of demographic characteristics
14.	Logistics	Domestic players are involved in all the activities.	International players with superior skill and systems are involved.

1.10 SIMILARITIES BETWEEN DOMESTIC AND INTERNATIONAL BUSINESS

There are some similarities between domestic and international business in terms of goals and objectives of the company:

1. Generating revenue- either by creating opportunities or by optimizing strengths
2. Corporate image building
3. Customer satisfaction and building loyalty as patronage buyers
4. Carrying out their operations respecting and adhering to local regulations
5. Generation of employment opportunities
6. Both are subject to a set code of conduct and ethics that includes corporate governance.
7. Mass production through cost reduction and achieving economies of scale
8. Building a strong network in order to make product and services available in any part of the nation or world
9. Adapting new standards and change in style and function.

1.11 MEANING OF GLOBALISATION

Globalization is the "strategy of optimizing" the resources available in various countries and catering to customers throughout the world with internationally standardized products, at competitive prices. It advocates that the nation or a company or product involved should be global. A global human is one who is born one nation, studies in another nation, having business operations in some other country and identify multiple business opportunities in multiple nation and in this way he becomes a part of globalization process.

Globalisation is integration of national market, investment, cultures, economies, industries and technology around the world through global network of transportation and communication migration.

Globalisation is basically a condition where imports duties are reduced, removal of Non-Tariff Barriers, import licensing, allowing Foreign Direct Investment (**FDI**) and Foreign Portfolio Investment (**FPI**). FDI and FPI are two ways through which foreign investors can invest in an economy.

According to IMF "The growing economic interdependence of countries worldwide through increasing volume and variety of cross border transactions in goods and services and of international capital flows, and also through the more rapid and widespread diffusion of technology."

STAGES FOR GLOBALIZATION FOR AN ENTERPRISE

Phases	Objective	Strategy	Anticipated risks and obstacle	Results
Phase:1	"Movement of products (goods and services) from the nation of its origin".	(i) Identify one country with market potential. (ii) Focus on single product or services. (iii) Assessing opportunity for exports.	(i) Local struggle for bringing. (ii) Technical and commercial barriers. (iii) Competitive forces from local and imported goods.	(i) Entry into one nation- successfully. (ii) Learning experience in a country outside.
Phase:2	"Reinforcement and stability in one overseas market."	(i) Build a strong association in single market. (ii) Encourage brand presence with customers and channels.	(i) Home nation competitors pose threats. (ii) Price warfare is inevitable.	(i) Reinforce one country by overcoming all the challenges. (ii) One or few importers extend co-operation and support for steady flow of goods.
Phase:3	"Set up manufacturing plant in the host nation".	(i) Narrow down to one local partner in host country. (ii) Establish an ideal place for production.	(i) Competitors raise their production capacity. (ii) Local regulations on labour and infrastructure may trouble the process.	(i) Domestic production brings down the cost. (ii) The company get close to the customers. (iii) Establishment of Brand loyalty.
Phase:4	"Expand sales & distribution and increasing production function in the region".	(i) Enlarging network in the adjacent nations. (ii) Setup warehouses / sub-dealer network in the state.	(i) All part of the region works differently. (ii) Policy and Rules are not uniform. (iii) Demand level	(i) Access in the entire region. (ii) Easy to test in other regions. (iii) Revenue is better.

			is not uniform in all country.	
Phase:5	"Shift to other regions by investing and producing".	(i) Locate subsidiaries. (ii) Develop networks. (iii) Introduce right people. (iv) Flexible to local environment.	(i) Diverse cultural complexities. (ii) Local flexibility. (iii) Promotional obstacles.	(i) Global take off assured. (ii) The company has a competency in skill and knowledge to go global.
Phase:6	"Global state of mind, customer orientation and regular novelty".	(i) Globalisation of Market. (ii) Globalisation of Investment. (iii) Globalisation of Technology.	(i) Challenge on governance. (ii) Ethical principles. (iii) Focuses on the locals. (iv) Human Resources complexity.	(i) Global Investment. (ii) Global proficiency. (iii) Global branding. (iv)Global organising.

Check Your Progress- A

Q1. Briefly explain the characteristics features of International Business.

Q2.Why is managing international business more complex than managing domestic business?

Q3. What are the different phases in the evolution of International Business?

Q4. Multiple Choice questions

Select the correct option:

i. Consumers in different countries differ in the speed with which they adopt new products, because of:
   a. economic reasons
   b. attitudes toward new products
   c. both of the above
   d. none of the above

ii. Import substitution aims at:
   a. reducing imports of manufactures
   b. saving foreign exchange
   c. reducing jobs
   d. reducing dependency on other countries

iii. The balance of trade forms part of the
   a) current account
   b) capital account
   c) none of the above
   d) both of the above

iv. NAFTA is an example of:
   a) Common Market
   b) Custom Union
   c) Economic Community
   d) Free Trade Area

B. State True or False:

v. Internal and external factors of globalisation can be divided into market, benefit, environmental, and competitive.
vi. Direct involvement in exporting means that the company works with and develops a relationship with foreign customers, suppliers or markets.
vii. Licensing is the granting of the right by a parent company to another, independent entity to do business in a prescribed manner.
viii. Companies who do not want to invest a significant amount of money on foreign

operations costs might consider selling products through a foreign intermediary.

1.12 SUMMARY

In this unit we discussed the concept of International Business; International Business is performing trade between two or more countries. When an enterprise expands its business operation in more than one Nation with an objective of targeting and serving the global customer it is called International Business. The topic covered are features of International Business, Importance of IB to home nation, Importance of IB to host nation and to the Company. The unavoidability of globalisation is very well explored by management Guru Peter Ducker in his Book "*Management Challenges for the 21st Century:* All institutions have to make global competitiveness a strategic goal. No institution, whether a business, a university or hospital, can hope to survive, let alone to succeed, unless it measures up to the standards set by the leaders in its field, any place in the world."

After that evolution of International Business is discussed. During late 1960's and early 1970's Arabian countries recognised that they are having rich source of crude oil but they were not having sufficient technology for extracting it. And there were certain countries which were searching for sources of raw material around the world. Some countries were rich in resources and other was having technology, in this way the interdependence generated companies to enter into International business. The companies searching for raw material were called Raw material seekers.

Advantages and disadvantage to home nation and host nation is discussed. International Business is an activity that involves the transfer of resources, goods & services, specialisation and information across national borders. Globalisation has created lot of new opportunities for the growth and development of International Business. We are living in an environment with cross-border business with fewer obstacles, where the economy of different nation is integrated into world economy and no doubt to say world has become global platform and global market.

After that Difference and similarities between domestic and International business was highlighted. The main objective behind studying International business is three decades ago very few companies ventured into international field, and most of them restricted themselves to physical movement of goods and services i.e. exports and imports. Restrictions, regulations and other barriers didn't allow them to take risks. Presently, the world has become an open market. Duties, license quotas, restrictions and other investment limitations have gradually been eliminated. Anyone can do business in any part of the globe. Risk factors are properly analyzed and evaluated and most of information about them is easily accessible. The aspirant entrepreneur can go to anywhere and explore opportunities. Most of the companies are entering into international business which provides them abundant opportunities for development and improved returns.

In this unit, attempts are made to familiarise with the basic concepts of International trade; history and Evolution, scope of International Business, objectives of International business, importance and factors effecting International business, types and strategy of International business. International business has become an important aspect for success of a company, which serves its global markets in a unique and better in this competitive world. The globalisation is also discussed in this chapter.

1.13 GLOSSARY

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

Absolute advantage: A country has an absolute advantage in the production of a product when it is more efficient than any other country at producing it.

Arbitrage: The purchase of securities in one market for immediate resale in another to profit from a price discrepancy.

Bill of exchange: An order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time.

Social mobility: The extent to which individuals can move out of the social strata into which they are born.

1.14 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress –A

Choose the correct alternative

i. c
ii. b
iii. a
iv. d

Check Your Progress –True/False

v. False
vi. True
vii. True
viii. True

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1.17 TERMINAL QUESTIONS

Q1. What are the barriers to international trade? List and explain all the types of barriers to international trade.

Q2. Why do companies import goods rather than produce them in their own country? Provide two reasons?

Q3. What are the factors causing conflict in international business?

Q4. Elucidate the political, economic and cultural environment of international business with real world example.

Q5. Is globalisation desirable for the Indian economy? Substantiate how globalisation will benefit the Indian Economy.

Q6. Discuss the history and process of globalisation and state its merits and demerits in the Indian context.

Q7. Write a detailed note on the necessity and economic benefits of international and foreign trade.

Q8. “The study of international business is fine if you are going to work in a large MNC, but it has no relevance for individuals who are going to work in small firms.” Comment.

Q9. In the light of the theory of comparative advantage, comment on the pros and cons of free trade.

Q10. What are Multinational Corporations? Give the arguments in favor of and against the MNCs from the point of views of the Indian business and trade.

Q11. What are the factors that affect the environment of an International business? Explain in brief. How do the political and legal factors influence the International business of a country?

UNIT 2 INTERNATIONAL BUSINESS: MODES, ENTRY, APPROACHES AND TYPES

2.1 INTRODUCTION

In an increasingly global environment, most of businesses may find international expansion to be a striking option for market extension. Entering an overseas market is complex process, there are numerous options for companies to enter a foreign market. There are several ways a company can enter a new country such as: an exporter; through a licensing agreement; in a joint venture; or by way of a wholly owned subsidiary. So it is important for managers to understand these different entry strategies before entering a new country.

When an enterprise expands its business operation in more than one nation with an objective of serving the global customer it is called International Business. Companies all over the globe are undergoing an elementary movement from independent to dependent on other nations from procuring raw material as well as supplying their products and services at minimum cost.

The unavoidability of globalization is very well explored by management Guru Peter Ducker in his Book "*Management Challenges for the 21st Century:* All institutions have to make global competitiveness a strategic goal. No institution, whether a school, a business, a university or hospital, can imagine to survive, unless it measures up to the standards set by the leaders in its field, any place in the world." As there is mounting trend towards a borderless business and due to increasing Privatization, liberalization, WTO mandated, gradually diminishing barriers to cross-border business. And, "Globalization, for better or worse, has changed the way the world does business... it (globalization) is all but unstoppable. The complexity that individuals and business face is learning how to live, manage and take benefit."

A company has many different entry modes to decide from, when it decides to internationalize its business operations. The external environment is so dynamic it impacts the internal decisions which create conditions that large number of companies expanding their business operations across country borders. Factors such as: the eradication of trade barriers, free trade agreements between nations stimulates the thought of entering global more attractive to organizations across the world. Rising profits, becoming a global brand and growing market share are motivating the organizations to globalize. As there are many drivers of internationalization and prospective opportunities to internationalize, there is no outstanding entry mode. As different companies have different cause for entering global, this will have an influence on selection of best mode of entry is suitable to them. In order to choose the entry mode, companies need to identify their required level of flexibility, presence, risk and control. Licensing, Exporting, Joint venture franchising and wholly owned subsidiary are foreign entry modes. The Modes of entry into an international business are the channels which organization employs to enter into a new international market.

This unit considers a number of key alternatives to enter into international market such as, Exporting, Licensing, Franchising, contract manufacturing, Strategic Alliances, Joint Ventures, Contract Manufacturing, Whole Owned subsidiary, Merger & Acquisition and Green field operations discussed in the later part.

Presently, the world has become an open market. Duties, license quotas, restrictions and other investment limitations have gradually been eliminated to an extent. Anyone can do business in any part of the globe. Risk factors are properly analyzed and evaluated and most of information about them is easily accessible. The aspirant entrepreneur can go to anywhere and explore opportunities. Most of the companies are entering into international business which provides them abundant opportunities for development and improved returns.

Factors like finance flow or investment plays significant role in International trade. Right technology is a pre-requisite to manage business internationally to manufacture goods. There should also be substantial market to generate revenue. To manufacture goods in any country, raw material, components, consumables and capital items are required. Easy access to all resources is easy quite similar to domestic procurements, today.

This unit attempt to highlight the different modes entering foreign market. It also discusses what organizational situation, goals, and objectives are best appropriate to the types of diverse entry modes. Examples of various organizations are also being quoted in the text which has used these, different entry modes while expanding their operations globally. There is no single entry mode that is superior to another; a company's internal resource and capabilities, and the environment of the country of entry are other important factors for selecting the foreign entry mode.

2.2 LEARNING OBJECTIVES

After studying this chapter you should be able to:

- To analyse the driving forces and various complexities of international business.
- Various entry strategies, Modes and Entry in International business.
- Various approaches to International Business.
- Factors effecting International Business.

2.3 INTERNATIONALISATION STAGES

Most of the companies go through different stages of internationalization. There are several enterprises that have international business since their establishment, that include 100 per cent export-oriented companies. Development of hundred per cent export-oriented companies passes through different stages of evolution in international business.

All company which is completely domestic becoming a truly global generally passes through various phase of internationalization. There are several companies which passionately and systematically enter international market as part of their corporate planning. However, initially many firms remain passive towards the international business and they get into the international business in response to some external factor. Most of the organizations involved in overseas business initially started with limited operations and low level of involvement but they gradually expanded. The stages in the evolutionary process are the following:

a) **Domestic company:**

Maximum international companies begin their business as domestic companies. This approach is called ethnocentric orientation. Initially a company operates domestically because initially they do not have sufficient resources to operate in international market. A home company may extend its products to foreign markets by exporting, licensing and franchising.

b) **International companies:**

International company are importers and exporters, they do not have investment outside of their home country.

c) **Multinational companies*:***

It is also called MNE (Multinational Enterprise) and MNC (Multinational Company) MNE's have investment in different other nation, but do not have coordinated product offerings in every country.

d) **Global companies:**

The Global companies have presence and investments in most of the nations. They introduce their products by using brand image in all markets. For global strategy generally a corporate office is responsible and stress is on volume, efficiency and cost management.

e) **Transnational companies:**

TNCs are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A parent enterprise is “an enterprise that controls assets of other entities in countries other than its home country, usually by owning a certain equity capital stake”. They are complex company in nature. They have investments in foreign operations, have a corporate facility and they are actively involved in decision-making, marketing policy and R&D to each individual overseas market.

f) **Multinational Corporation:**

According to the International Labor Organization (ILO), "the essential of the MNC lies in the fact that its managerial headquarters are located in domestic country (home country), while the enterprise carries out operations in a number of the other countries (host countries)."

A "multinational corporation" also referred to as an international, transactional or global corporation. Multinational is a foundation step, for expanding firm as it gradually becomes transnational and then turns into a global corporation. Transnational Corporation is a stage where, the ownership and control of the concerned organization crosses the national boundaries.

2.4 APPROACHES TO INTERNATIONAL BUSINESS

An orientation is an assumption or belief, often unconscious about the nature of the world. Dr. Howard Perlmutter, Professor in the University of Pennsylvania firstly observed three basic orientations guiding the international executives: i.e. EPG (Ethnocentric, Polycentric and Geocentric). Afterwards Regional orientation was included in EPG and became an EPRG scheme (Ethnocentrism, Polycentrism, Regiocentrism, Geocentrism).

Ethnocentric Orientation: The ethnocentric orientation is an assumption that the home nation is superior than other nation and the product that are superior in domestic country will work successful in host nation so should be used everywhere. In the ethnocentric approach, domestic operations are given priority than overseas operations and home countries strategies are prime means of disposing of excess domestic production. Strategies for overseas markets are developed in the home nation utilizing policies and procedures identical to those employed first at home country. The home nation product is offered in the overseas without conducting marketing research in the targeted market. No changes are made to the product offered to domestic’s country and foreign market consumers need is not considered.

Polycentric Orientation: The polycentric orientation is the opposite of ethnocentric approach. It is true that all countries are unique and different in their characteristics like culture, language, taste, life style, living standard, political, economic, technological aspect. In order to succeed each company must identify every country's unique features and serve the different countries as different market. In this phase, subsidiaries are established in different overseas markets. Each subsidiary operates independently as per their country and establishes its own marketing objectives and strategies. Marketing strategies is organized on a country-by-country basis, with each market is having its own unique marketing policy.

Regiocentric Orientation:

Regiocentric orientation and polycentric are similar, but an organization not only recognizes the particular nature of diverse foreign markets, but it also perceives some similarities of these foreign markets. As a result, it makes groups of similar markets (regions) with similar characteristic features (Radomska, 2010).

In other words, similarities among the countries and their markets placed in one region are used in order to develop an integrated regional strategy (Bartosik-Purgat, 2010). It should be notice that groups of countries naturally emerges due to processes of trade liberalization. Examples of such regions are NAFTA and the European Union.

Market segmentation is based on finding regions (groups of countries) similar to each other. These similarities may exist on the economical, cultural or political background.

For example: General Motors. The company has significantly different strategies in Asia Europe and Americas. Top managers in different regions have significant freedom in decision making. Regiocentric orientation is typically associated with the increase in decentralization in the enterprise. Kajda (2009)

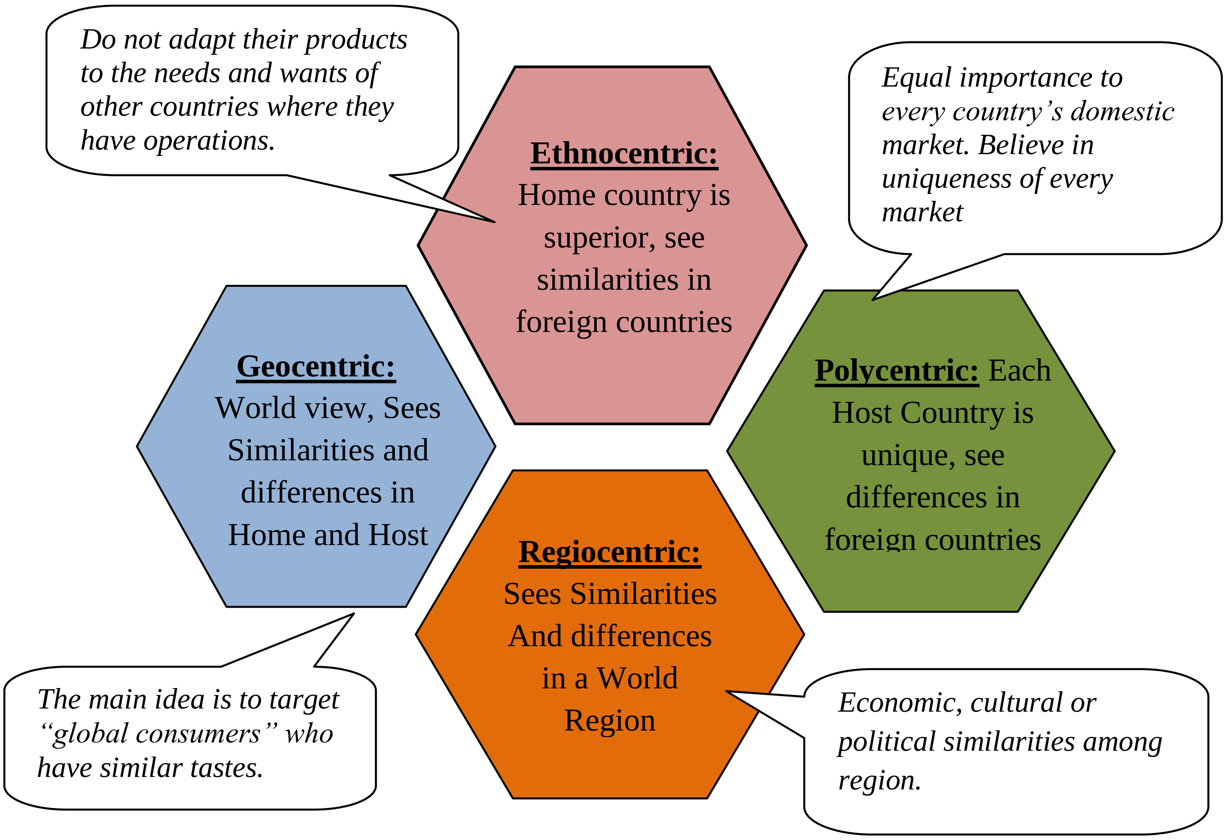

Fig 2.1 EPRG Framework

Geocentric orientation:

According to Keegan and Schlegelmilch (1999, p. 21) "the geocentric orientation represents a combination of polycentrism and ethnocentrism; it is a "worldview" that sees similarities and differences in markets and countries, and seeks to create a global strategy that is fully responsive to local needs and wants."

Geocentric orientation is the one, which is present when an organization treats all foreign markets as the one, i.e. global, market. The global market is a market, i.e. sociologically and economically the same. This similarity is much simplified, but a geocentrically oriented organization assumes that some differences can be deliberately forgotten. Moreover, that customer would accept such a universal approach (Radomska, 2010). It is also exciting that the technological advancement and the exchange of information allow the formation of global, transnational enterprises since the very beginning of their existence. They are sometimes called "born global" (Radomska, 2010). Such companies produce unique, specific products. For example, computer software, or a high-tech medical equipment.

In this, the company views the region or entire world as single market and always tries to design integrated market strategies whereas the geocentric orientation is a combination of the ethnocentric and the polycentric orientation. The regiocentric orientation kind of geocentric orientation that is restricted to a region which means that is, management will see the region as a world, but will regard the rest of the world with either an ethnocentric or a polycentric orientation, or a combination of the both.

The ethnocentric orientation is centralized in its marketing strategies, the polycentric is decentralized in organizational policies, and the regiocentric and geocentric companies are integrated. As per the ethnocentric orientation, home-country products are superior to other available. In the ethnocentric home country products, polices, and programs are extended to other nation. The polycentric approach believe that there are cultural, economic, and market conditions differences between countries in the world so it is impractical to introduce any product, policy, or program from other nation or to integrate any country‘s program. To implement the geocentric approach, dynamic team, international experienced management and a great deal of commitment are required.

Ethnocentrism	**Polycentrism**	**Regio-centrism**	**Geocentrism**
Main decisions made in the headquarter	Minor role of the main headquarter	Main decisions made in regional headquarters	Collaboration with local headquarters
Home standards applied on all markets	Local standards applied on local markets	Regional standards in regions	Universal standards
Focus on domestic objectives	Focus on local objectives	Focus on regional objectives	Focus on global objectives
Identification with the owner's nationality	Identification with the nationality of host country	Identification with the region	Global view
High positions taken by managers from owner's country	High positions taken by local managers	High positions taken by regional managers	Having an experience in different countries is a must to take a high position

2.5 INTERNATIONAL BUSINESS ENTRY STRATEGIES

The decision to enter in international business will affect the company's other functional. One wise decision will add value to the brand whereas a small mistake creates unnecessary trouble in long run. The firm needs to decide on several issues.

- The target product/market,
- The goals of target markets,
- The mode of entry,
- The time of entry,
- A marketing-mix plan, and
- A control system to monitor the performance in the entered market.

Company need to ponder upon major decisions that constitute market entry strategies. Selection of potential target markets is a critical step in developing an international expansion strategy. Companies can adopt many different approaches to pick target markets.

Following are steps explaining the initial screening process.

Step 1: Select indicators and collect data.

Firstly, to pick a set of socio-economic and political indicators those are critical. The indicators that a company selects are driven by the strategic objectives highlighted in the company‘s worldwide mission. For instance, Colgate-Palmolive and Coca-Cola views per-capita purchasing power as a major driver behind market opportunities. McDonald‘s starts with countries that are same to the United States in lifestyle, country with a large population of women working. Information on these country indicators can easily be gathered from authentic available sources. Generally, countries that do well on one indicator, rate poorly on other indicators. We need to match available information to come up with an overall measure of market attractiveness.

Step 2: Evaluating importance of country indicators.

The next step is to determine the weight of each indicators of the different country. Constant-sum allocation technique is one common method. After that allocate one hundred points across the set of indicators according to their significance in achieving the company‘s objectives. So, the most critical indicator will be allocated higher number. The total number of points should add up to 100.

Step 3: Rate the countries in the pool on each indicator.

In this step, each country is scored on each of the indicators. For example, 7-point likert scale (1 meaning very unfavorable; 7 meaning very favorable). Higher the score the better country does on a particular indicator.

Step 4: Calculate overall score for each country.

At last, derive an overall score for each prospect country. Calculate the weighted scores that the country obtained on each indicator. Countries with the maximum overall scores are the one that are most attractive.

2.6 MODES AND ENTRY TO INTERNATIONAL BUSINESS

Modes of entering international business, are the channels which a company adopt to enter a new international market. In this unit modes of entry into international business such as the Exporting, Licensing, Franchising, contract manufacturing, Joint Ventures, whole owned subsidiary, Merger & Acquisition and Green field operations.

a) Exporting

Exporting is the easiest method of entering a foreign market. The company uses its existing resources of home nation for production & distribution. It manufactures goods in home nation and exports them beyond its borders into another country's market. By exporting, a company is able to enter other country without actually establishing its operations in another country. The product manufactured could be shipped to the overseas country. Exporting is a cross border sale of domestically grown or produced goods (Cavusgil, 2004). Exporting has become more common across the world due to the elimination of trade barriers, and advancement in transport, technology, communication modes are becoming cheaper and more efficient (Shaver, 2011). There are three types of exporting: indirect exporting, direct exporting and cooperative exporting. Indirect exporting is very low risk entry mode as there is effectively no direct exposure to the foreign market and its associated risks (Kotler & Armstrong, 2012). The following are three types of exporting:

i) Direct Exporting,

ii) Indirect Exporting and

iii) Cooperative Exporting

i) Direct exporters sell directly to overseas buyers and may have sales teams in those countries. Direct exporting is a very ordinary entry mode used by organizations that want coverage in a foreign market, but want to limit the risks associated with other types of entry modes. A direct export doesn't involve an agent to sells the good to the intermediary. The Red Bull an energy drink supplier from Austria entered Australia using direct export as its entry mode. It is the leading energy drink brand in the Australian market, it is holding more than 36% market share (Speedy, 2011). So exporting can be a one of the successful foreign entry mode strategy.

ii) Indirect exporting is the very small risk entry mode as there is no exposure to the foreign market and its associated risks (Kotler & Armstrong, 2012). The enterprise is only selling their product to a mediator (agent) in the foreign market who sells the product to an intermediary. This is a ordinary method used by company when they first enter a new countries market. The receptive of their brand and product in foreign market is test by choosing indirect export as an entry mode. After successful acceptance in foreign market, the company goes for further establish their presence in the foreign market with higher commitment and higher presence as well as higher risk foreign entry mode strategies (Cavusgil, 2004).

iii) Cooperative exporting is done by an agreement with another foreign to use its distribution network (Kotler & Armstrong 2012). This allows company to enter the foreign market without the associated risks. Cooperative exporting is equally advantageous, provided the goods being exported don't hamper the sale of other products being sold (Kotler & Armstrong, 2012). For the successful Cooperative exporting, the exported product should match, as resist to compete against other products being sold. Wrigley, a chewing gum Company of US successfully entered the Indian market using cooperative export. They have a cooperative export agreement with Parrys, a local confectionery company; with this Wrigley got advantage to access 250,000 retail outlets (Kotler & Armstrong, 2012).

b) Licensing

International licensing is a cross border contract that allows company in the target countries markets the privileges to use the assets of the licensor (Kotler & Armstrong, 2012). Licensing is a contractual arrangement where the licensor company offers some proprietary resources to a foreign company-the licensee-in exchange for royalty fees. These assets are usually intangible that include patents, copyright, trademarks and production techniques. The licensee company has to pay a fee for the specified rights in the contract. It has low risk and has low exposure to economic as well as political conditions, has high return on investment and is preferred by domestic country governments (Agrawal & Ramaswami, 1992). For example: Microsoft Corp and Walt Disney Co are two examples of large multinationals that have used licensing as their entry mode.

Licensing involve franchising, Turnkey contracts and Contract manufacturing.

I. In Licensing a fee and/or royalty is charged for the use of its technology, brand and/or expertise.

II. In Franchising, the franchiser providing branding, concepts, expertise. Examples include Dominos Pizza, Coffee Republic and McDonald's Restaurants.

III. A turnkey project includes the training & development of core employees where skills are sparse – for example, Toyota's car plant in Adapazari, Turkey.

c) Franchising:

Franchising is a foreign market entry approach where the franchisee pays fees and royalties to the franchiser to use a company's trademark and sell its products and/or services (Kotler & Armstrong, 2012). The franchise conditions depending on the contract, it generally includes: operations and management manual, equipment, staff training and location consent (Alon, 2014). The common advantages of franchising are that it capitalizes an already successful strategy, the franchisee usually has knowledge about the market, it's less risky than equity based foreign entry modes, and the franchisor isn't exposed to risks associated with the foreign market (Alon, 2014). Pizza Hut, McDonalds, Subway and 7-Eleven.

Franchising is a conventional and successful method for foreign market entry, but there are a few limitations. This leads to decrease of brand quality because they do not have full control over franchises, not maximizing profit as franchisor only receives a royalty fee and not the full profit made, and the possibility of nurturing a future competitor.

d) Contract Manufacturing :

In this MNC contracts with a local firm to provide manufacturing services. The arrangement is akin to vertical integration, except that instead of establishing its own production locations, the MNC subcontracts the production. With contract manufacturing, the company arranges with a local manufacturer to manufacture parts of the product or even the entire product. Marketing is still the responsibility of the international firm. Several companies have become successful by specializing in contract manufacturing.

NatSteel Electronics (NEL) Singapore based company is one of the leading global electronics contract manufacturers, has facilities in countries such as China, Indonesia, Malaysia, and Mexico. Its include Fortune 500 companies such as Compaq, IBM, Apple, and Hewlett-Packard.

Cost control is the prime motivation behind contract manufacturing. Cost savings can be achieved effectively for labor-intensive production processes by sourcing the product from a low-wage country. Savings can also be achieved via taxation benefits, lower energy costs, raw materials costs, or overhead. Monitoring of quality and production levels is a must especially during the start-up phase.

e) Joint Ventures (JV) or Strategic alliances

When more than two companies agree to pool their assets, it is called a joint venture. The unique feature of joint venture is its shared ownership. Joint Ventures tend to be equity-based i.e. a new company is set up with parties owning a proportion of the new business. Joint ventures have the benefit of providing companies with a partner who knows the local environment well. The reasons behind the companies entering Joint Ventures are: Access to technology, core competence and management skills. For example, Honda’s relationship with Rover in the 1980’s was to gain entry to a foreign market. For example, a company wants to enter China needs to source local Chinese partners. Manufacturing, Access to distribution channels, and R&D are most common forms of Joint Venture. The drawback of a joint venture is that it does not give a company entire control over the function.

The main limitation in this situation is the local government. A domestic government (home nation) may enforce strictness on wholly owned foreign investment for few reasons, such as: threat to local players, threat to the environment, threat to the long term prosperity of the industry etc.

For example, the Singapore Airlines entering the Indian market. The Indian government imposes restrictions on foreign airlines entering the local airline industry as a wholly owned subsidiary (The Indian Express, 2014). Conversely, Singapore Airlines entered a joint venture with the Tata group, and owns a 49% stake in the SIA/Tata alliance (The Indian Express, 2014). At the same time SIA wanted to enter the Indian domestic airline market with maximum presence, entering as a wholly owned subsidiary was not possible. The best entry mode for SIA was Joint venture, it allowed, maximum flexibility, maximum coverage, maximum potential rewards and maximum commitment.

f) **Wholly Owned Subsidiary**

A wholly owned subsidiary is the method where an organization enters a foreign market with 100% ownership of the foreign entity (Yiu & Makino, 2002).

Companies often prefer to enter new markets with 100 percent ownership in foreign markets by two ways: acquisitions, where a company buys up existing companies, or Greenfield operations that are started from scratch. Acquisition is the purchase of a foreign company as a means to enter a new marketplace. A Greenfield operation is the formation of a new company and legal entity in the overseas market. Many organizations that want to control their risk, while maximizing their disclosure to the foreign market will choose acquisition as overseas entry mode. In acquisition an already established company’s brand name and customer base is enchased. Acquisition and Greenfield both are equally beneficial and don’t have superiority over one another, the selection of entry mode depend on organizations environmental conditions, objectives and goals.

The common stock of these company is fully owned by another company, known as the **Parent company**. A company that enters a market as a wholly owned subsidiary has: high control, presence, commitment and high risk/reward. It allows an organization to reach diverse markets, different industries and geographic regions. in the course of entering the potential markets and with competent management a wholly owned subsidiary is a protection against environment changes, such as political, legal and speculation in different sectors (Yiu & Makino, 2002).

g) Mergers and Acquisitions

In this, the domestic company selects and merges itself with an overseas company. The foreign company acquires the control of ownership which gives an outstanding competitive advantage over others. These companies build strong manufacturing services and marketing arrangement. For example, Tata bearing acquired Metal Box in India. Proctor & Gamble entered Mexico and became leaders, in four-five years by acquiring Loreto. The acquisition cost is comparatively low, simple and prompt. It is having some disadvantages:

- The host countries may impose strict restrictions on acquisitions.
- It is a complex task involving banks, lawyers, lawyers, and politicians.
- The work force problem is a huge challenge to acquisitions particularly in developing nations where unemployment is a serious issue.

Laxmi Niwas Mittal, the worldwide Steel-King, started and continued its successful acquisition of steel mill in Indonesia, which continued in Trinidad, Kazakhstan, Hungary and many others. Hindalco Industries Limited, metals Flagship Company of the Aditya Birla Group, is the industry leader in aluminium and copper. The Hindalco acquisition of Novelis has strengthened its market access for non-ferrous category and production synergy in the worldwide market.

h) Greenfield Operations:

It offers the more flexibility than acquisitions in areas such as plant layout, human resources, logistics, suppliers, or manufacturing technology. Greenfield investments avoid the costs of integrating the acquisition into the parent company. Another motivation is the package of goodies (e.g. tax holidays) that host government sometimes offers to sharpen the desire of foreign investors. The drawback of Greenfield operations is that they require huge investments of time and capital. Brownfield involves purchasing an existing company in a foreign country. Brownfield developments can be beneficial because they offer local expertise, but they can be complex because there may be resistance from those in the company.

i) Turnkey projects:

A turnkey project is an agreement under which a company is fully involved in creating, designing and provide the production facility and handover the project to the purchaser on completion in operational condition.

It includes from investment, supply of human resource and creation as well as setting up of plant. The company either gets a fixed fee or the cost plus profits over a specific time period. Projects like railway lines, metro train, airports, power plants, dams, highways and refineries are undertaken on a turnkey projects. L&T, Mitsubishi, Hyundai, Brown Bovery and Daewoo are turnkey contractors for international projects. Terms like BOT (Build, Operate and Transfer) and BOOT (Build, Own, Operate and Transfer) are used depending upon the level of participation and obligations. In turnkey projects, the contractor is capable of cutting costs on material and manpower or finances or speed of completion, as each element increases profitability.

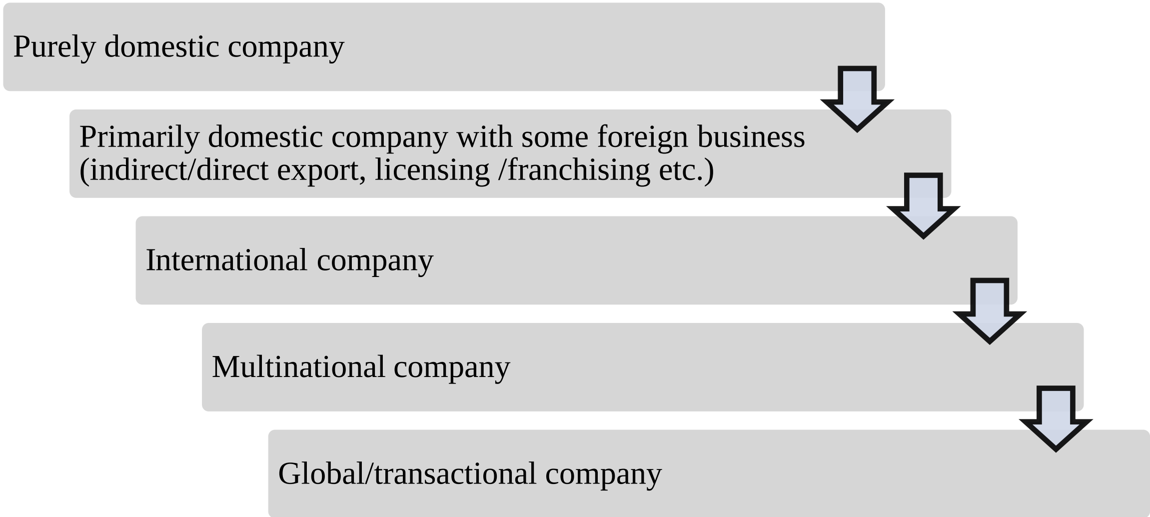

Fig 2.2 Purely Domestic Company to Global/transactional Company

2.7 FACTOR EFFECTING INTERNATIONAL BUSINESS

The following are some decision criteria that influence the selection of mode of entering international business. In general, two factors are responsible for selection of mode of entering.

1. Internal factor (Company-specific)
2. External factor (Environment-specific)

The major external factors are:

As external factors those factor that exist in the external environment which are beyond the control of the company.

A. Targeted Market Size and Growth: Size of the market is the key factor for entry choice decision. Large markets validate major resource commitments in the form of joint ventures or wholly owned subsidiaries. Market opportunity can relate to the current market size. Forthcoming business opportunity is measured via the expansion rate is often even more crucial, mainly when the target markets include emerging markets.

B. Risk: It is another major concern while choosing entry modes. Threat relates to the unpredictability in the political and economic atmosphere that may impact the company‘s business opportunities. The greater the risk involved, the less ready companies are to make resource commitments to the country.

The degree of risk changes over time. For example, the harmony process in the Middle East and the abolition of the apartheid regime in South Africa has attracted many MNCs to these regions.

C. **Government Regulation:** Government regulations are also one of the most important factors in entering international business. Trade barriers of all different kinds control the entry choice decision

D. **Competitive Environment:** The character of the competitive situation in the home market is one more driver. The supremacy of Kellogg Company as a universal player in the ready-to-eat cereal market was a key motivation for the making in the early 1990s of Cereal Partners international, a joint venture between Nestle and General Mills. This joint venture gained some market share in various markets, however mostly at the expense of few players like Quaker Oats and Ralston Purina.

E. **Local Infrastructure:** The infrastructure of a market refers to the country‘s distribution system, logistics, transportation and communication network. The poorer the local infrastructure, the more averse the company is to commit major resources.

The major internal factors are:

A. **Company objectives:** Company objectives are a key factor in selecting entry modes. Firms that have minimum ambition of achieving will usually prefer entry options that involve a minimum amount of commitment (e.g., licensing). The companies with ambitious calculated objectives will generally pick entry modes that give them the flexibility and control to achieve their goals. The company is setting up factories in Central Europe and China and a joint venture in India with Tata, a truck company, to attain its target of a 15-20 percent market share of the world tire market.

B. **Need for Control:** MNCs would like to have a certain control over their foreign operations. Control may be desirable for any element of the marketing-mix: product, pricing, positioning, and advertising correlated with the amount of resource commitment: the smaller the commitment. For example Caterpillar, prefers to continue in complete control of its abroad operations to protect its proprietary know-how. Caterpillar avoids joint venture. So, most firms face a trade-off between the degree of control over their foreign operations and the level of resource commitment they are willing to take.

C. **Internal Resources and Capabilities**: Companies with limited resources have constrain to low commitment such as exporting and licensing that are not too demanding on their resources. Large companies should carefully allocate their resources between their diverse markets, including the home country market. In few cases, major resource commitments to an identified potential market might be premature in given the amount of risk. If a firm is too hesitant with committing resources, the firm might miss by sacrificing major market opportunities. Internal strength also influences the choice-of-entry mode. When the company lacks certain skills that are essential for the success, the company tries to fill the gap by a strategic alliance.

D. **Flexibility:** As local environment constantly changes new market segments come out. Local customers become demanding or price conscious. To handle the environmental changes, global players require certain flexibility. The flexibility offered by the different entry-mode alternatives. Contractual arrangements like joint ventures or licensing tend to provide little flexibility. When important exit-barriers exist, wholly owned subsidiaries are hard to divest in.

2.8 INTERNATIONAL BUSINESS DECISIONS

A firm which plans to go international has to make a sequence of strategic decisions. They are discussed below:

(i) **International Business Decision:** The first and foremost decision a company has to make, is whether to enter international business or not. It is based on a serious consideration of a number of essential factors, such as the existing and prospective overseas opportunities, present and upcoming opportunities in domestic market, the assets of the company (particularly skill, experience, production and marketing capabilities and finance), company objectives, etc.

(ii) **Market Selection Decision***:* After the international business decision, the next essential step is the selection of the most suitable market. For this reason, a systematic analysis of the competence of the diverse overseas markets and their individual marketing environments is crucial. Company possessions and objectives may not allow a company to enter in all the overseas markets. Further, several markets are not potentially good, and it may be desperate to misuse company resources in such markets. An appropriate selection of the overseas market(s), therefore, is very significant.

(iii) **Entry and Operating Decisions:** After the market selection decision, The next main task is to find out the appropriate mode of entering the overseas market.

(iv) **Marketing Mix Decision*:*** The overseas market is considered as a number of uncontrollable variables. The marketing mix includes internal factors which are controllable. The effectiveness of international marketing depends on the suitability of the marketing mix. The elements of the marketing mix — product, price, place and promotion should be properly designed so that they may be modified to the features of the foreign market.

(v) **International Organization Decision:** A company that wants to enter foreign market through direct exporting has to decide about its organizational structure, so that the exporting task may be appropriately performed. The decision should be based on a careful consideration of expected quantity of export business, the nature of the goods & services, the size and assets of the company, the nature of the foreign market and the length of its export. The nature of the organization structure will depend on a number of factors like its nature of business, size of business, international orientation, etc.

Check Your Progress- A

Select the correct option:

1. **Internationalization stimuli refer to:**
   a) Internal motives for foreign investment.
   b) Internal organizational factors arising from within the organization that influence a firm's decision to initiate, develop, and sustain international business activities.
   c) A multinational firm's motives for establishing an investment in a foreign location.
   d) Internal and external factors that influence a firm's decision to initiate, develop, and sustain international business activities.
2. **A Born Global firm is a firm that:**
   a) Develops international new ventures from its birth by using outsourcing from foreign locations in multiple countries.
   b) Overcomes psychic distance and the liability of foreigners by investing in foreign locations in multiple countries.
   c) Ignores the challenges of psychic distance and the liability of foreigners when planning its expansion to foreign locations in multiple countries.
   d) From its birth seeks competitive advantage by using resources from different countries and by selling its products in multiple countries.
3. **Franchising involves:**
   a) The transfer of patented information and trademarks, information and know-how as well as information needed to sell a product or service.
   b) The use of franchising for licensing new technologies in global markets.
   c) The transfer of a business concept, with corresponding operational guidelines, to non-domestic parties for a fee.

d) Greenfield investment in a completely new facility, or acquisition of or merger with an already established local firm.

4. Horizontal and Vertical are types of:

a) Greenfield strategy

b) Licensing and franchising

c) Mergers and acquisitions

d) Greenfield investments

5. Over which of the following does the MNE parent company have most control?

a) An affiliate company

b) A strategic partner

c) A subsidiary in which it owns 60% of the shares

d) A wholly-owned subsidiary

2.9 SUMMARY

International business requires more dynamic & complex functional and operational activities when compared to domestic business. As business crosses territory, it faces diverse legal, political, economical, cultural, languages which must be incorporated into business practices. Entering into international business varies from the simplest form to complex ones exporting through other entry methods, including licensing, franchising, contract manufacturing, direct investment, joint ventures, wholly owned subsidiaries.

In this unit we have discussed the different forms of International business operations; Domestic business, International business, Multinational business, Global business, Transactional business. This is how a domestic company expands its business function by crossing the territory of home nation and establishes its brand had acceptance in rest of the world. There are basically four approaches i.e. ethnocentric orientation, Polycentric orientation, Regiocentric orientation and geocentric orientation (EPRG).

As per Kahler, (1983) some of the basic entry modes are Direct exporting, Indirect exporting, Foreign Licensing, Joint Venture, Wholly-owned subsidiary, Turnkey Operation and Management Contract.

Keegan and Green (2005, pp295) state that "Licensing is a contractual arrangement whereby one company (the licensor) makes a legally protected assets available to another company (the licensee) in exchange for royalty, license fees, or some other form of compensation. The licensed assets may be a brand name, company name, patent, trade secret, or product formulation". The author further states that the other form of licensing is franchising. It "is a contract between a parent company-franchisor and a franchisee that allows the franchisee to operate a business developed by the franchisee in return for a fee and adherence to franchise-wide policies and practices". Low or no investment and scattered risk are the benefits for firms. However, lose control over marketing activities for licensing and quality control for franchising is a major drawback (Hill, 2003).

Joint ventures is like tying a knot with the foreign operating firm, wherein the company which is going international has enough equity to have a voice in the management but cannot completely control the foreign operating firm (Terpstra and Sarathy, 2000). Features like overcoming legal and cultural barriers and access to local distribution system works as an advantages for joint venture. However, ownership and control have remained an issue to a certain extent (Cateora and Ghauri, 2000). As per Paliwoda and Ryans Jr (1995) "Co-production arrangement strategies involve long-term relationships between partner firms and typically are designed to transfer intermediate goods such as knowledge and/or skills between firms in different countries".

Paliwoda and Ryans (1995, cited in Kogut and singh, 1988) described acquisition as purchasing sufficient amount of stock in a foreign existing company to acquire control and Green-field Investment as investment or establishment of a new firm to start-up investments in new facilities which are wholly owned or represent a joint venture between two or more parties.

Lastly, the factors effecting international business are discussed in the unit.

2.10 GLOSSARY

Ethnocentric orientation - A home country orientation or an unconscious bias or belief that the home country approach to business is superior.

Polycentric orientation- Polycentric orientation (sometimes called multilocal). Each Host Country is unique, see differences in foreign countries.

Regiocentric orientation- Similarities between the countries and their markets located in one region are used in order to develop an integrated regional strategy.

Geocentric orientation- when an organization treats all foreign markets as the one, i.e. global, market. The global market is understood as a single market, i.e. sociologically and economically uniform.

Green-field Investment - A Greenfield site investment is when a parent company chooses to begin operations in a foreign country establishing the construction of new production facilities from scratch, including all the necessary offices, living quarters and distribution hubs**.**

Brownfield Investment - a land or building or infrastructure which was operational in the past but now it is not in use or in idle condition. It is called Brownfield project when a parent company invests in such land or infrastructure for their project.

Licensing- Licensing is a contractual deal where the licensor company offers some proprietary assets to a foreign company-the licensee-in exchange for royalty fees.

Franchising- Franchising is a business relationship in which the franchisor (the owner of the business providing the product or service) assigns to independent people (the franchisees) the right to market and distribute the franchisor's goods or service, and to use the business name for a fixed period of time.

Turnkey project- A turnkey project is an agreement under which a company is fully involved in creating, designing and provides the production facility and handover the project to the purchaser on completion in operational condition.

2.11 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress –A

Choose the correct alternative

1. d
2. d
3. c
4. c
5. d

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2.14 TERMINAL & MODEL QUESTIONS

Q1. When companies choose to go international using a joint venture approach rather than a whole owned subsidiary approach? Give an example.

Q2. Distinguish between direct and indirect exporting modes.

Q3. Discuss the advantages and disadvantages of the main entry modes.

Q4. Point out as many entry modes as you are able to and give brief characteristic of their advantages (strengths) and disadvantages (weaknesses).

Q5. What determinants should be taken into consideration while selecting an entry mode? In what way do these factors affect the entry mode choice?

Q6. Discuss the external and internal factor involved in International business.

Q7. Briefly explain various approaches of International Business.

Q8. Why is managing international business more complex than managing domestic business?

Q9. Give a brief account of the economic, political and cultural environment of business between nations and their implications for business.

Q10. What is turnkey contract?

UNIT 3 ROLE OF INTERNATIONAL INSTITUTIONS IN INTERNATIONAL BUSINESS

3.1 INTRODUCTION

Countries with closed economy face various financial and social problems and the free flow of goods and services with the other countries is not there at all. Therefore the economic activity of the country was less and the country had a very weak foreign exchange reserves status.

With the development of the International Trade, the proof of its advantages to the world stage is widely visible, the most evident of which is monetary benefits that have accrued to the various countries. The more inclusive the market, the more open is the exchange of goods and services between nations, creating more financial assets for the economic development, infrastructure development, improved job market, higher degree of economies of scale, work specialization and social stature. Various rules and model laws were required to oversee and administer global trade.

3.2 OBJECTIVES

After reading this unit, learners shall be able to;

- Understand the conceptualisation of GATT and WTO
- Assess the Role of GATT and WTO.
- Comprehend Synergies between GATT and WTO

3.3 GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT)

GATT was a lawful understanding between numerous nations, whose general intention was to advance global exchange by decreasing or dispensing with exchange hindrances, for example, duties or quantities.

GATT and WTO

In 1993, the GATT was refreshed (GATT 1994) to incorporate new commitments upon its signatories. A standout amongst the most noteworthy changes was the formation of the WTO. The present 75 GATT entities and the European Communities turned into the establishing individuals on 1 January 1995 from the WTO. The remaining 52 entities of GATT re-joined the WTO in the accompanying two years (the last being Congoin 1997). Since the formation of WTO, 21 fresh non-GATT entities have joined and 29 are right now arranging enrolment. There is an aggregate of 164 nations in the WTO, with Liberia and Afghanistan being the most up to date individuals starting at 2016.

Of the first GATT individuals, Syria and the Yugoslavia have not re-joined the WTO. Since FR Yugoslavia, (renamed as Serbia and Montenegro and with enrolment arrangements later split in two), its application is viewed as another non-GATT one. On 4 May 2010, WTO's General Council consented to build up a working gathering to look at the demand of Syria for WTO membership. Montenegro turned into a part in 2012, while Serbia is in the choice phase of the transactions and is relied upon to end up an individual from the WTO later on.

While GATT was an arrangement of tenets settled upon by countries, the World Trade Organization is considered to be an institutional body. All things considered, GATT was only a gathering for countries to talk about, while the WTO is a legitimate universal association (which infers physical base camp, staff, delegation). The WTO extended its extension from exchanged products to incorporate exchange inside the administration area and protected innovation rights. In spite of the fact that it was intended to serve multilateral understandings, amid a few rounds of GATT transactions (especially the Tokyo Round) plurilateral assertions made specific exchanging and caused fracture among individuals. WTO game plans are by and large a multilateral assertion settlement system of GATT.

Consequences for exchange liberalization

The normal duty levels for the real GATT members were around 22 percent in 1947 because of the principal arranging rounds, levies were lessened in the GATT center in USA, Australia, Canada and United Kingdom, in regard to non-GATT participating entities and other contracting parties. By the Kennedy cycle (1962– 67), the normal levy levels of GATT members were around 15%. After the Uruguay Round, taxes were under 5%.

As per Dartmouth financial student of history Douglas Irwin, the booming of the world economy over the last 50 years owes an extraordinary arrangement to the development of world exchange which, thusly, is halfway the aftereffect of farsighted authorities who made the GATT. They built up an arrangement of techniques offering dependability to the exchange approach condition and along these lines encouraging the quick development of world exchange.

3.4 WORLD TRADE ORGANIZATION(WTO)

WTO is an intergovernmental association that directs global exchange. The WTO authoritatively initiated on 1 January 1995 under the Marrakesh Agreement, attended by 123 nations on 15 April 1994, overriding the General Agreement on Tariffs and Trade (GATT), which begun in 1948. It is the biggest global financial association in the world.

The WTO's present Director-General is Roberto Azevêdo. Seven rounds of exchanges occurred under GATT. The foremost authentic GATT trade rounds concentrated on furthermore diminishing charges. By then, the Kennedy Round in the mid-sixties accomplished a GATT unfriendly to dumping Agreement and a portion on progression. The Tokyo Round in the midst of the seventies was the chief significant endeavour to handle exchange hindrances that don't appear as levies, and to enhance the framework, embracing a movement of concessions to non-charge impediments, which from time to time interpreted existing GATT rules, and in others broke totally new ground. Since these plurilateral understandings were not recognized by the full GATT support, they were much of the time calmly called "codes. A couple of these codes were amended in the Uruguay Round, and changed into multilateral obligations recognized by all WTO people. Only four remained plurilateral (those on government acquirement, ox-like meat, common flying machine also, dairy things), yet in 1997 WTO people agreed to end the bovine like meat and dairy assertions, leaving just two. Despite endeavours in the mid-1960s to make some sort of institutional part for overall trade, the GATT continued working for 50 years as a semi-standardized multilateral bargain administration on a temporary basis.

Uruguay Round

During the Doha Round, the US government pointed the finger at Brazil and India for being rigid and the EU for hindering horticultural imports.

A long time prior to GATT's 40th anniversary, its people reasoned that the GATT framework was stressing to conform to another globalizing world economy. Considering the issues recognized in the 1982 Ministerial Declaration (fundamental needs, flood impacts of explicit countries' procedures on world trade GATT couldn't regulate, etc.), the eighth GATT round - known as the Uruguay Round - was moved in September 1986, in Punta del Este, Uruguay.

It was the best masterminding order on trade at any point concurred: the discussions would expand the trading system into a couple of new regions, prominently exchange administrations and protected advancement, and to change trade the sensitive zones of cultivating and materials; all the primary GATT articles were up for survey. The Final Act shutting the Uruguay Round and legitimately developing the WTO organization was stamped 15 April 1994, in the midst of the clerical gathering at Marrakesh, Morocco, and henceforth is called as the Marrakesh Agreement.

The WTO exists as an umbrella settlement for exchange merchandise for GATT, refreshed because of the Uruguay Round transactions (a refinement is made between GATT 1994, the revived pieces of GATT, and GATT 1947, the first assertion which is as yet the core of GATT 1994). GATT 1994 isn't however the main lawfully official understanding included by means of the Final Act at Marrakesh; a considerable rundown of around 60 assertions, expansions, decisions and understandings was grasped. The understandings fall into six principle parts, the Agreement Establishing the WTO, the Multilateral Agreements on Trade in Goods, the Agreement on Trade-Related Aspects of Intellectual Property Rights, the General Agreement on Trade in Services, Dispute settlement and surveys of governments' exchange policies.

Capacities

Among the distinctive components of the WTO, these are seen by observers as the most vital:

- It regulates the usage, organization and activity of the secured agreements.
- It gives a gathering to transactions and for settling disputes.

Moreover, it is WTO's obligation to audit and engender the national exchange arrangements, and to guarantee the soundness and straightforwardness of exchange approaches through observation in worldwide financial strategy making. Another need of the WTO is the assistance of growing, slightest created and low-wage nations on the move to acclimate to WTO principles and teaches through specialized participation and training.

The WTO ought to energize the utilization, association and activity and further the destinations of this Agreement and of the Multilateral Trade Agreements, and might likewise give the system to the execution, organization and task of the multilateral Trade Agreements.

The WTO should give the social occasion to plans among its people concerning their multilateral trade relations in issues managed under the Agreement in the Annexes to this Agreement.

The WTO should oversee the Understanding on Rules and Procedures Governing the Settlement of Disputes.

The WTO is in like manner a point of convergence of monetary research and examination: customary appraisals of the overall trade picture in its yearly distributions and research gives an account of specific subjects are conveyed by the association. At last, the WTO facilitates personally with the two distinct sections of the Bretton Woods structure, the IMF and the World Bank.

Standards of the exchanging framework

The WTO builds up a system for trade game plans; it doesn't describe or show results. That is, it is concerned about setting the guidelines of the exchange arrangement games. Five gauges are of explicit hugeness in understanding both the pre-1994 GATT and the WTO:

- Non-segregation. It has two noteworthy segments: the most upheld nation (MFN) administer, and the national treatment approach. Both are embedded in the essential WTO controls on product, organizations, and ensured advancement, yet their careful augmentation and nature differentiate over these locales. The MFN choose necessitates that a WTO part ought to apply comparable conditions on all trade with other WTO people, for example a WTO part needs to yield the best conditions under which it grants trade a particular thing write to all other WTO members. "Permit someone a one of a kind help and you have to do similarly for all other WTO individuals." National treatment suggests that shipped in product should be managed no less emphatically than locally created products (in any event after the outside products have entered the market) and was familiar with handle non-charge obstacles to trade (for example particular models, security benchmarks et al. victimizing imported goods).

- Correspondence. It reflects both a want to limit the degree of free-riding that may develop due to the MFN administer, and a want to acquire better access to remote markets. A related point is that for a nation to organize, it is fundamental that the pickup from doing all things considered be more conspicuous than the expansion open from uneven headway; corresponding concessions intend to ensure that such thing materialises.

- Official and enforceable responsibilities. The levy responsibilities made by WTO people in a multilateral trade plan and on increment are specified in a timetable (list) of concessions. These calendars develop "rooftop ties": a country can change its ties, yet essentially consequent to counselling with its trading assistants, which could mean remunerating them for loss of exchange. In the event that fulfilment isn't procured, the protesting country may summon the WTO question settlement methodology.

- Straightforwardness. The WTO people are required to circulate their trade headings, to keep up establishments mulling over the review of administrative decisions affecting trade, to respond to requests for information by various people, and to advise changes in return procedures to the WTO. These inside straightforwardness necessities are enhanced and energized by discontinuous country specific reports (trade technique audits) through the Trade Policy Review Mechanism (TPRM). The WTO system attempts in like manner to improve consistency and steadiness, disheartening the utilization of shares furthermore, extraordinary estimates utilized beyond what many would consider possible on measures of imports.

- Security esteems. In particular conditions, governments can limit exchange. The WTO's assertions enable people to accept measures to guarantee nature just as general prosperity, animal prosperity and plant well-being.

3.5 INTERNATIONAL MONETARY FUND(IMF)

The International Monetary Fund (IMF) is a worldwide association headquartered in Washington, D.C., of "189 countries endeavoring to support overall cash related investment, secure budgetary reliability, energize worldwide trade, advance high work and viable money related improvement, and abatement destitution around the globe." Formed in 1945 at the Bretton Woods Conference fundamentally by the thoughts of Harry Dexter White and John Maynard Keynes, it came into formal presence in 1945 with 29 nations and the objective of reproducing the universal installment framework. It now assumes a focal part in the administration of adjust of installments troubles and worldwide budgetary crises. Countries contribute assets to a pool through a standard framework from which nations encountering parity of installments issues can acquire cash. Starting at 2016, the reserve had SDR477 billion (about $668 billion).

Through the reserve, and different exercises, for example, the get-together of measurements and examination, observation of its individuals' economies and the interest for specific policies, the IMF attempts to enhance the economies of its constituent countries. The association's destinations expressed in the Articles of Agreement are: to advance worldwide money related co-task, global exchange, high business, swapping scale dependability, maintainable monetary development, and making assets accessible to part nations in budgetary difficulty.

IMF attempts to cultivate worldwide development and monetary strength by giving strategy, exhortation and financing the individuals, by working with creating countries to enable them to accomplish macroeconomic soundness and lessen poverty. The method of reasoning for this is private universal capital markets work incompletely and numerous nations have constrained access to money related markets. Such market defects, together with adjust of-installments financing, give the support to official financing, without which numerous nations could just right extensive outside installment awkward nature through measures with unfavorable monetary consequences. The IMF gives substitute wellsprings of financing.

Upon the establishing of the IMF, its three essential capacities were: to direct the settled conversion scale game plans between countries, in this manner helping national governments deal with their trade rates and enabling these legislatures to organize monetary growth, and to give here and now funding to help the adjust of payments. This help was intended to keep the spread of global financial emergencies. The IMF was additionally expected to help repair the bits of the worldwide economy after the Great Depression and World War II. As well, to give capital ventures to monetary development and undertakings, for example, foundation.

The IMF's part was on a very basic level modified by the gliding trade rates post-1971. It moved to looking at the financial approaches of nations with IMF understandings to decide whether a lack of capital was because of monetary vacillations or monetary strategy. The IMF additionally looked into what sorts of government arrangement would guarantee monetary recovery. A specific worry of the IMF was to anticipate money related emergency, for example, those in Mexico 1982, Brazil in 1987, East Asia in 1997– 98 and Russia in 1998, from spreading and debilitating the whole worldwide budgetary and cash framework. The test was to advance and execute arrangement that diminished the recurrence of emergencies among the developing business sector nations, particularly the center salary nations which are helpless against enormous capital outflows. Rather than keeping up a place of oversight of just trade rates, their capacity wound up one of reconnaissance of the general macroeconomic execution of constituent nations. Their part turned into significantly more dynamic in light of the fact that the IMF now oversees financial approach instead of simply trade rates.

Also, the IMF arranges conditions on loaning and advances under their strategy of conditionality, which was set up in the 1950s. Low-pay nations can obtain on concessional terms, which implies there is a timeframe with no financing costs, through the Extended Cr Facility (ECF), the Standby Cr Facility (SCF) and the Rapid Cr Facility (RCF). No concessional advances, which incorporate financing costs, are given for the most part through Stand-By Arrangements (SBA), the Flexible Cr Line (FCL), the Precautionary and Liquidity Line (PLL), and the Extended Fund Facility. The IMF gives crisis help by means of the Rapid Financing Instrument (RFI) to individuals confronting earnest adjust of-installments needs.

Observation of the worldwide economy

The IMF is commanded to regulate the worldwide fiscal and money related framework and screen the monetary and budgetary strategies of its constituent countries. This movement is known as observation and encourages universal co-operation. Since the destruction of the Bretton Woods arrangement of settled trade rates in the mid-1970s, reconnaissance has advanced to a great extent by method for changes in systems as opposed to through the reception of new obligations. The duties transformed from those of watchman to those of administrator of individuals' approaches.

The Fund regularly investigations the propriety of every nation's monetary and budgetary arrangements for accomplishing precise financial development and surveys the outcomes of these strategies for different nations and for the worldwide economy.

Capabilities

Any nation may apply to be a piece of the IMF. Post-IMF development, in the early after war time frame, rules for IMF participation were left moderately free. Individuals expected to make intermittent participation installments towards their amount, to cease from cash limitations unless conceded IMF consent, to keep the Code of Conduct in the IMF Articles of Agreement, and to give national financial data. In any case, stricter tenets were forced on governments that connected to the IMF for funding.

The nations that joined the IMF in the vicinity of 1945 and 1971 consented to keep their trade rates secured at rates that could be balanced just to adjust the main disequilibrium to be decided of installments, and just with the IMF's agreement.

Advantages

Constituent nations of the IMF approach data on the monetary arrangements of all constituent nations, the chance to impact other individuals' financial strategies, specialized help with saving money, monetary issues, and trade matters, budgetary help in the midst of installment troubles, and expanded open doors for exchange and investment.

Leading body of Governors

The Board of Governors comprises of one representative and one exchange senator for every constituent nation. Every constituent nation names its two governors. The Board ordinarily meets once per year and is in charge of choosing or delegating official chiefs to the Executive Board. While the Board of Governors is authoritatively in charge of favoring standard expands, Special Drawing Right assignments, the permission of new individuals, necessary withdrawal of individuals, and alterations to the Articles of Agreement and By-Laws, by and by it has designated the majority of its forces to the IMF's Executive Board.

The Board of Governors is prompted by the International Monetary and Financial Committee and the Development Committee. The International Monetary and Financial Committee has 24 individuals and screens improvements in worldwide liquidity and the exchange of assets to creating countries. The Development Committee has 25 individuals and prompts on basic advancement issues and on money related assets required to advance financial advancement in creating nations. They additionally prompt on exchange and ecological issues.

3.6 IBRD

The IBRD is the first of five establishments that make the World Bank Group. The headquarters of IBRD is in Washington, D.C., United States. It was built up in 1944 with the mission of financing the reproduction of European countries crushed by World War II. The IBRD and its concessional loaning arm, the International Development Association, are on the whole referred to as the World Bank as they share a similar administration and staff. Following the reproduction of Europe, the Bank's order extended to progressing overall monetary improvement and killing neediness. The IBRD gives business review or concessional financing to sovereign states to subsidize ventures that look to enhance transportation and framework, instruction, household arrangement, ecological cognizance, vitality speculations, human services, access to nourishment and consumable water, and access to enhanced sanitation.

In 2011, it brought $29 billion USD up in capital from bond issues made in 26 distinct monetary standards. The Bank offers various money related administrations and items, including adaptable advances, gifts, chance ensures, budgetary subsidiaries, and cataclysmic hazard financing. It revealed loaning duties of $26.7 billion made to 132 ventures in 2011.

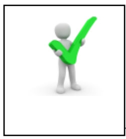
The IBRD and International Monetary Fund (IMF) were built up by delegates at the Bretton Woods Conference in 1944 and ended up operational in 1946. The IBRD was set up with the first mission of financing the recreation endeavors of war-torn European countries following World War II, with objectives shared by the later Marshall Plan. The Bank issued its inaugural advance of $250 million ($2.6 billion of every 2012 dollars to France in 1947 to back foundation ventures. The organization additionally settled its first field workplaces in Paris, France, Copenhagen, Denmark, and Prague in the previous Czechoslovakia. All through the rest of the 1950s, the Bank financed ventures trying to dam streams, produce power, and enhance access to water and sanitation. It additionally put resources into France, Belgium, and Luxembourg's steel industry. Following the remaking of Europe, the Bank's command has changed to killing neediness around the globe. In 1960, the International Development Association (IDA) was set up to fill in as the Bank's concessional loaning arm and give low and no-cost fund and allows to the poorest of the creating nations as estimated by net national wage per capita.

The IBRD is represented by the World Bank's Board of Governors which meets every year and comprises of one senator for each constituent nation (regularly the nation's back priest or treasury secretary). The Board of Governors appoints the vast majority of its power over day by day matters. The Board of Directors comprises of 25 official executives and is led by the World Bank Group's President. The official executives by and large speak to each of the 189 conditions of the World Bank. The president administers the IBRD's general course and day by day operations.

In spite of the fact that individuals contribute cash-flow to the IBRD, the Bank secures subsidizes essentially by acquiring on global capital markets by issuing securities. The Bank raised $29 billion USD worth of capital in 2011 from securities issued in 26 distinctive currencies. The IBRD has delighted in a triple-A FICO assessment since 1959, which enables it to acquire capital at positive rates. It offers benchmark and worldwide benchmark securities, securities named in non-hard monetary standards, organized notes with exclusively custom fitted yields and monetary standards, markdown notes in U.S. dollars and Eurodollars. In 2011, the IBRD looked for an extra $86 billion USD (of which $5.1 billion would be paid-in capital) as a major aspect of a general capital increment to expand its loaning ability to center salary countries. The IBRD communicated in February 2012 its expectation to offer kangaroo (securities designated in Australian dollars issued by outside firms) with developments enduring until 2017 and 2022.

The IBRD gives money related administrations and in addition key coordination and data administrations to its obtaining constituent countries. The Bank just funds sovereign governments specifically, or ventures sponsored by sovereign governments. The World Bank Treasury is the division of the IBRD that deals with the Bank's obligation arrangement of over $100 billion and monetary subordinates exchanges of $20 billion.

The IBRD's Enclave Partial Risk Guarantee to cover private undertakings in constituent nations of the IDA against sovereign governments' disappointments to satisfy legally binding obligations. The Bank gives a variety of money related hazard administration items including outside trade swaps, cash transformations, loan cost swaps, loan fee tops and floors, and product swaps. To enable borrowers to secure against fiascoes and other extraordinary dangers, the bank offers a Catastrophe Deferred Drawdown Option to give financing after a cataclysmic event or pronounced highly sensitive situation. It additionally issues disaster bonds which exchange disastrous dangers from borrowers to investors. The IBRD revealed $26.7 billion in loaning responsibilities for 132 undertakings in monetary year 2011, altogether not as much as its $44.2 billion in duties amid financial year 2010.



Check Your Progress- A

1. The Headquarters of International Monetary Fund is situated in:

a) New York

b) Geneva

c) Chicago

d) Washington

2. Which of the following statement regarding WTO is not true:

a) Is a permanent organization

b) WTO owes its origin to Uruguay round

c) Highest policy making body of WTO is Ministerial Conference

d) WTO came into existence on 1/1/1991

3. Major functions of IMF are:

a) Overseas fixation of exchange rate

b) Providing capital for short-term

c) Providing thought leadership on health matters

d) Both a and b

4. UNCTAD was founded in the year:

a) 1964

b) 1966

c) 1968

d) 1969

5. The International Monetary Fund came into existence on:

a) 12/5/1945

b) 27/7/1945

c) 27/12/1945

d) 27/9/1945

3.7 INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA)

The International Development Association (IDA) is a global money related establishment which offers concessional crs and concedes to the world's poorest creating nations. The IDA is an individual from the World Bank Group. The headquarters of IDA is in Washington, D.C., United States. It was set up in 1960 to supplement the current IBRD by loaning to creating nations which experience the ill effects of the most minimal gross national pay, from disturbed reliability, or from the least per capita wage. Together, the International Development Association and IBRD are all in all by and large known as the World Bank, as they take after a similar official administration and work with the same staff.

The IDA's expressed point is to help the poorest countries in developing all the more rapidly, evenhandedly, and economically to decrease poverty. The IDA is the single biggest supplier of assets to monetary and human improvement extends on the planet's poorest nations. From 2000 to 2010, it financed ventures which selected and prepared 3 million educators, vaccinated 310 million youngsters, subsidized $792 million in advances to 120,000 little and medium endeavors, fabricated or reestablished 118,000 kilometers of cleared streets, assembled or reestablished 1,600 extensions, and extended access to enhanced water to 113 million individuals and enhanced sanitation offices to 5.8 million people. The IDA has issued an aggregate $238 billion USD in advances and allows since its dispatch in 1960. Thirty-six of the affiliation's acquiring nations have moved on from their qualification for its concessional loaning. In any case, eight of these nations have backslid and have not re-graduated.

Amid the 1950s, creating nations with the poorest wages started understanding that they could never again bear to get capital and required more-great loaning terms than offered by the IBRD. At the beginning of his inaugural term in 1949, at that point President of the United States Harry S. Truman amassed a warning gathering to recommend approaches to achieve his Point Four Program, of which a critical part was a push to fortify creating nations, particularly those closest toward the Eastern Bloc, to discourage them from lining up with other socialist states. The warning gathering prescribed a universal system that would work some place in the middle of giving entirely advanced and entirely allowed funds. The UN and United States government distributed reports communicating support for the formation of a multilateral, concessional loaning program for the poorest creating countries. However, the United States was to a great extent inert and at last occupied by its inclusion in the Korean War and unconvinced that improvement required more prominent budgetary stimulation.

Creating nations became progressively baffled with not having the capacity to manage the cost of IBRD loaning and saw the Marshall Plan as a similarly liberal blessing to European countries. In the late 1940s and mid-1950s, creating nations started requiring the United Nations (UN) to make an improvement organization that would offer specialized help and concessional financing, with a specific want that the office hold fast to other UN bodies' tradition of every nation having one vote rather than a weighted vote. Notwithstanding, the United States at last restricted recommendations of that nature. As the United States developed more worried over the development of the Cold War, it made a concession in 1954 at the command of its Department of State by support the origination of the International Finance Corporation (IFC). In spite of the dispatch of the IFC in 1956, creating nations continued in requesting the production of another concessional financing system and the thought picked up footing inside the IBRD. Then-President of the IBRD Eugene R. Dark, Sr. started circling the thought of an International Development Association, instead of a thought of a concessional named the Special United Nations Fund for Economic Development (SUNFED) represented by the United Nations. Paul Hoffman, the Marshall Plan's previous Administrator, proposed the possibility of a delicate cr office inside the World Bank, where the US would have a prevalent voice in the distribution of such loans. Democratic Senator Mike Monroney of Oklahoma upheld this idea. As Chairman of the Senate Subcommittee on International Finance, Monroney proposed a determination prescribing an investigation of the potential foundation of an International Development Association to be partnered with the IBRD. Monroney's proposition was more favored got inside the United States than the SUNFED. The determination passed the senate in 1958, and after that U.S. Treasury Secretary Robert B. Anderson urged different nations to lead comparable investigations. In 1959, the World Bank's Board of Governors affirmed a U.S.- conceived determination requiring the drafting of the articles of agreement. SUNFED later turned into the Special Fund and converged with the Expanded Program of Technical Assistance to frame the United Nations Development Program.

Administration and Activities

The IDA is administered by the World Bank's Board of Governors which meets every year and comprises of one representative for each constituent nation (regularly the nation's fund priest or treasury secretary). The Board of Governors designates the vast majority of its power over day by day matters. The Board of Directors comprises of 25 official executives and is led by the World Bank Group’s President. The official chiefs all in all speak to every one of the 187 conditions of the World Bank, despite the fact that choices with respect to IDA matters concern just the IDA's 172 constituent states. The president manages the IDA's general course and day by day operations.

The IDA is assessed by the Bank's Independent Evaluation Group. In 2009, the gathering recognized shortcomings in the arrangement of controls used to secure against extortion and debasement in ventures upheld by IDA lending. In 2011, the gathering prescribed the Bank give acknowledgment and motivations to staff and administration for actualizing exercises which execute the Paris Declaration on Aid Effectiveness standards of harmonization and arrangement, advance more noteworthy utilization of area wide ways to deal with coordination, and clarify the reasons why when a nation's money related administration framework isn't utilized so the customer nation may address those deficiencies. It likewise prescribed that the Bank work together with advancement accomplices to reinforce nation level authority of improvement help coordination by offering more noteworthy money related and specialized support. Development business analysts, for example, William Easterly, have directed research which positioned the IDA as including the most straightforwardness and best practices among contributors of advancement aid.

Analysts from the Center for Global Development expect that the IDA's gathering of qualified obtaining nations will diminish significantly by the year 2025 (denoting the 65th commemoration of the affiliation's foundation) because of graduations and that outstanding borrowers will comprise essentially of African nations and will confront generous populace decreases. These progressions will suggest a requirement for the relationship to painstakingly look at its budgetary models and business tasks to decide a fitting technique going ahead. The inside suggested that the World Bank administration start examining the long haul eventual fate of the IDA.

The IDA has 173 nations which pay commitments at regular intervals as renewals of its capital. The IDA loans to 81 obtaining nations, about portion of which are in Africa. Membership in the IDA is accessible just to nations who are individuals from the World Bank, especially the IBRD. Throughout its lifetime, 36 getting nations have moved on from the affiliation, in spite of the fact that some of these nations have backslid as borrowers after not maintaining their graduate status.

3.8 INTERNATIONAL FINANCE CORPORATION (IFC)

IFC, International Finance Corporation, is a worldwide money related foundation that offers venture, warning, and resource administration administrations to energize private-division advancement in creating nations. The IFC is an individual from the World Bank Group. The headquarters of IFC is in Washington, D.C. It was set up in 1956 to progress monetary improvement by putting resources into for-benefit and business ventures for neediness decrease and advancing development. The IFC's expressed point is to make open doors for individuals to escape destitution and accomplish better expectations for everyday comforts by preparing money related assets for private endeavor, advancing available and focused markets, supporting organizations and other private substances, and making employments and conveying vital administrations to the individuals who are destitution stricken or generally vulnerable.

Since 2009, the IFC has concentrated on an arrangement of advancement objectives that its ventures are relied upon to target. It will likely increment manageable horticulture openings, enhance social insurance and instruction, increment access to financing for microfinance and business customers, propel foundation, enable independent companies to develop incomes, and put resources into atmosphere health.

The IFC is claimed and administered by its constituent nations however has its own particular official administration and staff that direct its typical business activities. It is a company whose investors are constituent governments. Initially, it was all the more fiscally incorporated with the World Bank Group, yet later, the IFC was built up independently and in the long run wound up approved to work as a monetarily self-governing substance and settle on free venture choices. It offers a variety of obligation and value financing administrations and enables organizations to confront their hazard exposures while ceasing from taking an interest in an administration limit. The organization likewise offers exhortation to organizations on deciding, assessing their effect on nature and society, and being mindful. It prompts governments on building framework and associations to additionally bolster private area improvement.

The organization is surveyed by a free evaluator every year. In 2011, its assessment report perceived that its ventures performed well and lessened destitution yet prescribed that the enterprise characterize neediness and anticipated that results all the more unequivocally would better-comprehend its adequacy and approach neediness diminishment all the more deliberately. The IFC is in great money related standing and got the most noteworthy evaluations from two free FICO assessment offices in 2010 and 2011.

IFC goes under successive feedback from NGOs that it can't track its cash in view of its utilization of budgetary middle people.

Other feedback centers around IFC working unnecessarily with huge organizations or well-off people effectively ready to fund their ventures without assistance from open foundations, for example, IFC, and such speculations don't have a satisfactory constructive improvement affect. A case frequently referred to by NGOs and basic writers is IFC conceding financing to a Saudi ruler for a five-star inn in Ghana.

The Board of Governors represent IFC which meets every year and comprises of one representative for every constituent nation (frequently the nation's back clergyman or treasury secretary). Each part normally selects one senator and furthermore one alternate. The Board of Directors of IFC comprises of 25 official chiefs who meet frequently. They work at the central command of IFC and is led by the World Bank Group's President. The official executives all things considered speak to each of the 184 nations. IFC's Chief Executive Officer supervises its general bearing and day by day operations. The Chief Executive Officer of IFC is Philippe Le Houérou.

In spite of the fact that the IFC organizes its exercises in numerous territories, it by and large works freely as it is a different element with lawful and budgetary independence. The company works with a staff of more than 3,400 representatives, of which half are positioned in field workplaces over its part nations.

The IFC's speculation administrations comprise of value, exchange back, syndicated advances, organized and securitized fund, customer hazard administration administrations, treasury administrations, and liquidity management. In its financial year 2010, the IFC put $12.7 billion of every 528 tasks crosswise over 103 nations. Of that aggregate speculation duty, around 39% ($4.9 billion) was put into 255 undertakings crosswise over 58 countries of the World Bank's International Development Association (IDA).

The IFC decides a reasonable reimbursement calendar and effortlessness period for each advance independently to meet borrowers' money and income prerequisites. The IFC may give longer-term advances or expand beauty periods if a venture is esteemed to warrant it. Leasing organizations and money related go-betweens may likewise get advances from the IFC. IFC has tried to structure advance items in neighborhood currencies. Its payment portfolio included advances named in 25 nearby monetary forms in 2010, and 45 neighborhood monetary standards in 2011, subsidized to a great extent through swap markets. Nearby monetary markets improvement is one of IFC's key concentration zones. The IFC focused on around $5.7 billion in new advances in 2010, and $5 billion of every 2011.

Despite the fact that the IFC's investors at first just enabled it to make crs, the IFC was approved in 1961 to make value ventures, a previous maker of car parts in Spain that is currently part of Bosch Spain. The IFC puts resources into organizations' value either specifically or through private value reserves, by and large from five up to 20% of an organization's aggregate value. IFC's private value portfolio at present stands at generally $3.0 billion focused on around 180 assets. The portfolio is broadly appropriated over various geographies, and as of late has put resources into Small Enterprise Assistance Funds' (SEAF) Caucasus Growth Fund and Leopard Capital's Haiti Fund. Other value speculations made by the IFC incorporate favored value, convertible crs, and cooperation loans. The IFC wants to contribute as long as possible, as a rule for a time of eight to fifteen years, previously leaving through the offer of offers on a residential stock trade, for the most part as a feature of a first sale of stock. At the point when the IFC puts resources into an organization, it doesn't accept a dynamic part in administration of the company.

Through its Global Trade Finance Program, the IFC ensures exchange installment commitments of in excess of 200 endorsed banks in more than 80 nations to relieve chance for universal transactions. The Global Trade Finance Program gives assurances to cover installment dangers for developing business sector banks with respect to promissory notes, bills of trade, letters of credit offer and execution bonds, provider credit for capital products imports, and progress payments. In its monetary year 2011, the IFC issued $4.6 billion in excess of 3,100 certifications. In 2009, the IFC propelled a different program for emergency reaction, which gives liquidity to worldwide exchange among creating nations.

The IFC works a Syndicated Loan Program with an end goal to activate capital for advancement objectives. The program was made in 1957 and starting at 2011 has diverted around $38 billion from more than 550 money related foundations toward improvement extends in more than 100 distinctive developing markets. Due to banks conserving from loaning crosswise over outskirts in developing markets, in 2009 the IFC began to syndicate parallel advances to the worldwide monetary foundations and other participants.

To benefit customers without prepared access to minimal effort financing, the IFC depends on organized or securitized money related items, for example, portfolio hazard exchanges, and Islamic finance. The IFC submitted $797 million as organized and securitized financing in 2010. For organizations that face trouble in acquiring financing because of an impression of high chance, the IFC securitizes resources with unsurprising money streams, for example, contracts, charge cards, advances, corporate obligation instruments, and income streams, with an end goal to upgrade those organizations.

Notwithstanding its venture exercises the IFC gives a scope of warning administrations to help corporate decision making with respect to business, condition, social effect, and supportability. The IFC's corporate counsel targets administration, administrative limit, versatility, and corporate obligation. It organizes the consolation of changes that enhance the exchange kind disposition and simplicity of working together with an end goal to exhort nations on encouraging a reasonable venture atmosphere. It additionally offers guidance to governments on foundation improvement and open private associations. The IFC endeavors to manage organizations toward more economical practices especially with respect to having great administration, supporting ladies in business, and proactively fighting atmosphere change.

Check Your Progress- B

1. **Discuss Administration and Activities of International Development Association (IDA)**

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2. **List, any two, advantages of IFC.**

3.9 UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT (UNCTAD)

UNCTAD, United Nations Conference on Trade and Development, was set up in 1964 as a lasting intergovernmental body.

UNCTAD is the essential organ of the General Assembly of United Nation managing exchange, speculation, and improvement issues. UNCTAD association will likely: "support the trade, theory and progression odds of making countries and help them in their undertakings to facilitate into the world economy on a fair premise."

The essential target of UNCTAD is to define strategies identifying with all parts of advancement including exchange, help, transport, back and innovation. The gathering usually meets once in four years; the interminable secretariat is in Geneva.

One of the premier achievements of UNCTAD (1964) has been to imagine and actualize the Generalized System of Preferences. It was contended in UNCTAD that to advance fares of made products from creating nations, it is important to offer uncommon tax concessions to such fares. Tolerating this contention, the created nations planned the GSP conspire under which producers' fares and import some farming merchandise from the creating nations enter obligation free or at decreased rates in the created nations. Since imports of such things from other created nations are liable to the ordinary rates of obligations, imports of similar things from creating nations would appreciate an upper hand.

The production of UNCTAD in 1964 depended on worries of creating nations over the worldwide market, multi-national enterprises, and incredible uniqueness between created countries and creating countries. The UNCTAD was built up to give a gathering where the creating nations could talk about the issues identifying with their monetary advancement. The association developed from the view that current foundations like GATT (now supplanted by the WTO, IMF and World Bank were not appropriately sorted out to deal with the specific issues of creating nations.

UNCTAD produces various important reports, such as:

- The Trade and Development Report
- The Trade and Environment Review
- The World Investment Report
- The Least Developed Countries Report

- UNCTAD Statistics
- The Information Economy Report
- The Technology and Innovation Report

UNCTAD is an establishing individual from the United Nations Sustainable Stock Exchanges (SSE) activity alongside the Principles for Responsible Investment and the UN Global Compact.

3.10 SUMMARY

The international financial institutions provide a relevant framework to assist in the development of its member nations by providing a robust framework to assist in growth and creating a conducive environment for growth and development. Over the years these institutions have formed the backbone of the world economy. The platform is used by member nations to collaborate and work together in achieving common objectives.

3.11 GLOSSARY

GATT: General Agreement on Tariffs and Trade

WTO: World Trade Organization

IMF: International Monetary Fund

IBRD: International Bank for Reconstruction and Development

IDA: International Development Association

IFC: International Finance Corporation

UNCTAD: United Nations Conference on Trade and Development

3.12ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress –A

Choose the correct alternative

Answer:
1. d
2. d
3.d
4. a
5. c

3.13 REFERENCES

- Economic Environment of Business – Gosh, Biswanath, South Asia Book, New Delhi
- International Business – Competing in the Global Market place – Charles W Hill and Arun Kumar Jain – Tata McGraw Hill
- International Business Environment –Black and Sundarma, Prentice Hall of India
- International Business – Text and Cases Francis Cherunilam –Prentice Hall of India
- International Business – Bhalla V.K., Anmol Publications, New Delhi
- International Economics – Prakash Vohra and Rakesh Mittal.
- Business Environment –Text And cases- Justin Paul, Tata McGraw Hill

3.14 SUGGESTED READINGS

1. International Business – Competing in the Global Market place – Charles W Hill and Arun Kumar Jain – Tata McGraw Hill
2. International Business – Text and Cases Francis Cherunilam –Prentice Hall of India
3. Business Environment –Text And cases- Justin Paul, Tata McGraw Hill

4. International Business – Bhalla V.K., Anmol Publications, New Delhi
5. International Business Environment –Black and Sundarma, Prentice Hall of India
6. Economic Environment of Business – Gosh, Biswanath, South Asia Book, New Delhi
7. International Economics – Prakash Vohra and Rakesh Mittal.

3.15 TERMINAL QUESTIONS

Q1. Discuss the different consequences of exchange liberalization under GATT.

Q2. Discuss the salient features of the Uruguay round.

Q3. Discuss the five standards that are of immense importance in understanding both the WTO and the GATT prior to 1994.

Q4. Briefly explain the different advantages of IMF.

Q5. Elaborate on the role of International Finance Corporation in building nations.

UNIT 4 BALANCE OF PAYMENTS

4.1 INTRODUCTION

In the previous Units, you have learned the evolution of International Business and its drivers, modes, entry, approaches, and types of International Business, and the Role of International Institutions in International Business. Now you are going to learn and understand the significance of the Balance of Payments in economics and business terminology. There constitute components in Balance of Payments (BOPs), there also exists a meaning behind its particular constituents, balance sheet, equilibrium and disequilibrium in BOPs, causes for disequilibrium in BOPs, and measurement of BOPs is also given due focus and consideration in this unit.

A register or record or the annual statement of all given economic transactions that ensue in a nation usually within the period of one year is known as the Balance of Payments. Some countries like the USA keep such records every quarter. These records help the government of a nation to know its international position to formulate its monetary, fiscal and trade policies. The government also consult important trade partners about their BOPs to make policy decisions. It is also important to banks, firms, and individuals who involved in international trade and finance directly or indirectly.

4.2 OBJECTIVES

After going through this Unit you should be able to :

- Understand the meaning and components of BOPs.
- Explain what is equilibrium and disequilibrium in BOPs.
- It can enumerate the causes for disequilibrium in BOPs.
- Able to discuss how to correct disequilibrium in BOPs and various measures adopted by a government to achieve equilibrium in BOPs.

4.3 MEANING AND COMPONENTS OF BALANCE OF PAYMENTS

Balance of Payments refers to registry of all economic transactions of a nation relative to that of the world. BO Sodersten, states that "BOPS is merely a way of listing receipts and payments in international transactions for a country". In the words of B.J.Cohen, "BOPs shows the country's trading position, changes in its net position as foreign lender or borrower and changes in its official reserve holding".

The principle of double-entry book-keeping is used in constructing the BOPs account. Every transaction of a country is entered in the balance sheet under two heads namely Credit (+) and debit (-). There is a difference between business accounting and BOPs accounting. The debit account composes the left-hand side and the credit account composes the right-hand side in business accounting. Whereas in BOPs, accounting credits shown on the RHS and debit on the LHS of balance sheets.

4.4 BALANCE SHEET OF BALANCE OF PAYMENTS

Any payments received from other countries are credit transactions and making payments to other countries are debit transactions. The items that are displayed on that of the credit side are goods and services exports, unilateral transactions (means one side transactions like gifts, grants, donations, etc.,) received from foreigners, borrowings from other countries, official selling of reserve domestic gold to other countries or organisations. Other items displayed under the debit side are of imports of goods and services, transfer payments to foreigners, giving loans to other countries, purchasing reserve assets from other countries or international organisations.

These items of credit and debit entered in balance sheet vertically as per the double-entry bookkeeping principal. The three categories entered horizontally are the current, the capital and the official settlement account.

4.4.1 THE CURRENT ACCOUNT

The current account of BOPs is a record of exports and imports of visible and invisible items and also unilateral transfers. Visible items mean merchandise items or goods and invisible items mean services. Generally, exports are calculated by excluding transportation costs, insurance, foreign tourist expenditure, etc., in domestic country and imports, are calculated by including transportation costs, insurance, tourist expenditure abroad, etc.

4.4.2 CAPITAL ACCOUNT

The Capital account is referred to as the systematic register of all types of capital flow. It reflects the change in capital stock viz. Assets or liabilities. These transactions may be distinguished as private and official transactions or short run and long-run investment. The investments may be either portfolio or direct.

Direct investment is the purchase of an asset and acquiring control of it in another country. Such transactions may be by individuals, firms, and multinational corporations. Portfolio investment is the acquisition of an asset but not having control over it. For example, purchasing shares of foreign companies or bonds issued by another country's government is Portfolio investment.

4.4.3 UNILATERAL TRANSACTIONS

This is the term used for gifts, grants, donations, private remittances, disaster relief, etc., which received from abroad are recorded under the credit side of the BOPs sheet. Similarly, gifts, grants, donations, private remittances, disaster relief, etc., made by the domestic country in another country are recorded under the debit side of the BOPs sheet.

4.4.4 OFFICIAL SETTLEMENT ACCOUNT

This account is represented by the holdings of the government or official organisations. These are accepted to settle international claims. The reserve assets in any country are nothing but the reserve stock of gold available, owned convertible foreign currencies and SDRs and the total net position of the country in the International Monetary Fund.

Table- 4.1Balance of Payments Account

Credits (+) **(Receipts)**	**Debits (-)** **(Payments)**
1.Current Account	
Exports	**Imports**
a) Goods	a) Goods
b) Services	b) Services
c) Transfer payments	c) Transfer payments
2.Capital Account	
(a) Borrowings from foreign Countries	(a) Lending to foreign countries.
(b) Direct investment by foreign	(b) Direct investment in foreign

countries.	countries.
3. Official Settlements Account	
(a) Rise in foreign Official holdings	(a) Rise in reserves of gold and other foreign currencies
Particular Errors and Particular omissions	

Table 4.1 shows the construction of BOPs account of a country

4.4.5 CURRENT ACCOUNT BALANCE

Current account balance essentially points to the flows in the value of goods, services, income and gifts, donations, grants between domestic country and abroad. If inflows are more than the outflows is called a positive current account or surplus in BOPs and when the inflows are less than outflows is called a negative current account or deficit in BOPs.

In other words, surplus current account means exports are more than the goods imports, services, investments and unilateral transactions. Vice versa, a current account deficit means imports are greater than exports. In other words, the country needs to pay higher amounts to other nations by giving up assets or liabilities are increasing.

Hence the current account balance represents the sum total foreign investment in national saving and domestic investment.

4.5 EQUILIBRIUM IN BOPS

BOPs are always in balance means the total of the net credit and debit of all the three accounts – the current, the capital and the official settlements account should be 0. The BOPs can be written as BOPs = Rf - Pf

Whereas BOPs are referred to as the country's balance of payments, Rf is the payments made by foreigners (for exports by foreigners) and Pf refers to the payment made to foreigners (for imports by own nationals).

If Rf – Pf > 0, it means payments made by foreigners exceed the payments made to foreigners, then there is BOPs surplus. Vice-versa, if Rf – Pf < 0 or Rf < Pf, it points to deficit in the BOPs, as the payments made to the foreigners exceed payments made by foreigners.

Flexible exchange rate creates excess of exports over imports, if the total foreign lending and investment are taken abroad. Depreciation of domestic currency in terms of other currencies will be witnessed. In relation to imports, exports will become cheaper. The following equation shows this situation.

$$X + B = M + I_f$$

Where, X = exports, M = imports, If = investment by foreigners, B = borrowings of foreigners. Or $X - M = I_f - B$

Or $(X - M) - (I_f - B) = 0$.

Equilibrium in BOPs is shown by the above equation. A current account surplus will be offset by capital account deficit and vice versa. BOPs balance always in an accounting sense. It can be shown as in following equation

$$C + S + T = C + I + G + (X - M) \quad \text{Or} \quad Y = C + I + G\ (X - M).$$

Where, C= Expenditure on consumption.
S= Domestic saving.
T= Receipts from taxation.
I= Expenditures on investment
G= Expenditures incurred by government.
X= Goods and services exported, and
M= Goods and services imported.

In the equation C + S + T is National Income (Y) or Gross national income. In a country, its savings (S_d) must be equal to its investment (I_d). Similarly, the Current account surplus must be offset by the excess savings of a country over its investment ($S_d > I_d$). Thus, in accounting sense BOPs is in equilibrium always. As the inflows and outflows of any transactions are recorded on credit and debit sides of the BOPs, the credit and debit items are always in balance. Of the current account record debit, it will be offset by the surplus in the capital account by borrowing or and lending and vice verse. Thus, in this sense also BOPs are always in balance.

If BOPs are balanced always, why a country experiences surplus or deficit in its BOPs? The answer is only when all items of BOPs included in BOPs there is no chance to witness surplus or deficit. If some items are excluded in BOPs then it will give rise to surplus or deficit.

Measuring of deficit or surplus in BOPs can be taken up in three ways. First basic balance – when long term capital account balance is included in the current account balance it is called basic balance. The second balance is net liquidity balance – along with basic balance it includes short term private non – liquid capital balance, allocation of SDRs and errors and omissions. The third balance is the official settlement balance. It includes short term liquid capital balance and total net liquid balance. These are shown in Table 4.2

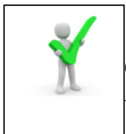
Trade Balance	a
Transfer payments balance	b
Current account balance	c = a + b
Long - term capital balance	d
Basic balance	e = (c+d)
Short -term private non liquid capital balance	f
Allocation of SDRs	g
Errors and omissions	h
Net liquidity balance	i = (e + f + g + h)
Short-term private liquid capital balance	j
Official settlement balance	k = (i + j)

Table.4.2 Official settlement balance

Various balances are shown in the table. Each item above the line is included in a particular balance and each item below the line are excluded from that balance. Otherwise, items below the line are called as 'settlement' or 'accommodating' or 'compensatory ' items. Similarly, items above the line are called as 'autonomous' items. In theory BOPs disequilibrium means 'autonomous' items balance. In short term capital transactions compensatory items redress disequilibrium in BOPs autonomous items.

It is clear from the Table that to determine the items of compensatory and autonomous is a difficult task. Short term Capital movements are responsible for deficits in BOPs. Short term private non-liquid capital movements are below the line in basic balance and above the line in net liquid balance. In the same manner, short term private liquid capital movements are below the line in net liquid balance and above the line in official settlement balance.

Therefore, according to the accounting principle, only in export accounting sense the BOPs are always in Balance. But deficit or surplus is possible under a fixed exchange rate and not possible under a flexible exchange rate system. BOPs can be in Equilibrium only when there are no compensatory transactions.



Check Your Progress- A

Choose the correct alternative.

1. **Balance of payments of invisible items includes**

a) Exportation of services

b) Importation of services

c) Both (a) & (b)

d) None of the above

2. When the exports of a country are more than its imports, balance of trade becomes;

a) Surplus
b) Deficit
c) Zero
d) Intermediate

3. If a country earns foreign exchange, it will be entered in BOPs as;

a) Debit
b) Credit
c) Separately
d) All of the above

4. Disequilibrium in capital account of the BOPs can be corrected by;

a) Devaluation
b) Borrowing
c) Canalisation
d) d) All of the above

5. Disequilibrium in current account of the BOPs can be corrected by;

a) currency devaluation
b) canalisation
c) Quantitative restrictions
d) All of the above

6. Demand for foreign exchange is by;

a) importers
b) exporters
c) borrowers
d) All of the above

7. Depreciation takes place with respect to;

a) Gold
b) Other currencies
c) Differential rate of monetary standard
d) None of the above

4.6 DISEQUILIBRIUM IN THE BALANCE OF PAYMENTS

We have seen that BOPs are always balanced only in an export accounting sense. If entries are made consistently always debits must be equal to credits. Thus, on the whole, no disequilibrium in BOPs will be witnessed. If we refer to disequilibrium in the BOPs we are referring only certain sections of credit and debits in the structure of BOPs. Kindleberger puts this as, "while total credits equal total debits in the BOPs, a number of partial balances have been devised to indicate the degree of approach to equilibrium".

When total receipts of from abroad are more than the payments of a country then BOPs said to be ‘favourable’ or ‘surplus’. When total payments of a country are more than the total receipts from abroad then BOPs said to be ‘unfavourable’ or ‘deficit’.

In other words, the BOPs statement consists of autonomous and induced transactions. Exportation or importation of goods and services is a real trade transaction when undertaken for profit or utility motive is an autonomous transaction. Any imbalance in the autonomous transaction needs to be counterbalanced by a change in foreign exchange reserve or short term capital movement and is induced transaction.

Thus induced transactions are undertaken to equalise the process of BOPs account. It consists of Short term capital movements like lending or borrowing, inflow or outflow of gold, addition or subtraction of reserves of foreign exchange, etc. These transactions are compensatory in nature. Imbalance in autonomous transactions is the real problem of a country. Disequilibrium is measured by its external assets and liabilities balance and a surplus or a deficit shows the strength or weakness of a country's external capital positions.

Prof. Machlup distinguished the concept of disequilibrium in the BOPs in three ways. They are a) Market Balance; which refers to balancing the demand and supply of foreign exchange. b) Program Balance, which refers to balancing the desires and hopes. c) Accounting Balance; this means a balance of credit and debits.

These concepts easily resolve the meaning of ‘deficit’ or ‘surplus’ to indicate disequilibrium in BOPs. Assuming that there are no restrictions on an exchange or no reserved supply to support the exchange rate, the deficit which occurs in the market BOPs refer to nothing but the creation of effective demand to offset the exceeds in the supply of foreign exchange at the unchanged rate of exchange.

Similarly, when foreign exchange is desired or needed, it exceeds its expected supply reveals a deficit in programme balance. The deficit in accounting balance means excess foreign exchange entered on the debit side of the accounting statement of the economic transactions. It reveals that disequilibrium in BOPs will be differing for each category of balance as stated above. However, in free and competitive economies the market balance has significant importance. In the modern protective world, it may not be having a practical use. The concept of programme balance appears to be most important in planned economies.

According to Prof. Triffin disequilibrium in BOPs has defined as incompatible levels of domestic activity, employment and income to prove maladjustments in the country’s economy are so grave and persistent. Change in exchange rates, rise in tariffs or protection in the form of exchange control, and measures of external defences, etc., should not be accompanied.

4.7 CAUSES FOR DISEQUILIBRIUM IN BALANCE OF PAYMENTS

Various reasons are known to bring in the disequilibrium in balance of payments. These various factors may be classified as economic, political and sociological factors.

4.7.1 ECONOMIC FACTORS

4.7.1.1 Development disequilibrium

This disequilibrium may be common in developing countries. Because expenditure on developmental activities is on a large scale which merely alters the prices, aggregate demand and purchasing power. This will lead to increasing imports. Its imports consist of intermediate goods, machinery, capital equipment, and services need to speed up developmental programmes, this will result in BOPs deficit.

4.7.1.2 Cyclical disequilibrium

Depression always brings in characteristic changes in the world trade which further shrinks and stimulates under-prosperity. These changes are due to cyclical fluctuation in business activity. A country experiences rapid growth in importation than exportation when enjoying the boom.

4.7.1.3 Secular Disequilibrium

Due to some secular trends in the economy, sometimes BOPs disequilibrium persists for a long period. Persistent, deep-rooted dynamic changes are the reasons for secular disequilibrium over a long period. For example, disposable income and purchasing power in developed countries are generally very high. At the same time, due to higher wages, the cost of production naturally increases too. Therefore, higher prices are observed. This particular situation may lead to observing higher imports than corresponding exports. Similarly, in newly developing country investments exceed the level of saving in initial stages of growth. Due to levels of abysmally low capital formation, dependence on importing huge amounts of capital from foreign countries is a must thereby leading to a situation where the country's imports exceed its exports. The insufficient inflow of capital may result in a secular deficit in BOPs.

4.7.1.4 Structural disequilibrium

Structural changes in some sectors will change the demand and supply of imports and exports which will result in a structural disequilibrium in the balance of payments. For example: if the demand for Indian Jute product declined in foreign country due to some substitutes, then in India, production of jute goods needs to be changed significantly to production of other variety of exports. If India does not make it, then it has to face a decline in its export levels. Whereas if imports remaining the same Bops disequilibrium arises.

Similarly, other reasons for the decline in the supply of exports may be crop failure in case of primary products, unavailability or fluctuating demands of raw materials or labour union strikes, hartals, etc., in that case, manufactured products also try to bring changes in export items and finally these changes will result in BOPs disequilibrium structurally. Changes in tastes, fashions, habits, income, economic progress etc., also may shift demand and bring change in import propensity. Demand for imports may increase or decrease that may lead to structural change and thus bring disequilibrium in BOPs. International capital movements also may have such change directly on country's BOPs.

4.7.2 POLITICAL FACTORS

BOPs disequilibrium may occur due to some political factors also. If a country is having political instability for a long period may experience a large outflow of capital and a decline in domestic investment and production. War or changes in world trade direction also may result in difficulties that lead to disequilibrium in BOPs.

4.7.3 SOCIAL FACTORS

Social factors such as change in tastes and preferences will show impact on import and export, thereby affecting BOP's.

4.8 MEASUREMENT OF BALANCE OF PAYMENTS - SURPLUS OR DEFICITS

If a country is enjoying a surplus then if never bothers any country. But if it faces deficit each nation will try its best to minimize its BOP's deficits. Several alternative measures are available to correct BOPs disequilibrium. The corrective measures are grouped into automatic and deliberate.

The BOPs of a country can be adjusted automatically by bringing certain changes in income levels and prices with the help of corrective policy measures namely, devaluation and direct controls if they have a deficit.

4.8.1 AUTOMATIC ADJUSTMENTS

Under gold standard BOPs, disequilibrium will be considered to be corrected automatically. With the given paper currency standard, it is also possible to have automatic corrections in disequilibrium in BOPs. The free flow of market forces, i.e., demand for and supply of foreign exchange will help to restore equilibrium automatically. For example: if there is disequilibrium or deficit, it is due to the rise in the foreign exchange demand rather than supply which results in hike in the corresponding exchange rate and a fall in domestic currency's external value. This leads to cheaper exports and dearer imports than before. In turn, the increase in the level of exports and the decrease in the level of imports will successfully lead to the restoration of BOPs equilibrium. The Automatic adjustment of BOPs can be attained through changes in price, interest, income and capital flow under a fixed exchange rate system.

4.8.1.1 Price Adjustments or Through Exchange Depreciation

The price of a currency is nothing but known as the rate of exchange. Demand and supply determine the exchange rate, like any other commodity. Changes in the rate of exchange is known as the outcome of changes of the demand and supply conditions. But there is every possibility to find exchange rate equilibrium which results in clearing exchange market for bringing about external equilibrium. Further, this can be achieved in an automatic process by corresponding currency depreciation in that particular country which is having a BOP deficit and in case of surplus by appreciating the country's currency. Depreciation means reduction or decrease in the value relative of its respective currency and appreciation means a rise in the relative value of the same currency. Depreciation usually shows effect on exports positively and on imports negatively. In other words, exports will be encouraged and imports will be discouraged. Appreciation has its effects positively on imports and negatively on exports. In other words, imports will be encouraged and exports will be discouraged. With exchange rate depreciation, the foreign prices will be transformed into the domestic prices.

For example, the dollar depreciates in terms of pounds; it reveals that the dollar price declined relatively with that of the pound price in the foreign exchange market. As a result, the prices of U.S. exports fell in Britain and the prices of Britain's imports observed a rise in the US. If import prices are high in US Americans purchase fewer goods than before from Britishers. On the other hand, US exports will increase to Britain as their prices are lower. Thus exports of the US will increase and imports will diminish automatically to attain equilibrium in BOPs.

4.8.1.2 Adjustment through Interest Rate

Besides the price effect, another monetary effect of BOPS is its effect on the short term interest rates. The surplus or deficit in BOPs is due to expansion or contraction of supply of money with corresponding fall or rise in the interest rates. An increase in the interest rates in home country which is facing a deficit will further encourage the investors to withdraw their funds from the foreign country and invest in their home country. Due to a dip in the interest rates in a BOPs surplus country, people of that country are encouraged to invest their funds in deficit countries in which the interest rates were raised. These changes in interest rates help to restore equilibrium in BOPs.

4.8.1.3 Income Adjustments

Under fixed exchange rate income changes will help to restore equilibrium automatically as demonstrated by J.M.Keynes, which was neglected by classists. He advises that an autonomous rise in export value leads to a rising national income which is equal to the amount of value of the foreign trade multiplier. The multiplier principle explains that with increasing investment, there will occur a rise in income greater than the increase in investment, when the MPC is higher than zero. In foreign trade, changes in income caused due to changing exports or investment is expressed by foreign trade multiplier in an open economy. The increased income spills over in the form of imports. In case of a deficit country, there will be an opposite action.

4.8.1.4 Adjustment through capital movement

Capital movements help to restore equilibrium between deficit or surplus countries. In the case of deficit country capital inflows help to finance the deficit and in a surplus country, capital outflow will adjust the BOPs disequilibrium.

We can understand the process of capital movements under flexible exchange rates and also where there is perfect capital mobility.

When there is perfect capital mobility, a little change in the rate of interest will result in large inflow of capital. When the domestic rate of interest becomes equal to world rate of interest, it is called equilibrium in BOP's. For example, if the world rate of interest is observed to be greater than the domestic rate of interest, there occurs capital outflow to a greater extent and results in a huge depreciation in the domestic currency of the country. Vice versa, if the observed world rate of interest is lesser than the domestic rate of interest, there will occur large capital inflows and result in an appreciation of the currency.

Based on the fiscal and monetary policies of a country the capital movements take place to make adjustments in its BOPs. These movements are shown in the figure.

Monetary policy operations of a country are shown by the LM curve and fiscal policy operations shown by IS curves. The combinations of both the national income and the interest rate level shows the equilibrium position of BOPs are given by the BOP line. Perfect capital mobility is reflected by the horizontal BOP curve. R_1 is the point showing the rate of interest at equilibrium BOPs.

Change in interest rate than this rate that means the higher or lower interest rate will have resulted in capital inflow or outflow.

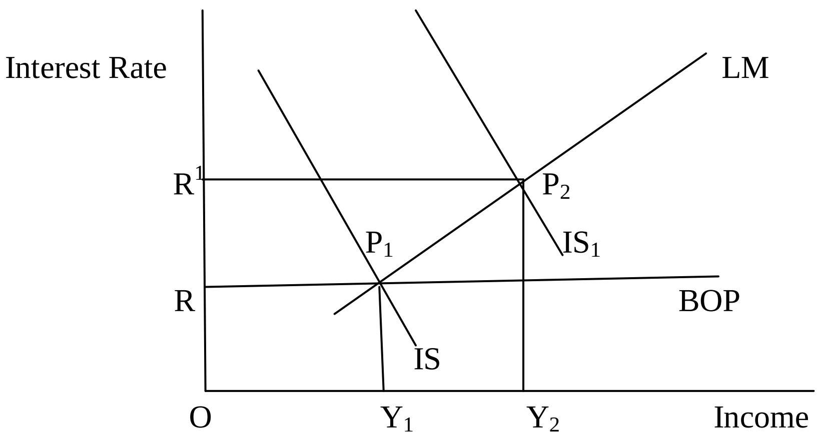


Figure – 4.1(A)

When we refer to the fiscal policy which is considered to be an expansionary fiscal policy, the IS curve makes a shift from IS to IS_1 without any change in LM curve. The corresponding newer position of the equilibrium will occur at P_2. At this point, the IS_1 curve intersects the LM curve with OR_1 as the rate of interest and income at OY_2. This point is above the BOP line exhibiting the surplus in its BOPs. When there is a surplus in BOPs, it leads exchange rate appreciation and therefore results in reduced demand for the domestic output. As long as the levels of domestic interest rate is above the world rate, then there will be a continuous inflow of capital as a result of appreciation process. The fiscal policy which is deemed to be expansionary will remain and effectively decrease the demand of goods until the corresponding IS curve shifts back from IS_1 to IS to re-establish the equilibrium at P_1. It is at this particular point that the rate of interest and income levels will be coming back to the original OR and OY_1. When expansionary monetary policy makes certain changes by lowering the rate of interest, and subsequently increasing the outflow of capital, thereby creating a deficit in it the BOPs. Removing deficit in BOPs is shown in the Figure below. Initial equilibrium is at point P_1. Under the expansionary monetary policy, the LM curve shifts from LM to LM_1 and the IS curve remains constant. The LM_1 curve intersects IS curve at P_0 where the rate of interest is reduced from OR1 to OR0 and the income levels rise from OY_1 to OY_2 as observed. As a consequence, there will be an outflow of capital that results in a deficit in BOPs and depreciation of the exchange rate.

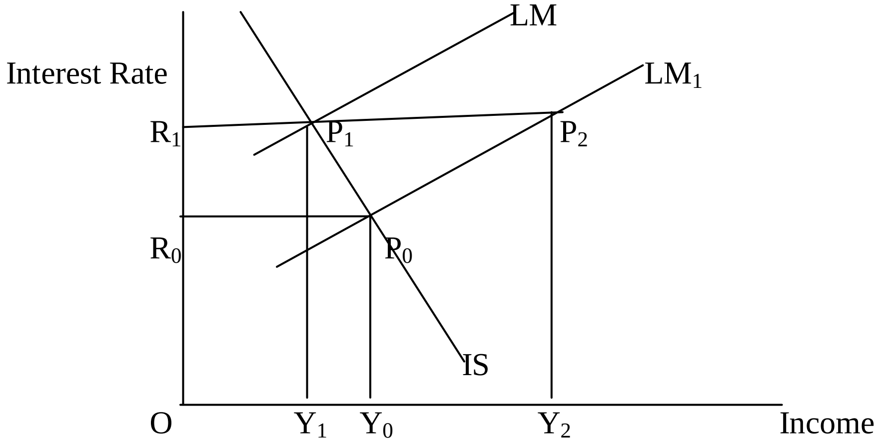


Figure 4.1 (B)

There occurs a rise in the demand for the domestic goods in the foreign country as a result of depreciation with subsequent rise in output and income of a country. The economy makes upward movement along the LM curve and will reach the point P_2, where OY_2 is the level of income and the rate of interest will rise to the old level of OR_1. Therefore, BOPs equilibrium will be restored at P_2. An overall rise in imports (due to increasing income) offsets the surplus of trade balance which is raised due to depreciation.

4.8.2 DELIBERATE CORRECTIONS OF DISEQUILIBRIUM IN BOPS

Automatic corrections of BOPs have several policy problems. Hence deliberate corrective measures are employed in recent times. Deliberate corrective measures mean to correct disequilibrium in the BOPs deliberately measures were taken by the countries. They are grouped into 1) Monetary measures 2) Trade measures and 3) Miscellaneous measures.

4.8.2.1 Monetary Measures

The following are some of the important monetary measures used deliberately to correct disequilibrium in BOPs.

a) Expansion or Contraction of Money

It is necessary to bring equilibrium in BOPs, for this, the expansion or contraction in the supply of money will certainly influence the price levels, levels of domestic demand, the demand for exports and imports. For example, if any deficit is there in its BOPs to bring equilibrium contraction of the money supply is needed. It will reduce the purchasing power, thus aggregate demand and also reduce domestic prices. This domestic situation will result in a reduction in demand for its imports. Price reduction in the country will stimulate the country's exports. Thus disequilibrium in BOPs will be eliminated by decreasing imports and increasing exports.

b) Devaluation

Reduction in the official rate of domestic currency in relation to the other country's currency is known as devaluation. To stimulate its exports and to discourage imports a country may devalue its currency to adjust or correct the fundamental disequilibrium of the balance of payments. The prices of domestic imports will rise and the corresponding foreign price of that of its exports will fall when a country undertakes devaluation. Hence it is also called an expenditure switching policy. Under this, a country will switch to make its expenditure on domestic goods rather than foreign goods. To meet the increased demand for its domestic as well as exports the country will produce more and reduce its imports. Thus deficit in its BOPs will be eliminated or disequilibrium will be corrected.

Price movements of exports and imports and the effects of devaluation in a devaluating country are shown in diagrams as under.

Suppose Britain Pound is devalued in relation to the US dollar and the price movements of the pound are taken before and after devaluation. In both exports and imports, elastic demand and supply curves are taken. Panel A of the diagram showing exports. There is no effect of the devaluation of pound on the supply of exports in the pound. Hence, Sx the supply curve of exports does not change. But the devaluation of the pound means British goods will be cheaper than before and US consumers demand more and more Britain goods.

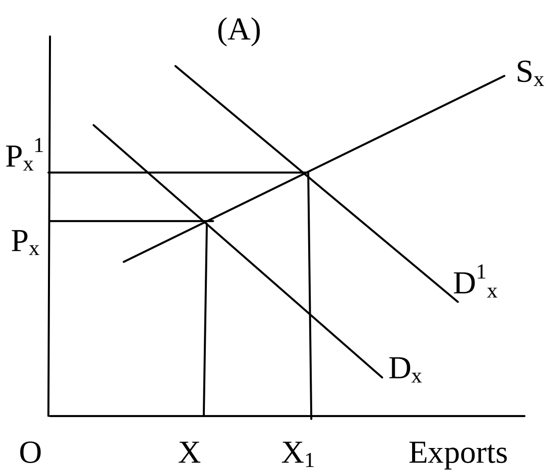


Figure 4.2 (A)

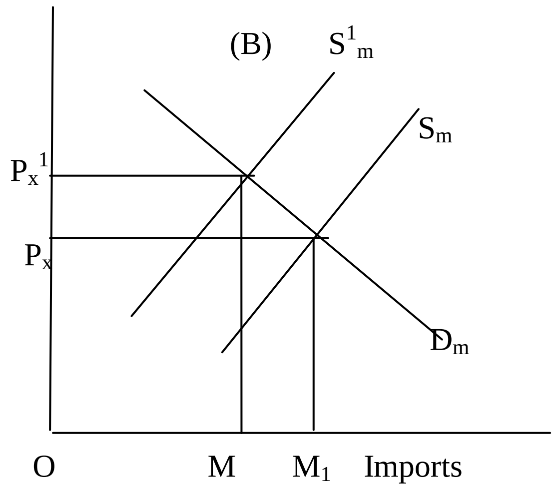


Figure 4.2 (B)

As a result demand for exports increases and the demand curve of exports shifts from D_x to $D^1{}_x$. The price of OX exports moves from OPx to OPx^1 after devaluation and exports increase to OX_1.

Panel B of the diagram showing Imports. When a devaluation takes place imports of a country will become dearer in the pound and as a result the volume of imports declines than before. Hence there will be a shift in the supply curve of imports from S_m to $S^1{}_m$ but the demand curve for imports does not change. The price of imports increases from OP_m to OP_m results in a decline in the number of imports from OM_1 to OM. Thus devaluation of a currency of a country will bring disequilibrium in the BOPs by increasing exports and decreasing imports.

c) **Exchange Control**

The government of a country that imposes exchange control asks the exporters to surrender the foreign exchange they earn through exportation to the government or central bank of the country. The exporters need to exchange foreign currency to get domestic currency. By having this type of control on foreign exchange reserves the government can control the importation of goods. Thus it will correct disequilibrium in BOPs.

4.8.2.2 Trade Measures

These measures mainly constitute of both export promotion and import substitution. Trade measures will help to enhance the exports and curtail the imports of a country.

a) Export Promotion

In order to promote exports the government of the country can take several measures like removal or a decrease in the export barriers or duties and thereby providing subsidy to exporters, which further encourages the production of export industries, providing monetary benefits to exporters along with fiscal, physical and institutional incentives and facilities for the exporters.

Exports can also be promoted by encouraging the quality products' production and productivity. By improving marketing facilities to its exports a country can increase its exports.

b) Import Substitution

In order to control imports government can take steps by imposing or increasing import duties, levying import quotas, prohibiting importation of unessential or unimportant items, issuing licenses and so on. In order to encourage the domestic industries to produce import substitutes, some incentives may be provided.

Government can also make a policy to produce goods which are imported previously and to replace imports by domestic production. In the initial period there will be a reduction in imports and in the later period there will be an initiation of exporting those products. It may result in a rise in the overall National Income with the working of the foreign trade multiplier by many times. Ultimately, exports rise faster than imports and help to eliminate disequilibrium in BOPs.

4.8.2.3 Various Other Measures

FDI in the home nation, development of tourism to make more and more foreigners visit in order to likewise systematically enhance the remittances from foreigners, incentives may be provided. These are some of the measures to help BOPs position more favourable to the country.

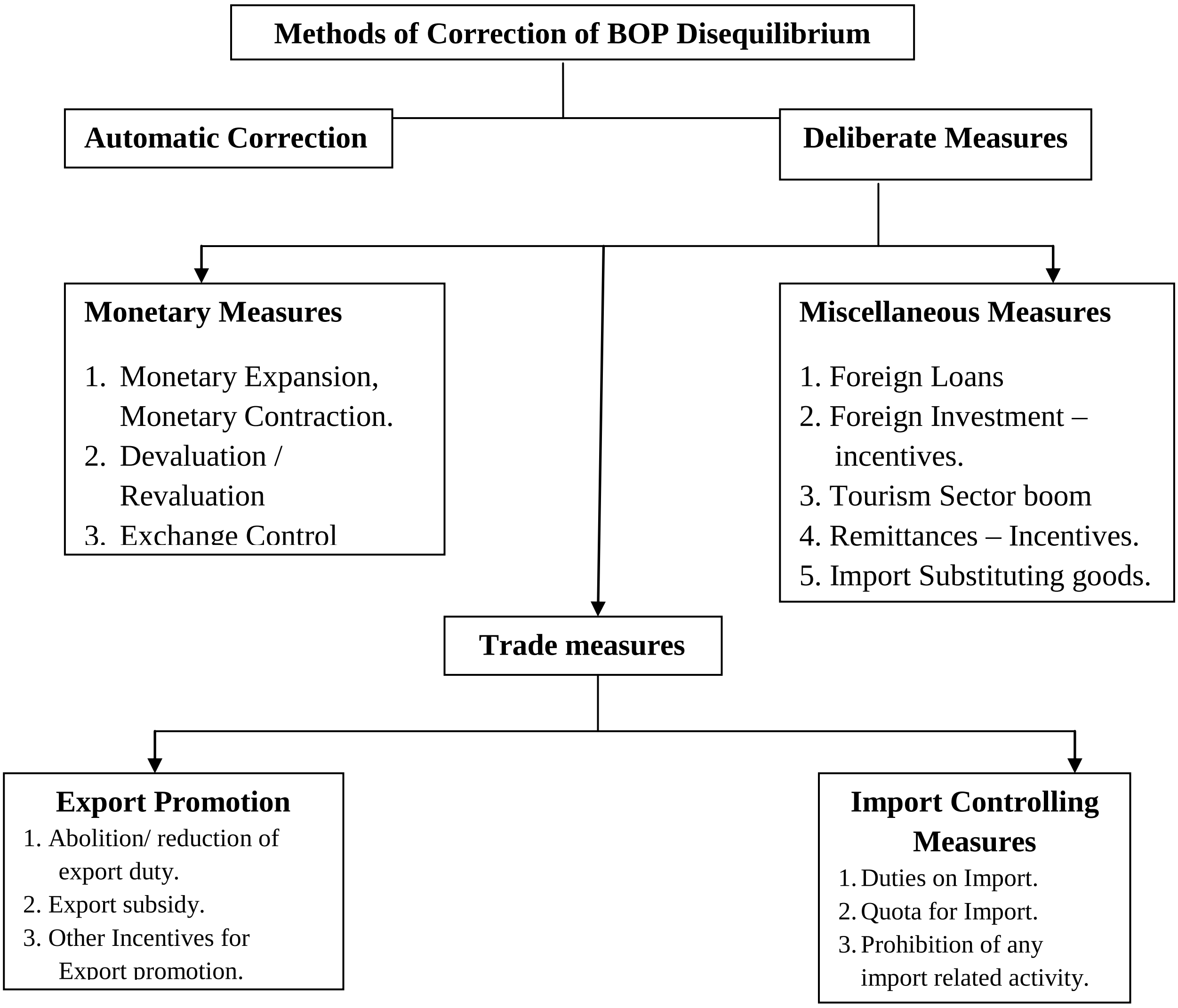


Figure 4.3: Methods of correcting BOP disequilibrium

4.9 SUMMARY

A systematic record or register of all the given economic transactions of the particular country compared to the rest of world in a given chronological time period is referred to as Balance of Payments or BOP, in short. A vertical division in BOPs account is composed mainly of capital account, current account, unilateral account, and official settlement account. Specifically, the current account displays the register of both invisible and visible items which constitute the exports and imports. All types of capital flow are recorded under the capital account. Unilateral transactions are one side transactions in the form of gifts, grants, disaster relief, etc., on both debit and credit sides. Official settlement account is nothing but the government or official transactions, which are accepted to settle the international claims.

The Balance of Payments are in equilibrium when the supply of the foreign exchange equals the demand for the specific foreign exchange. Disequilibrium in BOPs may arise due to economic, political and social factors. The disequilibrium in BOPs can be corrected by both automatic and deliberate measures.

4.10 GLOSSARY

Balance of Payments (BOP) : BOP is nothing but a systematic register of the possible economic transactions of the given country with that of the world.

Current Account: Current Account of the BOPs is also a register of exports and imports of visible and invisible items and also unilateral transactions.

Capital Account: This refers to all types of capital flows either direct or portfolio.

Double Entry Book Keeping: Almost all given economic transactions have two sides i.e., a debit side and a credit side. Each international transaction is recorded twice an equal amount recorded once on the credit side and once on the debit side. When we sell something we get income, it is entered on the credit side. When we buy something we pay for it, which is entered on the debit side. This is called double-entry bookkeeping.

The deficit in BOPs: If the sum of all the following – the capital, the current and the financial accounts is summarily negative, then there occurs a deficit in the BOPs. The deficit will be covered by the official settlement account.

The surplus in BOPs: If the sum of three given accounts – capital, financial and current account is summarily positive, then there occurs a surplus in the BOPs. This situation can be corrected by increasing the international reserves or by reducing foreign official holdings.

4.11 CHECK YOUR PROGRESS

Check Your Progress- A

1. (c)

2. (a)

3. (b)

4. (b)
5. (d)
6. (a)
7. (b)

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4.14 TERMINAL QUESTIONS

Q1. Explain the components of Balance of payments and discuss about its structure.

Q2. “Balance of Payments Always Balances” critically analyse. Explain how disequilibrium occurs in BOPs.

Q3. What are the various causes for disequilibrium in BOPs? Explain.

Q4. Discuss various types of corrective measures of disequilibrium in BOPs with examples.

UNIT5 MULTINATIONAL CORPORATIONS

5.1 INTRODUCTION

In this unit, you will study about multinational corporations. Generally speaking, multinational corporations derive at least a quarter of their revenues outside their home country. Many multinationals are based in developed nations. Advocates of multinationals say they create high-paying jobs and technologically advanced goods in countries that otherwise would not have access to such opportunities or goods. Critics, however, say multinationals have undue political influence over governments and tend to exploit developing nations and create job losses in their own home countries.

5.2 OBJECTIVES

After reading this unit you will be able to:

- Understand the meaning of Multinational Corporation.
- Understand the nature of Multinational Corporation
- Learn about the types of Multinational Corporation.

- Learn about the role of Multinational Corporation.
- Learn about the functioning of Multinational Corporation.

5.3 ORIGIN & EMERGENCE OF THE MULTINATIONAL CORPORATION

Multinational Corporation is an organization involved in producing and selling goods/services in more than one country with the intention of utilizing global resources in the most optimal manner. The allocation of resources is coordinated on a global basis. The essential elements that qualify a company to be a multi-national corporation necessarily include the approach and the degree of involvement in foreign markets.

Companies in the nineteenth and twentieth centuries ventured into foreign lands in search of raw material. These companies under the protection of the colonial empires started operations in other countries to exploit raw material. The twentieth century has been a witness to such organizations expanding their operations in different parts of the world to seek raw material like oil and minerals. These companies may be referred to as the earliest category of multi-nationals. Examples include British Petroleum and International Nickel

The next category of multi-nationals was those that explored foreign lands to produce and sell their goods and services. The primary purpose was to seek new markets. The reasons for seeking new markets either growth in terms of market share, sales and profitability or /and saturated domestic markets or enhancing revenues to offset research and development costs that are difficult to recover in home market because it is not big enough. Philips etc are examples.

The most recent category of multi-national corporation includes firms that explore low-cost production sites around the globe to benefit from cost advantage and maintain an edge over competitors. Production bases of many companies in Taiwan and China were set up with the intention of gaining cost advantage.

Fortune Global 500 companies generated $ 32.7 trillion in revenues ($ 2.15 Trillion in profits) in 2019 up 9% from last year. These companies employ 69.2 million people worldwide.14 female CEOs . There are 113 government owned companies on the global fortune 500. Amazon.com debuted on the list in 2009 at number 445 and shot up to the 13th spot in 2019.

5.4 UNDERSTANDING THE MNC IN TERMS OF DEGREE OF INVOLVEMENT

Let us try and understand the nature of a Multinational organization in terms of the nature, approach and the extent of involvement in foreign nations. A firm may have presence in more than one country. For example a company like Maruti Suzuki may sell cars in foreign markets directly through own sales outlets or indirectly through intermediaries. Does it imply that Maruti Suzui is a Multi-National Company? It is important to understand how much aa company is involved in foreign markets.

If Maruti Suzuki manufactures cars in India and apart from selling cars in India the company chooses to sell in Bangladesh, Bhutan, the Middle East and Europe. The decision to sell in many countries could be because the company wants to realise economies of scale or enhance revenues by extending the domestic market. The involvement of the company in this case is quite limited. Such companies may best be described as Exporters.

The degree of involvement in foreign markets is more if a company chooses to refine and modify the elements of the marketing mix according to the specific requirements and needs of customers in each such foreign market. These differences may be due to social and cultural differences.

If the approach of the company changes and instead of dividing foreign markets as distinct units, each with it's own set of marketing mixes, it considers an entire region or the entire globe as one market the company's involvement in the region and the world is quite high.

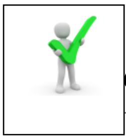
5.5 ELEMENTS OF THE MULTI NATIONAL CORPORATION

Size: Multi-national corporations are usually huge. The gigantic size is due to it's operations – resource procurement, sales and production in more than one country

International presence: MNCs operate in many countries

Financial muscle & Influence: Multinational companies are financially very strong and exhibit tremendous power due to the economic might. The turnover of some MNCs is more than the GDP of many countries.

Optimal utilization of resources: MNCs consume global resources in the most optimal manner with a view to maximise competitive advantage.



Check Your Progress-A

Q1. What is a Multi-National Corporation?

Q2. Describe the characteristics of a Multi-National Corporation.

Q3. Write a brief note on the 21st century multi-national corporation.

5.6 BENEFITS/ADVANTAGES OF A MULTI NATIONAL CORPORATION

1. Multi-national corporations stimulate innovation:

MNCs nurture an innovative culture by stimulating new ideas and investing in them to create newer and better products and services.

2. They create consistency for consumers.

The basic expectation of consumers from a brand is that it will look and function in a similar manner. The core ethics and values of the corporation are evident at all places even if the company serves different products in different countries. Similar designs, ordering procedures, and best practices are implemented at all locations for a multinational company. Customers believe in these institutions because they realize what the value proposition is before they ever spend any money with that brand

3. They can enforce minimum quality standards.

Vendors want to do business with multinational corporations because it allows them to enter new markets or contact new demographics for their goods or services. Multinational corporations improve the consumer experience because they naturally enforce minimum quality standards on the goods and services they make available. If a vendor doesn't deliver something of a proper quality, the corporation will find another supplier who will.

4. MNCs generate employment opportunities at the local level.

Multinational companies create jobs that meet or exceed local expectations. The employment and income opportunities created by these companies contribute to the growth of the local economy.

5. They facilitate cultural awareness

They serve as a bridge between the various cultures they serve, helping their customers become aware of the diversity that strengthens the world. With this influence, multinational corporations can have a positive influence on other businesses, in politics, and in the general welfare of people at the local level. When people expand their reasoning to include new viewpoints and opinions, the planet becomes a better place. These organizations provide a resolute influence on cross-culture information when this advantage becomes a prime preference for them.

6. Multinational corporations promote best practices in business.

These multinational organizations use leverage (due of their global presence and overall sizes) with their associates to produce a desired action for each customer.

7. Multinational corporations facilitate diversification of economies.

Almost all people, nations, and marketplaces depend on a set of core products for their survival. Most of these items are related with agriculture-based industries. Multinational companies offer these economies more variety in product and price choice. Diversity is thus created for the local consumer. This diversity reduces their dependence on products and materials that generally have very volatile pricing structures due to their dynamic demand and supply conditions.

8. The presence of multinational corporations facilitates development and improvement of infrastructure.

Multinational corporations usually contribute to improvements in infrastructure to motivate local populations to develop skill-based workers that can take on their needed tasks. Employment opportunities are created in local markets for communities. It is quite common to see businesses helping to fund local road projects, build bridges, and reduce other transportation barriers around the world.

An example is that of the Coca-Cola Company. The firm developed a 2020 Vision Program to encourage more local infrastructure development in the Asia-Pacific region as a way to develop more middle class households. Billions of dollars are being spent to help raise the standard of living of millions in least and less developed countries where workers still survive on less than $2 per day. Many other multinational companies have similar development projects around the globe.

9. The Multinational corporations stimulate the export-import market.

Investment and other activities of multinational corporations in the developing world helps nations to develop better access to the import-export market. Each marketplace in turn gets better access to valuable goods and creates good opportunities for trade. The standard of living and the quality of life improves as a result.

10. Multinational companies reduce dependence on others and need for foreign aid.

Less developed countries often rely on foreign aid as a way to balance their domestic budget each year. Aid and contributions from the developed world contribute to the GDPs of poor nations. The presence of multinational companies in such markets makes it easier to build profits and improve conditions despite the fact that the value of these transactions is not significant compared to global scales. The presence of MNCs tend to boost the levels of trade in the least developed and the developing world.

11. The presence of multinational corporations stimulates capital inflows.

Almost all big multinational companies have their headquarters in the developed world. These companies rely on the resources of those mature marketplaces to maintain the diversity of their revenue streams because it is cheaper to develop production assets outside of their domestic market. These firms venture into the developing world to generate profits through the investments to maintain the value of their overall portfolio. Multinational companies are a leading source of capital inflows to the developing world because they build manufacturing centers, investing in workforce training, and support institutions of learning to advance their productive capacity in foreign markets.

5.7 DISADVANTAGES OF THE MULTINATIONAL CORPORATION

1. Multinational corporations can create monopolistic markets.
   Large companies look for opportunities to monopolize markets. In doing so, they drive the competition away, allowing them to set their own prices on items.
   The assets of a multinational corporation are treated as an independent structure by most countries, instead of looking at the hierarchy of the business for what it tends to be. This allows each firm to have more flexibility in how they handle the local marketplace. Global monopolies do not exist in current markets but firms like Alphabet, Illumina, and Broadridge, all manage a 50% share or more of their industry. The advantages of scale allow the multinational corporation to restrict competition and price other players out of the market. Local competition may still exist, but the average consumer will be attracted to the cheapest offer if it provides a similar amount of value for them.
2. Multinational corporations destroy small enterprises and local business.
   Multinational corporations may provide new opportunities for some markets, but they do so at the expense of the current businesses already operating in that space. Being

able to offer low prices comes at a high cost. Even when brands have an established name, retail pricing efforts can disrupt the entire supply chain.

The size and scale of multinational corporations aggravates the problem. Larger companies can process larger bulk orders and ensure a per-unit price savings when compared to SMEs.

3. Profits usually go back to the multinational company instead of staying in the local market.

   Multinational companies do provide job opportunities in local markets, but at the same time they also channelize most of the profits back to their centralized office. This may be viewed as a return on their infrastructure and other investments but it can also weaken an already underperforming government or economy.

4. Multinational corporations deprive the local economy of available raw materials.

   The entry of multinational corporations into a developing country leads to infrastructure benefits but the investment in construction efforts are usually meant to benefit the business and not the local market. Roads and bridges are built to facilitate procurement and movement of raw materials, distribute goods, and manage processes rather than improving the livelihood of those living in the region. Once the purpose is served and all of the goods are removed, then the firm may decide to abandon the project.

4. They can exploit local workers because of local conditions.

   Local workers may be exploited in a variety of ways to serve the purposes of business.

5. Multinational corporations can have adverse impacts on the environment.

   Most of the developing world do not have the same level of regulation and oversight that the developed world has to protect the environment. When these firms from the developed world do business in the international market, they are subject to local laws – not the ones that govern their domestic headquarters. It becomes easier for them to obtain raw materials even at the cost of environment. Less developed nations and governments often trade an increase in revenues for access to their natural resources. The relaxed standards lead to better pricing structures for each customer but it also damages the environment. Sustainability issues are generally compromised. Some nations even trade in recycled materials and trash, which can place even more stress on local resources.

6. Multinational corporations are often accused of fueling political corruption.

   According to Paddy Ashdown, a British diplomat and politician "The multinational corporations are now developing budgets that are often bigger than medium-sizes countries," "These live in a global space which is largely unregulated, not subject to the rule of law, and in which people may act free of constraint."

Legal lobbying is a multi-billion dollar industry, even if you were to only take the spending that happens in the United States. According to data published by Open Secrets, the U.S. Chamber of Commerce spent $94.8 million on lobbying efforts in 2018. The National Association of Realtors spent $72.8 million, while the Pharmaceutical Research and Manufacturers of America spent $27.9 million. When you add in the under-the-table deals that happen internationally, corruption occurs because companies have the financial muscle.

8. Multinational companies may import their skilled workforce.
Multinational corporations, sometime, may not hire local workers, opting instead to import positions from the centralized office to enhance productivity. Some benefits still accrue to the local economy and provide a handful of jobs that fall outside of this disadvantage. The import leakages, therefore, tends to benefit the company and the workers more than the local community. The highest paying jobs, available in the developing country go to someone outside the local community, meaning thereby, that their salaries will not have the same economic impact that they would have if a local employee was in that position.

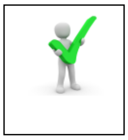
9. They enter a community at a high cost.
According to Forbes, Walmart workers in 2014 cost U.S. taxpayers a total of $6.2 billion in public assistance funds. That is because the wages they offered workers, though legal, was not enough to meet standard of living needs. A single Walmart in the U.S. could cost up to $1.75 million for local taxpayers. At the same time, in 2013, Walmart captured 18% of the SNAP food stamp market. That means they generated $13.5 billion in food stamp sales while not paying workers competitive wages.
These multinational corporation pros and cons give us a glimpse of what can happen when a few hold power over the many. When that power is ethically and morally wielded, then societies benefit from what can be accomplished. If that power is used for profit over anything else, then households are harmed by their activities. We need multinational corporations to accomplish our daily tasks. We also need to ensure that their power doesn’t grow so great that it overwhelms who we are or what we do.

5.8 THE WORLD'S LARGEST COMPANIES IN TERMS OF REVENUE (2019)

RANK	NAME OF THE FIRM	SECTOR/INDUSTRY	REVENUES	EMPLOYEES	PROFITS
			($ M)		($ M)
1	Wal-Mart	General Merchandisers	$ 5,14,405	22,00,000	$ 6,670
	(Bentonville, USA)	Retailing			
2.	Sinopec	Energy/Petroleum	$ 4,14,649	6,19,151	$ 5,845
	(Beijing, China)	Refining			
3.	Royal Dutch Shell	Energy/Petroleum	$ 3,96,556	81,000	$ 23,352
	(The Hague, Netherlands)	Refining			
4.	China National Petroleum	Energy/Petroleum	$ 3,92,976	13,82,401	$ 2,270
	(Beijing, China)	Refining			
5.	State Grid	Energy/ Utilities	$ 3,87,056	9,17,717	$ 8,174
	(Beijing, China)				
6.	Saudi Aramco	Energy/ Mining	$ 3,55,905	76,418	$ 1,10,974
	(Dhahran, Saudi Arabia)	Crude oil production			

7.	BP	Energy/Petroleum	$ 3,03,738	
73,000	$ 9,383			
	(London, UK)	Refining		
8.	Exxon Mobil	Energy/Petroleum	$ 2,90,212	
71,000	$ 20,840			
	(Irving, USA)	Refining		
9.	Volkswagen	Motor Vehicles	$ 2,78,341	6,64,496
	$ 14,322			
	(Wolfsburg, Germany)	& Parts		
10.	Toyota Motor	Motor Vehicles	$ 2,72,612	3,70,870
	$ 16,982			
	(Toyota, Japan)	& Parts)		

Table 5.1 The World's Largest Companies in Terms of Revenue (2019) Source: Fortune.com



Check Your Progress- B

Q1. How can MNCs ensure minimum quality standards on the goods and services they make available?

Q2. How can multinational corporations promote cultural awareness?

Q3. How do MNCs sometime create monopolistic markets?.

Q4. Write a brief note on the impact of multi-national corporations on the environment.

5.9 SOME OF THE LARGEST MULTINATIONAL COMPANIES IN INDIA

1. Microsoft
   (Since: 1990)

Founded by Bill Gates and Paul Allen in 1975, with its central office in Washington. Microsoft Corporation according to the Forbes 2019 ranking generated revenues of 1,10,360 million billion dollars. The company is renowned for their operating systems, software products, Edge Web browsers, Microsoft Office Suite and Internet Explorer.
Microsoft Corporation entered the Indian market in 1990 and is headquartered at Hyderabad. They work very closely with the Government of India and IT firms, contributing to human resource and technological development.

2. Proctor & Gamble
   (Since: 1964)

Founded by William Procter and James Gamble, P&G is operating in multiple sectors like beauty and grooming, healthcare, and household care. P&G products include Vicks, Ariel, Tide, Whisper, Olay, Gillette, Ambipur, Pampers, Pantene, Oral-B, Head & Shoulders, Wella and Duracell.

Procter and Gamble has achieved high standards of quality and serves about 650 million consumers across India and has 92,000 employees worldwide. Their central office is in Ohio and the company generated a revenue of 66,832 million dollars worldwide in 2019

3. Nestle
   (Since: 1912)

Founded by Henri Nestlé, headquartered at Vevey, Switzerland, it is a multinational food and beverage company that is globally known for their high-quality food products. Famous Nestlé products in India include Maggi, KitKat, Bar One, Nestlé Slim Milk, Milkmaid and Nescafe.

4. Coca-Cola
   (Since: 1993)

Founded by John Stith Pemberton, in 1886, Coca-Cola's range of extremely popular, non-alcoholic beverages include Maaza, Fanta, Coca Cola, Coca-Cola Zero, Sprite, Limca, Thums Up, Minute Maid juices and Georgia tea.

The company started work in India from 1993 through the Coca-Cola India Private Limited subsidiary. The head office in India is in Kolkata.

5. PepsiCo
   (Since: 1989)

Founded by Caleb Bradham, after the merger of Pepsi-Cola Company and Frito Lay in 1965. PepsiCo operates in India through its subsidiary, PepsiCo India Holding Private Limited.

Their brands include Pepsi, Lays Potato Chips, Seven Up, Mountain Dew, Tropicana, Mirinda etc. The PepsiCo headquarters is in New York and headed by Indira Nooyi. .

6. CITI Group
   (Since: 1902)

Citi began operations in India over a century ago in 1902 in Kolkata and today is a significant foreign investor in the Indian financial market. As promoter-shareholder, Citi has played a leading role in establishing important market intermediaries such as depositories, credit bureau, clearing and payment institutions. Citi helped lay the foundation of the Indian software industry by establishing Citicorp Overseas Software Ltd. and Iflex Solutions Ltd.; it pioneered the ITES industry in financial services through Citigroup Global Services Ltd. (CGSL).

Citi India's products and services are organized under two major segments: Institutional Clients Group (ICG) and Global Consumer Banking (GCB).

The ICG serves Citi's best-in-class products, services and execution through four major client groups: Corporate and Investment Banking, including Capital Markets Origination, Markets & Securities Services, Treasury & Trade Solutions and Private Banking.

Under GCB, Citi India offers the full range of consumer banking products and services. It offers personalized and customized offerings for customers across the wealth continuum—starting with salaried accounts (*Suvidha*), the emerging affluent (*Citi Priority*), the affluent (*Citigold*) and for high-net-worth individuals (*Citigold Private Client*). Citibank is one of the leading card issuers in India with a diverse suite of innovative and differentiated products.

7. 8.Sony Corporation
   (Since 1994)

   Founded by Masaru Ibuka, Sony Corporation is a Japanese multinational started in 1946. They have emerged as a pioneer in the entertainment and electronics sector, producing state-of-the-art entertainment units. They entered the Indian market in 1994 and their product range includes televisions, mobile phones, cameras, PlayStations, headphones and memory cards etc.

   Sony products are immensely popular and known for their superior quality and technical innovation. In India, Sony is headquartered in Delhi.

8. Hewlett Packard (HP)
   (Since 2002)

   Founded in 1939 by David Packard & Bill Hewlett at Palo Alto, California, Hewlett Packard is a technology company that has branches in more than 170 countries.

   Their products are broadly classified into three categories: the Personal Systems Group (PCs, mobile computing devices, and workstations), Imaging and Printing Group (Printers and printing supplies) and the Technology Solutions group. In India, they are headquartered in Bangalore.

9. Apple Inc

   Founded in 1976 by Steve Jobs, Steve Wozniak, and Ronald Wayne

   Their products include the iPhone, iPod, MacBook, Apple Watch and Apple TV.

   Apple products are comparatively more expensive than the rest but in spite of their cost, they are the most traded products on the market.

   On August 2, 2018, Apple made history by becoming the world's first $1 trillion company measured by market capitalization. While it see-sawed in the second half of the year, losing over $450 billion in the last quarter of 2018, it has since recovered most of that amount and now stands at $967.87 billion as of September 2019.

   Since 2010, Apple (AAPL) has been one of the most valuable companies in the world.

10. TATA Group

    Founded in 1868 by Jamsetji Tata, the TATA Group boasts of 100 independent operations in many countries. Some well known companies under the TATA umbrella include Tata Chemicals, Tata Consultancy Services, Tata Steel, Tata Global Beverages, Tata Communications and Tata Teleservices.

With about 660,800 employees, the Tata Group has become synonymous with providing trustworthy and premium services. Tata Consultancy Services has a market value of 98.4 billion dollars, Tata Motors 16.8 billion dollars and Tata Steel has 10.2 billion dollars. On the whole, the group is worth more than 103.5 billion dollars.

11. Aditya Birla Group

Founder: Seth Shiv Narayan Birla

The Aditya Birla Group is a multinational conglomerate started by Seth Shiv Narayan Birla in 1857. They are headquartered at Mumbai with regional offices in 35 countries and about 120,000 employees worldwide.

The group is present in many sectors such as viscose staple fiber, metals, cement, viscose filament yarn, apparel, carbon black, insulators, financial services, BPO and IT services. In 2018, their revenue was 44.3 billion dollars. The Aditya Birla Group has a marked presence in Thailand, Malaysia, Indonesia, Philippines, and Egypt.

Their leading brands include Birla Sun Life Insurance Company, Idea Cellular, Ultratech Cement and Grasim Industries.

12. Google

Founded in 1998 by Larry Page and Sergey Brin, Google is an American multinational company. Since its start, Google has gone beyond its core search engine function to involve a massive range of services like Google Docs, Google Sheets, Google Slides, cloud storage, social networking, Google Allo, Hangouts and the development of the Android operating systems.

Google offices in India are located in Bangalore, Gurgaon, Hyderabad, and Mumbai. As of May 2018, the value of Google is 132.1 billion dollars.

13. Cognizant

Year of Entry: 1996

Founded by Francisco D’Souza and Kumar Mahadeva in 1994, Cognizant is a leader in information technology related services providing consultancy, business process services, application services and IT infrastructure services. Their focus is on analytics, mobile computing, BPO and testing, insurance, healthcare, manufacturing, and retail. Cognizant started serving external clients from 1996.

The company employs more than 255,800 employees globally, of which over 150,000 are in India in Chennai, Bangalore, Coimbatore, Gurgaon, Noida, Hyderabad, Kochi, Kolkata and Mangalore.

14. Infosys
    Year of Entry: 1981
    Founded by Narayana Murthy, Nandan Nilekani, S. Gopalakrishnan, S. D. Shibulal, K. Dinesh, N.S. Raghavan and Ashok Arora in 1981, Infosys's key products NIA (Next Generation Integrated AI Platform), Infosys Consulting for global management solutions, Infosys Information Platform, Edge Verve Systems and Panaya Cloud Suite.
    Headquartered in Bangalore, Infosys has offices in USA, China, Middle East, Japan and Europe. In 2018, $10.93 billion revenue was generated.

5.10 ROLE OF MULTINATIONAL CORPORATIONS IN DEVELOPING COUNTRIES

The contributions to the development of world economy by the Multinational Corporations cannot be underestimated. They have stimulated growth in many host countries.

The significance of Multinational Corporations in developing countries is as follows:

a. The Multinational Corporations improves business culture in the host country.
b. Multinational Corporations stimulate exports in the host country.
c. Multinational Corporations reduce the host country's dependence on imports by producing several goods required in the host country.
d. MNCs facilitate development process in the host country by transfer of technology and better management practices.
e. Multinational Corporations help in generating employment and income in developing host nations.
f. Multinational Corporations stimulate growth & modernization.
g. Multinational Corporations tend to equalize the cost of production in the global market due to their wide network of productive activity.
h. Multinational corporations help in developing and improving health facilities in their host countries through socially responsible activities

5.11 SUMMARY

The multinational corporations facilitate the integration of national and international markets. The growth of MNCs has great influence on the industrial, social & economic environment.

Multinational corporations are an important and essential components of globalization and have proved to be a significant force in the expansion of world economy.

The 21st century multinational corporations have a revolutionary effect on the economic system all over the world. This is due to the growth of international transactions of the multinationals, which has great effect on the traditional forms of international trade & capital flows for economies at large. In the world economy they form a powerful force. The multinational firms have tremendously influenced international trade and finance.

Diversified conglomerate Reliance Industries (RIL) has become the top-ranked Indian company to feature in the latest Fortune Global 500 list.

The oil-to-retail major has toppled state-run Indian Oil Corporation (IOC) as the top-ranked Indian company.

RIL has attained a rank of 106 in the latest list, recording an improvement of 42 positions from its previous ranking.

On the other hand, IOC improved its position to 117th rank, registering a jump of 20 spots.

Other Indian companies in the Fortune 500 Global List include ONGC (160), State Bank of India (236), Tata Motors (265), Bharat Petroleum (275) and Rajesh Exports (495).

The 2019 ranking was led by Walmart, followed by Sinopec Group, Royal Dutch Shell, China National Petroleum and State Grid.

5.12 GLOSSARY

Multinational: A large corporation with operations and subsidiaries in several countries.

Common Market: A group of countries committed to the pursuit of a common external trade policy.

Comparative Advantage: The theory that countries should specialize in the production of goods and services they can produce most efficiently.

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

Globalization of markets: Moving away from an economic system in which national markets are distinct entities.

Import Quota: A direct restriction on the quantity of a good that can be imported into a country.

International Monetary Fund (IMF): International institution set up to maintain order in the international monetary system.

International Strategy: Trying to create value by transferring core competencies to foreign markets where indigenous competitors lack those competencies.

Multinational Enterprise (MNE): A firm that owns business operations in more than one country.
Multidomestic Strategy: Emphasizing the need to be responsive to the unique conditions prevailing in different national markets.
Predatory Pricing: Reducing prices below fair market value as a competitive weapon to drive weaker competitors out of the market.
Price Discrimination: The practice of charging different prices for the same product in different markets
Specific Tariff: Tariff levied as a fixed charge for each unit of a good imported.
Tax Haven: A country with exceptionally low, or no, income taxes.
Voluntary Export Restraint (VER): A quota on trade imposed from the exporting country's side, instead of the importer's; usually imposed at the request of the importing country's government.
World Trade Organization (WTO): The organization that succeeded the General Agreement on Tariffs and Trade (GATT) as a result of the successful completion of the Uraguay round of GATT negotiations.

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5.14 SUGGESTED READINGS

1. No Billionaire Left Behind: Satirical Activism in America
2. https://www.goodreads.com/book/show/16157997-no-billionaire-left-behind
3. The Shadow Elite: The New Agents of Power and Influence Who Are Undermining Government, Free Enterprise, and Democracy (Hardcover)
4. https://www.goodreads.com/book/show/3883268-the-shadow-elite

5.15 TERMINAL QUESTIONS

Q1. Discuss the origin and evolution of the Multi-National Corporation.

Q2. Discuss the role of Multi-National Corporations in enhancing growth and development.

Q3. Describe the problems that may arise because of the growth of MNCs.

Q4. Write a note on some of the largest MNCs in India.

Q5. Elaborate the role of Multi-National Corporations in developing countries.

Block II
International Trade and Environment

UNIT 6 THEORIES OF INTERNATIONAL TRADE

6.1 INTRODUCTION

In the previous block you have learned an over view of International Business and various models, approaches and types of international business. You are going to learn theories of international trade and these theories examine the basis of trade and gains from trade. In other words what is the basis for trade? And what are the gains from trade?

The basic points we understand in this unit are along with basis for trade and gains from trade we also learn how gains from trade are divided between nations? What is the pattern of trade? Pattern means what commodities are traded, which commodities are exported and which commodities are imported by each nation. How trade expands, these issues will be explained in this Unit.

Writings of international trade were traced back to 17^{th} century even before the publication of Adam Smith's `The Wealth of Nations' (1776) in countries viz., England, Spain, France, Portugal and Netherlands. Specifically during 17^{th} and 18^{th} centuries a group of men wrote essays and pamphlets on international trade. Their philosophy was called as ***Mercantilism***.

Mercantilists maintained that a nation to become rich and powerful it has to export more and import less. The export surplus will result in the inflow of more and more precious metals, primarily gold and silver. Thus to mercantilists the government should stimulate exports and restrict imports. Since all nations may possess fixed amount of gold at a particular point of time, they could not have export surplus simultaneously. Hence, a nation can gain at the expense of the other nation. By encouraging exports and restricting imports the governments would stimulate national output and employment.

6.2 OBJECTIVES

After going through this unit you should be able to;

- Understand what is absolute advantage
- Understand the Law of Comparative Advantage
- Assess the Heckscher-Ohlin Theory and theories of inter-industry trade.
- Explain what the factors are leading to commodity price differentiation among nations and causes for the basis of international trade.

6.3 INTER INDUSTRY THOERIES OF TRADE

Views of mercantilists are important mainly for two reasons. First, the ideas of classical economists (Adam Smith, David Ricardo and others) are reaction to the views of mercantilists on trade and government role. Second, today we see resurgence of neo-mercantilism, as all the nations experiencing high level of unemployment are following protection measures to stimulate domestic production and employment.

The classical theories of Adam Smith and David Ricardo, Neo-classical Theories of Haberler, Heckscher-Ohlin, Leontief, Karvis, Linder and some other important theories of recent times like Rybezynski and Jagadish Bagavathi are briefly discussed.

6.3.1 ABSOLUTE ADVANTAGE THEORY OF TRADE

Adam Smith in his publication, the `Wealth of nations' pointed out that there should be free trade among nations. and also advocated a policy called as `Laissez Faire', which means minimum intervention of the government. Thus, he laid a strong foundation for the classical view of international trade and division of labour. To Smith, trade is possible between two nations only when both the nations gain. Otherwise, nations refuse to enter into trade.

6.3.1.1 Absolute Advantage

Meaning

Mutually-beneficial trade between two nations may be possible by having absolute advantage. According to Smith, when one nation is more efficient (has absolute advantage) in production of first commodity but less efficient in production of second commodity and another nation is efficient in production of second commodity than the production of first commodity, then both the nations can gain by enter into trade. The nations will specialise the commodity in which they are enjoying absolute advantage. Thus resources in both the nations can be utilised more efficiently and output increases. This increase in output measures the gains from trade. Which will be divided between two nations through trade.

Example:

Table - 6.1

ABSOLUTE ADVANTAGE

Nations	Commodity X	Commodity Y
A	10	5
B	5	10

To illustrate there are two nations A and B, producing two commodities X and Y. Country A is having absolute advantage in production of commodity X and country B is having absolute advantage in commodity Y.

The table 6.1 reveals that country A can produce 10 units of X and 5 units of Y by using one unit of labour, whereas country B produces 5 units of Commodity X and 10 units of commodity Y by using one unit of labour. it means A has absolute advantage in producing Commodity X and country B is having absolute advantage in Commodity Y.

Now both the nations can specialise in production of their absolute advantage commodity that results in increase in output of that commodity. This is shown in table 6.2.

Table - 6.2

GAINS FROM TRADE

Country	**Production before Trade**		**Production after Trade**		**Gains from Trade**	
	Commodity X	**Commodity Y**	**Commodity X**	**Commodity Y**	**Commodity X**	**Commodity Y**
A	10	5	20	0	+ 10	- 5
B	5	10	0	20	- 5	+10
Total Production	15	15	20	20	+5	+5

Adam Smith believed that all nations would gain by following free trade. He strongly advocated the policy of 'Laissez Faire'. Meaning of 'Laissez faire' is minimum government interference with economic system of the nation. Free trade results in efficient and full utilisation of all the resources available in a nation. This leads to maximisation of world's welfare. Exceptions to policy of laissez faire are construction and maintenance of some important public works and national defence.

Merits of Absolute Advantage Theory

1. Efficient utilisation of world's resources.
2. Maximisation of output and employment.

Demerits of Absolute Advantage Theory

1. Explains only a very small part of international trade today. For instance trade between developed and developing nations.
2. Trade between developed nations cannot be explained

To conclude unexplained part of trade by Adam Smith has been taken up by David Ricardo with the law of Comparative advantage theory. It explains the basis for trade and gains for trade. Absolute advantage theory is a special case of comparative advantage theory.

6.3.2 COMPARATIVE ADVANTAGE THEORY OF TRADE

The Law of Comparative Advantage was advocated by David Ricardo in his book on `Principles of Political Economy and Taxation' in 1817. With many practical implications the law of Comparative advantage is more important and unchallenged one in Economics.

6.3.2.1The Law of Comparative Advantage

David Ricardo postulated that there is possibility to beneficial trade if one nation is less efficient than other nation even in production of both the commodities. A nation will specialise in the production of and export the commodity in which it has greater absolute advantage and import the commodity in which it has less absolute advantage.

6.3.2.2 Assumptions of the theory

1. Two nations and two commodity model.
2. Tastes are equal in both the nations.
3. Labour theory of value.
4. No change in technology.
5. There is free trade.
6. No transport cost.
7. Full employment condition.
8. Constant cost conditions.
9. Perfect competitive market prevails in all markets.

6.3.2.3 Explanation of the Theory

For example: If nation A is more efficient in production of both X and Y commodities and nation B is less efficient in production of both X and Y commodities. The production of X and Y are given in the Table.

In case of Nation A, production of Commodity X has comparative advantage because it can produce one unit of X with 80/120 x 100 or 67 % of the nations B’s effort. But it takes

90/100 x 100 or 90% of the nation B's effort to produce one unit of Y. Hence nation A is comparatively more efficient in production of X and Y.

In case of Nation B production of both commodities has absolute disadvantage, why because it can produce one unit of X with 120/80 x 100 or 150% of the nation A's efforts. But it takes 100/90 x 100 or 111% of the nation A's efforts to produce commodity Y. Thus the absolute disadvantage is greater in production of X and it has a comparative advantage in production of Y.

Table - 6.3

COMPARATIVE ADVANTAGE

	Man hours required to produce one unit of	
Country	**Commodity X**	**Commodity Y**
A	80	90
B	120	100

6.3.2.4 Gains from trade

Let us assume both nations produce both commodities before entering into trade. Nation A takes 80 hours of labour to produce one unit of X and 90 hours of labour to produce one unit of Y. Commodity Y is more expensive than commodity X. One unit of X = 80/90 or 0.89 units of Y. Nation B takes 120 hours of labour to produce one unit of X and 100 hours to produce one unit of Y. It means commodity X is more expensive than Y. One unit of Y = 120/100 or 1.2 units of X.

Now nation A likes to import more than 0.89 unit of Y for one unit of X, it gains. Similarly, nation B likes to import one unit of X at less than 1.2 units of Y, it too gains. Thus both countries will gain.

Now if both nations enter into trade we assume that in international market one unit of X exchanged for one unit of Y. Then it is advantageous to nation A to export X and import Y and to nation B to export Y and import X. The following table explains how each nations gains from trade. Up to this point we wanted to prove that though a nation is less efficient in production of both commodities still there is scope for mutually beneficial trade.

Table – 6.4

GAINS FROM TRADE

Country	**Labour Hours to produce X and Y**	**Production before trade**		**Production after trade**		**Gains from trade**	
		X	**Y**	**X**	**Y**	**X**	**Y**

A	80+90= 170	1	1	2.125	-	+1.125	-1
B	120+100=220	1	1	-	2.2	-	+1.2
Total	390	2	2	2.125	2.2	+0.125	+0.2

Exceptions to the comparative advantage theory

When the absolute disadvantage in one nation with respect to another nation is same in both commodities there is no scope for mutually beneficial trade.

6.3.2.5 Criticisms

The comparative advantage theory has been the very basis for international trade for more than 100 years. The critics have been able to modify and amplify this theory. Prof Samuelson stated that certainly the comparative advantage theory rate high in that, it is an elegantly logical structure.

But it is not free from some defects. The following are the criticism against this theory.

1. Unrealistic assumption of labour cost
2. Most severe criticism against this theory is assumption of labour theory of value. According to this theory labour is homogeneous, price of the product is determined by the cost of labour used in production, which is not find in reality. labour is different in terms of skill, knowledge, productivity.
3. No similar tastes
4. Similar tastes of all individuals is also an unrealistic assumption.
5. Constant Cost conditions
6. This is another unrealistic assumption which we do not find in practical economic activities of the industries.
7. Two country Two commodity model
8. This is another unrealistic assumption. at present world there are more than two nations entering into trade and trading more than two commodities.
9. One sided theory
10. Is one sided because it considers only supply side of the trade but not demand side.
11. Transport cost ignored
12. Transport cost plays an important role in final price of the commodity, which is neglected by Ricardo. if we consider high transport cost the comparative advantage may nullify between the trading nations.
13. To conclude despite of all weaknesses the law of comparative advantage accepted widely and has undergone many modifications and refinements in the theory over a period of time.

6.3.3. THE OPPORTUNITY COST THEORY

Now we are learning how the comparative advantage theory has been modified by Gottfried Haberler in 1936. He explained the theory of Comparative Advantage on the basis of

Opportunity Cost. So some times the law of comparative advantage referred to as the law of comparative cost.

According to the Haberler's theory, the cost of a commodity is the amount of a second commodity that must be given up to release just enough resources to produce one additional unit of the first commodity. Except the Labour theory of value all other assumptions are taken to explain the comparative advantage. Thus, the nation with the lower opportunity cost in the production of a commodity has a comparative advantage in that commodity.

For example: Let us take two nations for example United States (US) and United Kingdom (UK), producing two commodities i.e., wheat and cloth. In the absence of trade US must give up 2/3 of cloth to produce one additional unit of Wheat. Then Opportunity Cost of Wheat is 2/3 of a unit of Cloth. If 1W = 2C in UK then the opportunity cost of Wheat is lower in US than UK. The US would have comparative advantage over the UK in Wheat. In two nations, and 2 commodity world the UK would then have a comparative advantage in Cloth. According to the law of comparative advantage, the US should specialize in producing Wheat and exports some of it in exchange for Cloth.

6.3.3.1 The production possibility frontier under constant costs

By using production possibility frontier or transformation curve opportunity costs can be illustrated. The production possibility curve shows the alternative combination of two commodities that a nation can produce utilising all of its resources with the best available technology.

Table – 6.5

ALTERNATIVES OF PRODUCTION POSSIBILITY IN US AND UK

Wheat (US)	Cloth (US)	Wheat (UK)	Cloth (UK)
180	0	60	0
150	20	50	20
120	40	40	40
90	60	30	60
60	80	20	80
30	100	10	100
0	120	0	120

Table shows that US can produce either 180 units of wheat and zero units of cloth, Or zero units of wheat and 120 units of cloth. US give up 30 units of wheat to produce 20 units of cloth. The opportunity cost in US is 1W = 2/3 cloth. On the other hand in UK can produce either 60 units of wheat and zero units of cloth or zero units of wheat and 120 units of cloth.

UK give up 10 units of wheat to produce 20 cloth. The opportunity cost in UK is 1W = 2C remain constant. Table -5 graphically shown in fig-6.6. Each point represents combination of wheat and cloth that a nation can produce.

For example: At point A, US produces 90 units of Wheat and 60 units of Cloth. At point A^1, UK produces 40 unit of Wheat and 40 units of Cloth.

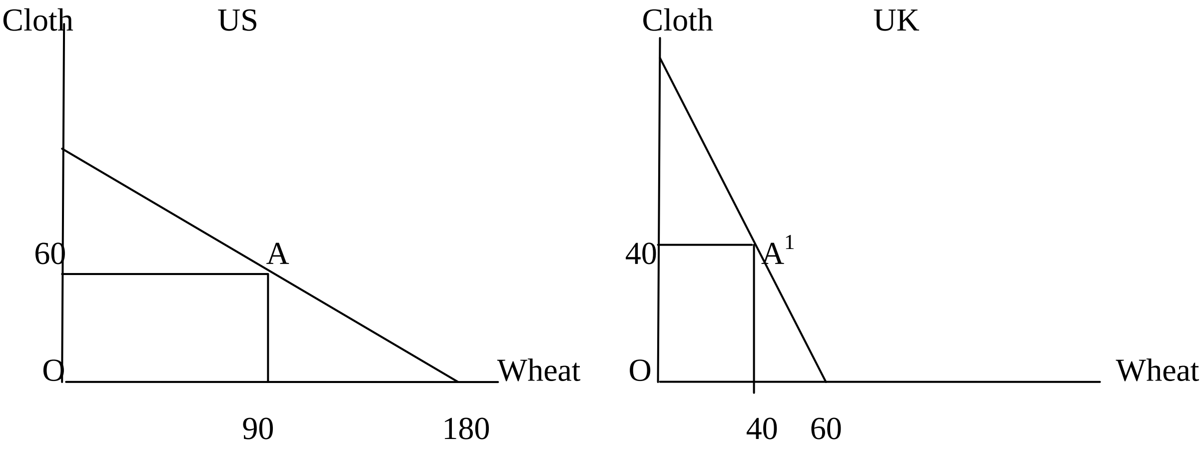

Figure 6.6

The downward or negative slope of Production possibility frontier indicates inverse relation between two commodities. If US and UK want to produce more wheat they must give up some amount of cloth production. The straight line of the production possibility frontier reflects the fact that their opportunity costs are constant. US must give up 2/3 of cloth to produce one additional unit of Wheat and UK must give up 2 units of Cloth to produce one unit of Wheat. Constant costs means the same amount of one commodity must be given up to produce each additional unit of the 2nd commodity. Constant costs are not realistic. They are discussed because they serve as a convenient introduction to the more realistic case of increasing costs.

6.3.3.2 The basis for and the gains from trade under constant costs

In any nation it can consume those commodities which are produced in that nation in absence of trade. Hence the production possibility frontier also represents consumption frontier. The choice of producing and consuming various combinations of commodities depends upon demand and tastes of the people.

6.3.3.3 Illustration of the gains from trade

In absence of trade US produce 90 units of wheat and 60 units of cloth, similarly UK produce 40 units of wheat and 40 units of cloth. US by specialising in production of wheat it can produce 180 units of wheat and Zero units of cloth. Likewise UK by specialising in production of cloth it can produce 110 units of cloth and zero units of wheat.

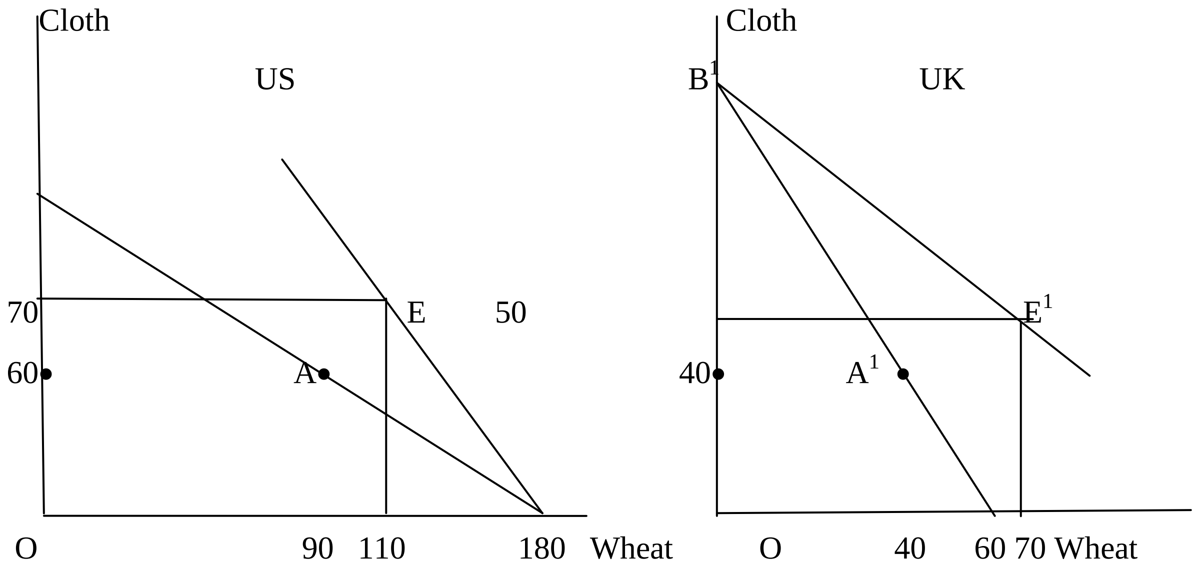

Figure – 6.7

If US exchanges 70 W for 70 C with UK, US ends up consumption at point E. (110 W + 70 C). UK ends up consumption at point E^1 (70 W + 50 C). Thus with trade US gains 20 W and 10 C UK gains 30 W and 10 C.

The increased production of both wheat and cloth in both nations was made possible by the increased output, resulted from specialization of commodities of its comparative advantage. Through specialisation increase in output of 50 W and 20 C is shared between US and UK represents gains from trade. Without trade US cannot produce only wheat or UK cannot produce only cloth because they want to consume both commodities.

6.3.4 THE HECKSCHER-OHLIN THEORY

Eli Heckscher, a Swedish economist, published an article entitled "the effect of foreign trade on the distribution of income" in 1919. In that paper he presented the outline of "modern theory of international trade". After 10 years Bertil Ohlin noticed and picked it up, built on it, clarified it and in 1933 published his famous book "Interregional and international trade". However since the essence of the model was first introduced by Heckscher, due credit is given to him by calling the theory the Heckcher-Ohlin Theory.

6.3.4.1Assumptions of H-O theorem

1. There are two nations (1&2) two commodities (X&Y) & two factors of production (labour & capital).
2. Both nations use the same technology in production.
3. Commodity X is labour intensive and commodity Y is capital intensive in both nations.
4. Both commodities are produced under constant returns to scale in both nations.
5. There is incomplete specialization in production of both nations.
6. Tastes are equal in both nations.

7. There is perfect competition in both commodities & factor markets in both nations
8. There is perfect mobility within each nation but no international factor mobility.
9. There are no transportation costs, tariffs or other obstructions to the free flow of international trade.
10. All resources are fully employed in both nations.
11. International trade between the two nations is balanced.

6.3.4.2 H-O theory can be presented in the form of two theorems

1) H-O Theorem - deals with and predicts the pattern of trade

2) The Factor - Price Equalization Theorem - deals with the effect of international trade on factor prices.

The Heckscher-Ohlin Theorem

The Theorem states that with given assumptions, 'A nation will export the commodity whose production requires the intensive use of the nations relatively abundant and cheep factor and import the commodity whose production requires the intensive use of the nation's relatively scarce and expensive factor'.

To start our discussion nation 1 is labor abundant nation where labour is available at cheaper price. As per assumptions labour intensive commodity is X, hence nation 1 specialize in production of X and exports some part of its output to nation 2. On the other hand nation 2 is capital abundant nation and capital is available at cheaper rate and by specializing in production of commodity Y and some part is exported to nation 1.

The differences in relative commodity and factor prices are the basic cause or determinant of comparative advantage and international trade. The H.O theorem explains comparative advantage is the difference in the supply of the various factors of production in different nations. The H.O theorem postulates that the difference in relative factor abundance and prices is the cause of the pre-trade differences in relative commodity prices between 2 nations.

A factor is considered as abundant or scarce in relation to the quantum of other factors. For example if supply of labour is 25 units and supply of capital is 20 units then the capital labour ratio is 0.8 in nation 1. Similarly in nation 2, supply of labour is 12 units and supply of capital is 15 units then capital – labour ratio is 1.25. Here nation 1 has more capital in absolute terms and nation 2 has more capital in relation to availability of labour which is clear from capital labour ratio. nation 1's capital labour ratio is less than nation 2

Pattern of trade according to Heckscher-Ohlin Theorem illustrated as follows.

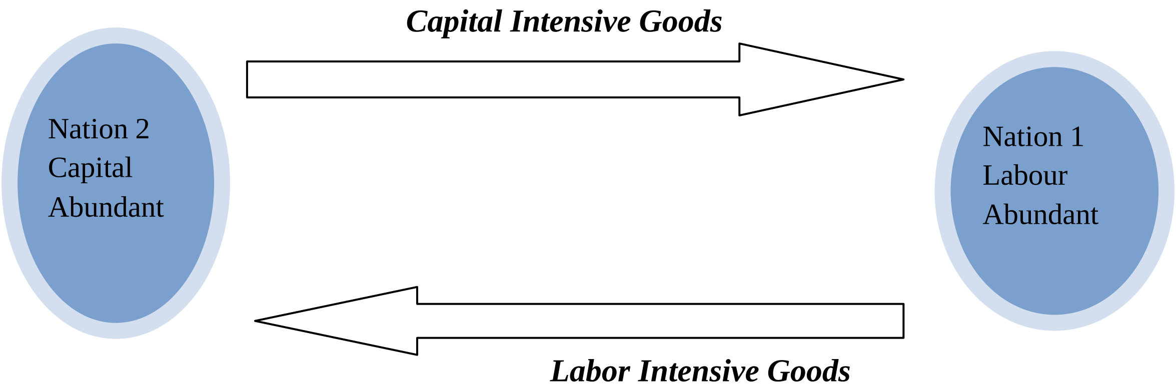

Figure 6.8 Pattern of trade under H – O Theorem

Factor - Price Equalization Theorem

The factor price equalization theorem explains that the equalization of factor prices among nations is the result of international trade, both in the relative and absolute returns to homogeneous factors across nations. This serves as a substitute for factors international mobility.

When both nations enter into trade nation 1 specializes in the production of commodity X (labor intensive) and reduces its production of commodity Y (capital intensive). As the relative demand for labour rise the relative prices for labour rises causing wages (w) to rise. While the relative demand for capital falls causing the interest rate (r) to fall. The exactly opposite occurs in nation 2. That is, nation 2 specializes in the production of Y and reduces its production of X with trade. Its demand for labour falls causing wage (w) to fall. While its demand for capital rise causing interest (r) to rise. Thus international trade reduces the pre-trade difference in wage and interest between the two nations with incomplete specialization. However, under complete specialization factor price equalization is not possible.

6.3.5 EMPIRICAL TEST OF H-O THEORY LEONTIEF PARADOX

A theory may be accepted only after empirical test conducted successfully otherwise it will be rejected. The Heckcher-Ohlin model tested empirically by Leontief in 1951. US considered as the most capital abundant nation. Hence, as per the H-O Theory Leontief expected that it export capital intensive commodities and import labour intensive commodities. He used input-output table of the US economy to calculate the amount of capital and labour in US exports and import substitutes.

The origin and destination of each product in the economy are shown in the input- output table which was developed by Leontief himself. The Leontief's test proved that US seemed to export labour intensive commodities and import capital intensive commodities this was opposite to what the H.O model predicted. Hence it is known as the Leontief paradox.

Leontief test showed that the capital labour ratio was high in the import substitution industries compared to export industries. He found that capital labour ration (dollars per man year) was only 13,911 in case of export industries as against 18,185 in import competing industries. Therefore, the argument of Leontief was US participation in international division of labour was based on its specialization on labour intensive rather than capital intensive lines of production. Thus US is participating in trade to economize its capital and dispose of its surplus labour.

Leontief's explanation of the paradox is as follows. In US numerically labour is less than capital stock but the effective supply of labour was greater on account of its high productivity. He points out that the productivity is three times more than the foreign worker. Another explanation of Leontief is that paradoxical results are due to exclusion of other factors like natural resources viz. agricultural lands, forests, rivers and mineral deposits.

US tariffs policy was another source of bias in the Leontief study. As such, it reduces imports and stimulates the domestic production of import substitution. Kravis (1956) in his study found that US protected heavily the labour intensive industries. This based the pattern of trade and reduced the labor intensity of US import substitutes, thus contributing to the existence of the Leontief paradox.

Leontief included in his measure of capital only physical capital (such as machinery, other equipment, buildings and so on) and completely ignored human capital. Adding the human capital component to physical capital would make US exports more capital intensive relative to US import substitutes. The analysis of human capital became fully developed in the works of Schultz in 1961 and Becker in 1964.

The research and development influences US exports. Thus human and knowledge capital are important considerations in determining the pattern of US trade. These were not considered by Leontief in his study.

6.3.6 KARVIS THEORY OF INTERNATIONAL TRADE

Karvis theory of international trade is also called as Availability Approach to the theory of international trade. It seeks to explain the pattern of trade in terms of domestic availability and non-availability of goods. The theory states that a nation will import those commodities which are not readily available domestically and export those whose domestic supply can be easily expanded to satisfy domestic demand.

According to Karvis there are four bases of the availability factors namely, national resources, technological progress, product differentiation and government policy. First three factors tend to increase the volume of international trade. The most important restrictions on International competition are those imposed by government. An important consideration must be quantitative availability of the factor in international trade.

6.3.7 LINDER'S THEORY

H-O Theory tells that a country specializes and exports a commodity depending on its factor endowments it may be primary product or manufactured product. Staffan Burenstam, Linder, Swedish economist, made distinction between primary product and manufactured product. According to Linder, a country produces and exports a commodity for which it has large domestic market. A country exports manufactured goods which it can produce in excess of its domestic demand. That is why his theory is known as spillover theory. Manufacturers produces a new product first for domestic market, where market size is large, it provides scope - for a large scale production. Large Scale production gives economics of scale, results in decreasing cost of production, it gains production skill and improves production techniques. This makes product price internationally competitive. This type of trade is possible between the high nations and similar per capita income.

6.3.8 THE RYBCZYNSKI THEOREM

The theorem propounded by T.M. Rybczynski is related to Economic growth and trade. The theorem states that in a two factor two commodity economy an increase in the supply of one factor, assuming the supply of the other factor constant, leads to an increase in the output of the commodity that used the increased factor intensively and to decline the output of the other commodity.

For instance, in a country if the supply of capital increases, the output of capital intensive commodity increases, while the output of labour intensive commodity declines. Similarly, if the supply of labour increases, the output of labour intensive commodity increases, while the output of capital intensive commodity declines.

Rybczynski theorem ha several implications relating to production, consumption, prices of factors and prices of commodities, welfare aspect, terms of trade and so on. It also has implication with regard to factor price equalisation.

Criticisms

Firstly, the results of the theorem cannot be possible if the supply of other factor also increases simultaneously. Secondly, this theorem cannot be extended to more than two factors of production.

6.3.9 IMMISERIZING GROWTH

The concept of immiserising growth is elated to terms of trade and economic growth. Edgeworth revealed that a country's economic growth may result in the deterioration of terms of trade of that particular country. Further the output gain obtained through economic growth may be nullified by the adverse terms of trade. This phenomenon was named as immiserising growth by Jagadish Bhagavathi.

Immiserising growth is more likely to occur in developing countries than in developed nations. Those countries depending on international trade to a greater extent and produce larger proportion of world market for primary commodities, whose demand is inelastic, will experience this problem. To tackle the problem of immiserising growth developing countries should adopt a policy of industrialisation as a import substitution strategy. They should concentrate on production of industrial goods with high price and income elasticity of demand, both for domestic as well as foreign market.

Check Your Progress- A

1. Which one of the following is objected by mercantilists?

a) Expanding exports
b) Reducing imports
c) Free trade
d) Accumulation of gold and silver

2. Smith's view on trade may be regarded as a reaction to;

a) Mercantilist's view
b) Ricardo's view
c) The Law of Comparative Advantage
d) All of the above

3. The Law of Comparative Advantage the based on;

a) The Law of Diminishing Returns
b) The Opportunity Cost Theory
c) The Labour Theory of Value
d) All of the above

4. Heckscher Ohlin Model explained the following type of trade;

a) Intra-industry Trade
b) Trade based on Imitation-gaps
c) Trade based on Product Cycles
d) Inter-industry Trade

5. According to Heckscher Ohlin Model the differences in relative commodity prices are due to ;

a) Factor endowments
b) Technology
c) Tastes
d) Demand conditions

6. The Leontief paradox showed US import substitutes 30 percent more capital intensive than US exports in the year;

a) 1947
b) 1957
c) 1967
d) 1977

7. Technological gap model explains that exports of industrial nations are based on

a) Demand
b) Supply
c) Tastes
d) Innovations

6.4 INTRA-INDUSTRY THEORIES OF INTERNATIONAL TRADE

In the above section, we have realised that the price is the determinant of trade among nations in inter-industry trade. But intra-industry trade is determined by non-price factors. Differences in quality and other features of goods lead to trade. In the coming section, we are going to discuss the reasons for intra-industry trade and brief presentation of various trade theories has been taken up. Today more than 75 per cent of the world trade is intra-industry trade.

Issues Related To Emergence of Intra-Industry Trade

These theories examine the trade related to differentiated products. This means products are similar but not identical. It refers to a situation where countries export and import the same products simultaneously. For example, US exports motor cars to Japan and at the same time imports Japanese motor cars. India also export as well as import the items like electric products, electrical equipment, motor cars, crude oil, petrochemicals, textiles and clothing, sugar etc.

Some of the reasons for intra-industry trade are economies of scale, product differentiation in monopolistic competition, fascination and interest towards foreign products, seasonal differences among various regions, transport cost variations, large scale production by multi-national companies etc.

Intra-industry takes place due to specialisation and increased division of labour. This is dependent on the size of the market. It takes place when both domestic and foreign companies produce identical varieties of the same product may invade each other’s home market. Gains from trade will be very high when product differentiation is high and economies of scale are strong.

Various Approaches to Intra-Industry Trade

There are two different explanations available for intra-industry trade. Firstly, producers in any nation try to concentrate on production of majority tastes and leave the minority tastes which are satisfied through imported goods. The Neo-Heckscher-Ohlin, Neo-Chamberlin and Neo-Hotelling models are based on this approach. Secondly, failure to recognise the number of segments within the industry with distinctive features leads to intra-industry trade. They are monopolistic competition or oligopolistic situations of the firms, strategies of multinational corporations, economies of scale, product differentiation etc.

6.4.1 THE NEO-HECKSCHER-OHLIN MODEL

Neo-Heckscher-Ohlin model explains intra industry trade in terms of factor endowments by relating various combinations of basic factor and product specifications. RE Falvey's model is as follows:

For example, by assuming two country model of an industry, industry X is producing differentiated products in both the nation, the basis for differences is quality. It is called as vertical differentiation. And also assumed high quality product requires high quality of capital. To have an improved quality product it requires high capital-labour ratio (K/L). Nation B will produce sub marginal quality product by incurring low cost. And capital rich nation A will produce super-marginal quality product and enjoy its advantage. This situation arises between developing and developed nations. Developed nations with sophisticated technology dominate super-quality products. Whereas developing nations because of either using of labour intensive technology or non-availability of sophisticated technology.

6.4.2 NEO-CHAMBERLIN MODELS

These models also explain intra industry trade with horizontal product differentiation. Horizontal product differentiation means product varieties are differ either actual or perceived characteristics. Colour differences are actual differences while differences based on tastes are perceived. It is difficult to think of a real commodity where horizontal differentiation exists without vertical differentiation. Economists such as Dixit and Norman, Venables, and Lawrence and Spiller have been analysed in similar lines as that of Krugman.

Venable model assumed that a homogeneous product produced under constant cost conditions, where multiple equilibria are possible. As per this model a nation can specialise in production of differentiated product and another nation in the homogeneous product.

Krugman model assumed a single factor of production. Lawrence and Spiller suggested two factor two product model, envisaging horizontal differentiated product with capital intensity and homogeneous product with labour intensity. Initially these two nations have different factor endowments. The number of differentiated products rise in capital rich nation and will fall in other nation. The scale of production of differentiated product rise in capital rich nation and labour rich nation increases homogeneous product. These results are similar to Heckscher-Ohlin model and Falvey model.

These models based on suggestion of Krugman. The economy under consideration has assumed to have only one factor of production. There is large number of firms. Each firm produces a different variety of the same product X. The firms are free to enter and exit the industry. There is no limitation for number of varieties that can be produced.

6.4.3 NEO-HOTELLING MODEL

The models grouped under Neo-Hotelling are based on the consumer behaviour as proposed by Lancaster. The set of characters, of horizontally differentiated products, are embodied in each variety of products. Consumers have diverse preferences over different sets of characters. It is not possible that each consumer buys different varieties of goods and blends them to obtain a variety to suit their preferences. To explain intra industry trade Lancaster suggested trade models incorporation his characteristics based on product differentiation.

Lancaster Model based on assumptions like free entry and exit of firms, equal preferences, and uniform cost structure, according to Lancaster in the long run equilibrium al variety of products produced actually are spaced evenly and each variety of product will be having same quality and sold at the same price, so that each firm earns only normal profits. It is a situation of perfect monopolistic competition.

To continue our discussion regarding intra-industry trade, the following assumptions were made:

1. Two countries are having identical features in all respects.
2. Two sectors i.e., manufacturing sector and agricultural sector.
3. Manufacturing sector produces differentiated products and agricultural sector produces homogeneous products.
4. Production taking place at constant cost conditions.
5. One factor is mobile i.e., labour but another factor is specific.

As the Lancaster model assumed two nations are identical in all respects, agricultural products are not traded but only manufactured products are traded between nations. The trading of the manufactured products will have to be balanced. i.e. the export volume of both nations is same and at the same price. In other words, in total number of varieties each nation will produce half of it and in total volume of each variety they produce half. In total production they sell half in domestic market and the rest in foreign market.

The consequences of the intra-industry trade based on horizontal product differentiation are as follows:

- The most-preferred choices of the consumer or ideal product availability will increase or trade modifies each nation’s consumption pattern and increases the benefits of the consumer.
- Each nation’s production will be modified. In the process some firms and varieties may exit.
- Trade increases output and reduces cost and price this results in stimulating consumption and improves welfare of the consumer.

Ultimately, Lancaster analysed that there are two mobile factors, with manufacturing capital intensive and agriculture labour intensive. The endowments of the factors in each nation are not dissimilar and will have complete specification with free trade. He argues that relatively labour rich nation will export both agricultural as well as some variety of manufacturing products and will import some other varieties. The varieties of manufactured products are few in labour rich nation and are high in capital rich nation. Hence, labour rich nation will be importer of manufactured products.

Oligopolistic Models

In the previous section, three intra-industry trade models were developed based on the market structure with existence of many firms. In other class, the models are existence of smaller number of firms or Oligopolistic models. An essential distinction between these two models is that in the later there is strategic interdependence of the firms in the industry. Some of the Oligopolistic models are given below:

6.4.4 BRANDER-KRUGMAN MODEL OR RECIPROCAL DUMPING MODEL

James Brander and Paul Krugman suggested an intra-industry trade in the oligopolistic situation. It is a popular model in intra-industry trade.

This model explains a situation where two firms of two nations resort to dumping in each other's domestic market. Dumping means selling a product in foreign market at a lower price than its domestic market. When dumping is leading to two-way trade in the same product that situation is called `reciprocal dumping'. This was for the first time noted by Brander in his article on `Intra-industry Trade in identical commodities', published in 1981. Afterwards both Brander and Krugman extended that article in 1983 by publishing another article `A Reciprocal dumping mode of International Trade'.

Brander-Krugman model suggests possibility of two way trade by two firms in the nations having same marginal cost and same price in two markets. They started the model by considering two monopolies producing same product both in home and foreign nations. For simplifying the analysis, they assumed these two firms have same marginal cost. If there is transport cost between the two markets and if firms change price, there will be no trade and each monopoly firm will be uncontested.

The emergence of trade is due to having possibility to introduce dumping. At a particular point of time, quantity of each firm is fixed in domestic market, where the marginal cost is equal to marginal revenue as in monopolistic firm. The price (average cost) will be higher than the marginal cost. Marginal revenue will fall below its marginal cost, if they try to sell more than this quantity in domestic market. Every additional sale of the quantity will results in loss. However, by adding transport cost, if the firm sell some quantity in foreign market at higher price than its marginal cost, there will be addition to its profits even if the price of its product in foreign market is lower than the domestic market. The increased supply in the foreign market will have its impact on the price of the foreign firm and will not affect the price in domestic market.

Without initial price differences in two markets homogeneous products can be traded internationally even with transportation cost. So, monopoly situation turns into duopolistic market situation by opening trade.

Brander-Krugman model explains the intra-industry trade with homogeneous products. By entering into trade, in short run the price will be settled between the pre-trade price and the marginal cost plus cost of transportation. In the long run, equilibrium price cannot be lower than average cost. The pure monopoly element present earlier will be eliminated with the emergence of reciprocal dumping model and results in some competition. The increased competition helps to offset the wastage in resources in transportation. The uncertainty in a nation's economic welfare is due to effect of such peculiar trade.

6.4.5 THE TECHNOLOGICAL GAP MODEL

The effect of technology will change the production in two ways, besides many other factors. Firstly, it can use new methods to produce the same commodity and secondly, through innovation it may produce new commodities. Ultimate result of these changes from technology is change in trade between nations. To explain this MV Posner developed technological gap or imitation gap model in 1961. He considers it is a continuous process. This will affect the pattern of trade between nations. He argues that even if the endowments, tastes are similar in both nations technological changes can give rise to trade. Production of new commodity as a result of technological innovation leads to imitation gap and demand gap in the other nation. To what extent the trade will take place between nations depends on the net effect of these two.

According to Posner, there are three components in imitation gap. They are the domestic reaction lag, foreign reaction lag and demand lag. The domestic reaction lag means the time required by the producers in a nation to produce new varieties and techniques to hold in domestic market and sustain in foreign market. The foreign reaction lag means the time taken by a nation to start producing new product through innovating firm. The demand lag means time taken by the consumers to develop a taste for the import of new innovative commodity.

Posner brings out a new concept called as dynamism by combining two concepts of innovation and imitation lag. To him, the rate of innovation of the new products introduced per unit of time and the speed at which it imitates foreign innovations is called dynamism in international trade.

The main drawback of this theory is, Posner did not explain technological gap in precise manner and fails to provide explanation with regard to why gaps in technology arise and how can they be eliminated.

6.4.6 VERNON'S PRODUCT CYCLE MODEL

To analyse the impact of technological change in international trade Prof Vernon and S Hirsch developed the product cycle model. This model explains the tendency for production of new commodities. In its early life is to be concentrated in developed nations but it moves to other nations later on. There are series or stages or a cycle in the development process, which changes comparative advantage through the cycle. Experiences on US economy are the basis for the development of the theory.

According to Vernon, the life cycle of the product consists of, new product stage, maturing product stage and standardised product stage. In the first stage, development and release of the innovative new product in the domestic market by the nation. In the second stage, production and distribution if this matured product on a large scale and exports will boost up.

There will be high foreign demand for the new product. Then other nations slowly imitate the production of that new product in their home nation. In the final stage the production becomes standardised and production declines in the innovating nation but increases in other nations. This is due to imitation or transfer of technology to other nations.

Thus new product will be produced at large scale in other nations. Now nation which initially innovated and exported the new product start importing that product at the end of the cycle. Examples are Television sets, semi conductor chips, passed through these product cycles in the innovating nations.

6.5 SUMMARY

We have learned the difference between inter-industry trade and intra-industry trade between two or more nations. Inter-industry trade focuses on the supply side of the trade where as intra-industry trade focuses on both supply and demand side of the trade. This unit explains the classical, neo classical and modern theories of international trade. Classical theories could explain only a small part of trade where as Heckscher-Ohlin trade theory explained an expanded concept of factor endowments including some of the dynamic aspects. Hence the H-O Theory was considered superior to previous theories of trade.

Modern theories of intra-industry trade have taken into consideration the technology and dynamic aspects which include more significant portion of the trade. we have examined number of models that may have certain common features despite of their variety.

Under intra-industry trade it is not possible to predict which good will be exported by which nation. preferences of the consumers are diversified this play important role in trade. similar tastes between nations also play major role in trading. the important source of gains from trade are economies of scale.

6.6 GLOSSARY

Absolute Advantage: According to Adam Smith one nation may have greater efficiency than another nation in the production of a commodity. This is the basis for trade.

Gains from Trade: Am increase in consumption of both nations by following specialisation in production and trade.

Law of Comparative Advantage: Even if a nation has an absolute advantage or less efficient in production of commodities, there is still possibility to enter into trade, if the less efficient nation specialise in the production of and exportation of that commodity in which it has less absolute advantage or comparative advantage.

Labour Theory of Value: Labour theory of value states that the price of commodity is equal to the amount of labour time used in its production.

Opportunity Cost: The amount of one commodity that must be given up to release just enough resources to produce each additional unit of another commodity.

Differentiated Products: Similar but not identical products produced by the same industry, Example: cars, tooth paste etc.

Intra - Industry Trade: If differentiated Products of the same industry are traded between nations it is called intra-industry trade.

Leontief Paradox: empirical results of H-O Theory by Leontief in 1947 showed that US import substitutes are more capital intensive than US exports to the extent of 30 percent. US considered as capital abundant nation. this result was just opposite to predictions of H-O Theory.

Product Cycle model: This model explains that the comparative advantage in introducing new product due to innovation by a nation shifts to another cheap labour nation once the product receives mass acceptance.

Technological gap Model: Production of new products and new production methods increases the exports of industrial nations.

6.7 CHECK YOUR PROGRESS

Choose the correct alternative

Answer :1 (c)

2. (a)

3. (c)

4.(d)

5. (a)

6. (a)

7. (d)

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6.10 TERMINAL QUESTIONS

Q1. Distinguish between inter-industry trade and intra-industry trade.

Q2. Discuss the classical theory of International Trade.

Q3. Explain the law of comparative advantage .

Q4. Outline the importance of modern theory of inter-industry trade or Heckscher - Ohlin Theory of international trade.

Q5. Discuss the Neo Chamberlin and Neo Hottelling models of intra-industry trade.

Q6. Critically evaluate the models in Intra-industry Trade.

UNIT 7 INSTRUMENTS OF INTERNATIONAL TRADE POLICY

7.1 INTRODUCTION

International trade is an unavoidable phenomenon in the modern increasingly interdependent world. Economy is now not restricted within the boundaries of a state, rather the whole world is becoming a united global economy. And thus no nation by itself can be self-sufficient in fulfilling the increasingly diverse needs and wants of life that now exist. We therefore have to fulfill our requirements from wherever efficiently and cost effectively we can. In this scenario, International trade is truly unavoidable and the world is becoming a global village partly due to international trade and partly because of development in the pace of communication due to technology.

Trade policies are formulated with a view to protect interests of the domestic markets and the instruments include Tariffs, subsidies, import quotas, voluntary export restraints, anti-dumping duties, subsidies and administrative policies.

7.2 OBJECTIVES

After reading this unit you will be able to:

- Understand the significance of international trade
- Understand what is trade policy.
- Learn about the instruments of trade policy.
- Learn about the reasons why governments formulate trade policies.

7.3 TRADE POLICY AND ITS PURPOSE

Governments control their national economic interests with certain instruments of trade policy, when they have threats to the existence and development of their local business. The threats may be anything like foreign dumping or cheaper imports of certain products which may have to be forfeited with tariffs, anti-dumping laws, import quotas and voluntary export restraints.

The size of markets is influenced by trade policies which in turn determine the nature and magnitude of investment. The influence of trade policies on the investment climate is steadily growing. Trade policies are significant in encouraging domestic and foreign investment. The factors that are contributing to accelerating development include liberal policies of host countries, changes in technology, and the development of global production chains within multinational enterprises (MNEs).

In view of the aforesaid discussion, nations sometime feel compelled to intervene in the free market activities and curtail the events in favor of their national economic interests. The major reasons for government intervention in the freely running market activities are protection of local industry and jobs, consumer interests, retaliation and furthering foreign policy objectives. The actions taken and the policies adopted by governments in pursuit of their objectives of protecting their national economic interests may therefore be termed as the trade policy adopted by those countries. The strategies formulated and implemented for this purpose may assume the form of implementing tariffs (on imports or exports), enforcing import quotas, giving subsidies, advising local content requirements, enforcing anti-dumping duties and adopting a variety of administrative measures that create obstacles in the conduct of trade. Generally, these hurdles are described as (international) trade barriers which the WTO or World Trade Organization is in favor of reducing to the maximum to ensure efficiency in international trade. The following sections will discuss detailed characteristics of each of these barriers of international trade as described by the WTO and instruments of trade policy for serving their own national interests as described by individual nations.

7.4 TRADE POLICY AND UNCERTAINTY

What steps has the government taken to reduce trade policy uncertainty and increase trade policy predictability for investors? Are investors and other interested parties consulted on planned changes to trade policy? Rationale for the question Trade policies which are predictable, consistent and transparent lower the risks for investors, implying a lower hurdle rate for any given project and hence more investment overall. This applies to all investors but is particularly important for foreign firms. Many empirical studies find that FDI is lower when policies are unpredictable. Policy certainty does not mean that policies should never be changed, merely that they should be done so transparently with ample prior consultation with all interested stakeholders, including foreign businesses.

Trade measures and legally-binding commitments entered into in multilateral and preferential trade and investment agreements can help to attract investment. These agreements can create larger markets, allow for greater scale economies and hence lower costs and, more broadly, lock in recent policy changes or signal future policy changes so as to promote an orderly adjustment to evolving competitive conditions. More recent preferential trade agreements typically feature a comprehensive set of disciplines on investment protection and liberalisation that complement domestic efforts to create a sound investment climate. They also often include provisions on services, intellectual property or competition policy which can also significantly affect both trade and investment.

Key considerations Governments need to formulate, negotiate and implement trade and investment agreements and to evaluate their impact with a view to maximising their benefits on overall host country performance. While unilateral liberalisation is extensive in many countries, particularly with regard to foreign investment and service sector policies, several countries or country groupings are also seeking to speed up their economic development through faster and broader liberalisation commitments scheduled under preferential trade and investment agreements. For some countries, particularly the least developed ones, a lack of capacity and resources severely impedes their ability to negotiate, implement and derive concrete benefits from this greater engagement. Engaging in formal trade negotiations at the bilateral, regional and multilateral levels allows private sector stakeholders to pursue enhanced trade and investment opportunities such as through integration into regional and global supply chains and distribution networks. Identifying such opportunities is a particularly daunting challenge for SMEs in both developed and developing countries.

7.5 TRADE POLICY AND INVESTMENT

Governments sometimes use trade policy instruments, such as import tariffs (including tariff peaks and escalating tariffs) and subsidies (investment incentives) to promote investment in targeted industries. Considerable care must be taken to ensure that such measures do not distort resource allocation and damage the overall investment climate. Favoured industries, typically domestically-controlled, compete for resources with foreign and other domestic enterprises, and any policy-induced favours can crowd out investment and production in more productive activities. Moreover, where the output of the targeted industry is an input to others, competitiveness in final products and in world markets may be harmed, reducing firm profitability and hence further investment in export-oriented sectors. These costs are typically long-lived, since they are often non-transparent and spread among many producers which reduces the incentive for governments to reform such practices. The promotion of investment in specific industries through trade policies should be both transparent and consistent with existing international obligations. A first-best approach is to maintain a trade regime that allows competitive industries to develop and flourish as much as possible without discrimination, rather than to try to nurture competitiveness behind trade policies that tilt competitive conditions in favour of incumbents (be they domestic or foreign). This does not necessarily imply removing all forms of import protection, nor does it assign a completely passive role to domestic policy. What it entails is a keener sense of the costs and benefits of using trade policy to achieve objectives that other domestic policy instruments may be more suitably equipped to pursue, such as labour market, education, innovation and SME development policies.

7.6 TARIFFS

Taxes levied on imports of certain goods are known as tariffs (usually levied on exports too). Tariffs protect local producers from foreign competition. Foreign goods are perceived as competition and threat to local production. Tariffs are particularly enforced when the goods being imported are cheaper than the locally produced ones, and an import tariff hikes their prices to either bring them at par with those of the local goods or even makes them more expensive. Tariffs may assume the following forms:

- Specific Tariff
  A specific tariff is an amount which is charged on per unit import of the specific good.
- Ad-ValoremTariff
  It is the tariff that is charged as a percentage of the total value of the imported goods. For example 25% of the total value of petroleum imports per shipment is an ad-valorem tariff.

Tariffs can be of various types, and consequently might have slightly different effects on the economy.

Specific tariff are taxes levied as a fixed charge for each unit of goods imported.

For Example

A specific tariff of Rs 100 on each imported toy with an international price of Rs 1000 means that a fixed sum of Rs 100 per bicycle would be collected as tax.

Taxes levied as a fraction of the value of the imported goods are Ad Valorem tariffs.

Let us try and understand this with the help of an example:

A 20% ad valorem tariff on any car generates a Rs 2000 payment on each imported car valued at Rs 10000 in the world market. A number of variations of the above tariffs is also possible. Thus, in the case of a compound duty (tariff) we deal with a combination of an ad valorem and a specific tariff.

Frequently changing terms of trade and tariffs influence the impact that an importing country may have on the price of foreign goods that it consumes. Therefore, a 'big country' can influence prices in the world market, by virtue of the amount that it demands from foreign producers. For example, the imposition of a tariff or any measure that restricts trade will mean a lower amount of imported goods in the country imposing them. Because of lower demand by a big country, prices of the protected goods will have to be lowered by the exporter whose sales are largely determined by the demand abroad. Ultimately, that will mean a lowering in the terms of trade of the exporting nation, and an increase in welfare for the importing nations, which can benefit from better terms of trade. However, it is crucial to understand as well that most importing countries cannot be defined as 'big countries' in the sense described above. Their demand for a foreign good normally represents only a small fraction of the world demand of that particular good produced by the exporting nation. Further, in order to understand the full effect of tariffs we need to understand how groups in an economy derive their welfare. /or that, it is useful to understand two concepts -consumer surplus & producer surplus.

Consumer and Producer Surplus

Economists and Policy makers make use of a parameter that can be aggregated and serves as a rupee denominated measure to compare individuals who may be impacted by the policies. Consumer Surplus and Producer Surplus are measures that are generally used for this purpose. Consumer surplus indicates the excess value a consumer attaches to having a unit of a good over and above what he has to pay for it. Consumer surplus, therefore, measures, the net welfare gain in rupees that a consumer experiences from buying a unit of the good. Thus, it measures the amount a consumer apparently gains from a purchase indicated by the difference between the price he actually pays and the price he would have been willing to pay. For example if consumers are willing to pay Rs 1000 for a bottle of wine, but the price they actually pay in the market is Rs 900, the consumer surplus can be regarded like an individual gain of Rs 100 for each bottle of purchased wine.

A parallel concept to consumer surplus is the **producer surplus.**

Producer surplus is the amount a producer gains from a sale. It is indicated by the difference between the price actually received and the price at which the producer would have been willing to sell. For Example:

If a producer receives Rs 1000000 for a car, that he would agree to sell for Rs 950000, the producer surplus is an individual gain of Rs 50000 for each car sold. Producer surplus thus measures, in rupees, the net welfare gain realized by a producer from a transaction.

Tariff Analysis

Tariffs are levied to protect selected national industries from foreign competition. Therefore, they have a direct impact on producers' surplus, which is expected to rise as a result of the imposition of a tariff that increases prices. Moreover, it is important to understand the extent to which this protection might affect other stakeholders in the country. Also, we need to determine whether tariffs benefit an importing country as a whole.

Costs and benefits of tariffs

The manner in which a tariff operates determines the following obvious results. By raising prices in the importing country, consumers would be adversely impacted, as they would have to pay the new, higher price. Producers in the importing country on the other hand can charge a higher price than in the case of free trade since foreign competition has been minimized or eliminated. The government of the country using protectionist measures by way of enforcing tariffs enhances its revenue.

7.7 IMPORT QUOTAS

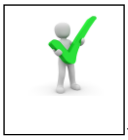
Direct restrictions on the quantity of imports permissible for a certain product are described as import quotas. An import quota may assume any of the following forms:

- Licenses issued to certain importers and restricting them by amounts to be imported.
- Voluntary Export Restraint - Granting the right to sell a particular amount of the product directly to the government of any country.

An importing country's restrictive trade policy may reduce the exporting country's sales abroad and therefore its ability to purchase imports and attract investment. Export-oriented investment by domestic players or foreign companies in developing countries depends on two factors – market access in developed countries and/or other countries with large markets. There will be less investment by local firms and multinationals if companies in the host country face high trade barriers to their main markets. The traditional advantages of developing nations - low labour costs and abundance of natural resources may be rendered useless. Governments should consider such external costs when evaluating specific domestic trade policy measures.

7.8 VOLUNTARY EXPORT RESTRAINTS

VERs are voluntary restraints on the export of a product, typically at the request of the importing country. A famous example is the voluntary export restraint on the auto exports by Japan to United States in the 1980s. The US government requested/pressurized Japan to restrict the amount of auto exports to the US.



Check Your Progress-A

Q1. Why do governments intervene in free market activities?

Q2. What do you understand by Ad Valorem Tariff?

Q3. What are import quotas?

7.9 ANTI-DUMPING ACTIONS

Dumping may be defined as selling of goods in a foreign market below the costs of production or the selling of goods in a foreign market below their "fair" market value.

Apparently, the purpose is to grab a foreign market share and destroy local competition. Gradually, prices are raised to a "fair" market value. Therefore, if any country feels that any foreign company has dumped a certain product in their country, they may impose an Anti-Dumping Duty on that product to make its price higher and prevent the local manufacturers from selling below their costs of production. A firm, as per WTO rules, can be accused of dumping if it charges a lower price in its export market than it does in its home market for the same good. Firms cannot dictate prices unilaterally in competitive global markets. The demand and supply conditions in the market determine prices. Dumping, therefore, is restricted to markets dominated by relatively few firms with enough market power to set their own prices. Moreover, the firms must separate their domestic and export markets to prevent resale of the product from the low-price to the high-price market. Only then the firm can charge different prices. Dumping is almost always regarded as an unfair trade practice. WTO rules permit member countries that can prove “adverse impact” to their domestic producers caused by dumping from foreign firms to take anti-dumping actions in response. These actions may involve authorization for a departure from general non-discrimination rules allowing the injured party to impose additional or anti-dumping duties on imports of the good from the specific country whose firm is deemed guilty of dumping. These duties, though, are generally not to exceed the minimum necessary to offset the damage done by the dumping. It is relatively easy to initiate anti-dumping actions, so they are often the policy of choice for protectionist influences.

The US initiated quite a few anti-dumping actions against other industrialized countries over this period, but both the US and the EU initiated many more against developing countries than they did against each other. Developing countries, too, have initiated a large number of anti-dumping actions against other developing countries over the same period. India has initiated by far the most anti-dumping actions of any nation, and China has been the most frequent target by a very large margin. Economists are of many minds on the issue of dumping. If the dumping is predatory in nature—intended by the foreign firm to drive domestic firms out of business so that the foreign firm would then be free to exercise greater monopoly power—dumping would be something to oppose. If, however, a foreign firm sells at a high price in its home market and a lower price in its export market because competitive or other market conditions in the export market require it to do so, there seems no good reason to oppose it.

7.10 SUBSIDIES

Subsidies are government grants to local producers for supporting them against the foreign competitors. The goal generally is to target those local producers who could become self-sufficient in the efficient production of the desired goods and services in the near future. No government promises to keep on providing subsidies permanently because after all the source from which they have to be paid is the tax-payers money. Subsidies may take on the shape of cash grants, low-interest loans, tax-breaks and governments' equity participation in the business.

Governments do not restrict trade with the objective to protect national industries and hopefully to promote their development. Thus, another policy complimentary to tariffs and promoting national production consists of incentives given to national industries for selling their goods abroad. These are known as export subsidies. In concrete terms, they are payments by the government to firms or individuals who sell goods abroad. With the export subsidy, shippers will export the good up to the point where the domestic price exceeds the foreign price by the amount of the subsidy. Thus, the effect of protectionism is this time a rise of prices in the exporting country, accompanied by lower prices in the importing country. On the other hand, where tariffs could better terms of trade, subsidies actually worsens them. Overall, it can be argued that subsidies lead to costs in excess of benefits in nations using them. Nevertheless, export subsidies are not unusual, and have been a major instrument used by the heavily protected agricultural sector in the European 1nion

We've seen that tariffs, quotas, export taxes, and export subsidies will always redistribute welfare among producers, consumers, and the government, and will in most cases also give rise to a net dead-weight loss in social welfare, at least in the small country. But tariff s help spur increased domestic production of import substitutes, and that may form part of an overall development plan. Export subsidies encourage increased production of exportables, and that, too, may be part of an overall development plan. However, subsidies to production, rather than taxes or subsidies to trade, will generally be able to achieve the intended objective at lower social cost.

7.11 ADMINISTRATIVE POLICIES

Last but not the least important, are the governments adopting such administrative policies which make the import or export of a product nearly impossible, despite the absence of any other trade barrier. The famous example can be quoted as that of the administrative policies adopted by Japan in case of Tulip (bulb) imports. Tulips are bulbs exported by Netherlands to nearly all the world countries except Japan, where the Customs Inspectors insist on cutting the Tulip bulbs vertically down the middle, reasoning checking for the presence of any objectionable material in it, and even the genius imitating entrepreneurs of Japan cannot put these torn apart bulbs together.

7.11.1 LOCAL CONTENT REQUIREMENTS

The governments may direct the manufacturers to produce a minimum amount of the product locally. This minimum amount may be in value terms or physical terms. For example "75% components of a certain product to be produced locally" are local content requirements in physical terms WHEREAS "75% of the monetary value of this product might be produced locally" is a local content requirement in value terms

A good amount of international trade involves business to business transactions. Modern business supply chains involve hundreds of domestic and international producers in locations that are best suited to such activities. This specialization of production raises productivity. Therefore, any trade policies that hinder access to intermediate goods and services and which raise their cost can durably affect the ability of local firms to participate in such networks or of the host country to attract new investment in these activities. Internationally traded services are a key input for many industries and an increasingly strategic component of global value chains in both, manufactured and service markets. The four modes of supplying services – across borders, through the movement of consumers, through an established presence (i.e. investment) or through the movement of service suppliers (business people) – are intrinsically linked. Trade in services has expanded rapidly in recent years in both developed and developing countries and is one of the fastest growing components of world trade. Significant changes in technology and in approaches to regulation have facilitated growth of a new international division of labour in services. Despite the rising tradability of many new services, the significance of local presence cannot be underestimated. There is a urgent need of progressively liberalizing FDI regimes in services.

Check Your Progress- B

Q1. What is 'dumping'?

Q2. Why do governments give subsidies to exporters?

Q3. What purpose do anti-dumping duties serve?

Q4. Briefly describe the different forms of subsidies.

7.12 SUMMARY

All the principal instruments of trade policy have been examined with focus on the impact each has on resource allocation and the distribution of welfare. The analysis reveals some broad patterns. Restrictions on trade will tend to favor some at the expense of others in case of a small trading country. As a general rule, restrictions in trade result in a loss in national welfare as production-side and consumption-side inefficiencies are introduced by stakeholders indicating thereby, that using trade policy instruments to achieve distributional goals becomes inefficient. Redistribution should be resorted to by more direct means so that market prices are not significantly distorted from their free trade levels. This will minimize associated production-side and consumption-side inefficiencies and it would be possible to achieve the same objectives at lower social cost. When the objective of policy is not redistribution, but to encourage production, trade policy will again prove to be an inefficient means of achieving the objective since it affects both consumption and production simultaneously. In such cases, subsidies to production will achieve the same production goal with no consumption-side effect, and so lower social cost. The assumption here is that in competitive world markets the trading country has no appreciable market power. However, there is an exception of an optimal tariff in the case of a large country: by exploiting its market power on the world market, a large trading country may be able to turn its terms of trade in its favor sufficiently to ensure an overall national welfare gain. This advantage, however, comes at the expense of its trading partners, who are very likely to retaliate. Tariff wars among nations will generally reduce welfare for all. An extension to this analysis may arise when home country and world markets are imperfectly competitive. In such cases, opportunities for strategic behavior by firms, and by governments, can qualify and even reverse some of our conclusions about the impacts of certain policy instruments. A detailed analysis of these exceptions is beyond the scope of this unit.

7.13 GLOSSARY

Ad valorem rate: An import duty rate determined according to the value (ad valorem) of the commodity entering a country, as opposed to the weight or other basis for calculation. An ad valorem tariff is a tariff calculated as a percentage of the value of the goods when clearing customs.

Anti-dumping duty: A tariff imposed to discourage the under-priced (below foreign countrys domestic market) sale of foreign goods in the Indian market, which might hurt Indian. manufacturers

Business to Business (B to B), Sometimes B2B: indicates a company to company business relationship.

Business to Consumer (B to C), Sometimes B2C: indicates a company to individual relationship.

Duty: A tax imposed on imports by the customs authority of a country. Duties are generally based on the value of the goods (ad valorem duties), some other factor such as weight or quantity (specific duties), or a combination of value and other factors (compound duties).

Export Subsidies: Government payments or other financially quantifiable benefits provided to domestic producers or exporters contingent on the export of their goods and services.

Import Quota: A restricted amount of certain types of goods entering a country, usually maintained through licensing importers, assigning to each a quota, after determining the amount of goods or commodities allowed for that period

World Trade Organization (WTO): The international organization which resulted from the Uruguay Round of GATT negotiations. The WTO seeks to establish global rules of trade between nations; its goal is to help trade flow smoothly, freely, fairly and predictably

7.14 REFERENCES

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7.15 SUGGESTED READINGS

1. The APEC-OECD Integrated Checklist on Regulatory Reform is a voluntary tool for governments to evaluate their regulatory reform process, focussing on regulatory, competition and market openness. Market openness is addressed through questions regarding how regulations are developed and implemented. The goal is to ensure that regulatory policies reinforce the ability of economies to benefit from globalisation and international competition.
2. The WTO Trade and Development Web page provides recent information on WTO-related work that takes place, i.a. in the Committee on Trade and Development and the Sub-Committee on Least Developed Countries. It links to various initiatives aiming at building trade capacity: Aid for Trade, the Enhanced Integrated Framework, and the Joint Integrated Technical Assistance Programme.
3. The OECD Tool Kit for Trade Policy Makers helps governments to understand trade policy issues and negotiating procedures in the context of the Doha Development Agenda. It presents OECD work on strengthening trade-related technical assistance and capacity building.
4. Current Trends in Regulatory Impact Analysis: The Challenges of Mainstreaming RIA into Policy-making by Jacobs and Associates. Regulatory Impact Assessment in Developing and Transition Economies: A Survey of Current Practice surveys governments on their use and understanding of RIAs and finds that while such assessments are being performed, both the process and

attendant benefits from RIAs would be enhanced if officials were more familiar with RIAs and the various stages of the RIA process were more standardised and thorough. The process could also be improved by providing examples of economic, social and environmental regulatory proposals and by increasing transparency.

5. The OECD Web page on integrated market access and the regulatory process surveys practices in applying six efficient regulation principles, including the avoidance of unnecessary trade restrictiveness. • The WTO Web pages on Technical Barriers to Trade and the Sanitary and Phytosanitary Measures contain updated information on their respective committees and related documents.

7.16TERMINAL QUESTIONS

Q1. How do governments sometimes use trade policy instruments to promote investment in specific industries?

Q2. Trade Policy instruments are basically barriers to international trade. Do you agree? Why?

Q3. How does the instrument of ‘Local Content Requirements’ help domestic markets?

Q4. ‘Subsidies lead to costs in excess of benefits in nations using them’. Do you agree? Why?

UNIT 8 DEVELOPMENT OF THE WORLD TRADING SYSTEM

8.1 INTRODUCTION

The term 'World Trading System' alludes to the different trading relations of the various countries which basically was formed after World War I, World War II and the great economic depression. It was envisaged that trade between countries could prove to be good way to bounce back from severe economic slowdown towards financial liberalisation. The entire world needed a system wherein the trade and financial interests of every country could be safeguarded against the other countries of the world. A full proof system was needed which could provide a platform for world trade and would provide a level playing field for all the countries. The persistence of the above mentioned philosophies gave birth to two of the world’s biggest international trade organizations – GATT and WTO.

8.2 OBJECTIVES

After reading this unit you would be able to;

- Understand GATT and its impact on world trade.
- Understand about GATT and WTO.
- Learn the Standards of the Trading System**.**

8.3 GATT

General Agreement on Tariffs and Trade (GATT) was a lawful understanding between numerous nations, whose general intention was to advance global exchange by decreasing or dispensing with exchange hindrances, for example, duties or quantities. As per its introduction, its motivation was the "generous lessening of duties and other exchange obstructions and the end of inclinations, on a proportional and commonly worthwhile premise."

It was first talked about amid the United Nations Conference on Trade and Employment and was the result of the disappointment of arranging governments to make the International Trade Organization (ITO). GATT was marked by 23 countries in Geneva on October 30, 947, and produced results on January 1, 1948. It stayed basically until the mark by 123 countries in Marrakesh on April 14, 1994, of the Uruguay Round Agreements, which built up the World Trade Organization (WTO) on January 1, 1995. The WTO is a successor to GATT, and the first GATT content (GATT 1947) is still basically under the WTO structure, subject to the adjustments of GATT 1994.

GATT, and its successor WTO, have effectively diminished duties. The normal levy levels for the real GATT members were around 22% of every 1947, except were 5% after the Uruguay Round in 1999. Experts trait part of these duty changes to GATT and the WTO.

8.4 ROUNDS

GATT held an aggregate of nine rounds:

Name	Start	Duration	Countries	Subjects covered	Achievements
Geneva	April 1947	7 months	23	Tariffs Signing of GATT	45,000 levy concessions influencing $10 billion of exchange
Annecy	April 1949	5 months	34	Tariffs	Countries traded nearly 5,000 levy concessions
Torquay	September 1950	8 months	34	Tariffs	Countries traded nearly 8,700 levy concessions, cutting the 1948 duty levels by 25%
Geneva II	January 1956	5 months	22	Tariffs, affirmation of Japan	$2.5 billion in levy decreases
Dillon	September 1960	11 months	45	Tariffs	Tariff concessions worth $4.9 billion of world exchange
Kennedy	May 1964	37 months	48	Tariffs	Anti-dumping Tariff concessions worth $40 billion of world exchange
Tokyo	September 1973	74 months	102	Tariffs, non-levy measures, "system" agreements	Tariff decreases worth more than $300 billion accomplished
Uruguay	September 1986	87 months	123	Tariffs, non-duty measures, rules, administrations, protected innovation, debate settlement,	The round prompted the making of WTO, and expanded the scope of exchange arrangements, prompting

				materials, farming, formation of WTO, etc.	significant diminishments in levies (around 40%) and agrarian sponsorships, a consent to permit full access for materials and apparel from creating nations, and an augmentation of licensed innovation rights.
Doha	November 2001	159		Tariffs, non-duty measures, horticulture, work norms, condition, rivalry, venture, straightforwardness, licenses etc.	The round has not yet finished up. Bali Package marked on the seventh December 2013.

Annecy Round: 1949

The second round occurred in 1949 in Annecy, France. 13 nations partook in the round. The fundamental focal point of the discussions was more duty diminishments, around 5000 altogether.

Torquay Round: 1951

The third round happened in Torquay, England in 1951. Thirty-eight nations partook in the round. 8,700 tax concessions were made totaling the rest of the measure of duties to ¾ of the levies which were in actuality in 1948. The contemporaneous dismissal by the U.S. of the Havana Charter implied the foundation of the GATT as an overseeing world body.

Geneva Round: 1955– 56

The fourth round came back to Geneva in 1955 and endured until May 1956. Twenty-six nations partook in the round. $2.5 billion in levies were disposed of or diminished.

Dillon Round: 1960– 62

The fifth round happened yet again in Geneva and endured from 1960-1962. The discussions were named after U.S. Treasury Secretary and previous Under Secretary of State, Douglas Dillon, who initially proposed the discussions. Twenty-six nations partook in the round. Alongside diminishing over $4.9 billion in duties, it additionally yielded exchange identifying with the making of the European Economic Community (EEC).

Kennedy Round: 1962– 67

The 6th round of GATT multilateral exchange arrangements, held from 1963 to 1967. It was named after U.S. President John F. Kennedy in acknowledgment of his help for the reformulation of the United States exchange motivation, which brought about the Trade Expansion Act of 1962. This Act gave the President the broadest regularly arranging specialist.

As the Dillon Round experienced the arduous procedure of thing by-thing duty arrangements, it turned out to be clear, some time before the Round finished, that a more extensive approach was expected to manage the rising difficulties coming about because of the development of the European Economic Community (EEC) and EFTA, and also Europe's re-rise as a noteworthy universal merchant all the more for the most part.

Japan's high financial development rate predicted the significant part it would play later as an exporter, however the point of convergence of the Kennedy Round dependably was the United States-EEC relationship. Without a doubt, there was a compelling American view that saw what turned into the Kennedy Round as the beginning of a transoceanic association that may at last prompt a transoceanic financial group.

To a degree, this view was partaken in Europe, however the procedure of European unification made its own worries under which the Kennedy Round now and again turned into an optional concentration for the EEC. A case of this was the French veto in January 1963, preceding the round had even begun, on participation by the United Kingdom.

Another was the inner emergency of 1965, which finished in the Luxembourg Compromise. Arrangements for the new round were instantly eclipsed by the Chicken War, an early indication of the effect variable requires under the Common Agricultural Policy would in the end have. A few members in the Round had been worried that the assembling of UNCTAD, planned for 1964, would bring about further entanglements, however its effect on the genuine transactions was insignificant.

In May 1963 Ministers achieved concurrence on three objectives to be negotiated for the round:

(a) Measures for the extension of exchange of creating nations as methods for advancing their financial improvement,

(b) Reduction or disposal of levies and different obstructions to exchange, and

(c) Measures for access to business sectors for rural and other essential items.

The working speculation for the levy arrangements was a straight tax cut of half with the most modest number of exemptions. A drawn-out contention created about the exchange impacts a uniform direct cut would have on the scattered rates (low and high levies very far separated) of the United States when contrasted with the considerably more thought rates of the EEC which additionally tended to be in the lower held of United States tax rates.

The EEC as needs be contended for a night out or harmonization of pinnacles and troughs through its cerement, twofold truck and thirty: ten propositions. When transactions had been joined, the elevated working speculation was soon undermined. The uncommon structure nations (Australia, Canada, New Zealand and South Africa), allegedly claiming their fares were overwhelmed by crude materials and other essential products, arranged their levy decreases altogether through the thing by-thing technique.

At last, the outcome was a normal 35% lessening in duties, except for materials, chemicals, steel and other touchy items; in addition to a 15% to 18% decrease in taxes for rural and sustenance items. Also, the arrangements on chemicals prompted a temporary concession to the abrogation of the American Selling Price (ASP). This was a strategy for esteeming a few chemicals utilized by the prominent States for the burden of import obligations which gave household makers a considerably more elevated amount of assurance than the levy plan demonstrated.

Be that as it may, this piece of the result was refused by Congress, and the American Selling Price was not annulled until the point that Congress embraced the aftereffects of the Tokyo Round. The outcomes on agribusiness in general were poor. The most striking accomplishment was concurrence on a Memorandum of Agreement on Basic Elements for the Negotiation of a World Grants Arrangement, which in the end was moved into another International Grains Arrangement.

The EEC guaranteed that for it the primary consequence of the arrangements on horticulture was that they "enormously characterized its own particular basic approach". The creating nations, who assumed a minor part all through the arrangements in this Round, profited in any case from generous levy cuts especially in non-farming things important to them.

Their principle accomplishment at the time, notwithstanding, apparently was the selection of Part IV of the GATT, which acquitted them from agreeing correspondence to created nations in exchange transactions. In the perspective of numerous creating nations, this was an immediate aftereffect of the call at UNCTAD for a superior exchange bargain for them.

There has been contention as far back as whether this representative motion was a triumph for them, or whether it guaranteed their prohibition later from important interest in the multilateral exchanging framework.

Tokyo Round: 1973– 79

Diminished levies and built up new directions went for controlling the multiplication of non-duty obstructions and deliberate fare limitations. 102 nations partook in the round. Concessions were made on $19 billion worth.

Uruguay Round: 1986– 94

The Uruguay Round started in 1986. It was the most driven round to date, wanting to grow the skill of the GATT to essential new regions, for example, administrations, capital, protected innovation, materials, and farming. 123 nations partook in the round. The Uruguay Round was likewise the principal set of multilateral exchange arrangements in which creating nations had played a dynamic role.

Horticulture was basically exempted from past assertions as it was given exceptional status in the territories of import amounts and fare appropriations, with just gentle provisos. In any case, when of the Uruguay round, numerous nations viewed the exemption of agribusiness as adequately glaring that they declined to sign another arrangement without some development on horticultural items. These fourteen nations came to be known as the "Cairns Group" and included for the most part little and medium-sized horticultural exporters, for example, Australia, Brazil, Canada, Indonesia, and New Zealand.

The Agreement on Agriculture of the Uruguay Round keeps on being the most considerable exchange progression understanding in agrarian items ever. The objectives of the assertion were to enhance advertise access for agrarian items, lessen local help of farming as cost mutilating appropriations and standards, take out after some time send out endowments on horticultural items and to fit to the degree conceivable clean and phytosanitary measures between part nations.

8.5 GATT AND THE WORLD TRADE ORGANIZATION

In 1993, the GATT was refreshed (GATT 1994) to incorporate new commitments upon its signatories. A standout amongst the most noteworthy changes was the formation of the World Trade Organization (WTO). The 75 existing GATT individuals and the European Communities turned into the establishing individuals from the WTO on 1 January 1995. The other 52 GATT individuals re-joined the WTO in the accompanying two years (the last being Congoin 1997). Since the establishing of the WTO, 21 new non-GATT individuals have joined and 29 are right now arranging enrolment. There is an aggregate of 164 nations in the WTO, with Liberia and Afghanistan being the most up to date individuals starting at 2016.

Of the first GATT individuals, Syria and the SFR Yugoslavia have not re-joined the WTO. Since FR Yugoslavia, (renamed as Serbia and Montenegro and with enrolment arrangements later split in two), isn't perceived as a direct SFRY successor state; subsequently, its application is viewed as another (non-GATT) one. The General Council of WTO, on 4 May 2010, consented to build up a working gathering to look at the demand of Syria for WTO membership. The contracting parties who established the WTO finished authority assertion of the "GATT 1947" terms on 31 December 1995. Montenegro turned into a part in 2012, while Serbia is in the choice phase of the transactions and is relied upon to end up an individual from the WTO later.

While GATT was an arrangement of tenets settled upon by countries, the WTO is an institutional body. All things considered, GATT was only a gathering for countries to talk about, while the WTO is a legitimate universal association (which infers physical base camp, staff, delegation). The WTO extended its extension from exchanged products to incorporate exchange inside the administration area and protected innovation rights. Although it was intended to serve multilateral understandings, amid a few rounds of GATT transactions (especially the Tokyo Round) plurilateral assertions made specific exchanging and caused fracture among individuals. WTO game plans are by and large a multilateral assertion settlement system of GATT.

Consequences for exchange liberalization

The normal duty levels for the real GATT members were around 22 percent in 1947. because of the principal arranging rounds, levies were lessened in the GATT centre of the United States, United Kingdom, Canada, and Australia, in respect to other contracting parties and non-GATT participants. By the Kennedy cycle (1962– 67), the normal levy levels of GATT members were around 15%. After the Uruguay Round, taxes were under 5%.

Notwithstanding encouraging connected duty decreases, the early GATT's commitment to exchange advancement "incorporate restricting the arranged tax diminishments for an expanded period (made more changeless in 1955), building up the all-inclusive statement of non-discrimination through most-favoured country (MFN) treatment and national treatment, guaranteeing expanded straightforwardness of exchange approach measures, and giving a discussion to future transactions and for the tranquil determination of two-sided debate. These components added to the defines of exchange arrangement and the diminishment of exchange boundaries and strategy uncertainty."

As per Dartmouth financial student of history Douglas Irwin, the thriving of the world economy over the past 50 years owes an extraordinary arrangement to the development of world exchange which, thusly, is halfway the aftereffect of farsighted authorities who made the GATT. They built up an arrangement of techniques offering dependability to the exchange approach condition and along these lines encouraging the quick development of world exchange. With the long keep running in see, the first GATT conferees helped put the world economy on a sound establishment and in this way enhanced the occupation of a huge number of individuals around the globe.

8.6 WTO

The World Trade Organization (WTO) is an intergovernmental association that directs global exchange. The WTO authoritatively initiated on 1 January 1995 under the Marrakesh Agreement, marked by 123 countries on 15 April 1994, supplanting the General Agreement on Tariffs and Trade (GATT), which started in 1948. It is the biggest global financial association in the world. The WTO manages direction of exchange merchandise, administrations and licensed innovation between taking an interest nation by giving a system to arranging exchange assertions and a debate determination process went for upholding members' adherence to WTO understandings, which are marked by delegates of part governments and endorsed by their parliaments. Most of the issues that the WTO centres around get from past exchange arrangements, particularly from the Uruguay Round (1986–1994).

The WTO's present Director-General is Roberto Azevêdo, who drives a staff of more than 600 individuals in Geneva, Switzerland. An exchange help assertion, some portion of the Bali Package of choices, was concurred by all individuals on 7 December 2013, the primary thorough understanding in the association's history. On 23 January 2017, the correction to the WTO Trade Related Aspects of Intellectual Property Rights (TRIPS) Agreement denotes the first run through since the association opened its entryways in 1995 that WTO agrees have been revised, and this change should secure for creating nations a legitimate pathway to get to reasonable cures under WTO rules.

History

The financial analysts Harry White (left) and John Maynard Keynes at the Bretton Woods Conference.

The WTO's antecedent, the General Agreement on Tariffs and Trade (GATT), was built up after World War II in the wake of other new multilateral establishments committed to universal financial collaboration –, for example, the World Bank and the International Monetary Fund. A practically identical universal foundation for exchange, named the International Trade Organization never began as the arrangement was not endorsed by the U.S. furthermore, other signatories, thus GATT gradually turned into an accepted worldwide organization.

Check Your Progress- A

Choose the correct alternative

1. GATT was founded in the year:

a) 1948

b) 1949

c) 1950

d) 1951

2. Which of the following statement regarding WTO is not true:

a) Is a permanent organization

b) WTO owes its origin to Uruguay round

c) Highest policy making body of WTO is Ministerial Conference

d) WTO came into existence on 1/1/1991

3. The successor of GATT is:

a) IMF

b) WTO
c) World Bank
d) UNESCO

4. The back-up body of the General Council is/are:

a) Council for Trade in Goods
b) Council for Trade-Related Aspects of Intellectual Property Rights
c) Council for Trade in Services
d) Trade Negotiations Committee
e) All of the above

5. GATT was conceived by 23 countries in;

a) Geneva
b) Amsterdam
c) Frankfurt
d) New York

8.7 GATT NEGOTIATIONS BEFORE URUGUAY

Seven rounds of transactions happened under GATT. The principal genuine GATT exchange rounds focused on additionally decreasing taxes. At that point, the Kennedy Round in the mid-sixties achieved a GATT hostile to dumping Agreement and a segment on advancement. The Tokyo Round amid the seventies was the principal significant endeavour to handle exchange hindrances that don't appear as levies, and to enhance the framework, embracing a progression of concessions to non-tax obstructions, which now and again translated existing GATT rules, and in others broke completely new ground. Since these plurilateral understandings were not acknowledged by the full GATT participation, they were frequently casually called "codes". A few of these codes were corrected in the Uruguay Round, and transformed into multilateral duties acknowledged by all WTO individuals. Just four remained plurilateral (those on government acquirement, ox-like meat, common flying machine and dairy items), yet in 1997 WTO individuals consented to end the cow-like meat and dairy assertions, leaving just two. Despite endeavours in the mid-1960s to make some type of institutional component for worldwide exchange, the GATT kept on working for 50 years as a semi-standardized multilateral bargain administration on a temporary basis.

Uruguay Round

Amid the Doha Round, the US government pointed the finger at Brazil and India for being rigid and the EU for hindering horticultural imports.

A long time before GATT's 40th commemoration, its individuals reasoned that the GATT framework was stressing to adjust to another globalizing world economy. considering the issues distinguished in the 1982 Ministerial Declaration (basic lacks, overflow effects of specific nations' strategies on world exchange GATT couldn't oversee and so forth.), the eighth GATT round – known as the Uruguay Round – was propelled in September 1986, in Punta del Este, Uruguay.

It was the greatest arranging command on exchange at any point concurred: the discussions would expand the exchanging framework into a few new regions, prominently exchange administrations and protected innovation, and to change exchange the delicate areas of farming and materials; all the first GATT articles were up for review. The Final Act closing the Uruguay Round and authoritatively building up the WTO administration was marked 15 April 1994, amid the clerical gathering at Marrakesh, Morocco, and henceforth is known as the Marrakesh Agreement.

The GATT still exists as the WTO's umbrella settlement for exchange merchandise, refreshed because of the Uruguay Round transactions (a refinement is made between GATT 1994, the refreshed parts of GATT, and GATT 1947, the first assertion which is yet the core of GATT 1994). GATT 1994 isn't however the main lawfully official understanding included by means of the Final Act at Marrakesh; a considerable rundown of around 60 assertions, extensions, choices and understandings was embraced. The understandings fall into six principle parts, the Agreement Establishing the WTO, the Multilateral Agreements on Trade in Goods, the General Agreement on Trade in Services, the Agreement on Trade-Related Aspects of Intellectual Property Rights, Dispute settlement and surveys of governments' exchange policies

As far as the WTO's rule identifying with levy "roof authoritative", the Uruguay Round has been fruitful in expanding restricting responsibilities by both created and creating nations, as might be found in the rates of taxes bound when the 1986– 1994 talks.

Pastoral meetings

The most elevated basic leadership body of the WTO is the Ministerial Conference, which as a rule meets each two years. It unites all individuals from the WTO, which are all nations or traditions associations. The Ministerial Conference can take choices on all issues under any of the multilateral exchange understandings. Some of these, for example, the inaugural ecclesiastical meeting in Singapore and the Cancun gathering in 2003 included contentions amongst created and creating economies alluded to as the "Singapore issues, for example, rural sponsorships while others, for example, the Seattle meeting in 1999 made vast showings. The fourth clerical gathering in Doha in 2001 affirmed China's entrance to the WTO and propelled the Doha Development Round which was supplemented by the 6th WTO ecclesiastical meeting (in Hong Kong) when rural fare sponsorships were consented to be eliminated and appropriation of the European Union's Everything except Arms activity to eliminate taxes for merchandise from the Least Developed Countries.

Doha Round (Doha Agenda)

The WTO propelled the current round of transactions, the Doha Development Round, at the fourth ecclesiastical meeting in Doha, Qatar in November 2001. This was to be a driven push to make globalization more comprehensive and help the world's poor, especially by slicing hindrances and endowments in farming. The underlying motivation included both further exchange advancement and new administer making, supported by responsibilities regarding reinforce significant help to creating countries.

Advance slowed down after finished contrasts between created countries and the significant creating nations on issues, for example, modern taxes and non-duty boundaries to trade especially against and between the EU and the US over their support of agrarian sponsorships—seen to work successfully as exchange hindrances. Rehashed endeavours to restore the discussions were unsuccessful however the reception of the Bali Ministerial Declaration in 2013 tended to bureaucratic obstructions to commerce

As of June 2012, the eventual fate of the Doha Round stayed dubious: the work program records 21 subjects in which the first due date of 1 January 2005 was missed, and the round is still incomplete. The contention between organized commerce on mechanical merchandise and enterprises yet maintenance of protectionism on cultivate endowments to household farming division (asked for by created nations) and the substantiation of reasonable exchange on rural items (asked for by creating nations) remain the real hindrances. This impasse has made it difficult to dispatch new WTO transactions past the Doha Development Round. Thus, there have been an expanding number of two-sided facilitated commerce understandings between governments. As of July 2012, there were different transaction bunches in the WTO framework for the current horticultural exchange arrangement which is in the state of stalemate.

8.8 FUNCTIONS OF WTO

Among the different functions of the WTO, these are viewed as the most vital:

- It regulates the usage, organization and activity of the secured agreements.
- It gives a gathering to transactions and for settling disputes.

Moreover, it is WTO's obligation to audit and engender the national exchange arrangements, and to guarantee the soundness and straightforwardness of exchange approaches through observation in worldwide financial strategy making. Another need of the WTO is the help of growing, slightest created and low-wage nations on the move to acclimate to WTO principles and teaches through specialized participation and training.

The WTO should encourage the usage, organization and activity and further the destinations of this Agreement and of the Multilateral Trade Agreements, and might likewise give the system to the execution, organization and task of the multilateral Trade Agreements.

The WTO should give the gathering to arrangements among its individuals concerning their multilateral exchange relations in issues managed under the Agreement in the Annexes to this Agreement.

With a view to accomplishing more prominent rationality in worldwide financial approach making, the WTO might participate, as fitting, with the global Monetary Fund (IMF) and with the International Bank for Reconstruction and Development (IBRD) and its partnered agencies.

The over five postings are the extra elements of the World Trade Organization. As globalization continues in the present society, the need of an International Organization to deal with the exchanging frameworks has been of imperative significance. As the exchange volume expands, issues, for example, protectionism, exchange hindrances, endowments, infringement of licensed innovation emerge because of the distinctions in the exchanging guidelines of each country. The World Trade Organization fills in as the go between the countries when such issues emerge. WTO could be alluded to as the result of globalization and furthermore as a standout amongst the most imperative associations in the present globalized society.

The WTO is likewise a focal point of monetary research and examination: customary appraisals of the worldwide exchange picture in its yearly distributions and research gives an account of particular themes are delivered by the organization. Finally, the WTO coordinates intimately with the two different segments of the Bretton Woods framework, the IMF and the World Bank.

8.9 STANDARDS OF THE TRADING SYSTEM

The WTO builds up a system for exchange arrangements; it doesn't characterize or indicate results. That is, it is worried about setting the guidelines of the exchange arrangement games. Five standards are of specific significance in understanding both the pre-1994 GATT and the WTO:

Non-segregation

It has two noteworthy segments: the most supported country (MFN) govern, and the national treatment approach. Both are implanted in the primary WTO controls on merchandise, administrations, and protected innovation, yet their exact extension and nature contrast over these regions. The MFN decide requires that a WTO part should apply similar conditions on all exchange with other WTO individuals, i.e. a WTO part needs to concede the most ideal conditions under which it permits exchange a specific item write to all other WTO members. "Allow somebody a unique support and you need to do likewise for all other WTO members." National treatment implies that transported in merchandise ought to be dealt with no less positively than locally created products (in any event after the outside products have entered the market) and was acquainted with handle non-tax hindrances to exchange (e.g. specialized models, security benchmarks et al. victimizing imported goods).

Correspondence

It reflects both a want to restrict the extent of free-riding that may emerge due to the MFN administer, and a want to acquire better access to remote markets. A related point is that for a country to arrange, it is vital that the pick-up from doing as such be more prominent than the increase accessible from one-sided advancement; proportional concessions mean to guarantee that such picks up will materialise.

Official and enforceable responsibilities. The levy responsibilities made by WTO individuals in a multilateral exchange arrangement and on increase are specified in a timetable (list) of concessions. These calendars build up "roof ties": a nation can change its ties, yet simply after consulting with its exchanging accomplices, which could mean remunerating them for loss of exchange. If fulfilment isn't acquired, the grumbling nation may conjure the WTO question settlement procedures.

Straightforwardness

The WTO individuals are required to distribute their exchange directions, to keep up foundations taking into consideration the survey of regulatory choices influencing exchange, to react to demands for data by different individuals, and to tell changes in exchange strategies to the WTO. These interior straightforwardness necessities are supplemented and encouraged by intermittent nation reports (exchange strategy audits) through the Trade Policy Review Mechanism (TPRM). The WTO framework tries likewise to enhance consistency and steadiness, disheartening the utilization of shares and different measures used as far as possible on amounts of imports.

Security esteems

In conditions, governments can limit exchange. The WTO's assertions allow individuals to take measures to ensure nature as well as general wellbeing, creature wellbeing and plant health.

There are three sorts of arrangement toward this path:

- articles taking into consideration the utilization of exchange measures to accomplish non-monetary destinations;
- articles went for guaranteeing "reasonable rivalry"; individuals must not utilize ecological assurance measures as a methods for masking protectionist policies.
- arrangements allowing intercession in exchange for monetary reasons.

Exemptions to the MFN guideline likewise consider special treatment of creating nations, territorial facilitated commerce zones and traditions unions.

Check Your Progress- B

Q1. What are the Functions of WTO?

Q2. What are the standards of Trading System?

Q3. Discuss the five standards that are of immense importance in understanding both the pre-1994 GATT and the WTO.

8.10 HIERARCHICAL STRUCTURE OF GENERAL COUNCIL

The General Council has the accompanying backup bodies which direct panels in various zones:

Council for Trade in Goods

There are 11 advisory groups under the locale of the Goods Council each with a errand. All individuals from the WTO take an interest in the advisory groups. The Textiles Monitoring Body is separate from alternate boards of trustees yet under the purview of Goods Council. The body has its own administrator and just 10 individuals. The body additionally has a few gatherings identifying with textiles.

Council for Trade-Related Aspects of Intellectual Property Rights

Data on licensed innovation in the WTO, news and authority records of the exercises of the TRIPS Council, and points of interest of the WTO's work with other universal associations in the field.

Council for Trade in Services

The Council for Trade in Services works under the direction of the General Council and oversees managing the working of the General Agreement on Trade in Services (GATS). It is available to all WTO individuals, and can make backup bodies as required.

Trade Negotiations Committee

The Trade Negotiations Committee (TNC) is the board that arrangements with the present exchange talks round. The seat is WTO's chief general. As of June 2012, the board of trustees was entrusted with the Doha Development Round.

The Service Council has three auxiliary bodies: monetary administrations, residential directions, GATS standards and commitments. The chamber has a few unique boards of trustees, working gatherings, and working parties. There are advisory groups on the accompanying: Trade and Environment; Trade and Development (Subcommittee on Least-Developed Countries); Regional Trade Agreements; Balance of Payments Restrictions; and Budget, Finance and Administration. There are working gatherings on the accompanying: Accession. There are working gathering

Dispute settlement

The WTO's question settlement framework "is the aftereffect of the advancement of principles, techniques and practices created over practically 50 years under the GATT 1947". In 1994, the WTO individuals conceded to the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) attached to the "Last Act" marked in Marrakesh in 1994. Dispute settlement is viewed by the WTO as the focal mainstay of the multilateral exchanging framework, and as a "one of a kind commitment to the dependability of the worldwide economy". WTO individuals have concurred that, on the off chance that they trust individual individuals are abusing exchange rules, they will utilize the multilateral arrangement of settling debate as opposed to making a move unilaterally.

The activity of the WTO question settlement process includes case-explicit panels delegated by the Dispute Settlement Body (DSB), the Appellate Body, The Director-General and the WTO Secretariat, arbitrators, and warning experts.

The need is to settle question, ideally through a commonly concurred arrangement, and arrangement has been made for the procedure to be directed in a productive and auspicious way so that "If a case is mediated, it ought to typically take close to one year for a board administering and close to 16 months if the case is advanced... On the off chance that the complainant regards the case dire, thought of the case should take even less time. WTO part countries are obliged to acknowledge the procedure as selective and compulsory.

Membership

The way toward turning into a WTO part is exceptional to every candidate nation, and the terms of promotion are reliant upon the nation's phase of monetary improvement and current exchange regime. The procedure takes around five years, by and large, however it can last more if the nation is not exactly completely dedicated to the procedure or if political issues meddle. The most limited promotion arrangement was that of the Kyrgyz Republic, while the longest was that of Russia, which, having first connected to join GATT in 1993, was endorsed for enrollment in December 2011 and turned into a WTO part on 22 August 2012. Kazakhstan additionally had a long increase exchange process. The Working Party on the Accession of Kazakhstan was built up in 1996 and was affirmed for enrollment in 2015. The second longest was that of Vanuatu, whose Working Party on the Accession of Vanuatu was set up on 11 July 1995. After a last gathering of the Working Party in October 2001, Vanuatu asked for more opportunity to consider its increase terms. In 2008, it showed its enthusiasm to continue and close its WTO promotion. The Working Party on the Accession of Vanuatu was reconvened casually on 4 April 2011 to talk about Vanuatu's future WTO enrollment. The re-met Working Party finished its command on 2 May 2011. The General Council formally affirmed the Accession Package of Vanuatu on 26 October 2011. On 24 August 2012, the WTO invited Vanuatu as its 157th member. An idea of increase is just given once accord is come to among intrigued parties.

A recent report contends that "political ties instead of issue-zone useful additions figure out who joins" and shows "how geopolitical arrangement shapes the interest and supply sides of membership". The "discoveries challenge the view that states initially change exchange to join the GATT/WTO. Rather, majority rule government and outside strategy comparability urge states to join."

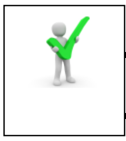
8.11 SUMMARY

In this unit ,you learnt that how the world Trading System emerged. You also learnt that various rules and model laws were required to oversee and administer global trade. They will probably open boundaries and modernize standard trades and decrease exchange obstructions around the globe. You are also learnt the outcome of various rounds of GATT. Now, in the next unit you would learn about International Business Environment.

8.12 GLOSSARY

General Agreement on Tariffs and Trade (GATT) was a lawful understanding between numerous nations, whose general intention was to advance global exchange by decreasing or dispensing with exchange hindrances, for example, duties or quantities.

The World Trade Organization (WTO) is an intergovernmental association that directs global exchange.



8.13ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress –A

Answers

1. a,
2. d
3. b
4. e
5. a

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8.15 SUGGESTED READINGS

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8.16 TERMINAL QUESTIONS

Q1. Discuss the impact of the Kennedy Round on improving the world trade.

Q2. Discuss the different limitations of GATT.

Q3. Discuss the impact of WTO on increasing the cooperation between member nations for improving the world trade.

Q4. Discuss the issues and challenges that are posed by member nations while implementing any trade reforms at the global market place.

Q5. Discuss the objectives with which IMF was founded.

UNIT 9 INTERNATIONAL BUSINESS ENVIRONMENT

9.1 INTRODUCTION

We have directly or indirectly been to trade since primitive time. Trade is any action of the buying and selling process, which involves mutual gain or benefit. Essentially trade involves transaction between two parties (i.e. buyers and sellers) where both parties are benefited by mutual gain. In economic terms trade can be defined as the process of buying or selling of goods or a service, which involves a compensation which is paid by the buyer to the seller and the seller exchanges these goods or services to the money worth. Economically these buyers and sellers within the economy can also be termed as the producers of the goods and services and the consumer of goods or services.

Ever since the growth of human civilization, the use of trade has been in existence. In earlier time, the concept of trade was there in barter system that is exchange of goods for goods. Those were the times were the concept of money was not developed and the unique medium of transaction was not evolved. As the civilization grew and society became more civilized the need for more smoother and unique form of transaction was felt and money was evolved. With money evolution, transactions where made easier and the value of goods where appropriately defined. The overall process of exchange and transaction became worthy.

9.2 OBJECTIVES

After studying this unit the learner should;

- Be able to understand the meaning and classification of trade.
- Be able to know the difference between domestic and international trade.
- Understand the meaning, concept and need of international business environment.
- Know the classification of international business environment including competitive environment, political environment, legal environment, socio cultural environment, ecological environment etc.

9.3 CLASSIFICATION OF TRADE

Trade in an economy can be classified into two major categories:

i. Domestic trade
ii. International trade

i. Domestic trade

It can also be referred to as internal trade. As the name suggests internal trade is the trading activity, which involves exchange of goods and services within the territorial jurisdiction of a country. It is also sometimes known as home trade. Since home trade or domestic trade involves the process of exchange within a specified territorial jurisdiction of a country, it essentially involves transaction with the help of the country's home currency only. Beyond the territorial jurisdiction of a country, domestic trade does not have its existence.

Domestic trade again can be classified into two categories

a) Wholesale trade
b) Retail trade

Wholesale trade involves exchanging of goods and services within the territorial jurisdiction of a home country in a bulk. Wholesale trade involves wholesalers, which sell their goods to the retailer in a bulk or large quantities. They do not directly come in contact with the ultimate customers or consumer of goods and acts as a connecting link between manufacturer and retailer.

Retail trade involves exchanging of goods and services within the territorial jurisdiction of home country in retail or small quantities. Retail trade involves retailers which sell their goods to the ultimate customers or consumers in small quantities as per their needs. These retail traders comes in the direct contact with ultimate customers or consumer of goods and acts as a connecting link between the wholesalers and the ultimate consumers or customers.

ii. International trade

It can also be referred to as external trade. As the name suggests external trade is the trading activity, which involve exchange of goods and services beyond the territorial jurisdiction of a home country. One can say that international trade involves trading between two or more countries or nation. International trade has wider scope in terms of coverage since they are spread across the territory of various nations.

International trade for further can be classified into the following categories:

a) Import trade
b) Export trade
c) Entrepot trade

a) Import trade refers to the bringing or importing goods or services from outside country to the home country. Import of these goods or services is essentially due to the requirements of the home country of those goods or services. Import of the items or goods either are required because the home country is not able to produce these goods or does not have the cost advantage for production of the goods.
b) Export trade refers to Selling of the goods or services by the home country to a foreign or outside country. Export trade generates revenue for the home country. The goods and services exported by the home country have cost advantage for the production of goods or services in comparison to that of the foreign or outside country.
c) Entrepot trade is a condition where goods are imported from an outside or a foreign country and then exported to the outside or a foreign country. Essentially the role of a home country is to transfer the goods from one nation to the other and performs the role of an intermediary. The goods imported are not for the purpose of consumption but for the purpose of export. The home country does generates revenue by transferring or re-exporting products or goods from one nation to the other. This trade is also known as re-export trade.

9.4 DISTINCTION BETWEEN DOMESTIC AND INTERNATIONAL TRADE

Domestic Trade

1. It involves trading activities, which takes place within the territorial jurisdiction of a home country.

2. In terms of the operating areas, it involves only one nation or domestic or home country.
3. In terms of coverage, domestic trade is confined or has limited coverage since it operates in a single or home country.
4. The goods produced and marketed within the country are not of international standards. Local made products, which can generate revenue with the home country, are generally of low quality.
5. Since the products are marketed within the home country, the production of goods requires low capital investment for setup and operations.
6. The transaction takes place within the buyers and sellers of the home country with home currency.
7. Domestic or home trade are subjected to very few restrictions within the country and trade processes are easy in operation within the home country.
8. The consumers of the goods for domestic trade are the home countries citizens, which are similar in their likings and preferences and thus are homogenous in nature.
9. All the factor of production i.e. land, labor and capital are mobile in nature and can be made easily available as per need within the geography of the home country.
10. Business research or market research can be easily performed as customer feedback can be easily obtained from the home country.

International trade

1. It involves trading activities, which takes place beyond the territorial jurisdiction of a home country.
2. In terms of operating areas, it involves two or more nations or countries.
3. In terms of coverage international trade involves multi-country for its operations. It is not confined to a single area and has unlimited coverage since it operates in more than one country.
4. The goods produced and marketed internationally are of international standards. The product quality are of superior class, which are accepted across various nations of the world.
5. The products are marketed in multi countries the production of goods require huge or large capital investment for the setup and operations.
6. The transaction that takes place within the buyers and sellers of different countries requires currency of those countries (multi-currency).

7. International trade are subjected to many restrictions. Since the process involve transaction across the globe, the trade processes are difficult to operate and are subjected to restrictions.
8. The consumers of the goods for international trade are spread across different nations of the globe, which are dissimilar in their liking and preferences and are non-homogeneous in nature.
9. All the factors of production i.e. land, labor and capital does not require easy mobility and thus are difficult to make available at the point of requirement within the trade process.
10. Business or market research cannot be easily performed as customer feedback are spread across various geographical territories, which cannot be easily obtained.

9.5 CONCEPT OF BUSINESS AND ITS ENVIRONMENT

Ever since the growth of human civilization, the need for business existed. Although there has been transformation in the ways and means of doing business, the idea of production came into existence with the need of product, and with the creation of product, all other factors associated with the consumption of the produced product came into picture. i.e. distribution, promotion etc. In order to understand the business, it is imperative to understand its meaning. Following are some of the under given definitions for business:

1. According to Business Dictionary, “Business is an organisation or economic system where goods and services are exchanged for one another or for money”.
2. According to Merriam Webster, “Business is usually a commercial or mercantile activity engaged in as a means of livelihood”.
3. Stephenson defines business as, "The regular production or purchase and sale of goods undertaken with an objective of earning profit and acquiring wealth through the satisfaction of human wants."
4. According to Dicksee**,** "Business refers to a form of activity conducted with an objective of earning profits for the benefit of those on whose behalf the activity is conducted."

In order for a Business to exist, it is important to understand the kind of operations it has and the kind of environment in which it exists. In other words, the surroundings in which a business operates is called as the business environment. Now the question arises that why it is important to study the business environment. It is a well-known fact that business operates to maximize efficiency in terms of its operations, profit, dynamics etc. Business depends on many surrounding factors in which it operates, and these surrounding factors are not static in nature. The surrounding factor of business changes from time to time, and thus it becomes important to understand the nature of business environment.

9.6 NEED OF INTERNATIONAL BUSINESS

1. By operating in domestically, one can generate revenue and earn profit in a limited means; therefore, firms go global in order to increase their profit.
2. Domestic country has a limited demand, by going global there is a need to further expand the production capacity of the firm in operation.
3. Often there is intense competition in the home country. By going global these severity in competition can be minimized by the firms.
4. The market size of the domestic country is limited in its geographical territory, and thus for extension of the market size firms go global.
5. Sometimes the political conditions of the home country is not favorable for the firms to operate. In those conditions firms search for countries with political favorableness for its operation.
6. The availability of resources at low cost (i.e. cost of work force, raw materials, transportation facilities etc.) in foreign countries is another reason for firms going global.
7. Firms also go global in search of more advanced and sophisticated technology for operations, which can provide them operational economies thereby reducing producing costs.
8. In order to explore liberalization, privatization and globalization, firms also opt for global trade.
9. The free trade barriers of operation have allowed most of the domestic firms to operate globally.

Check Your Progress- A

Q1. What are the two main classifications of Trade?

Q2. What is the need of International business?

9.7 CLASSIFICATION OF BUSINESS ENVIRONMENTAL FORCES

There are a number of forces, which acts upon the organisation in order to operate in an environment. The forces that act upon the domestic environment and international environment can be different because both the problem as well as the prospects of domestic and international environment shows variations. One of the classifications of business environmental forces enacting organisations is:

1. Competitive environment
2. Economic environment
3. Technological environment
4. Ecological environment
5. Political environment
6. Legal environment
7. Cultural Demographic and Social environment

9.7.1 THE COMPETITIVE ENVIRONMENT

The competitive environment operates within the condition of dynamism and understanding the nature of competitiveness is very essential to construct organisational strategy. For determining the competitive environment, it is essential to understand the industrial and competitive conditions in which the firm function. It is needful to reduce the uncertainty condition in the market in which an organisation trade. Market in an economy can be classified into various types- monopoly, perfectly competitive, oligopoly and monopolistic. The competition level in the classified market depends upon numerous conditions:

1- The products nature: It is important to understand the nature of the product supplied by the firm. In case of identical firms producing and supplying similar or homogenous products, then the ability of the firm for producers to set the price of the offering it is reduced down. This in turn can affect the profit. It is important that firm should engage themselves in offering differentiation with the product offering so as to gain price fixation flexibility.

2- Number of operating firms/ organisations: It is obvious that a single firm when operates in a market there is no likely condition for competition. Moreover, for monopoly condition there exists no law regulation mechanism for control. Here there is a potential scope for making profit. On the other hand, if the number of players/ organisational offerings increases intensity of competition increases and idea of potential profit margin drops down.

3- Conditions for market entry: Competition in the market is also affected by offered conditions for entry into the market. There are 7 types of market barriers which creates hurdles in entry to the prospective competitors. On the other hand, some of the markets do not have such hurdles of entry.

4- Intentionally created trade barriers: In some cases trade barriers are intentionally created in order to prevent the newly entrance into the market. The strategy involved in preventing the new entrants could be excessive expenditure on research and development activities, introduction of sophisticated technology, creative advertising, debate offering to the customers, use of predatory pricing etc. Brand proliferation can also prevent the newly entrance to the market. Some firms producing very good multiple brands also acts as a trade barrier to the new firms who are attracted to a particular market for some or other means.

5- Innocent barriers: These are the type of barriers, which are based on the concept of absolute cost advantage. In other words if a firm is able to produce products or goods in a relatively lower cost in comparison to that of the other similar firms it is said to be advantage in terms of cost. Here the per unit cost of production is lower.

6- Economy of scale: This concept is based on the fact that higher the production lower will be the total average cost per unit of production. Generally, larger plants or organisation producing higher quantities of output get the advantage of economy of scale of production. Let us take an example of a small medium and large plant producing different units of output. In the figure below x and y-axis represents output in units and total average cost per unit of production respectively. It can be clearly observed that small plants producing less output have higher total average cost per unit whereas when the output is increased (by the medium plant) the total average cost per unit of production goes down or falls. If these two conditions are compared to the larger plants it can be clearly observed that while producing higher volume of outputs the total average cost per unit of production further reduces. For having higher lot of production and producing in higher quantities, offers advantage in terms of cost per unit of production. Economy of scale acts as a huge barrier, as the new entrants have to prepare themselves in terms of concrete cost advantages and should be able to respond and change quickly in this dynamic environment.

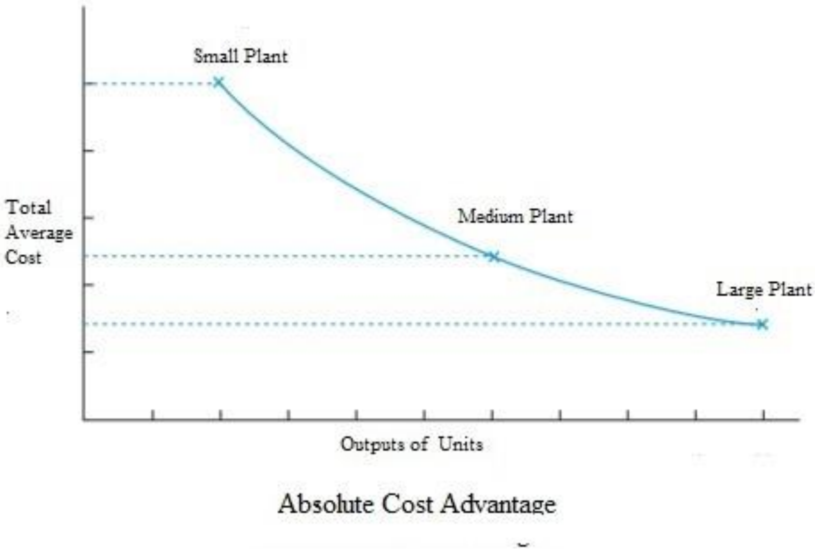

Fig 9.1 Economy of Scale

7- The experience curve: The concept of experience curve was for the first time popularized by an American consultancy named Boston Consulting groups (BCG) in the year 1968. The concept of experience curve is based on the fact that performance of a company depends on the form of experience the company has gained over the period of time. The experience curve takes specialisation and learning factor into consideration, which is gained in an organisation after a specific period. Say for example an organisation has experience gained over a period of time in terms of production specialisation, when this organisation increases its volume of production the cost per unit of producing the product, is automatically reduced down. Operating down the experience curve provides cost advantage and acts as a barrier for the potential entrance by offering marginal cost differentiation for product offering.

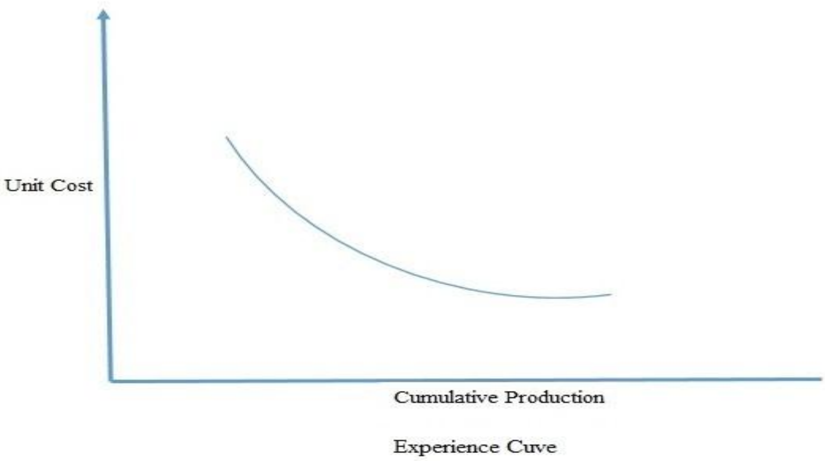

Fig 9.2 The Experience Curve

9.7.2 THE COMPETITIVE FORCES

In order to understand the structure of competition it is very much important to first have a clear understanding on industry structure. This understanding probably give rise to the strategic analysis. Strategic analysis give a detailed framework in understanding the nature, function in terms of characteristics of an industry, and therefore becomes imperative in shaping the competitive environment of an industry.

Michael Porter in 1980 in this regard forwarded a model popularly called as porter's five forces affecting competition. Porter in his model suggested that the five forces determine the state of competition of an industry namely:

1- Competitors rivalry.

2- Threat of entry.

3- Threat of substitute

4- Bargaining power of buyers.

5- Bargaining power of the suppliers.

1- Competitors rivalry: It is obvious that if a market becomes intensely competitive it will create rivalry among competitors, this increase competition in the market can reduce the profit margin. The strength of rivalry depends on many factors.

a- Industrial growth rate: The industrial growth rate is a predominant factor, which determines the strength of rivalry. Industry, which is slow in growth rate, are likely to become more competitive, whereas industry with high growth rate are less competitive.

b- Cost differentiation: Cost differentiation can be studied in terms of the investments made by the organisation for undertaking business. For example, business with high capital investment in fixed cost are more focused to cut the prices in order to sell the output. These firms can offer competitive price in comparison to that of their competitors.

c- Low product differentiation: In condition where there are very little to discriminate between the products offered by two competitive firms, the likely possibility of competition between the firms increases.

d- Very high exit barriers: Exit barrier can be explained in terms of cost incurred by firm at the time of leaving an industry. The intensity of competition is also dependent on the exit barrier. If the exit barrier is high, the cost involved in leaving the industry is also very high.

2- Threat of entry: If any new firm enters into a market, it is likely to be a threat to all the competitors. Generally, a new firm while entering into a market is attracted by many factors. i.e. high rate of return, exploring new resources, gaining new market share etc. Threat of entry depends on the barriers enacted for potential entrants. The potential entrance may suffer from such barriers including challenges to manage for differentiation in product, gaining economy of scale and cost advantages, overcoming legal barriers, sustaining high capital requirements, access to markets through various distribution channels etc.

3- Threat of substitution: Product substitute can be made by making similar product or services which organisation supplies, in comparison to that of the competitors. This rate of substitution is also dependent on many factors like propensity of the buyers in the market to prefer substitute, the switching cost involved, the performance of the substitute product and the relative price of the substitute offered.

4- Bargaining power of the buyers and suppliers: organisations carrying out their business purchase their raw materials and other components which are involved in producing products and services. The bargaining power of the suppliers can significantly alter the profit margin of the organisation carrying out business. On the other hand organisational output are purchased by the ultimate buyers, who in turn, by their bargaining skill can alter the profit margin of the organisation.

9.7.3THE INTERNATIONAL ECONOMIC ENVIRONMENT

Organisations operating in international business environment need to make a critical analysis on the requirement of resources for production, the demand condition of the product supplied, weather forecast of future demand and changes occurring within all this factors. Structural changes which takes place across the economy of the globe tends to affect the ability to trade. Major economies of the world concentrate on the economic goals. The major economic goals can be striving for high level of economic growth, having strong balance of payment, maintaining the level of inflation and creation of employment. Each factor can be described as under:

1- Achieving economic growth: The first and the foremost objective of a country's progress is to achieve economic growth. This economic growth can be measured in terms of gross domestic product. Countries like USA, France, Germany, Japan and UK are among the developed nation, which strive for high growth rate. However, countries across the globe move with the different pace with respect to Gross Domestic Product (GDP). In this sense, it can be said that two countries can have different economic growth at a given point of time. The high economic growth can accelerate real income in the economy and is able to provide goods and services of high variety. Achieving economic growth is also affected by the policy measures of the government of different countries. Factors which contributes in accelerating the economic growth of a country includes the pattern of investment in education, the structure of capital saving and investment criteria, patterns of investment in equipments and fixed capital, the level of human capital etc. On the other hand the factors which contributes to the deceleration of economic growth includes low level of expenditure by the government of the home country, instability due to political and social conditions, high trade barriers, the nature of political governance etc.

2- The nature of structural changes within the economy: Structural changes within an economy can be accessed through the primary secondary and the tertiary sectors. By studying the nature of structural changes, international environment can be accessed to make congenial business decisions. Changes occurring within the primary sectors, which covers natural resources, gives an idea on growth of economy. Some developed countries across the globe do not try to harness the natural resources i.e. mining, extraction, use of petroleum and other non renewable resources of energy while underdeveloped and developing countries tries to make full use of it. The secondary sector includes the manufacturing industries, which uses the material produced by the primary sector while tertiary sector of economy includes health, banking, finance, tourism etc. Tertiary sector generally falls into the category of private ownership. The assessment of structural changes taking place within the economy provides a broader picture and clear the idea to trade within a country.

3- Level of inflation: Inflation can be defined as the increase in the price of goods and services offered within an economy over a period. It is very important to study the level of inflation since it gives an idea about the purchasing power of money at a given point of time. Level of inflation can be measured by retail price index (RPI). Fluctuations in inflation causes redistribution. Inflation within the home country causes adverse effect on economy. It affects both individual as well as business firms. The prices of the goods produced within the home country becomes expensive and less competitive in the foreign market and thus makes imported goods cheaper. Government tries to prevent these fluctuations in inflation by suitable policy measures. Higher inflation rate brings in price control and wage cuts and may lead to industrial unrest. Thus, it is important to understand the inflationary trend of the world economy for trade.

4- Employment: Economics across the globe tries to increase the level of employment and decrease the level of unemployment. When the relative inflation is low in economy it can favour competitiveness among firms and can provide higher level of jobs in the economy. However, with the rise in population across nation the geometrical progression of employment creation have ceased and raises only in arithmetic means. Countries with high rate of population growth fail to give employment to the mass.

9.7.4TECHNOLOGICAL ENVIRONMENT

One of the major changes brought to the organisations in the 21st century is the use of Technology. Unlike some other forces, which are beyond the control of organisation, technological forces are well known to the managers and are within the control of the organisation. Firm’s competitiveness is well affected by the degree of technological adoption by competitors. It is also been seen that technological adoption by the employees of the organization is imperative. Positive employee attitude towards technological change and adoption leads to high productivity in long run, whereas negative attitude of the employees can hamper organisation and leads to deterioration. Technology can also be directly related to innovation. It is the other means to product processes which has greater efficiency in comparison to that of man-made indigenous method of production. In earlier days, the use of technology was just viewed as a labour saving device, however with respect to changing time it has brought structural changes in the organisation. Technological adoption for firms can be both attractive as well as problematic because at one end, it can make the work easy and efficient but on the other, it involves complexity and with respect to time, it can become obsolete and is subjected to upgradation.

1- Use of Technology in modern organisation: Organisations operating in modern era have adopted the use of technology, however many of the technologies are subjected to the cause of pollution and depletion of the resources. Globalization has affected almost every sphere of life. Use of technology in global era have demanded for technological upgradation, since identical products are demanded across two different countries of the globe and therefore technology can bring revolutionary changes in the world market.

2- Technological differences across nation: No two nations across the globe are identical in the means of using technology. Indeed adoption and use of technology largely depends on the research and development activities a country is involved in. Technological advancement is the fruit of targeted research. Many countries like USA, Germany, France, UK, Canada and Italy make lot of investment in research and development activities. Well, companies like Ford automatic, General Motor automotive, Simon electronics, IBM, Microsoft, Motorola spend high in research and development activities. The outcome of these research activities are the indicators of technological progress. Activities like applying for patents and deploying it in technology dependent sector are the key indicators, which show the present and future use of technology in organisation.

3- Use of technology across various sectors: No to business enterprises are alike in terms of using technology. One firm may have the higher use of technology the other may not be using technology at all. Many of the service organisations may not need technology at wider application. Some of the sectors like pharmaceuticals, computer software, IT, hardware, electronics and electrical, healthcare, vehicle manufacturing, refining use more information technology then the other sectors like food industry, transport industry etc.

Check Your Progress- B

Q1. What do you mean by Experience Curve?

Q2. What is importance of Technological Environment in International Business?

9.7.5 ECOLOGICAL ENVIRONMENT

Although 21st century has marked the beginning of an era signifying high growth and development, however the range of environment related problems has grown. The cost of development have now been affecting the environment at large. Business and companies are affecting the environment by causing certain pollution which is depleting the natural environment. Many manufacturing companies contributes to the source of carbon dioxide, methane, nitrous oxide and other harmful gases which are threat to environment as well as human life. The need for more industrial development has brought in to use the natural resources in the form of coal and petroleum which are limited by nature. Excessive burning of these resources contributes to excessive emission of carbon dioxide gas and chlorofluorocarbons. These two gases are the sources of greenhouse effect. Increase in these gases leads to the greenhouse effect which raises the global temperature. Rise in the global temperature would result in the melting of the polar ice which use would result in the increase in the sea level by 50 centimeter by the year 2100. Again this rise in sea level would result in excessive flooding specially in the coastal areas. It could also significantly reduce the total land coverage of the planet. Global warming has also resulted in occasional forest fire which is another source of depletion of the forest resources by natural means. Emission of chlorofluorocarbon has resulted in the depletion of ozone layer, thereby the ultraviolet rays from the sun directly enters into the earth surface causing various types of diseases to human population.

With the rise in these problems, need for preventing the ecological environment has become key imperative for the government. The decisions to set up a business enterprise largely depend on the factor of regulatory mechanism setup with respect to causing less harm to the ecology. Business in this regards should follow ecologically sound principles. Transformation in products, production, strategy, management practices are essential to operate in ecologically changing environment. Government in this regard has got crucial role to play. The allocation of goods and services has become imperative due to given following factors:

1. There is a need to change the supply policy as per demand conditions and business cycle in concern to that of ecology.
2. To stop monopolies as they bring in the unfair use of resources with unethical practices.
3. To bring in equity in terms of wealth distribution by formulating suitable taxation policies to support stakeholders.
4. To provide more of law and order conditions with respect to public goods and services.
5. To charge heavy for undesirable commercial activities which causes threat to ecology, public concerns should be given more importance as compared to that of the private profit motive.
6. To work in the line of social well being for preventing the environment, and not sacrifice in the same at the cause of rapid industrialisation.
7. By making strict trade regulation with respect to property rights, market solutions, trade permits etc.

9.7.6 POLITICAL ENVIRONMENT

International political environment refers to the affairs of the states to intrude and influence the business activities carried out by a firm at a multinational level. Government of the home country is an important stakeholder, which effects firms operation. Political environment of a country is one of the most important aspects to be considered for trading between two countries. As a means of market entry the concepts of trade or export has now acquired the means of foreign direct investment. There are a lot of barriers with create pressure in terms of entry to a foreign market due to the presence of regulations and laws formulated by the home country for doing business. While foreign direct investment is encouraged in the global setup, a firm has to undergo a lot of complexity for expansion of business at international platform. The political system of two countries functions in interdependent manner, and the strength of relationship is determined by their diplomatic relationship and this diplomatic relationship in turn determines the economic relationship between two countries.

Trade between two countries is largely affected by the political ideologies of the political party within the home country. The entire system of politics constitutes of its various stakeholders viz. government, political parties, labour and religious organisations, environmental activist and so on. These stakeholders in some or other way influences the decision which is made within the country and every stakeholder has a unique set of belief which affects the decision making. Some of these political parties create political viability by influencing the political decision making process, this creates pressure exertion by the groups. Again the form and kind of pressure may vary from country to country depending on the active interest of various religious, communal regional parties operating within the country. For instance some countries strongly oppose rapid industrialisation because it can create automation and deplete the environment. They exert political pressure and exercise high entry barrier to prevent trade.

Economic Systems

1. Communism: The communism system holds that the factor of production i.e. land, labour, and capital are owned and controlled by the government of that country. The profit earned by the enterprises is redistributed among people of the country. Government plays a very active role in managing the business activities and acts central to planning and organising function of business. This type of economic system discourages individual entrepreneurship as majority of the firms are owned and controlled by the government itself. The major focus is on social welfare rather than on Profit seeking. One of the major drawbacks this system faces is the lack of appropriate motivation for production, hence it becomes ineffective. For example, China the former Soviet Union, Eastern European countries, South Korea and Vietnam.
2. Socialism: The socialism system holds that key or priority industries are operated by the government, where as small businesses are run and managed by private means. Some of the key industries which are owned by the government in socialism include railways, minings, shipbuilding, airlines, steel etc. Socialism differs from communism in the sense that the extent of government control in socialism is lower as compared to that of the communist form of government. Example of socialist system includes Sweden, France, India and Poland.
3. Capitalism: The capitalism system holds that individual ownership are the key players in the economic system. Here all the resources and key or priority industries are controlled and managed under private ownership and they are provided with complete freedom to do business. It is considered to be a free market economy. The prices of a commodity are dependent on the demand and supply conditions. The role of the government is to act as a facilitator in promoting trade. Capitalism encourages individual entrepreneurship and is fragile system when compared to socialism or communism form of economic system.

Apart from all this above factors of economic system of governance within the country there are certain other factors which tends to affect the ability to trade. Some of the factors are listed below:

1. Bureaucracy: It is one of the factor which also affects the international business. Bureaucracy is ownership or governance which is based on hierarchical Structure. Here there are predetermined rules and regulations which govern the entire system and governance is discouraged on the basis of personal skills or characteristics. Firms operating in a bureaucratic form of government find it difficult for operation.
2. Violence: Violence can be defined as a set of behavioral or physical activity which tends to influence or damage someone without any cause or reason. Violence created by the act of terrorism or local crimes creates unrest among public at large. International violence activities includes mass killing, kidnapping, bombarding etc. Cyber crime in the form of hacking is also predominant form of crime in present business. Terrorism or violence is a major threat to international business as it can cost significant business cost due to terrorist activity.
3. Economic freedom: Absence of violence in a country gives rise to economic freedom which increases the ability to trade. Countries across the globe having higher economic freedom are more developed. The constituent of economic freedom include factors like business, trade, fiscal, government size, monetary, investment, financial, property rights, corruption, and labour freedom. Countries like Hong Kong, Singapore, Ireland, US, Newzealand and Canada are among economic freedom countries. In this context India is rated to have 54.2 % of economic freedom.

9.7.7 LEGAL ENVIRONMENT

Legal environment is another essential factor considered in global marketing. Legal environment constitutes a set of rules or principles which binds two countries for following it. Factors governed under legal environment includes export and import controls, transfer pricing regulations, direct and indirect tax regulation, antitrust rules, distribution of equity, patents and trademarks. IMF and GATT Play major role in legal growth of a global business.

International Monetary Fund: International Monetary Fund was established in the year 1945 with his head office at Washington DC. There were 191 nations as on 2005 as its members. The idea behind the establishment of IMF was to formulate an orderly International Monetary system which can solve the problems of global payment and exchange rate system across countries. Some of the key functions of IMF includes:

1. To accelerate and develop global business in legal framework and to contribute for growth of employment and income.
2. To contribute for the global operation of business.
3. To work for the benefit and extension of developmental activities related to business across the globe.
4. To facilitate the establishment of multifaceted system of payment within the member countries.

5. To enhance trade quality encouraging systematic trade among the member nation.
6. To promote financial and economic growth among member countries.

General Agreement on Tariffs and Trade (GATT): General agreement on tariffs and trade helps in regulation of international trade. It is a multinational trade agreement. General objective of GATT to reduce the trade barriers and preferences in a reciprocal manner which is advantageous for both the countries trading with each other. Following are the major functions of GATT:

1. Most favoured Nation: Under the principles of gate all the members of the system are treated equally and are considered as the most favoured nation. Trade is carried out on the basis of reciprocity on the account of mutual benefit. No discrimination is there for the member countries for the member countries.
2. Trade negotiations: Right from the inception of GATT till 2001 there has been 12 trade negotiations. The outcome of trade negotiations are based on tariff concessions and reductions, resolving of intellectual property dispute, settlement creation of World Trade Organisation, governance under commercial law, market access, e-commerce etc.
3. Tariff and non tariff measures: International trade are opened obstructed by heavy traffic tariff. The role of GATT is to reduce tariff between the member countries so as to facilitate trade. The work related to tariff concessions are the key priority of GATT. Also there are issues which are not related to tariff measures which are dealt by GATT. Some of the non tariff measures include custom valuation, procurement from the government side, import related licensing procedures, retrenchment on subsidical use, permission governing anti dumping etc.
4. Dispute settlement: Countries trading with each other often are subjected to disputes. This disputes are coming within the period of time are settled by GATT. the process of dispute settlement include organising talks on bilateral basis. If the dispute is not resolved at preliminary level it is further referred to the panel of independent experts of GATT.

9.7.8 INTERNATIONAL CULTURAL DEMOGRAPHIC AND SOCIAL ENVIRONMENT

Since the advancement of 21st century this environment has acquired a prominent place in international business arena. Culture and demographics do not directly affect the international business but they play an indirect role in affecting the business.

The National Cultural Environment

There are numerous definition of culture. Culture can be said as the “accustomed practices followed by a group of people”. In other words, it is a sort of programming occurring within the minds of people, which help to discriminate between one groups of individuals to the other. Culture in a broader sense is a set of norms and believes broadly practiced by group of people and is influenced by various factors like language, legal system prevailing within the society, education, political system religion etc. The degree of globalization in business has made organisations to operate in dynamic business conditions and has to cope with the existing culture of the home country. Convergence of culture between two countries leads to quick adoption to the business conditions and gains higher acceptance within the home country. Global brands like Cocacola, Nike and Nokia some of the globally accepted brands. On the other hand divergence across culture leads to lower acceptance within the home country leading to less production adoption. Many of the products in the international level fail because of cultural differences. Identification of differences persisting across nation can be studied by power distance, individualism, uncertainty avoidance and masculinity.

1. Power distance: This is the dimension presents the social difference between people residing within a community. It represents the social difference between people of two different ranks within a society or class. In high power distance countries the superior has vital role in decision making process and subordinates respect their decision. Where as in low power distance country the difference between superior and subordinates is low and participate in the decision making process. The manager of these countries is paid with less respect and is challenged more openly than the others.
2. Individualism: Individualism refers to an idea where people perceive themselves either being an individual or having collective approach solve organisational problems. In an individual approach individuals initiative to solve problem or to make decisions relating to organisation is very high whereas in collective approach, collective view of people within the organisation taken for making complex decisions. USA is an example where individualism is followed widely where as Singapore is an example where collectivism is predominantly seen.
3. Uncertainty avoidance: Dimension which reflects the people's tolerance level in handling ambiguity situations. Countries with high uncertainty avoidance means people feel distracted or depressed for not being guided in the right direction leading to confused positioning. It depends and varies from country to country that how far people can tolerate the level of ambiguity which may result in high or low level of resistance.
4. Masculinity: Masculinity is a kind of culture which determines the strength of cooperation with can exist within the organisation. It is identified as one of the most complex variables which stand for assertiveness competitiveness and the strength to achieve results. Organisations representing low muscularity level have high degree of cooperation among the workers and high muscularity level would result in discrimination between male and female managers within the organisation.

Demographic Environment

This is another most important factor affecting business environment. Unlike the other factors which cannot be predicted, demographic factors can be easily predicted for effect on the environment in which it operates. The study of population or its change is called as demography. There are many factors which influence change in population or demography.

1. Birth rate: It represents the number of live births per thousand of population. Birthrate of a country can have remarkable impact on the population change of a country and is affected by the attitude of the country men towards the family size. Religion can also play an important role in formulation of attitude towards family size. Availability of human population can have direct effect on the labour size and labour cost of a country. Rapid increase in population by high birth rate for rapid decrease in population by low birth rate can adversely affect the labour size and structure of the country.
2. Death rate: It represents the number of deaths per thousand of population. If the becomes more stable then the likely concentration of the older people within the country will show a gradual rise. This should suddenly result in high death rate because of more concentration of older people. Death rate of a country depends upon the kind of hygiene and hospitality, services a country provides its people, the state of prolonged civil war and the kind of epidemic diseases which is the country suffers with.
3. Migration factor: It has become a matter of global issue at present time. With the event of technological reforms and spread of world has become much more smaller and people across the globe move from one place to the other for numerous reasons. New avenues of opportunities give rise to the prospect of economic development which in turn attract people to move from one place to the other. 19th century was remarked by the movement from Western Europe to USA in search of economic prosperity. Migration can fill the skill gap within a labour market and can significantly add to enrich the economy of the home country.

9.8 SUMMARY

In this unit you learnt that the world of business operates under the condition of uncertainty. Business performance depends on the type of environment in which it operates. International business environment constitutes of various forces which acts upon business operation at a global level. For successful business it is imperative to understand the nature and type of environment in which it operates. In this unit, you learnt about types of trades, concept of international business environment, its types and requirements.

9.9 GLOSSARY

Wholesale trade: It involves exchanging of goods and services within the territorial jurisdiction of a home country in a bulk. I

Domestic trade : It can also be referred to as internal trade.

Experience Curve: The concept of experience curve is based on the fact that performance of a company depends on the form of experience the company has gained over the period of time.

Cost differentiation: It can be studied in terms of the investments made by the organisation for undertaking business.

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9.12 TERMINAL QUESTIONS

Q1. What are the different types of trades?

Q2. What is import Trade?

Q3. Define business?

Q4. What is business environment?

Q5. What are the types of environmental forces acting upon organisations?

Q6. Define competitive business environment?

Q7. What is economy of scale?

Q8. State the advantages of experience curve?

Q9. Illustrate international economic environment?

Q10. How can you define technology across boundaries?

Q11. How ecological environment can affect international business?

Q12. Define political environment?

Q13. What is capitalism?

Q14. What are the key functions of IMF?

Q15. What is GATT?

Q16. Define cultural environment?

Q17. What is the difference between wholesale and retail trade?

Q18. How can you discriminate between domestic and international trade?

Q19. State the need of international business?

Q20. State the conditions on which the competitive environment forces depends. Explain with the help of porter's five forces affecting competition?

Q21. How does technological advancement affects ability to trade?

Q22. How does economic system of a country affects international trade?

Q23. Explain in detail the cultural, demographic and social environment of international business?

UNIT 10 INTERNATIONAL FINANCIAL ENVIRONMENT

10.1 INTRODUCTION

In this unit you will learn about the international financial environment. Organisations like living organisms are influenced by the environment in which they operate. The Political, Economic, Social, Technological, Environmental, and Legal (PESTEL) are the significant domains of environments which are generally discussed to be influencing business organisations. In the same manner the activities related to the finance departments of organisation, like financing, investing, dividend distribution, and risk management are also influenced by the external environment in which the entity operates. The above PESTEL factors belong to the native country's frontiers, in the case of domestic companies. When the company grows into an International, Multinational, and Transnational company, the finance function also graduates from being purely domestic to International Finance Function. In such a context, there is a need to understand the enhanced scope of the environment in which the organisation would operate. Though the framework of PESTEL does not change, but the scope of such influences gets enlarged in the International Finance function. This unit is focussed on discussing such enhanced environment in which the International Finance function operates. While a complete discussion of the PESTEL components is not relevant in the context of Finance function, some significant components, like the Multilateral Financial Institutions, Currency Markets, Exchange Rate Systems, International Financial Markets and the instruments traded in them, regulatory frameworks related to Banking, Markets, and Taxes need to be discussed.

10.2 OBJECTIVES

After study of this unit you will understand the following:

- Globalization - opportunities and challenges
- Need for a financial system
- Components of financial system
- Understanding FOREX Market and Exchange Rate Systems

10.3 GLOBALISATION AND INTERNATIONAL FINANCIAL ENVIRONMENT

Today, with almost no barriers to international trade, technologies integrating all financial markets, almost all transactions in finance are becoming international. The companies engaging in International Business experience unique problems in financial transactions and international trade. Special issue is the use of different currencies in different countries. The exchange rate of one unit of one currency differs for another currency. For example, one unit of United States Dollar can be exchanged for 0.81 of British Pound. It is not the same as to one unit of United States Dollar that can be exchanged for Indian Rupee. The changes in exchange rate effects sales, costs, profits and assets of companies engaged in international business.

Knowledge of international finance environment in the context of globalised world can help International Businesses to explore and take advantage of changes happening in the markets and also protect the business from negative effects. For example, declining exchange rates is associated with relatively high interest rates and inflation; when a country’s currency value declines, the stock prices of the companies with foreign currency debt declines. The examples convey that the way exchange rate moves and prices of other financial transactions are interrelated. Because of the integration of financial markets, events that happen across the world like changes in the prices of oil and gold, election results, the outbreak of war influences international businesses.

Globalisation has not only improved international trade but has also resulted in growing importance of foreign investment in the money market, the bond market, and the stock market. Sometimes international investors’ investments are so high that the investment made by domestic investors is insignificant. There have been an increased number of mergers and acquisitions. New and hybrid financial instruments are developed to cater to international markets.

Globalisation has made global movement of funds easy; there is efficiency in asset allocation in investment decisions. The globalization of investment has its demerits on investment in terms of increased foreign exchange risk; country risk; and norms on repatriation of income. Globalisation has led to increased importance of multi-national corporations and transnational corporations (example: Walmart).

Globalization has its opportunities and challenges for the international financial environment.

Advantages are:

1) There is an active international capital flow that has improved the efficiency of the allocation of world financial resources.
2) There is integration of world markets.
3) The technology improvements have resulted in lower transaction and information cost for various players in financial system.
4) Non-bank financial (non depository) institutions have become more active in the international financial system. They are playing a major role in moving funds from one entity to another.
5) Globalization updated concepts like risk-taking, supervision and regulation of banking systems.
6) New financial instruments and markets developed.

Challenges are:

1) The ever growing international capital flows, and development of financial instruments have made transactions more complex.
2) In spite of financial institutions taking measures to manage risk, they are exposed to increased risks that are there in the various countries of the world. For example: inflation of different countries; currency fluctuations; interest rate fluctuations; differences in legal and regulatory systems etc.
3) Risk of contagion effect.

10.4 NEED FOR A FINANCIAL SYSTEM

In an economy there are markets that trade in goods and services called the product market and the other market that trade factors of production is called factor market. The factor market deals with a factor of production called capital otherwise known as financial assets/instruments. What are financial assets? An asset can be tangible like building, machinery etc or intangible assets. Intangible assets are those that have a legal claim for a future benefit (eg. patent, copyright). Financial assets belong to the class of intangible assets. These assets/instruments are traded and this exchange between lenders, investors, and borrowers is facilitated by the financial system. What is a financial system? A financial system may be defined as a set of institutions, instruments and markets which encourages savings and channelizes them to the right places/entities so that the funds can be optimally used. A financial system could be at an international, regional or organizational level. A few key points to understand international financial system:

- The international financial system is the intermediation point for international capital flows between countries.

- In the absence of international financial system there will no network of financial institutions, financial markets, financial instruments and financial services that will enable and support transfer of funds between countries.
- Every country will have savers, intermediaries, instruments and the ultimate user of funds. The international financial system ensures cross border interactions of savers, intermediaries and users of funds for their mutual benefit.
- The international financial system mobilizes savings from surplus countries to countries of deficit. This helps developing nations in economic and financial development.
- There is an inter-relationship between developed financial system and sustainable economic growth of country.
- International financial system deals with foreign exchange, credit and finance.

The Figure 10.1 given below gives an overview of how the unbalanced trade between countries is balanced by capital flows.

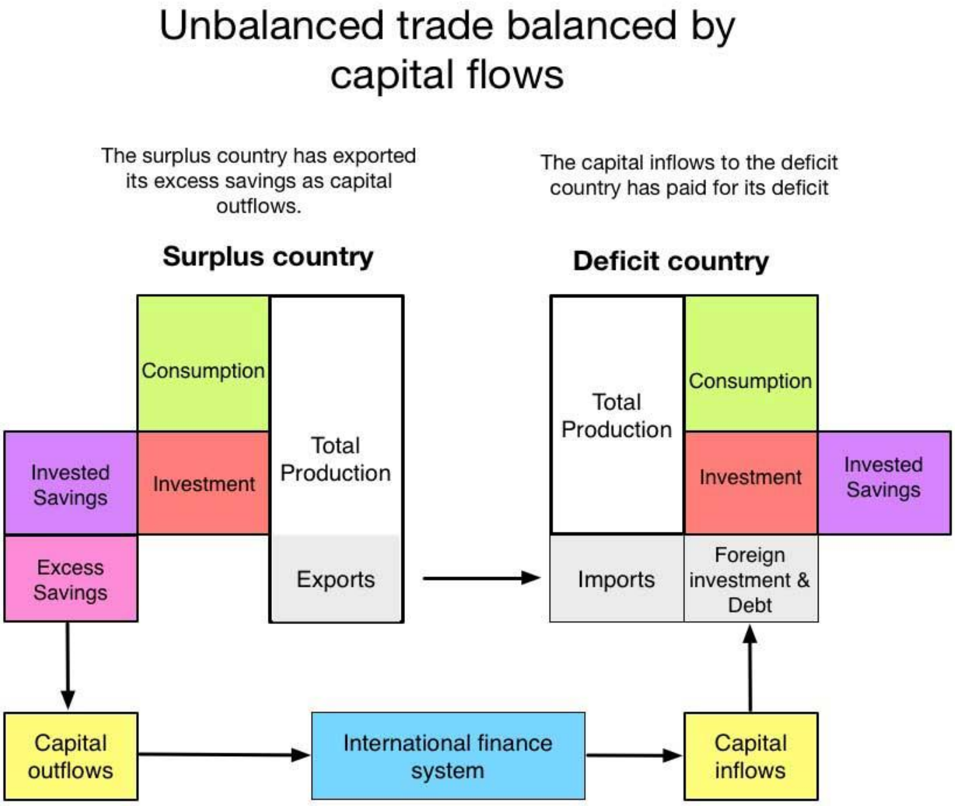


Fig 10.1 Unbalanced trade balanced by capital flows

Source: https://fromtone.com/how-economic-imbalances-lead-to-imbalances-in-trade/

10.5 COMPONENTS OF FINANCIAL SYSTEM

The basic components that make the financial system are: Financial Institutions; Financial Markets; and Financial Instruments.

Financial Institutions: The financial markets are not accessible to all buyers or sellers. Everyone does not have professional knowledge to understand the credit worth of borrowers or lenders. Financial institutions connect buyers and sellers of funds. This intermediation reduces costs involved for buyer and seller. Financial institutions can be classified into 1) Institutions that accept deposits known as depository institutions and 2) Non Depository institution

a. Depository Institutions:

1) ***Commercial Banks***: They are the most popular type of financial intermediary. They offer a variety of deposit accounts. They transfer deposited funds as direct loans or purchase investments with the surplus funds that they have. The rate of interest depends on the type of loan, amount and market conditions. Global commercial banks provide loans/finance in domestic and foreign currency to individuals, companies, governments, agencies, and sovereigns. The limit of exchange of a foreign currency is regulated by laws of the country. Banks are crucial in financing trade and non-trade international operations. The different types of loans and services provided by banks vary from country to country. Banks bear the risks that are attached with their services. For example there is risk of non repayment of loan given to a customer. This is known as default risk. Banks have risk management measures to reduce the level of risk. These risk management measures are essential as banks to increase the confidence level of the investor, lender and the bank (intermediary). BASEL III norms has regulations particularly to maintaining a minimum level of capital, relative to their size, so that they have a cushion to absorb possible losses from defaults loans provided by the bank.

2) **International Agencies and Development Bank**s: These institutions are set up by the Governments with a purpose. Generally, they are established to promote free flow of capital; to promote exports; development of infrastructure in developing economies etc. Every country has such institutions at national, regional and international levels for funding various projects (for example - International Finance Corporation (IFC), EXIM Bank and Asian Development Bank). These institutions provide funding to companies that are engaged in development activities. The businesses/projects have high risk and so they are unable to access private sector capital markets.

An Initiative of IFCs for developing nations

IFC created EDGE (Excellence in Design for Greater Efficiencies)—a building resource efficiency certification program—especially for emerging markets like Vietnam. IFC introduced EDGE to Vietnam in 2015, with support from the government of Switzerland's State Secretariat for Economic Affairs (SECO) and the Hungarian Export-Import Bank, to help the building sector meet the needs of the country's fast-urbanizing population. The program guarantees savings of at least 20 percent in energy and water consumption, as well as energy savings in building materials, leading to reductions in greenhouse gas emissions.

Source: www.ifc.org

One example given above is the source of finance given by IFC.

Export financing agencies like US EXIM (Export-Import) bank, JEXIM (Japan Export Import), HERMES (is an export credit guarantee (ECG) by the German Federal Government) and COFACE (is an institution specializing in trade credit, and risk management) promote international exports. One major service that they offer is export credit.

Export Credit Agencies (ECA) provide tied and untied financing. 'Tied financing' is financing cover from an ECA that is tied to the exports from its home country. ECAs charge a premium depending on the commercial and/or political risks associated with the loan. Country risk is also a key factor that is taken into consideration for fixing the level of premium to be charged on the finance given to the project. Untied financing does not make it mandatory for procurement of goods or services from host country.

3. A ***credit union is a cooperative bank*** that is owned and managed by its members, all of whom have accounts in the bank. These are normally non-profit organizations and do business only with their members. These members share a common purpose such as common employer or union or purpose. The institution has more equity when compared with other depository institutions. The equity is accumulation of earnings of the past due to Credit Unions activities. This is the next largest form of depository institution after commercial banks in United States.

b. **Non Depository Financial Institutions:**

They do not accept deposits from public but they raise funds from other sources:

1) ***Finance Companies***: These institutions do not accept deposits from public. They borrow from their sources. So what do they do? These institutions can be categorized on basis of the customers they serve as –
    - Sales finance institutions serve a specific manufacturer or service provider; Personal credit institutions lend to consumers for purchasing used automobiles, for home improvement or debt repayment, for purchase of consumer goods etc;

- Business credit institutions lend to businesses especially in the form of leasing and factoring. Example for factoring is - a garment manufacturer has a contract from a retailer. The business does have funds to do the contract. The manufacturer pledges the account receivable, borrows the funds needed to begin manufacturing and repays the loan from collections.

All loans must be secured by tangible personal assets. Loans from finance companies are more costly than bank loans.

2) ***Mutual Funds***: Mutual funds are managed by Institutional investors. The money that institutional investors use is not actually money that the institutions own themselves. Institutional investors generally invest for other people. Because of their size, institutional investors can often negotiate better fees on their investments. They also have the ability to gain access to investments normal investors do not. Mutual funds collect funds from institutions and retail investors. Invest the amount collected in equity, bonds and other instruments. They collect fees for the professional management of funds. The fund managers inform the investors of the fund objective and securities that the mutual fund invests in. The mutual funds invests in money market and capital market
3) ***Insurance Companies***: These are institutional investors Insurance services offered by these financial institutions who compensate individuals and corporations (policyholders) if a specified negative event like death, accident, damage to property etc., mentioned in the contract occurs. The customers of these institutions pay premiums for the insurance contracts that they entered into with the insurance companies. The insurance companies invest a large proportion of premiums collected in stocks or bonds of government companies. Insurance services are classified into two major groups: (1) Life and 2) Non-life. The main risk that insurance companies face is that mismatch of the premiums collected to actual losses.
4) ***Pension Funds***: Many corporations and government agencies offer pension plans to their employees. The employees and their employers (or both) contribute to the pension funds. These funds are savings for retirement. Pension fund companies manage these contributions made by individuals and their employers until they are withdrawn on retirement. Insurance companies and mutual funds are main investment alternatives and sources of finance for pension funds.
5) ***Securities Firms:*** These institutions provide support in the trading of securities in the secondary markets. They may be brokers or dealers. These institutions need not require large equity as they trade or hold securities for their customers. They earn commission or brokerage fees for the services that they provide.

Every institution given above has different regulatory institutions that supervise and regulate their activities. They are different in different countries. The level of freedom given for these institutions to operate depends upon the various factors, one such factor is the category of a nation according to international institutions. For example- a low income economy like Africa may have more regulations with regard these institutions in comparison with high income group countries like United States. This may be due to information not being freely available, low level of financial literacy of investors, political instability requiring more protection of funds that is there in the system, just to name a few. The ***regulations*** are in place to protect the financial institutions from the following risks:

- Credit risk: When a lender offers credit to the counterparty (through loans, credits on invoices, investing in bonds or insurance), then there is always a risk for the lender that the credited amount may not be received by it again.
- Settlement risk: Probability of loss arising from the failure of one of the party to settle its end of the deal, thus preventing other parties in the contact to settle their commitments. It arises usually when payments are not exchanged simultaneously (http://www.businessdictionary.com/definition/settlement-risk.html)
- Market risk: The risk that the financial institutions face due to events or situations or policies beyond its control that has a negative effect (eg: financial crisis).
- Liquidity risk: Sometimes financial institutions are not in a position to obtain funding or repay their obligations. This risk is termed as liquidity risk.
- Operational risk: According to banking regulators operational risk is "the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events." In India we have the classic case of Punjab National Bank lending to Nirav Modi on the basis letter of credit without checking for the originality of the document.

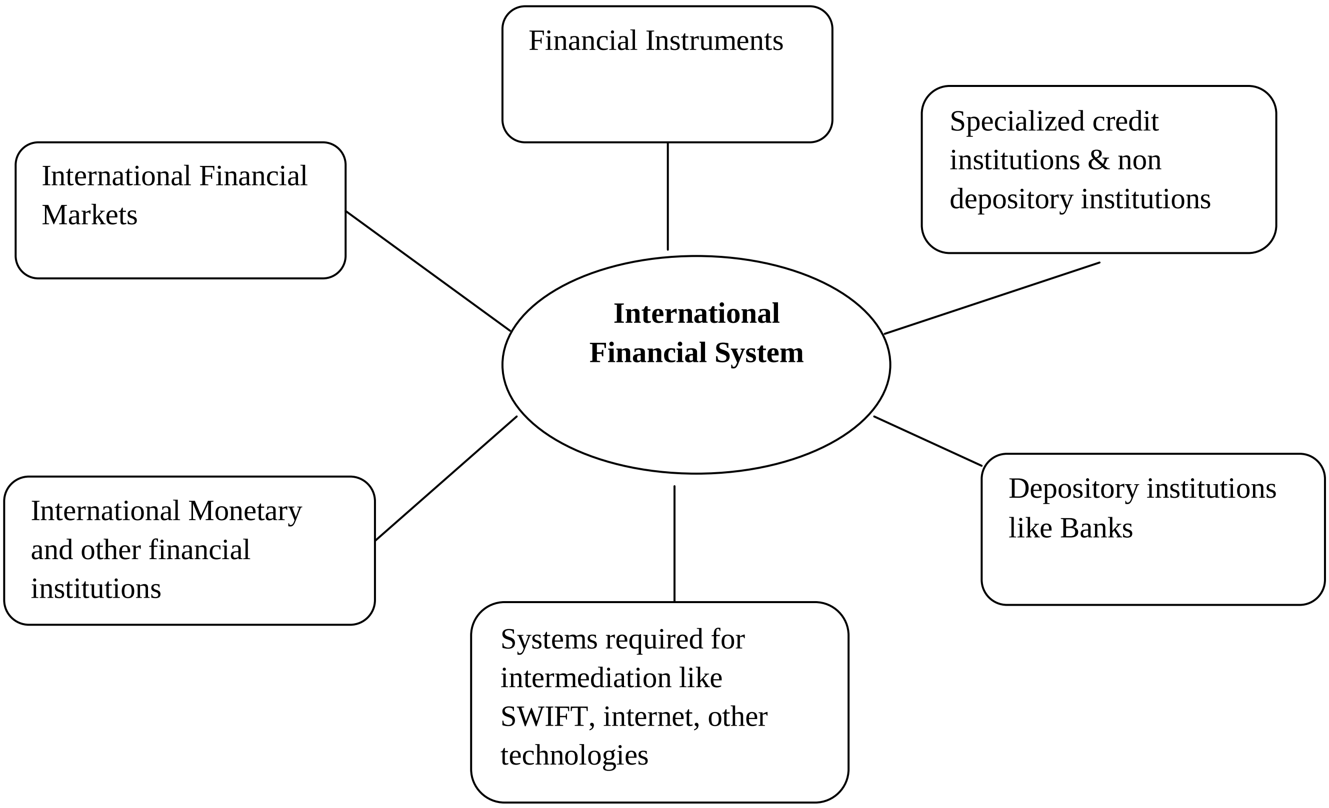


Figure10. 2: Components of International Financial System

10.6 CLASSIFICATION OF FINANCIAL MARKETS

International financial markets comprises of Eurobond market, and international stock market. Eurocurrency market originally called as Eurodollar market helps to deposit surplus cash efficiently and conveniently, and it helps to raise short-term bank loans to finance corporate working capital needs, including imports and exports.

According to authors Fabozzi J Frank and Modgiliani the financial markets can be classified on the following basis:

- **Classification by Nature of Claim**
  - a. **Debt Market**
  - b. **Equity Market**
- **Classification by Maturity of Claim**
  - a. **Money Market**
  - b. **Capital Market**
- **Classification by Seasoning of Claim**
  - a. **Primary Market**
  - b. **Secondary Market**
- **Classification by Immediate Delivery or Future Delivery**
  - a. **Cash Or Spot Market**
  - b. **Derivative Market**

1) ***Primary and secondary market***:
   Primary markets deals with issue of new securities. Secondary markets facilitate the trading of existing securities, which allows for a change in the ownership of the securities. The primary market is a source of finance for a company issuing securities for the first time.
2) ***Equity market and Debt Market***:
   When we say securities it can be ownership funds or loans taken by the company. The market where ownership funds or equity is traded is Equity market. The market where loans are traded is known as Debt market. Both markets will have primary and secondary market too. Globalisation has led to new markets known as Eurobond Markets and international stock market. An example for Eurobond is as follows: Imagine that a U.S.-based company wants to expand into India's market and needs to raise capital to build some infrastructure in India. The company has to make payments in Indian rupees. The company may not be able to take a loan in rupee as they are new to Indian market and their credit history is not known to lenders. So the company with issue Rupee Bonds in US.
3) ***Capital Market and Money Marke***t: Short term securities that have a maturity of one year or less than one year are traded in money market. Money market securities are in demand as they are liquid. They have a good secondary market. The Eurocurrency market is utilized by banks, multinational corporations, and mutual funds. The Eurocurrency market is the money market in which currency held in banks outside of the country. Dollars held outside US is Eurodollar or Eurocurrency in dollars. The

market where Long Term funds are traded is called Capital Market. The most commonly traded securities in capital market are Equity and Debt.

4) ***Derivative Market***: The market where derivatives are traded is derivative market. What are derivatives? The term "derivative" arises from the fact that the agreement "derives" its value from the price of an underlying asset such as a stock, bond, currency, or commodity. A stock index futures derives its value from an underlying stock index, a foreign currency option derives its value from an underlying exchange rate, and so on. The basic derivative contract designs are known as Forwards, Futures and Options. These derivative instruments are traded in derivative market either in exchanges or Over the Counter Exchanges (OTC). Exchange-traded contracts are standardized by underlying asset, time and location of delivery, method of settlement, and other factors. Customized contracts are traded in OTCs. These instruments are used to hedge risk.

Regulations are in place for financial markets too. They are designed for the following reasons:

- prevent issuers of securities from defrauding investors by concealing relevant information
- to promote competition and fairness in trading
- to promote the stability of financial institutions
- to restrict the activities of foreign concerns in domestic markets and institutions
- to control the level of economic activity

Source: Foundations of financial markets and institutions / Frank J. Fabozzi, Franco Modigliani, Frank J. Jones (2009).

10.7 FINANCIAL INSTRUMENTS

Financial instruments are assets that can be traded. Most types of financial instruments provide efficient flow and transfer of capital all throughout the world's investors. A financial instrument is a real or virtual document indicating a legal agreement which has value of money.

1) **Equity Capital:** is the ownership capital contributed by owners of the company. Shareholders jointly own the company and share the profits and bear the risks of the owning the business. The shareholders have right to income, right to control the firm, right to share the assets after paying off all the creditors in case of liquidation.

   a. Advantages of Equity Capital:

      i. It's a long-term source of financing. Distribution of dividends is not compulsory. The company will pay only when excess profits are available.

ii. There is no obligation to repay as there is no date of maturity for equity capital.

iii. Lenders who are evaluating finance proposal look at equity capital of a company as a commitment of shareholders. The company will be rated better in terms of credit worthiness. They can raise more funds from lenders. The lenders also have a positive feeling about good governance of the company. It means that the equity owners who have contributed capital will take responsible decisions keeping in view the best interest of the company.

b. Dis- advantages of Equity Capital:

i. The return expected by shareholders is usually the highest. So the cost of raising equity is expensive for the company.

ii. Cost of issuing equity capital includes underwriting commissions, brokerage fees, etc. This makes issuing costs high for equity capital.

2) **Subordinated loans:** These are known as mezzanine financing or quasi equity. It is a loan that is unsecured. This is a loan that is senior to equity capital for repayment. But in the case of liquidation of a company, it ranks only after liquidator, government tax authorities and other senior debt. These debts are very risky for the lender. Sources for subordinated debt are finance companies, risk capital companies and insurance companies.
Advantages of Subordinated loans:
i. Subordinated debt is usually lent at a fixed rate, its long term and unsecured.
ii. This debt is considered as equity for debt equity calculations by senior lenders.
b. Disadvantages of Subordinated loan:
i. The lender of subordinated loan looks at profit and cash-flows of a company. This is important for them to assess sufficiency of funds to repay principal, interest of senior debt and subordinated debt.
ii. Lenders of subordinated loan scrutinize capabilities of management as they lend without any asset backup. They also look at equity kickers if they are lending to a project with low creditworthiness.

3) **Senior Debt:** The largest form of is using debt. Sources of senior debt are Commercial Banks. These loans are repaid first in case of any financial trouble of the project. Senior debt can be secured or unsecured. The security for a senior debt can be in many forms (example - agreement to be paid by a ratio of dedicated cash-flows or lien agreement on specific assets of the company). Banks and financial institutions are major source for giving secured and unsecured loans. The lenders of senior debt hold security interest in the project.

4) **Debentures:** Debenture is a document issued by the company. It is a certificate issued by the company under its seal acknowledging a debt. According to the Companies Act 1956, "debenture includes debenture stock, bonds and any other securities of a company whether constituting a charge of the assets of the company or not."

Debentures are issued for long-term fixed maturity period and are repayable with the principal investment at the end of the maturity period. Debenture holders are eligible to get fixed rate of interest at every end of the accounting period. They have priority of claim in income of the company over equity and preference shareholders.

5) The instruments common in international markets are:
   a) **Eurocurrency Loans**: a) The most commonly used source of financing is External Commercial Borrowings (ECBs). The instrument used for borrowing is Eurocurrency Loan. It is a syndicated loan where a group of lenders agree to lend to a borrower under a single loan agreement. Eurocurrency means currency held in a bank outside the country where it is minted. For example- An Indian Company purchases technology from United States (US). The Indian Company pays in US Dollars to the US Company. The US Company deposits this amount in a German Bank. This deposit in German Bank is Euro-Dollar deposit. The German bank will use this Dollar to give Euro-Dollar loans (how to understand this concept- It is the word Euro followed by currency held eg: Dollar, Pound, Yen, Chrona and finally instrument loan/deposit). The loans are given at floating rate of interest. The rate is linked to international lending rates like – LIBOR (London Inter Bank Offer Rate), SIBOR (Singapore Inter Bank Offer Rate).
   b) **Eurocurrency Bonds:** When companies require large amounts of loan and want to explore cheaper markets they look to debt from international debt market or Eurobond markets. These debts are known as Eurocurrency Bonds. The same meaning of Eurocurrency loans applies for Eurocurrency bonds. Eurodollar bonds are sold outside United States. Euroyen bonds are sold outside Japan. This is a bearer bond. This is payable to the person whoever holds the instrument. The lending rates in eurodebt market are lower that domestic market.
   c) **Global Depository Receipts:** If project requires indirect equity investments in euro markets then the project sponsor issues Global Depository Receipts (GDRs). A company that wants to raise funds by GDR enters into an agreement with an international bank for holding its shares. The bank is known as depository. The bank issues claims against these shares to the public. These claims are called depository receipts. Each receipt has a claim on a specific number of shares. The currency of issue is generally in US dollars. GDRs can be traded in stock exchanges. Ministry of Finance, India and Foreign Investments Promotion Board has to give clearances for issue of GDR as it is considered as a form of Foreign Direct Investment (FDI).

Check Your Progress- A

Choose the correct alternative

1. **What is a financial system?**
   a. It's a set of institutions, instruments and markets
   b. It's a set of currency, banks and equity
   c. It's a set of people, countries and governments
2. **A financial system helps in moving funds from;**
   a. Deficit destination to Surplus destinations
   b. Surplus destinations to deficit destinations
   c. One company to another

3. **Financial institutions can be categorized as ;**
   a. Depository and Non depository
   b. Equity and Debt
   c. Euro Loan and External commercial borrowings

4. **Mutual Funds and Insurance Funds are examples of**;
   a. Depository institutions
   b. Non-depository institutions
   c. Commercial Banks

5. **Institutions that accept deposits are known as**;
   a. Depository institutions
   b. Non-depository institutions
   c. Commercial Banks

6. **When a lender offers credit to the counterparty through loans, credits on invoices, investing in bonds or insurance and faces risk of not receiving the amount is known as;**
   a. Credit risk
   b. Market risk
   c. Payment risk

7. **The market where long term instruments are traded is called**;
   a. Money market
   b. Debt Market
   c. Capital Market

8. **The market where new issues are traded is called;**
   a. Primary market

b. Secondary market
c. Forex market

9. The market where ownership funds are traded is known as

a. Debt market
b. Equity market
c. Derivatives market

10. The institution that promotes international monetary cooperation is

a. IMF
b. EXIM
c. IFC

11. _______________ are removing barriers that prevent free flow of funds between financial institutions.

a. Derivatives market
b. Taxation
c. Financial innovation

10.8 UNDERSTANDING FOREX MARKET AND EXCHANGE RATE SYSTEMS

First lets discuss about Forex market;

1. ***FOREX Market***: International financial transactions require exchange of currencies. Many commercial banks and other financial institutions serve as intermediaries in the foreign exchange market. Some of these financial institutions also act as dealers. Individuals also engage in forex markets. The price of one currency in terms of another is called an exchange rate. The exchange rate is market determined depending on demand and supply of currencies. Exchange rate is important for international business transactions. A comparison of prices of goods and services produced in different countries is possible by use of exchange rates. For example, a business wants to decide on purchase of machinery from United States (US) or Japan. Apart from comparing technical aspects of the machinery the purchaser should also consider price of the machinery. The machinery by the US seller will be quoted in dollars (eg: 5,000 US dollars). The machinery by Japanese seller will be quoted in yen (eg: 55,000 Japanese yen). The purchaser can decide on if the relative price of dollar to yen is known.
An exchange rate can be quoted in two ways (if we consider US as home country) as the price of the foreign currency in terms of dollars (for example, $1.0612 per euro) or as its inverse, the price of dollars in terms of the foreign currency (for example, €0.9424 per dollar). The first of these exchange rate quotations (dollars

per foreign currency unit) is said to be in direct (or "American") terms; the second (foreign currency units per dollar) is in indirect (or "European") terms. Once the money prices are expressed in same currency the businesses can make decisions on international exports or imports and the destinations.

Foreign exchange trading takes place in many financial centres, with the largest volumes of trade occurring in such major cities as London (the largest market), New York, Tokyo, Frankfurt, and Singapore. The institutions are linked each other through telephones, computers and other electronic means which helps them in transactions.

Forex trading hours operate around the world like this:

1. New York between 01:00 pm – 10:00 pm GMT
2. At 10:00 pm GMT Sydney comes online
3. Tokyo opens at 00:00 am and closes at 9:00 am GMT
4. London opens at 8:00 am and closes at 05:00 pm GMT

The market is operating 24 hours as one country's Forex market or the other is awake and trading. That is the reason why the exchange rates are constantly changing. Each nation's market has its own infrastructure for foreign exchange market operations and for other financing activities. There are laws, banking regulations, accounting rules, and tax codes.

1. **Evolution of Exchange Rate Systems and International Monetary Fund (IMF):** The world economy has evolved through a variety of international monetary systems since the 19^{th} century.

a) The gold standard: Since 1819 gold coins have been used as a medium of exchange, it has a unit of account and store value. Britain was the leading economic power during that time and other countries like United States Germany, Japan, and other countries also adopted the gold standard so that they can also achieve economic success like Britain. Central bank used to fix the exchange rate between gold and its currency during this period. So the external balances were seen as maintenance of gold balance. Because international reserves took the form of gold during this period, the surplus or deficit in the balance of payments had to be financed by gold shipments between central banks. All economies were adjusting their gold reserves to achieve Balance of Payment equilibrium. After World War I, the practices of selling domestic assets in the face of a deficit and buying domestic assets in the face of a surplus came to be known as the gold standard "rules of the game" – a phrase reportedly coined by Keynes. Because such measures speeded the movement of all countries toward their external balance goals, they increased the efficiency of the automatic adjustment processes inherent in the gold standard. But later it was found that deficit countries were bearing the burden of bringing Balance of Payment of all countries to equilibrium. The surplus countries were not taking any action to reduce gold inflows into their countries. This created more problem for deficit countries as there was limited supply of gold.

b) **International Economic Disintegration:** As the depression continued, many countries moved away from the gold standard and allowed their currencies to float in the foreign exchange market. All countries realised that economic development of their nation will improve if there was freedom for international trade and an environment of financial stability. There was an urgency for policymakers to step up efforts to boost the financial system's resilience by developing a exchange rate regime and setting up macro prudential policy tools. It was this understanding that made countries come under one agreement known as Bretton Woods agreement**.**

c) **The Bretton Woods System and the International Monetary Fund:**
In July 1944, representatives of 44 countries meeting in Bretton Woods, New Hampshire, drafted and signed the Articles of Agreement of the International Monetary Fund (IMF). The main purpose was to promote full employment and price stability. By this system there will be freedom for individual countries to attain external balance without restrictions on international trade. The system recommended fixed exchange rate against U.S.dollar and an unvarying dollar price of gold at 35 dollars an ounce. Countries signing the agreement followed gold exchange standard with dollar as their reserve currency. Presently there are 189 member countries in IMF.
The fundamental purposes and objectives of IMF are :

1. To promote international monetary co-operation through a permanent institution
2. IMF will provide the machinery for consumption and collaboration in international monetary problems.
3. The institution will facilitate the expansion and balanced growth of international trade.
4. It will promote exchange stability, maintain orderly exchange arrangements among members, and provide competitive exchange depreciation.
5. IMF will assist in the establishment of a multilateral system of payments in respect of current transactions between member and in the elimination of foreign exchange restrictions which hamper the growth in the world trade.
6. To lend confidence to members by making the Fund's resource available to them under adequate safeguards.

IMF will work on its objectives to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

To fulfill the above objectives, The IMF performs the following functions:

1. The IMF operates in such a way as to fulfill its objectives as laid down in the Bretton Woods Articles of Agreements. It's the Fund's duty to see that these provisions are observed by member countries.
2. The Fund gives short term loans to its members so that they may correct their temporary balance of payments disequilibrium.

3. It aims at reducing tariffs and other trade restrictions by the member countries.
4. The Fund also renders technical advice to its members on monetary and fiscal policies.
5. It conducts research studies and publishes them in IMF staff papers, Finance and Development, etc.
6. It provides technical experts to member countries having BOP difficulties and other problems.

d) **Digital Financial Innovations:** The development of block chain technology has changed the way the financial institutions are connected and how they transact business. Digital financial innovations such as PayPal, Paytm and other mobile payment solutions are removing barriers that used to prevent free flow of money. Adapting new products, processes in to new systems also resulted in financial innovations. For example, interest-sensitive funding and variable rate lending/borrowing are very common features of the Euro-markets. These were subsequently adapted by domestic financial markets.

e) **Taxation:** The international financial system should also be understood in the context of taxation too. When there is cross border movements of goods and services there is tax regulation that comes into picture as there is also simultaneous flow of foreign exchange. It can be an inflow for one country while it will be an outflow for another country. Every business will engage in international tax planning to understand the different tax regimes of the countries in which they operate. There is foreign Value Added Tax, customs duties and other import charges, issues of double taxation, withholding tax etc. which we need understand.

10.9 SUMMARY

This unit provides you with an understanding of globalization and its opportunities and challenges in the context of international financial environment. It then introduces you to the need for financial system explaining it with a diagram showing how unbalanced trade is balanced by capital flows because of the existence of financial system. The financial system has components. When we read through the components we understand that they are financial markets, financial instruments and financial institutions. This section elaborates about the classification of financial markets; explains the different types of financial institutions and also throws light on some important instruments that are used by firms engaged in international business. This evolution of international financial environment is supported by International Monetary Fund.

10.10 GLOSSARY

Asset allocation: Asset allocation is an investment strategy that aims to balance risk and reward by apportioning a portfolio's assets according to an individual's/ investment managers goals, risk tolerance and investment horizon.

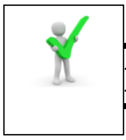
Contagion: In economics and finance, a contagion can be explained as a situation where a shock in a particular economy or region spreads out and affects others due to various reasons.

Seniority reference: In finance, seniority means the order in which claims are settled in event of sale or bankruptcy. Seniority reference can be made to either debt or preference capital.

Lien: Lien is an official agreement that allows someone to keep the property of a person/company who owes them money until it has been paid.

Security Interest: A security interest on a loan is a legal claim on collateral that the borrower provides that allows the lender to repossess the collateral and sell it if the loan goes bad.

Syndicated loan: Syndicated loan is where a group of lenders agree to lend to a borrower under a single loan agreement.



10.11 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress –B

1. a
2. b
3. a
4. b
5. a
6. a
7. c
8. a
9. b
10. a
11. c

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10.14 TERMINAL & MODEL QUESTIONS

Q1. What are the challenges and opportunities that are faced by international financial environment due to globalisation?

Q2. What is the need for financial system?

Q3. Discuss depository and non- depository financial institutions that facilitate movement of capital.

Q4. “Regulations of financial institutions control different types of risk”-Discuss

Q5. Explain the various financial instruments used to raise funds.

Q6. Elaborate the financial markets that help international businesses to raise capital.

Q7. What is IMF? What are its functions and objectives?

Q8. What is Bretton Woods agreement? Explain the evolution of exchange systems.

International Business
MS 111

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ISBN:
978-93-85740-17-6

Uttarakhand Open University, Haldwani

MS 111

School of Management Studies and Commerce

International Business

Block III Strategies of International Business

Block IV Emerging Scenario in International Business

MS 111

International Business

Block – III
Block Title- Strategies of International Business
Block – IV
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ISBN : **978-93-85740-17-6**
Copyright : **Uttarakhand Open University**
Edition : **2020 (Restricted Circulation)**
Published by : **Uttarakhand Open University, Haldwani, Nainital – 263 139**
Printed at : **(Name of the Printer)**

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Course Code- MS 111

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Suggested Readings:

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Block III
Strategies of International Business

UNIT 11 GLOBAL STRATEGIES

11.1 INTRODUCTION

We are living in an era of globalisation where geographical boundaries are no longer a constraint for businesses in expanding their operations. Trade barriers are being demolished and international cooperation among countries coupled with advancement in technology have made it easier to foray into markets around the globe. In order to serve multiple locations around the world in an efficient and cost effective manner business houses have to establish various operational units outside home country. Every market has some specific challenges while many others are universal. In order to tide over these challenges smoothly, a business organisation should have a successful global strategy. In this unit, we are going to look at some of the strategies being employed by business corporations the world over with special focus on the Indian firms.

11.2 OBJECTIVES

After reading this unit you will be able:

- To understand the need for global strategy for an organisation
- To find out about global strategies adopted by Indian firms
- To know about the success stories of few global Indian businesses.

11.3 NEED FOR GLOBAL STRATEGY

The scale of operations outside the home country can be international, multinational or global. When the main focus of operations and sizeable chunk of revenue is from the home country and outside markets are served from home country, the firm can be said to be having international operations. The product and service is mainly developed keeping in mind the home market. In case the firm has interests in many countries for which it develops or delivers unique products or services due to the market characteristic in each country, it can be termed as multinational. Here, the share of revenue would be substantial from markets outside home country and unique strategy will be employed for each country. However, some firms have a product or service which is similar in each market without any local variation. They deploy same strategy across the world for running their businesses and are called as global firms. The companies which have businesses spread the world over may have an international, multinational or global strategy in respect of some or all of their products. In essence, global strategy refers to adopting a universal strategy for conducting businesses around the world.

There are many advantages of going global and adopting a global strategy for business. Some of them include:

- Various markets across the globe can replicate same strategy thereby reducing costs for each market. There is no need to specially formulate a new strategy for each market. Inputs received and improvements undertaken in one market can be replicated in other markets as the customer perception and reaction is assumed to be uniform across all markets.
- The economies of scale allow for continuous investment in research and development, attracting high quality talent and keeping business competitive. The incremental per unit cost of undertaking new initiatives is affordable enough.
- The global strategy, if successful, creates powerful brand image across the countries which helps in entering new markets with ease as well as easy customer acquisition.

This is so because customers expect and are assured of uniform quality standards across the world.

- In case of any crisis, production can be shifted to other locations. Similarly, managerial resources can be easily shifted without bothering for customisation.

11.4 STRATEGIC ENTRY ALTERNATIVES FOR GLOBALISATION

When a firm decides to go global in its operations, it has to carefully decide upon the strategy to be adopted across the markets. This will depend upon the kind of product, the size of market, the risks involved and the capital available for funding the operations. The key strategies for entry outside the home country include the following:

Exporting

This is the simplest strategy to start international operations. The exporter has to identify a seller for his goods in the foreign market and the sales can start with minimal risk and capital investment. However, it is feasible only when the cost of production plus shipping cost to foreign market would be lower than production cost in export market or when the product / technology is unique and is not available in the foreign market. Also, under this strategy, the exporter has no control over sales and distribution of the product. Any inefficiency on part of the importer could impact the business significantly.

Licensing

Under this strategy, the owner of a technology or product or brand gives the right to somebody else in foreign country to produce the product or use the technology or brand. The technology/brand owner firm is called licensor and the firm obtaining rights to use it in foreign market is called the licensee. A pre-agreed fee/royalty is paid by the licensee to the licensor. This is also a safe way to enter foreign markets as there is no risk of product failure or political and economic uncertainty. However, the downsides include mistrust among both parties, leakage of intellectual property and litigations.

Franchising

It is another way to enter foreign markets with low risk and investment. This is similar to licensing except that here more control is exercised. The franchisor agrees to allow the franchisee to use its branding/technology/product in return for a royalty. Here, the franchisor provides the trademark, operating procedures, staff training and development, quality control, advertising content etc to the franchisee. The franchisor keeps a close watch on the franchisee's operations as any deficiency would adversely impact the image of the former in the eyes of the customers. It has similar advantages and limitations as licensing.

Multi Country and Global Strategy

Sometimes, the foreign markets might behave differently from each other. These differences may arise due to a variety of factors including economic standards, socio cultural patterns and beliefs, government regulations, geographical conditions etc. Under such scenario, companies may adopt multi country or customised strategy for each country. Sometimes, a cluster of markets representing few countries might have similar customer characteristics for which a uniform strategy might be adopted. However, there are many cases where the product characteristics, appeal, ingredients, delivery etc are uniform across the world. In such cases, the firms may adopt a global strategy which means that right from production to marketing, distribution, pricing and customer service would be uniform. This can truly provide economies of scale to the firm.

Strategic Alliance

This strategy refers to entering into an agreement with a foreign partner to mutually benefit from each other's core competency or jointly exploiting a resource. This agreement or understanding may be formal or informal and may be for short term or long term. Under this arrangement, both the entities maintain their individual autonomy. This is helpful in reducing learning curve in a new industry. However, its success might be limited due to conflict in the interest of the partners and difference in work culture.

Joint Ventures

This relates to formation of a joint business venture between a local and a foreign partner. The partner may be chosen for capital or technology. This helps the foreign investor to reduce political risk as firms with local stake are treated favourably as compared to fully foreign owned firms. Also, the local partner provides better understanding of local market, customer requirements and ease in regulatory control.

Sole Foreign Direct Investment

This is the riskiest form of entry in a foreign market. Hence, lot of due diligence and feasibility studies are required before taking a decision. Political stability, economic growth, favourable regulatory environment, availability of resources are the key parameters which should be analysed carefully before deciding upon setting up a wholly owned subsidiary in foreign territory. These days almost all countries are having favourable investment climate for ventures which can bring exports and employment to the host country. This type of strategy provides the company complete autonomy on the way it conducts its business and the profits are not shared. The trade and intellectual secrecy can also be maintained.

11.5 GLOBALISATION AND INDIAN BUSINESSES

The Indian business environment witnesses a sea change post liberalisation era which began with opening up of the economy in 1991. While that brought FDI in India, it also rang warning bells for Indian businesses. Many years since then, lot of Indian companies have not only successfully faced competition from foreign companies but charted their own globalisation path. Some of the factors aiding Indian companies to go global are as under:

1. After exploiting the local market, it is imperative for companies to explore global markets for growth. One market cannot fulfil the growth needs of a firm. True economies of scale can be achieved by achieving global footprint. Initially, it could start from exports and later could go to establishing foreign subsidiary. Acquisition and joint venture overseas are also adopted by bigger firms.
2. India's pool of skilled technical human resources also allows firms to foray into international territories. Indian tech firms have the ability to deliver tech services at affordable price to other developing markets globally. Also, comparatively lower cost of labour helps them to stay competitive.
3. There has been growing trend of entrepreneurship with strong support from the government. This has led to Indians looking at entering global markets especially in technology related products and services.
4. Exposure to international best practices being followed by foreign companies in India has armed Indian firms with application of such practices in their own ventures. This has facilitated in execution of international ventures.
5. Technological advancement has made it easier to get access to customers outside home country. It is no longer required to meet your customers, suppliers, partners in person and even business deals are executed on virtual platforms.
6. Many times, there are lucrative reasons are offered by foreign markets like tax incentives by foreign government on investment, unexploited market, cheaper raw material availability etc which can make good case for Indian companies to venture abroad.

However, the present state of Indian corporate sector is far from its true potential. In the Nikkei Asian Review's annual rankings for 2017, only 20 companies could make it in Asia's top 100 while the Fortune 500 list had only 7 Indian companies in the same year. Analysts say that the Indian companies will have to be innovative in products and managerial practices to become global success stories. In the next section, we shall look at some Indian companies which have truly inspired many others to achieve success globally.

11.6 CHALLENGES FOR INDIAN COMPANIES IN GOING GLOBAL

While many foreign companies are making huge investments in India, there has been a steady flow of investment by Indian companies in foreign countries. Most of Indian investments have been in Asia, West Asia and Africa. This has primarily been fuelled by global integration of markets, easier access to capital and strong business leadership in the pharmaceuticals, information technology and consumer goods. However, there are still various challenges before these Indian firms to make their mark or compete with other international players. Some of these critical factors are as under:

Global Talent Pool

To run a successful business globally, a company requires human resources which can handle diverse challenging opportunities across diverse markets. These managers and technical experts need to have global exposure for which Indian companies need to train them over a period of time or they can hire experts from foreign countries. Both of these strategies require heavy investment over a long period of time. This is a big challenge for Indian companies as barring few large old corporate houses, others struggle to attract or retain highly skilled manpower which can contribute in global outreach.

Scale of Domestic Exposure

Various multinational companies execute large scale projects in their home countries and elsewhere due to which they are able to handle any scale of investment. However, in India there are only a handful of companies who have the capacity and experience of handling large scale projects. Normally, the prior project handling experience is considered as key in award of various projects abroad and Indian companies fall short of expectations in this area.

Regulatory Constraints

The world over, increased regulations on matters related to environment, health quality, labour laws, immigration, outsourcing, quality etc are increasingly challenging smoother expansion of businesses and Indian business houses have to go several notches higher to adopt global business practices if they wish to exploit foreign territories. This is very challenging as the domestic conditions cannot be replicated for overseas businesses. The Indian companies have to overcome this huge challenge as any failure to meet these regulatory norms can bring huge financial setbacks to the business.

Fluctuations in Global Economy

The global markets provide opportunities on one hand but also provide volatility in terms of uncertainty in growth, variations in exchange rates, changes in political climate and other such factors. Recession for long periods of time can hit capital investment badly and businesses may find it difficult to survive the gloomy phase. Similarly, adverse exchange rate movements can make products or services uncompetitive. Political unrest or change in regime brings irreversible changes which are difficult to handle. All of these are challenges for those Indian companies which are smaller in scale.

As per the prestigious Fortune 500 list published by Fortune magazine every year, seven Indian companies have featured in the list for 2018. This list of top 500 companies in the world has 132 from the USA, 109 from China, 51 from Japan and 15 from South Korea. Looking at India's size the number of just 7 companies looks quite small. In fact, the first Indian company to be featured on this list is Indian Oil Corporation, a state run entity, at 137^{th} place. It has reported revenues of USD 65.9 billion while the other entrants are Reliance Industries Limited at 148^{th} place (revenue of USD 62.3 billion, Oil and Natural Gas Corporation (ONGC) at 197^{th} place (revenue of USD 51.2 billion), State Bank of India at 216^{th} rank (revenue of USD 47.5 billion), Tata Motors at 232^{nd} rank (revenue of USD 45.2 billion), Bharat Petroleum at 314^{th} rank and Rajesh Exports at 405^{th} rank. As is evident, four out of the seven Indian companies in the Fortune 500 list are from the public sector which shows that the Indian private sector still has a long distance to catch up with its Asian counterparts. Reliance Industries Limited was found to be the most profitable Indian company and was ranked 99^{th} in the world as per profitability.

Check Your Progress- A

1. Fill in the Blanks

a. Globalisation leads to _______________ in costs for standardised products.

b. _________________ is paid by licensee to use technology owned by licensor.

c. Under franchising agreement, the brand name used is owned by ____________.

d. Two firms work independently with mutual understanding and benefit under ____________ alliance.

e. New business established by two or more firms is known as _____________.

f. The trade barriers have ______________ in the globalised world.

g. Inorganic growth is a _________________ way to grow business.

h. India's key comparative advantage globally is _____________________

11.7 GLOBAL INDIAN CORPORATE: 1. THE TATA GROUP

From a small automobile manufacturing company in 1940s to a global Indian behemoth, the Tata group is indeed the flag bearer of successful global companies. The group footprint is now in over 100 countries and more than 60% of its revenue of around US$100 billion came from international operations in 2017. Its interests range from automobiles to steel, telecom, software, beverages, hospitality, energy and many others and is primarily owned by the holding company- Tata Sons. Among the 29 publicly listed Tata group companies, Tata Steel, Tata Motors, Tata Consultancy Services, Tata Power, Tata Chemicals, Tata Global Beverages, Tata Teleservices, Titan, Tata Communications and Indian Hotels are most prominent. The market capitalisation of these companies was over 150 US$ as on march 2018..

Earlier, the group achieved growth organically (through growth in sales, adoption of new technology, inventions) but there was a shift in strategy last decade when the group took major steps to grow inorganically. Starting early 2000, the group went on acquiring lot of foreign businesses including Tetley by Tata Tea; Corus, NatSteel and Millennium Steel by Tata Steel; Daewoo Commercial Vehicles, Jaguar and Land Rover by Tata Motors; Brunner Mond and General Chemical Industrial Products by Tata Chemicals, Tyco Global Network by Tata Communications and many others. These acquisitions have significantly contributed to the group's profits and made it a global player. However, the group has also seen one of the major group company- Tata Consultancy Services (TCS) majorly investing in greenfield projects for its expansion.

As per Tata group website, 'Tata companies use the Tata Business Excellence Model (TBEM), which covers business aspects that range from strategy and leadership, to safety and climate change.' This is a kind of think-tank which provides strategic direction, assessment of business performance and practices of all group companies, improvements and rewards aimed at bringing excellence and contribute towards overall efficiency. The group has established major institutions promoting health, art, culture and sports and runs many philanthropic institutions. Normally family businesses do not last beyond a few generations as evidenced globally, but the Tata group's professionalism and quest for excellence has led it to a stage where it is not only growing rapidly but has attained a respectable status from the industry.

11.8 GLOBAL INDIAN CORPORATE: INFOSYS

Infosys is a shining example of India's success story in software and information technology. With a humble beginning in 1981, today it is a global leader in consulting and IT services. Started with an investment of mere US$250 by seven engineers in Pune, today the company's market capitalisation is in excess of US$ 42 billion, revenues exceeding US$ 11 billion and an employee strength of more than two lakh employees. The company transformed India's image as a leader in software services. It became the first company to be listed on NASDAQ. It also introduced the concept of employee stock options in India where employees were given shares of the company as reward of their performance.

The company is present in 45 countries across the globe in consulting, technology and outsourcing. Earlier its foreign operations were majorly in the United States but now its footprint has expanded to almost all major countries from Europe to Australia. Unlike the orthodox practice of first strengthening domestic operations before venturing out, Infosys became global in its foundation years alone. The global vision of founders led to foreign customer acquisition from the very beginning. The company has always been at the forefront of adhering to global best practices and compliances. It was the first company to implement US GAAP standards. It has been investing hugely in maintaining a talented, multi cultural, multi locational pool of human resources across its offices worldwide. Creation of a pool of multi-ethnic workforce is a strategic asset for the company.

Some of the company's products like Trade Edge, EdgeVerve and Finacle are the operational engines for businesses around the world. Majority of Indian banks run their core banking solutions on Finacle. The company keeps reinventing itself by continuous redesigning of strategy and communicating with its employees. Its client retention ratio is quite high and it is now banking upon digital revolution as an opportunity for next growth stimulus. The company is acquiring businesses across platforms as well as preparing itself for its next leap of success.

11.9 GLOBAL INDIAN CORPORATE: ADITYA BIRLA GROUP

Another example of a family business gone global with diversified interests, the Aditya Birla group is among the best known success stories of the Indian corporate sector. Originating at Pilani, Rajasthan in the 19th century from the business family of Birlas, the group started globalisation way back in the 1970s when the concept was unheard of in India. Becoming the first Indian brand to go global, today it is over US$ 44 billion enterprise with over 1,20,000 *employees and 42 companies under its fold. It is a global leader in Aluminium rolling, Viscose staple fibre and Carbon black. Apart from this it has strong presence in cement, telecom, fertilisers, financial services, branded apparel, software etc.*

Ably led by group chairman Kumar Manglam Birla, the group has achieved significant milestones and retained its global outlook. The group's presence in 35 countries with more than 50% of revenues originating outside India is proof of its global footprint. It is reputed for its best employee practices and diversified work force. In USA, more than 90% of its workforce is American. The group has started a unique e-MBA program with a University in Singapore for its managers under which they can learn new skills and perspectives for managing international businesses in the modern competitive scenario and earn a global MBA degree. The group has uniquely appointed Deputy Managing Directors in all its major companies to prepare second line of leadership and democratic decision making.

Its growth has been a mix of organic and inorganic strategies. The group's acquisition of US based companies- Novelis (a leading global metal company) and Columbian Chemicals catapulted it into the big league. In India it strengthened its apparel retail business by acquiring Pantaloons.The merger of the group's telecom company Idea Cellular with Vodafone India has created India's largest telecom company in 2018. The group has been ranked first in Asia Pacific region and fourth in the world in the study titled "Top Companies for Leaders" by Fortune magazine. Like the Tatas, the group has taken strong initiatives in social welfare by running scores of projects in health, education, livelihood etc for upliftment of marginalised citizens in India and abroad. It has established various educational institutions from schools to colleges for higher education. With its established leadership and proven record, the group is poised to add lot more feathers to its crowded cap of global success.

11.10 SUMMARY

Global Strategies are critical to the survival of businesses in an era of increasing globalisation of trade. Companies, small to large are investing in markets outside home countries. Global strategy includes aiming for economies of scale, adopting global best practices, managing multi-ethnic work force, mitigating political and economic risks and facing competition. Various entry strategies for globalisation of business include exports, licensing, franchising, subsidiary, joint ventures etc. Many Indian companies are going global but India is still far from its potential. There are various challenges which need to be overcome to compete with global players in the increasingly competitive world business markets.

11.11 GLOSSARY

Globalisation: The phenomenon of businesses becoming global in operations.

Economies of Scale: Reduction in per unit cost due to large scale production.

Licensing: Giving somebody else the right to use technology, IPR in return for fee.

Franchising: Allowing another party to use brand name, processes and systems to produce a specified product/service commercially.

Strategic Alliance: Two or more parties working together for mutual benefit in business.

Joint Venture: Formation of a new business by existing parties jointly.

Organic growth: Growing your own business with increase in turnover and not by acquiring other businesses.

Fortune 500: List of top 500 companies in the world by turnover published by Fortune magazine.

FDI: Investment in creating assets in foreign country for long term.

11.12 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress- A

a. Reduction

b. Royalty

c. Franchisor

d. Strategic

e. Joint Venture

f. Decreased

g. Faster

h. Skilled and cheaper human resource

11.13 REFERENCE/ BIBLIOGRAPHY

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11.15 TERMINAL & MODEL QUESTIONS

Q1. Describe the importance of developing global strategy for businesses?

Q2. Critically examine the reasons for limited global footprint of Indian companies.

Q3. Discuss the various entry strategies for entering into global markets.

Q4. Bring out some of the success stories of Indian companies which have achieved success globally.

UNIT12 TECHNOLOGICAL STRATEGY

12.1 INTRODUCTION

In the previous unit you learnt about Global Strategies as part of a broader unit that covers "Strategies of International Business." The purpose of this unit is to delineate the components of a technological strategy.

Technology has become an indispensable aspect of modern business. A competent firm needs to acknowledge and adapt to rapid technological advances that characterise the current business environment. A contemporary development, technological strategy encompasses activities and decisions associated with the management of a firm's technology. This chapter covers some of the most important components of a technological strategy.

12.2 OBJECTIVES

After reading this unit you will be able to:

- Understand the meaning of technology strategy
- Understand the factors involved in making and buying new technologies.
- Learn about leading and following in the adoption of new technologies.
- Learn about investments and methods of appropriating technologies

12.3 WHAT IS TECHNOLOGICAL STRATEGY?

Over the last 20 years of extensive information diffusion, technology has become an indispensable aspect of international business. It is essential for each firm to pay close attention to ongoing and potential technological advancements to either help in the development or sustainment of a competitive advantage. Therefore, technological strategy is a set of plans and decisions that revolve around the acquisition, use, and the management of technological resources in a corporation. The purpose of a technological strategy is to confer advantage to a firm by maximising efficiency with proper use of the right technologies.

Traditionally, technology-related strategies focus on the following components which will be explored throughout this chapter:

- The decision regarding purchase or development of new technologies (Make or Buy)
- How will partners and suppliers be involved in the development or acquisition of technology
- Does a company lead or follow in the development and adoption of a given technology?
- Investments
- User acceptance

12.4 MAKE OR BUY?

It is important for a firm to carefully assess its current and forecasted environment before making a decision about the development or acquisition of a new technology. The make-or-buy decision involves making a strategic choice between developing a technology internally and buying it externally. Developing a technology involves pooling together resources and expertise. It requires investments in R&D and extensive planning. Buying a new technology on the other hand, has gained prominence more recently because of the rise of multinational corporations. Firms now focus on lean manufacturing and utilize the concept of outsourcing. For many leading multinationals, production is carried out in countries that have cheap labor and resources. As a result, technology management of such companies is also outsourced. Irrespective of the choice, it is paramount that firms keep their suppliers and customers in mind while devising the technological strategy. Communication with these stakeholders is essential to a successful technological strategy.

Make-or-buy analysis is conducted at the strategic and operational level. Obviously, the strategic level is the more long-range of the two. Variables considered at the strategic level include analysis of the future, as well as the current environment. Issues like government regulation, competing firms, and market trends all have a strategic impact on the make-or-buy decision. Of course, firms should make items that reinforce or are in-line with their core competencies. These are areas in which the firm is strongest and which give the firm a competitive advantage.

Check Your Progress-A

Q1. State the meaning of a technological strategy.

Q2. What are the 4 main components of a technological strategy according to this book?

Q3. Explain the process of developing a new technology in terms of activities involved.

Q4. What is a make-or-buy analysis? How is it used to make a decision about a technology?

12.5 LEAD OR FOLLOW?

This section sheds light on a more general dimension of strategic decision-making. For a firm to implement an effective technological strategy, it has to pay attention the current situation and market forces that will either hinder or enhance the adoption of a new technology. This involves close attention to innovation management.

"Innovation distinguishes between a leader and a follower" – Steve Jobs.

Organizations have the freedom of following either a *proactive* or a *reactive* strategy when it comes to technology adoption. Becoming a disruptor involves prompt response to emerging trends. It is important that enterprises start and scale fast by removing obstacles that hinder innovation. Removing these obstacles to focus on the development of a new technology usually involves the following:

(i) Adopting a framework for evaluating emerging technologies: the idea is to focus on the objectives and to come up with the best possible method to enhance the technological strategy's effectiveness. Managers do this by defining exactly what the company intends to achieve with the adoption of the new technology and then developing a clear framework for the evaluation of current and emerging technologies.

(ii) Stay ahead of your customers: listening to customers constantly helps organisations anticipate their needs. Ongoing research, tight links between IT and marketing and continuous assessments of emerging technologies are vital. Disruption needs room to breathe, so it is important to not stifle employees' innovation by limiting them to legacy constraints. Above all, a firm should maintain a holistic mindset. Convergence is the key to unleashing the power of emerging technologies. For example, the usefulness of drones depends entirely on the integrated intelligent technology layered on them. Telecommunications companies use drones for cell tower inspections, but without the technology to stitch those images together into meaningful intelligence, analysts would be left staring at thousands of images

Check Your Progress-B

Q1. What is the difference between a proactive and a reactive strategy when it comes to technology adoption?

Q2. As explored in section 12.5, state and explain the 2 courses of action involved in the development of a new technology?

Q3. Leading or following – which is the better option for a first-mover? Discuss the merits and drawbacks of both options and make a choice.

Q4. What are some other ways of ensuring that a company keeps up with the latest technological fads?

12.6 INVESTMENTS AND OTHER FACTORS

A company should keep in mind that adopting a new technology is essentially an investment. Therefore, each investment opportunity should be analyzed very carefully to ensure that it does not affect the financial position of the firm adversely. One of the most important measures used in investment planning is the ***Net Present Value***. More commonly known as NPV, this is essentially the present value of cash flows that occur over a period of time (CFI, 2018).

NPV Formula

The formula for Net Present Value is;

$$\mathrm{NPV}_{\mathrm{XYZ}} = \frac{z_1}{1+r} + \frac{z_2}{1+r} - X_0$$

Where;

z_1 = Cash Flow in Time 1

z_2 = Cash Flow in Time 2

r = *Discount Rate*

$X_0 = \textit{Cash outflow in time } 0 (\textit{i.e. the Purchase Price or Initial Investment})$

Why is Net Present Value (NPV) Analysis Used?

NPV analysis helps determine how much an investment, project, or any series of cash flows is worth. Taking into account revenue, expenses, and other costs associated with the investment over its useful life, it is an all-encompassing metric.

In addition to factoring all revenues and costs, it also takes into the account the timing of each cash flow that can result in a large impact on the present value of an investment.

Why Are Cash Flows Discounted?

Cash flows are discounted for two main reasons:

(i) Adjusting for the risk of an investment opportunity

(ii) Accounting for the time value of money

Adjusting for risk is necessary because not all projects and investments have the same level of risk. For example, the chances of receiving cash flow from a treasury bill are significantly higher than the probability of receiving cash flow from a startup. The aforementioned discount rate is therefore, higher for riskier investments.

Accounting for time value of money is important because of the following factors:

- Inflation: receiving $1000 today is worth much more than receiving $1000 in five years. Earning money today enables an individual to invest and earn interest.
- Interest rates
- Opportunity costs

OTHER FACTORS

Another important business criterion is the ***market size*** for products manufactured using current and emerging technologies. It is important that the firm identifies strong demand for its products. Essentially, it is critical that the market is engaged and customers are willingly and regularly making decisions about the goods produced.

A company also needs to pay attention to ***employee well-being***. After investing in a new technology, companies might encounter problems associated with the desirability of workspace. Exposure to health hazards could seriously maim the efficiency and image of any company. Therefore, it is essential that the firm looks at the new technological investment in terms of how it affects employment, employee morale and overall human capital well-being.

Check Your Progress- C

Q1. What is Net Present Value? How does it assist in making decisions?

Q2. Calculate the net present value of a machine with an expected lifespan of 4 years with the following cash flows. Why should the machine (not) be purchased?

- **Cost of purchase: 10000**
- **Cash flow (Y1): 3500**
- **Cash flow (Y2): 4500**
- **Cash flow (Y3): 5000**
- **Cash flow (Y4): 2000**
- **Discount rate: 7.5%**

Q3. Why are cash flows discounted? Explain.

Q4. Why is accounting for the time value of money important?

Q5. What are some of the "other factors" involved in decision-making associated with a technological investment?

12.7 USER ACCEPTANCE

A technology is only valuable to a company when it is accepted and easily used by its employees. User acceptance models explain variance in intentions to use technology. The purpose of this section is to explain the basic concepts and methods of user acceptance research. This research explores the nature of those variables that indicate a user's intention of using a new technology and the actual use of the technology. The Technology Acceptance Model (TAM) (Davis, 1989) was among the first serious models which correlated perceived usefulness and perceived ease of use. The idea behind this model is that a person who perceives a new technology as useful and easy to use will have a stronger likelihood of accepting and using it. Since then, a number of different user acceptance models have been developed by different authors. Finally, Venkatesh et al. (2003) combined all these models into the Universal Theory of Acceptance and Use of Technology (UTAUT).

User acceptance models assume the following basic concepts: users will have (1) an individual reaction to use of the technology, they will have (2) intentions to use the technology, and there will be (3) actual use of the technology. Actual use (3) is the dependent variable, and intentions (2) have been established as a predictor of use. Individual reactions influence both intentions and actual use. However, what these reactions are is different in each of the acceptance models. In TAM, perceived usefulness and perceived ease of use are individual reactions, affecting intentions and use. UTAUT combines eight previous user acceptance models into one. Resulting from the combination of eight user acceptance models, UTAUT consists of four main variables that influence intentions and actual use. Additionally, there are four key moderators that influence the strength of each variable. The first two variables are *performance expectancy* and *effort expectancy*. The third variable is social influence, which refers to what the user believes others will think of him if he uses the technology. Finally, facilitating conditions refer to the user's belief that support exists for use of the technology. These four main variables are all moderated in different ways by the user's gender, age, experience, and voluntariness of use.

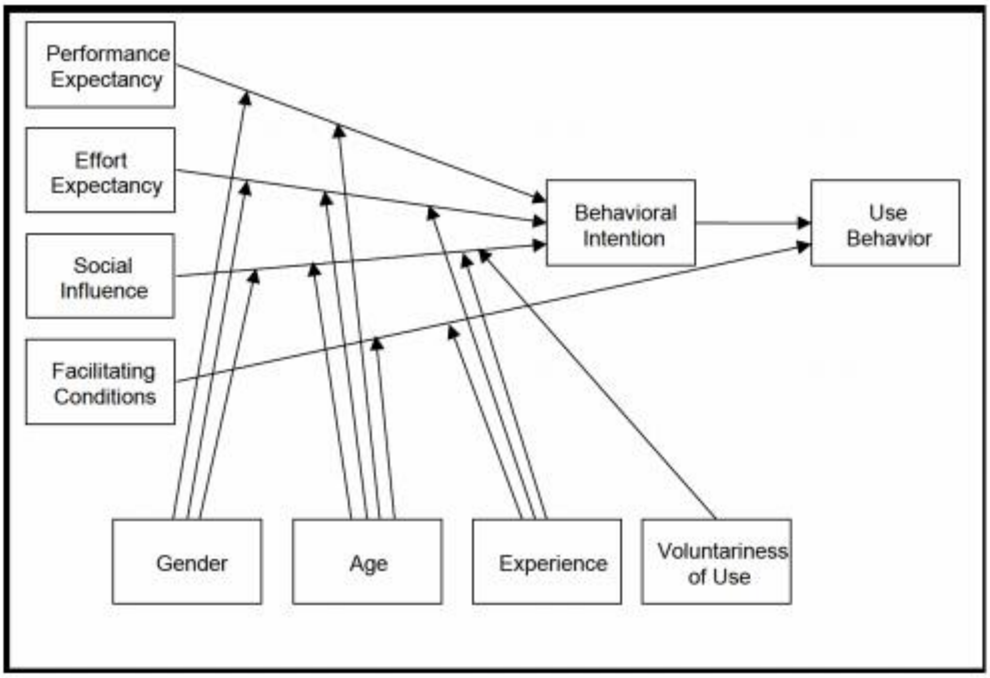

Fig 12.1 UTAUT

User acceptance models have a strictly defined scope. The goal of these models is to predict the likelihood that a given user will accept a certain technology. This is intrinsically related to the way these models are created and also used. Surveying large number of (potential) users gives a correlation between the main variables and the dependent variable, 'use'. In constructing UTAUT, social influence is apparently found to correlate to use; thus, all other things being equal, someone who feels positive social influence is more likely to accept the technology.

12.8 SUMMARY

It is essential for each firm to pay close attention to ongoing and potential technological advancements to either help in the development or sustainment of a competitive advantage.

Therefore, technological strategy is a set of plans and decisions that revolve around the acquisition, use, and the management of technological resources in a corporation. The purpose of a technological strategy is to confer advantage to a firm by maximising efficiency with proper use of the right technologies.

Traditionally, technology-related strategies focus on the following components:

•The decision regarding purchase or development of new technologies (Make or Buy)

•How will partners and suppliers be involved in the development or acquisition of technology

•Does a company lead or follow in the development and adoption of a given technology?

•Investment: The Net Present Value could be a vital instrument that helps a company make decisions about whether or not it should invest in a certain technology.

•User acceptance

12.9 GLOSSARY

Authorization: Granting permission for someone or something to carry out an act.

Availability: The requirement that an asset or resource be accessible to authorized parties.

Biometrics: Methods for differentiating humans based upon one or more intrinsic physical or behavioral traits such as fingerprints or facial geometry.

Business continuity plan (BCP): The documentation of a predetermined set of instructions or procedures that describe how an organization's critical business functions will be sustained during and after a significant disruption.

Centralized storage: Storage on a central server made available over a network to users.

Change: Any implementation of new functionality, interruption of service, repair of existing functionality, and/or removal of existing functionality to an information system.

Change management: The process of controlling modifications to hardware, software, firmware, and documentation to ensure that information systems are protected against improper modification before, during, and after system implementation.

Confidential: The classification of data of which unauthorized disclosure/use could cause serious damage to an organization or individual.

Confidentiality: Characteristic of information indicating it is intended to be known by a limited set of people.

Confidential information: Information maintained by the university that is exempt from disclosure under the provisions of the Public Records Act or other applicable state and federal laws. The controlling factor for confidential information is dissemination.

Control: Method used to reduce the probability of occurrence or the negative impact of the realization of a risk.

Digital data: The subset of Data (as defined above) that is transmitted by, maintained, or made available in electronic media.

Disclosure: The act, intentional or otherwise, of revealing information that is otherwise held as confidential or protected.

DNS: The Domain Name System (DNS) is a naming system for computers, services, or other resources connected to a network that associates a name with an IP address.

Emergency change: When an unauthorized immediate response to imminent critical system failure is needed to prevent widespread service disruption.

Encrypted data: Data rendered unreadable to anyone without the appropriate cryptographic key and algorithm.

Encryption: Process of numerically changing data to enhance confidentiality. Data is obscured using a specific algorithm and key both of which are required to interpret the encrypted data.

End user: A person given authorization to access information on a system.

Escrow: Data decryption keys or passwords held in trust by a third party to be turned over to the user only upon fulfillment of specific authentication conditions.

Exposure: State during which a system's controls do not adequately reduce risk that the information could be stolen or exploited by an unauthorized person.

Firewall: An access control mechanism that acts as a barrier between two or more segments of a computer network or overall client/server architecture, used to protect internal networks or network segments from unauthorized users or processes. Such devices include hardware that is placed in the network to create separate security zones, provide NAT, and create a point of access control.

Hardening: The process of making computer and network systems more resistant to tampering or malicious software.

Incident: Any set of circumstances in which the anticipated and configured delivery of a service is interrupted, delayed, or otherwise unavailable.

Incident Management: Process of returning service as quickly and effectively as possible.

Information owner: Responsible for specified information and establishing the controls for its collection, creation, processing, access, dissemination, and disposal. The owner of a collection of information is the person responsible for the business results of that system or the business use of the information. Where appropriate, ownership may be shared by managers of different departments. See OP 44.00 for a list of duties and responsibilities.

Information system: The equipment and software such as files, computers, tablets, servers, hard drives, removable thumb drives, cloud storage, etc. used to collect, record, process, display, and transmit information.

12.10 REFERENCES

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12.12 TERMINAL & MODEL QUESTIONS

Q1. Explain user acceptance.

Q2. State and explain the two user acceptance models discussed in section 12.7.

Q3. What are the basic concepts underlying user acceptance models.

Q4. What are the 4 main variables in a UTAUT model?

Q5. What are the 4 moderating variables in a UTAUT model?

UNIT 13 GLOBAL ALLIANCES, MERGER AND ACQUISITION

13.1 INTRODUCTION

In this rapidly changing corporate world mergers and acquisition (M&A) , joint ventures, global alliance has become imminent in today's globalised economy as a strategy for companies in achieving quality and excellence in their field of operations , to gain synergy, focused growth and is essential part of the corporate restructuring all round the globe . In this unit , you will get familiar with the basic concept of M&A, different forms of mergers, rationale behind the companies opting for global alliances, various advantages and limitations of M&A and reasons behind the failure of mergers.

13.2 OBJECTIVES

In this unit , the student will learn about the following:

- Basic concept of mergers and acquisitions.
- Various types /forms of M&A
- Understand the rationale behind global alliances
- Motives of Merger and Acquisition.
- Advantages and limitations of M&A

13.3 CONCEPT OF ALLIANCES

Every firm has the prime objective of a profitable growth which can be done both, by internally and also by externally as well. Internal growth could be strive by enhancing the capacities of existing product or introduction of new product , increasing sales force etc, whereas, external growth as it may be attained by mergers and acquisitions of existing firms . M&A have emerged as a worldwide phenomenon as a strategic process of corporate restructuring . The trend towards liberalization, globalization and privatization of all national and regional economies, the corporate sector has become vulnerable to both local and international competition, which has also raised the frequency of mergers with the aim to establish more competitive, feasible , big players in each and every industry.

In today's fast changing business scenario , the concept of M&A has assumed greater significance and are being acknowledged by the Indian companies as one of the important tools of business strategy, and also, to gain competitive strength, increase the market share or to exploit the new market or product segmentation . M&A could be used as a corporate strategy by most of the firms to enter the market through an established brand, or to increase market share, to reduce tax – liability, to take advantage of synergy and to have a competitive edge , also to set- off accumulated losses of one firm against the other profit making firm.

Almost every day our daily newspaper reads of a new M&A or spin-off or some business alliances such as joint venture, franchising etc, or any other forms of corporate restructuring doing the rounds in the corporate circle. Under no circumstances, it can be said that a company is shielded from M&A possibility, but at the same time M&A is the sine qua non for the robust growth and expansion of the firm and also for its shareholder's.

13.4 MEANING OF MERGER AND ACQUISITION

a) Defining Merger:

When two or more companies combined into a single company where one survives and the others lose their corporate existence is termed as merger.

Merger can be explained as 'a transaction involving two or more companies in the exchange of securities and only one company survives'. When the equity holders of the two company, decides to pool the resources of their firm under a common entity it is called 'merger'.

Merger can also be regarded as the fusion of two or more existing firms, where, all the assets, liabilities and stock of one firm gets transferred to 'Transferee Company' in exchange of some kind of payment in the nature of equity shares of 'Transferee Company' or debentures or cash or a mix of all the three way.

'Amalgamation' is said to happen when, as a consequences of merger , a new company is formed instead, the process is called 'amalgamation' . Some example include the creation of

Centurion Bank of Punjab by merging the two entities , the Bank of Punjab and Centurion Bank ; another example of amalgamation is establishment of a new company Aditya Birla Nuvor by the merger of their companies i.e Indian Rayon Ltd, Indo Gulf Fertilizers Limited (IGFL) and Birla Global Finance Limited (BGFL) or the inception of Brooke Bond Lipton India Ltd by the merger of Brooke Bond India Ltd and Lipton India Ltd

Generally, the outcome of a merger, is , one entity survives and while the others entity loses their independent existence, then merger is in the nature of 'absorption'. Example of 'absorption' include the merger of Global Trust Bank Limited (GTB) with Oriental Bank of Commerce (OBC) where, the existence of GTB is lost while, the OBC continues its operations. Also, the merger of Tata Fertilizer Ltd with Tata chemicals Ltd is an example of absorption as TFL has transferred both the assets and liabilities to TCL Ltd and ceases to exist, while TCL Ltd preserves its identity.

b) Acquisition:

Acquisition is a way to obtain effective control over the assets or the control over the management (purchase is done either by lump sum consideration or by item–wise consideration or by the purchase of shares or gaining control over the board) of one company that is the 'target company' by another company called the 'acquiring company', without physically acquiring shares of that company.

Another variety of acquisition is 'Takeover'. It is regarded as one of the corporate strategy of acquiring control over the management of the 'target company', either directly or indirectly. Takeover is described as the process of acquisition of equity shares carrying majority of voting power , or , to gain control over the assets and management of the company. It is considered as a general phenomenon all over the globe and 'the acquirer' aim for health and cash rich firms with good growth prospects along with low equity stake of the owners. Some example of M&A include Tata steel takeover of corus , or merger of Exxon and Mobil to form Exxon-Mobil.

13.4.1 Types of Merger and Acquisitions

The following are the types of mergers and acquisitions;

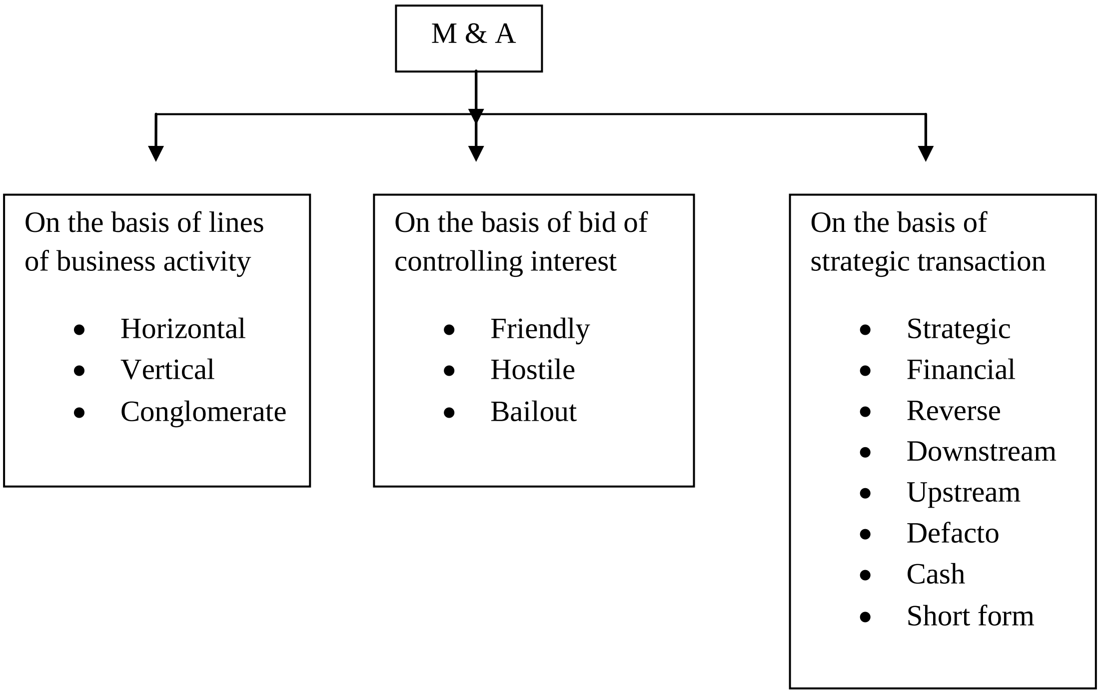

Fig 13.1 Types of mergers and acquisitions ***Source: (Kishore, 2009)***

1. **On the basis of lines of business activity:**

   M&A can be broadly categorized into ;

   a) ***Horizontal merger:*** is a merger where two entity comes together and joins hand which are in the similar lines of business or, are in the same stage of industrial life cycle and also compete in similar business environment. Major objective behind this form of merger is to have economies of scale and to attain synergy from the combined unit as they are in the same lines of business or operating in the same market . It is also assumed to eliminate or reduce competition, effective and efficient marketing and management, putting an end to price war etc.

   Major advantage of horizontal M&A is it leads to reduction in competition within the same industry as horizontal mergers and acquisition takes place between those firms who are manufacturing, selling or distributing similar type of product or services.

   The drawback of horizontal merger is that it can lead to monopolistic behaviour in the market as there will be very few players which can lead to collusion by setting the prices at a very higher level than the price determined by the forces of market demand and supply.

Example : Merger of Tata oil Mills Company ltd with Hindustan lever Ltd is a form of horizontal merger as both have similar products. Another example is the merger between Glaxo Wellcome Plc. and SmithKline Beecham Plc is a horizontal merger as the two companies are the British mega pharmaceutical company and the merger of the two helps to form a leading drug manufacturing company internationally. The two companies have a complementary drug portfolio and the merger of the two would let them pool there R&D fund together, can explore a bigger market with increased market share and high sales growth.
Another example can be , let’s say a TV manufacturing company taking over the washing machine manufacturing company will also be a horizontal M&A as both companies are in consumer durable market .

b) ***Vertical Merger:*** The vertical merger and acquisition takes place between the companies in the different stage of their production and operation cycle but are in the same industry. Vertical M&A can take the form of either forward integration / or merger or backward integration/merger.
   - **Forward merger** also called “downstream merger” is a type of merger which occurs when the company lets say , expands or move forward in the direction more close to their consumer. Example : A raw material supplying firm joins hand with the manufacturing firm is an example of forward merger as the company is moving ahead in the supply chain.
   - **Backward merger** also called “upstream merger” is a type of merger where the company expand backward to the supplier of the raw material.

   The main aim of such mergers is to lower the distribution cost , lower the buying cost of materials and creating entry barriers for the competitors and the new players in the market. Example : when a manufacturing company join hands with its suppliers of its raw materials is an example of backward M&A as they are moving backward in the supply chain .

c) ***Conglomerate Merger:*** Conglomerate Merger is concern with those companies which are engaged in unrelated business or in the different industries or two firms are in different business operation, when combined together is called a Conglomerate Merger. In a conglomerate M&A, the combining companies are totally in different lines of business. The two merging companies are not competitors to each other, neither their products, services or operations are complementary to each other.
   - The main aim of this merger is to increase economic power, profitability and diversification of activities of the firm.
   - Now, since the two firms are in unrelated businesses , it will help to bring stability in profit and revenue, as the two firms are in different industries which some way or the other complement each other.
   - When a firm joins hand with another , which is operating in a different business environment sometimes helps the combined new firm to make up

for the fluctuations in product life cycle and thus effective in balancing product cycle.

- Effective and efficient utilization of unutilized financial resources , lowering cost of capital and maximizing shareholder's wealth and value of the firm .

It is also called concentric merger as the companies which are in different geographical locations also opt for these types of merger. Conglomerate merger is sub-divided into:

- Financial conglomerate
- Managerial conglomerate
- Concentric Conglomerate

a) Financial Conglomerate: The main objective behind these types of conglomerate is to improve the managerial performance and helps in easy mobilization of funds to each and every segment of the business and to helps to eliminate risk associated with it. Financial conglomerate plays an effective role in taking the financial responsibility and control, improving risk –return ratio, providing effective competitive process, and manage day to day activities.

b) Managerial Conglomerate: Two firms of unequal or different managerial competences combines and the new entity formed will have a greater economic benefit and more potential for improving performance.

c) Concentric Conglomerate: The merger is considered as concentric conglomerate , when in the two combining company, there are some activities which are of complementing nature in their specific management functions. Example :One company is having technological expertise and high in R&D activities can combined together with the firm having sufficient financial resources but lacks in R&D and technological expertise.

2. On the basis of bid of controlling interest :

a) ***Friendly Takeover*** : It is also refer to as 'consent takeover', where the acquirer purchases the controlling shares through a 'friendly negotiations' and agreement and the takeover bid is finalized in accord with the majority shareholders (Board of directors) of both the target company and the acquirer , with the aim to further some common objectives of both the parties. Section 395 of the Companies Act, 1956 governs this type of takeover.

b) ***Hostile Takeover***: It is also refer to as the 'Violent takeover' as it is against the wishes of management and Board of directors of the target company as they have no desire to be acquired or merged by the another company 'acquiring company' . The acquiring company purchases the required number of shares from the non- controlling shareholders in the open market , without informing the other company. The acquirer or the 'acquiring company', thus makes a direct offer to the shareholders of the 'target company' without the knowledge and permission of the promoters or management.

c) ***Bailout Takeover*** : is a process where a financial sound company with a decent growth and stability tries to takeover a weak company with the objective to revive its financial strength . This takeover is govern by as per the provisions of Sick Industrial Companies (Special Provisions) Act, 1985 .

3. On the basis of strategic transaction:

a) **Strategic M&A**: involves operating synergies, i.e., two companies are more profitable combined than separate.
b) **Financial M&A:** the bidder usually believes that the price of the company's stock is less than the value of company's assets.
c) **Reverse M&A:** is the merger of a large (financially sound/ profit-making) company with a small (financially weak/ loss-making) company.
d) **Downstream M&A**: is the merger of a parent company with its own subsidiary.
e) Upstream M&A: is the merger of a subsidiary company with its own parent
f) **Defacto M&A:** has economic effect of merger as per legal provisions, but is entered in the form of acquisition of assets.
g) **Cash M&A:** occurs when certain shareholders accept cash for their shares, while other shareholders receive shares in the surviving company.
h) **Short-Term M&A** : takes place when a parent company acquires the total voting power in a subsidiary.

Check Your Progress- A

Q1. Define the term 'Merger' and 'Acquisition'.

Q2. What are the various types of Merger and Acquisition?

Q3: What do you mean by Friendly Takeover?

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13.5 SIGNIFICANCE OF MERGER AND ACQUISITIONS

M&A have become the significant form of business strategy there could be a number of reasons to be cited in support of merger proposal which can be growth, diversification, advantage of economies , utilization of tax shield, cost reduction , strategic benefits. The main objectives behind any M&A deals are as follows:

13.5.1 Objectives of Merger and Acquisition

However , the main objectives of M&A aims to achieve synergy, faster growth, focus on core strengths, strategic benefits, efficient and effective allocation of managerial capabilities, economies of scale , economies of scope, benefit of tax shield etc.

- **Economies of scale :** When two or more companies combine , it will result into larger volume of operations of the new combined entity. This combined new company can often reduce its fixed costs by removing duplicate departments or operations, lowering the costs of the company relative to the same revenue stream, thus increasing profit margins, thus it will result into economies of scale . It arises as a result of increased production capacities, data processing , research and development, increased distribution network etc.
  Economies of scale are more common in horizontal merger where the aim of utilization of resources are more, as compare to that of vertical merger where the main objective is to improve coordination of activities, lower inventory levels and increased market share . The important point to be noted is that, the economies of scale operates up to a certain level and after that level , one cannot take the advantage of it as per unit average cost increases beyond that point. To summaries in a simple words, economies of scale refer to per unit cost reduction which is associated with larger volume / scale of operations of the combined entity.
- **Economies of scope :** A Firm may use a specific set of expertise or may owns a specific assets that may broaden the scope of its activities. Therefore, Economies of scope arises when two business unit from different industries share their resources together such as R&D cost, manufacturing unit, advertising strategy, distribution channel which helps the company to attain economies of scope by reducing costs.

- **Tax Shields :** When a loss making firm merges with a profit- making firm , tax benefits can be attained quickly. The firm with losses when merge with a profit making firm , its accumulated losses can be set off against the profits with the profitable firm, and they can use the target's loss as their advantage by reducing their tax liability. Example : Absorption of Ahmedabad Cotton Mills Limited (ACML) by Arbind Mills in 1979. ACML was facing labor problems , strikes and lockout and was closed until 1977 . After the merger in 1979, they have saved about two crore in tax liability by setting-off ACML's accumulated loss against its profits.
- **Synergy :** The combined effect of two or more course of action is always greater than the sum of individual companies. Synergy means working together. It is assumed that the two companies together with different complementary activities or skill is able to create more value which is higher than the individual company's value before merger.

  The concept of synergy can be explained as below :

  If a firm 'X' merges with another firm 'Y', the value of merged entity i.e XY, is expected to be greater than sum of the independent values of X and Y.

  $$\{ V(X)+ V(Y) \} < V(XY) \quad ,$$

  Where, V(X) = Independent value of company X.

  V(Y) = Independent value of Company Y.

  V(XY) = Value of the merged entity.

  Let's take an example one company may have more profitable investment Opportunities while the other company may have huge financial resources. Synergy arises when these two companies with profitable investment and huge financial resources are merged.
- **Increase in Effective value**: The value of the firm increases when a firm acquires the assets of another firm. For example, A Ltd and B Ltd merge and form a new company C Ltd, and then the effective value of the C Ltd is expected to be greater than the sum of the A Ltd. and B Ltd. This is because of the synergy benefits. Or, Sometimes because of integration of target and acquiring firm resources can create value through either overcoming information asymmetry or by combining scarce resources.
- **Fast Growth** : A Merger often enables the amalgamating firm to grow at a faster rate than is possible thorough internal expansion, because acquiring company enters into a new market segment more quickly, lot of the time and resource gets saved in building new plant and technology, and establishing new product lines.
- **Utilization of Surplus funds** : A company in its maturity cycle may have enough cash but might not have the opportunities for profitable investment. Such a firm distribute dividends frequently and even buy back its shares. Some firms have a tendency for profitable investment , but don't have cash , in such cases a merger with another firm involving cash compensation results in efficient utilization of surplus

funds . A cash rich company always look for takeover of cash strapped/ deprived company to utilize the surplus funds in investible projects.

- **Strategic Benefit** : when a firm choose to enter into a new market or expand into a particular industry or acquiring a company in the same industry, all these moves by a company offer various strategic advantage like it prevents a competitor firm to take the similar position in the same industry , another strategic benefit of M&A is it help the firm to take the 'timing advantage' because merger enables a firm to escape several stages in the process of expansion. It also helps to reduce risk and associated cost. In the 'saturated market' mergers and acquisitions are more beneficial option than internal expansion.
- **Diversification:** Risk reduction through diversification can be achieved by merger and acquisitions. M&A can be the main strategy for the firms looking for growth, diversification and stability. Diversification mainly concern with unrelated business activity, which can efficiently manage the product life cycle, brand image, changes in customer preferences, R&D and changes in economic policies.

  When a company produces single product then the profit and cashflow might fluctuate , which increase the business risk. Diversification help to reduce risk , therefore the merger of company whose earnings are negatively co-related brings greater reduction in risk and stability in the earnings of the combined firms.
- **Managerial Effectiveness** : M&A is beneficial in the replacement of inefficient management. Sometimes an existing management team is poorly performing and can be replaced by a more effective management team through merger and acquisition . Another reason for merger is that a greater congruence can be achieved between the interest of the manager and the shareholder.

13.5.2 Motives of Merger and Acquisitions

Companies opt for mergers and acquisitions for a number of reasons, where maximization of shareholder's value is the important aspect for motives behind M&A. Theoretically speaking , firms should pursue merger or an acquisition if it helps to increase the effective or overall value of the firm Or let's put it in simple words, a merger or acquisition is rationalized if occurs some form of 'synergies' in the new combined entity. Synergies can be of the following forms: operating, financial, or managerial.

Operating Synergies: Operating synergies associated with firm to increase their operating income, high growth in new and existing market and increased market share and better margins. The first form of operating synergies is 'revenue enhancement' which involves gaining pricing power in a new or existing market or able to increase sales volume and market share by exploiting new market. For example, a firms acquires an another firm which have a established distribution network , sales force , brand name and it uses these strengths to market its own product to other firms customers and increase its market share

Another form of operating synergies is ‘cost reduction’. Companies look for M&A with the aim to get benefit from economies of scale with lower production costs, research and development, marketing and sales. Thus, revenue enhancement and cost reduction are more commonly associated with horizontal mergers.

Financial Synergies come from lower financing costs. Big corporate houses have access to a wider and much economical pool of funds than compare to small firms. Diversifying into unrelated businesses helps companies to reduce risk and, increase their debt capacity and lower their before tax cost of financing. Thus, a profitable firm acquiring a loss making firm , it can take advantage of its net operating losses to set off its tax burden.

Managerial Synergies arise when a high-performing management team replaces an inefficient management from an organization. M&A act as a quick remedy to remove the incompetent managers, that could improve the target’s performance. Research has shown that some managers keep their own self- interest ahead instead of the interest of shareholders. M&As can be use to build empires and diversify their human capital. Managers also sometimes suffer from hubris; they are overconfident in their ability to negotiate a good deal and run the combined entity and end up paying more consideration for their acquisitions.

One can also summarize the motives of M & A as shown below:

1. Strategic Motive	2.Financial Motive	3.Organizational Motive
• Economies of scale and economies of scope. • Competitive edge. • Increased market share • Penetration into new market and product segment. • Integration (backward and forward integration) • Synergy • Core competence	• Market capitalization • Proper tax planning • Revival of Sick Unit • Creation of shareholder’s wealth • Increase in EPS	• Retention of managerial talent • Removal of Inefficient management • Manager’s hubris • Empire-building • Improvement of quality management

• Diversification and growth • Leverage on resources • Entry or exit from the market • Offset the fluctuations in product life cycle.		

Table 13.2 Motives of M & A

Source: Adopted from Raghunandan,B.V, modified by author.

13.6 DISADVANTAGE OR LIMITATIONS OF M&A

- Merged companies might face certain social and cultural differences among the employees of the two entities which can result major obstacle in working together.
- After the M&A process , employees and staff of the small merging entity sometimes may require exhaustive training and re- skilling .
- In case of integration of two companies, a poorly managed integration with little planning and design can lead to failure of merger process .
- Friction or internal competition may occur among the staff or the employees of the new entity which can lead to difficulty in operating the daily activities of the newly formed entity. There can be conjoint risk of getting surplus employees in one department .
- Merging two companies that are in the same lines of business or have similar activities might lead to replication of some business operations and over capability within the company that may need retrenchments.
- The uncertainty with respect to the approval of the merger by proper assurances.

13.6.1 Reasons For Failure of M&A

- Failure to Integrate properly: Integration of the two entities requires efficient and effective high level management decisions, but if , this process is poorly managed with little planning and design leads to failure of merger process .
- Limited focus : When the merger is carried out with a very limited focus on a single aspect of the business operation i,e financially motivated merger or a tax driven merger can have an adverse effect in the business consequences .

- Insufficient due diligence : Top level officials in the hierarchy are responsible to observe the due diligence in the process, inefficient or improper performance by the officials can have an adverse effect in the merger process, it may give negative results or delay in the process.
- Strategically unfit : The two merging entities having different strategic approach, visions and objectives which will not fit together , may lead to conflict with one another.
- Financial misinformation : improper auditing of the financial details of the target companies, inappropriate assessment of financial and technical competencies, without evaluation of its cost , assets and liabilities before the acquisition might lead to risk of failure of M&A motives.
- Payment of excessive consideration : With the intention to achieve economies of scale and synergies , an excess consideration is paid for the target company, and if the synergies are not realized after the M&A , the premium paid can never be recovered back and thus it can lead to the risk of failure of such M&A
- Incompatibility of the partners and Ego clashes: Sometimes an alliance between two strong companies or two weak companies can have friction in the merger process, and the difference of opinion among the directors and top level officials can lead to ego clashes .
- Diverging from core activity and loss of identity: M&A sometimes result in loss of the identity of the acquiring firms and loss of its major strengths because the firm sometimes gets diverted from its core activities and spent too much time and resources in the new activities and operations while neglects the old activities which are actually their major strength.

Check Your Progress- B

1. **An agreement between two firms to cooperate in pursuit of a joint goal is called a:**
   a) Takeover
   b) Joint venture
   c) Buyout
   d) Strategic alliance.
2. **The positive gains or benefit associated with the combination of two firms through a merger or acquisition is**
   a) Goodwill
   b) Agency problem
   c) Consolidation

   d) Synergy

3. **The merger of two or more firms in the same industry , having the same product line but operating at different stage of the product life cycle is called:**
   a) Synergy
   b) Economies of scale
   c) Vertical merger
   d) Horizontal merger
4. **A large firm can reap the benefit from producing goods in high volume , which is not available to small firm is called:**
   a) Backward integration
   b) Economies of scale
   c) Economies of scope
   d) Acquisition
5. **Following can be a good motive for merger :**
   a) Economies of scale and scope
   b) Complementary resources
   c) Industry consolidation
   d) All the above.

13.7 GLOBAL ALLIANCES

Global alliances have become increasingly popular in international business. Various benefits can be reaped out of these alliances including risk sharing, competitive advantage , leverage resources , to achieve joint strategic goals and synergistic effects of shared knowledge and expertise. In most situations, a well planned business alliances are viable alternatives to M&A. Some examples are : General Motors and Toyota entered into an unprecedented joint venture agreement in 1980, another example is of IBM which announces business alliance worth $30 billion with companies like Cisco and Dell computers.

Common Form of Business Alliances are joint venture, strategic alliances, equity partnership, licensing, franchising alliance and network alliance. Lets understand each form of alliances one by one:

Joint Venture: Joint venture is setup as an new independent/ separate legal entity in which two or more separate companies participate, and the joint venture contract clearly state how the ownership/ control, operational and financial responsibilities, revenues and the risk and returns can be mutually shared by the partners in the joint venture. The most important aspect of joint venture is that it is a contractual agreement and is for short time or for some specific purpose or for a specific project. In joint venture both the management preserves its own corporate identity and has complete autonomy as it is not an acquisition.

Strategic Alliance: Strategic alliance is a contractual agreement between two entities to transfer technology, provide R&D service, and marketing rights. It is different from joint venture as it does not create a separate legal entity and the partners in the alliances do not take any equity positions in one another. The main benefit of strategic alliance is to maximize the return and leverage the resources. Some example: Starbucks partnered with Barnes and Nobles bookstore in1993 to create an ambience of in house coffee shop and both the partners are at a win- win situation.

Equity partnership: It is in same line with the strategic alliance but the major difference is that one party takes the equity stake in the other party .

Licensing: There can be two forms of Licensing , first form involves licensing agreement between two companies , where one giving permission to other for using its product , technology or processes for a specified payment. While other form involves licensing patents, trademark and copyright.

Franchising: it is special business agreement where one company called 'franchiser' authorizes another company 'franchisee' and grants the right to use its brand name, or to sell its product and services, or technical – know how etc in different geographical locations for a certain consideration called licensing fee. Example: Mc Donald's, Subway, Domino's, Dunkin' Donuts**,** etc.

Network Alliance: It is a special agreement where two companies may collaborate in one market but might compete in another. Such Alliances can be seen in multimedia, telecommunication industry etc.

Benefits of Global Alliances

Most often Global alliances encourage the firms to gain easy access into new market, cost reduction, risk aversion, sharing of technological know-how, to overcome strict regulatory framework etc . Some of the advantages are discussed below as:

1. **Ease of market entry**: With the advancement in telecommunications, technology and transportation have helped to remove the barriers in the entry into international markets , and the firms can reap the benefits of both the economies of scale and scope in its operations A firm may enter into a new market by forming a strategic alliance with its partner, to market its product and services through the use of distribution channel and sales force of another firm, which will overcome the difficulties of the high cost of accessing in an altogether new market which is beyond the abilities of a single firm but, by entering into a strategic alliance with an international firm , one can get the advantage of quick entry while managing the cost.
2. **Shared risks**: When a market is new for the firm or there is uncertainty in a particular market, sharing risks is the necessity.. The businesses entering into the new market or launching a new product or developing a new technology can be very risky and expensive for a single firm , therefore strategic alliance is effective way to delimit a firm's risk**.**

3. **Shared knowledge and expertise:** Some firms have their strengths in a particular market segment or have their core competencies in specific functional areas but at the same time lack expertise in other areas. Developing a strategic alliance can be beneficial to such firms as it allows easy access to knowledge, expertise and competitive advantage in that area where the company lacks. The skill, knowledge and expertise that can be in the form of product development, resource acquisition, or dealing with government regulatory framework can be exploited for other projects and purposes also.
4. **Synergy and competitive advantage**: Competition becomes more efficient and effective when the two entities merging or coming together can leverage off each other's strengths and weakness, can bringing synergy and take competitive advantage into the business process, which otherwise would be a difficult task to achieve if a firm attempting to enter a new market or industry alone**.**
5. **Overcoming Strict Regulatory Framework**: Strategic alliance is a beneficial way for companies to enter into new international markets by overcoming political, economic and social barriers. Sometimes stringent government policies and rules, creates an entry barrier for the firms to enter into new international markets. Alliances help to overcome such restrictions by joining forces with other organizations.
6. **Cost Reduction:** Sharing or combining with alliance partner helps in reducing cost through joint operation and mutually beneficial relationship, also helps to gain access to assets like brand name, expertise etc.

Global alliance thus provides a competitive edge to the companies by utilizing the economies of scales and augmentation of resources, to gain new and innovative skill and expertise , knowledge sharing ,also help to reduce internal and external uncertainties in environment, increased performance, productive capacity and increased revenue along with reduced cost.

13.8 SUMMARY

This unit attempts to give an overview of merger and acquisition and the rationale behind global alliance. With the increase in global and domestic competition in the corporate sector, merger and acquisition has become one of the major strategies for corporate restructuring in this current business scenario. The unit further explains about the conceptual framework of M&A, its various forms and the pros and cons associated with M&A. The detailed explanation of global alliances and its various types has been discussed along with its various advantages and disadvantages to the corporate firms.

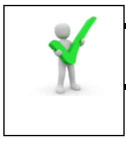
13.9 GLOSSARY

Corporate Restructuring: Reorganizing the structure or to bring about a change in the composition of a firm to make it more profitable and more efficient.

Merger: merger occurs when two or more companies combined to form one company , it can be in the form of amalgamation or absorption.

Amalgamation : Two companies merging together and forming a new company , while the merged companies will go for liquidation.

Absorption: when one firm merged into other, the ‘transferor company’ transfers its assets , liabilities and shares to the ‘transferee company’ which continues to exist while the ‘transferor company’ liquidates itself.



13.10 ANSWER TO CHECK YOUR PROGRESS

Check your Progress-B

Choose the correct alternative:

Answers: 1(d).

2(d).

3(c).

4(b).

5(d)

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13.13 TERMINAL QUESTIONS

Q1. Bring out the difference between ‘Hostile takeover’ and ‘Bailout Takeover’.

Q2. What do you mean by the term ‘Takeover’? What are the different kinds of Takeover?

Q3. Explain in detail the objectives of Merger and Acquisition?

Q4. What are the behind the failure of mergers and Acquisitions?

Q5. Write a note on limitations of M&A? Explain the possible reasons for the companies going for horizontal and vertical merger.

Q6. Write a note on Alliances? What are the common forms of Business Alliances?

Q7. Illustrate the benefits of Business Alliance?

UNIT14 INTERNATIONAL MARKETING STRATEGIES

14.1 INTRODUCTION

International Marketing is characterized as the way toward modifying the marketing strategies of your organization to adjust to the states of different nations. Obviously, International Marketing is more than offering your item or service. It is the full strategy of planning, innovating, marketing promoting the items in a worldwide market.

Enormous organizations normally have workplaces abroad for nations they market to. As of now, with the expansion of the web, even private companies can reach the customers anyplace on the planet. In case a business picks not to broaden globally, it can confront competition from domestic players from organizations that are expanding their universal presence. The presence of this opposition nearly makes it a prerequisite for some, organizations to have a worldwide presence.

Global Marketing has numerous benefits, when it is conducted nicely.

- First, it can enhance the viability of your item or service. This is because of the more you develop, the learning that takes place is also more, and the speed of learning also increases, you turn out to be more powerful at creating new item or service offerings.
- Second, you can have a solid upper hand. It is sufficiently simple for organizations to contend in the nearby market. In any case, there are not very many organizations who can do as such on the overall field. Thus, in case you can contend in the overall market and your rivals can't, you have turned into a solid power in your industry.
- Third, you increment awareness of the consumer towards your brand and service or items. Through the web, customers can monitor your worldwide progress.
- Finally, Global Marketing can decrease your expenses and increment your investment funds. While concentrating on different markets, economies of scale can be achieved by institutionalizing your strategy – also the reserve funds that you get when you use the web!

14.2 OBJECTIVES

From this unit, you will be able to ;

- understand about global marketing strategies.
- know sample global marketing strategies.
- learn about Global Market Entry Strategies.

14.3 GLOBAL MARKETING STRATEGIES

The most critical parts of worldwide strategy is the Global Marketing Strategies of any company. With a specific end goal to make a decent worldwide advertising strategy, you should have the capacity to reply to the below mentioned issues:

- ‘What I am attempting to accomplish in a universal market?’
- ‘What are my organization's qualities and shortcomings for that market?’
- ‘How might I counter difficulties in this market?’
- ‘What potential will I have in this market?’

Besides, a great Global Marketing strategy joins every one of the nations from all regions of the earth and manages their marketing endeavours in like manner. Obviously, this strategy does not generally cover every one of the nations but rather ought to be connected for specific regions.

Past its breakdown per nation or area, a Global Marketing strategy quite often comprises of a few things: (1) same brand names; (2) similar packaging; (3) product similarity; (4) standard publicizing messages; (5) synchronized points of pricing; (6) facilitated launching of products; and (7) amicable deals campaigns.

All in all, these two are the most understood International Marketing strategies utilized by organizations extending globally:

- Create a reliable and solid brand culture. Making a solid and reliable brand that dependably appears to be common place to clients is a need for organizations developing globally. With the always rising and growing web, brand structure has turned out to be even more like a brand culture. To be exact, it has ended up being more common these days that the brand you bolster mirrors your way of life. It can be harming in case you trade off your image culture.

- Market as though there were no fringes. Because of the expansion of computerized platforms, brands can't generally receive diverse strategies per nation. As it were, because of the web, organizations need to embrace an advertising approach.

14.4 GLOBAL MARKETING CAMPAIGN DEVELOPMENT

To build up your crusade comprehensively, there are a couple of things you should remember. You need to know the market, you need to make an advertising plan, you should tailor fit your way to deal with advertising, and you ought to limit your correspondences.

Knowing the Market

When your organization chooses to expand your marketing and advertising around the world, you need to comprehend the setting of where you will work. Each locale has different practices and standards as it manages marketing messages; how individuals might want to be reached; and what is fitting for that place, and so forth.

You have to guarantee that you investigate how the market will react to the promotion methodology you have, so you can get much use from your new market.

Developing a Marketing Plan

Getting to be effective worldwide isn't only adjusting your dialect. You need to influence your Global Marketing to design reliable with your neighborhood endeavors. However, despite everything it should be modified, as indicated by your local learning. When you understand the worldwide condition, draft a marketing plan that points of interest your activities.

In the first place, recognize your destinations and objectives. When that has been built up, draw a guide that covers the general strategy and strategies to accomplish those targets.

Customizing Your Approach

Something that works for somebody may not work for everybody. So many things that applies to domestic customers may not be interpreted in the same manner by the foreign customers. Attempt to adjust your drives to your group of onlookers, giving them a tailor fit affair. Unquestionably, what works for one nation may not work for another.

Communications to be localized

It isn't just applicable to know the dialect and social obstacles and altering your correspondences for each market, it is likewise basic to know all the social references and significant occasions and occasions. You must make a more customized involvement.

In any case, make a point not to commit global advertising errors while translating the message of your brand.

14.5 GLOBAL MARKETING ISSUES AND MISTAKES

Organizations, particularly their marketing groups, regularly confront the accompanying issues and oversights while growing around the world. These can move toward becoming obstacles in making universal progress.

Standardization of Products

An institutionalized product strategy is the point at which your business chooses to deliver and advertise a similar essential product in all business sectors. This methodology has economies of scale benefits, for what it's worth significantly less costly to outline one product and mass create it to take care of worldwide demand. Institutionalization is at its best if the product has similar uses and advantages in every nation or culture. Powerlessness to separate to meet diverse uses or inclinations is a test with institutionalization, particularly if the product has different uses in different markets.

Customization of products

Customization as a worldwide product strategy implies that you offer item varieties or altered forms of your product in every nation or market. A straightforward case of this is when films are given subtitles or named voice-overs in business sectors with various dialects. In different cases, certain highlights or attributes of product are modified to coordinate the necessities or wants of clients in a given market.

Promoting globally

Global promoting strategy is the point at which your organization displays a similar fundamental message of brand or product far and wide. This approach ties intimately with the institutionalized product strategy. The general thought is to give a widespread product benefits that apply to clients in each focused on commercial center. Leverage of a globalized methodology is consistency, in that clients in each market can relate to your brands as they venture to the far corners of the planet. While the organization designs menus and messages in a few cases, McDonald's has profited from a reliable sense of duty regarding its worldwide message of effective, family-accommodating fast food.

Promoting internationally

International promotional strategy is when special messages shift starting with one nation then onto the next or where crusades are custom fitted to various locales. This system is utilized with either the standard products or products which are customized. With an institutionalized item that has diverse utilizations, varieties in promoting venture distinctive advantages or incentives considering the utilizations in each market. With customized product strategy, advancements are custom-made to underscore the estimation of the different products that are offered in each market. This can create more grounded dependability in business sectors where brands are seen in an unexpected way, however the expenses are generally more noteworthy with customized promotion strategy.

Non-Specification of Countries

Numerous businesspersons for the most part consider offshore markets ambiguously as if they need to move to Asia or they need to expand their development by offering their items to Europe. It is hazardous to take things too basically. Buyers dependably distinguish themselves at the nearby level and advertising groups need to recollect that each country has its own standards, laws, installment writes, and specific business hones.

By being in the beginning, organizations can organize the markets they need to get into, create a recruitment plan, and allot the financial plan. These are extremely critical for achieving the worldwide goals of a business.

Internal Information is not the focus

You need to direct specific and complex statistical surveying when you will make a worldwide strategy to enter any market. One should think through the potential open door in the market, how simple or then again hard it would be for your business to work in that market, and how productive you starting at now are in the market.

There are a ton of organizations that focused on outside information to help their basic leadership, as depicted previously. Regardless, you can basically utilize your own internal data to get the information, on whether there is a solid fit between your item or benefit and the market. Keep in mind that information from outsiders don't comprehend your organization or even know your purchaser. Just you have the best contribution on this.

Absence of Dynamic Sales and Marketing Channels

Most of the organizations in West believe that they can enter new markets by doing likewise things that brought them achievement locally.

As earlier said, it is essential to have brand consistency; however contrasting markets might want specific marketing approaches. Besides, advertisers need to consider that they should showcase their products at which channels, considering market conduct.

For example, for Brazil, marketing efforts are more effective through Facebook because of its prominence there. Be that as it may, in Latin America, you can attract a greater gathering of people through Twitter. Thus, one has to figure out that amongst all channels, which one gives the best outcomes through statistical surveying.

Absence of Modification of Product Offerings

Business can simply accomplish a fit between their items and the market. In any case, as a rule, organizations endeavor to dispatch similar products in different markets. Fundamentally, they are overlooking that they are connecting with different customers in different markets.

For example, if a tech organization offers a comparable product abroad that it offers locally and if the new clients don't have the foggiest idea about the propelled highlights of the product, the association could be in a bad position. Then again, the organization should start with the fundamental variant.

On a similar note, a market that is further developed may require extra features than what the product as of now has.

Non-Usage of Local suggestions

Maybe one of the standard errors organizations make in worldwide advertising is neglecting to think about the contribution of solid and capable representatives in their foreign markets, particularly while making important decisions.

These people are huge claiming they know their nation and your organization. Since one of the greatest issues organizations confront while including domestic market input is correspondence, the marketing group must have a framework that ensures that domestic viewpoints are assembled and circulated frequently.

Absence of Knowledge on Global Logistics

Advertisers frequently make utilization of programming that enables them to distribute site content, send email, publish messages via web-based networking media, and conduct other marketing related exercises. In any case, these initiatives do not necessarily bolster each market.

Advertisers need to guarantee that they could advertise to clients in the nations they are entering. They ought to think about how to show the domestic money, how to email customers specifically time zones, and how to help the dialects of the shoppers.

14.6SAMPLE INTERNATIONAL MARKETING STRATEGIES

Push– pull strategy

In the Pull system, production starts upon stock achieving a specific level, while in the push system, productions start based on the demand patterns – whether actual or forecasted. The CONWIP is a mix of the push and pull system.

Push and Pull system is widely used in logistics, marketing, supply chain management and is also widely used in the hotel industry. Wal-Mart is a case of an organization that uses the push versus pull strategy.

Push: As expressed by Bonney et al. (1999) data flow control and the flow of the goods is in the same direction.

Semi push or Push-pull: The request for preceding hub is made by succeeding hub. Preceding hub responds by recharging from stock that is replenished after every period. There are a few levels of semi-pull frameworks as a hub can have stock at a few layers in an organization.

Pull: Succeeding hub makes request for preceding hub. Preceding hub responds by delivering the order, which includes every single inward task, and replenished them when wrapped up.

Data flow

With a push-based store network, items are thrust into the channel, right to the retailer from the factory. The producer sets creation at a level as per historical pattern of the orders from retailers. It takes more time for a push-based inventory network to react to changes sought after, which can bring about overloading or bottlenecks and deferrals (the bullwhip impact), unsatisfactory service levels and the fact that the product can become obsolete.

In a pull system, acquisition, creation and dissemination are request driven as opposed to forecast. Be that as it may, a pull strategy does not generally need make-to-order production. Toyota Motors Manufacturing is regularly utilized for instance of pull system, yet don't commonly produce to order. They maintain a constrained stock and is recharged as it is devoured. For Toyota's situation, Kanban cards are utilized to flag the need to renew stock.

Supply chain management is quite often a mix of both push and force, where the interface between the push-based stages and the pull-based stages is to a great extent known as the push-pull limit. However, due to the unobtrusive distinction between pull and built-to-order manufacturing, a more exact name for this might be the decoupling point. A case of this is Dell's made-to-order store network. Stock levels of individual parts are controlled by gauging general request, however last get together is considering a client's demand. The decoupling point would be toward the start of the sequential construction system.

- Applied to that fragment of the stock network where request vulnerability is generally little
- Production and appropriation choices depend on long haul gauges
- Based on past requests got from retailer's distribution center (may prompt bullwhip impact)
- Inability to take care of changing demand designs
- Large and variable generation clusters
- Unacceptable service levels
- Excessive inventories because of the requirement for substantial wellbeing stocks
- Less use on promoting than Pull strategy

The buyer asks for the item and drags it through the conveyance channel in a Marketing Pull framework. A case of this is the auto producing organization Ford Australia. Ford Australia just delivers autos when they have been requested by clients.

- Applied to that part of the production network where request vulnerability is high
- Production and appropriation are request driven
- No stock, reaction to orders

- Point of Sale (POS) information comes is useful when imparted to store network accomplices
- Decrease in lead time
- Difficult to actualize

Utilization of push, pull and mixed push-pull strategy

Harrison condensed when to utilize every one of the three production network strategies:

- A push-based store network strategy is generally proposed for items with low request vulnerability, as the estimate will give a decent sign of what to create and keep in stock, and furthermore for items with high significance of economies of scale in diminishing expenses.

- A pull-based inventory network strategy, as a rule proposed for items with popularity vulnerability and with low significance of economies of scales, which implies, accumulation does not decrease cost, and henceforth, the firm would deal with the store network in view of acknowledged request.

- A mixed push– pull system, normally recommended for items which vulnerability sought after is huge, the economies of scale are vital in diminishing creation and conveyance costs. A case of this system is the furniture business, where generation strategy needs to take after a force-based strategy, since it is difficult to settle on creation choices considering long haul conjectures. Be that as it may, the dispersion strategy needs to exploit economies of scale with a specific end goal to diminish transportation cost, utilizing a push-based strategy.

International Trade Fairs

A trade fair (public exhibition or expo) is a display sorted out so organizations in a industry would showcase be able to and exhibit their most recent items and services, meet with industry accomplices and clients, think about exercises of adversaries, and inspect late market patterns and openings. As against consumer fairs, just some trade fairs are available to the general population and others are aimed at organization delegates (individuals from the exchange, e.g. experts) and individuals from the press. A couple of fairs are crossovers of the two; one case is the Frankfurt Book Fair, which is exchange just for its first three days and then opens up to the overall population on its last two days. They are hung on a proceeding with premise in for all intents and purposes all business sectors and regularly pull in organizations from around the world. For instance, in the U.S., there are at present more than 10,000 exchange demonstrates held each year, and a few online indexes have been built up to help coordinators, participants, and advertisers recognize fitting occasions.

Current trade fairs follow in the custom of trade fairs set up in Europe during medieval times, in the period of dealer free enterprise. In this time, producers went by towns for trading fairs, to offer and feature items. From the late eighteenth century, mechanical presentations in Europe and North America turned out to be more typical mirroring the innovative dynamism of the Industrial Revolution.

In the late nineteenth century, the idea of yearly broad exchange demonstrates picked up footing, spreading from European assembling focuses to North America. By the twentieth century, specific organizations appeared just to deal with the expo business, and lasting public expo grounds or tradition focuses were built up as scenes that included a pivoting calendar of expos.

With the quick industrialization of Asia, in the 21^{st} century, expos and displays are presently ordinary all through the Asian mainland, with China commanding the presentations business in Asia, representing more than 55 for every penny for every space sold in the area in 2011.

Trade fairs regularly include an extensive promoting speculation by partaking organizations. Expenses incorporate space rental, stall outline and development of public expo showcases, media communications and systems service, travel, lodging, and special writing and things to provide for participants. What's more, costs are brought about at the show for services, for example, electrical, corner cleaning, web services, and drayage (otherwise called material taking care of). Arrangement and follow-up require impressive time that likewise must be invested.

With four in each five-public exhibition guest being a planned customer, organizations allot a huge spending plan to taking an interest in such occasions. Innovative headways have conveyed visual computerization and advanced presentations to the bleeding edge. Expenses may likewise incorporate fun exercises and amusements to pull in guests and increment mark review after the finish of the event.

Exhibitors going to the occasion are required to utilize an exhibitor manual or online exhibitor manual to arrange their required services and finish any vital printed material, for example, wellbeing and security assertions. They are expanding in prevalence because of their moderately minimal effort and claiming there is no compelling reason to movement whether you are going to or displaying.

Check Your Progress- A

Choose the correct alternative

Q1. The different benefits of global marketing are:

a) It can enhance the viability of your item or service

b) You can have a solid upper hand

c) You increment awareness of the consumer towards your brand and service or items

d) Global Marketing can decrease your expenses and increment your investment funds

e) All of the above

Q2. The mix of Pull and Push system is;

a) CONWIP

b) COWWIP

c) COMWIP

d) COSWIP

Q3. Global Marketing Development campaign involves;

a) Knowing the market

b) Developing the Marketing plan

c) Customizing your Approach

d) Communications to be localized

e) All of the above

Q4. Succeeding hub makes request for preceding hub is a feature of;

a) Push strategy

b) Pull strategy

c) Semi Pull strategy

d) Semi Push strategy

Q5. Which of the following is a global market entry strategy?

a) Direct export

b) Franchisee

c) Joint Ventures

d) Acquisition

e) All of the above

14.7 GLOBAL MARKET ENTRY STRATEGIES

There is an assortment of manners by which an organization can enter a remote market. A single marketing strategy does not work for every market. Direct exports might be the most fitting methodology in one market while in another you may need to set up a joint meander and in another you may well allow your assembling. There will be various components that will affect your choice of strategy, including, however not restricted to, duty rates, the level of adjustment of your item required, promoting and transportation costs. While these variables may well build your costs, it is normal, and the expansion will offset these costs. The different strategies are the principle section choices open to you.

Direct Exports

Exporting directly is offering straightforwardly in the market one has picked using as a part of the primary case you possess assets. Numerous organizations, once they have built up a business program swing to operators as well as merchants to speak to them promote in that market. Specialists and merchants work personally with you in addressing your interests. They turn into the substance of your organization and subsequently they become critical that your selection of operators and wholesalers is taken care of essentially you would get a key staff person.

Authorizing

Authorizing is a moderately refined course of action where a firm exchanges the rights to the usage of a thing or administration to another firm. It is an especially helpful strategy if the buyer of the permit has a generally huge piece of the pie in the market you wish to target for entering. Licenses could be used for promotions.

Franchisee channel

Franchise is a normal North American process for quick market extension, yet it is picking up footing in various regions of the world. Diversifying capacities outstandingly for firms that have a repeatable game plan (e.g. sustenance outlets) that can be effectively moved into different markets. Two provisos are required while considering using the foundation illustrate. The first is that your strategy should either be uncommonly unique or have strong brand affirmation that can be utilized globally, and you might make your future rivalry in your franchisee.

Banding together

Banding together is just about a need when entering outside business sectors and in a few regions around the world, such as Asia, it might be required. Collaborating can take an assortment of structures from a straightforward co-promoting plan to a refined key partnership for assembling. Banding together is an especially helpful strategy in those business sectors where the lifestyle, both business and social, is substantively not exactly equivalent to your own as nearby accomplices bring neighborhood advertise information, contacts and if picked carefully clients.

Joint Ventures

Joint endeavors are a specific type of organization that includes the making of a third autonomously oversaw organization. It is the strategy wherein two organizations come together to gain a multi fold advantage. Two organizations consent to cooperate in a specific demonstration, either geographic or product demonstration, and make a third organization to attempt this. Dangers and benefits are regularly shared similarly. The best case of a joint venture is the cell phone by Sony/Ericsson.

Purchasing a Company

In a few markets purchasing a current nearby organization might be the most proper strategy to enter a market. This might be claiming the organization has considerable piece of the pie, are an immediate contender to you or in view of government bearings this is the fundamental decision for your firm to enter the market. It is surely the most exorbitant and deciding the genuine estimation of a firm in an outside market will require significant due persistence. Notwithstanding side this entry methodology will right away give you the status of being an area association and you will get the upsides of nearby market information, a set up client base and the government of that area will deal with you as a local firm.

Piggybacking

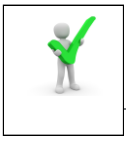
A very interesting method for entering the universal field is through Piggybacking. If you have an especially fascinating product or service that you could pitch to expansive household firms that are as of now associated with remote markets, you might need to figure out and check whether your company's service or product can be consolidated into their stock for worldwide markets. This lessens your hazard and expenses since you are basically offering locally, and the bigger firm is showcasing your product or service for you globally.

Turnkey Projects

Turnkey ventures are specific to organizations that give services, for example, natural counseling, design, renovations and building. A turnkey venture is the spot the workplace is created beginning from the most punctual stage swung over to the client arranged to go - turn the key and the plant is operational. This is a not too bad technique to enter remote markets as the client is regularly a service and frequently the task is being financed by a global money related organization, for instance, the World Bank so the peril of not being paid is cleared out.

Greenfield Investments

Association plays a major role in universal business while making Greenfield Investments. A Greenfield venture is when you buy the land, construct the office and work the business on a progressing premise in a far-off market. It is decidedly the most extravagant and holds the most dumbfounding threat anyway a couple of markets may anticipate that you should embrace the cost and hazard because of government controls, transportation costs, and the capacity to get to innovation or talented work.



Check Your Progress- B

Check Your Progress –B

Q1. Explain the various benefits of Global Marketing.

Q2. Discuss the different stages in Global Marketing Campaign Development.

Q3. Explain the push-pull strategy with the help of an example.

14.8 GLOBAL MARKETING EXAMPLES

If you are looking for motivation on the most proficient method to advertise your organization effectively in the global field, look at these cases from surely understood organizations.

Airbnb

Airbnb is for individuals who book and rundown facilities everywhere throughout the world. For the most part, it is a group commercial center that has in excess of a million postings more than 34,000 urban areas on the planet. Airbnb turned out to be extremely fruitful all-inclusive considering web-based social networking.

This social analysis had Airbnb requesting that its group do irregular demonstrations of accommodation for individuals they didn't know and take a photo or video with them and offer by making utilization of the hashtag. In just 3 weeks after the battle was propelled, more than 3 million individuals made substance, drew in, or discussed the crusade.

Coca-Cola

Coca-Cola being a major organization focuses on programs in little groups and gives a lot of money to philanthropic activities. For example, Coco-Cola fabricated 650 clean water establishments in Egypt and supported dinners (Ramadan) for youngsters in the Middle East. In addition, the brand runs with a feeling that everybody knows — bliss.

Domino's

Domino's positioned its menu development in the front line to build its universal mindfulness and intrigue. They have reliable things for the pizza in all business sectors like their sauce, bread, etc., where it works anyplace. They simply refresh the fixings for each market.

McDonald's

McDonald's keeps its menu steady, but they do try and give some nearby flavor to specific menu items. McArabia was launched in the Middle East by McDonald's. McArabia is a flatbread sandwich. It additionally acquainted France with its macaroons and incorporated the McSpaghetti in the Philippines.

14.9 SUMMARY

In this unit you learnt about organizations developing towards International Marketing are very progressive. The main stage has the organization focusing on the local side, with its exercises concentrated on their domestic turf. The second stage has the organization yet cantering locally but tries to cater to export market as well. By the third stage, the organization has understood that they must adjust their marketing focussed towards foreign markets. The fixation moves from multinational. Subsequently, adaption has turned out to be urgent. The last stage, i.e. the fourth stage, has the organization creating value when it stretches out its projects and items to serve overall markets. Unquestionably, there are no unequivocal eras to this evolution strategy. In this unit, you learnt importance of global marketing and you also came to extend you learning with the few examples of proficient method to advertise your organization effectively in the global field.

14.10 GLOSSARY

Customisation: Customization as a worldwide product strategy implies that you offer item varieties or altered forms of your product in every nation or market.
Push– pull strategy: In the Pull system, production starts upon stock achieving a specific level, while in the push system, productions start based on the demand patterns – whether actual or forecasted.
Data flow: With a push-based store network, items are thrust into the channel, right to the retailer from the factory.
Greenfield Venture: A greenfield venture is when you buy the land, construct the office and work the business on a progressing premise in a far-off market.

Turnkey Projects: Turnkey ventures are specific to organizations that give services, for example, natural counseling, design, renovations and building.

14.11ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress- A

Answer: 1. e

2. a

3. e

4. c

5. e

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14.14 TERMINAL QUESTIONS

Q1. Discuss the challenges faced by a company while implementing global marketing strategies in a local market.

Q2. Elaborate the different problems faced by a company while entering any new market.

Q3. Discuss, any two, global marketing strategies that have evolved in the last ten years.

Q4. Differentiate between the Push and Pull strategy of Marketing.

Q5. Discuss the different factors on which the Global Marketing strategies of a company depends on.

UNIT 15 INTERNATIONAL HUMAN RESOURCE MANAGEMENT AND STRATEGIES

15.1 INTRODUCTION

With the advancement in technology, the world has become a global village. It is quite common to hear from people about their visit to some foreign country on some assignment. They may have gone for a short period, medium period or long period too. The travels have become easy and financially viable these days. Since India is providing workforce globally and lot of companies have come to India, we need to understand the challenges involved in managing workforce from this perspective. In this unit, you will study about the different typrs of organizations based on the operations and the challenges faced from different HR functions domestic and international context.

15.2 OBJECTIVES

After reading this unit, you will be able to:

- Understand types of organizations involved in international business.
- Understand the external factors affecting human resource needs in international context.

- Differentiate between domestic and international aspects of Human Resource Management.
- Discuss the recruitment process for companies in international operations
- Identify crucial training needs for employees involved internationally.
- Discuss the problems in performance appraisals in host country.
- Understand challenges related to compensation in international employment

15.3 TYPES OF ORGANIZATIONS

The companies doing international business can be characterized into four types based on the way operations are done.

International corporation: These are basically local firms that have developed their capacity to explore business in other countries. For example, Honda, General Electric, and Procter & Gamble were the companies of this nature. They increased their production capacity in their country to meet needs of other countries and made profit out of this.

Multinational Corporation (MNC): It is a type of organization where the company establishes independent units in other countries. For example, Shell, Philips, and ITT are those MNC's which developed their units overseas to take care of problems in the host countries.

Global Corporation: It is similar to the multinational corporation, except for the fact that the all operational control is maintained in the home country. For example**,** Matsushita and NEC in Japan, bring together all global operations together to show its profitability in Japanese economy.

Transnational Corporation: These companies are similar to global corporations but behave like local companies in the countries of operation. For example, Ford, Unilever, and HSBC have tried to bring local ways of doing business and modifications in products and services according to the local markets.

15.4 EXTERNAL ENVIRONMENT AND IHRM

We are living in a world where we can choose the country where we want to do business. Else we may just start operating globally with no particular company in mind. The challenge the companies come across is relocation of their employees and countries that are safe to do business. The factors that can affect the business operations can be broadly stated as below:

a. Economic factors
b. Political-legal factors
c. Cultural factors

When India was rated higher on, 'Ease of Doing Business', we started expecting more companies coming to India for business. Similarly, who would like to start business in countries where per capita income, i.e. affordability is low. In many of the African countries, the property rights are not protected. Depending on the authority one has, the properties can be acquired. Likewise, in disturbed areas like Syria, Combodia or North Korea, we cannot guarantee the safety of our employees nor business. Intellectual property rights are also not secured in many countries hence any such service or product would be a big failure in such countries.

As we observe that as different parties come to power in India, there are many changes in the way business is done. The support from the government depends on the political stability in our country. Hence the ratings for investments go up or go down based on stable government and its policies. Environmental restrictions can also affect business scenario of the countries. The countries who are struggling economically do not have restrictions related to pollution, child labour etc.

A country's acceptability of different cultures is also an important factor affecting the HR issues. Acceptance of different languages, religious practices and beliefs of different countries affect success of business in those countries. We find a lot of call centers in India getting a lot of projects from companies in English speaking countries. By understanding a different way of life, new business opportunities can be explored. In many countries, you do not have a night shift, while in some they will provide transport for the same. In India, all BPO's and KPO's like Genpact, Deutche Bank, Teleperformance, etc are providing cab facility and incentives for night shifts. Understanding culture of host countries is necessary to manage all issues related to employees in those countries.

15.5 HRM IN DOMESTIC AND INTERNATIONAL COMPANIES

Globalization in business world has been much faster in the recent years. International issues related to HRM are different from domestic issues in terms of context. Since people are open to locations globally, the challenges related to relocation, adaptation to new environment including culture, climate and language are more common.

Such international operations involve full time HR professionals dealing with the globalization process. Even HR policies for day to day operation may have to vary due to political-legal conditions of the host country.

British Airways, manages an HR team, who keep on travelling to manage issues in different countries of operation. They need to be updated on international economic situation and threats or opportunities from any region. Coca-Cola also keeps an HR team round the clock. They are supposed to support employees working around the world. At the Head Office of Atlanta, trainings are held every year for two weeks bi-annually. Thus the HR staff get a platform to discuss their problems and achievements and at the same time resolve problems from other countries. At times people from one country move to another to boost productivity of the companies.

Since doing business across borders can be complex, companies like Cendant Mobility, Boston Global Consulting, etc. are specialising in some services. They provide help to people on international assignment to relocate new house and other related services.

At times, a minor cultural issue can cause a major hurdle to setting up a simple HR information system. Lucent Technologies launched its PeopleSoft system in more than 90 countries, it was found that entering names of employees from different countries in similar pattern was very difficult. It took them two months to settle out the issues. In domestic HRM, we do not come across such issues.

Check Your Progress-A

Q1. List the types of international organization based on operation?

Q2. How does external environment affect the International HRM?

Q3. Fill in the Blanks with appropriate word or words.

a) With the advancement in technology, the world has become a ………village.

b) The companies doing international business can be characterized into …… types based on the way operations are done.
c) A country's acceptability of different …………is also an important factor affecting the HR issues
d) Since people are open to locations globally, the challenges related to …………, adaptation to new …………. including culture, climate and language are more common.

15.6 CHALLENGES IN HR FUNCTIONS IN INTERNATIONAL OPERATIONS

Staffing

As in domestic operations, HR managers are responsible for ensuring staffing in all countries.

There are three ways in which staffing for international operations takes place. First it can send its own country nationals also known as expatriates or home-country nationals to other countries of operation. Second way is to hire local people of the country where operations are established, also termed host-country nationals. Third way is to hire a national of some other country and post them in the country of operations, also known as third-country nationals. The third-country employees are neither from home-country nor host-country. All these methods have their own merits and demerits. Usually the companies use all the three ways while staffing for international operations.

In the initial years of business, it is logical to send people from own country to establish business in host countries. But this turns out to be very expensive as relocation expenses to up and employees also suffer from home sickness. Coming back frequently from foreign countries is not possible. Gradually the host country nationals are trained into the job and standards required and major part of operations is managed by them. Hiring the locals is a strategy used at this stage. For expertise of labour required, the companies then plan for transnational employees.

In the recent past, short term project based assignments have been observed. Companies send expatriates for short term, from two months to three years, till the host country nationals are hired for the desired profile. Usually, hiring locals is less expensive, they understand their culture and legal requirements and the customers want to deal with locals who speak their language. Transnational employees understand culture and language of more than two countries and require less training. The local governments of host country also put pressures on the international firms related to local hiring, tax and quotas.

International Recruitment

With the advancement in technology, online communication has become more comfortable as an employer. Besides overseas travel has also become cheaper. Interestingly, most of the employees of a company called Dell, are working outside USA. The head quarter of Rolls Royce is in UK and has more than 5000 employees working outside UK. China with its one child policy had different kind of labour shortage. HR managers need to be careful about political, economic, legal and cultural aspects in both domestic and international framework while recruiting internationally. Almost all countries have restrictions related to number of people from other countries as compared to total workforce. While recruiting, companies have to understand the norms related to work permit or visa issue to an employee. The inability to procure visa soon, may result into not hiring a talented employee.

Selection process

The selection processes vary across the globe. It may be the best qualified person or a person with best referral based on origin and language depending on the country. Equal opportunity laws are being enforced across the globe and discrimination on the basis of caste, religion, race, gender and language needs to be avoided. Labour unions can also affect the selection process.

Levi Strauss has listed six skill categories for a manager in international context as follows:

- Can identify strategic opportunities
- Can work with decentralized companies
- Knowing international issues
- Understands and manage diversity issues
- Ability of go along with others
- Ability to develop communal harmony

Not just a best candidate, when an individual applies for a foreign posting of work or expatriation, their interest should be matched with their capacity to manage cultural differences. Besides, if local or host country nationals are technically qualified for the job, they should be considered first before sending expatriates.

The following steps can help in selection process of right individuals for foreign assignment:

1) Introspection: The employees should introspect on their own career goals and interest in international assignment. Just jumping on the assignments because at times they are

lucrative may be dangerous for individual as well as the company. The individuals should keep in consideration that their families may also need to move and take them in confidence. At times, the expatriate wants to come back because of family reasons within a short time period. Deloitte & Touche ask their employees to administer self-selection instruments. This helps in understanding the advantages and disadvantages of taking up foreign assignment. Some companies ask their employees to administer these tests to their spouses also.

2) Create talent pool: Once we have a set of employees ready for foreign assignments, a pool of such employees is created on HR information systems.

3) Skill information: From this pool, the technical skills need to be graded for different kinds of assignments.

Training & Development

All companies look for right skilled employee at the right place. Though it is easier said than done. In spite of all good selection tools, employees do need training. Sometimes it is for basic job and at times for updating them on newer practices or tools of job. It is wrong to assume that people are the same in all countries. It is crucial to understand how negotiation takes place when you are dealing with Chines/ Japanese/ Americans / Germans or any other country citizens. Dealing with people is the biggest challenge in multi-national companies. Motorola conducts intensive training at all centers worldwide through Motorola University, which is an educational arm of the company. All the employees receive 40 hours of yearly training be effective as, “Motorola People”.

In weaker economies, host country nationals look forward to these training programs to be able to achieve company’s standard and so it attracts good employees for the job. Some organizations like World Bank and ExxonMobil are collaborating with executive programs of universities to provide a customized training for expatriates and foreign employees.

The major cause of dissatisfaction of employees on assignments in other countries has been inadequate or no training provided. People visiting abroad for job need to know the country, its culture, values and beliefs along with the understanding of one’s own organization. The employee has a challenge of coordinating own needs and organization’s needs in a setup of a foreign country. A lot of information is available through internet, books lectures, videos etc.

However, basic training needs for an international employee are language training, cultural training, work life balance and finally repatriation. The candidates aspiring to be part of global team should aim at learning the language of the region or country they look forward to join. The China Europe International Business School (CEIBS), co-founded in 1994 by the European Union & Chinese government offers training in different languages. Some companies have their own center for language training. Fortunately for Indians, English is like the second language across the country and they are versatile enough to pick up another language very fast. Hence Indian immigrants are present across the globe.

Cross cultural issues are the most difficult aspects of international business. While to a Brazilian, an American is serious, structured and in hurry, they are viewed as relaxed, impulsive and extrovert by Japanese. Studying cultural aspects will help managers understand their workforce better. Relatively, Japanese are more loyal to their company as compared to Americans. While Japanese focus on team based performance, Americans believe in individual performance. Another aspect is leadership in international context, where employee participation in decision making may be acceptable in one country and may be seen as poor leadership in another country.

Repatriation

Repatriation is coming back of home country nationals after their assignments in other countries. Many companies like Monsanto, 3M, EDS, and Verizon have developed orientation plans for helping people settle down, once they are back to their own country. At times, it is equally difficult to settle back in your own country. ExxonMobil tells its expatriates, as to what they can expect once they are back from their international assignments in advance.

Several studies have indicated that companies do not have an effective repatriation plan and some of the findings were:

1. About 30% of the companies had some form of repatriation plan.

2. Another 30% think of repatriation plan when hardly two months are left in assignment.

3. The remaining 40% had no plans related to repatriation of their employees, who were in for a surprise when they come back.

When the employees come back, they at times had experienced running international operation independently and at home branch they are involved in job where their experience is of no use. Some of their colleagues must have moved on to other operations and companies and for them it is like moving to a new organization back. The companies with repatriation plans introduce the expatriates to the ones who have successfully completed their international assignments. This also helps in providing better training of self and their families too. Retaining employees after repatriation is difficult for the companies and about 50% leave the organization within two years.

Compensation:

Compensation is one major motivator for an employee to take up an international assignment. Whether financial or non-financial returns, different companies follow different norms. In individualistic cultures, pay plans are based on individual performance and expatriates demand more than their counterparts in home countries. In cultures like Japan and Taiwan team based work is followed. Usually here, pay plans are based on internal equity. Pay of host country employee is usually based on output or time spent on the job or both. In countries like Japan, a senior person is paid more with less importance of real output. In host countries, the usual pay plan is slightly higher than those of local companies. This is to make sure that good talent finds it lucrative to join the multi-national company.

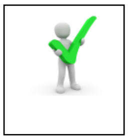
Employee benefits also vary a lot from one country to another. In France benefits range to about 70% while in USA it is 40%. Paid vacations of 25 days is applicable in UK, France and Netherlands, as compared to 10 days in USA and 30 in Sweden and Austria. If the international assignment has to be attractive, compensation plan of expatriate should be competitive and easy to understand and administer. To optimize the output, compensation package for international jobs should:

1. Incentivize leaving home country.
2. Provide measures to maintain at least current standard of living
3. Make security provisions for self and family in case of disturbed regions.
4. Provide medical care for self and family.
5. Help in filing taxes in domestic and international context.
6. Provide trips back home with family and allow communication with relatives.
7. Facilitate repatriation

While for short term assignments, usually per day compensation is provided wherein the expatriates can stay in hotel or service apartments. For long term assignments there is a need to balance pay in home country and pay in host country for the same job, adjusting to cost of living expenses in another country. In home based pay comparison is mad with the compensation at home country while in host based pay comparison is made with the pay package of locals in that country.

Performance Appraisal

We notice that an employee is motivated to take up international assignments to learn new skills, prove one's capacity and lucrative compensation. Usually an expatriate has allegiances to two or more countries, in home country and in host country. The appraisal system in one can be counter-productive in another. The American style of appraisal is individualistic while in countries like China and Japan it is team based. Hence at times performance appraisal issues can be demotivating to expatriates. Similar issues are seen when an employee goes for 6 months to another country and spends the rest of 6 months in home country. Due to different appraisal systems, the overall appraisal may be below satisfaction. Hence appraisal system should take into account performance in home country as well as host country.



Check Your Progress- B

Q1. What are the three ways while staffing for international operations?

Q2. What are the steps that can help in selection process of right individuals for foreign assignment?

Q3. What are the basic training needs for an international employee?

Q3. Fill in the Blanks with appropriate word or words.

a) …………… is coming back of home country nationals after their assignments in other countries.

b) Compensation is one major ………… for an employee to take up an international assignment.

c) To be effective, an international compensation program must ………….. leaving home country.

d) Performance appraisal system should take into account …………… in home country as well as host country

15.7 SUMMARY

There are four classifications of organizations into international business, viz. International Corporation, Multinational Corporation, Global corporation and Transnational Corporation.

The external environment like cultural, economic, political, legal affects the business globally. Any of these external factors can be detrimental to the employees of the company, more so for the expatriates.

International HRM though practices everything that is applicable for domestic HRM; its emphasis is more on relocation, orientation, and training for different environment.

Just being good at job will not be enough for selection in international assignments. Many factors like readiness for relocation, family adjustments, personal goals etc. need to be analysed before selecting an individual.

Expatriates may be the initial choice but they cannot be relied on for very long terms as they are expensive and it is always advisable to pass on the day to day operations to host country nationals. Transnationals are also preferred as they require less training.

On selection, expatriates need a lot of training on language, culture, work life balance and repatriation. It is always good to connect to employees who have returned after the assignments to understand their challenges.

Compensation needs to be strategically developed to motivate individuals to take up international assignments. They should be compensated for the cost of living, security and safety of self and their families.

Performance appraisals in different countries can have different approaches. This is likely to confuse the expatriate on the way they would be appraised and might affect their career growth. Combining the home country and host country evaluations proportionally might be one good option.

15.8 GLOSSARY

International corporation: A local firm that increases its capacity to explore international markets.

Multinational corporation (MNC): A company having independent operations in many countries.

Global corporation: A company which has main office in home country and controls operations in different countries through that office**.**

Transnational corporation: A company that combines local requirements and specialized operations in different countries**.**

Cultural environment: The cultural aspects of a country includes beliefs, values and social practices in the country.

Host country: The base country of international operations.

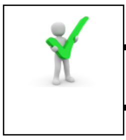
Expatriates, or home country nationals: People from the base country, who are sent to other countries on job.

Host-country nationals: People working in operations of other countries.

Work permit, or Visa: An official document of the country giving permission to work in foreign country.

Transnational teams: Employees from one country working in other countries, except the home and host countries**.**

Repatriation: Returning of employees to the base country after their foreign assignment is over.



15.9ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress –A

Q3. Fill in the Blanks with appropriate word or words.

a) With the advancement in technology, the world has become a *global* village.
b) The companies doing international business can be characterized into *four* types based on the way operations are done.

c) A country's acceptability of different *cultures* is also an important factor affecting the HR issues

d) Since people are open to locations globally, the challenges related to *relocation*, adaptation to new *environment* including culture, climate and language are more common.

Check Your Progress –B

Q3. Fill in the Blanks with appropriate word or words.

a) *Repatriation* is coming back of home country nationals after their assignments in other countries.

b) Compensation is one major *motivator* for an employee to take up an international assignment.

c) To be effective, an international compensation program must *incentivize* leaving home country.

d) Performance appraisal system should take into account *performance* in home country as well as host country

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TERMINAL QUESTIONS

Q1. What major HR issues do you see in an organization as it grows from one type to another type of international organization?

Q2. If you aspire to be working for an international firm in other country as an HR manager, how would you prepare yourself?

Q3. Discuss the effects of cultural environment on different functions of HRM, in international scenario.

15.13 CASE LETS/CASES

Case Study: McDonalds

McDonald's is the most popular fast food chain in the world. Golden arches are recognized as symbols of McDonalds. The fast food chain that emerged from USA spread to more than 19 countries. With over 18000 restaurants world-wide, there are more than thirty million customers worldwide per day. Operations beyond USA, are important part of business and more than 50% income results from sales outside US. McDonalds provides employment to more than two million people beyond US borders.

Operating in so many countries, McDonald had to localize itself in all products based on business environment of those countries. For Japanese customers, McDonald designed burgers by local method and called it Teriyaki. Understanding gender sensitivity in Middle East, separate spaces for men and women were designed in McDonald restaurants.

HR practices have also been adopted. Before beginning operations in a different country, HR professionals study the lifestyle and cultural aspects of the country and determine how HR activities should be conducted. This information is also collected from Hr managers of those companies who are already operating in the new country of operation. They collect information related to legal byelaws for labour and work related conditions. In addition, the organization conducts an analysis using a detailed outline to ensure that all data is gathered. The data may pertain to employment restrictions applicable on ages of employees or may be the scale of part time job permitted in the country. In some countries in Eastern Europe, water facility is poor and at times this may cause delay in workers reporting for job. Hence some companies provide this facility to ensure the presence of the workers. Also public transportation needs in different countries need to be evaluated.

Usually, McDonalds is seen as a desirable employer and lot of candidates apply for the job mainly in customer service section. Some of the promising candidates are given an opportunity to be a temporary worker for few days to assess their ability to cope up with the work environment and required skills. This is instrumental in acquiring good name for the company and more workers are interested in working there.

After getting the employees on board, the most challenging job is to train them for the required job of customer service. Since McDonald is famous food chain, they want to ensure standards of quality too. McDonald’s has taken its Hamburger University curriculum from the United States. It has been translated in more than twenty languages and is used for uniformity in training in all places globally. After getting trained, the employees go back to their branches and train their colleagues over there globally.

Q1. List the cultural and political factors that are important in designing a training program for food chain employees at McDonald’s in gulf countries. What are the problems you foresee for the company?

Q2. How are the methods for imparting training to home country national, parent country national and trans country national different? Give an example.

UNIT 16 INTERNATIONAL INVESTMENT AND FINANCING STRATEGIES

16.1 INTRODUCTION

In this unit you will learn about the basic concept of international investment, you will understand how the international operations are financed, what are the various international sources available from where funds can be generated by the business. This unit will also provide insight into the foreign exchange markets and its participants, about the international capital market. A brief discussion about the depository receipt and the functioning of euro currency markets will help you to understand the global financial strategies. You will also learn about how the foreign companies manages risk and what are the various alternates available to companies to hedge against the foreign exposure along with various examples.

16.2 OBJECTIVES

After reading this unit you will be able to understand the:

- Basics of foreign exchange market and its participants
- Managing foreign risk and Hedging Exposure
- Alternatives available to company to hedge against foreign exposure
- Financing international operations
- Foreign direct investment
- Fund transfer across countries where international capital market is discussed.
- How ADRs/GDRs are issued, similarities and dissimilarities between then and its various categories
- A brief discussion about the euro currency markets and its functioning.

16.3 CONCEPT OF INTERNATIONAL INVESTMENT AND FINANCING STRATEGIES

A multinational firm operates in more than one country and their operations are influenced by various factors (political, economic, social) and the laws of the land of that country where the firm operates. Thus, they face high level of risk as compared to domestic firms. As a matter of great concern, it is an important task for an international firm to take into account the matters of international investment and to analyse the implications of the changes in the interest rate, inflation rate and the exchange rate on their decisions making so as to minimize the foreign exchange risk.

16.3.1 FOREIGN EXCHANGE MARKET

It is a global decentralized market where the currency of one country is exchanged for the currency of another country. The following is a classification of participants in forex market:

- Arbitrageurs : They are a type of investor who aim to earn risk-less profits from market inefficiencies by capitalizing on the difference in exchange rate among countries.
- Trader : They engage in the export or import of goods , and they operate in foreign exchange market because there are exporters who receive foreign currencies which have to be converted into local currencies, and importers make payment in foreign currencies which they purchase by exchanging the local currency.
- Hedgers: they are a type of investors who try to offset price change in spot market by trading in future contracts. International firms have their business activities in various countries and their assets and liabilities are in foreign currencies. Fluctuations in the exchange rate causes a cutback in home currency value of their assets and liabilities. They operate as hedgers to protect their profit or limit their expenses against the risk of fluctuations in the foreign exchange rates.
- Speculators : They are a type of investors who take risk in the hope of making profit.

16.3.2 SOME IMPORTANT TERMS TO KNOW

- *Foreign exchange rate*: It is the price of one currency quoted in terms of another currency. e.g ,we can say that the price of one U.S dollar in INR is 71.94, that is, INR 71.94/U.S$.
- *Spot exchange rate*: It is the rate at which one currency can be bought against selling another for immediate delivery which is within two business days after the day of the trade.
- *Bid-ask spread :* The difference between the highest buying price (bid) which the buyer is willing to pay , and lowest selling price(ask) rate which the seller is ready to accept is the spread , Therefore, bid –ask spread is the difference between the bid and ask rate of a currency.

$$\text{Spread} = \frac{\text{Ask price} - \text{Bid price}}{\text{Ask price}}$$

This spread is the cost of transacting in the foreign market .

- Forward exchange rate : It is the rate that is presently (today) paid, for the delivery of a currency at some future date . In the forward markets, currencies are traded for future delivery.
- Forward premium or discount : The forward rate may be at premium or at a discount. Example 1: Suppose that US$/INR spot exchange rate is U.S$ 0.025063/INR (which means price of 1INR is $0.025063) . You can purchase US dollar at this exchange rate for immediate delivery(within 2 business days). Instead of buying US dollar immediately , you can enter into an agreement with the bank to deliver US dollar to you after six months . The bank has quoted a 6 month forward rate of U.S$ 0.024390/INR. Is the 6 month forward rate of US $ at a premium or at a discount.
  Calculation : the annualized forward premium or discount can be given by the formula:

Forward premium or discount = (Spot rate – forward rate / spot rate)x 360/days

= (0.025063-0.024390/0.025063)x 360/180

= 5.5%

We may observe that the forward rate of U.S $ is lower than the spot rate . Therefore, if you purchase a US dollar for a 6 month delivery, you will get fewer dollars for your rupees than in the spot purchase. Since forward dollar are more expensive than the spot dollar, so the dollar is said to be trading at a premium relative to Indian rupee.

16.4 MANAGING FOREIGN EXCHANGE RISK AND HEDGING

As we know that an international firm deals in foreign currency, therefore it also expects to receive or make payment in that currency . The exchange rate might rise or fall by the time the firm receives or make the payment. This exposes the firm to foreign exchange risk. It is a risk that arises when the domestic currency value of cash flows(e.g Indian rupees) , which is denominated in foreign currency (U.S dollar), may change because of the fluctuation in the exchange rates. Foreign exchange exposure refer to the possibility that a firm will gain or lose because of changes in exchange rates. Three types of foreign exchange exposures are :

- Transaction exposure
- Economic exposure
- Translation exposure

16.4.1 TRANSACTION EXPOSURE

This exposure point out the situation of being open or vulnerable to risk. Usually there is a time gap between the sale of goods or services and the receipt of payment, and during this period the exchange rate may change and there may arise a risk due to exchange rate . This risk is known as the transaction exposure.

Example 2 : Suppose XYZ ltd enters into an agreement with ABC ltd to buy raw materials . The price of the raw material is fixed in French franc. XYZ will receive the raw materials immediately but will make the payment of the total value of FF 1,000 million after six months. The current spot exchange rate is INR 6.50/FF. at this rate , the value of the contract is FF 1,000 million x 6.50 = INR 6,500million. The exchange rate can change in the six month time. Now suppose the exchange rate after six month is INR 6.95/FF, now XYZ will have to pay FF 1,000 million x 6.95= INR 6950 millions which is 450 million more .

Therefore from the above example , it can be said that XYZ ltd cannot predict what the exchange rate would be after six month’s time and so, XYZ ltd is exposed to transaction risk.

16.4.2 ECONOMIC EXPOSURE

When the change in the foreign exchange rate affects the cash flows from operations, it leads to the change in the value of the firm and also affects the expected cash flows. This type of exposure is called the economic exposure. It is also called operating exposure or long – term cash flow exposure. It refers to the change in the value of the firm caused by the uncertainity in the exchange rate movement.

Example 3 : Suppose there is an Indian company operates internationally, it imports and export goods and services from U.S, and the prices are denominated in U.S dollars. If the exchange rate between Indian rupee and U.S dollar changes , then value of cash flow in Indian rupees will change affecting the operating profitability. The value of the expected cash flow can change due to various factors like input cost, prices of goods or investments done or the change in the pricing policy.

The future cash flows are affected by the change in the rates,and the change in rate can also affects the price, market share, or a firm's competitiveness.

The firm can manage the effects of change by adjusting markets, product mix and the input sourcing. The exchange rate exposure should be dealt strategically.

16.4.3 TRANSLATION EXPOSURE

The exchange rate at the end of accounting period may differ from the rate in the beginning of the accounting period . Translation exposure refers to the exchange gain or loss occurring from the difference in the exchange rate at the beginning and at the end of the accounting period .

16.5 HEDGING FOREIGN EXCHANGE RISK

Hedging, In International business, is a risk management strategy undertaken specifically to offset some exposure arising out of the firm's usual operations.

Hedging is thus a process of buying on one side and selling on another side in order to produce a risk – less security. In this two investment are involved that are perfectly correlated. **Example**, if the returns from X and Y are correlated , then under hedging one has to Buy X and Sell Y so as to make a net position risk less.

There are three Alternative available to companies to hedge against the foreign exchange exposure:

- Forward exchange contract
- Futures contract
- Currency option hedge
- Money market hedge

a) **Forward exchange contract**: It is a type of foreign currency transaction . It consist of buying and selling a currency to settle exposure or hedge a balance sheet position . An importer will buy in advance through forward contract, but at a predetermined exchange rate the total amount of foreign currency he needed to pay for his imports. And , Alternately, an exporter can sell in advance the amount of foreign currency to be received against exports.
Now if, the home currency gets weakens (e.g 1U.S $= INR 70, but as the home currency which is INR gets weakens the new rate will be 1U.S$= INR76) , then the importer has to pay less and therefore makes an opportunity gain , as he will be

paying less number of units of home currency and for the exporter , an opportunity loss.

Note: The forward contract are not traded on the exchange (they are unstandardized), they are customized according to the need and demand of both the parties involve and they can be canceled only upon the mutual agreement of both the parties.

b) **Futures contracts** or foreign exchange future: is a standardized contract, a legal agreement is made between two parties where the exchange of one currency takes place for another at a specified date in the future but , at an agreed price on the date of purchase. These contract are traded in the stock exchange market.

c) **Foreign currency option hedge**: A Currency option is a right (but not an obligation) to buy or sell a currency at an agreed exchange rate (which is called the 'exercise price') on or before an agreed maturity date . 'Call option' gives owner the right to buy, and 'a put option' give the right to sell . A foreign currency holder will exercise his right only if it is advantageous.

- ***Hedging payable with foreign currency call option***: (It has a 'right' but not the 'obligation' to buy)
  Lets take an example , ABC ltd is a firm which has its payables in British pound.
  Now if the spot rate of the pound (which is the current rate or today's rate) remains lower than the exercise rate (which is the agreed future rate), throughout the life of an option, then the firm which needs British pound will do no action and could let the option expires and purchase them at the existing spot rate (as the spot rate is lower than the exercise price)
  On the other side , if the spot rate of the pound appreciates, the option allow the firm to purchase pound at the exercise rate.

- ***Hedging receivables with currency put options:*** (It has the 'right' but not the obligation to sell) : If the existing spot rate of the foreign currency is above the exercise price when the firm receives the foreign currency , the firm can sell the currently received at the spot rate and let the option expires.

d) **Money market Hedge** : Another hedging technique is the money market hedge. Lets take an example (example 2 as mentioned above) . Suppose XYZ ltd has no surplus funds available . It could borrow enough Indian rupee today and convert it into French franc and invest for the next six month in the French money market . It will have enough French francs to pay to ABC ltd. It would also repay its Indian borrowings from its domestic resources. The difference in the forward rate and the spot rate is the reflection of the difference in the interest rates in two countries. By this way XYZ ltd will be able to hedge against the change in the exchange rate.

Some drawback in the money market hedge which are highlighted are that the market is not open and all the currencies are not fully convertible as there are restrictions to the free flow of funds outside the country also.

Check Your Progress- A

Q1. What do you mean by Foreign Exchange Market?

Q2. Differentiate Between Transaction Exposure and Translation Exposure.

Q3. What do you mean by Foreign currency option hedge?

16.6 FINANCING INTERNATIONAL OPERATION

International investment deals with investments on the global level. International investment and finance help organizations which deals in cross- border transaction with other foreign business partner like (customers, investors, supplier). Most of the countries of the world depend on foreign capital to some extent for the economic and Industrial growth and development . The degree to which a country depends on international finance further varies upon the level of mobilization of its domestic capital, technology development, attitude and policies of the government, balance of payment support etc. Various international sources from where funds may be generated include the following :

a) International capital market
b) Commercial bank
c) International Agencies and Development Bank

Foreign capital

Official foreign capital

a) Bilateral government funding arrangements
   1.loans and advances
   2.foreign aid , grants / subsidies/concessions
b) International financial institutions

Private foreign capital

a) Foreign direct investments
b) Portfolio investment
c)Deposits and investment by NRIs
d) Investments by FIIs
e) Euro issues and External commercial borrowings

Fig 16.1 The above chart showing the division of foreign capital

16.6.1 OFFICIAL FOREIGN SOURCE OF FINANCE

a) Bilateral government funding Arrangement : Some developed and advance countries provide assistance in the form of loans and advances , grants , subsidies to the under-developed and developing countries. The funds are provided at a concessional rate of interest, maturity and flexible repayment schedule.
b) Loans from financial institutions : world bank, IMF, ADB(Asian development bank), IBRD provide major source of external finance to India
c) Foreign capital in the form of ECBs (external commercial borrowing) can also be obtain from agencies like US EXIM Bank, Japanese EXIM Bank etc.

16.6.2 PRIVATE SOURCE OF FINANCE (OR NON- OFFICIAL SOURCE OF FINANCE)

a) Foreign direct investment (FDI):

FDI is an important driving force for the growth and development of the nation. FDI provide foreign exchange which assist to bridge up the balance of trade deficit. It raises the technological standards , level of efficiency, export potential by providing better access to foreign markets and also the competitiveness of the host country. FDI is permitted under the form of investments:

- ✓ Through equity participation or financial collaboration.
- ✓ Through joint venture and technical collaboration
- ✓ Through capital market (euro currency markets, ADRs/ GDRs/ foreign bonds)
- ✓ Through preferential allotment or private placement.

FDI is an investment from a party in one country into the business or operations in another country with the intention behind this investment of lasting interest. ('lasting interest' exist when an investor obtains at least 10% of the voting power in a firm).

Financial collaboration means a foreign partner's stake in the capital of the receiving country's companies.

Technical collaboration means the foreign partner is providing facilities like licencing, trade mark, patent, technical services against which the foreign partner will receive lumpsum fee in the form of royalty payment.

- **Factors that attract FDIs in India :**

1. India has a good reputation among other countries of the world as to fulfill its commitments about repayment obligations, remittances of dividends etc.
2. India has a vast potential of unskilled labour available at cheap rates and a vast natural resources that attract foreign investors.
3. More investment friendly policies adopted by the government and also with the launch of Make in India program and skill Program help attract more foreign inflows. The political stability in the country also plays a major role.
4. India has a vast potential of young entrepreneurs in the private sector. Their skill and competence is used in carrying out production activities and export to neighbour countries
5. A Well developed financial system and an organized network of banks and financial institutions and robust capital market attracts foreign institutional investors for investment.

Certain other factors which attract investors are the size of the local market, its growth rate, infrastructure facilities, labour cost, technological status of the country , brand name ,favourable location, climate, intellectual property granted by the government.

b) Investments by Foreign institutional investors (FII):

SEBI (foreign institutional investors) Regulations, 1995, define FIIs as an institution established or incorporated outside India which proposes to make investment in India in securities. Before operating in Indian securities market, FIIs need to seek registration with SEBI. Foreign institution investments are made by the foreign entities in securities traded on the primary and secondary markets including equity and other securities which are listed on the stock exchange in India with the intention not to take a controlling interest in the enterprise but to diversify their portfolio and to gain high returns with flexible entry and exit. FIIs include institutions such as pension fund, mutual fund, AMCs etc

c) Investments by NRIs:

The government has recognized the importance of the role of NRIs for the Indian economy and has made efforts to encourage deposits and investments . They are also aimed to encourage technology collaboration between Indian and foreign companies. NRI investment are both direct and indirect. Direct investment are in shares, debentures , govt. securities, UTI units etc, and indirect investment are in the form of mopping up their surplus funds into savings account and mutual funds.

16.7 INTERNATIONAL CAPITAL MARKET

The main function of International capital market is to transfer funds in and effective and efficient manner across countries .The government regulation in many countries do not allow foreigners to access funds from these domestic financial market. Sources of international finance are :

Euro currency loans, euro bonds and foreign bonds, American depository receipt (ADR), Global depository receipt(GDR), Foreign currency convertible (FCCB).

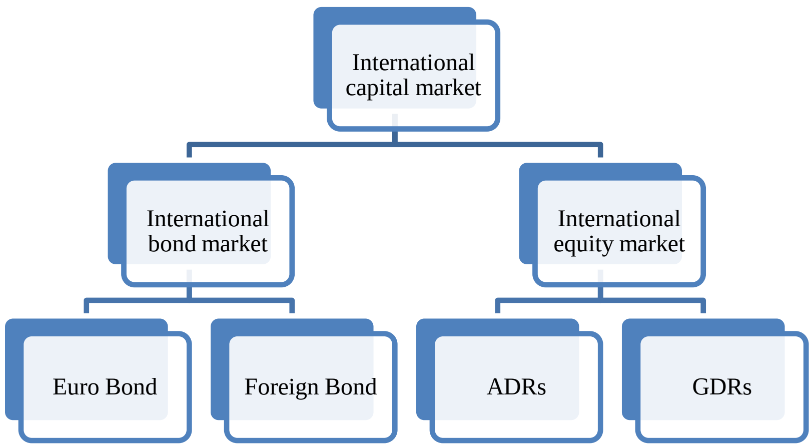

Figure16.2 International Capital Market

Choice of the sources of funds:

Short term borrowing and long term borrowing both suffers from certain benefit and limitation. Therefore, it is recommended to use the combination of various sources of funds because there exist no sources of fund which is free from some or the other limitations, instead on relying only on a single source, a mix of sources of fund or portfolio of funds should be used for investment purposes.

The factors that affect the choice of source of finance are as follows :

1. Cost: There are two types of cost associated with the procurement and use of funds , first is the cost of obtaining the funds and second is the cost of utilization of the funds. Therefore, while deciding about which sources of funds to be used by an organisation both these cost should be taken into consideration.
2. Financial strength: when the earnings of the firm are unstable , fixed charged funds like preference shares and debentures should be carefully selected as these add to the financial strain on the organization. Firms should be in a good financial position to be able to repay the amount back along with the interest on the borrowed fund.
3. A form of organization and reputation: Type of organization and its reputation in the market influence the choice of sources of raising money. Example : A partnership firm cannot raise money by issue of equity shares as these can be issued only by a joint stock company.
4. Purpose and Duration of funds: A short term need can be met through borrowing funds at a low rate of interest through trade credit , commercial papers etc. For long term finance, sources such as issue of shares and debenture are required. Therefore , the choice of sources of raising money should be according to the time period for which the funds are required
5. Risk Involved: Business evaluates each of the sources of finance in terms of the risk involved while issuing them. Example: Risk is least in equity as the share capital has to be repaid only at the time of winding up and dividends need not be paid if no profits are available, whereas risk of debenture is highest as there is fixed rate of return to be given to holders irrespective of the profitability or earnings of the firm .
6. Control over management: when the issue of equity shares takes place it somehow means that there is a dilution of the control of ownership . Therefore , a particular source of fund can affect the control and power of the owners on the management of the firm.
7. Tax benefit: The nature of the source of raising funds can assess in terms of their tax benefit . Example : dividend on preference share is non tax – deductible , interest paid on debenture and loan is tax deductible.

16.8 DEPOSITORY RECEIPT

The depository receipt originated in 1920's in U.S. During that time, it was difficult for companies from developing countries to raise equity capital from developed capital markets. The country risk of these companies is high and the listing and disclosure requirements of the developed capital market, like US market are very stringent. With the aim of resolving such complexities involve in buying shares in foreign countries , and the difficulties associated with trading at different prices and currency values lead to the origin of depository receipt.

Therefore, an indirect way of raising funds from foreign market is to issue depository receipt. Depository receipt are a type of negotiable (transferrable) financial security that can be traded on a local stock exchange , representing ownership of shares in companies of other countries. Depository receipt represent the number of foreign shares that are deposited in a bank in the foreign country. For example , an Indian company can issue American Depository Receipt (ADRs) in the US and raise capital there. By this way , an Indian company can finance its business from foreign country investors by issuing instruments like American Depository Receipt (ADRs) and global depository receipt (GDRs).

16.8.1 AMERICAN DEPOSITORY RECEIPT

ADRs were introduced in the financial market in 1927. Each ADR represent a specific number of shares (one or more) in a foreign company.

How are ADRs issued ?

- A Indian company can issue its shares in U.S through the appointment of a reputed International financial institution , a U.S bank , that act as overseas depository bank or transfer agent.
- The overseas depository bank then enters into an agreement with the domestic custodian bank of such company. The domestic custodian bank will keep these shares in its custody.
- On the instruction of domestic custodian , the depository bank will bundles a specified number of shares as a depository receipt and issues receipt called American depository receipt to the investors in the U.S.
- ADRs are negotiable instrument accepting a claim on foreign security (Indian company’s securities in this case). ADRs can be listed and traded on the U.S stock exchanges.
- The depository receives dividends from the issuing Indian firm and then pays it to the depository receipt holders in the U.S. ADRs are denominated in U.S dollars and ADR investors receive dividend in dollars equivalent.

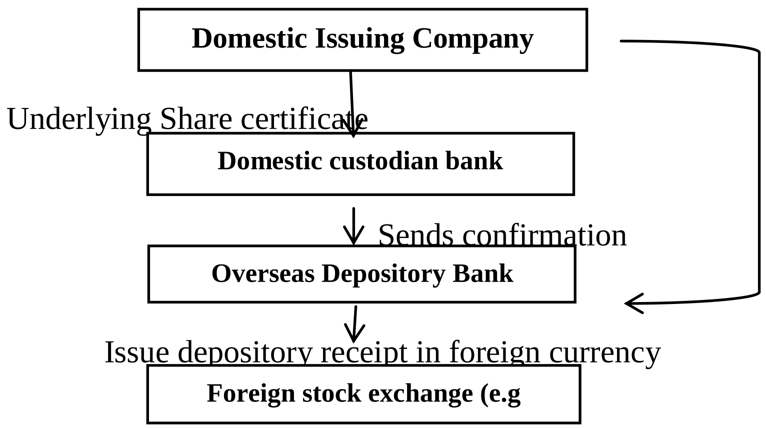

Figure 16.3: Process of Issue of America Depository Receipt

16.8.2 GLOBAL DEPOSITORY RECEIPT

GDR is a financial instrument in which a company located in domestic country issues securities outside the domestic country. GDRs are used by private market to raise capital denominated in either U.S dollars or any currency like euros. The Indian firm can also issue global depository receipt in many countries. Example: GDR allow an Indian firm to raise funds from the UK , and can list and trade their GDRs on the London stock exchange . GDRs are commonly listed on European stock exchange , such as Luxembourg and London stock exchange or on the Asian stock exchange such as Dubai and Singapore stock exchange.

a) ***ADRs and GDRs has the following similarities***:

1. The ADR/GDR could be issued in a negotiable form.
2. The physical possession of the equity shares will be with another intermediary called 'custodian' bank.
3. The custodian will act as an agent of the depository.
4. Instead of issuing shares in the name of individual shareholders ,the shares are issued by the issuing company to an intermediary called the 'depository' or usually in overseas depository bank's name.
5. It is the depository , which further issues ADR/GDR to the subscribing public in the foreign country by listing it in stock exchange.
6. The shares in ADR/GDR are specified in a certain fixed ratio.
7. The holder of ADR/GDR can transfer the instrument and are also entitled for divided , bonus shares and rights issue as and when declared.
8. The holder of both the instrument may exercise their vote through the overseas depository bank (ODB).

Despite the various similarities in both the instruments there are certain dissimilarities like

- ADRs are listed on an American stock exchange , where as all GDRs are listed in a stock exchange other than American stock exchange , say London or Luxemburg.
- The disclosure requirement for the issue of GDRs are less stringent.
- In GDRs , mainly, institutional investors can participate and it has lower liquidity as compare to ADRs , whereas , In ADR listing, retail investors can participate in the offering, which provides wider interest and better valuation of the company's stocks.

16.8.3 CATEGORIES OF ADRS

ADRs are of the following categories:

- **Level I ADR**: This is the most basic type of ADR which are not normally listed on any U.S stock exchange. They are generally traded on over the counter market . They are the simplest , easiest, and the least expensive means for the issuance of the shares by the company as ADRs.

- **Level II ADR**: This type of ADRs are listed on the U.S Exchange. They are subjected to strict compliance by SEC (Securities Exchange Commission), a market regulator of U.S than compared to level I ADRs .
- **Level III ADR**: It is most important out of the three type of ADRs. When the issuer floats a public offering of ADRs on U.S stock exchange , then, an ADR is considered as level III ADR. The major difference in level III ADR is it allows the issuer to raise capital through a public offering of ADRs in the U.S which can be used for a variety of purpose. Example : the raising of capital to finance acquisition or the establishment of an (ESOP) employee stock ownership plan for the issuer's U.S subsidiary. The cost of setting and maintenance is quite high in level III ADR and SEC reporting is more strict.
- **Unsponsored ADRs**: An unsponsored ADR does not involve the formal participant of the foreign company whose securities will be represented by ADRs. They trade on the OTC.
- **Sponsored ADRs**: They create a legal relationship and a formal participation between the ADR and the foreign company, which absorbs the issuing cost of the security also. They can be listed on major exchanges.
- **Restricted ADRs** : SEC (securities exchange commission) has introduced it in 1990 to encourage capital raising in the US by non – US issuers , by privately placing depository receipt for resale only to qualified institutional buyers (QIBs) so as to enhance the liquidity to the private placement market .

16.8.4 BENEFITS OF ADR/ GDR ISSUE

a) To the Indian company :

- It provide exposure to international markets and share prices moves in line with the international trend .
- Increases recognition of the firm globally by bankers, customers , suppliers and useful in strengthening the business operations in the overseas market.
- No risk of foreign exchange fluctuations as the company will be paying the interest and dividend in Indian rupees to the domestic depository bank.
- The issuer company will collects the proceeds from the issue of ADR/GDR in the foreign currency and can utilize it for meeting the foreign exchange component of its project cost, repayment of loans in foreign currency.

b)To the overseas investors :

- ADRs are denominated in U.S dollars and they pay dividends in U.S dollars and trade exactly like any other U.S security which makes it easier for investors to invest in it.
- Overseas investors will not be taxed in India for the capital gains on the transfer of ADRs to another non resident outside India .

- Global investors / holders of ADRs / GDRs need not be registered with SEBI.
- Quick settlement process, high liquidity and cost effectiveness, as there is no need to customize underlying securities in India.

16.9 FOREIGN CURRENCY CONVERTIBLE BONDS (FCCB)

FCCB is a type of convertible bond issued in foreign currency different from the issuer's domestic currency . Example : an American company issues a bond in India in Indian rupees. It is a quasi-debt instrument , which can be converted into equity shares at the choice of the investor . It acts like a bond by making regular interest and principal payment , but also the bond holder have an option to convert the bond into share. The investor will be benefited if the conversion price is higher than the traded price .

FCCBs are issued as a bond by an Indian company in the foreign currency , and the principle and interest are payable in the foreign currency . The maximum tenure of the bond is 5 years.

This hybrid product offers the advantage of both equity and debt. The denomination of FCCB is foreign currency which makes it more acceptable in the international market as the buyer of FFCB can take the advantage of the difference in the international rates.

Advantage to issuing company:

- The company gain high leverage as debt is reduced and equity capital increases upon conversion.
- FCCB does not dilute the ownership immediately , as the holder of ADR/GDR do not have voting rights .
- The coupon rate is lower than the traditional bank finance , there by reducing the debt financing costs.
- Credit rating is not mandatory upon the issue of FCCB.

Advantage to investors:

FCCB provides dual advantage of debt and equity to the investors. A guaranteed return in the form of coupon or YTM and also an option to take advantage of the increase in the prices of the stock.

Disadvantage :

- FCCB when converted to equity bring down the earnings per share and will also dilute the ownership.
- In the rising stock market , FCCB is preferred , while when the market is showing downside there will be no demand of it , and FCCB may remain as debt and might not get converted at all.

- Any depreciation in rupee against the given foreign currency can make the interest and principal repayment costly . (exchange rate risk).
- The end use of proceed is restricted, which means proceeds generated by FCCB should not be used for lending or investment in capital market or acquiring a company in India by a corporate.

16.10 EXTERNAL COMMERCIAL BORROWINGS (ECB)

It is a type of financing used in India to help companies access overseas funds. ECBs are a borrowing of over 180 days , by corporate and financial institution from international markets.

ECBs include commercial bank loans , buyers credit, suppliers credit , security instrument such as floating rate notes and fixed rate bonds, credit from export–credit agencies etc.

ECBs refer to commercial loans availed from non resident lenders with minimum average maturity of 3 years. ECB is raised generally for investment in real sectors (means industrial sector and infrastructure sector) such as import of capital goods , working capital, refinancing of earlier ECBs , new project , modernization / expansion , general corporate purpose etc. ECBs can be accessed under two routes : a) Automatic Route b) Approval Route .

Under approval route the applicant are required to submit an application to RBI, while in automatic route funds can be accessed without prior approval of RBI. Banks, financial institutions and financial intermediaries are allowed to access through automatic route.

Check Your Progress- B

Fill in the Blanks :

1. LIBOR stands for ___________
2. The ___________is a negotiable certificate issued by a depository bank which represents the beneficial investors
3. _____________ADRs do not qualify or are not intended to be listed on stock exchange.
4. Depository receipt that are traded in an international market other than the U.S are referred to as_______
5. Foreign bond issue in japan is called_________
6. Exchange rate entail delivery of trade currency within two business days known as _________________.

7. The difference between the bid and ask quotes for a currency is _____

16.11 DOMESTIC AND OFFSHORE MARKETS

16.11.1 EURO- CURRENCY MARKETS :

What are they ?

The euro currency market refers to funds channelized through financial intermediaries from international lender to international borrower. It is mainly an interbank market, trading in time deposit and various debt instrument. Example : Euro – dollars are deposits of U.S dollars in the bank located outside the U.S , euro sterling are deposits of British pound in banks outside UK.

Euro currency market in a broad sense include markets of euro deposit , euro credit, Eurobond, euroshares, eurobill etc.It is a universal international market that combines element of currency, credit transaction and securities transaction. The euro –currency market provide the short to medium term debt required by banks, corporate and government borrowers.

A ‘Eurocurrency Deposit’ is a deposit in the foreign currency with a bank situated outside the home country of that currency. Example: A dollar deposit with a bank in London is a Euro-dollar deposit, a Deutschemark deposit with a bank in Luxembourg is a Euro- mark deposit.

It is to be noted here that, what is important is, the location of the bank, neither the ownership of the bank nor the ownership of the deposit is important , but the place where the bank is located need to be taken into consideration. So, for e.g , a dollar deposit belonging to an American company held with the Paris subsidiary of an American bank is still a Eurodollar deposit. The euro currency market is an external banking system that runs parallel to the domestic banking system of the country that issues the currency. Both banking system accept deposits and provide loans to customers from the deposited funds.

16.11.2 EURO CURRENCY LOANS

Eurocurrency is a freely convertible currency deposited in bank outside the country of its origin.

How it functions ?

- Depositors put their savings in banks for a short period , and they made short term claims on bank.
- Banks that provide eurocurrency loans to the international companies for a long period of time uses these deposits .

- Thus, short term deposits are converted into long term claims on the borrowers.
- Euro currency loans are loans of very large amount, therefore these loans are syndicated by more than one bank.
- Euro currency loans are priced according to the 'LIBOR plus margin', margin over the LIBOR(London interbank offering rate) depend on market condition and the credit quality, riskiness of the borrower.
- The importance of 'Euro' Prefix is mainly to refers it to the high volume of these funds circulating in Europe , mainly through London. The prefix 'euro' is somewhat misleading since the bank in which deposits are made need not be located in Europe.

16.11.3 EURO BONDS AND FOREIGN BONDS

A company can raise funds by issuing Eurobond and Foreign bonds to investors in other countries.

Euro- bond :

- These are bonds sold outside the country in whose currency they are denominated. They are issued directly by borrowers to investors. Example: An Indian company may issue US dollar – denominated bonds to the investor outside U.S , say in ,Switzerland.
- Euro bond may be issued in different currencies and are known by the currency in which they are denominated. Eg. Borrowers all over the world may use U.S dollar Eurobond (Eurodollar bond), Japanese yen Eurobond (Euro yen bond)
- Euro bond market is a self regulated market .
- Euro bond are usually a bearer bond . The bearer is the owner of the bond .When the bearer bond is sold , it is transferable to the buyer and the buyer becomes the owner. Therefore, ease of transferability is there.

Foreign bond :

- These bonds are denominated in the currency of that country where it is issued, and are subjected to the law and regulation of that country only.
  Example: A Mexican country may issue U.S dollar denominated bond in the USA itself or a German company issuing dollar denominated bond to the U.S investor.
- These bond are different from euro-bond as they are governed by the regulation of the country in which they are issued whereas euro bonds are not.
- Foreign bonds are named on the capital market in which they are floated . Some foreign bonds are: a) Yankee bonds : The dollar denominated foreign bond issued in U.S is called Yankee bonds. b) Samurai bond : are Yen denominated foreign bond sold in japan . c) Bulldog bond : are pound denominated bond issued in U.K domestic market by a non U.K borrower.

- Registered bond are those bonds where the owner's name is on the bond certificate . when a registered bond is sold , a new certificate is issued to the buyer with his name on it.

16.12 SUMMARY

This unit attempts to give an overview of the various concepts in relation to international investment in the simplest possible manner. Starting with the foreign exchange market and explaining various participants in it along with examples to illustrate the forward exchange rate and calculation of spread. It further distinguish between the three different types of foreign risk : transaction exposure, economic exposure and translation exposure along with examples. It also explains the alternatives available to hedge the foreign risk via forward contract, currency option , money market operations. Next , it provide insight into various international financing options , explains the working of American depository receipts, along with its benefits and the functioning of euro currency markets .

16.13 GLOSSARY

Exchange risk : It arises due to fluctuation in the currency of borrowing .

Euro issue: the issue made abroad through instruments denominated in foreign currency and the securities are listed on oversears stock exchange

SEC: U.S securities exchange commission

Forward contract : this is an obligation to exchange foreign currency at a date in the future typically 30, 60 ,90 days.

EXIM : Export - Import bank of India is a finance institution in India.

YTM : yield to maturity is the total return expected on a bond, if it is held until its maturity.

Arbitrage : risk- free investment strategy .

16.14 ANSWER TO CHECK YOUR PROGRESS

Check your Progress B

Answers

1. London interbank offer rate
2. Depository receipt
3. Level 1
4. GDRs ,
5. Samurai bonds
6. Spot rate
7. Spread.

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16.17 TERMINAL AND MODEL QUESTIONS

Q1. What is foreign exchange markets? Who are the participants and what are their motivations?

Q2. What do you understand by foreign direct investments? What are the factors that attract FDIs in India ?

Q3. Write a short note on hedging? Explain the foreign exchange options as a hedging technique.

Q4.How are American Depository Receipt issued? Bring out the similarities and the difference between ADRs and GDRs?

Q5. What is the role of FIIs in the development of Indian economy?

Q6. What is Euro currency markets? How do Euro currency loans differ from Euro bonds?

Q7. What are the sources of foreign capital available to Indian entrepreneur?

Q8. Briefly explain the following : a) FCCB, b) ECB, c) Yankee bonds d) Economic exposure.

Q9. How do companies manage foreign exchange risk ? what are the various foreign exchange exposures , explain with example .

Q10. What is spot exchange rate ?how is it different from forward rate? How will you calculate forward premium or discount?

UNIT 17 MANAGEMENT OF EXCHANGE RATE AND INTEREST RATE RISK

17.1 INTRODUCTION

Conversion scale hazard administration is a fundamental part in each company's choices about outside cash presentation (Allayannis, Ihrig, and Weston, 2001). Cash chance supporting methodologies involve wiping out or lessening this hazard and require comprehending both ways that the conversion standard hazard could influence the activities of monetary operators and procedures to manage the resulting hazard suggestions (Barton, Shenkir, and Walker, 2002). Choosing the suitable supporting methodology is regularly an overwhelming assignment because of the complexities associated with estimating precisely current hazard presentation and settling on the fitting level of hazard introduction that should be secured. The issue of money chance administration for non-monetary firms is autonomous from their main business and is typically managed by their corporate finance departments. Most global firms have likewise chance boards of trustees to direct the treasury's technique in dealing with the swapping scale (and financing cost) chance (Lam, 2003). This demonstrates the significance that organizations put on chance administration issues and procedures. Then again, universal financial specialists as a rule, however not generally, deal with their swapping scale chance freely from the hidden resources as well as liabilities. Since their cash introduction is identified with interpretation chances on resources and liabilities named in outside monetary forms, they tend to consider monetary standards as a different resource class requiring a money overlay command (Allen, 2003).

17.2 OBJECTIVES

After reading this unit you will be able:

- To understand the concept of Exchange Rate Risk.
- To measure Exchange Rate Risk.
- To know about the Best Practices in Management of Exchange Rate Risk.
- To learn Management of Interest Rate Risk.

17.3 KINDS OF EXCHANGE RATE RISK

A typical meaning of conversion standard hazard identifies with the impact of startling swapping scale changes on the estimation of the company (Madura, 1989). Specifically, it is characterized as the conceivable direct misfortune (because of an unhedged presentation) or roundabout misfortune in the company's money streams, resources and liabilities, net benefit and, thus, its securities exchange an incentive from a swapping scale move. To deal with the conversion scale chance inborn in multinational firms' activities, a firm needs to decide the kind of current hazard presentation, the supporting system and the accessible instruments to manage these money dangers. Multinational firms are members in cash advertises by goodness of their universal activities. To gauge the effect of swapping scale developments on a firm that is occupied with outside money named exchanges, i.e., the inferred Value in danger (VaR) from conversion standard moves, we must recognize the kind of dangers that the firm is presented to and the measure of hazard experienced (Hakala and Wystup, 2002). A swapping scale change in the cash of section of any such contract will bring about an immediate exchange conversion scale hazard to the firm.

17.4 MEASUREMENT OF EXCHANGE RATE RISK

In the wake of characterizing the sorts of swapping scale chance that a firm is presented to, a significant viewpoint in an association's conversion standard hazard administration choices is the estimation of these dangers. Estimating money hazard may demonstrate troublesome, at any rate with respect to interpretation and financial hazard (Van Deventer, Imai, and Mesler, 2004; Holton, 2003). A widely used strategy is the Value at Risk (VaR) demonstrate. Extensively, Value in danger is characterized as the most extreme misfortune for a given presentation over a given time skyline with z% certainty. The VaR system can be utilized to quantify an assortment of kinds of hazard, helping firms in their hazard administration. Be that as it may, the VaR does not characterize the end result for the introduction for the (100 – z) % purpose of certainty, i.e., the dire outcome imaginable. Since the VaR display does not characterize the most extreme misfortune with 100 percent certainty, firms frequently set operational cut-off points, for example, ostensible sums or stop misfortune orders, notwithstanding VaR limits, to achieve the most astounding conceivable scope (Papaioannou and Gatzonas, 2002). The VaR measure of swapping scale hazard is utilized by firms to gauge the danger of a remote trade position coming about because of a company's exercises, including the outside trade status of its treasury, over a specified time period and age bracket under unique conditions (Holton, 2003). The VaR computation relies upon 3 parameters:

- The holding time frame, i.e., the period over which the remote trade position is intended to be held. The commonplace holding time frame is 1 day.
- The certainty level at which the gauge is intended to be made. The classic levels of certainty are in the range of 95% to 99%.
- The unit of cash to be utilized for the section of the VaR.

Expecting a holding time of x days and a level of certainty of y%, VaR measures the extent of misfortune (i.e., the lessening in the market estimation of an outside trade status) for x days. Along these lines, if the outside trade position has a VaR of 1-day at the 99 percent certainty level of $10 million, the firm ought to expect that, with a likelihood of 99 percent, the estimation of this position will diminish by close to $10 million amid 1 day, gave that typical conditions will beat that 1 day. As such, the firm ought to expect that the estimation of its remote swapping scale position will diminish by close to $10 million 99% of the times, or by more than $10 million 1% of the time. To compute the VaR, there exists an assortment of models. Among them, the even more broadly utilized are:

- cash returns on an association's remote trade position will have an indistinguishable appropriation from they had before;
- the money returns on a company's aggregate outside trade position are dependably (mutually) regularly circulated and that the adjustment in the estimation of the remote trade position is directly subjected to all money returns; and

- Monte Carlo recreation, which accepts that future money returns, will be arbitrarily conveyed.

The chronicled recreation is the most straightforward technique for computation. This includes running the association's present remote trade position over an arrangement of recorded conversion scale changes to yield a dispersion of misfortunes in the estimation of the outside trade position, say 1,000, and afterward figuring a percentile (the VaR). Therefore, expecting a holding period of one day and a certainty level of 99%, VaR can be figured by arranging in climbing request the 1,000 day by day misfortunes and removing the eleventh biggest misfortune from the 1,000 (since the certainty level infers that 1 percent of misfortunes – 10 misfortunes – ought to surpass the VaR). The primary advantage of this technique is that it doesn't accept an ordinary circulation of cash returns, as it is all around recorded that these profits are not typical but instead leptokurtic. Its weaknesses, notwithstanding, are that this count requires a substantial database and is computationally serious. The fluctuation – covariance demonstrates that

- the adjustment in the estimation of an association's aggregate remote trade position is a direct blend of the considerable number of changes in the estimations of individual outside trade positions, with the goal that likewise the aggregate money return is directly reliant on all individual cash returns; and
- the money returns are together ordinarily appropriated. Along these lines, for a 99 percent certainty level, the VaR can be computed as: VaR= - Vp (Mp + 2.33 Sp) where,

  Vp: Underlying quality (in cash units) of the outside trade position;

  Mp: Mean of the money return on the association's aggregate remote trade position, which is a weighted normal of individual remote trade positions;

  Sp: Standard deviation of the money return on the company's aggregate remote trade position thereby reflecting the weighted change of the standard deviation of the fluctuation covariance grid of individual remote trade positions (take note of that the last incorporates the relationships of individual remote trade positions)

While the difference covariance show considers a speedy figuring, its disadvantages incorporate the prohibitive suppositions of a typical dispersion of money returns and a direct mix of the aggregate remote trade position. Note, be that as it may, that the ordinariness supposition could be casual (Longin, 2001). At the point when a non-ordinary conveyance is utilized rather, higher would be the computational cost because of the extra estimation of the certainty interim for the misfortune surpassing the VaR. Monte Carlo re-enactment often includes essential segments examination of the variance covariance display, trailed by arbitrary recreation of the segments. While its fundamental points of interest incorporate its capacity to deal with any hidden circulation and to even more precisely - 7 - survey the VaR when non-straight money factors are available in the remote trade position (e.g., choices), its genuine disadvantage is the computationally escalated process.

17.5 MANAGEMENT OF EXCHANGE RATE RISK

In the wake of distinguishing the kinds of swapping scale hazard and estimating the related hazard presentation, a firm needs to choose whether to fence or not these dangers. In universal back, the issue of the fitting methodology to oversee (fence) the distinctive kinds of conversion scale hazard presently can't seem to be sorted out (Jacque, 1996). Practically speaking, be that as it may, corporate treasurers have utilized different money chance administration procedures depending, ceteris paribus, on the pervasiveness of a specific kind of hazard and the span of the company (Allen, 2003).

A. Supporting Strategies

Indicatively, exchange chance is regularly supported strategically (specifically) or deliberately to save money streams and profit, contingent upon the company's treasury see on the future developments of the monetary forms included. Strategic supporting is utilized by most firms to fence their exchange money chance identifying with here and now receivable and payable exchanges, while key supporting is utilized for longer-period exchanges. In any case, a few firms choose to utilize latent supporting, which includes the upkeep of a similar supporting structure and execution over general supporting periods, regardless of cash desires. Interpretation, or monetary record, chance is supported rarely and non-efficiently, regularly to maintain a strategic distance from the effect of conceivable sudden cash stuns on net resources. This hazard includes for the most part long haul remote exposures, for example, the company's valuation of auxiliaries, its obligation structure and universal ventures. In any case, the long-haul nature of these things and the way that money interpretation influences the accounting report instead of the wage proclamation of a firm, influence supporting of the interpretation to hazard to a lesser degree a need for administration. For the interpretation of money danger of an auxiliary's Value, it is standard practice to fence the net monetary record exposures, i.e., the net resources (net resources less liabilities) of the backup that may be influenced by an unfavorable swapping scale move. Inside the structure of supporting the conversion scale hazard in a merged accounting report, the issue of supporting an association's obligation profile is additionally of fundamental significance (Marrison, 2002; Jorion and Khoury, 1996). The cash and development piece of an association's obligation decides the vulnerability of its net value and income to conversion standard changes. To decrease the effect of trade rates on the instability of profit, the firm may utilize an enhancement model to devise an ideal arrangement of supporting methodologies to deal with its cash hazard. Supporting the rest of the cash presentation after the advancement of the obligation structure is a troublesome undertaking. A firm may utilize strategic supporting, notwithstanding improvement, to diminish the remaining cash chance. In addition, if trade rates don't move the expected way, interpretation chance supporting may cause either income or profit instability. In this way, supporting interpretation chance regularly includes watchful measuring the expenses of supporting something. Economic hazard is regularly supported as a leftover hazard. Financial hazard is hard to measure, as it mirrors the potential effect of conversion scale proceeds onward the present estimation of future money streams. For this situation, the effect on each stream might be gotten out finished product offerings and crosswise over business sectors, with the net monetary hazard ending up little for firms that put resources into numerous outside business sectors due to counterbalancing impacts. Additionally, if conversion scale changes take after expansion and a comapny has an auxiliary that faces cost swelling over the general swelling rate, the firm could discover its intensity disintegrating and its unique Value decaying because of swapping scale modifications that are not in accordance with PPP (Froot and Thaler, 1990). In these conditions, the firm could best fence its monetary presentation by making payables (e.g., financing activities) in the money that the association's auxiliary encounters the higher cost expansion (i.e., in the cash that the company's Value is defenseless). Modern corporate treasuries, be that as it may, are creating effective boondocks of supporting techniques as a more coordinated way to deal with fence money hazard than purchasing a plain vanilla support to cover certain outside trade presentation (Kritzman, 1993). A productive wilderness measures the cost of the support against the level of hazard supported. In this manner, a proficient wilderness decides the most productive supporting methodology as that which is the least expensive for the most hazard supported. Given a money view and presentation, supporting improvement models for the most part contrast 100 percent unhedged procedures and 100 percent supported utilizing vanilla advances and choice methodologies keeping in mind the end goal to locate the ideal one. Even though this way to deal with overseeing hazard gives the slightest cost supporting structure for a given hazard profile, it fundamentally relies upon the corporate treasurer's perspective of the conversion scale. Note that such advancement can be utilized for exchange, interpretation or financial cash hazard, gave that the firm has a money see (i.e., a conceivable conversion scale estimate over a predefined day and age).

B. Supporting Benchmarks and Performance Hedging

The hazard inherent in the support is generally communicated through VaR that acts as a reliable measure. Supporting streamlining models, as techniques for advancing supporting systems for money designated money streams, help locate the most productive fence for singular cash exposures, while a large portion of them don't give a supporting procedure to various money supporting. Hence, both execution and VaR are estimated as viable fence rates, figured for each supporting instrument utilized and the hazard as far as a certainty level. A solitary ideal supporting procedure is then chosen by characterizing the hazard that a firm will take. This procedure is the most minimal conceivable successful fence rate for a satisfactory level of vulnerability. Along these lines, when the company's cash see involves a view of instability, alternatives produce a superior or comparative compelling support rate at bring down vulnerability than the unhedged position. Moreover, when neighborhood money has a generally high return and low unpredictability, choices will quite often create a superior powerful supporting rate than forward supporting. As a component of the money hazard administration strategy, firms utilize an assortment of supporting benchmarks to deal with their supporting systems viably. Such benchmarks could be the supporting level (i.e., a specific percent), the announcing time frame, particularly for firms that utilization forward supporting to restrict the instability of their net value, (e.g., quarterly or year benchmarks), and spending trade rates, contingent upon the common bookkeeping rules. In addition, benchmarks empower the execution of individual fences to be estimated against that of the firm.

C. Supporting and Budget Rates

Budget trade rates furnish firms with a reference conversion scale level (Madura, 1989). Setting spending trade rates is frequently connected to the company's sensitivities and benchmarking needs. In the wake of settling on the spending rate, the corporate treasury should secure a suitable support rate and guarantee that there is negligible deviation from that fence rate. This procedure will decide the recurrence and instruments to be utilized as a part of supporting. It ought to be additionally called attention to those constant moves in respect to the numeraire (useful) money ought to be reflected in the spending rates, or key situating and supporting ought to be considered. Firms have distinctive practices in setting spending trade rates (Lam, 2003). Numerous corporate treasurers of multinational firms like to utilize PPP rates as spending trade rates, frequently with the understanding that strategic supporting might be required over the fleeting where the estimating execution of the PPP display is typically poor. However, other multinational firms like to set the spending rate as per their business timetable and, thusly, with their supporting procedure. For instance, if a firm has a deals timetable every three months, it might choose to fence its one year from now's quarterly outside money trade stream out such a path, to the point that they don't vary by in excess of a specific rate from the trade stream out a similar quarter of a year ago. As needs be, this will require four fences for every year, every one of one-year tenor, with supporting being done toward the finish of the period, utilizing the finish of-period conversion scale as its spending rate. On the other hand, a firm may choose to set its spending swapping scale at the everyday normal conversion standard over the past financial year (Barton, Shenkir, and Walker, 2002). Then the company would require utilizing one fence through, maybe, a normal based instrument like an alternative or a manufactured forward. This supporting activity will often be executed on the most recent day of the past monetary year, with beginning day the main day of the new financial year. Besides, a firm may likewise utilize inactive money supporting, for example, supporting the normal estimation of a remote money income over a predefined day and age, with respect to a past period, through choice structures accessible in the market. This sort of supporting system is genuinely basic and less demanding to screen. The relative variant of the PPP hypothesis expresses that respective trade rates would conform to the relative value differentials of a similar decent exchanged the two nations. Setting spending trade rates is likewise urgent for an association's evaluating methodology, notwithstanding their significance for characterizing the benchmark supporting execution and tenor of a fence (as the last by and large match income supporting necessities). In any case, the spending swapping scale used to conjecture money streams should be near the spot conversion standard to dodge conceivable real changes in the association's valuing technique or to rethink its supporting procedure. In this association, it ought to be noticed that anticipating future trade rates is a key part of an association's evaluating system

(Papaioannou, 1989). Forward rates are poor indicators of future spot rates, auxiliary or time-arrangement swapping scale models should be utilized for such an undertaking (Bansal and Dahlquist, 2000; Fama, 1984). It's pretty obvious if we look at a company's net money streams evaluated by utilizing the figure rate and the future spot conversion scale. For an interest in a remote backup, also, the spending swapping scale is frequently the bookkeeping rate, i.e., the conversion scale toward the finish of the past monetary year.

17.6 BEST PRACTICES IN MANAGEMENT OF EXCHANGE RATE RISK

For their money hazard administration choices, firms with huge swapping scale introduction frequently need to build up best practices in operational structure (Allen, 2003; Jacque, 1996). The above standards may include recognizable proof of the sorts of swapping scale hazard that a firm is presented to and estimation of the related hazard introduction. As said previously, this includes assurance of the exchange, interpretation and financial dangers, alongside particular reference to the monetary forms that are identified with each kind of money hazard. Furthermore, estimating these cash dangers—utilizing different models (e.g. VaR)— is another basic component in distinguishing supporting positions. In the wake of recognizing the sorts of money hazard and estimating the company's hazard introduction, a cash system should be built up on better and efficient methods which can manage these dangers. Specifically, this system ought to determine the association's cash supporting destinations—regardless of whether and why the firm ought to completely or somewhat fence its money exposures. Moreover, a nitt-gritty money supporting methodology ought to be set up. It is basic that a firm subtle element the general cash chance administration methodology at the execution level, including the operational procedure of money supporting, the supporting instruments to be utilized, and the observing systems of money fences. This substance will oversee conversion of standard gauging, the supporting methodology systems, the bookkeeping strategies with respect to cash hazard, expenses of money supporting, and the foundation of benchmarks for estimating the execution of cash supporting. (These activities might be attempted by a specific group which a treasurer heads, for huge multinational firms, by a central merchant.)

Advancement of an arrangement of controls to screen a company's conversion scale hazard and guarantee suitable position taking incorporates setting position limits for each supporting instrument, position checking through stamp to-showcase valuations of all money positions consistently (or intraday), and the foundation of cash supporting benchmarks for occasional observing of supporting execution (normally month to month). Hazard oversight advisory group panel would specifically endorse restrains on position taking, look at the suitability of supporting instruments and for related VaR positions, and survey the hazard administration approach all the time. Overseeing conversion scale chance introduction has picked up noticeable quality in the most recent decade, because of the bizarre event of countless emergencies. From the corporate directors' point of view, cash chance administration is progressively seen as a reasonable way to deal with diminishing a company's vulnerabilities from significant swapping scale developments (Van Deventer, Imai, and Mesler, 2004). The above mentioned state of mind has likewise been strengthened by late worldwide consideration on both bookkeeping and monetary record dangers.

Check Your Progress- A

Choose the correct alternative

Q1. The VaR computation relies upon 3 parameters:

a) Money The holding time frame, i.e., the period over which the remote trade position is intended to be held. The commonplace holding time frame is 1 day.

b) The certainty level at which the gauge is intended to be made. The typical certainty levels are in the range of 95% and 99%.

c) The unit of cash to be utilized for the section of the VaR.

d) All of the above

Q2. The different ways to manage risk is/are:

a) Performance Hedging

b) Supporting and Budget Rates

c) Both a) and b)

d) Neither a) nor b)

Q3. A swap that is utilized to sidestep danger of exchange rate due to currency mismatching is named:

a) currency swaps

b) fixed swaps

c) floating swaps

d) notion swaps

Q4. Understanding between two parties to trade money streams in future and money streams depend on underlying instruments is named:

a) index

b) exchange

c) interchange

d) swaps

Q5. Financial Institutions manage derivatives by using:

a) Foreign exchange risk

b) Credit risk

c) Interest rate risk

d) All of the above

17.7 HEDGING INSTRUMENTS FOR EXCHANGE RATE RISK MANAGEMENT

Inside the system of a money hazard administration methodology, the supporting instruments permitted to oversee cash hazard ought to be determined. The accessible supporting instruments are huge, both in assortment and multifaceted nature, and have taken after the emotional increment in the supporting needs of the cutting-edge company (Hakala and Wystup, 2002; Jacque, 1996; Shapiro, 1996). The different instruments incorporate both OTC and trade exchanged items. Among the most widely recognized OTC money supporting instruments are cash advances and cross currency swaps. Money advances are characterized as purchasing a cash contract for future conveyance at a value set today. Two sorts of advances contracts are regularly utilized: out and out advances (including the physical conveyance of monetary forms) and non-deliverable advances. With advances, the firm is completely supported. Notwithstanding, the expensive nature of forward contracts and the danger of the swapping scale moving the other way are not kidding weaknesses. The two most normally utilized cross-money swaps are the cross-cash coupon swap and the cross-cash premise swaps.

The cross-money coupon swap is characterized as purchasing a cash swap and, in the meantime, balance money settled and get skimming premium installments. Its leeway is that it enables firms to deal with their remote conversion scale and loan fee dangers, as they wish, however it leaves the firm that purchases this instrument powerless against both money and financing cost hazard. Cross-money premise swap is characterized as purchasing a cash swap and, in the meantime, pay gliding enthusiasm for a cash and get skimming in another cash. This instrument, while accepting a similar cash chance as the standard money swap, has the preferred standpoint that it enables a firm to catch winning loan cost differentials. In any case, the real weakness is that the essential hazard for the firm is loan cost chance rather that cash chance. For trade exchanged money supporting instruments, the fundamental sorts are cash alternatives and cash prospects. The improvement of different structures of cash alternatives has been exceptionally fast and is credited to their adaptable nature. The most well-known sort of alternative composition is the plain vanilla call characterized as purchasing an upside strike in a conversion standard with no commitment to work out (Allen, 2003). Its points of interest incorporate its straightforwardness, bring down the cost and the anticipated most extreme misfortune—which is the premium. Be that as it may, its price is more than other modern choices structures, for example, call spreads (purchase an at-the-cash call and offer a low delta call). Money fates are trade exchanged contracts indicating a standard volume of a specific cash to be traded on a settlement date. They are like forward contracts in that they enable a firm to settle the cost at a future date to be paid in cash. However, their qualities contrast from forward rates, both as far as the accessible exchanged monetary forms and the run of the mill (quarterly) settlement dates. Be that as it may, the cost of cash fates will typically be like the forward rates for a specified amount and a given settlement date.

Looking at money forward and cash prospects showcases, the span of the agreement and the conveyance date are customized to singular demands in forward market (i.e., agreed between the bank and the company), rather than cash fates gets that are institutionalized and ensured by some composed trade. While there is no different clearing-house work for forward business sectors, all clearing activities for prospects markets are taken care of by a trade clearing house, with day by day check to-advertise settlements. The settlement of forward contracts are settled by real conveyance and just some by balance - at a cost, interestingly, most fates contracts are settled by counterbalanced and just not very many by conveyance

17.8 MANAGEMENT OF INTEREST RATE RISK

Financing cost chance exists in an enthusiasm bearing resource, for example, an advance or a security, because of the likelihood of an adjustment in the benefit's Value coming about because of the changeability of loan fees. Loan fee hazard administration has turned out to be critical and arranged instruments have been produced to manage financing cost chance.

This article takes a gander at a few ways that the two organizations and shoppers oversee financing cost hazard utilizing different loan fee subordinate instruments.

17.9 SUSCEPTIBILITY TO INTEREST RATE RISK

Financing cost hazard is the hazard that emerges when indisputably the level of loan fees varies. Loan fee hazard straightforwardly influences the estimations of settled salary securities. Since financing costs and security costs are contrarily related, the hazard related with an ascent in loan costs causes bond costs to fall, and the other way around. Security financial specialists, particularly the individuals who put resources into long haul settled rate securities, are even more straightforwardly defenseless to loan fee chance.

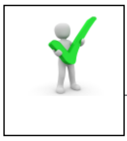
Assume an individual buy a 3% settled rate 30-year security for Rs.10,000. It pays Rs.300 every year through development. In the case of, amid this time, loan fees ascend to 3.5%, new bonds pay Rs.350 every year through development, accepting a Rs.10,000 venture. On the off chance that the 3% bondholder keeps on holding his security through development, he misses out on the chance to acquire a higher financing cost. On the other hand, he could offer his 3% security in the market and purchase the security with the higher loan cost. Be that as it may, doing as such outcomes in the speculator getting a lower cost on his offer of 3% bonds as they don't appeal any more to financial specialists since the recently issued 3.5% bonds are additionally accessible.

Interestingly, changes in loan costs additionally influence value speculators yet less specifically than bond financial specialists. When loan fee increases, the partnership's cost of acquiring cash additionally increments. This could bring about the company delaying getting, which may bring about less spending. This diminishing in spending may back off corporate development and result in diminished benefit and eventually bring down stock costs for financial specialists.

17.10 IMPORTANCE OF INTEREST RATE RISK

Similarly, as with any hazard administration evaluation, there is dependably the choice to sit on it and it's done by numerous individuals as well. Be that as it may, in conditions of unusualness, now and again not supporting is sad.

Luckily, the individuals who need to support their speculations against loan cost chance have numerous items to browse.



Check Your Progress- B

Q1What are Hedging Instruments for Exchange Rate Risk Management?

Q2. Write a note on susceptibility to interest rate risk.

17.11 INVESTMENT PRODUCTS

Forwards: A forward contract is the most fundamental loan fee administration item. The thought is basic, and numerous different items talked about in this article depend on this thought of significance today for a trade of something at a particular future date.

Forward Rate Agreements (FRAs): FRA depends on the possibility of a contract, where the most important factor is the financing cost. The importance of paying a settled loan cost and gets a gliding financing cost equivalent to a reference rate. The real installments are ascertained in light of a notional essential sum and paid at interims dictated by the gatherings. Just a net installment is made – the failure pays the victor, as it were. FRAs are constantly settled in real money.

FRA clients are normally borrowers or loan specialists with a solitary agreed date on which they are expected to finance cost obligation. A progression of FRAs is like a swap (talked about beneath); be that as it may, in a swap all installments are at a similar rate. Each FRA in an arrangement is evaluated at an alternate rate, unless the term structure is level.

Futures: A fates contract is like a forward, yet it gives the counterparties less hazard than a forward contract – in particular, a reducing of default and liquidity chance because of the incorporation of a go-between.

Swaps: Swap is a trade. More particularly, an interest rate swap looks a great deal like a mix of FRAs and includes a clause between counterparties to trade sets of future money streams. The most widely recognized is a plain vanilla swap which is a kind of interest rate swap, which includes one gathering paying a settled financing cost and getting a drifting price, and the other person to the contract pays an accepted rate.

Options: Interest rate administration choices are choice contracts for which the basic security is an obligation commitment. These instruments are helpful in ensuring the gatherings engaged with a gliding rate advance, for example, customizable rate contracts (ARMs). A gathering of financing cost call alternatives is alluded to as a loan fee top; a blend of loan cost put choices is alluded to as a loan fee floor. When all is said in done, a cap resembles a call and a story resembles a put.

Swaptions: A swaption, or swap alternative, is just a choice to go into a swap.

Imbedded Options: Many financial specialists experience intrigue administration subsidiary instruments by means of inserted alternatives. If a bond is purchased with a call arrangement, the guarantor of your callable security is protecting that if loan costs decay, they can bring in the bond and new bonds with a lower coupon rate can be issued.

Caps: A cap, additionally called a roof, is a call alternative on a financing cost. For eg. A borrower going long or paying a premium to purchase a cap and getting money installments from the top merchant (the short) when the reference loan fee surpasses the strike rate of the cap. The installments are intended to counterbalance financing cost increments on a skimming rate advance.

On the off chance that the real loan cost surpasses the strike rate, the merchant pays the distinction between the strike and the financing cost increased by the notional vital. This alternative place a furthest cutoff, on the holder's advantage cost.

The financing cost top is really a progression of alternatives for every period the top understanding exists. A caplet is intended to give a fence against an ascent in the benchmark loan cost, for example, LIBOR, for an expressed period.

Floors: Just as a put alternative is viewed as the perfect representation of a call choice, the floor is the identical representation of the top. The loan fee floor, like the top, is really a progression of different choices, except for that they are put choices.

Collars: A defensive neckline can likewise help oversee loan fee hazard. Catching is refined by at the same time purchasing a top and offering a story (or the other way around), simply like a neckline secures a financial specialist who has taken a long position. A zero-cost neckline can likewise be set up to bring down the cost of supporting, however this decreases the potential benefit that would be delighted in by a loan fee development to support you, as you have set a roof on your potential benefit.

17.12 SUMMARY

Every one of these items gives an approach to support loan fee chance, with various items more suitable for various situations. There is no free lunch in the world. With the available options, one surrenders something – either cash, as premiums paid for alternatives, or opportunity cost, which is the benefit one would have made without supporting.

17.13 GLOSSARY

Forwards: A forward contract is the most fundamental loan fee administration item. The thought is basic, and numerous different items talked about in this article depend on this thought of significance today for a trade of something at a particular future date.

Forward Rate Agreements (FRAs): FRA depends on the possibility of a contract, where the most important factor is the financing cost.

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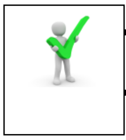

17.14 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress –A

Ans: 1d
2c
3a
4d
5d

17.15 REFERENCES

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17.16 SUGGESTED READINGS

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2. Foreign Exchange International Finance Risk Management, Fifth Edition - A.V. Rajwade, H. G. Desai, Shroff Publishers, New Delhi
3. Managing Interest Rate Risk - Clive R. Grumball, Praeger Publishers Inc, Santa Barbara, CA
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17.17 TERMINAL QUESTIONS

Q1. Discuss the interest rate risk with the help of suitable example.

Q2. Discuss the best practices that are used for Interest Rate Exchange Rate Risk Management.

Q3. How can interest rate risk be measured?

Q4. Discuss the different investment products that are traded in the derivatives market.

Q5. Discuss the different factors on which the exchange rate of a currency depends upon.

Block IV

Emerging Scenario in International Business

UNIT 18 REGIONAL ECONOMIC GROUPING

18 .1 INRODUCTION

Regional Economic Grouping are the association of countries situated in a particular region and they come to a common understanding regarding rules and regulations to be followed while import and export of goods among them. The member countries have liberal rules for themselves while a separate set of rules for the non-members. The main objective of these grouping is to raise cross-border trade and investments and standard of living of the member countries. There are three ways of economic integration or grouping; global integration through world trade organization, bilateral integration, where two countries decide to cooperate through the tariffs reduction and regional integration, multilateral integration, where more than two countries located in same geographic proximity decide to cooperate, such as European Union (UN). In the mid 1940s, some of the countries realized that if they want to emerge from the wreckage of World War II and also want to promote economic growth and stability, they would have to assist and get assistance from neighboring countries. In this unit we will discuss some of the regional economic grouping or agreements among countries in a geographic region to reduce, and ultimately removal of, tariff and non tariff barriers for the free flow of goods, services and factors of production between each other. Regional economic grouping is the political and economic agreements among countries that give priority to the member countries with regard to the removal of tariff and non-tariff barriers. Some of the regional economic agreements which we will discuss in this unit are European Union (EU), the North American Free Trade Agreement (NAFTA), the Association of South -East Asian Nations (ASEAN), Asia Pacific Economic Cooperation (APEC). These groups are popularly known as Trading Blocs.

The Economic case for Integration

In unit 6 we studied that the theories of international trade predict that free trade will allow countries to specialize in production of goods and services that they produce more efficiently. This will result in greater world production than would be possible with trade restrictions. In unit 16 we learned about Foreign Direct Investment (FDI). How FDI transfer technological, marketing and managerial know how to host nations and how host nations withdraw benefits from all of these. In sum, economic theories state that free trade and investment is a positive sum game, in which all participating countries stand to gain. International institutions like WTO also making efforts to move the world towards a free trade system. But in a world of many nations and with many political ideologies it is very difficult to get all countries to a common set of rules. Against this background, regional economic integration can be seen as option to achieve additional gains from free flow of trade and investments between limited numbers of countries than among the whole world community. Coordination and policy harmonization problems generally arises when the number of countries are large that seek agreement. The larger the number of countries involved, harder it will be to agree on the terms of conditions. Thus regional economic grouping are motivated by a desire to exploit the gains from free trade and investments.

The political case for Integration

The political case for regional integration also has loomed large in several attempts to establish free trade areas, customs unions and the like. Trade agreements with neighboring countries and making them dependent on each other increase the political cooperation and also reduce the potential for violent conflict. Countries when come together also increase their political weight in the world.

18.2 OBJECTIVES

After reading this unit you will be able to:

- Understand meaning of Regional Economic Grouping
- Describe the different types of regional economic grouping
- Understand the effects of regional economic grouping
- Come to know about the major regional trading groups such as EU, NAFTA, APEC, SAARC, ASEAN.

18.3 REGIONAL ECONOMIC INTEGRATION

The most trade groups contain countries of the same region or economic zone. Neighboring countries tends to be come to an agreement for several reasons:

- The distance that goods need to travel between such commodities is short.

- Consumers' tastes are likely to be similar, and distribution channels can be easily established in adjacent countries.
- Neighboring countries may share a common history and interest, and they may be more willing to coordinate their policies.

Levels of Regional Economic Grouping

Regional Economic Grouping may be classified into four levels from a very loose integration of countries in Free Trade Area to the complete economic integration, where the economies of member countries are completely integrated.

Stages of Integration

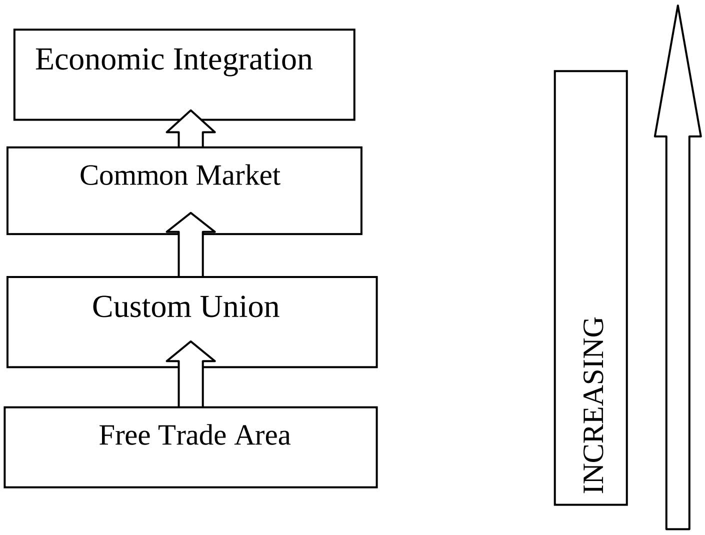

Fig 18.1 Levels of Regional Economic Grouping

1. **Free Trade Area (FTA)** – The goal of an FTA is the complete removal of tariffs on trade of goods and services among member countries. Ideally in a free trade area there is no discrimination tariffs, quotas, subsidies or administrative impediments are allowed between member countries. Each country, however, is allowed to determine its own trade policies with regard to non members. Free trade agreements are the most popular form of regional economic grouping, accounting for almost 90% of regional agreements. The most enduring free trade area in the world is EFTA. Established in January 1960 EFTA was founded by those Western European countries that initially decided not to be part of the European Community (forerunner of EU). Its original members included Austria, Great Britain, Denmark, Finland and Sweden all of which are now members of European Union (EU). The emphasis of EFTA has been on free trade in Industrial goods and not on consumer goods. Member countries are free to determine the level of protection applied to goods coming from outside EFTA. The North America Free Trade Agreement (NAFTA) is also an example of such a free trade area and it includes the USA, Canada and Mexico. NAFTA we will discuss in detail later in the unit.
2. **Customs Union** – The customs union is one step farther the full economic integration. A customs union in addition to eliminating the internal trade barriers

adopts a common external trade policy for the non member countries. Most countries that enter into a customs union desire greater economic integration farther. The EU began as a customs union, but has now moved beyond this stage. The example of customs union is the Andean Community (formerly known as Andean Pact) between Bolivia, Colombia, Ecuador, Peru and Venezuela. The Andean Community has free trade between member countries and imposes a tariff between 5 to 20 percent, on products imported from outside.

3. **Common Market**- The next level of economic integration is common market, has no tariffs between member countries, have common external trade policy and free mobility of factors of production such as labor, capital among the member countries. This means that labor is free to move for work in any country in the common market without restrictions. In the absence of common market arrangement, workers would have to apply for visa to enter into another country, and that might be difficult to come by. For years, the European Union (EU) functioned as a common market, but now it has moved beyond this stage. MERCOSUR, the South American grouping of Argentina, Brazil, Paraguay, and Uruguay hopes will establish itself as a common market.
4. **Economic Integration**- Economic integration refers to the single economic market, a common trade policy, a single currency, a common monetary policy and fiscal policy, including common tax and benefits rates – in short, complete social and economic harmonization by adopting common economic policies. EU is an Economic Union, although an imperfect one because many member countries of EU have not adopted the Euro, the currency of EU, the differences in tax rate and regulation across countries still remain, and some markets, such as market for energy is still not fully deregulated. Although no region has attained complete economic integration, but EU which we will discuss in this unit comes the closest.

Basic Elements of the Stages of Economic Integration	
Free Trade Agreement (FTA)	Zero tariffs between member countries and reduced non-tariff barriers
Customs Union (CU)	FTA + common external tariff charges
Common Market (CM)	CU + free movement of investments and labour, some policy harmonization
Economic Union (EU)	CM + common economic policies and institutions

Table 18.2 Basic Elements of the Stages of Economic IntegrationSource: http://publications.gc.ca/Collection-R/LoPBdP/inbrief/prb0249-e.htm

18.4 EFFECTS OF REGIONAL ECONOMIC INTEGRATION

The regional trade agreements can affect the member countries in social, cultural, political and economic ways. For example, prior to the NAFTA agreement, Canada has a small successful film industry. However, removal of trade barriers meant that U.S. film industry would have overrun the Canadian Market. The provinces control film distribution in Canada, and one province –Quebec-requires that foreign film bear a Canadian Government issue classification sticker before being sold or distributed in Canada. During the NAFTA negotiation, the Canadian government wanted to retain these restrictions in order to protect its film industry. The added regulatory restrictions by Quebec mean the fewer U.S. films are being distributed there than would be the case in a free trade environment. Multinationals are especially concerned with the economic effects of integration. The imposition of tariffs and non tariffs barriers disrupts the free flow of goods, affecting resource allocation. Regional economic integration eliminates those barriers for the member countries. It produces both **static effects** and **dynamic effects.** Static effects are the shifting of resources from inefficient producers to efficient producers as trade barriers fall. Dynamic effects are the overall growth in the market and impact on a company caused by expanding production and by the company's ability to achieve greater economies of scale. Static effects may develop when either of two of the following conditions occurs.

Trade Creation – production shifts to more efficient producers for reason of comparative advantage allowing consumers access to more goods at a lower price than would have been possible without integration. Companies that are protected in their domestic markets face real problems when the tariff barriers are removed and they then attempt to compete with more efficient production companies. The strategic implication is that companies that might not be able to export to another country- even though they might be more efficient than producers of that country – are now able to export when these trade restrictions are removed.

Trade Diversion- Trade diverted to the country of trading bloc at the expanse of trade with the countries not in bloc, even though the non-member companies might be more efficient in the absence of trade barriers. For Example, U.S companies are importing same products from Mexico and Taiwan. If U.S. comes into trade agreement with Mexico then it will import goods from Mexico because of lower tariffs. This does not mean that Mexican products are better and cheaper (in the absence of integration) than the Taiwan's products, but the lower tariffs give them a competitive edge in the market.

Dynamic Effects of integration occur when trade barriers are eliminated and market size increases. For Example, Argentina, a country of 37.4 million people is a member of MERCUSOR, is a bloc comprising Argentina, Brazil, Paraguay and Uruguay. The size of that market is 221million people. Argentine companies can export to neighbours countries in the absence of trade agreement, but high tariffs would probably limit their ability to compete. When trade barriers come down, the market size for the Argentine companies increases dramatically. Because of the larger size of market, Argentine companies can increase the production and can reap the benefits of economies of scale. Companies can produce more cheaply, which is good because they become more efficient to survive. Another important dynamic effect is increase in efficiency due to increase in competition. Many multinational enterprises in Europe have taken the route of mergers and acquisition to achieve the size necessary to compete in the larger market.

Check Your Progress- A

Q1. What is regional economic grouping?

Q2. What are the different levels of Economic Integration?

Q3. What is the difference between a Free Trade Agreement and Custom Union?

Q4. What are the benefits of regional Economic Integration?

18.5 MAJOR REGIONAL ECONOMIC GROUPINGS

There are two ways to look at different trading blocs: by location and by type. There are many trading groups in every region of the world. It is impossible to cover every group in every region, so in this unit we will cover a few of the major groups. However, it is important to understand that each regional group fits into one of the type defined above: Free trade area, custom union, common market, or economic integration, with most of the trading blocs comes under FTA and Custom union.

Companies are interested in regional trading groups for their markets, sources of raw materials and production locations. The larger and richer the new market, the most likely is to attract the attention of the major investor countries and companies.

18.5.1 THE EUROPEAN UNION (EU)

Europe has two trade blocs- the European Union (EU) and the European Free Trade Association (EFTA). Out of these two, EU is more significant not in term of its member states but also in terms of its economic and political influence in world economy. In this unit we will discuss EU in detail. The European Union (EU) is a political and economic union of 28 member states that are located primarily in Europe. It began as a custom union, but the formation of the European Parliament and the establishment of a common currency, the euro, make the EU the most ambitious among the regional trade group. After World War II, European political leaders realized that great cooperation among their countries would help speedy Europe's recovery. Many organisations were formed including the European Economic Community (EEC), which eventually emerged as the organization that would bring together the countries of Europe into the most powerful trading bloc in the world. The EEC, later called the European Community (EC) and finally the European Union (EU), set about to remove internal tariffs in order to more closely integrate European markets and hopefully allow economic cooperation to help avoid further political conflict.

The EU's Organizational Structure

The European Union (EU) have principal decision making governing bodies, these are: the European Parliament, the Council of European union, the European Commission, the European Court of Justice, the European Central Bank and the European Court of Auditors. It is very important for the management of multinational enterprises (MNEs) to understand the governance of EU, just as they need to understand the governance process of each of the individual European country in which they are investing or doing business. These governing bodies, set parameter under which MNEs must operate, so management need to understand these bodies and how their decision that could affect corporate strategy.

The European Commission- the European Commission is the only institution empowered of initiating proposals for legislation, serves as the 'Guardian of the Treaties' and also the manager and executor of union policies and of international trade relationships. The commission manages the annual budget of the EU, manages the EU and negotiate trade agreement. It is run by group of commissioners appointed by each member country for five years renewable terms. There are 28 commissioners, one from each member state. The entire commission has to be approved by European Parliament before it began its work. The commission makes proposals which go to the Council of European Union and then to the European Parliament. The council cannot legislate without commission proposal in front of it. The European Commission also monitor and makes sure that member countries are complying with EU laws. In this policing role, the commission ask the member states to comply with the EU laws that are being broken.

The Council of European Union- It brings together one representative minister from the government of each member state. The membership depends upon the topic being discussed. When agriculture related issues are to be discussed, then agriculture ministers from each member state attend the meeting, when transportation is being discussed, transportation ministers attend and so on. Before 1993, all council's issues decided through the unanimous agreement among the member states. This often leads to multiple council sessions and a failure to reach agreement on commission proposals. In an attempt to clear the resulting logjams the Single European Act formalized the use of voting rules on issues in council. The votes of the country in the council depend upon the size of the country. For example, Britain a large country has 29 votes, whereas Denmark a much smaller state has 7 votes.

The European Parliament- The parliament consists of 751 members, is directly elected by the citizens of EU in every five years on the basis of proportional representation (membership is based on country population).The three major responsibilities of the Parliament are legislative power, control over the budget and supervision of executive decisions. The commission presents community legislation to the parliament. Parliament must approve the legislation before submitting it to the council for adoption.

The European Court of Justice- The Court of Justice comprises the one judge from each country, is the supreme appeals court for EU laws. It ensures the uniform application of EU law and resolves disputes between EU economic bodies and member states, and against EU bodies on behalf of individual.

The European Central Bank - The European Central Bank is responsible for monetary stability within member states.

The European Court of Auditors- The European Court of Auditors investigate the proper management of finance within both of EU entities and EU funding provided to its member states.

The Single European Act

The European Union has been moving toward single market since the passage of the Single European Act of 1987. The Single Market refers to the EU as one territory without any internal borders or other regulatory obstacles to the free circulation of goods, capital, people and services- the "four Freedom". A functioning of Single Market stimulates competition and trade, improves efficiency, raises quality, and helps cut prices. The European Single Market is one of the EU's greatest achievements. It has fuelled economic growth and made the everyday life of European businesses and consumers easier. Two of the highly important objectives of the European Economic Community were the development of a common market, subsequently becoming a single market, and a customs union between its member states. The single market results in the free circulation of goods, capital, people, and services within the EU and the customs union involves the imposition of a common external tariff on all goods entering the market. Once goods have been admitted into the market they cannot be subjected to customs duties, discriminatory taxes or import quotas, as they travel internally. The non-EU member states of Iceland, Norway, Liechtenstein and Switzerland participate in the single market but not in the customs union.

Free movement of capital is intended to permit movement of investments such as property purchases and buying of shares between countries. Until the drive towards economic and monetary union the development of the capital provisions had been slow. Post-Maastricht there has been a rapidly developing corpus of EC judgments regarding this initially neglected freedom. The free movement of capital is unique insofar as it is granted equally to non-member states.

The free movement of persons means that EU citizens can move freely between member states to live, work, study or retire in another country. This required the lowering of administrative formalities and recognition of professional qualifications of other states.

The free movement of services and of establishment allows self-employed persons to move between member states to provide services on a temporary or permanent basis. While services account for 60–70% of GDP, legislation in the area is not as developed as in other areas. This lacuna has been addressed by the recently passed Directive on services in the internal market which aims to liberalize the cross border provisions of services. According to the Treaty the provision of services is a residual freedom that only applies if no other freedom is being exercised.

The Euro

The creation of single currency has become the main objective of the European Economic Community in 1969. The EU nations signed the Treaty of Maasstricht in 1992 which set steps to accomplish to two goals political union and monetary union. The decision to move to a common currency in Europe eliminated currency as the barrier to trade. To replace each national currency with a single European currency called the euro, the member countries required to meet the convergence criteria. The countries wanted to join had first to join the European Exchange Rate Mechanism. As per the Maasstricht Treaty the joining states has to fulfill important financial obligations and procedures before entering the monetary union. The criteria outlined in the Treaty and which apply on euro applicants are the following;

Annual government deficit must not exceed 3 percent of GDP.

Total outstanding government debt must not exceed 60 percent of GDP.

Rate of inflation must remain within 1.5 percent of the three best performing EU countries.

Average nominal long-term interest rate must be within 2 percent of the average rate in the three countries with the lowest inflation rate.

Exchange rate stability must be maintained, that for at least two years, the country concerned has kept within the "normal" fluctuation margins of the European Exchange Rate Mechanism.

After a great deal of effort, 11 out of 15 countries of EU joined the European Monetary Union (EMU) by January 1, 1999. Greece joined on January 1, 2001. Those not yet participating in the euro are the United Kingdom, Sweden and Denmark (by their choice). Sweden announced in July 2002 that it has met all the criteria for joining the EMU, although it has not set a date for entry. In 2002, the currency was fully put into place, when euro notes and coins were issued and national currencies began to phase out in the euro zone, which by then consisted of 12 member states. The next enlargements were to states which joined the EU in 2004, and then joined the euro zone on 1 January in the year noted: Slovenia (2007), Cyprus (2008), Malta (2008), Slovakia (2009), Estonia (2011), Latvia (2014), and Lithuania (2015). The euro zone (constituted by the EU member states which have adopted the euro) has since grown to 19 countries. Nine countries (Bulgaria, Croatia, Czech Republic, Denmark, Hungary, Poland, Romania, Sweden, and the United Kingdom) are EU members but do not use the euro. Before joining the euro zone, a state must spend two years in the European Exchange Rate Mechanism (ERM II). Denmark and the United Kingdom obtained special opt-outs in the original Maastricht Treaty. Both countries are legally exempt from joining the euro zone unless their governments decide otherwise, either by parliamentary vote or referendum.

The other seven countries are obliged to adopt the euro in future, although the EU has so far not tried to enforce any time plan. They should join as soon as they fulfill the convergence criteria, which include being part of ERM II for two years. Sweden, which joined the EU in 1995 after the Maastricht Treaty was signed, is required to join the euro zone. However, the Swedish people turned down euro adoption in a 2003 referendum and since then the country has intentionally avoided fulfilling the adoption requirements by not joining ERM II, which is voluntary. The following 28 sovereign states or countries constitute the European Union.

Exhibit 18. 3 Sovereign states or countries constituting the European Union

The euro, and the monetary policies of those who have adopted it in agreement with the EU, administered by the European Central Bank (ECB), which was established on July 1, 1998 in Frankfurt. The ECB is the central bank for the euro zone, and thus controls monetary policy in that area with an agenda to manage the exchange- rate system for all the Europe since January 1, 1999. The implied loss of national sovereignty to the ECB is the main reason for many countries to stay out of the euro zone for now. Many in these countries are suspicious of the ECBs ability to remain free from the political pressure and to keep inflation under tight control. The Maastricht Treaty Prohibits the ECB from taking orders from political leaders. Since its establishment January 1, 1999, the euro has a volatile trading history against the world's major currency, the US dollar. In the first year of its life, the euro fluctuated in value between a high of $1.1827 per euro to a low of nearly $1.00 per euro. Its value fell as compared to US dollars in 2000 and 2001 and began rising again in 2002. Some analysts believe it is still undervalued by 15 percent and will continue its upward swing. The ECB began distributing actual banknotes, replacing individual national currencies on Jan 1, 2002.

18.5.2 NORTH AMERICAN FREE TRADE AGREEMENT (NAFTA)

NAFTA, which includes Canada, the United States and Mexico, entered into force on, January 1, 1994. The United States and Canada historically had various forms of mutual economic agreements. In January 1, 1989 they signed the Canada-U.S free trade agreement which eliminated all tariffs on bilateral trade by January 1, 1998. In February 1991 Mexico approached the United States to establish a free-trade agreement. The formal negotiations that began in June 1991 included Canada resulting North American Free Trade Agreement became effective on January 1, 1994. NAFTA is an American counterpart to the EU. EU main objective is the political and economic integration whereas in American integration the objective is purely economic. NAFTA trade bloc is one of the largest trade blocs in the world by Gross Domestic Product (GDP). Numerous tariffs, particularly those related to agriculture, textiles and automobiles were gradually phased out between January 1, 1994 and January 1, 2008. NAFTAs purpose was to encourage economic activity among North America's three major economic powers.

NAFTA covers the following areas:

- Market access- tariffs and non tariffs barriers, rules of origin and government procurement.
- Trade rules- safeguards, subsidies, countervailing and antidumping duties, health and safety standards.
- Services- provides for the same safeguards for trade in services (consulting, engeering, software etc.) that exists for trade in goods.
- Investments – establishing investment rules governing minority interests, portfolio investment, real property and majority – owned and controlled investments from the

NAFTA countries; in addition, NAFTA coverage extends to investments made by any company incorporated in a NAFTA country, regardless of country of origin.

- Intellectual property- all three countries pledge to provide adequate and effective protection and enforcement of intellectual property rights, while ensuring that enforcement measures do not themselves become barriers to legitimate trade.
- Dispute settlement- provides a disputes- settlement process that will be followed; desired to keep countries from taking unilateral action against an offending party.

Mexico had made significant steps in tariff reduction after joining GATT in 1986. At that time its tariff averaged 100 percent. Since then, it has reduced tariffs dramatically. As a result of NAFTA, most tariffs on originated goods traded between Mexico and Canada were eliminated immediately or phased in over 10 –year period. In the first five years of NAFTA, Mexico reduced its average tariff on U.S. goods from 10 percent to 2 percent, while U.S tariffs on Mexican products dropped to less than 1 percent.

NAFTA provides the static and dynamic effects of economic integration discussed earlier in this unit. For example Canadian and U.S consumers will benefit from lower cost agriculture products from the Mexico, a static effect of economic liberalization. U.S. producers also benefit from the large and growing Mexican market, which has a large demand for the U.S products –a dynamic effect.

In addition NAFTA is a good example of trade diversion. Many U.S and Canadian companies have established their manufacturing units in Asia because of the cheap labor facility available there. After NAFTA, U.S and Canadian companies established manufacturing units in Mexico to take advantage of cheap labor. For example, IBM is making computer parts in Mexico that was earlier made in Singapore. In five years, IBM boosted exports from Mexico to U.S from $350 million to $2 billion. If the subassemblies not made in and exported from Mexico, they would be made in Singapore and other parts of Asian countries. GAP Inc. and Liz Claiborne are increasingly buying garments from Mexican contractors, who can offer faster delivery than can Asian contractors.

Exhibit 18. 4 NAFTA

Rules of Origin and Regional Content

An important component of NAFTA is the concept of rules of origin and regional content, because NAFTA is a free trade agreement and not a custom union. Each country set its own tariffs to the rest of the world. That is why a product entering in the United States from Canada must have a commercial or customs invoice that identifies the product's ultimate origin. Otherwise, an exporter from a third country would always ship the product to the NAFTA country with the lowest tariff and then re-export it to other two countries duty-free.

According to regional content rules, at least 50 percent of the net cost of most products must come from NAFTA origin. The exceptions are 55 percent for footwear, 62.5 percent for passenger automobiles and light trucks and the engines and transmissions for such vehicles, and 60 percent for other vehicles and automotive parts. For example- a ford car assembled in Mexico could use parts from Canada, the United States, and Mexico, as well as labor and other factors from Mexico. For the car to enter in the United States and Canada according to preferential NAFTA duty, at least 62.5 percent of its value must come from North America.

Special Provisions of NAFTA

Most free agreements in the world are based solely on one goal; to reduce tariffs. However, NAFTA is a very different free trade agreement. Due to strong objections to the agreement by labor unions and environmentalists, two side agreements covering those issues were included in NAFTA. Critics worried that lower labour costs in Mexico would attract U.S and Canadian companies resulting in manufacturing units will shift to Mexico and loss of manufacturing jobs in United States and Canada. Environmentalists, on the other hand were concerned about the potentially disastrous effect of rapid industrialization in Mexico. As a result, the labor lobby in the United States forced the inclusion of labor standard, such as the right to unionize, and the environmentalist lobby pushed for an upgrade of environmental standards in Mexico and the strengthening of compliance.

Effects of NAFTA

NAFTA produced mixed results. It turned out to be neither the magic bullet that its supporters had expected nor the devastating blow that its critics had predicted. Since NAFTA has been in place, Mexico did experience a dramatic increase in its exports, from about $ 60 billion in 1994 to nearly $ 400 billion by 2013. The increase in exports was accompanied by an explosion in imports as well, resulting in an inflow of better quality and lower-priced goods for Mexican consumers. Economic growth during the post NAFTA period was not impressive in any of the countries involved. Several economic recessions in United States and Canada, including the great recession of 2007-2009, overshadowing any beneficial that could have because of NAFTA. Also Mexico's Gross

Domestic Product (GDP) grew at lower rate compared with other Latin American countries such as Brazil and Chile, and its growth in income per person was not significant enough, though there was an expansion of middle class in the post NAFTA years. Because of immigration restrictions, the wage gap between Mexico on the one hand and the United States and Canada on the other hand did not shrink. Lack of infrastructure in Mexico caused many U.S and Canadian companies to invest directly in Mexico. As a result no significant job losses in U.S and Canada and also no environmental disaster caused by industrialization in Mexico.

Expansion of the Agreement

In 2004 the Central America Free Trade Agreement (CAFTA) expanded NAFTA to include five Central American countries (EI Salvador, Guatemala, Honduras, Costa Rica and Nicaragua). In the same year, the Dominican Republic joined the group by signing a free trade agreement with the United States, followed by Colombia in 2006, Peru in 2007 and Panama in 2011. The Trans-Pacific-Partnership (TPP) that was signed in October5, 2015, constituted an expansion of NAFTA becomes the world's largest free trade bloc, covering the 40% of the global economy.

Renegotiation

When Donald Trump became President of United States in 2017, he withdrew the United States from TPP agreement .Trump criticized this agreement, stating that it would push more manufacturing jobs to overseas, increase the U.S. trade deficit, and fail to address currency manipulation by U.S trade partners. Trump also expressed negative views of NAFTA, calling it "the single worst trade deal ever approved in this country". He threatened to remove the United States from NAFTA if the agreement was not renegotiated to his liking. However, months of negotiations brought little progress. At the end of August 2018 Mexico and United States announced that they had introduced number of significant changes in trade agreement. Under the pressure of being the odd country out, Canada, also agreed to join the new trade accord, which was branded as United States-Mexico-Canada Agreement (USMCA).

18.5.3 ASSOCIATION OF SOUTH EAST ASIAN NATIONS (ASEAN)

The Association of South East Asian Nations (ASEAN), organized in 1967, comprises Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. It promotes cooperation in many areas, including industry and trade. Member countries are protected in terms of tariff and nontariff barriers. ASEAN region has a large market size (more than 600 million people) and area of 1.7 million square miles (4.5 million square km). ASEAN replaced the Association of South East Asia (ASA) which had been formed by the Philippines, Thailand and the federation of Malaya (now part of Malaysia) in 1961.

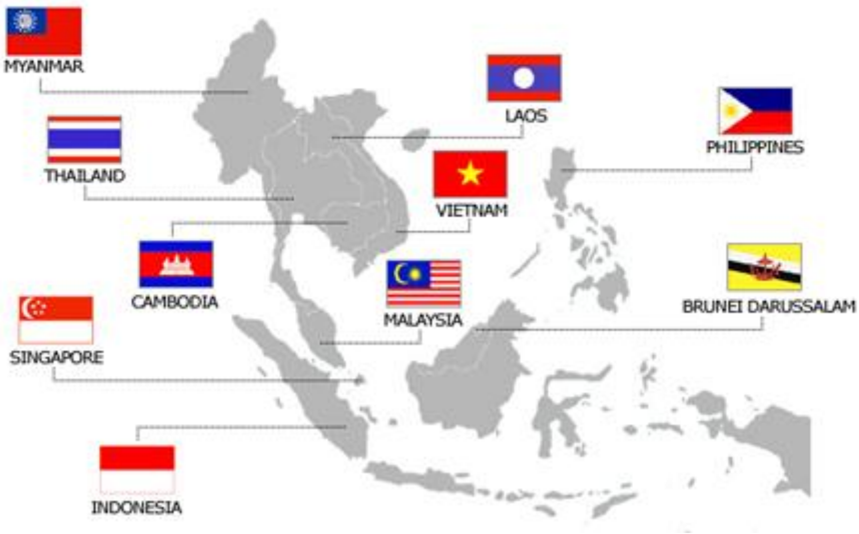

Exhibit 18. 5 ASEAN Countries

AIMS AND PURPOSES

As set out in the ASEAN Declaration, the aims and purposes of ASEAN are:

1. To fasten the economic growth, social progress and cultural development in the region through joint activities in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of Southeast Asian Nations.
2. To follow the principles of the United Nations Charter and so as to promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among South East Asian countries.
3. To develop as a collaborative and mutually assisting group of countries with a aim of meeting common interest in the economic, social, cultural, technical, scientific and administrative fields.
4. To give support to each other in the form of training and research facilities in the educational, professional, technical and administrative spheres.
5. To collaborate more effectively for the greater utilization of their agriculture and industries, the expansion of their trade, including the study of the problems of international commodity trade, the improvement of their transportation and communications facilities and the raising of the living standards of their peoples.
6. To encourage Southeast Asian studies; and
7. To maintain close and beneficial cooperation with other existing international and regional bodies have similar aims and purposes.

In 2015, it established the ASEAN Economic Community (AEC), a major milestone in the organization's regional economic integration agenda. The AEC envisions the bloc as a single open market with free movement of goods, services, investments and skilled labour, and freer movement of capital across the region. The organization also strives towards peace and stability in the region. Member countries have signed a treaty pledging not to develop nuclear weapons, and most have agreed to a counter-terrorism pact, which includes sharing intelligence and easing the extradition process of terror suspects. Despite their different cultures, histories and languages, the 10 member states of ASEAN share a focus on jobs and prosperity. Household purchasing power is rising, propelling the region into the next frontier of consumer growth. The region must now meet the challenges of providing enormous investment in infrastructure and human-capital development to ensure it realizes its full potential.

18.5.4 SOUTH ASIAN ASSOCIATION OF REGIONALCOOPERATION (SAARC)

Economic integration has also taken place in Indian sub continent. On 8th December 1985 SAARC was come into force with the signing of the SAARC Charter in Dhaka. SAARC comprises of eight member states; Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. The Secretariat of the association is established in Kathmandu (Nepal) on 10th January 1987 and was inaugurated by Late King Birendra Bir Bikram Shah of Nepal. SAARC comprises 3% of the world's area, 21% of world's population and 3.8% (US $ 2.9 trillion) of the global economy as of 2015.

Exhibit 18. 6 SAARC Members

Objectives of the SAARC

1. To promote the welfare and improve the life quality of people of South Asia.
2. To increase economic growth, social progress and cultural development in the region and to provide people opportunities to live in dignity and to realize their full potential.
3. To promote and strengthen collective self-reliance among the countries of South Asia.
4. To contribute to mutual trust, understanding and appreciation of one another's problems.
5. To promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields.
6. To strengthen cooperation with other developing countries.
7. To strengthen cooperation among member countries in international forums on matters of common interest.
8. To cooperate with international and regional organization having same aims and purposes.

18.5.5 THE ASIA PACIFIC ECONOMIC COOPERATION (APEC)

APEC was formed in November 1989 to promote multilateral economic cooperation in trade and investment in Pacific Rim. It is composed of 21 countries that border the Pacific Rim- both in Asia as well as in Americas. During the meeting in 1994 in Bogor, Indonesia, APEC leaders adopted the Bogor Goals which aim is to achieve free and open trade in the region by 2010 for the industrial nations (which generate 85 percent of the regional trade) and by 2020 for the rest of the members. The U.S. Department of State stated, "APEC has played an important role in promoting trade and investment liberalization in the region". As a result of these efforts, APEC markets are considerably more open today than they were 10 years ago, creating new opportunities for American business and creating new opportunities for American workers. India has requested the membership in OPEC and it is also supported by United States, Australia, Japan and Papua New Guinea. Officials have decided not to allow India to join for various reasons, considering that India does not share the border of Pacific Ocean, which all current members do. However, in November, 2011 India was invited to be an observer.

18.7 Asia Pacific Economic Cooperation (APEC)

Check Your Progress- B

Q1. What is the European Union single market?

Q2. What was the main goal of NAFTA ?

Q3. Which are the SAARC countries?

Q4. Who is the current president of SAARC?

Q5. What are the ten ASEAN countries?

Q6. What are the main goals of APEC ?

Q7. Discuss the benefits of NAFTA to Canadian, Mexican and U.S economies.

18.6 SUMMARY

Regional Economic Integration began to emerge after World War II as many of the countries saw benefits of cooperation and larger market size. The major types of economic integration are the free trade area, customs unions, common market and complete economic integration. Regional, as opposed to global economic integration occurs because of the distance between such countries is short, consumers tastes are more likely to be similar, also the neighboring countries may have common history and interests, and they are more willing to coordinate their policies. The important examples of regional economic grouping are EU, NAFTA, SAARC, and ASEAN. Many more other examples of regional integration can be found around the world, although the EU and NAFTA are the most successful, given the size of their respective economies and the degree of progress toward free trade. Regional integration in Asia has not been as successful as EU and NAFTA because most of the countries in the region have relied on the United States as major markets for their products.

18.7 GLOSSARY

Free Trade Area - A form of regional Economic Integration in which internals tariffs are abolished, but member countries set their own external tariffs.

Economic system- The system concerned with allocation of scarce resources.

Developing Country- A poor country. Also known as an emerging country.

Quota – A limit on the quantitative amount of a product allowed to be imported into or exported out of a country.

Tariffs- Tax levied on goods, usually imports, shipped internationally: the most common type of trade control.

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18.10TERMINAL AND MODEL QUESTIONS

Q1. Why do countries form themselves in to regional trading blocs?

Q2. "NAFTA is likely to produce net benefits to the US economy". Discuss.

Q3. Do regional trading blocs help or hurt world trade?

UNIT 19 ASSETS PROTECTION AND MULTILATERAL SETTLEMENTS

19 .1 INTRODUCTION

Due to the attractiveness of trading globally and having scopes of getting good returns and expansion of the business in international markets, many multinational companies aggressively try to expand globally. Due to this global expansion and trading in other countries, there is sometimes loss of assets which incur loss to the companies. Assets like trademarks, patents, copyrights, licensing agreements, franchising are under threat in certain countries if the local laws of those countries are not strong or enforceable. The unauthorized use of trademarks, patents, logos, brands and copyrights have economic and non-economic consequences.

It is estimated that companies of the Unites States of America which develop new technologies and have great brand value, loose about 61 billion dollars annually due to infringement of patents and copyrights in the developing countries. It is therefore, imperative to safeguard and protect the company’s assets for profitability and loss of business.

While trading internationally, though there is great margin for expansion and good returns, there is always some risk to the business. Different type of risks to international business occur in other countries like credit risk, political risk, liquidity risk, settlement risk, foreign exchange risk, etc. Though proper planning and risk assessment is done before entering a foreign market, there are instances where the assets are under threat or compromised. This calls in for strategies to protect the investment and procedures like business diplomacy and dispute settlements.

19 .2 OBJECTIVES

After reading this unit you will be able to:

- Understand what are assets
- Understand the various types of assets.
- Learn about the different types of risks in international trade
- Understand what is Assets Protection in international trade
- Understand method of assets protection in international trade
- Understand dispute settlements international trade and its methods

19 .3 ASSETS

Assets are any resources which are owned by a business or a corporation with the expectation that ownership of those assets will generate revenues for the business. The examples of assets are land, buildings, material, money in bank, machines, Foreign Direct Investment (FDI), technology, inventions, innovative ideas, copyrights, patents, etc.

Assets can be tangible or intangible. Tangible assets are assets having finite monetary value and usually in physical form. They include items like property, machineries, plants and equipment, office supplies, stocks and security, etc.

Intangible assets on the other hand are those assets which do not have physical form and have theorised value. Intangible assets include things like patents, goodwill, trademarks, copyrights, trade secrets, brands and corporate intellectual property, etc.

Intangible assets like intellectual properties, describe inventions, identify a special character or certain technology, innovative features that make it stand apart from the other products those are sold in the same market, and goodwill are all included under the intellectual properties.

Reasons for Assets Protection in Foreign Countries

In developed countries like US, UK and in Europe, unauthorized and improper use of intellectual properties is considered to be illegal and its misuse comes under the category of unfair competition. Thus, there are many laws which provide protection against such things such as using similar looking or sounding brand name, having similar packaging, etc. which can confuse the consumer as well as counterfeiting of the product, etc. However, these rules do not apply in the international market and different legal dimensions have to be taken to protect the product and the intellectual property rights concerning the product in the global market.

With the rise of globalization and especially after sudden spurt in communication technologies the awareness for different products and their brand value has reached people all over the world. Sometimes a product is intended for one market but get famous in other parts of the world due to the influence of communication and media. Due to the prestige associated with these products and also as the demand for better and innovative products has increased, the local companies produce the product through counterfeiting and infringement of intellectual property rights.

Though counterfeiting and infringement of intellectual property rights have been on rise since World War II, they have reached unprecedented levels due recent advances in communication technology as result of which the highly branded products are known to a global audience immediately.

Countries have great difference in the laws that they have for protecting intellectual property rights. Generally, poor and developing countries have weak legal protection than developed and industrialized countries.

There are many Business to Government and Government to Government conflicts over the idea of intellectual property and the rights to use them. Intellectual properties are the creative, innovative, expertise and some intangible insights that give the individual companies a competitive advantage.

Intellectual property Right is the legal right granted to the companies which allows them to determine how to use them. The idea of granting and intellectual property right is to allow the company to commercialise it in order to get back the initial investment and earn additional profits. However, some countries think that intellectual property right is anti-socialistic and unrestricted access should be given to them for social welfare. In this argument some developing countries restrict the patent rights of the product in the name of social welfare so that they can make affordable copes for their citizens.

19.4 RISKS TO ASSETS IN INTERNATIONAL TRADE

The MNEs when want to invest in foreign countries, have various risks to their investment. Risks like expropriation, hostile takeover, sudden change of rules, increase in trade barriers, variation in foreign exchange rates, rioting, loss of property, etc. are present when a company invests in foreign countries due to probability of good returns and rapid expansion.

The reasons why international business faces risk to its investment when operating in foreign country are because they have to operate with countries with different political ideology along with different rules, taxation system and culture. The different markets they compete in across the country have different levels of competition and efficiencies. They also have to trade in different currencies and go through foreign exchange markets. Thus, they have the risk of incurring losses of assets or suffering damages to assets due to the variability and volatility of the markets.

The different kinds of risks are as follows:

1. Foreign exchange risk
2. Interest Rate Risk
3. Credit Risk
4. Legal Risk
5. Liquidity Risk
6. Political Risk
7. Cargo Risk
8. Settlement Risk

19.4.1 FOREIGN EXCHANGE RISK

Due to unanticipated changes in the exchange rate of foreign currency, the cost of the project may change due to the local currency becoming stronger or weaker. E.g. When dollar becomes stronger (e.g. when 1 dollar = 70 Rs), and the foreign project is of one lakh dollars, then more Indian rupees i.e. seventy lakh rupees will have to be paid for the same project. In the same way, when the dollar becomes weak (e.g.1 dollar = 68 Rs), less Indian rupees (sixty-eight lakh rupees) will have to be paid for the same project. This kind of risk where the cost of the project changes is called as foreign exchange risk.

19.4.2 INTEREST RATE RISK

Abrupt fluctuations or sudden increase in the interest rate of loans may affect the cash flow of a firm for the payment of interest. In case the loan is taken on fixed rate of interest and later the interest rate comes down, the firm will be at a disadvantage as it has to pay higher interest rate. Similarly, when firm opts for a loan on floating interest rate basis and the interest rate goes up, the firm will have to pay more interest and will be at a disadvantage. Thus, borrowing on floating rate as well as on fixed rate has uncertainty when the interest rate of the lending institution of that country changes.

19.4.3 CREDIT RISKS

In most of the businesses, goods are sold on credit and realization of the sale proceeds is done later. In case of any problem occurring, which may hamper the realization of the sale proceeds is known as credit risk. Credit risk may occur due to inability of the buyers to pay on time. Sometimes, even though the buyer has made the payment, due to situation in the country, the funds may not reach the seller.

Due to sudden changes in political and economic changes globally, credit risk has assumed a serious position and having credit risk insurance is highly recommended for the relevant institution.

19.4.4 LEGAL RISKS

These kinds of risks can occur due to changes in law in host country which can make the foreign investment unattractive. E.g. Changes in law, creation of new taxes, creation of new trade barriers such tariffs and quotas or change in Government to a socialistic one. All can create risks to the investment. As different laws prevail in different countries and legal proceeding are complex, expensive and time taking, having provisions of appointment of arbitrator in case of disputes is prudent.

19.4.5 LIQUIDITY RISK

If due to change in market, the assets cannot be liquidated at the current market price except with a huge loss in sale of those assets, such kind of resultant risk is known as liquidity risk.

19.4.6 POLITICAL RISK

Due to changes in the political opinion and policies, civil unrest or friction and differences between the host and the other countries specially when the company's home country is not popular any longer with the country it has invested in, there may be takeover of their properties, destruction of operation, damage to their assets and certain changes In the rules governing the business which they create very expensive operational cost.

Managers normally predict political risk by analysing past pattern, understanding the social economic condition and consulting experts. Political situations can change rapidly. In certain cases, governments have taken over companies or banned companies for operating due to security risks. E.g. Recently United States had banned Huawei to operate citing security concerns and espionage. This had affected operations of Huawei in many countries and they were banned or restricted for the 5G operations and trails in many countries. Thus, the Chinese government had requested the Indian government to act objectively in this matter and allow Huawei to compete in the forthcoming 5G market in India and disregarding the actions of US in the market.

The concerns with which an MNE may have before investing in a host country are about the stability of the present government and whether it will run its full term. In case of large investment, concerns over re-election of the government are there. Another concern is that whether government policies in force at the time of investment will remain unchanged after the change in government. Whether the central government is strong and can control the states where the investment is being done is another important concern. Another concern is about the public opinion regarding foreign investment and trade issues and whether the government is reacting to those opinions or is insulated. It is also to be checked what the record of country's compliance to international agreement and regulations.

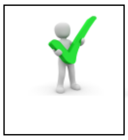
Further, it is to be seen whether the judiciary is fair and impartial and whether the laws and contracts are enforceable. Before investing in a project social and economic factors are of special concern like environmental impact, human rights, standards of labour, etc.

19.4.7 CARGO RISK

There are lot of risks during the transportation of cargo. Most of the goods are transported by seaways. Risks like storms, collision, theft, leakage, spoilage, explosion, fire and sea robbery exists when transporting goods by sea. Thus, every exporter must have a working knowledge of the maritime environment and marine insurance for offsetting the losses.

19.4.8 SETTLEMENT RISK

Settlement risk occurs when one party in international trade fails to pay or deliver the assets to the other party involved in trade. It is also called as Delivery risk and occurs very rarely.



Check Your Progress- A

Q1. What is Asset?

Q2. Explain political risk.

Q3. What is Exchange Rate Risk?

Q4. What are the reasons of assets protection in international trade?

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19 .5 PROTECTION OF ASSETS

These include unilateral, bilateral and multilateral arrangements/settlements to secure potential gaps in the protection of intellectual property rights;

Protection of assets

19.5.1 Home country asset protection

19.5.2 Use of Bilateral Agreements for Assets Protection

19.5.3 Use of Multilateral Agreement for Assets Protection

19.5.4 Asset Protection by Multinational Agreement for IPR

19.5.5 Collaboration as a means of Assets Protection

19.5.1 HOME COUNTRY ASSET PROTECTION

Sometimes when investing in foreign countries the companies fear that in case of any problem, that foreign country may seize or nationalize their assets without paying them proper compensation. An example of this type of situation arising is nationalization of Iran Oil Industry and also of Saudi Arabia's ARAMCO. In these cases, not only the tangible assets like FDI are lost but also other intangible assets like trademarks, copyrights and patents are at risk. Thus, in such cases, where it is beyond the power of company to protect their assets, they request the government of their home country where the business is originated to intervene on their behalf and to deal directly with the government of the other country and protect their tangible and intangible assets.

The historic background of home country protection was that in case of confiscation of the property by the host country, the home used to use military action to coerce them to give adequate and prompt compensation. This principle was known as the international standard of fair dealing and was in use until the Second World War. However, later due to series of supporting UN Resolutions, it was reinforced that the home country should not intervene militarily to protect their investments as most of the expropriations in history have been selective only. Also, as now the priorities of the host countries have shifted towards attracting FDIs, the home governments have fewer concerns about protecting their investor.

The concern now for the home government is that their companies, FDI proposals are reviewed promptly and given proper weightage and concern. There is also the dependancia theory still held by certain developing countries by which they feel that as host countries and they have no power when dealing with Multi National Enterprises (MNE) from powerful countries. Due to this, still many developing countries are reluctant to allow investment by MNEs in to their countries.

19.5.2 USE OF BILATERAL AGREEMENTS FOR ASSET PROTECTION

To encourage foreign investment for their MNEs, many countries have bilateral treaties with other countries regarding the protection of their investments. Although, these agreements are different, generally, they provide insurance by their home country for losses like expropriation, political risks, cancellation of contract by the government, currency control, etc. The home country, by approving such insurance, protect the investor and settle the losses of the investor on Government to Government basis.

Some bilateral treaties like prevention of double taxation and treaties of friendship of commerce and navigation. An example of this is that United States offers protection through Overseas Private Investment Corporation (OPIC). OPIC provides more than 280 million dollars of political risk insurance coverage to the American companies involved in Russian projects. In case any of these companies suffer losses due to the political fluctuation in Russia, they would be reimbursed by OPIC and later the US government will ask for settlement regarding these losses from the Government of Russia.

19.5.3 USE OF MULTILATERAL AGREEMENT AND SETTLEMENTS FOR ASSETS PROTECTION

In case of a dispute regarding the assets if the MNE cannot reach settlement with the host country, they sometimes agree to involve a third party to settle their disputes regarding protection of assets. The third party may be any neutral organisation like the International Chamber of Commerce in Paris or the Swedish Chamber of Commerce or specialized associations for arbitration in London. The Government to Government trade disputes are now are addressed by WTO which you will read later in Multilateral Dispute Settlements.

19.5.4 ASSET PROTECTION BY MULTINATIONAL AGREEMENT FOR INTELLECTUAL PROPERTY RIGHT (IPR)

Intangible assets like patents, trademarks, copyrights and other IPRs are under threat in foreign countries as the host countries differ in the protection of the IPRs. Generally, poor and developing countries have weaker legal protection against the infringement of the Intellectual Property Rights. Thus, the weak protection of the IPRs let the local companies to duplicate and reproduce the products of the companies that own the copyrights and patents. Sometimes, even though the countries enforce the IPR strongly, their procedures are different and can cause problems. E.g. In the United States, the application for patent is strictly confidential and the patents are granted within two years. On the other hand, in Japan the patent applications are available for public scrutiny and the patents are granted in four to six years. Thus, because of these kind of different approaches to IPR by different countries having international agreement regarding the different concerns of IPR are beneficial to both the companies as well as governments.

The GATT agreement from the Uruguay round thus, provides for IPR reciprocity which means that a country must grant the same level of property right protection to the foreign companies which it has granted to its own.

19.5.5 COLLABORATION AS A MEANS OF ASSET PROTECTION

Many countries provide very little protection for intellectual property rights like trademarks, copyright, patents, logos, knowhow, brands, brand packaging, etc. However, collaborating with a well-known local partner can help in these matters. The local companies nudge the authorities repeatedly into action and they also monitor the local market to know if infringement of intellectual property rights taking place. Also, certain countries in order to give growth opportunities to local industries only, want local collaboration with the foreign firms.

Also, in certain countries if an internationally registered asset is not registered in their country within a specified period then a local company is allowed to use it if it does it first. E.g. Though Berger King was a famous brand in United States, it did not use its brand name in time and local Australian company adopted it. Thus today, the name Burger King is used by a local Australian company and the international Burger King sells its burger in restaurants call Hungry Jack.

Intangible assets are creative ideas, abstract insights and innovative expertise which give a competitive advantage a company over others. An intellectual property right is the legal right that is granted to the companies for the use of their ideas and creations. Thus, the registered owner of the copyright has a legal right to decide who can copy it or use it for whatever purpose. IPR cover both industrial properties such as innovation, inventions and unique production techniques or innovative features in the product which are distinctive of the companies as well as creative and artistic properties like books, recordings, films, computer programmes and softwares.

Companies, that develop and own these intangible assets, want them to be protected by means of enforceable patents, copyrights and trademarks for the purpose of gaining sales and profits. They believe that there is social benefit of having patents and protection as otherwise the industry will have no incentive to develop new and innovative products which are beneficial to the society. However, critics to the above reflect that such restrictions hurt the welfare of the people as unrestricted access to an innovative product or services can lower the price and be beneficial to all the poor in all the countries. Also, the critics add that due to restrictions and protection provided with regards to the intellectual property rights the companies have a monopoly and charge exorbitant price. This is particularly true in the case of medical innovations, life-saving drugs and procedures which are out of reach of the poor people in developing countries. E.g. Stent makers were charging exorbitant prices for stent used in angioplasty in India until the Government put a cap on the prices. In the view of these socialistic arguments, many developing countries restrict the patent rights of essential products like medicines and essential technology so that they can make cheaper and affordable copies of those products for the welfare of their populace. E.g. The popular anti-diabetic drug **Vildagliptin** has recently come out of its protective period under the patenting and is now available cheaply to consumers and therefore, it is predicted that all anti-diabetic drugs will become cheaper due to availability of cheaper medicine.

Swiss multinational Novartis Galvis which is **Vildagliptin** finished its patent in December 2019 and as result its price has dropped from Rs. 20 - 25 per dose to Rs. 5 - 6 per dose which has benefitted India’s 73 million diabetics. Similarly, another cardiac drug **Ticagrelor** finished its patent this year and its price has come to from Rs. 55 per dose to Rs. 12 per dose which has benefited to the cardiac patients.

Intangible assets are classified in five categories

1. Inventions, Patterns, Designs, Formula, Processes and Patents
2. Copyrights for literary, musical or artistic compositions.
3. Trademark, Brand names and Trade names
4. Franchises, contracts and licenses
5. Programmes, procedures, systems and methods

19 .6 DISPUTE SETTLEMENTS

The dispute settlement procedure of the World Trade Organization (WTO) is governed by the understanding on rules and procedure governing the Settlements of Dispute (DSU). DSU is uniformly applicable to any disputes that arises in context of all the WTO agreements. For the interest of reliable multi-trade system, all the members have agreed that in case they think that any member has broken any trade rule causing economic loss and inconvenience to the other member (or members), they will not take unilateral or bilateral action against the member but refer the matter to the dispute settlement mechanism and settle it multilaterally as per the mechanism of DSU.

- Multilateral Agreements and Settlements
- Bilateral or Alternative Methods of Dispute Settlements

19.6.1 MULTILATERAL AGREEMENTS AND SETTLEMENTS

As discussed above in section 19.5 'Use of Multilateral Agreements and Settlement in Asset Protection', the Government to Government disputes are under the domain of WTO.

Proper mechanism for settlement of disputes is essential for effective and smooth functioning of trade system. The World Trade Organisation's procedure for rule settlement makes the international trade system secure and transparent. There are clearly defined rules along with definite timetable for completing the cases.

The members of World Trade Organisation have unanimously agreed that in the case they find out that certain member nations are violating the rules of international trade then they will not act against them unilaterally but will take help of multilateral system of settling the disputes (also known as multilateral settlement).

Normally, a dispute arises when one country takes some action against the interest of any other country or does not carry out its obligation towards the other country. In this case, a third group of countries may declare that they also have interest in the case and have some rights by virtue of the same.

Though there were provisions of settling disputes under the old General Agreement on Tariffs and Trade (GATT), due to unavailability of a fixed schedule, the cases were not resolved for long time. The problem with dispute settlement under GATT was that any member country could appeal or reject the decision and thus the process was stalled. These problems left lot of countries dissatisfied with the judgement.

Thereafter, the Uruguay round agreement in the year 1986 introduced a greater discipline regarding the time a case should take to be settled and a more structured process was agreed with clearly defined stages in the procedure of dispute settlement.

It was agreed that normally it should not take more than a year for a case to run its full course and fifteen months if an appeal is made. These agreed time limits are generally flexible and in case of urgency when perishable goods are involved, acceleration of timeline may be possible. Under the previous GATT procedure, rulings could only be adopted by consensus among all the members and even a single objection by any one member could block the ruling. Now after the Uruguay round agreement, rulings are automatically adopted and a consensus has to be made to reject the ruling. Any single country for its own interest cannot block a ruling and it has to persuade all of the members of the World Trade Organisation including its own adversary in the case.

The timeline for settling of the disputes approximately for each step is as follows:

1. 60 days are granted for consultations and mediations.
2. 45 days are granted for setting up the panel and appointment of the panelists.
3. 6 months are granted for presenting the final panel report to the parties.
4. 3 weeks for presenting the final panel report to WTO members.
5. 60 days' timeline is for the adoption of report by the Dispute Settlement Body.

   The total timeline, therefore is one year if there is no appeal. In case there is any appeal then 60-90 days are granted for the report of appeal. 30 days are granted for the adoption of appeal report by Dispute Settlement Body. The total timeline with appeal is one year three months.

Dispute Settlement Body or the General Council, which includes all the members of WTO, shoulders the responsibility of dispute settlement.

- First stage: First stage is the consultation which lasts up to 60 days in which before any action is taken, the countries having the disputes are made to communicate with each other. This is to see if the countries can resolve their dispute themselves. If this does not work then mediation of Director General of WTO is sought to settle the dispute amicably.
- Second stage: In case the dispute is not settled in first stage then a panel is appointed for which 45 days are provided., The panel thus formed gets a timeline of 6 months to conclude its deliberation.

  The main stages of the working of the panel are as follows:
  - Before the first hearing each side has to present its case in written to the panel.

- At the first hearing both sides and countries, having interest in the dispute, state their case to the panel.
- Thereafter, at the panel's second meeting written counter arguments and rebuttals are presented.
- Experts may be consulted or appointed in case scientific or technical matters are involved to make advisory report.
- Thereafter first draft, containing facts and arguments, is made and the panel submit its report to both sides giving them two weeks to comment.
- Thereafter an interim report is given by the panel which contains its findings and conclusions regarding the disputes to both the sides. Both the sides are given one week for review. In case review is done, the panel may hold review meetings with both sides which may not take more than two weeks.

- Once all these internal proceedings of the panel are concluded, the panel makes a final report which is given to both sides.
- After a period of three weeks, the report is circulated to the remaining member countries of the WTO.
- The recommendations given by the panel regarding the settlement of dispute becomes a ruling of the dispute settlement body if there is no appeal and it is not rejected within sixty days by a consensus of all WTO members.
- In case there is an appeal, it is heard by the Appellate Body set up by Dispute Settlement Body for the same.
- The Appellate Body gives its report within 60-90 days in which it can either uphold, modify or reverse the conclusions of the panel.
- In case there is no rejection by consensus of all the WTO member countries within 30 days, the Dispute Settlement Body accepts the appeal report.

19.6.2 BILATERAL OR ALTERNATIVE METHODS OF DISPUTE SETTLEMENTS

As described in the previous section, resolving trade dispute at Government to Government level is one of the core activities of WTO. When a dispute arises due to the violation of an agreement or commitment by a member nation, the other members multilaterally settle the dispute as unilateral action has been discouraged by the WTO.

Other than the exhaustive procedure involving panel and Appellate bodies in the multilateral WTO dispute settlement system, there are alternate ways of solving the disputes within the framework of the WTO. Sometimes, the parties try to solve the dispute in a cooperative manner and not by taking recourse to the panel and the appellate body. In these cases, the parties settle their disputes by finding a mutually agreed solution in bilateral settlements, however, these mutually acceptable solution must be consistent with the WTO agreement. This means that the interest of the other WTO members in the case must be upheld and opportunity must be given to them to raise their concerns regarding the settlement. It is implicit or understood that under no condition, the parties to the dispute must settle on a solution which is detrimental to the interest of any third party. The bilateral consultations which are required to take place at the beginning of any dispute are intended to provide a platform for both the parties to arrive at a mutually agreeable solution.

In case the parties have found a solution to their matter and have appealed to the WTO prior to the finding of mutually agreeable solution bilaterally, they may withdraw the appeal at any time.

Check Your Progress- B

Q1. What is Dispute Settlement?

Q2. Explain bilateral method of dispute settlement?

Q3. Explain the role of panel and appellate body in dispute settlement?

Q4. Explain home country asset protection?

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19 .7 SUMMARY

Assets are any resources which are owned by a business or a corporation with the expectation that ownership of those assets will generate revenues for the business. The examples of assets are land, buildings, material, money in bank, machines, Foreign Direct Investment (FDI), technology, inventions, innovative ideas, copyrights, patents, etc.

The MNEs when want to invest in foreign countries, have various risks to their investment. Risks like expropriation, hostile takeover, sudden change of rules, increase in trade barriers, variation in foreign exchange rates, rioting, loss of property, etc. are present when a company invests in foreign countries due to probability of good returns and rapid expansion.

In developed countries like US, UK and in Europe, unauthorized and improper use of intellectual properties is considered to be illegal and its misuse comes under the category of unfair competition. Thus, there are many laws which provide protection against such things such as using similar looking or sounding brand name, having similar packaging, etc. which can confuse the consumer as well as counterfeiting of the product, etc. However, these rules do not apply in the international market and different legal dimensions have to be taken to protect the product and the intellectual property rights concerning the product in the global market.

The various methods of asset protection are Home country asset protection, Use of Bilateral Agreements for Assets Protection, Use of Multilateral Agreement for Assets Protection, Asset Protection by Multinational Agreement for IPR and Collaboration as a means of Assets Protection.

19 .8 GLOSSARY

Assets - Assets are any resources which are owned by a business or a corporation with the expectation that ownership of those assets will generate revenues for the business.

Tangible assets are assets having finite monetary value and usually in physical form. E.g. property, machineries, plants and equipment, office supplies, stocks and security. etc.

Intangible assets on the other hand are those assets which do not have physical form and have theorised value. Intangible assets include things like patents, goodwill, trademarks, copyrights, trade secrets, brands and corporate intellectual property, etc.

Intellectual Property Rights (IPR) - Intellectual property Right is the legal right granted to the companies which allows them to determine how to use the intangible assets such as technology, inventions, innovative ideas, copyrights, patents, etc.

General Agreement on Trade and Tariff (GATT) - The General Agreement on Tariffs and Trade is a legal agreement between many nations to promote international trade by lowering or eliminating trade barriers such as tariffs or quotas.

Multi National Enterprise (MNE) – It is an enterprise which produces and delivers goods and services in multiple nations.

World Trade Organisation (WTO) – It is an intergovernmental organisation the objective of which is to deal with the rules of international trade between countries.

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19 .11 TERMINAL AND MODEL QUESTIONS

Q1. What are assets?

Q2. What are different types of risks in International Trade?

Q3. What are multilateral settlements?

Q4. Explain asset protection through collaboration.

Q5. Why asset protection is important in international trade? Explain how Intellectual Property Right can be protected using multinational agreement.

UNIT 20 PREFERENTIAL TRADE AGREEMENTS

20.1 INTRODUCTION

Regional trade agreements have existed historically between neighbouring countries however, in recent decades, tremendous increase in such treaties and agreements such as Free- Trade Agreements (FTA) and Preferential Trade Agreements (PTA) has been observed for boosting the regional trade. Earlier, the theory of mercantilism existed which influenced the trade policies dominantly and between sixteenth to eighteenth century, all the key states in Europe were influenced by it. Mercantilism trade policy, whose objective was to have a balance of trade in favour of its own nation, discouraged trade agreements between different nations.

After the writings of Adam Smith and David Ricardo which stressed on the necessity of imports and the comparative advantage of doing business with other nations, the mercantilism theory came under attack and international trade expanded with trade agreements of increasing complexity being made between different nations.

Preferential Trade Agreement (PTA) is defined as the agreement made between two or more nations in which the members nations agree to lower barriers to trade like quota and tariff to allow increase in trade of services and goods.

Preferential Trade Area, can be described as a type of trading bloc where countries located in a certain geographical have a mutual understanding to lower or eliminate trade barriers like tariffs and quotas on selected goods which are imported from other member countries. These agreements give the member nations a special or preferential access to areas of each other's markets and boosting the trade.

In today's world, the dominant feature of international trade policy of different nations is making preferential trade agreements with other countries to boost their trade. NAFTA, APEC, ASEAN are some of the famous examples of preferential trade agreements made worldwide.

India has signed bilateral FTAs with Sri Lanka (1998), Afghanistan (2003), Thailand (2004), Singapore (2005), Bhutan (2006), Nepal (2009), Korea (2009), Malaysia (2011) and Japan (2011).

20.2 OBJECTIVES

After reading this unit you will be able to:

- Understand the meaning of Regional Economic Integration.
- Describe Preferential Trade Agreement.
- Understand the forms of Preferential Trade Agreements.
- Learn about various Preferential Trade Agreements.

20.3 REGIONAL ECONOMIC INTEGRATION

Regional Economic Integration or Grouping as the name suggests is a group formed of countries located in a particular region. The purpose of the grouping is to boost their economies by the coordination of monetary and fiscal policies. Typically, this is done by reduction or elimination of trade barriers like tariff and quotas. This economic integration of the countries raises the cross-border trade and investment along with the quality of life of the populace of the member nations.

The regional economic integration has benefitted nations across the globe in not only increasing the international trade but also in technological innovation, more investment in the capital scarce countries, less expensive goods and services, etc. Technological innovations such as instantaneous communication, rapid transportation have helped the multinational organizations to develop international production network leading to more tightly linked markets.

After the end of World War II the economy of most of the European countries was in shambles and as they were struggling, they realized that for the promotion of economic growth and stability they would have to coordinate and cooperate with their neighbours.

20.4 PREFERENTIAL TRADE AGREEMENTS

Many economists have accepted the Adam Smith's proposition, published in his book "The Wealth of Nations", that free trade will improve the overall economy of the countries.

Preferential Trade Agreement (PTA) is defined as the agreement made between two or more nations in which the members nations agree to lower barriers to trade like quota and tariff to allow increase in trade of services and goods. As the name suggests, in preferential trade agreements, a preferential access is given to some products of the participating economies by reducing tariffs on them. Generally, it is seen that the developed and industrialised countries give a lower or preferential tariff to the poor and developing countries for their imports. In addition to the above there are other preferential schemes which are non-reciprocal in nature designed for promoting economic growth and trade in the developing countries. In this parlance, the preferential trade agreement is also known as the General System of Preference (GSP) which has the objective to foster economic growth in the developing countries and this trade agreement either provides lower duty or duty-free entry for products specified in the PTA from the beneficiary developing countries.

"Preferential Treatment" means any concession or privilege granted under this Agreement by a country by lowering or eliminating tariffs on the movement of goods. The internal tariff amongst the member countries of Preferential Trade Agreement is eliminated but the members are allowed to have different tariff for the non-member countries i.e. discrimination against the non-members. The reduction of internal tariff helps in increasing the trade and therefore the total welfare of the member countries.

World Trade Organisation (WTO) and PTA allow countries to set reducing trade barriers, but there is a significant difference between the two types of agreements. WTO follows the non-discrimination policy against the non-member countries. For example, when country A is in agreement with country B and lowers its import tariff on a particular good e.g. machinery from country B, then this new tariff will be applicable to import of that good from any other country.

The United States of America grants "Most Favoured Nation" (MFN) status to many countries. The MFN status is a guarantee to the exporting nation that they will pay the same tariff as that of the nation which pays the lowest tariff. It means that the exporting nation will not have to pay tariff higher than that of the lowest paying nation. But PTAs go against the principle of nondiscrimination i.e. its member countries are allowed to have different tariff for the non-member countries. Having Preferential Trade Agreement allows countries to attain deeper liberalization of trade while avoiding the free-rider problem.

20.5 FORMS OF PREFERENTIAL TRADE AGREEMENTS

The different forms of Preferential Trade Agreements are as follows:

1. Partial Scope Agreement

2. Free Trade Area
3. Customs Union
4. Common Market
5. Economic Union

20.5.1PARTIAL SCOPE AGREEMENT

This agreement is partial in scope as the name suggests and within it trading of only small number of goods is allowed. The partial scope agreement promotes investment between two economies and allows for increased investment between both countries. It also incorporates for settlement of disputes between the investor and the country it invests in.

Recently America has signed a Partial Scope Agreement with China on January 15, 2020. It was agreed to respect intellectual property rights and to stop the eighteen months trade war. The deal included means to stop intellectual property theft and forced technology transfer and to increase the Chinese purchase of US goods. The deal will have trade worth 200 billion dollars of US goods into the Chinese market.

20.5.2FREE TRADE AREA

In Free Trade Agreement, the members are allowed to have free trade among themselves while having their own tariff or trade policy for the non-member nations.

A free trade area is a region of a group of countries who have consented to enter into a trade agreement for economic co-operation and growth. The objective of having a free trade area is to lower or remove tariffs, import duties and other restrictions in trading and to encourage free trade among the countries which are member to the free trade agreement.

Free Trade Agreement is done between two or more countries for the purpose of economic growth and cooperation by agreeing on mutual terms of trade. They agree on the duties and tariffs on the goods imported and exported by the member countries. It is mandatory for businesses to abide by the laws and customs of the free-trade agreement to avoid civil and criminal penalties.

The advantages of free trade areas are as follows:

- By encouraging competition in the market, the products and services become better and cheaper thereby, in long term increasing the efficiency of the country's industry.
- Due to competition for the market, each country will expand the production of the items in which they are most efficient and reduce producing the products which are inefficient to produce. This will lead to specialization of industries in the countries and thus lead to absolute cost advantage as explained by Adam Smith, thus, being a win-win situation for all countries.
- As more players and industries enter the market, monopoly of local production houses is reduced and the buyers have a better choice of goods and services to choose from.

- As a large number of products and services are available to the consumer, it will lead to lower prices being offered by the competitors to capture the market. Thereby, benefitting the consumers.

While the free trade areas have a number of advantages as described above, they also have some disadvantages which are described as below:

- Due to cheaper imports from countries having low production cost, the local industry may wither and die, thereby, leading to loss of livelihood to the local population engaged in the trade. This is a collateral loss which will accompany the growth of the economy and can have potential socio-political repercussions for the government in power. E.g. India walked away from the proposed free trade agreement called the Regional Comprehensive Economic Partnership (RCEP) in November 2019 to protect its industries due to concerns that there would be a massive increase in imports from China which will destroy its own farming and industries.
- In countries having poor labour laws and lower wages, the workers will be exploited and made to work in substandard working conditions.
- As import duties and taxes are lowered or removed there is loss of revenue earned by import taxes.

The examples of free trade area are North American Free Trade Agreement (NAFTA), Association of South East Asian Nations (ASEAN), The Trans-Atlantic Trade and Investment Partnership (TTIP), Trans-Pacific Partnership (TPP), etc.

North American Free Trade Agreement (NAFTA)

To encourage trade with Mexico and Canada, the United Stated of America initiated the North American Free Trade Agreement with an objective of creation of jobs. It was thought that removal of tariffs to increase trade would lead to creation of one million jobs in five years. The agreement came into force on 1st January, 1994 and thereafter tariffs related to agricultural goods, automobiles and textiles were removed in a phased manner leading to increase in trade. Over a period of twenty years after the agreement, there was an increase in regional trade from about 290 billion US dollars (1993) to 1.1 trillion US dollars (2016).

Today a quarter of US imports like fresh produce, livestock, and agriculture goods, etc. come from Canada and Mexico and a large amount of US exports such as goods like machinery, vehicle parts, mineral and fuel oil are sent to Canada and Mexico.

Association of South East Asian Nations (ASEAN)

Established in 1967 between Vietnam, Singapore, Indonesia, Cambodia, Laos, Malaysia, Philippines, Myanmar, Brunei and Thailand, this free trade agreement known as, The Association of South East Asian Nations (ASEAN), encourages collaboration among member countries in the areas of trade and industry. ASEAN is the largest market of more than 650 million people with the combine GDP of the ten members of 2.8 trillion dollars and a land area of about 4.4 million square km. Though the profile of the countries is largely different with Singapore being fully urban and Cambodia being largely rural, the countries at different stages of development all share large potential for growth.

20.5.3 CUSTOMS UNION

In customs union all the members have a common policy against non-member countries and an equal tariff is set against them. While a free trade area is about reducing or removing tariff for the member countries for trading within the free trade area, any imports from non-member countries cannot be freely traded within the area. On the other hand, in a customs union any import done by a member country from a non-member country is subject to single and one-time tariff and thereafter it can be traded free of any further tariff.

The objective of customs union is to enable easier trade freely within member countries. It reduces the administrative and financial cost of enforcing trade barriers and encourages cooperation on the economic front within member countries. In customs union the member countries have to align their domestic economic policies with the trade deals of the custom union to gain advantage from the membership.

The customs union increases trade with the help of economic integration. The European Union is the largest customs union in the world as per the economy of its members.

The advantages of customs union are as follows:

- Better political cooperation between member nations of the customs union.
- Better economic cooperation between member nations of the customs union.
- Creation of a common market with monitory and fiscal integration.
- Better allocation of resources as nations having absolute advantage in certain goods trade with less efficient member nations.
- It leads to increase in trade creation.
- It protects the less efficient countries in the union to sell their goods and services to other members of the union as non-member efficient countries have a trade barrier due to external tariffs.
- Though imposition of external tariff on non-member countries to trade in the customs union leads to trade diversion because of lesser trade, however, if the gains from trade creation (by less efficient economies capitalizing on their position) are more, then it leads to economic advantage for those countries.
- In the long run the customs union is beneficial to the economies as it helps small countries to have access to markets larger than their domestic front.
- Due to good transport and infrastructure of the customs union, large external economies of scale can be achieved by the smaller countries.

- Due to exposure and competition from other economies, the domestic industries are forced to increase their efficiency and cut cost.

The disadvantages of customs union are as follows:

- Individual members of customs union do not have freedom to negotiate their own trade deals which may be beneficial to their economies but have to abide by the rule of the customs union.
- Formation of customs union leads to trade diversion as efficient countries which are not members of the customs union have tariffs imposed on them to compete in the market. Thus, it reduces the opportunity for those countries to sell their goods and services in the customs union.
- Individual member countries cannot impose protective barrier tariffs to protect their industries in infancy.
- Similarly, member countries cannot liberalize their trade more than that allowed by the customs union.
- Distribution of tariff revenues is not even and 20-25 % of the revenue is kept by the member who collects the same. This leads to unfair distribution of the revenue and affects the countries that trade outside the customs union. E.g. UK trades more with countries outside the union and does not get the fair share of its tariff revenue.
- The process of setting the tariff rate is costly, complex and time-consuming.
- Some countries find it very difficult to stop the production and trade of certain goods and services socio-politically because of other member countries being efficient in them and it leads to internal unrest and protest in that country. This is a major issue that UK is dealing with during BREXIT.

The examples of customs union are European Union (EU), Customs Union of Russia, Belarus and Kazakhstan formed in 2010.

European Union (EU)

Formed by 28 member bodies, the European Union is an economic union. The European Union has a common currency and has eliminated all border restrictions between member countries and allow free flow of goods and services. It also allows the workers to work and reside in any of the member countries. Any of the member countries are free to bid for tenders and public contracts. Taxes, exchange rates and import tariffs from non-member countries are standardised and similar for all the member countries.

European Union has 28 countries as members which are Sweden, Cyprus, Spain, Slovenia, Slovakia, Italy, Latvia, Finland, Lithuania, Bulgaria, Luxembourg, Malta, Belgium, Croatia, Hungary, Czech Republic, Netherland, Poland, Portugal, Romania, Denmark, Germany, Estonia, Greece, France, Ireland, Austria and United Kingdom.

The governing of the European Union is done by three bodies which are called as the European Union Council, the European Commission and the European Parliament. The European Union Council is the one which has the responsibility to propose the new rules and policy setting. The presidency of the European Union is changed every six months and a new leader is elected.

The Parliament elects its member every five years and is assigned with discussion and approval of laws. The European Commission is delegated with executing the laws and ensuring that all the members follow them. Euro is the common currency which is used in the European Union.

20.5.4 COMMON MARKET

Common market is a formal agreement between different member nations which permit free trade and free movement of capital and labour amongst the member nations. They also have a common external tariff to no non-member countries while having no tariff, quotas or trade barriers among the member countries. In a common market the member nations remove barriers to internal trade and allow free movement of goods and services while adopting common external trade barriers.

The objective of the common market is to provide improved economic benefits to the member nations. The conditions to be met for being defined as a common market are that among the member countries all tariff, quotas and barriers are eliminated. All member countries have common tariffs for trade with non-member countries. Labour and capital are allowed to move freely among member countries. The difference between a common market and a customs union is that in customs union labour and capital are not able to move freely.

Common market has following advantages:

- Free movement of people, goods and services without any obstruction created by the borders of the country. Hence it is also known as a single market.
- Common market increases efficiency among the members as the infrastructure is located efficiently and allocation of resources and factors of production is done efficiently. Due to competition inefficient companies are wiped out.

The disadvantages of common market are as follow:

- Due to common market companies protected and subsidized by the government struggle to remain competitive.
- As factors of production migrate to other countries, there may be resultant loss of employment in the parent country.
- Due to influx of cheaper labour into a country, local workers may suffer from lower wages or loss of employment.

The examples of some common markets are MERCOSUR (Southern Common Market), East African Common Market and West African Common Market.

Southern Common Market (MERCOSUR)

MERCOSUR was formed by Brazil, Argentina, Uruguay, Paraguay, Venezuela and Bolivia in 1991. The main objective of the agreement is to promote a common space that generates business and investment opportunities through the competitive integration of national economies into the international market. MERCOSUR has signed commercial and political agreements with many nations.

The main aim of MERCOSUR is to promote free trade and smooth movement of goods, services, capital and labour. The member countries follow a common trade policy amongst them.

East African Common Market (EAC)

East African Common Market, commonly called East African Community, became operational on 1st July, 2010. It is a regional intergovernmental organization. It has six partner states: Kenya, Burundi, South Sudan, Rwanda, Uganda and Tanzania.

EAC is one of the fastest growing regional economic blocs in the world. The EAC has a combined Gross Domestic Product of 193 billion UD dollars as per the EAC statistics. EAC is increasing the co-operation among the Partner States in social, political and economic spheres for their mutual benefit.

20.5.5 ECONOMIC UNION

Economic union is full integration of economies of the member nations where they have no trade restriction in between them while having common trade barriers and trade tariff for non-member countries. The member countries have alignment of their economic and fiscal policies. They all have a common currency with fixed common exchange rate. There is free movement of labor and capital amongst the member countries.

An economic union though is similar to customs union differs from it in the aspect that in economic union the members have a common currency and they also allow the workers to move freely and work in any member country of the economic union. Economic union also requires that all the member nations have the alignment of their economic policies and coordinate in the formation of policies, taxes and spending. Also, the common currency in use is to have fixed exchange rate in all the member countries.

The various examples of economic union are European Union (EU), CARICOM Single Market and Economy (CSME), Central American Common Market, Eurasian Economic Union (EEU), Gulf Cooperation Council (GCC).

European Union (EU): It is formed by twenty eight member states and its common currency is Euro. It is the largest import market and the biggest exporter in the world.

CARICOM Single Market and Economy (CSME) is an economic union of fifteen member states of the Caribbean community. Central American common market has six member countries from Central America. Eurasian Economic union (EEU) is a union of states in central and northern Eurasia. Gulf Cooperation Council consists of all Arab states of Persian Gulf except Iraq.

Check Your Progress- A

Q1. What is preferential trade agreement?

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Q2. What are the different forms of preferential trade agreement?

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Q3. What is Free Trade Area?

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Q4. What are the benefits of Free Trade Agreements?

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20.6 INDIAN TRADE AGREEMENTS

The various trade agreements of India with other countries are as follows:

- In the year 1998, India signed bilateral Free Trade Agreement with Sri Lanka. Thereafter, India signed bilateral Free Trade Agreements with other countries as follows:
    a. With Afghanistan in 2003.
    b. With Thailand in 2004,
    c. With Singapore in 2005,
    d. With Bhutan in 2006,
    e. With Nepal in 2009,
    f. With Malaysia and Japan in 2011.

- Apart from the above, India also signed two regional trade agreements which are the South Asian Free Trade Agreement (SAFTA) in 2004 and the India-Association of Southeast Asian Nations Agreement (ASEAN_ in 2010.
- Outside of Asia India has signed free trade agreement with MERCOSUR in 2004 and with Chile in 2006.

20.7 LIST OF INTERNATIONAL TRADE AGREEMENTS

1. African, Caribbean, and Pacific Group of States (ACP Group): It was established on June 6, 1975 with an objective of sustainable development and poverty reduction. The member countries are Democratic Republic of the Congo, Republic of the Congo, Cook Islands, Cote d'Ivoire, Angola, Antigua and Barbuda, The Bahamas, Barbados, Belize, Benin, Botswana, Djibouti, Dominica, Dominican Republic, Equatorial Guinea, Eritrea, Ethiopia, Fiji, Gabon, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Kiribati, Lesotho, Liberia, Madagascar, Malawi, Mali, Marshall Islands, Mauritania, The Gambia, Ghana, Grenada, Guinea, Guinea-Bissau, Guyana, Haiti, Jamaica, Kenya, Mauritius, Federated States of Micronesia, Mozambique, Namibia, Nauru, Niger, Nigeria, Niue, Palau, Papua New Guinea, Rwanda, Saint Kitts and Nevis, Seychelles, Sierra Leone, Suriname, Swaziland, Tanzania, Togo, Tonga, Trinidad and Tobago, Tuvalu, Uganda, Vanuatu, Zambia, Zimbabwe, Saint Lucia, Saint Vincent and the Grenadines, Samoa, Sao Tome and Principe and Senegal.
2. Andean Community of Nations (CAN): It was previously known as Andean Group (AG) and Andean Common Market (Ancom) subsequently. It was established on May 26, 1969 and present name was agreed on October 1, 1992. Its objective is to promote harmonious development along with expansion of markets and provide effective economic development of the region. Its member countries are Venezuela, Peru, Bolivia, Colombia and Ecuador.
3. Arab Cooperation Council (ACC): It was formed on 16th Feb 1989 with an objective of having closer economic co-operation among its members who were left out of the Gulf Co-operation Council (GCC). The member countries were Egypt, Iraq, Jordan and Yemen. The ACC has been suspended after invasion of Kuwait by Iraq as the member countries chose different sides.
4. Asia-Pacific Economic Cooperation (APEC): It was established on 7th November 1989 with an objective to facilitate economic growth, cooperation, trade and investment in the Asia-Pacific Region. The 21 member countries of APEC's are: United States of America, Australia, Japan, Russia, Canada, Singapore, Chile, China, Hong Kong, Indonesia, Malaysia, Republic of Korea, Philippines, Peru, Mexico, New Zealand, Chinese Taipei, Thailand, Vietnam, Brunei and Papua New Guinea.

5. Black Sea Economic Cooperation Zone (BSEC): It was formed on 25th June, 1992 to enhance the regional stability through economic cooperation. It has 11 member countries and 9 observer countries. The member countries are: Armenia, Azerbaijan, Greece, Albania, Bulgaria, Russia, Turkey, Georgia, Moldova, Ukraine and Romania.

   The observer countries are Germany, France, Egypt, Poland, Austria, Israel, Tunisia, Italy and Slovakia.

6. Caribbean Community and Common Market (Caricom): It was established on 4th July, 1972 but came into force on 1st August, 1973. Its objective is to promote the development and economic integration of the less developed nations. It is a group of fifteen members and five associate members. They fifteen members are: The Bahamas, Antigua and Barbuda, Dominica, Belize, Haiti, Barbados, Grenada, Jamaica, Montserrat, Guyana, Saint Kitts and Nevis, Saint Vincent and the Grenadines, Suriname, Saint Lucia and Trinidad and Tobago. The five associate members are: Anguilla, Bermuda, British Virgin Islands, Cayman Islands and Turks and Caicos Islands

7. European Free Trade Association (EFTA): Formed in 1960, European Free Trade Association is the intergovernmental organisation of Norway, Iceland, Switzerland and Liechtenstein. It came into force on May, 3, 1960. It is set up with an objective to promote free trade and economic integration to the benefit of its four member countries and the benefit of their trading partners around the globe.

8. North American Free Trade Agreement (NAFTA): To eliminate trade barriers, increase investment opportunities, promote fair competition, provide protection of intellectual property right and to create procedures to settle disputes, North American Free Trade Agreement was created by Us, Canada and Mexico.

9. South Asian Association for Regional Cooperation (SAARC): It was agreed on December 8, 1985 by eight member countries which are: India, Bhutan, Bangladesh, Maldives, Pakistan, Afghanistan, Nepal and Sri Lanka.

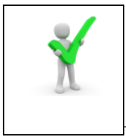
   The objectives of the association are as follows:

   - To stimulate the economic growth and development along with social progress in the member nations.
   - Improvement of quality of life and welfare of the people of these South Asian countries.
   - To promote self-reliance among these countries of South Asia.
   - To provide opportunities to the individuals from these countries to reach their highest potential and live a dignified life.
   - To have communication and understanding of problems faced by the members leading to understanding and mutual trust amongst each other.

- Promotion of mutual assistance and enable cooperation in fields like science, technology, economy and culture, etc.
- To represent themselves in international forums regarding matters in which they have common interests.
- To have cooperation with organizations regional and international in nature which have common doctrine, aims and interests.

10. The Trans-Atlantic Trade and Investment Partnership (TTIP):

The Trans-Atlantic Trade and Investment Partnership is an agreement between the United States and European Union.



Check Your Progress- B

Q1. What is European Union?

Q2.What is NAFTA ?

Q3. Which are the SAARC countries?

Q4. What are the objectives of SAARC?

Q5. Write a short note on Caricom.

Q6. How many countries are members of APEC? List them.

20.8 SUMMARY

The regional economic integration has benefitted nations across the globe in not only increasing the international trade but also in technological innovation, more investment in the capital scarce countries, less expensive goods and services, etc. Technological innovations such as instantaneous communication, rapid transportation have helped the multinational organizations to develop international production network leading to more tightly linked markets.

Preferential Trade Agreement (PTA) is defined as the agreement made between two or more nations in which the members nations agree to lower barriers to trade like quota and tariff to allow increase in trade of services and goods. These agreements give the member nations special or preferential access to the goods and services of each other's markets thus boosting the trade.

In today’s world, the dominant feature of international trade policy of different nations is making preferential trade agreements with other countries to boost their trade. NAFTA, APEC, ASEAN are some of the famous examples of preferential trade agreements made worldwide.

The examples of Preferential Trade Agreements are North American Free Trade Agreement (NAFTA), Association of South East Asian Nations (ASEAN), The Trans-Atlantic Trade and Investment Partnership (TTIP), Trans-Pacific Partnership (TPP), European Union, European Free Trade Agreement (EFTA), South Asian Association for Regional Cooperation, Asia Pacific Economic Cooperation (APEC) etc.

20.9 GLOSSARY

Regional Economic Integration - It is a group formed of countries located in a particular region for the purpose of boosting their economies by the coordination of monetary and fiscal policies.

Preferential Trade Agreement (PTA) is defined as the agreement made between two or more nations in which the members nations agree to lower barriers to trade like quota and tariff to allow increase in trade of services and goods.

Free Trade Area - A form of regional Economic Integration in which internals tariffs are abolished, but member countries set their own external tariffs.

Common Market - A common market is an arrangement in which the member countries operate as a single market for the goods, services, capital and labour. It has common revenue and trade laws.

Customs Union – In customs union all the members have a common policy against non-member countries and an equal tariff is set against them.

Economic Union – Economic union is full integration of economies of the member nations where they have no trade restriction in between them while having common trade barriers and trade tariff for non-member countries.

NAFTA – North American Free Trade Agreement

ASEAN – The Association of Southeast Asian Nations

SAARC – South Asian Association for Regional Cooperation

EU – European Union

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20.12 TERMINAL AND MODEL QUESTIONS

Q1. What is Economic Union? How is it different from Customs Union?

Q2. “India walked away from the proposed free trade agreement called the RCEP in November 2019 to protect its industries”. Discuss.

Q3. Does free trade help or hurt the world trade?

Q4. Are preferential trade agreements (PTAs) stumbling blocks or building blocks towards multilateral trade liberalization?

UNIT 21 CONTEMPORARY ISSUES IN INTERNATIONAL BUSINESS

21.1 INTRODUCTION

In the previous units you learnt about international business, the socio-economic, cultural and financial environment of international business, modes of entry, and strategies for international trade.

In this unit, you will study about the contemporary issues in international trade.

21.2 OBJECTIVES

This unit has following learning objectives:

- Explain the differences between international business and domestic business.
- Appreciate the contemporary issues facing international business.
- Providing a managerial solution to solve the issues facing international business.

21.3 MEANING OF INTERNATIONAL BUSINESS

International business is said to happen when the manufacturing and/ or distribution of products or resources takes place across the borders of a country. It is the exchange of good s and services across many countries. For example, when a company manufactures its products in India and sells it in Europe, Japan and Africa, international business is said to happen. Globalization is said to be a major force behind international business and has created more opportunities for international business by creating a borderless world.

Peng (2013) proposes that international business is said to happen when "an organization does cross border economic activities"

Cavusgil et al (2015) define "international business as performance of trade and investment activities by firms across national borders."

International business may involve one or all of those given below:

- Tangible Goods
- Intangible Services like those of healthcare, banking, insurance, consultancy etc.
- Technology such as manufacturing, processing, software, back end support, satellite technology, etc.
- Capital and
- Knowledge

21.4 FORMS OF INTERNATIONAL BUSINESS

International business is varied in its forma and complexity. It may range from something as basic as international exports and imports to a committed investment in a far flung nation in the form of foreign direct investment.

- **Importing & Exporting**

  Exports are the goods, services or resources made in one country but sold across different nations. This means that the production is domestic but distribution is cross border.

  Imports are just the opposite of exports. It means that goods, services or resources made in other countries are purchased by consumers of a country.

  For example if sports equipment made in India are sold in South Africa, that means India has exported the sports equipment and South Africa has imported the sports equipment.

- **Licensing and Franchising**

Under licensing the licenser gives permission to the licensee to use its brand names, trademarks, technology or patents. The licensee pays to the licenser a fee for the rights to use the intellectual property rights of the licenser. This fee is called as royalty. The licenser also provides guidance, support and constancy to the licensee. It is a relatively low cost, fast and risk free entry mode in international business. This is a cheaper entry mode as there is no up-front expenditure for setting up a facility and hiring employees and the like.

Under franchising, a company gives rights to another company to use its technology or a brand name, for some defined time period. The first company is called as the franchisor and the second company is called as franchisee. The franchisee gives a fees called as royalty to the franchisor. This strategy is very commonly used by McDonald's. McDonald's has expanded globally using a franchising strategy. All franchisees pay McDonald's a royalty and also a commission on percentage of its sales. McDonald's gives to the franchisee the right to use its brand name, products, systems, services, and management know how. This is how McDonald's has become a global brand, riding high on the franchising wave.

- **Joint venture**

An international joint venture takes place "when businesses located in different countries get into a partnership for expanding their business".

According to Hill (1999) "a cooperative enterprise entered into by two or more business entities for the purpose of a specific project or other business activity."

A company that wants to expand internationally but does not want to assume all the responsibilities and activities of international business, chooses to go for an international joint venture.

Examples:

a) Vodafone & Telefónica have formed a joint venture to share their mobile network.

b) BMW and Toyota have a joint venture for working together on vehicle electrification.

c) Google and NASA jointly developed the Google Earth.

- **Foreign direct investment (FDI)**

Foreign direct investment (FDI) is "an investment in a business by an investor from another country for which the foreign investor has control over the company purchased". Ownership here means having an ownership of more than 10% in a foreign company. For an investor owning less than 10%, the International Monetary Fund chooses to call it as part of stock portfolio rather than as FDI. The intention to control and manage the invested company is important. FDI can happen in many ways:

a. Investing funds within company
b. Property investments
c. Investing in plants, or equipment
d. Buying assets in a foreign company
e. Investing in technology.

FDI is a relatively long term investment strategy and government and political environment plays a major role in determining the FDI policy of a nation. Foreign direct investment really very critical for the development of an emerging economy. Developing countries need the resources and expertise of an overseas company to expand their business internationally. This creates employment opportunities and raises the wages of an invested company.

Foreign Direct Investment in India is regulated in some industries 100% FDI is allowed while in some industries 100% FDI is not permitted. The percentage ranges from 26% to 49% to 51%.

In some industries, FDI is strictly not allowed. These industries are

a. Atomic Energy
b. Gambling
c. Lotteries (online, private, government, etc)
d. Investment in Chit Funds
e. Cigarettes
f. Tobacco industry
g. Legal sector

Sensitive sectors like media, insurance and defence have limits to FDI. For example, defence industry allows only 49% FDI.

- **Foreign institutional investment (FII)**

A foreign institutional investor (FII) is "a large investor or investment fund registered in a country outside of the one in which it is investing. Institutional investors most notably include hedge funds, insurance companies, pension funds, and mutual funds".

The term is very commonly used in India.

Example:

There is a mutual fund investment in the United States. It gets to understand that infrastructure industry in India is at a boom and seeing an opportunity it invests in an Indian company of the infrastructure sector by purchasing the equity on the Indian public exchange. Such an investment is called as foreign institutional investment.

Difference between FDI and FII

Parameter	**FDI**	**FII**
Meaning	A company from a country investing in a company based in some other country	A company from one country makes investment in the stock market of another country
Entry	Difficult	Easy
Exit	Difficult	Easy
Tenure	Long term capital	Short term capital
Transfer	Funds, IPR, technology, process, skills etc	Only Funds
Economic Growth	Yes	No
Outcome	Increase in GDP	Increase in capital of country
Target	Company	Financial Markets
Control over company	Yes	No

Check Your Progress-A

Q1. State the meaning of international business?

Q2. Explain different forms of international business?

Q3. MCQs

(i) FDIs invest in

a. Companies in the same Country
b. Companies in another country
c. Stock Market in another country
d. All of the above

(ii) A café named Tea Connect wants to enter into Dubai, but does not want to invest a huge sum of money. What should it do?

a. Franchising
b. Greenfield Venture
c. Wholly Owned subsidiary
d. FDI

(iii) Identify an Indian multinational company:

a. Infosys
b. Unilever
c. P&G
d. LG

Q4. **Fill in the Blanks with appropriate word or words.**

i. ______________________ and ___________________ are special modes of entry in the foreign market.
ii. _________________________ has given a big encouragement to international business.
iii. FDI brings _________________ term capital to a country.
iv. Maruti Suzuki is an example of a ______________ _____________.
v. Globalization means a more a ______________ and ______________ world.

21.5 CONTEMPORARY ISSUES IN INTERNATIONAL BUSINESS

Doing business in an unknown and distant country is a difficult thing to venture into. The land, the geography, the people, the culture, economy, language all have an impact on business and are very difficult to understand and manage.

The biggest issues facing international business have been identified as follows:

a. Company structure
b. Regulatory Environment
c. Accounting Practices
d. International Pricing
e. Payment Modes
f. Fluctuation in currency
g. Shipment and logistics
h. Cultural barriers
i. Uncertainty and risk in political environment
j. Supply Chain
k. Environmental issues

21.5.1 ISSUES 1 TO 6

Company Structure

In order to compete in an international market, one must have the right company structure and the best team in place. Organizational structure and location of team are two important factors for the success of an international business.

There are 2 options for operating internationally:

a. Operating from a central headquarter or corporate office
b. Operating from offices and representatives that are based in the host country.

The next question is about organizing the teams. How will they be organized? How much empowerment and autonomy should be given to them? How would they manage operations across different time zones?

Another option could be hiring local employees who understand the culture of the host country and work in close co-ordination with the corporate office.

Coca-Cola is a brilliant example of an excellent **multinational business organization structure**. The company has Presidents to supervise the different continental divisions. The central Presidents manage the Presidents of smaller, geographies or smaller regional subdivisions. The brand is a global brand and the product is consistent and same across the globe.

Regulatory Environment

Once the company structure has been decides, next arises the question of having a knowledge of the local regulatory environment. Concerns are many-will the product be legal in the country of operation? Is pricing a fair price in that country? Does the product's advertising comply with the rules and regulations of the country? Are product ingredients, specifications, labelling and packaging according to the laws of the country?

There are huge penalties of violating the laws. For example, Airbnb had to face a problem in 2014 in Barcelona. The advertisement was not in line with the norms and laws of local housing, real estate and tourism regulations in the country and had to shell out a huge penalty of €30,000 in Barcelona.

Similarly, labor laws and employment conditions also differ across the globe. Maternity leave rules also change on the basis of geography. For example Europe countries have at least 14 weeks maternity leave norm while US has a different norm. Hiring an experience legal advisor is thus a must for international operations.

Besides the written rules and regulations, one has to understand the unwritten cultural guidelines. Local practices, bribery, corruption makes operating in international market a real challenge.

Accounting Practices

International accounting should aim at achieving tax efficiency Tax compliance is the most difficult issue in international business. Different Accounting conventions, different tax regimes, rates, and norms makes accounting a challenge in international business. The purpose of a judicious accounting is to maximize revenue.

The tax regime and rates depend upon the location where the business is registered. For example, Flipkart is registered in Singapore to avail tax benefits. Business also needs to be aware of the tax agreements that exists between two countries so that multiple taxation can be avoided. For example Ireland is known for providing an ease of business by having a relaxed and liberal tax policy and hence many organizations decide to heave their headquarter in Dublin to have the benefits of tax consolidation. Some examples include Google, Facebook, and Intel.

International Pricing

Price setting is a major concern and challenge in international business. Marketing is an exchange of value between the company and the customers and thus one should be aware that one cannot charge more than the value that it delivers. Further, the price cannot lie below costa and above the competitor's price for the same offering. Thus, cost, competition and market are major pricing considerations. Costs should always remain low in order to ensure profit. A serious research is needed to understand the pricing models of the local competitors. The calculation of the cost of manufacturing and transportation, labor, marketing, and logistics together with the profit margin, should be done to make the business profitable.

Pricing depends on brand positioning and brand perception too. Is your product a popular product or a premium product? Does it reflect a status or it is a necessity?

The country of operation is also important while deciding a price. For example, Ikea –a furniture brand from had a bad time in China because China had cheap labor and cheap raw material and thus local competitor's products were cheaper than Ikea. Ikea then decided to use labor and raw material from China by locating itself in China. Access to local raw material and chap labor helped it reduce the cost of production and hence compete with local Chinese brands easily.

Payment Modes

E-commerce websites have given a boost to international business. Different countries have different payment modes and the commonly accepted payment mode in one country may not be available abroad. Thus, deciding upon a safe, secure, in use payment mode is an important decision in international business.

Worldpay is a well-known global payment mode. Similar examples include, JCB(Asia) or Yandex Money (Russia). Other payment options include wire transfers, PayPal and Crypto currency like Bitcoin,.

Fluctuation in currency rates

Currency rate fluctuation is the gravest issue facing international business. Keeping a pulse on the exchange rates is thus necessary. Sometimes, the rates fluctuate drastically and thus forecasting profits becomes impossible. Profits may also turn into loses.

For example, if a company manufactures in US, then it has to pay its suppliers and producers in U.S. dollars. Now this company sells its products in countries with a weak or unpredictable currency, then it can have a very small profit margin and even losses. One solution to this problem could be keeping the currency same in all selling and buying transactions. This is possible only when production happens locally and a good balance is struck between expenses and sales revenue .

21.5.2 ISSUES 7-11

Shipment and Logistics

E Commerce offers a huge international business but a successful business has its roots in a safe, secure, fast, reliable, on time shipping and logistics function. The size of the shipment and the location of the destination affects the choice of transportation viz. seaways, roadways, airways, or a combination of all. The choice of transportation affects the cost and thus the revenue. The customs duty, warehousing, local distribution costs are also important decisions to make in an international context. Many countries also have their own regulations and shipping requirements.

For a quick tab on costs, UPS International has developed TradeAbility, an online app, to help shipping of good across countries.

Cultural barriers

Communication strategy is the core of any business, more so if it is international business. Cross cultural communication is a real challenge because it requires an understanding of the culture of another country as well as anticipating how a particular communication would be perceived in a cultural context. Any aspect of marketing, right from the selection of a brand name to advertising has to be viewed in a cultural context. Not only verbal communication, but also nonverbal communication is equally important. Handshakes, head nods, distance, space, tone, pitch, body language all need to be aligned to the culture of the country where a company wants to operate. A serious research is thus needed to understand the cultural values, protocols and norms acceptable in a particular culture. An understanding of religion, social class, ethnography and race is important too to avoid business pitfalls.

Product, packaging, promotion, pricing and distribution all need to be aligned to a cultural context. For example, when McDonald’s entered India, it realized after its research that hamburger will not have an acceptance with Indian customers. Ham will disturb the religious sentiments of many. Hence, it launched an aaloo tikka burger which cut across all Indian customers.

Starbucks, an American coffee chain had a bad time in Australia. It struggled because small, local, independent coffee shops dominated the Australian market and establishing an expensive corporate coffee chain did not appeal to the customers.

A lot of ethnographic research and sound decision making is needed. A scooter was launched in Spain with brand name-NOVA. It was perfect piece of engineering, design and marketing but still failed. The reason being the word NOVA in Spanish language had a negative meaning. It meant ‘dead’ ‘no go’. Surely, one would not like to buy a product by a name which means ‘dead and defunct’.

Uncertainty and risk in political environment

Political uncertainty and instability affects business, more so if it's unpredictable. Emerging markets offer huge business opportunities, but a scanning for economic and political stability is must before one decides to go overseas. Emerging markets have a number of issues- underdeveloped infrastructure, unframed policies, poorly executed laws, red tapism, nepotism, corruption, bureaucratic set up leading to delays in decision making. All these can create difficulties in managing a business in international markets. Terrorism is another aspect that affects business. Many countries demonstrate economic nationalism and this makes the environment unfriendly for international businesses. Social media companies , for example, Facebook are prohibited to enter China, because of socio-economic nationalism and also because of government's mandate to regulate internet content. A scanning of political environment is a must do thing for a company that wants to go overseas.

Supply Chain

A company today is as good as its supply chain. The competition today is not between two companies, but between the supply chains of the two companies. Supply chains are a source of competitive advantage. Longer the supply chain, more the cost and also the possibility of corrupt and illegitimate business practices raising their ugly head. Forced labor and worker exploitation also becomes an added danger in long supply chains in international markets. A study has revealed that 77% of businesses believe that the practice of slavery still happens at in their supply chains. Moreover, sustainable green chains are also needed to address the issues of environment protection and preservation. Securing and maintaining an ideal supply chain is an important concern in international markets.

Environmental issues

Education has made masses aware of environmental degradation and the risks that follow it. The climate summit, Kyoto protocol, UN declaration of Sustainable Development Goals have raised sustainability **issues on a higher pedestal and the world is watching the corporates very closely**. Corporates are under a close radar and can't escape the actions of their business activities that are environmentally detrimental. Waste disposal and green washing have necessarily become corporate mandates. Eco-friendly ways of running business need to be explored and established. It's important to note not only are these legal pressures, but today even consumers are looking forward for eco-friendly products and processes. Sustainable practices is a new differentiator even for consumers and they choose between brands using the sustainability lens. Consumer behavior has changed and thus are the companies pressurized to look for **sustainable models of starting and scaling up a business.**

Check Your Progress- B

Q1. Explain the major issues in international business with example.

Q2. Write a short note on currency rate fluctuation and its impact on international business decisions.

Q3. Explain the importance of culture in communicating in international business.

Q4. Identify the issue involved:

a) Brand name of a product has a negative meaning in another country.

b) Rupee has fallen with respect to US dollar.

c) Advertising to children is banned in Europe.

d) A company must make sure that its operations do not harm the environment.

21.6 SUMMARY

The module talks about the process of internationalization and going global. The focus of the module is on entry strategies. Also elaborated upon is the contemporary issues facing international business. It also talks about the strategies needed to face the challenges faced by an organization/individual planning to go overseas.

21.7 GLOSSARY

Balance of Payments - The International Monetary Fund's accounting system that tracks the flow of goods, services, and capital in and out of each country.

Balance of Trade - The difference between a country's total imports and exports over a set period.

Balanced Economy - In national finances, it is when exports are equal to imports.

Barter - Trade in which merchandise is exchanged directly for others without use of money or the involvement of a 3rd party.

Bilateral Trade Agreement - A commercial agreement between two countries, often detailing what specific quantities of what specific goods can be exchanged.

Copyright - A copyright grants the exclusive legal right to sell, produce, publish or distribute an individual or organizations original work.

Culture - Collective mental paradigms that a society imparts to individuals in the form of behavior patterns, shared values, norms and institution

Currency Risk - The risk of unexpected changes in foreign currency exchange rates. Also known as foreign exchange risk.

Developed Countries - The richer, more industrialized countries in the world.

Developing Country - A country that is in the process of becoming industrialized. A developing country typically lacks industrialization, infrastructure, high literacy rate and advanced living standards.

Direct Exporting - Marketer takes direct responsibility for its products abroad by selling them directly to foreign customers or through local representatives in foreign markets.

Emerging Market - An emerging market is a country that has similar attributes of a developed country, but does not yet encompass all aspects of a developed country. Emerging markets are attractive to investors as they provide a higher risk and return than developed countries and the markets are experiencing rapid growth and industrialization. Different from an emerging economy as emerging markets are not constrained to any political boundaries.

Export - Any resource, intermediate good, or final good or service that producers in one country sell to buyers in another country.

Financial Market - The market for the exchange of credit and capital in an economy. It consists of the money market and the capital market.

Financial Price Risk - The risk of unexpected changes in a financial price, including currency (foreign exchange) risk, interest rate risk, and commodity price risk.

Financial Risk - Financial risk refers to unexpected events in a country's financial, economic, or business life.

21.8 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress –A

Q3. Multiple Choice Questions

Answers;

i. b
ii. a
iii. a

Fill in the blanks

i. Franchising and Licensing
ii. Globalization
iii. Long term
iv. Joint Venture
v. Integrated, Independent

Check Your Progress –B

Q4 –Identify the issue involved

a. Cultural Issue
b. Economic Issue
c. Legal Issue
d. Environment Issue

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21.11 TERMINAL QUESTIONS

Q1. What do you understand by International Business? Is it true that International Business is more complex than domestic business? Explain giving reasons for your answer.

Q2. Briefly explain the important economic indicators that a manager needs to consider before deciding to go international.

Q3. What is culture? What are the different elements of culture?

Q4. How does culture affect international business decisions? Explain.

Q5. Write an elaborate note on the contemporary issues facing international business and how would you decide as a manager.

Q6. Choice of entry mode is a serious international business decision. Discuss.

Q7. Write a note on franchising.

Q8. FDI is a blessing for a host country. Discuss.

21.12 CASE LETS/CASES

Kellogg's is a prominent producer in ready-to-eat breakfast cereals category. It entered India in 1995 and with an investment exceeding Rs. 150 crores. It launched itself with a bang and an aggressive campaign. The campaign talked about crunchiness, that is, when a piece of corn was chewed between the jaws- a sound of crunchiness could be heard. The advertisement also had an audio which was very much like the sound of chewing the Kellogg's corn between the jaws. Kellogg's was very happy about its promise of crunchiness and the advertisement also showing the same. But, much to the surprise of the company, the customers were not convinced with the claims made in the advertisement. A research study that followed proved that the customers thought that the company had made a false claim regarding crunchiness. Kellogg's was taken aback. It conducted a study which showed that the Indian customers were eating Kellogg's corn flakes made in hot, rather boiled milk, and thus the flakes lost all the crunchiness and appeared soggy.

The company had expected and assumed that the customers would consume corn flakes in cold milk as it is a cold cereal breakfast. But, much to the company's surprise it was being consumed in hot milk. The right way to cook and consume was not used. Perhaps, the cultural context went wrong. Kellogg's did not know that Indians consume hot milk more fondly than cold milk, especially when it is the first drink of the day.

Read the above caselet and answer the following questions:

a. Was Kellogg's wrong in entering India with its ready-to-eat cereal? Discuss.

b. What could have Kellogg's done to avoid being misunderstood by the customers in India?

c. What lessons can a marketer draw from the Kellogg's failure in India at the time of its launch?

International Business
MS 111

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ISBN:
978-93-85740-17-6