PREFACE

In the curricular structure introduced by this University for students of Post-Graduate degree programme, the opportunity to pursue Post-Graduate course in a subject is introduced by this University is equally available to all learners. Instead of being guided by any presumption about ability level, it would perhaps stand to reason if receptivity of a learner is judged in the course of the learning process. That would be entirely in keeping with the objectives of open education which does not believe in artificial differentiation. I am happy to note that university has been recently accredited by National Assessment and Accreditation Council of India (NAAC) with grade 'A'.

Keeping this in view, the study materials of the Post Graduate level in different subjects are being prepared on the basis of a well laid-out syllabus. The course structure combines the best elements in the approved syllabi of Central and State Universities in respective subjects. It has been so designed as to be upgradable with the addition of new information as well as results of fresh thinking and analysis.

The accepted methodology of distance education has been followed in the preparation of these study materials. Co-operation in every form of experienced scholars is indispensable for a work of this kind. We, therefore, owe an enormous debt of gratitude to everyone whose tireless efforts went into the writing, editing, and devising of a proper layout of the materials. Practically speaking, their role amounts to an involvement in 'layout of the materials. Practically speaking, their role amounts to an involvement in 'invisible teaching'. For, whoever makes use of these study materials would virtually derive the benefit of learning under their collective care without each being seen by the other.

The more a learner would seriously pursue these study materials, the easier it will be for him or her to reah out to larger horizons of a subject. Care has also been taken to make the language lucid and presentation attrative so that they may be rated as quality self-learning materials. If anything remains still obscure or difficult to follow, arrangements are there to come to terms with them through the counselling sessions regularly available at the network of study centres set up by the University.

Needless to add, a great deal of these efforts is still experimental—in fact, pioneering in certain areas. Naturally, there is every possibility of some lapse or deficiency here and there. However, these do admit of rectification and further improvement in due course. On the whole, therefore, these study materials are expected to evoke wider appreciation the more they receive serious attention of all concerned.

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Netaji Subhas Open University

Post Graduate Degree Programme

Subject : Commerce (M. com)

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Unit 1 ❑ International Business

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1.1 Objectives

After studying this unit, you will be able to:

- understand the meaning and features of international business
- know the composition and importance of international business
- analyze the motives of international business
- assess the risk in international business
- distinguish between international business and domestic business
- comprehend the trends in international business

1.2 Introduction

By the term, international business, we mean the cross border business activities of individual firms, while economists use international trade to refer to aggregate cross-border flows of products and services between nations. While international business describes an enterprise-level phenomenon, international trade describes the macro phenomenon of aggregate flows between nations. Now a days international business refers to the exchange not only of physical goods but also services, capital, technology and human resources. It covers a very broad spectrum of activities. Many aspects of domestic business are also found in international business, but they are treated differently because international business lays emphasis on cross-border aspects. Similarly, international business covers most, if not all, of the same topics of international management but it goes much further. Where international management focuses mainly on decisions made by individuals operating within a corporate setting, international business also incorporates the broader political, economic, social, technological, philosophical and environmental contexts within which firms operate. In this unit you will come across different facets of international business.

1.3 Cconcept of International Business

The concept of international business is very simple and it is nothing but "cross-border economic activity" or cross-border business. Thus, international business refers to any business activity conducted in a foreign country by crossing of national boundary. Any business firm has to perform various activities such as marketing, sales, production, finance etc. When any one or more of such activities or the complete business is conducted in abroad, the business firm is said to have the characteristics of international business.

Now a days, international business refers to the exchange not only of physical goods but also of services, knowledge, skills and information and it covers a very broad spectrum of activities. Thus, by international business we mean business activities that involve the transfer of resources, goods, services, knowledge, skills or information across national boundaries. The resources include raw materials, capital and people. Goods consist of semi finished and finished assemblies and products. Services may be accounting, legal counsel, banking, insurance, management consulting, trade service, education, healthcare, tourism etc. Knowledge and skill may include technology and innovation, organizational and managerial skill, intellectual property rights such as copyrights, trademarks and brand names. Information flows may be database and information networks.

The different participants involved in the international business may be individuals (e.g., tourists and individual investors buying foreign stocks and bonds), companies (private or public), company clusters (e.g., alliances), government bodies (e.g., central banks), and international institutions (e.g., the World Bank, the International Monetary Fund). However, among these participants, companies are the dominant players. They are the primary economic agent facilitating and gaining (or suffering) from international business. Since the transactions of these companies arise from the foreign activities, these transactions are often called international transactions which are manifested mainly in international trade and international investment. International trade takes place when a company exports goods or services to buyers (importers) in another country. International investment takes place when the company invests resources in business activities outside its home country.

Any firm, regardless of its size, engaged in international business, is known as an international firm. A firm that invests abroad and has at least one working affiliate in a foreign country (e.g., a factory, a branch office) over which it maintains effective control, is called multinational enterprise or MNE. Thus, multinational enterprises have regular dealings outside their home country and MNE is a more general term to describe the broad category of firms, ranging from huge firms to small and medium sized enterprises (SMEs) to micro firms, engaged in international business.

1.4 Salient Features of International Business

The following are the salient features of international business:

1) ***Immobility of factors:*** Some degree of immobility of factors generally in terms of capital and labour is observed in international business. The international mobility of capital is restricted due to political uncertainty, legal requirement, instability of values foreign currencies etc. The reasons for international immobility of labour are differences in languages, custom, occupational skills, family ties, high travelling expenses to the foreign country etc.

2) ***Heterogeneous markets:*** The participants of international business have to consider the different heterogeneous markets across the world. It is so because international markets lack homogeneity due to differences in climate, language, preferences, habits, customs etc.

3) ***Different currencies:*** Different types of currencies are involved in international business. So each country has its own policy with regard to exchange rates and foreign exchanges.

4) ***Geographical and climate differences***: Every country cannot produce all commodities due to geographical and climatic conditions. So countries having climatic and geographical advantages specialize in the international business and trade them with others.

5) ***Natural resources***: Natural resource also plays a vital role in international business. Different countries are endowed with different types of natural resources. Hence they tend to specialize in the international business for those commodities in which they are richly endowed and trade them with others where such resources are scarce.

6) ***Balance of payments***: The problem of balance of payments is perpetual in international business. The policies which a country chooses to correct its disequilibrium in the balance of payments may give rise to a number of other problems.

7) ***Different national policies and government intervention:*** Economic and political policies are different from one country to another. Policies pertaining to international business differ widely among countries. Tariff policy, import quota system and other controls adopted by government interfere with the cause of international business.

1.5 Composition of International Business

International business transactions are broadly composed of international trade and international investment. By international trade we mean exchange of products (merchandise) and services (intangibles) across national boundaries. Exchange can be done through exporting (an outbound activity) or importing (an outbound activity) or global sourcing ("The procurement of product or services from suppliers located abroad for consumption in the home country or a third country"). Both finished products and intermediate goods (e.g., raw materials, components etc.,) are included in import and export activities.

By international investment we mean the transfer of assets to another country, or the acquisition of assets in that country. These assets include capital, technology, managerial talent and manufacturing infrastructure. With trade, products and services cross national

boundaries; while in investment, the firm itself crosses border to secure ownership of assets located abroad.

There are two types of international investment- foreign direct investment (FDI) and foreign portfolio investment (FPI). When the firm establishes a physical presence abroad through acquisition of productive asset such as capital, technology, labour, land, plant and equipment, it is known as foreign direct investment. It is an internationalization strategy that gives investors partial or full ownership of a productive enterprise which performs manufacturing, marketing or research and development activities. On the other hand, by foreign portfolio investment we mean the passive ownership of foreign securities such as stocks and bonds for the purpose of generating financial return and it does not entail active management or control over the assets.

1.6 Importance of International Business

The importance of international business can be discussed from the perspectives of the global economy, the national economy, the firm, global corporate citizenship and career standpoint. These are also the reasons to study international business.

1) ***Facilitator of the global economy and interconnectedness:*** International business transforms the world into a global village. An unprecedented growth in international trade and investment is observed during the post decade of GATT. Emerging markets provide new impetus to worldwide economic interconnectedness since the 1980s. The fast growing emerging markets have also been experiencing substantial market liberalization, privatization and industrialization which are also fueling global economic transformation. Along with market globalization, the internet and e-commerce make international business increasingly essential for firms of all sizes and resource levels. Actually, the growth of international business activity coincides with the broader concept of globalization of markets which refers to the ongoing economic integration and growing interdependency of countries world-wide. Globalization allows many firms to internationalize and has substantially increased the volume and variety of cross-border transactions in goods, services and capital flows.

2) ***Contributor of national economic well being:*** International business contributes to economic prosperity and standard of living and helps countries to use their resources more efficiently. International trade and investment can also

help to reduce poor economic conditions in developing economies. The rapid economic growth of emerging countries is stimulating solid gains in living standards. International trade and investment help to promote freedom and democracy and may reduce the likelihood of cross border conflict and to limit international tension by reducing world poverty (World Bank, 2004).

3) ***A competitive advantage for the firms:*** Firm must participate in the international business and acquire the necessary skills, knowledge and competence to sustain a competitive advantage in the global economy. Foreign markets are likely to generate favourable outcomes for the firms in term of sales, profit margin, growth and new knowledge. Besides, firms can maximize the efficiency of their operations through international business.

   International business allows firms to access critical resources that may not be available in the home market. It broadens the options for dealing with competitors and offers opportunities to make global strategic moves and counter moves that help the firms to compete more effectively with domestic and foreign rivals.

4) ***An opportunity for global corporate citizenship***: As firms venture into international market, they need to learn how to become global citizen. Beyond delivering value added products, technology and other benefits to their customer, they need to be responsive to the needs of other stakeholder groups, including the media, local communities, academics and the non-profit sector. In foreign markets, firms must try to meet local expectations with respect to labour and environment standards, accepted codes of conduct and the overall welfare of the society that hosts them. International firms must embed corporate citizenship into their strategic decisions as well as their ongoing processes and practices.

5) ***Career standpoint***: Managers of the world‘s leading corporations honed their managerial skills in international business. Managers of these corporations are exposed to range of enlightening experiences, new knowledge, novel ways of seeing the world and various unusual challenges. Managers with international exposure are generally more confident, cosmopolitan and better suited to meet the variety of challenges they may encounter through their careers. Thus, acquiring knowledge and managerial skills in international business is not only exciting, challenging and fun, but it is also a unique professional development opportunity.

1.7 Why Do Firms Expand Internationally? Or Why Do Firms Pursue Internationalization Strategies ? Or Why Do Companies Go Global?

The motivations for conducting international business include a variety of reasons. Firms often have more than one motive for international expansion. The motives will vary from one business activity to another. Generally companies go “global” for the following reasons:

(1) ***To seek opportunities for growth through market diversification:*** When the companies diversify into foreign markets, they can generate sales and profit opportunities that cannot be matched with the domestic markets. Besides, when a company has reached its maturity in the home country, growth opportunities are available better in foreign markets. Thus, many companies, namely, Coca-cola, McDonald’s, Gillette, Sony, are aggressively expanding their businesses into overseas markets.

(2) ***To earn higher margins and profits:*** Sluggish market growth is observed for many types of products and services in mature economies. As a result, firms operating in these economies are able to get slim profit margins. On the other hand, high-growth emerging foreign markets may be underserved or not served at all (developing economies). In these foreign markets companies can earn higher profit margins due to less intense competition, combined with strong market demands. For example, as compared to their respective home markets, bathroom fixture manufacturer’s American Standard and Toto of Japan have found more favourable markets in Indonesia, Mexico and Vietnam.

(3) ***To gain new ideas about products, services and business methods:*** Firms get new ideas for products, processes and business methods from foreign environments. The experience of doing business abroad helps firms to acquire new knowledge for improving organizational effectiveness and efficiency. For example, just-in-time inventory techniques were refined by Toyota and then adopted by other manufacturers all over the world.

(4) ***To serve key customers that have relocated abroad:*** In a global economy, many firms go to international markets to serve clients over there. For example, when Toyota opened its first factory in the UK, many Japanese auto parts suppliers followed to establish their own operations there.

(5) ***To seek raw materials:*** Many companies in extractive industries have major subsidiaries around the world to ensure access to the basic resources needed to sustain the company's primary business line.

(6) ***To get factors of production at lower costs:*** Internationalization enables the firms to access capital, technology, managerial talent, labour and land at lower costs, higher-quality at different locations worldwide. For example, the Japanese firm, Canon, relocated much of its production to China to profit from that country's inexpensive and productive work force.

(7) ***To seek production efficiency:*** Companies in high-cost countries are shifting production to low-cost regions. For example, BMW, in response to high production costs in Germany, has built assembly plants in the United States of America.

(8) ***To develop economies of scale:*** Economies of scale refer to the reduction of the per-unit cost of manufacturing and marketing due to operating at high volume. By expanding internationally, the firm increases the size of its customer base, thereby increasing the volume of products and lowering the total cost.

(9) ***To confront international competitors more effectively:*** The firm can enhance its competitive positioning by confronting competitors in international markets or entering a competitor's home markets to destabilize and curb its growth.

(10) ***To build rewarding relationship with a foreign partner:*** Firms often have long term strategic reasons for venturing abroad. Joint ventures or project-based alliances with key foreign players can lead to the development of new products, early positioning in future key markets on profit making opportunities. For example, Black and Decker entered a joint venture with Bajaj, an Indian retailer, to position itself for expected long-term sales in the huge Indian market.

(11) ***To avoid political and regulatory hurdles:*** Companies go global in order to avoid political and regulatory hurdles in the home country. The primary reason that Japanese auto companies moved production to the United States, was to get US import quotas.

(12) ***To diversify risk***: Spreading risk is generally seen as a safe business principle because it helps to avoid over-dependence on a single location of the market. Thus, the multinational firms want to spread risk by working in more than one country at a time.

1.8 Risks in International Business

Broadly, international business faces four types of risks: cross-cultural risk, country risk, currency risk and commercial risk which are to be managed to avoid financial loss or product failure. These risks are discussed below:

Cross-cultural risk: Cross cultural risk is defined as "a situation or event where a culture miscommunication puts some human values at stake". It arises in international business because of the diverse cultural heritage of the participants. "Culture refers to the learned, shared and enduring orientation pattern in a society". People show their culture through values, ideas, attitudes, behaviours and symbols. Thus, in the context of international business, cross-cultural risk is composed of differences in language, lifestyle, mindsets, customs and / or religion. Values unique to a culture tend to be long-lasting and are transmitted from one generation to the next. These values influence the mindset and work style of employees and the shopping patterns of buyers. Language is also a critical dimension of culture. Miscommunication due to cultural differences gives rise to inappropriate business strategies and ineffective relations with customers.

Country risk: Country risk refers to the potentially adverse effects on company's operations and profitability due to political, legal and economic environment in a foreign country. It is also known as political risk. Country risk includes the possibility of foreign government intervention in firms' business activities, laws and regulation of foreign countries etc.

Currency risk: Currency risk refers to the risk of adverse fluctuation in exchange rates. Currency risk arises because of international transactions being after conducted in more than one national currency. Inflation and other harmful economic conditions experienced in one country may have immediate consequences for exchange rates due to growing interconnectedness of national economies.

Commercial risk: By commercial risk we mean the firm's potential loss or failure from poorly developed or executed business strategies, tactics or procedures. Managers may make poor choices in respect of selection of business partners, timing of market entry, pricing, creation of product failures and promotional themes. The consequences of such failure are usually most costly in international business as compound to domestic business.

All the firms engaged in international business face these four types of international business risks. These risks cannot be avoided, but they can be anticipated and managed.

Experienced international firms conduct research to anticipate potential risks, understand their implications and take proactive action to reduce their effect.

1.9 International Versus Domestic Business

International business is the outgrowth of domestic business. Most of the major firms that are actively participating in the international business at present, started their operation in the domestic business earlier. Leading Japanese automaker such as Toyota, Honda started their operations in their domestic market before exploring into foreign markets. As the magnitude of their operations grow, they found it profitable or otherwise necessary to build their plants and facilities in other foreign countries. Although international business is often considered as an extension of domestic business, it is significantly different from the latter due to the following reasons:

1) ***Different currency denomination:*** In case of domestic business, a single currency is used. For example, India has the rupee, USA has the dollar, Japan has the Yen etc. But in the case of international business, different currencies are involved. Cash flows of a multinational firm in various parts of the world are denominated in different currencies. Hence, an analysis of exchange rates must be considered in the international business transactions. Besides the possibility of variations in the exchange rates between different currencies increases the currency risk in the international business. The domestic business generally does not consider these factors.

2) ***Economic and legal ramifications:*** In case of domestic business, each country has its own unique economic and legal system. The firms engaged in the international business face different types of economic and legal system worldwide. These differences can cause significant problem to international entrepreneurs. For example, differences in tax laws among countries can cause different after tax consequences to the multinational enterprises. Similarly, differences in legal systems of host nations, such as the Common Law of Great Britain versus the French Civil Law, complicate the matter in the international business transactions.

3) ***Language differences:*** The ability to communicate is critical in all business transactions. In domestic business generally different regional and national languages are used along with international language, i.e., English. However, the managers of international firms need to know several international languages to operate their businesses abroad. For example, European and Japanese business-

people are usually fluent in several language, including English. Thus, they can invade different international market more easily than the US citizens.

4) ***Culture differences:*** In domestic business, every country has unique cultural heritages that shape values and influence the conduct of business. However, culture differences exist in international business. Multinational firms vary dramatically from one country to other with respect to dealing with employees, attitudes towards risk, the ability to curtail unprofitable operations etc.

5) ***Role of government:*** The role of government is generally minimal in the domestic business of United States and Western Europe, but it is not the situation in most of the world. In international business, the different terms under which companies compete, the actions that must be taken or avoided and the terms of trade on various transactions, are determined not in the market place but by direct negotiation between the host government and the multinational firms.

6) ***Risk:*** International business firms generally encounter four types of risks; namely cross-cultural risk, political risk, currency risk and commercial risk. These risks cannot be avoided but they can be anticipated and managed by the experienced international firms. However, the domestic business firms generally do not come across these types of risks in conducting their business operations.

1.10 Trends in International Business

In this section, the present trends and the probable future trends in international business have been discussed:

1.10.1 Present Trends in International Business

In this sub-section, the present trends in international business are discussed from the perspectives of international trade and international investment.

International trade

International trade can be broadly divided between trade in goods (merchandise) and trade in services. World trade in goods has increased dramatically over the last decade, rising from about $10 trillion in 2005 to more than $18.5 trillion in 2014 but, then fell to about $16 trillion in 2015. Trade in services greatly increased between 2005 and 2015 (from about $2.5 trillion to almost $5 trillion). Although increasing, trade in services accounts for a much lower share. However, growth has slowed down significantly

in the last few years and virtually stalled in 2015. In particular, while export volumes from developing countries had been growing at rates of more than 10 per cent per year between 2003 and 2008, the figure for 2015 was about one per cent. Moreover, volumes of trade fell for many countries both in terms of imports and exports, including China.

In spite of the financial crisis of 2009, developing countries as a group have almost doubled the volumes of trade in goods since 2009. While import volumes have been growing relatively more than export volumes for developing countries, the opposite has happened in regard to developed countries. The relatively larger increase in the volumes of imports can be explained by the increase in consumer demand in developing countries. Growth in trade volumes has slowed down substantially in the last few years, especially in comparison to developing countries. Developed countries' trade volumes continued to increase, while trade volumes for developing countries stalled, both in regard to imports and exports.

The value of trade in goods is virtually equal in developing and developed countries. On the other hand, about two thirds of trade in services originated from developed countries. BRICS account for an important share of trade in goods and services. LDCs continue to account for a very small share in overall trade. In 2015 the value of world trade has declined both for developed and developing countries.

Developed countries' relative importance as suppliers in international markets is declining. Still, they account for about half of the value of exports of goods and about two thirds of exports of services. In 2015 developed countries' exports of goods were about $8 trillion, while that of services added up to about $3 trillion. In 2015, developing countries' trade summed up to about $8 trillion in regard to goods and about $2 trillion in regard to services. In 2015 BRICS exported about $3 trillion in goods and about $500 billion in services. LDCs' contribution to world trade remained minimal, although some increases in exports and imports of these countries have been recorded over the past decade.

A very large part of world trade is clustered around three regions: North America, Europe and East Asia. Other regions' contribution to world trade is much lower. During 2015 trade declined in all regions across all trade flows, however with some differences. Trade flows declined the most in relation to the transition economies. Trade from and to North America was relatively more resilient.

The increase in world trade between 2004 and 2014 was largely driven by the rise of trade between developing countries (South–South). By 2014, the value of South–

South trade had reached almost $5.5 trillion, a magnitude close to that of trade between developed countries (North–North). The substantial decline in trade in 2015 was evenly spread between the trade flows of developing and developed countries. The significance of South–South trade flows for developing countries is evident when considering that in recent years, they represent more than half the trade of developing country regions (imports and exports). South–South trade share varies by region, from about 40 per cent in Latin America to almost 70 per cent in South Asia and East Asia. Although a certain proportion of South–South trade encompasses intraregional flows, an important part involves trade with China. Since 2005, China has become an increasingly important partner for all other developing country regions. Trade with China was more resilient in 2015, while a large part of the trade downturn was related to other South–South flows.

International trade in goods can be differentiated by stage of processing, depending on their intended use along the production chain. Goods are, therefore, classified as primary, intermediates, consumer and capital (the latter comprising of machinery used for the production of other goods). Goods can also be differentiated by broad category, including natural resources, agriculture and manufacturing. With regard to the stage of processing, although there was a substantial contraction in 2015, intermediate products continued to make up the bulk of world trade. Trade in consumer and capital products represents another important share of world trade. In 2015, the value of trade in these two categories declined, but only marginally. Trade in primary products was greatly affected by the 2015 trade downturn, as in 2015 their value was at about $2.6 trillion. With a value of over $12 trillion in 2015, trade in manufacturing goods held a dominant position over trade in natural resources and agricultural products. Trade in agriculture was somewhat more resilient than the rest of the world trade.

Trade related to developed countries remains an important part of international trade, especially in relation to imports. Participation in international trade varies significantly among developing regions. BRICS countries account for an important part of developing countries' trade, especially with respect to trade in intermediates and exports of consumer products. The participation of other developing country regions in world trade, both as importers and exporters, is more limited.

In terms of value, a large amount of world trade relates to energy products (oil, gas, coal and petroleum products), chemicals, machinery, communication equipments and motor vehicles. In contrast, light manufacturing sectors, including textiles, apparel and tanning, comprised of a much smaller share of world trade. Agricultural sectors – which include food, vegetable and animal products, as well as oils and fats, tobacco and beverages –

accounted for a total of over $1.5 trillion of trade flows, or less than 10 per cent of international trade. While the value of trade increased in all sectors between 2005 and 2014, it sharply fell in 2015, especially in energy products and basic metals. During the last decade, developing countries' presence in international markets has increased substantially as compared with developed countries. Their export market share has increased across all sectors and in particular in machinery, non-metallic minerals and communication equipments.

With regard to services, travel and other business services represent the largest sectors, amounting to more than $1 trillion each in 2015. Other important sectors include transport, telecommunications, computing and finance- related services. With exception of transport and other business services, trade in most of the other categories of services has been resilient to the trade downturn of 2015. The share of global exports of different service categories pertains to developed and developing countries. Although developed countries still account for the largest part of exports of services, the export market share has been shifting to the advantage of developing countries in most sectors. Two exceptions are intellectual property and goods-related services, the latter still originating on the whole from developed countries. Developing countries are also becoming important suppliers to international markets with regard to travel and transportation as well as computer and information services.

(Source: Key Statistics and Trends in International Trade 2016, United Nations, Geneva, 2017)

International investment

FDI inflows

In 2016, FDI inflows to developed economies increased, after significant growth in the previous year. Inflows rose by 5 per cent to $1 trillion. Developed economies' share in global FDI inflows grew to 59 per cent, the highest share since 2007. The increase of FDI in developed economies was mainly driven by equity investment flows in terms of cross-border M&As targeting developed countries. Large deals included the $101 billion acquisition of SABMiller PLC (United Kingdom) by Anheuser-Busch Inbev (Belgium), the $39 billion purchase of the generic drugs unit of Allergan PLC (United States) by Teva Pharmaceutical Industries Ltd (Israel) and the acquisition of ARM Holdings (United Kingdom) by SoftBank Group (Japan) for $32 billion.

Developing economies, in contrast, lost ground in 2016. Weak commodity prices and slowing economic growth affected foreign investment inflows, which fell by 14 per

cent to $646 billion – a level last observed in 2010. Cross-border M&A activity suffered a widespread downturn across developing regions during the year, falling by 18 per cent in aggregate value. In contrast, the value of announced greenfield projects rose by 12 per cent to $516 billion, pulled by the announcement of a few very large investments in a small number of countries, while the majority of countries recorded declines. In developing Asia, the decline in inflows (-15 per cent to $443 billion) was relatively widespread, with every major subregion registering reductions, except South Asia. Economic recession in Latin America and the Caribbean, coupled with weak commodity prices for the region's principal exports, factored heavily in the decline in FDI flows to the region (down 14 per cent to $142 billion). Flows to Africa also registered a decline (-3 per cent to $59 billion), with the region suffering external vulnerabilities similar to those in Latin America.

The United States remained the largest recipient of FDI, attracting $391 billion in inflows, followed by the United Kingdom with $254 billion, vaulting from its 14th position in 2015 on the back of large cross-border M&A deals. China was in third position with inflows of $134 billion – a 1 per cent decrease from the previous year.

FDI outflows

The flow of outward FDI from developed economies declined in 2016, falling 11 per cent to $1 trillion. Nevertheless, their share in global outward FDI flows was roughly stable – dipping to 72 per cent from 74 per cent in 2015 – as outflows from developing economies slipped 1 per cent to $383 billion and those from transition economies contracted 22 per cent to $25 billion.

Investment by European MNEs, which had surged in 2015, retreated significantly in 2016, falling 23 per cent to $515 billion. This was driven by sharp reductions in outflows in Ireland (down 73 per cent to $45 billion), Switzerland (down 71 per cent to $31 billion) and Germany (down 63 per cent to $35 billion). While the prolonged slump in corporate profits in Europe crimped investment, it provided renewed impetus to some corporations to seek transformative deals providing access to new markets and to generate cost savings. As a result, the value of cross-border M&As concluded by the continent's MNEs continuously increased, rising 40 per cent to $435 billion.

Investment by North American MNEs held roughly steady in 2016, despite a significant reduction in the value of their cross-border M&A purchases. The United States remained the world's largest outward-investing country, although flows declined marginally (-1 per cent) to $299 billion. Net purchases through cross-border M&As by MNEs, in contrast, fell sharply (-39 per cent to $78 billion), reflecting in part a slowdown in tax inversion

deals. FDI outflows from Canada posted a similar decline (-1 per cent to $66 billion), despite the value of Canadian MNEs' acquisitions abroad falling 33 per cent to $57 billion.

A relatively small number of megadeals bolstered FDI flows by MNEs from other developed countries, which rose 20 per cent to $164 billion. The ARM – SoftBank deal lifted outflows from Japan (13 per cent to $145 billion). Investment by Israeli MNEs increased 26 per cent to $13 billion, thanks in part to a series of acquisitions by Teva Pharmaceutical Industries. Outflows from other developed countries were also boosted by a significant swing from net divestment to net investment by Australian MNEs (from -$2 billion in 2015 to $6 billion in 2016).

The year was marked by significant variation in outward investment by MNEs from developing and transition economies. Chinese outward FDI surged, rising 44 per cent to $183 billion, propelling the country to the position of second largest home country for FDI for the first time. This coincided with the country becoming a net outward direct investor during the year. Chinese MNEs invested abroad to gain access to new markets and to acquire assets that generated revenue streams in foreign currencies. The rise in outward investment by Chinese MNEs was not without controversy, as a number of deals were scrutinized by policymakers both in China and abroad.

Outward investment by African MNEs rose slightly (1 per cent to $18 billion), largely reflecting a rise in outflows in Angola (35 per cent to $11 billion) that more than offset a sharp reduction in flows from South Africa (-41 per cent to $3 billion). In contrast, outward investment by MNEs from Latin America and the Caribbean collapsed (-98 per cent to $751 million), falling to its lowest point since 1988, as outflows from Brazil and Mexico both swung to net divestment of foreign assets. FDI outflows from the transition economies registered a 22 per cent decline, falling to $25 billion, as intracompany loans by MNEs from Kazakhstan turned negative.

FDI by selected groups

FDI flows to and from large economic groups such as the G20 and Asia Pacific Economic Cooperation (APEC), continued to dominate the global FDI landscape in 2016. These groups accounted for more than 50 per cent of global FDI inflows and outflows. Inflows to most groups (G20, APEC, NAFTA and BRICS) and country associations, such as the Commonwealth of Nations, rose for various economic and corporate reasons. Corporate reconfiguration, economic growth and improved business sentiments contributed

to the rise in these groups. The share of the largest groups in world FDI inflows (G20 and APEC) remained proportionately small relative to their weight in the global economy.

Inward FDI stock exceeded outward stock in the Commonwealth, BRICS and ACP members, while the G20, APEC and NAFTA members continued to be significant capital exporters. The former groups are predominantly developing economies and are net recipients of FDI inflows, while the latter consist of comparatively more developed countries and emerging economies with increasing numbers of MNEs. Companies in the G20, APEC and NAFTA remained active investors. With the exception of NAFTA, outward FDI flows from all selected groups rose in 2016. Intragroup connectivity through FDI remained strong in the G20 and APEC, and growing in BRICS and ACP. In most groups, M&A activity significantly contributes to intragroup connectivity.

FDI by sector, industry and mode of entry

By 2015, the latest year for which data are available, about two thirds of global FDI stock was concentrated in the services sector, in line with its share in the world economy. Manufacturing and the primary sector accounted for 26 per cent and 6 per cent, respectively. Among services industries, the largest recipients of inward FDI stock were finance, business activities, trade and telecommunication. Within the manufacturing sector, five major industries, namely chemical products, food and beverages, electronics, motor vehicles and petroleum products, accounted for more than 70 per cent of all FDI stock in specified manufacturing activities. Within the primary sector, FDI in extractive industries, including oil and gas and metal mining, dominates, while investment stock in agriculture remains low.

Low commodity prices have significantly affected FDI inflows to the primary sector over the last few years, which is weighing on the share of the primary sector in FDI stock, especially in Africa, Latin America and West Asia. Extractive industries play a dominant role in these developing regions' economies and they account for 20 to 30 per cent of their FDI stock. The amount of announced greenfield investment increased significantly as well. The total value of cross-border M&A sales rose by about 18 per cent to $869 billion, the highest level since the outbreak of the global financial crisis. Cross-border M&A sales picked up across all three sectors, but particularly in major industries such as electronics, food and beverages, oil and gas, trading activities and utilities.

In contrast to the rapidly rising value of cross-border M&As over the 2014–2016 period, the value of announced greenfield investments increased only modestly, suggesting

a relatively slow pace of international production expansion by MNEs. In 2016, the value of greenfield FDI announcements increased by 7 per cent to $828 billion, pulled by some very large announced investments in a small number of countries while the rest of the world experienced a widespread slump. At the sectoral level, all manufacturing industries recorded a decline, with the total amount of greenfield FDI announced in the sector down by about 9 per cent to $292 billion. Greenfield FDI in services registered an increase as well, rising by 15 per cent to $481 billion, driven by a concentrated surge in construction investment in a small number of countries.

(Source: World Investment Report 2017: Investment and The Digital Economy, United Nations)

1.10.2 Future Trends in International Business

Multinational enterprises always have one eye to the future, by employing qualified staff to detect and plan for political, economic, social, technological and/ or ecological trends that might have a significant impact on future operations. The objectives of this 'watch' function or competitive intelligence is to help the company to position itself so as to take advantage of any opportunities and/ or protect itself from future rivals and adverse conditions. However, it is very difficult for MNEs to detect the event that are likely to bring them future success or failure in the context of complications inherent in today's rapidly shifting and increasing globalized markets. Since the year 2000 the international managers have focused on two of the main trends in international business- firstly, the rise of new economic powerhouses and secondly, the growing ecological constraint.

The shifting geography of international business:

McKinsey consultancy group (2008) stated that international executives' main concerns are: emerging economies, ecological sustainability, technological innovation, the globalization of labour, ethical business, powerful capital markets, advances in knowledge management and socio-economic or demographic changes. But every MNE is not affected to the same extent by each of the trends. However, there is a strong consensus among the experts that all the MNEs can expect to experience a 'global remix ' due to the rise of the BRICs (Brazil, Russia, India and China) especially the last two. Though OECD economies and Middle Eastern OPEC states are holding important positions in the international business, the BRICs' rise constitutes an important change in the geographic centre of international business. Statistics reveal a clear rise in the proportion of international business conducted by the developing world, particularly the BRICs, in spite of industrialized countries ongoing dominance of world trade and investment.

The business conditions in the BRICs are that: *Firstly*, Brazil, Russia, India and China do have several characteristics in common. Since the 1990s each country in BRICs has placed the greater emphasis on market economies. *Secondly*, growth in the BRICs can be divided between 'exogenous' drivers like exports and 'endogenous' internal dynamics which is mainly composed of domestic demand and investment including FDI by foreign firms. The foreign firms use these countries (BRICs) as manufacturing platforms for products and services that may be re-exported elsewhere. One driver for FDI is that the enormous number of young engineers and scientists are currently being trained in Chinese, Russian and particularly Indian Universities. *Thirdly*, rising wages in the BRICs have led to a rapid expansion in their middle classes. These expansion of the BRICs' middle classes is also significant because of the kinds of products that households purchase when they shift out of poverty. As income rises, people spend in areas (entertainment, consumer durables, leisure) that were once beyond their reach. This is a great opportunity for firms in the sector concerned. For mid-scale fast-moving consumer goods, rising demand from the BRICs' new middle classes has been a great opportunity for global retailers such as Wal-Mart, Carrefour and Tesco. *Fourthly*, the BRICs have provided a much needed boost for global car makers and their component manufacturer. For example, General Motors built corporate campus near Shanghai to develop environment friendly technologies targeting the local market. The southern Indian city of Chennai has recently hosted new factories built by leading carmakers like Nissan, Toyota, BMW and Ford.

Companies originating in the BRICs are more accustomed to environments characterized by low costs, low prices and (sometimes) lower quality. The rise of MNEs in the 'global south' is a significant trend and is likely to have a strong impact on the future of international business. However, it is too early to predict whether international business, under the influence of BRICs and in reaction to the 2008 crisis, is about to go through a full-scale paradigm shift similar to the ones that were experienced in the 1930s and 1970s.

The ecological constraint on international business:

There is an almost unanimous opinion among governments, business leaders and academicians that the future will be characterised by an ever-tightening ecological constraint because of two reasons. *Firstly*, there is the damage caused by the pollution that is generated by the business firms. *Secondly*, there is resource depletion (i.e., consumption of raw material that cannot be replaced) or the exhaustion of the global stocks of the physical commodities that companies need for their production processes. Historically,

the business world has given insufficient recognition to the ecological constraint, but this is no longer the case. Now sustainability has become a mainstream concern. Accordingly, environmentalism (i.e., attitude that ecological sustainability should be priority factor in personal and organizational decision making) will be viewed not as a marginal concern but as an integral aspect of international business.

In the future, MNEs will need to manage resources more efficiently and promote alternative energy sources through technological innovations. These changes will affect all international managers. Cross border supply chains will affect the global transportation of goods. Renewed localization will affect product definition and marketing. Logistics constraints will change human dynamics by increasing the use of video-conferencing and promoting long-term overseas assignments as opposed to short-term travel. International managers who integrate these ecological constraints into their business planning will have a competitive advantage over everyone else.

1.11 Summary

- International business refers to any business activity conducted in a foreign country by crossing of national boundary. Any business firm has to perform various activities such as marketing, sales, production, finance etc. When any one or more of such activities or the complete business is conducted abroad, the business firm is said to have the characteristics of international business.
- Now a days, international business refers to the exchange not only of physical goods but also of services, knowledge, skills and information and it covers a very broad spectrum of activities. Thus, by international business we mean business activities that involve the transfer of resources, goods, services, knowledge, skills or information across national boundaries. The resources include raw materials, capital and people. Goods consist of semi finished and finished assemblies and products. Services may be accounting, legal counsel, banking, insurance, management consulting, trade service, education, healthcare, tourism etc. Knowledge and skill may include technology and innovation, organizational and managerial skill, intellectual property rights such as copyrights, trademarks and brand names. Information flows may be database and information networks.
- The following are the salient features of international business: immobility of factors, heterogeneous markets, different currencies, geographical and climatic differences,

natural resources, balance of payments, different national policies and government intervention.

- International business transactions are broadly composed of international trade and international investment. By international trade we mean exchange of products (merchandise) and services (intangible) across national boundaries. By international investment we mean the transfer of assets to another country, or the acquisition of assets in that country. These assets include capital, technology, managerial talent and manufacturing infrastructure. With trade, products and services cross national boundaries; while in investment, the firm itself crosses border to secure ownership of assets located abroad.
- There are two types of international investment- foreign direct investment (FDI) and foreign portfolio investment (FPI). When the firm establishes a physical presence abroad through acquisition of productive assets such as capital, technology, labour, land, plant and equipment, it is known as foreign direct investment. On the other hand, by foreign portfolio investment we mean the passive ownership of foreign securities such as stocks and bonds for the purpose of generating financial returns and it does not entail active management on control over the assets.
- The importance of international business can be discussed from the perspectives of the global economy, the national economy, the firm, global corporate citizenship and career standpoint. These are also the reasons to study international business.
- The motivations for conducting international business include a variety of reasons. Firms often have more than one motive for international expansion. The motives will vary from one business activity to another. Generally companies go "global" for the following reasons: to seek opportunities for growth through market diversification; to earn higher margins and profits; to gain new ideas about product, services and business methods; to serve key customers that have been relocated abroad; to seek raw materials; to get factors of production at lower costs; to seek production efficiency; to develop economies of scale; to confront international competitors more effectively; to build rewarding relationship with a foreign partner; to avoid political and regulatory hurdles in order to diversify risk.
- Broadly international business faces four types of risks: cross-cultural risk, country risk, currency risk and commercial risk which are to be managed to avoid financial loss or product failure.

- International business is the outgrowth of domestic business. As the magnitude of their operations grows, they find it profitable or otherwise necessary to build their plants and facilities in other foreign countries. Although international business is often considered as an extension of domestic business, it is significantly different from the latter due to the following reasons: different currency denomination; economic and legal ramifications; language differences; cultural differences; role of government; risk etc.
- World trade in goods had increased dramatically over the last decade, rising from about $10 trillion in 2005 to more than $18.5 trillion in 2014 and then fell to about $16 trillion in 2015. Trade in services greatly increased between 2005 and 2015 (from about $2.5 trillion to almost $5 trillion). Although increasing, trade in services accounts for a much lower share.
- In spite of the financial crisis of 2009, developing countries as a group have almost doubled the volumes of trade in goods since 2009. While import volumes have been growing relatively more than export volumes for developing countries, the opposite has happened in regard to developed countries. The relatively larger increase in the volumes of imports can be explained by the increase in consumer demand in developing countries. Growth in trade volumes has slowed down substantially in the last few years, especially with regard to developing countries. Developed countries' trade volumes continued to increase, while trade volumes for developing countries stalled, both in regard to imports and exports.
- A very large part of world trade is clustered around three regions: North America, Europe and East Asia. Other regions' contribution to world trade is much lower. During 2015 trade declined in all regions across all trade flows, however with some differences. Trade flows declined the most in relation to the transition economies. Trade from and to North America was relatively more resilient.
- The increase in world trade between 2004 and 2014 was largely driven by the rise of trade between developing countries (South–South). By 2014, the value of South–South trade had reached almost $5.5 trillion, a magnitude close to that of trade between developed countries (North–North). South–South trade share varies by region, from about 40 per cent in Latin America to almost 70 per cent in South Asia and East Asia. Although a certain proportion of South–South trade encompasses intraregional flows, an important part involves trade with China. Since 2005, China has become an increasingly important partner for all other

developing country regions. Trade with China was more resilient in 2015, while a large part of the trade downturn was related to other South–South flows.

- In 2016, FDI inflows to developed economies increased, after significant growth in the previous year. Inflows rose by 5 per cent to $1 trillion. Developed economies' share in global FDI inflows grew to 59 per cent – the highest share since 2007. The increase of FDI in developed economies was mainly driven by equity investment flows in terms of cross-border M&As targeting developed countries. Large deals included the $101 billion acquisition of SABMiller PLC (United Kingdom) by Anheuser-Busch Inbev (Belgium), the $39 billion purchase of the generic drugs unit of Allergan PLC (United States) by Teva Pharmaceutical Industries Ltd (Israel) and the acquisition of ARM Holdings (United Kingdom) by SoftBank Group (Japan) for $32 billion.
- The flow of outward FDI from developed economies declined in 2016, falling 11 per cent to $1 trillion. Nevertheless, their share in global outward FDI flows remained roughly stable – dipping to 72 per cent from 74 per cent in 2015 – as outflows from developing economies slipped 1 per cent to $383 billion and those from transition economies contracted 22 per cent to $25 billion.
- FDI flows to and from large economic groups such as the G20 and Asia Pacific Economic Cooperation (APEC), continued to dominate the global FDI landscape in 2016. These groups accounted for more than 50 per cent of global FDI inflows and outflows. Inflows to most groups (G20, APEC, NAFTA and BRICS) and country associations, such as the Commonwealth of Nations, rose for various economic and corporate reasons. Corporate reconfiguration, economic growth and improved business sentiments contributed to the rise in these groups. The share of the largest groups in world FDI inflows (G20 and APEC) remained proportionately small relative to their weight in the global economy.
- By 2015, the latest year for which data are available, about two thirds of global FDI stock was concentrated in the services sector, in line with its share in the world economy. Manufacturing and the primary sector accounted for 26 per cent and 6 per cent, respectively. Among services industries, the largest recipients of inward FDI stock were finance, business activities, trade and telecommunication. Within the manufacturing sector, five major industries, namely chemical products, food and beverages, electronics, motor vehicles and petroleum products, accounted for more than 70 per cent of all FDI stock in specified

manufacturing activities. Within the primary sector, FDI in extractive industries, including oil and gas and metal mining, dominates, while investment stock in agriculture remains low.

- Multinational enterprises always have one eye to the future, by employing qualified staff to detect and plan for political, economic, social, technological and/ or ecological trends that may have a significant impact on future operations. The objectives of this 'watch' function or competitive intelligence is to help the company to position itself so as to take advantage of any opportunities and/ or protect itself from future rivals and adverse conditions. However, it is very difficult for MNEs to detect the event that are likely to bring them future success or failure in the context of complications inherent in today's rapidly shifting and increasing globalized markets. Since the year 2000 the international managers have given focus on two of the main trends in international business- firstly, the rise of new economic powerhouses and secondly, the growing ecological constraint.
- The shifting geography of international business: McKinsey consultancy group (2008) stated that international executives' main concerns are: emerging economics, ecological sustainability, technological innovation, the globalization of labour, ethical business, powerful capital markets, advances in knowledge management and socio-economic or demographic changes. But every MNE is not affected to the same extent by each of the trends. However, there is a strong consensus among the experts that all the MNEs can expect to experience a 'global remix ' due to the rise of the BRICs (Brazil, Russia, India and China) especially the last two. Though OECD economics and Middle Eastern OPEC states are holding important positions in the international business, the BRICs' rise constitutes an important change in the geographic centre of international business. Statistics reveal a clear rise in the proportion of international business conducted by the developing world, particularly the BRICs, in spite of industrialized countries ongoing dominance of world trade and investment.
- The ecological constraint on international business: There is an almost unanimous opinion among governments, business leaders and academics that the future will be characterised by an ever-tightening ecological constraint because of two reasons. *Firstly*, there is the damage caused by the pollution that is generated by the business firms. *Secondly*, there is resource depletion (i.e., consumption of raw materials that cannot be replaced) or the exhaustion of the global stocks of the physical commodities that companies need for their production process.

Historically, the business world has given insufficient recognition to the ecological constraint, but this is no longer the case. Now sustainability has become a mainstream concern. Accordingly, environmentalism (i.e., attitude that ecological sustainability should be priority factor in personal and organizational decision making) will be viewed not as a marginal concern but as an integral aspect of international business.

1.12 Self Assessment Questions

A. Objective type questions:

Choose the correct answer from the given four alternatives.

1. International business refers to any business activity conducted in a foreign country by crossing of
   a) national boundary.
   b) regional boundary.
   c) state boundary.
   d) local boundary.
2. International business involves
   a) the transfer of resources, goods, skills or information across national boundaries.
   b) the transfer of resources, goods, services, knowledge, skills or information across state boundaries.
   c) the transfer of resources, goods, services, knowledge, skills or information across national boundaries.
   d) the transfer of skills or information across national boundaries.
3. Which one is not a salient feature of international business:
   a) heterogeneous markets
   b) different currencies
   c) geographical and climate differences,
   d) mobility of factors

4. When the firm establishes a .... through acquisition of productive asset such as capital, technology, labour, land, plant and equipment, it is known as foreign direct investment.

   a) Virtual presence

   b) physical absence

   c) physical presence abroad

   d) physical presence in home country

5. Foreign portfolio investment refers to the .... of foreign securities such as stocks and bonds for the purpose of generating financial return and it does not entail active management on control over the assets.

   a) Active ownership

   b) passive ownership

   c) no ownership

   d) passive leadership

6. ______________________ is defined as "a situation or event where a culture miscommunication puts some human value at stake".

   a) Country risk

   b) Business risk

   c) Financial risk

   d) Cross culture risk

7. Country risk is also known as

   a) Political risk.

   b) Legal risk

   c) Cross culture risk

   d) Business risk

8. Currency risk refers to the risk of adverse fluctuation in

   a) Interest rates

   b) Exchange rates

c) Stock price

d) Bond price

9. ………………… refers to firm's potential loss or failure from poorly developed or executed business strategies, tactics or procedures.

a) Currency risk

b) Country risk

c) Commercial risk

d) Cross culture risk

10. Environmentalism (i.e., attitude that ecological sustainability should be priority factor in personal and organizational decision making) will be viewed not as ……………………………..of international business.

a) a marginal concern but as an integral aspect

b) an integral aspect but as a marginal concern

c) an integral aspect

d) None of the above

Answer: 1 a); 2 c); 3 d); 4 c); 5 b); 6 d); 7 a); 8 b); 9 c); 10 a);

B. Short answer type questions:

1. What is international business?
2. What is MNE?
3. Who participates in international business?
4. What do you mean by international trade?
5. What do you mean by global sourcing?
6. What is meant by international investment?
7. What is FDI?
8. What is FPI?
9. What is cross-culture risk?
10. What do you mean by country risk?

11. What is currency risk?
12. What is commercial risk?
13. What are the international executives' main concerns according to McKinsey consultancy group?
14. State the business conditions in BRICs.
15. State the two future main trends in international business.
16. Why will future be characterised by an ever-tightening ecological constraint?
17. What is environmentalism?

C. Long answer type questions:

1. What is international business? Discuss its salient features.
2. Narrate the composition of international business.
3. Explain the importance of international business.
4. Why should you study international business?
5. Why do firms expand internationally?
6. Why do firm pursue international strategies?
7. Why do companies go global?
8. Discuss different types of risk in international business.
9. How does international business differ from domestic business?
10. Write a short note on the present trends in international business.
11. Discuss future trends in international business.
12. What are the various types of risks that firms face when they conduct international business?
13. What are some of the key motivations for firms to engage in international business?

Unit 2 ❑ The Foreign Exchange Market

Structure

2.1 Objectives

2.2 Introduction

2.3 Concept of foreign exchange market

2.4 Features of a foreign exchange market

2.5 Participants in the foreign exchange market

2.6 Structure of the foreign exchange market or Market Segments of the foreign exchange market

2.7 Functions of the foreign exchange market

2.8 Exchange Rates

2.9 Foreign Exchange Quotation

2.9.1 Principles of Exchange Rate Quotes

2.9.2 Direct and Indirect quotations

2.9.3 European terms and American terms

2.9.4 Spread

2.9.5 Cross Rates

2.9.6 Spot exchange rate and Forward exchange rate

2.9.7 Illustrations

2.10 Concept of Devaluation and Revaluation of Domestic Currency

2.11 Devaluation as a Policy For Correcting Deficit in the Balance Of Payments

2.11.1 Elasticity Approach

2.11.2 Absorption Approach

2.12 Different Exchange Rate Regimes and their Mechanisms

2.12.1 Optimum Currency Areas

2.12.2 Currency Board Arrangements

2.12.3 Dollarization

2.12.4 Hybrid Exchange Rate Systems

2.13 Summary

2.14 Self assessment questions

2.1 Objectives

After studying this unit, you will be able to:

- understand the meaning and features of foreign exchange market
- know the structure and functions of foreign exchange market
- get an idea of different facets of foreign exchange quotation
- comprehend the concepts of devaluation and revaluation of domestic currency
- realize the concept of devaluation as a policy for correcting deficit in the balance of payments
- grasp the different exchange rate regimes and their mechanisms

2.2 Introduction

There are more than 164 different types of currencies circulating among the 193 countries in the world. Individuals, companies and governments of these countries deal with trade and financial transactions with the help of their currencies. Liberalization, privatization and globalization create a need for a mechanism to convert one currency into another. Without such a mechanism, it would be difficult for companies to import and export foreign goods or for individuals to travel, spend and invest money in other countries. In this backdrop, the present unit provides an overview of the foreign exchange market and its different facets. It describes the different ways in which exchange rates are quoted and calculated. This unit also explains devaluation and revaluation of domestic currency and the different exchange rate regimes and their mechanisms.

2.3 Concept of Foreign Exchange Market

One currency is exchanged for another currency in the foreign exchange market. According to Kindleberger, “the foreign exchange market is a place where foreign moneys are bought and sold”. Foreign exchange market or the forex market or FX market is an institutional arrangement for buying and selling of foreign currencies. Exporters sell the foreign currencies and importers buy them.

Until the 1970s, the foreign exchange market was small and specialized. The market changed fundamentally when the post-war Bretton Woods system broke down. Under the Bretton Woods system, the U.S. dollar was convertible into gold and other currencies were convertible to U.S. dollars at fixed exchange rates. In 1971, the US suspended the convertibility of the dollar into gold, and by 1973 the U.S. and other nations had accepted floating exchange rate. The change to floating exchange rates, the growth in the international trade, and the increase in the capital flows around the world led to the rapid growth of the foreign exchange market.

The forex market is not located in the physical space and does not have a central exchange. Rather, it is an electronically linked network of a large number of individual foreign exchange trading centers, in which the market participants deal directly with each other. Thus, the foreign exchange market provides a single, cohesive, integrated and worldwide market by linking various individual foreign exchange trading centers spread all over the globe.

There are a large number of foreign exchange trading centers in the world and each country has its own center(s). The functioning of each trading center is governed by the respective countries’ laws, tax code, banking regulation, accounting rules and financial systems. Unlike the trading and stock exchange or commodity exchanges, foreign exchange trading is not governed by any unified body.

Foreign exchange traders carry out their business through a network of communications. Although market participants are geographically far away from each other, they communicate with others with the help of high speed communication networks provided by the Society for World wide Interbank Financial Telecommunication (SWIFT). The Clearing House Interbank Payment System (CHIPS) links several banks and dealers involved in the forex transactions.

In the past, forex transactions were conducted primarily by telegram, telephone or telex. But in recent times a lot of progress has been observed. The latest development in

foreign exchange trading is electronic trading. The electronic trading is a method of trading in which the market participants can see the bid- ask rates quoted by potential counter parties on their computer screens, match orders, and make deals electronically. With the advent of high speed digital data lines and satellites based communication systems, foreign exchange transactions are now carried out very rapidly. In most cases of currency trading, there is no physical transfer of paper notes and coins, but a series of digital entries exist in the account of the two parties. In view of developments in international communication networks, foreign exchange markets all over the world have eventually become one sophisticated global market.

2.4 Features of a Foreign Exchange Market

The features of a foreign exchange market are discussed below:

i. ***Location***: Foreign exchange market is considered as an over the counter (OTC) market as there is no physical place the participants meet to execute the deals of foreign exchange transactions. It has no fixed trading floor and no single governing authority. It is more an informal arrangement among the banks and brokers operating in a financial center to buy and sell currencies and it is connected to each other by tele-communications and satellite communication network. In the wholesale segment of the foreign exchange market, the dealings take place among the banks. However, in the retail segment of this market, the dealings take place between banks and their customers. The retail segment is located at different places of large cities. They cannot be considered as foreign exchange markets, but as the counters of such markets.

ii. ***Size***: Foreign exchange market is the largest financial market with a daily turnover of over USD 3 Trillion. Although forex markets were primarily developed to facilitate settlement of debts arising out of international trade, presently the turnover of this market is equivalent to the magnitude of world trade in goods and services. The largest foreign exchange market is London, followed by New York, Tokyo, Zurich and Frankfurt.

iii. ***24 hours market***: The global foreign exchange market is a twenty-four-hour, non-stop market. Currency trading is carried out around the clock, around the globe. As foreign exchange centres are spread throughout the world, at any given point of time, some centers are closed while others are open for trade.

For example, Europe's morning hours overlap with the late hours in Asia, and Europe's afternoon hours correspond to the morning hours in North America. The different time zones make the global foreign exchange market a real-time market.

iv. ***Heavy trading during overlapping hours***: Some centers are characterized by very heavy trading during certain times when their business hours overlap with those of many other trading centers. For example the morning business hours of New York and the afternoon business hours of London overlap and therefore, very heavy trading takes place during these hours in these two centers. This happens because participants can have access to the maximum number of potential buyers and sellers when many trading centers are open.

v. ***Vehicle currency***: The US dollar is sometimes called a vehicle currency because of its pivotal role in so many foreign exchange deals. A vehicle currency is one that is widely used to denominate international contracts made by parties who do not reside in the country that issues the vehicle currency. The Euro, which was introduced at the start of 1999, will evolve into a vehicle currency on a par with the dollar. Japanese yen is the third most important currency. The pound sterling, once second position to the dollar as a key international currency, has declined greatly in importance after the emergence of Euro.

vi. ***Settlement of transactions***: Forex markets make extensive use of the latest developments in telecommunications for transmitting as well as settling foreign exchange transactions. Banks use the exclusive network SWIFT to communicate messages and settle the transactions at electronic clearing houses such as CHIPS at New York.

2.5 Participants in the Foreign Exchange Market

The participants in the foreign exchange market comprise of the following:

i. ***Individuals***: At the primary level, individuals who get remittances denominated in a foreign currency may sell their foreign currency for domestic currency, and those who travel abroad may buy foreign currency.

ii. ***Corporates***: The business houses, international investors and multinational corporations engaged in international business, may buy or sell foreign currency.

They operate by placing orders with the commercial banks. The deals between banks and their clients form the retail segment of foreign exchange market.

iii. ***Commercial banks***: Commercial banks are the major players in the market. They buy and sell currencies for their clients. They may also operate on their own.

iv. ***Investors***: Investors, including institutional investors may also require foreign currency for their direct investment or portfolio investment purposes.

v. ***Dealers and Brokers***: Dealers and brokers play a major role to buy and sell foreign currencies. Dealers act as a principal in a transaction and conduct business in their own account by committing their own funds, while brokers act as agents for an actual buyer/seller of foreign exchange and do not commit their own funds. Brokers do not take positions and, therefore, are not exposed to foreign exchange risks. They rely on the brokerage commission or fees that they receive from their clients. Dealers, on the other hand, rely on their bid-ask spread.

   There are different types of dealers. For example, in India an authorized dealer (AD) is an entity that is authorized by the RBI, to buy and sell foreign exchange. ADs are usually commercial banks, but non-bank entities may also be given this privilege. A money changer is an entity (which is not an AD) that is authorized by the RBI to trade in foreign exchange with non-banking clients (such as individuals), but has to surrender all foreign exchange received, to an AD. A market maker is an entity (usually a commercial bank) that offers two-way quotes (bid and ask) in the foreign exchange market.

vi. ***Central Bank***: The central bank of a country buys and sells foreign exchange with the view to stabilizing exchange rates and maintaining them within a range that it considers appropriate.

The above individuals and institutions that participate in the forex market may also be classified as hedgers, arbitragers and speculators. Hedgers participate in the forex market to reduce the foreign exchange risk. They try to insure themselves against adverse foreign exchange rate movements while benefiting from favorable movements. Arbitragers attempt to make risk-less profits by entering into foreign exchange transactions simultaneously in two or more market centers. Speculators take positions in the forex market by anticipating whether the exchange rate will go up or down. They take positions to profit from exchange rate fluctuations.

2.6 Structure of the Foreign Exchange Market or Market Segments of the Foreign Exchange Market

The foreign exchange market is divided into wholesale market and retail market. The wholesale market is also known as the interbank market. The participants in this market consist of commercial banks, investment banks, central banks, corporations and high-net-worth individuals. These entities are discussed briefly:

- Commercial banks buy and sell foreign currencies for their customers and trade large volumes of foreign exchange with each other.
- Investment banks and other financial institutions (e.g. insurance companies, mutual funds, hedge funds etc.) also enter the forex market and become direct competitors to commercial banks.
- Domestic and multinational corporations participate in the forex market for their business purposes. Some high-net-worth individuals also participate in this market to meet their investment needs.
- The central banks of different countries may also participate in the forex market in order to control money supply, inflation and interest rates by influencing exchange rate movements in a particular direction.

Among these participants, primary price makers or professional dealers make a two-way quotation to each other and to their clients. This group includes mainly commercial banks but some large investment dealers and a few large corporations also play the role of primary dealers. Three-tier system is observed among the professional dealers. In the first tier, a few giant multinational banks deal in a large number of currencies, in large amounts and often deal directly with each other without using brokers. In the second tier, there are large banks who deal in a smaller number of currencies and use the services of brokers more often. The last tier includes local institutions which make the market in a very small number of major currencies against their home currency.

In the interbank market, currency notes rarely change hands. The buying/selling of a particular currency is actually the buying/selling of a demand deposit denominated in their currency.

The retail market segment consists of trades between commercial banks and their corporate and non-corporate clients. Such trades are called merchant trades. Companies

need to buy/sell foreign exchange due to exports/imports, overseas loans, foreign exchange remittances (inward and outward) and inter-subsidiary transfers. Individuals need foreign exchange to meet the needs of education, medical treatment, tourism and travels. They may also wish to convert gifts of foreign currency into domestic currency.

Currency notes, traveler's cheques and bank drafts are the common instruments in the retail market. Authorized restaurants, hotels, shops, banks and other entities deal with these instruments to provide easy access to foreign exchange for individual customers and also to convert their foreign currency into their home currency.

The bid-ask spreads in the retail market are much wider than those of primary price makers. The transaction costs are also higher in this segment as compound to wholesale segment because of the small fraction of the turnover in the foreign exchange market.

2.7 Functions of the Foreign Exchange Market

The foreign exchange market serves the following important functions:

i. To effect transfer of purchasing power between countries which is known as transfer function;

ii. To provide credit for foreign trade which is called credit function; and

iii. To minimize exposure to the risks of exchange rate changes that is known as hedging function. These functions are explained below:

Transfer function

Each country has a currency in which the prices of goods and services are quoted. In the United States, it is dollar ($); in Great Britain, it is pound (£); in Japan, it is the Yen (¥) and so on. In general, within the borders of a particular country, one must use the national currency. This is not true for outside of a particular country. For example, a U.S tourist cannot use U.S dollars in Scotland to buy a bottle of Scotch whisky. Dollars are not recognized as legal currency in Scotland, the tourist must use British pounds. Fortunately, the tourist can go to a bank and exchange his/her dollars for pounds. Then he/she can buy the whisky.

Thus, the basic function of the foreign exchange market is to facilitate the conversion of one currency into another, i.e., to accomplish transfers of purchasing powers between two countries. Transfer of purchasing power is necessary because international trade and

capital transactions normally involve parties living in countries with different national currencies. Usually participants in the forex market want to deal in its own currency, but the trade on capital transactions can be taken place outside the domestic market. Hence, they must deal in a foreign currency.

When a tourist goes from one country to another, he/she is participating in the foreign exchange market. However, tourists are minor participants in the forex market; companies engaged in international trade and investment are major ones. International businesses have four main uses of foreign exchange markets.

First, the payments a company receives for its exports, the income it receives from foreign investments, or the income it receives from licensing agreements with foreign firms may be in foreign currencies. To use those funds in its home country, the company must convert them to its home country's currency. For example, a company in Scotland exports its whisky to the United States. For this purpose, the Scotch company receives dollars, but since those dollars cannot be spent in Great Britain, they must be converted into British pounds.

Second, international businesses use foreign exchange markets when they must pay a foreign company for its products or services in its country's currency. For example, a large British travel company arranges vacations for British school children and their teachers in France. French hotel proprietors demand payment in Euros, so British company must convert large sums of money from pounds into Euros to pay them.

Third, international businesses use foreign exchange markets when they have additional cash that they wish to invest for short terms in money markets. For example, consider a U.S company that has $100 million it wants to invest for six months. The maximum interest in US market may be 7 percent. However, the company may earn 13 percent if it invests in South Korean money market. Thus, the company may change its $100 million into Korean won and invest it in South Korea. Note that the actual rate of return it earns on this investment depends not only on the Korean interest rate, but also on the charges in exchange rate between won and dollar during the intervening period.

Finally, currency speculation is another use of foreign exchange markets. Currency speculation involves the short-term movement of funds from one currency to another in the hope of earning profits from shifts in exchange rates. For example, consider a U.S. company with $10 million to invest for three months. Suppose the company suspects that the U.S. dollar is overvalued against the Japanese yen. In other words, the company expects the value of the dollar to depreciate against that of the yen. Suppose the current

dollar/yen exchange rate is $1 = ¥120. The company exchanges its $10 million into yen, receiving ¥1.2 billion. Over the next three months, the value of the dollar depreciates until $1 = ¥100. Now the company exchanges its ¥1.2 billion back into dollars and finds that it has $12 million. The company has made a $2 million profit on currency speculation in three months on an initial investment of $10 million.

Credit function

Another function of the foreign exchange market is to provide credit, both national and international, to promote foreign trade. Because the movement of goods between countries takes time, inventory in transit must be financed. Specialized instruments, such as bankers' acceptances and letters of credit are available to finance international trade.

Hedging function

A third function of the foreign exchange market is to hedge foreign exchange risk. In the context of forex market, hedging means covering risk arising from changes in the exchange rate. In a free exchange market when exchange rates change, there may be a gain or loss to the party concerned. Under this condition, a person or a firm undertakes a great exchange risk if there are huge amounts of net claims or net liabilities which are to be met in foreign money. Exchange risk as such should be avoided. For this the exchange market provides facilities for hedging anticipated or actual claims or liabilities through forward or futures contracts in exchange.

For instance, suppose an Indian importer imports goods from the USA for $10 million and he needs this amount for making payments to the exporter. For this purpose, he will purchase US dollar futures contract which would lock in the price to be paid to the exporter in terms of US dollar at a future settlement date. By holding a futures contract, the importer does not have to worry about any change in the spot rate of the US dollar over time. On the other hand, if the Indian exporter exports goods to a US firm and has to receive US dollar for the exports, the exporter would sell a US dollar futures contract. This way the exporter will be locking in the price of the export to be received in terms of US dollar. Thus, the forex market provides 'hedging' facilities for transferring foreign exchange risk.

2.8 Exchange Rates

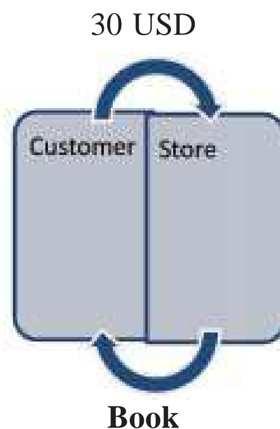
An exchange rate is the rate at which one currency can be exchanged for another. It is the price of one currency expressed in terms of another currency. In this context you

keep in mind basic pricing, say the price of an apple. If the price is Rs 50/apple, the price is Rs 50, the unit is the apple. Just as a product has a price in a store, a unit of currency has a price. For example, a book in a British airport can cost 13.25 British pounds or 30 US dollars. Likewise, a euro can cost either £0.72 or $1.17.

£13.25	£0.72
$30.00	$1.17

Focusing on the US dollar price for the book and the euro, these are the two ways to look at a transaction-from the customer perspective and from the store perspective. In the case of the book, from the customer perspective, the customer gets a book in exchange for 30 dollars.

30 USD



Book

This relationship can be written in terms of an 'exchange rate':

$$\frac{1\text{ book}}{30\text{ USD}} = \frac{1}{30}\text{ book/USD} = 0.03\text{ book/USD}$$

This ratio says that the customer gets one book per 30 US dollars. Or, we put another way; one-thirtieth of a book per 1 US dollar. From the store perspective, it gets 30 US dollars per book, or:

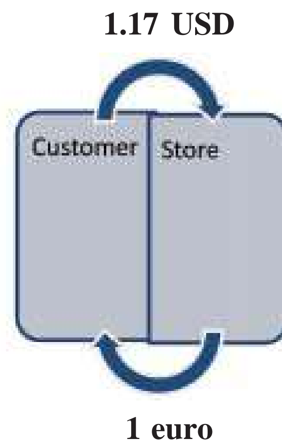
$$\frac{30\text{ USD}}{1\text{ book}} = \frac{30}{1}\text{ USD/Book} = 30\text{ USD/Book}$$

This rate says that the store gets 30 U.S. dollars per one book.

You note that the exchange rates above-1/30 book/USD and 30/1 USD/Book- are simply inverse ratios of one another.

In the case of the euro, from the customer perspective, the customer gets one euro in exchange for 1.17 US dollars.

1.17 USD



1 euro

The exchange rate then is:

$$\frac{1\text{ euro}}{1.17\text{ USD}} = \frac{1}{1.17}\ \textit{Euro/USD} = \textit{0.85 euros/USD}$$

This ratio 0.85 Euros/USD says that the customer gets 1 euro per 1.17 U.S. dollars. Or, put another way 0.85 Euros per 1 US dollar.

The inverse of that ratio gives the store perspective:

$$\frac{1.17\text{ USD}}{1\text{ Euro}} = \textit{1.17 USD/Euro}$$

This ratio says that the store gets 1.17 U.S. dollars per 1 euro.

It is no matter which form the exchange rate takes-the ratio or inverse ratio-the relationship between the currencies is the same. Getting 1.17 US dollars per 1 euro is the same as getting 1 U.S. dollar per 0.85 Euros.

2.9 Foreign Exchange Quotation

A foreign exchange quotation (or quote) is a statement of willingness to buy or sell at an announced rate for the two currencies. Quotations may be designated by traditional currency symbols or by ISO (International Standards Organization) codes. Actually ISO developed three-letter codes for all the currencies which abbreviate the name of the country as well as the currency. The codes were developed for use in electronic communications. Some of the major codes are given in the following table:

Currency	Traditional Symbol	ISO code
US Dollar	$	USD
European Euro	•	EUR
Great British Pound	£	GBP
Japanese Yen	¥	JPY
Australian Dollar	A$	AUD
Hong Kong Dollar	HK$	HKG
Indian Rupee	₹	INR
South Korean Won	W	KRW
Russian Ruble	R	RUB
Switzerland Franc	Fr	CHF

Today, all wholesale trading, that is, the trading of currencies between major banks in the global market place, uses the ISO codes. Although there are no hard and fast rules in the retail markets and in business periodicals. European and American periodicals have a tendency to use the traditional currency symbols, while many publications in Asia and the Middle East have embraced the use of ISO codes. The paper currencies (bank notes) of most countries continue to use the country's traditional currency symbol.

2.9.1 Principles of Exchange Rate Quotes

Foreign exchange quotations follow a number of principles/conventions. The inter-bank market uses quotation conventions adopted by ACI (Association Cambiste Internationale). These conventions are explained below:

i. Every currency exchange involves two currencies, currency 1 (CUR 1) and currency (CUR2): CUR1/CUR2 a currency pair is denoted by the three letter ISO codes for the two currencies, separated by an oblique or a hyphen. For example

USD/INR	:	US dollar-Indian rupee
GBP/JPY	:	Great Britain Pound-Japanese Yen
EUR/USD	:	European euro-US dollar

ii. The currency to left of the slash is called the base currency or the unit currency. The currency to the right of the slash is called the price currency or quoted currency. Thus, in USD/INR, US dollar is the base currency and Indian rupee is the quoted currency.

iii. The quotation always indicates the number of units of the quoted currency, CUR2, required in exchange for receiving one unit of the base currency, CUR1. For example a USD/INR quotation will be given as number of rupees per dollar. Thus, a quotation of USD/INR 68 designates the US dollar (USD) as the base currency and Indian rupee (INR) as the quoted currency and the exchange rate is INR 68.00 = USD 1.00. If you can remember that the currency quoted on the left of the slash is always the base currency and always a single unit, you can avoid confusion.

iv. Although a newspaper or magazine article will state an exchange rate as a single value, the retail or wholesale market for buying and selling currencies, uses two different rates, one for buying and one for selling. Thus, a quotation consists of two prices- bid price and ask price. This way of quoting exchange rate is known as two-way quotations. A two-way quotation gives the exchange rate at which an authorized dealer (AD) is ready to buy a currency in the currency pair, and the exchange rate at which the AD is ready to sell a currency in the currency pairs.

   A bid is the price (i.e., exchange rate) in one currency at which a dealer will buy another currency. An ask price is the price (i.e., exchange rate) at which a

dealer will sell the other currency. The price shown on the left of the oblique is the bid price and the price on the right is the ask price.

For example, GBP/EUR 1.4015/1.4025

The dealer will buy 1 GBP and pay EUR 1.4015 in return. His bid rate for GBP is EUR 1.4015. He will sell one GBP and would want to be paid EUR 1.4025 in return. His ask rate for one GBP is EUR 1.4025.

v. Quotations in inter-bank markets are usually given upto five or six significant digits and for decimal places. The last two digits have a value of 0.0001 if the currencies are quoted to four decimal places. The last two digits are called 'points' or 'pips' which represents the smallest price increment a currency can make against another currency in foreign exchange trading.

vi. The quotations are usually shortened as follows:

GBP/JPY: 1.5660/1.5670 will be given as 1.5660/70. When two dealers are conversing with each other, this may be further shortened to 60/70. The first three digits *viz*. 1.56 are known as the 'big figure' and professional dealers are supposed to know what the big figure is at all times. The quotations are always with respect to the dealers.

For example,

EUR/USD	**1.2170/1.2178**	**Or 1.2170/78**
EUR- Base currency USD - Quoted currency	You can sell 1 euro for $1.2170-Bid price You can buy 1 euro for $1.2178-Ask price	78 - Traders may quote only the last two digits on a rate.

However, according to Eiteman *et al*., the order of currencies in quotations used by traders is quite confusing. As noted by one major international banking publication: The notation EUR/USD is the system used by traders, although mathematically it would be more correct to express the exchange rate the other way around, as it shows how many USD have to be paid to obtain EUR 1. This is why the following currency quotes are also expressed as:

EUR/USD	1 .2170	→	$1.2170/•
USD/JPY	83.16	→	¥83.16/$
GBP/USD	1.5552	→	$1.5552/£

and so on.

vii. For every quote (A/B) between two currencies, there exist an inverse quote (B/A), where currency A is being bought and sold with its price expressed in terms of B. Thus, a (B/A) quote is $= \dfrac{1}{\left(\frac{A}{B}\right)_{ask}} \Big/ \dfrac{1}{\left(\frac{A}{B}\right)_{bid}}$

2.9.2 Direct and Indirect Quotations

A direct quote is the price of a foreign currency in domestic currency units. In direct quote, the home currency fluctuates and the foreign currency against which it is quoted remains constant. Thus, a direct quote is a quote where the exchange rate is expressed in terms of number of units of the home currency of that country per unit of foreign currency. For example, if we say that \$1 = Rs. 68, we are expressing one unit of dollar (a foreign currency for an Indian) in terms of some units of domestic currency. Therefore, it is a dollar direct quote for an Indian in India and it is also expressed as USD/INR 68 or INR 68 per USD. Let us take another example. A woman might see the following quote in Paris:

EUR 0.8415 = USD 1.00

In France, the home currency is the euro and the foreign currency is the dollar. This quotation in France is termed as a direct quote on the dollar or a price quote on the dollar. Verbally, she might say to herself "0.8415 euro per dollar" or "it will cost me 0.8415 euros to get one dollar". At the same time a man in New York City may see the following quote in a bank window:

USD 1.1883 = EUR 1.00

In New York, the home currency is the dollar and the foreign currency is the euro. Thus, this would be a direct quote on the euro in the New York (the home currency price of one unit of foreign currency).

An indirect quote is the price of the domestic currency in foreign currency units. In indirect quote, the foreign currency fluctuates and the home currency remains constant. Thus, an indirect quote is a quote where the exchange rate is expressed in terms of units of the foreign currency per fixed number of units of home currency. For example, if we say that ≠ 1 = \$0.0147, we are expressing a standard unit of rupee (domestic currency for an Indian) in terms of some units of foreign currency (\$). Thus, in this type of quote,

the foreign currency fluctuates and the home currency remains constant. In ISO code the above indirect quotation is expressed as INR/USD 0.0147 or USD1.4705 per INR100 where unit for rupees is 100s.

In the previous France-New York example of direct quotes, the corresponding indirect quotations for the two countries will be as follows:

In France : USD1.1883 = EUR 1.00

In New York : EUR0.8415 = USD 1.00

The two quotes are obviously equivalent, one being the reciprocal of the other:

$$\frac{1}{\text{EUR}0.8415/\text{USD}} = \text{USD } 1.883/\text{EUR}$$

As the indirect quotation is the reciprocal of the direct quote, one can obtain an indirect quote, given a direct quote and vice versa.

2.9.3 European terms and American terms

European terms have been market practice for quotations in most of the countries of the past 60 years or more where the base currency is the US dollar. It refers to the quoting of the quantity of a specific currency per one US dollar. It means that whenever a currency's value is quoted, it is quoted in terms of number of units of currency to equal one US dollar. The result is that most currencies are quoted per U.S. dollar— Japanese yen per U.S. dollar, Brazilian real per U.S. dollar, Chinese renminbi per U.S. dollar and so on.

There are two major exceptions to this rule of using European terms: the euro and the U.K pound sterling. Both are normally quoted in American terms; the U.S. dollar price of one euro and the US dollar price of one pound sterling. Additionally, Australian dollars and New Zealand dollars are normally quoted on American terms. Thus in American terms, USD becomes the quoted currency against these currencies (i.e., euro, U.K pound, etc.). American terms are used in quoting rates for most foreign currency options and futures, as well as in retail markets that deal with tourists and personal remittances. However, this is largely a result of established practices which have been perpetuated, not based on some basic laws of nature or finance. For instance, GBP 0.6210/USD, read as "0.6210 British pounds per US dollar" is a quotation in European terms (i.e., the foreign currency price of one US dollar). The USD1.6103/GBP, read as "1.6103 US dollars per British pound" is a quotation in American terms (i.e., the US dollar price of one unit of the foreign currency).

Let us take another example of currency quotations in European terms and American terms. Let us also assume that we are having two currencies-U.S. dollar (USD) and euro (EUR).

European terms	**American terms**
⇩	⇩
Foreign currency price of one dollar (USD)	US dollar price of one euro (EUR)
⇩	⇩
USD/EUR 0.7125	EUR/USD 1.4035
Or	Or
USD 1.00 = EUR 0.7125	EUR 1.00 = USD 1.4035
⇩	⇩
USD is the base or unit currency EUR is the quoted or price currency	EUR is the base or unit currency USD is the quoted or price currency

Thus, $\frac{1}{\text{EUR } 0.7125 / \text{USD}}$ = USD 1.4035/EUR

It indicates that American terms and European terms are reciprocals.

Foreign exchange traders may also use nicknames for major currencies. Some of the nicknames are as follows:

Nick names	Currency/ Currency pair
Cable	Exchange rate between U.S. dollars and U.K. pounds sterling
Loonie	Canadian dollar
Kiwi	New Zealand dollar
Aussie	Australian dollar
Swissie	Swiss francs
Sing dollar	Singapore dollar

and so on.

2.9.1 Spread

Spread is the difference between the ask price and the bid price in a two-way quotation. The rate at which the dealer buys the foreign currency is known as bid rate/ price and another rate for selling the foreign currency is referred to as ask rate/price. Since dealers expect profit in foreign exchange operations, the two prices cannot be the same. The dealer will buy the foreign currency at a lower rate and sell the foreign currency at a higher rate and will make their profit from the spread. The spread is affected by a number of factors-such as currency involved, the volume of business, the market sentiments etc. The bid-ask spread may be quite large for currencies that are traded infrequently, in small volumes or both. In percentage terms, spread can be expressed in terms of the following:

$$\text{Spread (percentage)} = \frac{\text{Ask price} - \text{Bid price}}{\text{Ask price}} \times 100$$

$$\text{Spread (percentage)} = \frac{\text{Ask price} - \text{Bid price}}{\text{Bid price}} \times 100$$

2.9.2 Cross rates

Many currencies pairs are inactively traded, so their exchange rate is determined through their relationship to a widely traded third currency. A cross rate is the exchange rate between two currencies that are each expressed in terms of a third currency. The third currency is called the vehicle currency. A cross rate can be obtained by multiplying two exchange rates so as to eliminate a third currency that is common to both rates. The most common use of cross rate calculations is to determine the exchange rate between two currencies that are quoted against the US dollar but not against each other.

Suppose there are three currencies A, B and C. Currency B is expressed in terms of A and currency C is also expressed in terms of A. Therefore, currency A is the vehicle currency. But currency B and C are not expressed in terms of each other. A cross rate is the exchange rate between currency B and C, using the exchange rates between currencies A and B, and currencies A and C. That is:

$$\frac{B}{C} = \frac{B}{A} \times \frac{A}{C}$$

Accordingly,

$$\left(\frac{B}{C}\right)_{bid} = \left(\frac{B}{A}\right)_{bid} \times \left(\frac{A}{C}\right)_{bid}, \text{ where } \left(\frac{A}{C}\right)_{bid} = \frac{1}{\left(\frac{C}{A}\right)_{ask}}$$

$$\left(\frac{B}{C}\right)_{ask} = \left(\frac{B}{A}\right)_{ask} \times \left(\frac{A}{C}\right)_{ask}, \text{ where } \left(\frac{A}{C}\right)_{ask} = \frac{1}{\left(\frac{C}{A}\right)_{bid}}$$

2.9.3 Spot exchange rate and Forward exchange rate

Spot exchange rates are applicable to the purchase and sale of foreign exchange on an immediate delivery basis. Spot rate refers to the rate of exchange of the day on which the transaction has taken place for delivery within two business days.

The forward exchange rate is the rate at which the actual exchange of currencies takes place at a specified date in the future. In general, spot rate and forward rates have two-way quotations, i.e. the quotation contains both the bid rate and the ask rate.

If a forward rate in home currency is more than the spot rate, the foreign currency is said to be at a forward premium and if it is less than the spot rate, the foreign currency is at a forward discount. If the forward rate is equal to the spot rate, the foreign currency is said to be flat.

The forward premium or discount can be expressed as an annualized percentage as follows:

Annualized percentage forward premium/discount

$$= \frac{\text{Forward rate} - \text{Spot rate}}{\text{Spot rate}} \times \frac{360}{n} \times 100$$

Where *n* refers to the number of days for which the forward contract has been made.

2.9.4 Illustrations

Problem 1

Identify whether the following is a direct quote in the USA. If not, find it.

a) ≠ 69 = 1$

b) GBP 1 = $0.748

Solution

A direct quote is one where one unit of foreign currency is expressed as some units of domestic currency. In the USA, $ is the home currency.

a) No. this is indirect quote in the USA.

Direct quote in the USA would be

$$\neq \; 1 = \$\frac{1}{69} = \$0.0144$$

b) This is a direct quote in the USA.

Problem 2

From a Japanese point of view, which of the following is direct quote? Which is the indirect quote?

a) JPY/GBP 310

b) GBP/JPY 0.00322

c) JPY/USD 230

d) USD/JPY 0.00434

Solution

A direct quote is one where one unit of foreign currency is expressed as some units of domestic currency. For Japan, JPY is the home currency.

a) Direct quote

b) Indirect quote

c) Direct quote

d) Indirect quote

Problem 3

A quotation is given as USD/CHF 1.6370/75

a) What are the two currencies involved?

b) Is the rate being stated as USD per CHF or CHF per USD?

c) At what rate will the bank give the quote to buy USD?

d) At what rate will it sell USD?

e) How much is the bid-offer spread in points?

Solution

a) The two currencies are US dollar and Swiss franc

b) The rate is being stated as CHF per USD or CHF price of 1 USD

c) The bank will buy 1 USD for 1.6370 CHF

d) The bank will sell 1 USD for 1.6375 CHF

e) The bid-offer spread is 5 points.

Problem 4

Given the bid-ask quotes for JPY/GBP 320-330, at what rate will:

a) Mr. A purchase GBP?

b) Mr. B sell GBP?

c) Mr. C purchase JPY?

d) Mr. D sell JPY?

Solution

a) Mr. A will purchase GBP at 330

b) Mr. B will sell GBP at 320

c) Here JPY/GBP 320 i.e., GBP/JPY 1/320 = 0.00312

Therefore, Mr. C will purchase JPY at 0.00312

d) Here JPY/GBP 330 i.e., GBP/JPY 1/330 = 0.00303

Therefore, Mr. D will sell JPY at 0.00303.

Problem 5

From the data given below, calculate forward premium or discount, as the case may be, of the dollar in relation to the rupee.

≠ /$	Spot	1 month forward	3 months forward
	67.8441 / 68.0144	68.1235 / 3000	67.5045 / 6456

Solution

Since 1 month forward rate is higher than the spot rate, the U.S. $is at premium. The premium amount is determined separately both for bid price and ask price.

$$\text{Premium with respect to bid price} = \frac{68.1235 - 67.8441}{67.8441} \times \frac{360}{30} \times 100$$

$$= 4.94 \text{ per cent per.annum}$$

$$\text{Premium with respect to ask price} = \frac{68.3000 - 68.0144}{68.0144} \times \frac{360}{30} \times 100$$

$$= 5.04 \text{ per cent per.annum}$$

In the case of 3 months forward, since spot rates are higher than the forward rates, the U.S. $ is at a discount.

$$\text{Discount with respect to bid price} = \frac{67.5045 - 67.8441}{67.8441} \times \frac{360}{90} \times 100$$

$$= -2.00 \text{ per cent p.a}$$

$$\text{Discount with respect to ask price} = \frac{67.6456 - 68.0144}{68.0144} \times \frac{360}{90} \times 100$$

$$= -2.17 \text{ per cent p.a}$$

Problem 6

Calculate the cross rates for:

a) Dinar/US dollar (ID/USD)

b) ≠ /shekel (INR/NIS)

c) Maltese lira/rupee (LM/INR)

from the direct exchange rates provided by an AD.

USD 1.1710/1•	≠ 17.10/AUD	≠ 44.20/USD
Dinar 7.71/1•	Shekel 6.40/AUD	Maltese Lira 57.50/USD

Solution

Step 1: Identify the vehicle currency from two currency pairs.

Step 2: Calculate the appropriate exchange rates needed for the cross rate.

Step 3: Apply the formula for the cross rate.

Exchange rate required	**Vehicle currency**	**Cross rate**
Dinar/USD(IS/USD)	Euro(•)	$\frac{\text{Dinar}}{\text{USD}} = \frac{\text{Dinar}}{\text{Euro}} \times \frac{\text{Euro}}{\text{USD}}$ $\frac{\text{Dinar}}{\text{Euro}} = \text{Dinar 7.71/euro}$ $\frac{\text{Euro}}{\text{USD}} = \frac{1}{\text{USD / Euro}} = \frac{1}{1.1710}$ = Euro 0.8539 / USD Therefore ID/USD = (7.71) x (0.8539) = Dinar 6.5836/USD
Rs/Shekel(INR/NIS)	AUD	(Rs/Shekel) = (Rupee/AUD) (AUD/Shekel) Rupee/AUD = Rs 17.10/AUD AUD/Shekel = 1 / (shekel/AUD) = 1/6.40 = 0.1563 Therefore, INR/NIS = (17.10)(0.1563) = Rs 2.6727/Shekel
Maltese Lira/Rs (LM/INR)	USD	(LM/INR) = (LM/USD) x (USD/INR) (LM/USD) = LM 57.50/USD $(\text{USD/INR}) = \frac{1}{\left(\frac{\text{INR}}{\text{USD}}\right)} = \frac{1}{44.20}$ = USD 0.0226/INR Therefore, (LM/INR) = (57.50)(0.0226) = LM 1.2995/INR

2.10 Concept of Devaluation and Revaluation of Domestic Currency

In a fixed exchange rate regime, reduction in the value of a currency relative to another currency is called devaluation of a currency. In other words, devaluation refers to

any increase in the exchange rate of the domestic currency relative to a foreign currency. The opposite phenomenon is known as revaluation or up-valuation of currency. Thus, revaluation refers to an increase in the value of the currency relative to another currency. For example, if the Government of India changes its official exchange rate from USD/INR 68 to USD/INR 70, it implies that the Indian rupee has been devalued against the US dollar. On the other hand, if the Government of India changes its official exchange rate from USD/INR 70 to USD/INR 66, it implies that the Indian rupee has been revalued or up-valued against the US dollar.

However, in the floating exchange rate regime, a fall in a currency value relative to another currency is known as depreciation of currency and any increase in a currency value relative to another currency is known as appreciation of currency.

It should be noted that the difference between devaluation and depreciation is that while devaluation is reduction of the external value of a currency as arbitrarily decided upon by the Government, depreciation stands for automatic reduction in the external value of a country's currency by market forces. However, both imply the same thing, i.e., lower value of the local currency in terms of foreign currencies. Similarly, both devaluation and depreciation produce similar effects-increase exports (by making local goods cheaper to foreigners), curtail imports (by making foreign goods expensive) and ultimately correct an adverse balance of payments and make it a favorable one.

2.11 Devaluation as a Policy for Correcting Deficit in the Balance of Payments

In this section, the method of correcting a deficit in the balance of payments has been examined by depreciation or devaluation of the nation's currency. The term, depreciation, is related to flexible exchange rate system and devaluation is related to fixed exchange rate system. Devaluation refers to the deliberate (policy) increase in the exchange rate by the nation's monetary authorities from one fixed or pegged level to another. If a country devalues its currency, its import prices rise and this leads to a fall in the demand for imports. At the same time, prices of exports of the devaluing country will decrease in the world market. So as a result of devaluation, imports will fall on the one hand and exports will rise on the other. Hence, the balance of payments of the devaluing country is likely to improve. Since both depreciation and devaluation operate on prices to bring about adjustment in the nation's balance of payments, they are both referred to as the

price adjustment mechanism. This is to be distinguished from the *income adjustment mechanism*, which relies on income changes in the nation and abroad.

However, there is no guarantee that devaluation will always lead to an improvement in the balance of payments. There are two approaches to consider the effectiveness of devaluation as a policy for correcting deficit in the balance of payments. The first approach is known as the elasticity approach, developed by Marshall and Lerner and the second approach is known as the absorption approach, developed by Sidney Alexander. These two approaches are discussed below:

[The following discussion has been adopted from International Economics, written by Salvatore, D. For a better understanding of the present section you are advised to go through the above reference]

2.11.1 Elasticity Approach

When a country suffers from deficit in the balance of payments, it wants to correct that deficit by raising the rate of exchange i.e., by devaluing its home currency. The condition under which devaluation will be successful has been discussed by Marshall and Lerner. The condition states that devaluation will be successful if the sum of absolute values of elasticities of demand for exports and imports is greater than unity. This condition is called the Marshall – Lerner condition. It is also known as elasticity approach as it is based on elasticities of demand for exports and imports.

We now derive mathematically the Marshall–Lerner condition that the sum of the elasticities of the demand for imports and the demand for exports must exceed 1 for the foreign exchange market to be stable. This is valid when the supply curves of imports and exports (i.e., S_M and S_X) are both infinitely elastic, or horizontal and initially there is equilibrium in the balance of payments.

To derive the Marshall–Lerner condition mathematically, let:

X = quantity of exports

M = quantity of imports

P_X and P_M = prices of exports and imports in foreign currency

q_X and q_M = prices of exports and imports in terms of domestic currency

r = rate of exchange defined as units of domestic currency per unit of foreign currency i.e., 1 unit of foreign currency = r units of domestic currency

Price elasticity of the demand for exports $(\eta_X) = \frac{dx(P_X)}{x(P_X)} \div \frac{d\,P_X}{P_X} = \frac{P_X}{x(P_X)} \frac{dX(P_X)}{d\,P_X} < 0$.

Therefore, $|\eta_X| = \frac{P_X}{x(P_X)} \frac{dX(P_X)}{d\,P_X}$.

Price elasticity of the demand for imports $(\eta_X) = \frac{dM(q_M)}{M(q_M)} \div \frac{d(q_M)}{q_M}$

$= \frac{q_M}{M(q_M)} \frac{dM(q_M)}{d(q_M)}$.

Therefore, $|\eta_X| = -\frac{q_M}{M(q_M)} \frac{dM(q_M)}{d(q_M)}$

By definition $P_X \cdot r = q_X$ and $P_M \cdot r = q_M$

B = Balance of trade in foreign currency

It is assumed that demand for exports depends on foreign price of exports

$$X = X\,(P_X) = X\left(\frac{q_X}{r}\right)$$

and demand for imports is a function of domestic price of imports

$M = M\,(q_M) = M\,(P_M \cdot r)$

Now $B = X \cdot P_X - M \cdot P_M$

$$= X\left(\frac{q_X}{r}\right)\left(\frac{q_X}{r}\right) - M\,(P_M \cdot r) \cdot P_M$$

Since supply of exports is infinitely elastic, q_x is constant. Similarly since the supply of imports is infinitely elastic P_M is also constant. Then B is a function of r only. When devaluation takes place, r increases. Now devaluation will be successful if $\frac{dB}{dr} > 0$. Differentiating B with respect to r we get

$$\frac{dB}{dr} = \frac{dX\left(\frac{q_X}{r}\right)}{d\left(\frac{q_X}{r}\right)} \cdot \frac{d\left(\frac{q_X}{r}\right)}{dr} \cdot \left(\frac{q_X}{r}\right) + X\left(\frac{q_X}{r}\right) \cdot \frac{d\left(\frac{q_X}{r}\right)}{dr} - \frac{dM(p_M.r)}{d(p_M.r)} \cdot \frac{d(p_M.r)}{dr} . P_M$$

$$=\frac{dX\left(\frac{q_X}{r}\right)}{d\left(\frac{q_X}{r}\right)}.\left(-\frac{q_X}{r^2}\right).\left(\frac{q_X}{r}\right)+X\left(\frac{q_X}{r}\right).\left(-\frac{q_X}{r^2}\right)-\frac{dM(p_M.r)}{d(p_M.r)}.P_M^2$$

$$=-\frac{dX(P_x)}{d\,P_x}.\frac{P_x^2}{r}.-X(P_x)\left(\frac{P_x}{r}\right)-\frac{dM(q_M)}{d(q_M)}.\frac{q_M^2}{r^2}$$

$$=\left\{-\frac{dX(P_x)}{d\,P_x}\frac{P_x}{X(P_x)}\right\}\frac{X(P_x)P_x}{r}-\frac{X(P_x)P_x}{r}-\left\{\frac{q_M}{M(q_M)}\frac{dM(q_M)}{d(q_M)}\right\}\frac{q_M M(q_M)}{r^2}$$

$$=|\eta_x|\frac{X(P_x)P_x}{r}-\frac{X(P_x)P_x}{r}+|\eta_m|\frac{q_M M(q_M)}{r^2}$$

$$=|\eta_x|\frac{V_x}{r}-\frac{V_x}{r}+|\eta_m|.\frac{V_M}{r}$$

$$=\frac{V_x}{r}\{|\eta_x|-1+|\eta_m|\}>0$$ [Since $V_X = V_M$ as B = 0 in initial position]

Or, $|\eta_x|+|\eta_m|-1>0$

Or, $|\eta_x|+|\eta_m|>1$

This is the Marshall – Lerner condition for successful devaluation. The condition states that for successful devaluation, the sum of absolute values of demand elasticities for exports and imports should be greater than unity.

2.11.2 Absorption approach

A nation can correct a deficit in its balance of payments by devaluation. Because the improvement in the nation's trade balance depends on the price elasticity of demand for its exports and imports, this method of correcting a deficit is referred to as the elasticity approach. The improvement in the deficit nation's trade balance arises because devaluation stimulates the nation's exports and discourages its imports.

However, the elasticity approach has been criticized on several grounds. *Firstly*, when

devaluation takes place, it is difficult to measure real-world values of elasticities of demand for exports and imports. Different studies confirm that the sum of the elasticities of the demand for imports and the demand for exports is either below or very close to 1 in absolute value and the pre-war elasticity optimism was replaced by post-war elasticity pessimism.

Secondly, the regression technique used to estimate elasticities leads to gross underestimation of the true elasticities in international trade which results from the identification problem in estimation (Orcutt, 1950).

Thirdly, when the nation's net balance of trade is plotted on the vertical axis and time is plotted on the horizontal axis, the response of the balance of trade to a devaluation looks like the curve of a *J* and the figure assumes that the original trade balance was zero. This tendency of a nation's balance of trade to deteriorate first before improving as a result of devaluation in the nation's currency is called the J-curve effect. Several studies [e.g., Harberger (1957), Houthakker and Magee (1969), Stern, Francis, and Schumacher (1976), Spitaeller (1980), Artus and Knight (1984) (summarized and reviewed by Goldstein and Khan, 1985), Marquez (1990), and Hooper, Johnson, and Marquez (1998) etc.] have also confirmed the existence of a J-curve effect.

Fourthly, there are not only lags in the response of a nation's trade and current account balances to a devaluation of its currency, but also the increase in the domestic price of the imported commodity may be smaller than the amount of the devaluation. Thus, the pass-through from devaluation to domestic prices may be less than complete i.e., less than one. The exchange-rate pass-through is the elasticity of local-currency import prices with respect to the local-currency price of foreign currency, often measured as the percentage change, in the local currency, of import prices resulting from a one percent change in the exchange rate between the exporting and importing countries. For example, a 20 percent depreciation in the nation's currency may result in a less than 20 percent increase in the domestic-currency price of the imported commodity in the nation. The reason is that foreign firms may be reluctant to increase in the price of its exports and are usually willing to absorb at least some of the price increase that they could charge out of their profits. Specifically, a foreign firm may only increase the price of its export commodity by 8 percent and accept a 12 percent reduction in its profits when the other nation's currency depreciates by 20 percent for fear of losing market share. That is, the pass-through is less than 1.

Sidney Alexander in 1952 developed an alternative approach in this respect which is called Absorption Approach. Alexander explained the Absorption Approach with the help of an identity that production or income *(Y)* is equal to consumption *(C)* plus domestic investment *(I)* plus foreign investment or the balance of trade *(X “M)*, all in real terms where X is the export and M is the import. That is,

$$Y = C + I + (X - M)$$

Suppose A is equal to domestic absorption (C + I) and B is equal to balance of trade (X – M), we have

$$Y = A + B$$

By subtracting A from both sides, we get

$$Y - A = B$$

That is, domestic production or income minus domestic absorption equals the balance of trade. To improve the balance of trade *(B)* as a result of devaluation, *Y* must rise and/ or *A* must fall. If the nation is at full employment, production or real income *(Y)* will not rise, and the devaluation can be effective only if domestic absorption *(A)* falls, either automatically or as a result of contractionary fiscal and monetary policies.

A devaluation of the deficit nation's currency automatically reduces domestic absorption if it redistributes income from wages to profits (since profits earners usually have a higher marginal propensity to save than wage earners). In addition, the increase in domestic prices resulting from the devaluation reduces the value of the real cash balances that the public wants to hold. To restore the value of real cash balances, the public must reduce consumption expenditures. Finally, rising domestic prices push people into higher tax brackets and also reduce consumption. Since we cannot be certain as to the speed and size of these automatic effects, contractionary fiscal and monetary policies may have to be used to cut domestic absorption adequately.

Thus, while the elasticity approach stresses the demand side and implicitly assumes that slack exists in the economy that will allow it to satisfy the additional demand for exports and import substitutes, the absorption approach stresses the supply side and implicitly assumes an adequate demand for the nation's exports and import substitutes. It is clear, however, that both the elasticity approach and the absorption approach are important and both must be considered simultaneously.

2.12 Different Exchange Rate Regimes and Their Mechanisms

"An exchange-rate regime is the way an authority manages its currency in relation to other currencies and the foreign exchange market"(Wikipedia). One must have an idea in foreign exchange rate regimes to understand foreign exchange rate behaviour better, since the choice of foreign exchange rate regimes can influence how the exchange rate between two currencies moves and fluctuates on foreign exchange markets. The exchange rate can be totally flexible or completely free to float on the foreign exchange market on the one hand, and fixed or pegged to one of the major currencies or a basket of currencies on the other hand. Between these two extremes, there can be a few types of exchange rate arrangements and combinations. The different prevailing exchange rate regimes are explained below:

[The following discussion has been adopted solely from International Economics, written by Salvatore, D. For a better understanding of the present section you are advised to go through the above reference, Pp. 656-673]

2.12.1 Optimum Currency Areas

An optimum currency area represents a group of nations whose national currencies are linked through permanently fixed exchange rates and the conditions that would make such an area optimum. The currencies of member nations could then float jointly with respect to the currencies of non-member nations. The formation of an optimum currency area also encourages producers to view the entire area as a single market and to benefit from greater economies of scale in production.

With permanently fixed exchange rates, an optimum currency area is likely to experience greater price stability than if exchange rates could change between the various member nations. This greater price stability encourages the use of money as a store of value and as a medium of exchange, and discourages inefficient barter deals arising under more inflationary circumstances. An optimum currency area also saves the cost of official interventions in foreign exchange markets involving the currencies of member nations, the cost of hedging, and the cost of exchanging one currency for another to pay for imports of goods and services and when citizens travel between member nations (if the optimum currency area also adopts a common currency).

The greatest disadvantage of an optimum currency area is that each member nation cannot pursue its own independent stabilization and growth policies in tune to its particular

preferences and circumstances. For example, a depressed region or nation within an optimum currency area might require expansionary fiscal and monetary policies to reduce an excessive unemployment rate, while the more prosperous region or nation might require contractionary policies to curb inflationary pressures.

The formation of an optimum currency area is more likely to be beneficial on balance under the following conditions: (1) the greater the mobility of resources among the various member nations, (2) the greater their structural similarities, and (3) the more willing they are closely to coordinate their fiscal, monetary, and other policies. An optimum currency area should aim at maximizing the benefits from permanently fixed exchange rates and minimizing the costs. It is not easy, however, to actually measure the net benefits accruing to each member nation or region from joining an optimum currency area. The case for the formation of an optimum currency area is to some extent also a case for fixed as opposed to flexible exchange rates.

In the context of an optimum currency area, in March 1979, the European Union or EU (then called the European Economic Community or EEC) announced the formation of the European Monetary System (EMS) as part of its aim toward greater monetary integration among its members, including the ultimate goal of creating a common currency and a Community-wide central bank. The main features of the EMS were (1) the European Currency Unit (ECU), defined as the weighted average of the currencies of the member nations, was created. (2) The currency of each EU member was allowed to fluctuate by a maximum of 2.25 percent on either side of its central rate or parity. The EMS was thus created as a fixed but adjustable exchange rate system and with the currencies of member countries floating jointly against the dollar. Starting in September 1992, however, the system came under attack, and in August 1993 the range of allowed fluctuation was increased from 2.25 percent to 15 percent. (3) The European Monetary Cooperation Fund (EMCF) was established to provide short and medium-term balance-of-payments assistance to its members.

In June 1989, a committee headed by Jacques Delors, the president of the European Commission, recommended a three-stage transition to the goal of monetary union. The ***first stage***, which started in July 1990, called for convergence of economic performance and cooperation in monetary and fiscal policy, as well as the removal of all restrictions to intra-Community capital movements. The ***second stage***, approved at a meeting in the Dutch city of Maastricht in December 1991, called for the creation of a European Monetary Institute (EMI) as the forerunner of a European Central Bank (ECB) to further centralize members' macroeconomic policies and reduce exchange rate margins by January

1994. The ***third stage*** was to involve the completion of the monetary union by either 1997 or 1999 with the establishment of a single currency and a European Central Bank that would engage in foreign exchange market interventions and open market operations.

At the beginning of 1999, the European Monetary System became the European Monetary Union (EMU) with the introduction of the euro and a common monetary policy by the European Central Bank. On January 1, 1999, the euro came into existence as the common currency of 11 countries of the euro area or Euroland (Austria, Belgium, Germany, Finland, France, Ireland, Italy, Luxembourg, Spain, Portugal, and the Netherlands). The creation of the euro is one of the most important events in postwar monetary history: Never before had a large group of sovereign nations voluntarily given up their own currency for a common currency. The European Commission, however, ruled that all countries (except Greece) had made sufficient progress for all to participate in the single currency. The United Kingdom, Denmark, and Sweden chose not to participate because of their unwillingness to lose complete control over their money supply and monetary policy, but they reserved the right to join later. Greece was admitted on January 1, 2001, Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009, and Estonia in 2011—thus increasing the number of members of the Eurozone countries to 17. As of the beginning of 2012, the 17 members of the Eurozone were Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. (see Figure 1).

From January 1, 1999, euros were traded in financial markets, new issues of securities were denominated in euros, and official statistics in the euro area were quoted in euros, but euro bank notes and coins were not introduced until the beginning of 2002. That is, until that date, the euro was only a unit of account and not an actual physical circulating currency. From January 1 until July 1, 2002, euros and national currencies circulated together for nations that so chose, but by July 1, 2002, all national currencies were phased out (taken out of circulation), and euro paper currency and coins became the sole legal tender in the participating members of the euro area.

2.12.2 Currency Board Arrangements

Currency board arrangements (CBAs) are the most severe form of exchange rate peg (fixed exchange rate system), short of adopting a common currency or dollarizing (i.e., adopting the dollar as the nation's currency). Under CBAs, the nation rigidly fixes (often by law) the exchange rate of its currency to a foreign currency and its central bank

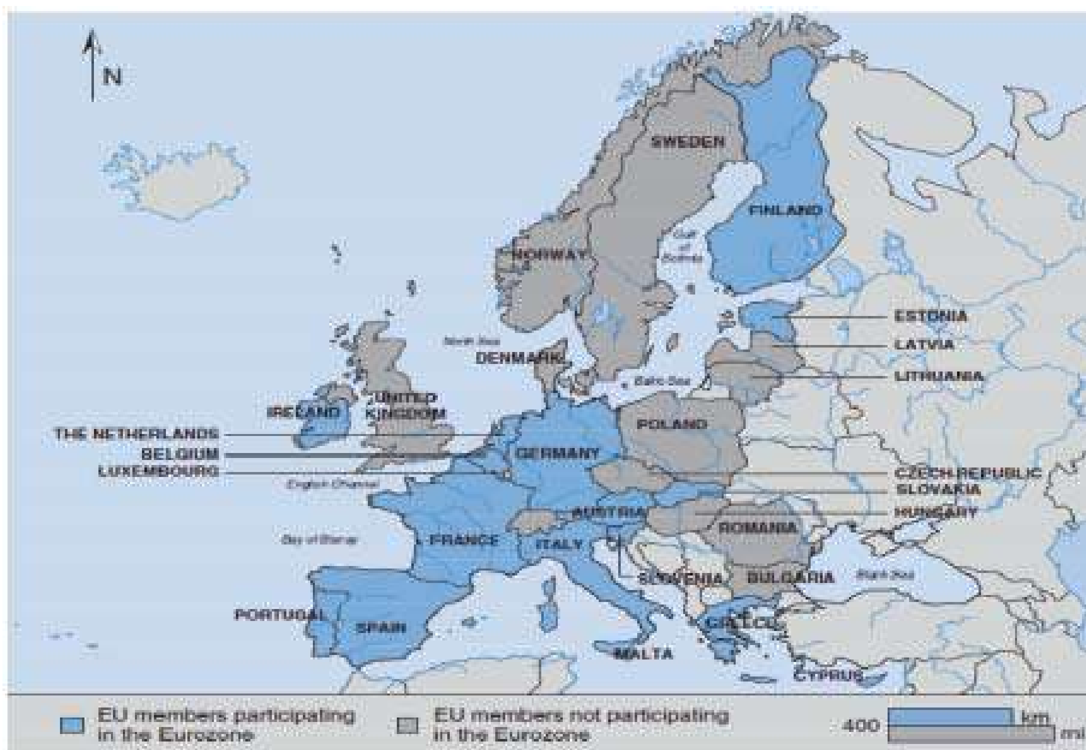


FIGURE 1: The Eurozone Countries as of the Beginning of 2012 (Adopted from Salvatore)

ceases to operate as such. CBAs are similar to the gold standard in that they require 100 percent international-reserve backing of the nation's money supply.

A nation usually makes this extreme arrangement when it is in deep financial crisis and as a way to effectively combat inflation. CBAs have been in operation in several countries or economies, such as Hong Kong (since 1983), Argentina (from 1991 to the end of 2001), Estonia (from 1992 to the end of 2010), Lithuania (since 1994), Bulgaria (since 1997), and Bosnia and Herzogovina (since 1997).

The main advantage of CBAs is the credibility of the economic policy regime which results in lower interest rates and lower inflation in the nation. The cost of CBAs is the inability of the nation's central bank to (1) conduct its own monetary policy, (2) act as a lender of last resort, etc.

2.12.3 Dollarization

Under dollarization, a foreign currency acts as legal tender. Besides the Commonwealth of Puerto Rico and the U.S. Virgin Islands, Panama has had full or official dollarization

since 1904. Ecuador fully dollarized in 2000 and El Salvador in 2001. Since 2001, Nicaragua has nearly fully dollarized and Costa Rica has considered it.

The benefits of dollarization arise from the nation (1) avoiding the cost of exchanging the domestic currency for dollars and the need to hedge foreign exchange risks; (2) facing a rate of inflation as a result of commodity arbitrage, and interest rates; (3) avoiding foreign exchange crises and the need for foreign exchange and trade controls, fostering budgetary discipline; and (4) encouraging more rapid and full international financial integration.

Dollarization also imposes some costs on the dollarizing country: (1) the cost of replacing the domestic currency with the dollar; (2) the loss of independence of monetary and exchange rate policies; and (3) the loss of its central bank as a lender of last resort to bail out domestic banks and other financial institutions facing a crisis.

2.12.4 Hybrid Exchange Rate Systems

Hybrid exchange rate systems combine some of the characteristics of fixed and flexible exchange rates in various degrees. These involve different exchange rate bands of fluctuation about a par value, adjustable peg systems, crawling pegs, and managed floating. These are explained below:

Exchange rate bands

Most fixed exchange rate systems usually allow the exchange rate to fluctuate within narrowly defined limits. That is, nations decide on the exchange rate, or par value, of their currencies and then allow a narrow band of fluctuation above and below the par value. For example, under the Bretton Woods system, which operated during the postwar period until 1971, the exchange rate was allowed to fluctuate within 1 percent above and below the established par value, or fixed exchange rate.

The actual exchange rate under a fixed exchange rate system is then determined by the forces of demand and supply within the band of fluctuation. The advantage of the small band of fluctuation under a fixed exchange rate system is that monetary authorities will not have to intervene constantly in foreign exchange markets to maintain the established par value, but only to prevent the exchange rate from moving outside the allowed limits of fluctuation.

Adjustable peg systems

An adjustable peg system requires defining the par value and the allowed band of fluctuation, with the stipulation that the par value will be changed periodically and the currency devalued to correct a balance-of-payments deficit or revalued to correct a surplus. The Bretton Woods system was originally set up as an adjustable peg system, with nations allowed to change the par value of their currencies when faced with a "fundamental"disequilibrium.

A truly adjustable peg system would be one under which nations with balance of-payments disequilibrium would in fact take advantage (or be required to take advantage) of the flexibility provided by the system and change their par values without waiting for the pressure for such a change to become unbearable.

For an adjustable peg system to operate as intended, however, some objective rule would have to be agreed upon and enforced to determine when the nation must change its par value. Any such rule would to some extent be arbitrary and would also be known to speculators, who could then predict a change in the par value and profitably engage in destabilizing speculation.

Crawling pegs

Under crawling peg system or system of "sliding or gliding parities", par values are changed by small preannounced amounts or percentages at frequent and clearly specified intervals, say every month, until the equilibrium exchange rate is reached.

The nation could prevent destabilizing speculation by manipulating its short-term interest rate so as to neutralize any profit that would result from the scheduled change in the exchange rate. For example, an announced 2 percent devaluation of the currency would be accompanied by a 2 percent increase in the nation's short-term interest rate. However, this would interfere with the conduct of monetary policy in the nation. Nevertheless, a crawling peg system can eliminate the political stigma attached to a large devaluation and prevent destabilizing speculation. The crawling peg system can achieve even greater flexibility if it is combined with wide bands of fluctuation. Nations wanting to use a crawling peg must decide the frequency and amount of the changes in their par values and the width of the allowed band of fluctuation. A crawling peg seems best suited for a developing country that faces real shocks and differential inflation rates.

Managed floating

Under a managed floating exchange rate system, the nation's monetary authorities are entrusted with the responsibility of intervening in foreign exchange markets to smooth out short-run fluctuations in exchange rates without attempting to affect the long-run trend in exchange rates. To the extent that they are successful, the nation receives most of the benefits that result from fixed exchange rates while at the same time retaining flexibility in adjusting balance-of-payments disequilibria.

Under a managed float there is still a need for international reserves, whereas under a freely floating exchange rate system, balance-of-payments disequilibria are immediately and automatically corrected by exchange rate changes (with stable foreign exchange markets) without any official intervention and need for reserves. However, the freely floating exchange rate system will experience exchange rate fluctuations that the managed float attempts to moderate.

What proportion of the short-run fluctuation in exchange rates monetary authorities succeed in moderating under a managed floating system depends on what proportion of the short-run excess demand for or supply of foreign exchange they absorb. This, in turn, depends on their willingness to intervene in foreign exchange markets for stabilization purposes and on the size of the nation's international reserves. The larger the nation's stock of international reserves, the greater is the exchange rate stabilization that it can achieve.

The present system thus exhibits a large degree of flexibility and more or less allows each nation to choose the exchange rate regime that best suits its preferences and circumstances. In general, large industrial nations and nations suffering from greater inflationary pressures than the rest of the world have opted for greater exchange rate flexibility than smaller developing nations or highly specialized open economies. Under the 1976 Jamaica Accords (which more or less formally recognized the de facto managed floating system in operation since 1973), a nation may change its exchange rate regime as conditions change, as long as this does not prove disruptive to trade partners and the world economy. In recent years a near consensus seems to be emerging that nations should only consider and choose between rigidly fixed exchange rates or fairly flexible ones. Intermediate systems are considered less attractive because they are more likely to lead to destabilizing speculation and thus become more easily unsustainable.

2.13 Summary

- Foreign exchange market or the forex market or FX market is an institutional arrangement for buying and selling of foreign currencies. Exporters sell the foreign currencies and importers buy them.
- The features of foreign exchange market are: (i) Foreign exchange market is considered as an over the counter (OTC) market as there is no physical place the participants meet to execute the deals of foreign exchange transactions. (ii) Foreign exchange market is the largest financial market with a daily turnover of over USD 3 Trillion. (iii) The global foreign exchange market is a twenty-four-hour, non-stop market. (iv) Some centers are characterized by very heavy trading during certain times when their business hours overlap with those of many other trading centers. (v) The US dollar is sometimes called a vehicle currency because of its pivotal role in so many foreign exchange deals. (vi) Forex markets make extensive use of the latest developments in telecommunications for transmitting as well as setting foreign exchange transactions.
- The participants in the foreign exchange market comprise of individuals, corporates, commercial banks, investors, dealers and brokers and central bank.
- The foreign exchange market is divided into wholesale market and retail market. The wholesale market is also known as the interbank market. The participants in this market consist of commercial banks, investment banks, central banks, corporations and high-net-worth individuals. The retail market segment consists of trades between commercial banks and their corporate and non-corporate clients. Such trades are called merchant trades.
- The foreign exchange market serves the following important functions:

  (i)To effect transfer of purchasing power between countries which is known as transfer function; (ii) To provide credit for foreign trade which is called credit function; and (iii) To minimize exposure to the risks of exchange rate charges that is known as hedging function.
- An exchange rate is the rate at which one currency can be exchanged for another. It is the price of one currency expressed in terms of another currency.
- A foreign exchange quotation (or quote) is a statement of willingness to buy or sell at an announced rate for the two currencies. Quotations may be designated

by traditional currency symbols or by ISO (International Standards Organization) codes. Actually ISO developed three-letter codes for all the currencies which abbreviate the name of the country as well as the currency.

- A bid is the price (i.e., exchange rate) in one currency at which a dealer will buy another currency. An ask price is the price (i.e., exchange rate) at which a dealer will sell the other currency.
- A direct quote is the price of a foreign currency in domestic currency units. In direct quote, the home currency fluctuates and the foreign currency against which it is quoted remains constant.
- An indirect quote is the price of the domestic currency in foreign currency units. In indirect quote, the foreign currency fluctuates and the home currency remains constant. Thus, an indirect quote is a quote where the exchange rate is expressed in terms of units of the foreign currency per fixed number of units of home currency.
- European term refers to the quoting of the quantity of a specific currency per one US dollar. It means that whenever a currency's value is quoted, it is quoted in terms of number of units of currency to equal one US dollar. In American terms, USD becomes the quoted currency against these currencies (i.e., euro, U.K pound, etc.). American terms are used in quoting rates for most foreign currency options and futures, as well as in retail markets that deal with tourists and personal remittances.
- Spread is the difference between the ask price and the bid price in a two-way quotation. The rate at which the dealer buys the foreign currency is known as bid rate/price and another rate for selling the foreign currency is referred to as ask rate/price.
- A cross rate is the exchange rate between two currencies that are each expressed in terms of a third currency. The third currency is called the vehicle currency. A cross rate can be obtained by multiplying two exchange rates by each other so as to eliminate a third currency that is common to both rates.
- Spot rate refers to the rate of exchange of the day on which the transaction has taken place for delivery within two business days. The forward exchange rate is the rate at which the actual exchange of currencies takes place at a specified date in the future.

- Devaluation refers to any increase in the exchange rate of the domestic currency relative to a foreign currency. The opposite phenomenon is known as revaluation or up-valuation of currency.
- There is no guarantee that devaluation will always lead to an improvement in the balance of payments. There are two approaches to consider the effectiveness of devaluation as a policy for correcting deficit in the balance of payments. The first approach is known as the elasticity approach, developed by Marshall and Lerner and the second approach is known as the absorption approach, developed by Sidney Alexander.
- The Marshall and Lerner condition states that devaluation will be successful if the sum of absolute values of elasticities of demand for exports and imports is greater than unity.
- Alexander explained the Absorrption Approach with the help of an identity that production or income *(Y)* is equal to consumption *(C)* plus domestic investment *(I)* plus foreign investment or the balance of trade *(X “M)*, all in real terms wheere X is the export and M is the import. That is, Y = C + I + (X “ M). Suppose A is equal to domestic absorption (C + I) and B is equal to balance of trade (X “M),we have Y = A + B. By subtracting A from both sides, we get Y “ A = B. That is, domestic production or income minus domestic absorption equals the balance of trade. To improve the balance of trade *(B)* as a result of devaluation, *Y* must rise and/or *A* must fall. If the nation is at full employment, production or real income *(Y)* will not rise, and the devaluation can be effective only if domestic absorption *(A)* falls, either automatically or as a result of contractionary fiscal and monetary policies.
- “An exchange-rate regime is the way an authority manages its currency in relation to other currencies and the foreign exchange market”.
- An optimum currency area represents a group of nations whose national currencies are linked through permanently fixed exchange rates and the conditions that would make such an area optimum. The currencies of member nations could then float jointly with respect to the currencies of non-member nations. The formation of an optimum currency area also encourages producers to view the entire area as a single market and to benefit from greater economies of scale in production.

- Currency board arrangements (CBAs) are the most severe form of exchange rate peg (fixed exchange rate system), short of adopting a common currency or dollarizing (i.e., adopting the dollar as the nation's currency). Under CBAs, the nation rigidly fixes (often by law) the exchange rate of its currency to a foreign currency and its central bank ceases to operate as such. CBAs are similar to the gold standard in that they require 100 percent international-reserve backing of the nation's money supply.
- Under dollarization, a foreign currency acts as legal tender. Besides the Commonwealth of Puerto Rico and the U.S. Virgin Islands, Panama has had full or official dollarization since 1904. Ecuador fully dollarized in 2000 and El Salvador in 2001. Since 2001, Nicaragua has nearly fully dollarized and Costa Rica has considered it.
- Hybrid exchange rate systems combine some of the characteristics of fixed and flexible exchange rates in various degrees. These involve different exchange rate bands of fluctuation about a par value, adjustable peg systems, crawling pegs, and managed floating.
- Most fixed exchange rate systems usually allow the exchange rate to fluctuate within narrowly defined limits. That is, nations decide on the exchange rate, or par value, of their currencies and then allow a narrow band of fluctuation above and below the par value.
- An adjustable peg system requires defining the par value and the allowed band of fluctuation, with the stipulation that the par value will be changed periodically and the currency devalued to correct a balance-of-payments deficit or revalued to correct a surplus.
- Under crawling peg system or system of "sliding or gliding parities", par values are changed by small preannounced amounts or percentages at frequent and clearly specified intervals, say every month, until the equilibrium exchange rate is reached.
- Under a managed floating exchange rate system, the nation's monetary authorities are entrusted with the responsibility of intervening in foreign exchange markets to smooth out short-run fluctuations in exchange rates without attempting to affect the long-run trend in exchange rates.

2.14 Self Assessment Questions

A. Objective type questions:

Choose the correct answer from the given four alternatives.

1. The forex market
   a) is not located in a physical space and does not have a central exchange.
   b) is located in a physical space and does not have a central exchange.
   c) is not located in a physical space and has a central exchange
   d) is located in a physical space and has a central exchange.
2. Foreign exchange market is considered as an
   a) Exchange traded market
   b) OTC market
   c) Spot market
   d) Futures market
3. The global foreign exchange market is a
   a) mid-night market
   b) option market
   c) twenty – four hour, non-stop market
   d) perfect market
4. Foreign exchange market serves the
   a) transfer function
   b) credit function
   c) hedging function
   d) all of the above functions
5. A bid is the price in one currency at which a dealer will
   a) buy another currency
   b) sell another currency

c) hold another currency

d) do nothing

6. An ask is the price in one currency at which a dealer will

a) buy another currency

b) sell another currency

c) hold another currency

d) do nothing

7. A direct quote is

a) the price of a domestic currency in foreign currency units

b) not the price of a domestic currency in foreign currency units

c) the price of a foreign currency in domestic currency units

d) similar to indirect quote

8. European term refers to the quoting of the quantity of a specific currency per one

a) Indian rupee

b) Russian ruble

c) Japanese yen

d) U. S. dollar

9. Spread is the difference between

a) the ask price and the bid price in a two-way quotation

b) spot price and futures price

c) futures price and option price

d) high price and low price

10. Hybrid exchange rate systems combine some of the characteristics of

a) fixed exchange rates

b) fixed and flexible exchange rates in various degrees.

c) flexible exchange rates

d) peg system

Answer: 1 a); 2 b); 3 c); 4 d); 5 a); 6 b); 7 c); 8 d); 9 a); 10 b);

B. Short answer type questions:

1. What do you mean by foreign exchange market?
2. What is vehicle currency?
3. Who participates in the foreign exchange market?
4. What do you mean by authorized dealer?
5. What do you mean by hedgers?
6. What is meant by arbitrageurs?
7. What is exchange rate?
8. What is foreign exchange quotation?
9. What is bid price?
10. What do you mean by ask price?
11. What is direct quote?
12. What is indirect quote?
13. Distinguish between European terms and American terms.
14. What is spread?
15. What do you mean by cross rate?
16. Distinguish between spot exchange rate and forward exchange rate.
17. What is devaluation?
18. What is revaluation?
19. What is Marshall-Lerner condition for successful devaluation?
20. What do you mean by managed floating exchange rate system?
21. What is crawling peg system?
22. What do you mean by dollarization?

23. What is optimum currency area?
24. What is Currency board arrangements?

C. Long answer type questions:

1. What is foreign exchange market? Discuss its salient features.
2. Discuss the different participants in the foreign exchange market.
3. Narrate the structure of foreign exchange market.
4. Explain the market segments of foreign exchange market.
5. Explain the functions of foreign exchange market.
6. How does international business use foreign exchange market?
7. Briefly discuss the principles of exchange rate quotes.
8. Explain direct and indirect quotations with examples.
9. Narrate European terms and American terms with illustrations.
10. Write a short note on cross rate.
11. Deduce the Marshall – Lerner condition for successful devaluation.
12. Discuss the absorption approach to the problem of correcting deficits in the balance of payments by means of devaluation.
13. Explain different exchange rate regimes and their mechanisms.
14. Write short notes on optimum currency area, currency board arrangements and dollarization.
15. Discuss different types of hybrid exchange rate system.

Unit 3 ❑ BALANCE OF PAYMENTS

Structure

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3.12 Summary

3.13 Self Assessment Questions

3.1 Objectives

After studying this unit, you will be able to:

- know the meaning and reasons for studying balance of payments
- understanding debit-credit rules for recording transactions in the BOP
- get an idea of different components of the balance of payments
- prepare the balance of payments statements
- know the balance of payments identity
- understand the different factors affecting equilibrium and disequilibrium of balance of payments

3.2 Introduction

In the era of globalization, the economies of the world are interdependent and companies operate within a global market place. Accordingly, international business transactions take place in many different forms over the course of a year. The statement of all international economic transactions between the residents of the reporting country and foreign residents are called the balance of payments (BOP). Politicians and the business houses realize the importance of this trade and capital flows. They pay attention to the balance of payments account in which these flows are recorded. This unit provides a type of navigational map to the understanding of balance of payments and identifies the basic factors underlying the flows of the goods, services and capital between countries. Besides, this unit also considers the identity, equilibrium and disequilibrium in the balance of payments.

3.3 Definition of The Balance of Payments

According to the Balance of Payments Manual of the International Monetary Fund (IMF), the balance of payments (BOP) is a statistical statement that systematically summarizes, for a specific time period, the economic transactions of an economy with the rest of the world. Transactions between the residents of a country and rest of the world consist of: (i) those involving goods, services and income; (ii) those involving financial claims on the rest of the world and liabilities to the rest of the world and (iii) those (such as gifts) classified as transfers.

Thus, the balance of payments is a statistical record of a country's international transactions with the rest of the world during a given period. A county's balance of payments keep records of both its payments to and its receipts from foreigners. Any transaction resulting in a receipt from foreigners is entered in the balance of payments accounts as a credit. Any transaction resulting in a payment to foreigners is entered as a debit. Three types of international transactions are recorded in the balance of payments: (i) Transactions that arise from the export or imports of goods as services (ii) Transactions that arise from the purchases or sale of financial assets and (iii) certain other activities that result in transfers of wealth between countries.

3.4 Reasons for Studying Balance of Payments

Business managers, investors, consumers and government officials require balance of payments data because the data influences and is influenced by other key macroeconomic variables such as gross domestic product, employment levels, price levels, exchange rates, and interests rates. To determine monetary and fiscal policy of any country BOP data are required. Besides, balance of payments is worth studying for a few reasons:

Firstly, balance of payments provides detail information concerning the demand and supply of country's currency. For example, if India imports more than its exports, then this means that the supply of rupee is likely to exceed the demand in the foreign exchange market, *ceteris paribus*. One can thus infer that the Indian rupee would be under pressure to depreciate against other currencies. On the other hand, if India exports more than it imports, then the rupee would be likely to appreciate. Thus, the BOP is an important indicator on a country's foreign exchange rate. Changes in the BOP may predict the imposition or removal of foreign exchange controls.

Secondly, a country's balance of payments data may signal as a potential business partner for the rest of the world. If a country is facing a major balance of payments difficulty, it may not be able to expand imports from the outside world. Instead, the country may be tempted to impose measures to restrict imports and discourage capital outflows in order to improve the balance of payments situation. On the other hand, a country experiencing a significant balance of payments surplus would be more likely to expand imports, offering marketing opportunities for foreign enterprises, and less likely to impose foreign exchange restrictions.

Thirdly, balance of payments data can be used to evaluate the performance of the country in international economic competition. Suppose a country is experiencing trade deficits year after year. This trade data may then signal that the country's domestics industries lack international competitiveness.

Fourthly, changes in a country's BOP may signal the imposition or removal of control over payments of dividends and interests, license fees, royalty fees, and other cash disbursements to foreign firms or investors.

3.5 Fundamentals of Balance of Payments Accounting

There are three main elements of the actual process of measuring international economic activity: (i) identifying what is and is not an international economic transaction; (ii) understanding how the flows of goods, services, assets and money debits and credits to overall BOP; and (iii) understanding the bookkeeping procedures for BOP accounting.

3.5.1 Define International Economic Transactions

Transactions in BOP sense consist of those involving goods, services and income; those involving financial claims and liabilities; and those classified as transfers between an economy and the rest of the world. However, the determination of what constitutes a transaction must not be made strictly on the basis of logic but through adoption of general agreed-upon conventions.

3.5.2 The BOP as a Flow Statement

The balance of payments is concerned with transactions and thus, deals with flows rather than with stocks. That is, the balance of payments deals with economic events that take place during a reference period and not with outstanding totals of economic assets and liabilities that exist at particular moments in time. Thus, the BOP tracks the continuing flows of purchases and payments between a country and all other countries. It does not add up the value of all assets and liabilities of a country on a specific date. Two types of business transactions dominate the balance of payments:

1. Exchange of real assets: The exchange of goods (e.g.; automobiles, computers, textiles etc) and services (e.g.; banking, consulting, travel services etc) for other goods and services (barter) or for money.

2. Exchange of financial assets: The exchange of financial claims (e.g.; stocks, bonds, loans and purchase or sales of companies) for other financial claims or money.

3.5.3 Bookkeeping Procedures for BOP Accounting

The balance of payments is a statistical statement structured in a systematic fashion and data in the statement are recorded according to specific accounting rules. The basic accounting convention for a BOP statement is that every recorded transaction is represented by two entries with exactly equal values. One of these entries is designated a credit with a positive arithmetic sign; the other is designated a debit with a negative sign. In principle, the sum of all credit entries is identical to the sum of all debit entries, and the net balance of all entries in the statement is zero. In BOP statements, the two entries are used to recognize the giving and receiving sides of every transaction. Therefore, the BOP statement is similar to a typical financial statement prepared in accordance with the double entry system regularly used for recording business transaction. Accordingly, every credit in the account is balanced by a matching debit and vice versa. In practice, however, the accounts frequently do not balance. Data for balance of payments estimates often are derived independently from different sources; as a result, there may be summary net credit or net debit (i.e.; net errors and omission in the accounts). A separate entry, equal to that amount with the sign reversed, is then made to balance of accounts. The following are the rules for debit and credit entries in the balance of payments:

1. A country earns foreign exchange on some transactions and expends foreign exchange on others when it deals with the rest of the world. Credit transactions are those that earn foreign exchange (i.e., currency inflows are recorded as credits) and are recorded in the balance of payments with a plus (+) sign. For example, the export of Indian made goods earns foreign exchange for us, and is hence, a credit transaction. Borrowing abroad also brings in foreign exchange and is recorded as a credit. The sale of a service to a foreign resident, such as an airline trip on Indigo or 'hotel booking' in an Indian hotel, also earns foreign exchange and is a credit transaction. The following are some of the important credit transactions: (a) Export of goods or services, (b) Unilateral transfers (gifts) received from foreigners, (c) capital inflows.

   Capital inflows appear as credits because the nation is selling (exporting) valuable assets to foreigners. The capital inflows can take either of the two forms:

   (a) an increase in foreign assets of the nation, (b) a reduction in the nation's assets abroad. For example, when a UK resident acquires a stock in an

Indian company, foreign assets in India go up. This is a capital inflow to India because it involves the receipt of a payment from a foreigner. Similarly, when an Indian resident sells a foreign stock, Indian assets abroad decrease. This transaction is a capital inflow to India because it involves receipt of a payment from a foreigner.

2. Transactions that lead to outflow of foreign exchange are recorded as debits (i.e., currency outflows are recorded as debits) and are entered with a minus (-) sign. For example, when residents of India buy machinery from Japan or perfumes from France, foreign exchange is spent and the import is recorded as a debit. Similarly, when Indian residents purchase foreign services, foreign exchange is used and the entry is recorded as a debit. Thus the following are some of the important debit transactions:

   (a) Import of goods and services,

   (b) Unilateral transfer (or gifts) made to foreigners,

   (c) Capital outflows.

   Capital outflows show up as debits because they represent purchase (imports) of foreign assets. Capital outflows can also take any of the following forms:

   (a) An increase in the nation's assets abroad

   (b) A reduction in the foreign assets of the nation.

Both the above transactions involve a payment to foreigners and are capital outflows. For example, an Indian resident purchases a US treasury bill. The transaction results in an increase in the Indian assets abroad and is a debit transaction since it involves a payment to foreigners. Similarly, the sale of an Indian subsidiary by a UK firm reduces foreign assets in India and is entered as a debit transaction.

The IMF has suggested the application of uniform principle of valuation to all transactions recorded in the balance of payments. It is necessary for three reasons:

(1) As each transaction has two sides, the double entry accounting rule would be violated if credit and debit entries did not possess the same values.

(2) The absence of a uniform valuation principle would make it impossible to compare the BOP statement of one country with the BOP statements of other countries.

(3) If a uniform valuation system is not used, items recorded in balance of payments cannot be compared with one another, and serious problem of interpretation would be created for data users.

3.6 Composition of Balance of Payments

Since the balance of payments records all types of international transactions of a country over a certain period of time, it contains a wide variety of items. However, a country's international transactions recorded in BOP can be grouped into the following four components:

1. The current account
2. The capital account
3. The errors and omissions
4. The reserve account

The current account records the exports and imports of goods, services and unilateral transfer between residents and non-residents. The capital account shows the transactions that involve changes in the foreign financial assets and liabilities of a country. The reserve account, on the other hand, records purchases and sales of international reserve assets such as dollars, foreign exchanges, goods and special drawings rights (SDRs). Let us now explain these accounts in a detailed manner.

3.6.1 The Current Account

The current account measures the transfer of real resources (goods, services, income, and transfer) between an economy and the rest of the world. The current account is further subdivided into merchandise account and invisibles account. The merchandise account consists of transactions relating to exports and imports of goods. In the invisible account, there are three broad categories, namely:

(a) Non-factor services such as travel, transportation, insurances and miscellaneous services,

(b) transfer which do not involve any value in exchange (e.g., gift or grant) and

(c) income which includes compensation of employees and investment income.

Thus, all commercial transactions (export and import of goods and services), private remittances, incomes and transfers of goods and services from the government of the home country to foreign governments constitute currents account of a country.

The current account is divided into four categories: merchandise trade, services, factor income and unilateral transfers. Merchandise trade consists of imports and exports of tangible goods, such as oil, wheat, cloths, automobile, computers and so on. Services include payments and receipts for legal, consulting, and engineering services, royalties for patents and intellectual properties, insurances premises, shipping fees and tourist expenditures. All exports of goods and services are credited to the current account and all imports of goods and services are debited to the current account.

Factor income consists largely of payments and receipts of interests, dividends and other incomes on foreign investments that were previously made. The interests, dividends and other income received on assets held abroad are credited to current account, while the interests, dividends and other payments made on foreign assets held in the country are debited to the current account.

Unilateral transfer involves "unrequited" payments. Examples include foreign aid, reparations, official and private grants and gifts. Unlike other accounts in the balance of payments, unilateral transfers have only one-directional flows, without offsetting flows. In the case of merchandise trade, for example, goods flow in one direction and payments flow in the opposite direction. For the purpose of the double entry bookkeeping rule, unilateral transfers are regarded as an act of buying goodwill from the recipients. So a country that gives foreign aid to another country can be viewed as importing goodwill from the latter. The remittances received and gifts or grants received under unilateral transfers, are credited to the current account, and the remittances made to other countries or unilateral transfers to foreigners are debited to the current account.

In short, the rules for recording a transaction as debit and credit in the current account are:

	Debit (outflows)	**Credit(inflows)**
Goods	Buy	Sell
Services	Buy	Sell
Investment income	Pay	Receive
Unilateral transfers	Give	Receive

The balance of trade measures whether a country is a net exporter or net importer of goods. It is the differences between the value of visible export goods and the value of

visible import goods. A trade surplus indicates that the county's exports are greater than its imports and a trade deficit indicates that the country's imports are greater than its exports. The invisible items (services, incomes and transfer) along with the merchandise determine the actual current account position (i.e., surplus and deficit).

The balance of currents account represents the difference between the value of visible and invisible export items and the value of visible and invisible import items. When the country earns more than it spends or gives away to abroad, it is said to have a current account surplus. On the contrary, when the country gives away more than it earns from abroad, it has a current account deficit.

3.6.2 The Capital Account

The capital account records the capital flows (or capital movements) into and out of the reporting country. Capital flows include both outflows and inflows. By capital outflow we mean all transactions which tend to enhance the net-claims position of the reporting country and capital inflow is defined as all transactions which tend to deteriorate it. Accordingly, capital outflows (or capital exports) refer to transactions giving rise to debit entries in the capital account of the balance of payments and capital inflows (or capital imports) refer to transactions giving rise to credit entries.

It should be kept in mind that the term 'capital' in this context does net refer to real capital goods such as machinery, building etc. It merely refers to the stock of reporting country's claims against foreigners and the stock of foreign claims against the reporting country. Accordingly, capital flows (inflows and outflows) refer to changes in these stocks of claims.

However, the capital account does not record the gross flows or movements. It rather records the net changes in the reporting county's foreign claims and liabilities. The net-claims portion is defined as the stock of all claims held by reporting county against foreigners minus the stock of all claims held by foreigners against the reporting country. The difference between capital inflow and capital outflows is called the balance of capital account. The sum of the current account and capital account indicates the balance of payments which could be in surplus or in deficit.

The capital account can be divided into three categories: direct investment, portfolio investment and other investment. Direct investment occurs when the investors acquire a measure of control of the foreign business. Portfolio investment mostly represents sales

and purchases of foreign financial assets that are purely profit motivated return and do not involve a transfer of control. Portfolio investment comprises equity securities and debt securities which include corporate shares, bonds and notes, money market instruments, financial derivatives etc. Other investments include transactions in currency, bank deposits, short & long term trade credit, cross border loans from all types of financial institutions and so forth.

All purchases of domestic assets by foreigners and all sales of foreign assets by Indians are credited to the capital account. All purchases of foreign assets made by the residents of India and all sales of domestic asset by foreigners are debited to the capital account. Increases in loans to foreigners by residents and decreases in loans to residents by foreigners are debited to the capital account. Increases in loans to residents by foreigners and decreases in loans to foreigners by residents are credited to the capital account.

In short, the rules for double entry recording here are as follow:

	Debit(Outflows)	**Credit(Inflows)**
Portfolio investment	• Receiving a payment from a foreigner • Buying a foreign asset • Buying back domestic asset from its foreign owner.	• Making a payment to a foreigner • Selling a domestic asset to a foreigner • Selling a foreign asset acquired previously
Foreign direct investment	• Buying a foreign asset for purpose of control • Buying back from its foreign owner a domestic asset previously acquired for purpose of control	• Selling a long term foreign asset acquired previously (not for purpose of control) • Selling a foreign asset previously acquired for purpose of control
Other investment	• Enhancing the net claims portion in terms of bank deposits, short term and long term trade credits etc.	• Deteriorating the net claims position in terms of bank deposits, short term and long term trade credits etc.

The above classification of BOP has been in use for a long time and almost all textbooks provide the same classification. However, in the recent past, the IMF [BOP Manual, 5th Ed., IMF] has switched to a different classification. Accordingly, all transactions are grouped into two categories: (a)The current account, and (b) The capital and financial account

The capital account is made up of transfers of financial assets and acquisition and disposal of non produced/ non financial assets. This account has been introduced as a separate component in the IMF's balance of payments only recently. The magnitude of capital transactions covered is relatively minor. The financial account consists of four components: direct investment, portfolio investment, net financial derivatives, and other assets investment.

3.6.3 Errors and Omissions

The balance of payments is theoretically constructed on the basis of double entry book keeping which implies that the sum of total debits must necessarily be equal to the sum of total credits. In practice, however, the collection of statistical data for the construction of the balance of payments is inherently imperfect due to many reasons, e.g., unrecorded short term capital movements, cross- border financial transactions conducted electronically etc. Accordingly, in practice the sum of debits is unequal to the sum of credits. Thus, an additional entry is made in the balance of payments to restore the equality between the two sides- total debit and total credit. In the US it is called "errors and omissions". Recently the US Department of Commerce changed its name to "statistical discrepancy" in order to identify it clearly as a residual. The British call it "Balancing item".

3.6.4 Reserve Account

The official reserve account includes transactions undertaken by the authorities to finance the overall balance and intervene in the foreign exchange market. When a country makes a net payment to foreigners because of a balance-of-payments deficit, the central bank of the country should either reduce its official reserve assets (such as gold, foreign exchange, SDRs etc.) or borrow funds from central banks. On the other hand, if a country has a balance-of-payments surplus, its central bank will either retire some of its foreign debts or acquire additional reserve assets from foreigners.

The official reserve account is the total reserve held by official monetary authorities within a country. These reserves are normally composed of the major currencies used in

international trade and financial transactions (so- called “hard currencies” like the US dollar, European euro and Japanese yen, gold, SDRs etc). While an increase in the holdings of foreign currency reserves by the country’s central bank is debited to the official reserve account, a decrease in the holding of foreign currency reserves by the country’s central bank is credited to the reserve account.

3.6.5 Illustrations

Problem 1

Write down the BOP entries for the following transactions:

(i) An Indian company sells Rs 2,00,000 worth of machinery to a UK Company. The UK Company pays for the machinery in 30 days.

(ii) An Indian woman visits her husband in Japan. She cashes Rs. 6,00,000 worth of her Indian traveller’s cheque at a Japan hotel. Before she returns to India, she spends Rs. 6,00,000 in Japan.

(iii) The US Red Cross sends $20,000 worth of flood relief goods in India.

(iv) A Japanese purchases yen 40,000 worth of UK bonds and pays for it with a cheque drawn on an account.

(v) A US bank lends $60,000 to a Canadian firm.

(vi) An Indian firm exports Rs 60,000 worth of goods to be paid in three months.

(vii) An Indian resident visits USA and spends Rs 2,00,000 on hotel and meals and so on.

(viii) A resident purchases foreign stock for Rs 1,00,000 and pays for it by increasing the foreign bank balances in India.

(ix) A foreign investor purchases Rs 50000 worth of Indian treasury bills and pays by drawing down his bank balances in India by an equal amount.

(x) US government gives a US bank balance of $ 200000 to the government of a developing nation as part of the US aid programme.

Solution

The BOP entries for these transactions are shown below:

Particulars	**Debit**	**Credit**
(i) Liquid short term capital Exports [Explanation: In this transaction, merchandise exports are credited because they provide India with an increase in its claims on foreigners. At the same time, the Indian exporter should increase its short-term investment abroad; i.e.; an increase in its account receivable.]	(-)Rs.200000	(+)Rs.200000
(ii) Total expenditure Liquid short- term capital [Explanation: In this case, India received travel services from Japan to the extent of Rs. 600000. In return for these tourist services, the bank of Japan now has Rs. 600000 worth of rupees. The services provided by Japan are clearly a use of funds. The resulting increases in deposits of bank Japan represent a source of funds.]	(-)Rs.600000	(+)Rs.600000
(iii) Transfer payments Exports [Explanation: The US sends its goods to India, this transaction reduces the real assets of the US. Thus, these transfers should be debited. The unilateral transfer of products by the US represents exports and these exports are credited.]	(-)$20000	(+)$20000
(iv) Portfolio investments Liquid short-term capital [Explanation: The Japanese now owes a UK bond, while UK owns Japanese Yen deposits.	(-)Yen40000	(+)Yen40000

Since the acquisition of the UK bond increases Japan's portfolio of bank investments in foreign countries, the portfolio investments must be debited. At the same time, the Yen balance owned by UK, represents an increase in Japanese liabilities to foreigners. Hence, Japan's short term capital should be credited.]		
(v) Non-Liquid short-term capital Liquid short-term capital [Explanation: Since this loan reduces US purchasing power, the US non-liquid short-term liabilities must be debited. At the same the bank creates an increase a deposit balance for the foreign firm through its loan. Because this loan increases US short-term liabilities to foreigners, the liquid short-term liabilities should be credited.]	(-)$60000	(+)$60000
(vi) Short-term capital outflow Merchandise exports [Explanation: Short-term capital outflow is debited because it represents an increase in Indian asset abroad while merchandise export is credited since this will lead to a receipt of payment from foreigners.]	(-)Rs. 60000	(+)Rs. 60000
(vii) Travel services Short-term capital inflow [Explanation: Travel services are debited for Rs 200000 because the transaction here is similar to an Indian export. The payment itself is then entered as a short-term credit because it represents an increase in foreign assets in India.]	(-)Rs.200000	(+)Rs.200000
(viii) Long term capital outflow Short term capital inflow [Explanation: Purchase of foreign stock increases	(-)Rs100,000	(+)Rs100,000

	Indian assets abroad and thus long-term capital outflow is debited. Short term capital inflow is credited because the increase in foreign bank balance in India represents an increase in foreign assets in India.]		
(ix)	Short term capital outflow Short term capital inflow [Explanation: Short-term capital outflow is debited because it represents a reduction in foreign bank balances in India while short-term inflow is credited since it represents a purchase of Indian treasury bills by a foreigner.]	(-)Rs 50 000	(+)Rs 50 000
(x)	Unilateral transfers Short term capital inflow [Explanation: Unilateral transfers are debited since extending aid involves a US payment to foreigners. Short- term capital inflow is credited because it represents an increase in foreign claims of foreign assets in the U.S.]	(-) $ 20 000	(+) $20 000

Problem 2

Record the following transactions and prepare the balance of payment statement.

i. A U.K firm exports $2000 worth of goods to be paid in six months.

ii. A U.K resident visits USA and spends $800 on hotel, meals and so on.

iii. U.K government gives a UK bank balance of $400 to the government of a developing nation as part of the UK aid program.

iv. A UK resident purchases foreign stock for $1600 and pays for it by increasing the foreign bank balance in the UK.

v. A foreign investor purchases $1200 of UK treasury bills and pays by drawing down his bank balance in the UK by an equal amount.

Solution

	Particulars	Debit (-) (in $)	Credit (+) (in $)
(i)	Short term capital outflows Merchandise exports	2000	2000
(ii)	Travel services purchased from foreigners Short term capital inflow	800	800
(iii)	Unilateral transfer madeShort term capital inflow	400	400
(iv)	Long term capital outflowShort term capital inflow	1600	1600
(v)	Short term capital outflowShort term capital inflow	1200	1200

If we assume that these five transactions are all the international transactions of UK during the year, the UK balance of payments is as follows:

Particulars	Debit (-) (in $)	Credit (+) (in $)
Merchandise		2000
Service	800	
Unilateral transfers	400	
Long term capital	1600	
Short term Capital, net (-$2000+$800+$400+$1600+$1200-$1200)		800
	2800	2800

3.6.6. Structure of India's BOP

The structure of India's BOP is represented below:

Balance of payment	
I.	Current Account
	1. Exports
	2. Imports
	3. Trade Balance (1-2)
	4. Invisibles (net)
	A. Services
	B. Income
	C. Transfers
	5. Current Account Balance (3+4)
II.	Capital Account
	i. External assistance (net)
	ii. External Commercial Borrowing (net)
	iii. Short term credit
	iv. Banking Capital (net) of which : Non-Residents Deposits (net)
	v. Foreign Investment (net) of which:
	A. FDI (net)
	B. Portfolios (net)
	vi. Other Flows (net)
	6. Capital Account Balance [(i+ii+iii+iv+v+vi)]
III.	Errors and Omissions
IV.	Overall Balance (5+6+III)
V.	Reserve Charge [increase (-)/ decrease (+)]

Source: RBI

3.7 The Balance-of-Payments Identity

Since the balance of payments statement is prepared in terms of debits and credits based on double-entry system of book-keeping, total of debit entries must be equal to total of credit entries, if all the entries are recorded correctly. This is because two aspects (debit and credit) of each transaction recorded are equal in amount but appear on the opposite sides of the different account. In this accounting sense, the balance of payment of a country must always balance.

In other words, the debit entries represent the total of all the uses made out of the total foreign exchange acquired by the country during a given period, while the credit entries represent the sources from which this foreign exchange is acquired by this country in the same period. The two sides as such necessarily balance.

When the balance-of-payment accounts are recorded correctly, the combined balance of the current account, the capital account and the reserve account must be zero, i.e.,

BCA+ BKA + BRA = 0

where BCA= Balance on the Current Account,

BKA= Balance on the Capital Account

BRA= Balance on the Reserve Account

The balance on the reserve account, BRA represents the change in the official reserves. The above equation is the Balance-of-Payment Identity (BOPI) that must necessarily hold. The BOPI equation indicates that country can run a balance-of-payment surplus or deficit by increasing or decreasing its official reserves.

However, it is not necessary that each account should individually balance. But these accounts taken together must balance each other. Thus, if there is a surplus in the current account, there must be a deficit in the capital account and vice-versa. The fact that the balance of payments always balances does not mean that there is no problem of surplus or deficit in the balance of payments. In fact, it is difficult to tell from the balance of payments of a country whether there exists any surplus or deficit in the balance of payments or not. Even if there is a surplus or deficit, the balance of payments must always balance. This equality of balance of payments account is an identity and is the results of the double entry system of accounts. It has no economic significance. It does not also represent any equilibrium condition.

3.8 Equilibrium and Disequilibrium in the Balance of Payments

If a country has a deficit in its balance of current account, there will always be an off-setting transaction on the capital account to bring the balance of payments into equilibrium. For example, if a country's importers have imported $100 more than the exporters have exported, they might have to borrow $100 from the foreign exporters to pay for their purchases, and this would be registered as an inflow of capital on the capital account. There are, however, other capital flows which have no connection with the country's balance of payments situation. It may be, for instance, that a foreign exporter buys an advertising agency in the country at the cost of $100, to be able to better market his products. This would also be registered as a capital inflow of $100. The significance of these two transactions for the country's balance of payments is very different. We, therefore, have to distinguish between two types of transactions.

The transactions recorded in the balance of payments account can be divided into two major categories: autonomous transactions and accommodating transactions. Autonomous transactions are those which are undertaken for their own sake, usually in response to business considerations and incentives but sometimes in response to a political consideration as well. Their main distinguishing feature is that they take place independently of the balance-of-payments position of the reporting country. All other transactions are called accommodating transactions. Thus, accommodating transactions do not take place for their own sake. Rather, they occur because other (autonomous) transactions are such as to leave a gap to be filled. Accommodating transactions may be automatic (i.e.; unplanned and unforeseen) or discretionary (i.e., planned and foreseen). In addition, accommodating transactions may be made by private persons or public authorities.

Examples of autonomous transactions are: all exports of goods and services undertaken for profit, unilateral transactions, long term capital movements, short term capital movements etc. On the other hand, examples of accommodating transactions are: the sale of gold or foreign currencies by the central bank in order to fill the gap between the receipts and payments of foreign exchange by the private residents of the country, a gift or loan received by the authorities of a country from foreign governments for the purpose of filling a gap in the autonomous receipts and payments and so on.

In order to know whether equilibrium exists in the balance of payments or not, we have to take into account only the autonomous transactions. If the autonomous receipts

and autonomous payments are equal, the balance of payments is said to be in equilibrium and no accommodating transactions will take place. If the autonomous receipts and autonomous payments are not equal, the balance of payments is said to be in disequilibrium. If a country's autonomous receipts are larger than its autonomous payments, it will have a surplus in its balance of payments. This will then be settled by an accommodating transaction (which is equal to surplus) and it thereby brings the balance of payments into equilibrium. A country has a deficit in its balance of payments if its autonomous receipts are smaller than its autonomous payments. This deficit will have to be settled by an accommodating transaction which brings the balance of payment into equilibrium.

3.9 Types of Disequilibrium in the Balance of Payments

The following are the main types of disequilibrium in the balance-of-payments:

Cyclical Disequilibrium

It takes place on account of trade cycles. Trade cycles follow different paths and pattern in different countries. There are no identical timings and periodicity of occurrences of cycles in different countries. Cyclical fluctuations cause disequilibrium in the balance of payments because of cyclical change in income, employment, output and price variables. When prices rise during prosperity in the foreign country a country which has a highly elastic demand for imports experiences a decline in the value of imports and if it continues its exports further, it will show a surplus in the balance of payments.

Structural Disequilibrium

It emerges on account of structural changes occurring in some sectors of the economy at home or abroad which may alter the demand or supply relations of exports or imports or both. For example, if foreign demand for India's jute products decline because of some substitutes then the resources employed by India in the production of jute goods will have to be shifted to some other commodities of export. If this is not easily possible, India's exports may decline, whereas imports remain the same. Disequilibrium in the balance of payments will arise. Moreover, a shift in demand takes place with the changes in tastes, fashion, habits, income etc. Propensity to import may change as a result. Demand for some imported goods may increase, while that for certain goods may decline leading to a structural change.

Short-run Disequilibrium

A short-run disequilibrium in a country's balance of payment will be a temporary one, lasting for a short period, which may take place once in a while. When a country borrows or lends internationally, it will have short-run disequilibrium in its balance of payments as these loans are usually for a short period or even if they are for a long duration, they are repayable later on. Hence, the position will be automatically corrected and poses no serious problem. When such disequilibrium (arising from the imports exceeding exports or even vice-versa) takes place year after year over a long period, it becomes chronic and seriously affects the country's economy and its international economic relations.

Long-run Disequilibrium

It refers to a deep-rooted, persistent deficit or surplus in the balance of payments of a country. It is secular disequilibrium emerging on account of the chronologically accumulated short-term disequilibria - deficits or surpluses. A long-term deficit in the balance of payments of a country tends to deplete its foreign exchange reserves and the country may also not be able to raise any more loans from foreigners during such a period of persistent deficits.

In short, true disequilibrium is a long-term phenomenon. It is caused by persistent deep rooted dynamic changes which slowly take place in the economy over a long period of time. It is caused by changes in dynamic forces/factors such as capital formation, population growth, territorial expansion, technological advancement, innovation etc.

Concept of Fundamental Disequilibrium

The International Monetary Fund (IMF) uses the term 'Fundamental Disequilibrium' to describe a persistent, long-run disequilibrium, especially deficits which exist continuously for a long period of time in a country's balance of payments. Unchecked series of short-run disequilibria in a country's balance of payments ultimately lead to the 'fundamental disequilibrium' in the long-run. There are deep-rooted causes and factors in a country's economy which are responsible for the emergence of fundamental disequilibrium in its balance of payments.

The main objective of macro-economic policy of a country is to correct this fundamental disequilibrium. To correct this, various measures are required to be undertaken. IMF insists that member country facing a 'fundamental disequilibrium' in its balance of payments should consult the Fund, so that the Fund can advice for and assist in taking some appropriate measures like devaluation in overcoming the grave situation.

3.10 Reasons for Disequilibrium in the Balance of Payments

Any disequilibrium in the balance-of-payments arises due to a large number of causes or factors operating simultaneously. Types of disequilibrium differ from country to country, while the different kinds of disequilibrium and their causes in the same country will differ at different times. The following are the important causes producing disequilibrium in the balance of payment of a country:

i. Cyclical fluctuations, their phases and amplitudes, differences in different countries, generally produce cyclical disequilibrium.

ii. Huge development and investment programs in the developing economies are the root causes of the disequilibrium in the balance of payments of these countries. Their propensity to import goes on increasing for want of capital for rapid industrialization, while exports may not be boosted up to that extent as these are the primary producing countries.

iii. One important cause of disequilibrium in the balance of payments is inflation in the domestic economy. If there is inflation in the country, prices of exports rise. As a result, exports fall. On the other hand, importable goods become relatively cheaper. So imports rise. All these result in adverse balance of payments.

iv. High population growth in poor countries also has adversely affected their balance of payments position. It is easy to see that an increase in population increases the need of these countries for imports and decreases the capacity to export.

v. Disequilibrium in the balance of payments also arises as a result of international borrowing and investment. For example, a country may tend to have an adverse balance of payments when it borrows heavily from another country.

vi. Changes in the production technique in domestic economy or in abroad may bring disequilibrium in the balance of payments. Technological changes in production will change quality, cost and prices of the products.

vii. Disequilibrium in the balance of payments may arise due to changes in tastes and preferences of the domestic or foreign consumers. Then the exports or imports of the country will change. This may cause fundamental disequilibrium in the balance of payments.

viii. Demonstration effect is another most important factor causing deficit in the balance of payments of a country - especially of an underdeveloped country. When people of underdeveloped nation come into contact with those of advanced countries through economic, political or social relations, there will be a demonstration effect on the consumption pattern of those people and they will desire to have western style goods and pattern of consumption so that their propensity to import increases, whereas their exports quantum may remain the same or may even decline with the increase in income, thus causing an adverse balance of payments for the country.

3.11 Measures for Correcting Disequilibrium

Various measures that may be used for correcting an adverse balance of payments are of two types: a) Monetary measures, and b) Non-monetary measures

3.11.1 Monetary Measures

Monetary measures usually have two-edged effects in improving the balance of payments position. They boost up exports as well as check or curtail imports. The following monetary measures are usually employed so as to correct the adverse balance of payments:

1. *Deflation*: A traditionally suggested method of correcting disequilibrium is to deflate the home currency. Deflation means contraction of the home currency through dear money and credit policy and fall in the cost and prices of domestic goods. Naturally, domestic goods and exporting items of the country in the foreign market become relatively cheaper and demand for them will rise so that exports will increase. Moreover, deflation attempts to restrict home consumption through reduction of incomes; demand for goods at home will be reduced and more surpluses may become available for export purposes so that exports may be increased. However, deflation is forcefully employed when countries are on a gold standard or fixed exchange rates, because its workability assumes that exchange rates are unchanged during its course.

2. *Exchange Depreciation*: Another important method of correcting an adverse balance of payments is to depreciate the external (exchange) value of the home currency. This device obviously assumes that the country has adopted flexible exchange rate policy. Thus, exchange depreciation is feasible. By exchange depreciation is meant a decline in the rate of exchange of one country in terms of another's.

Exchange depreciation of a country will tend to cheapen its domestic goods for the foreigners so that its exports will be boosted up, while its imports will be costlier so that they will tend to decline. Thus, imports will be checked and exports will be stimulated by a fall in exchange rate as the external value of the currency of a country. The country may thus, achieve a favourable balance to pay off an earlier deficit.

3. *Devaluation*: A mostly commonly adopted method consists of devaluation of the currency of a country faced with an adverse balance of payments. Devaluation simply means the lowering of the external value (i.e., exchange rate) of a country's currency by an official order.

   It should be noted that the difference between devaluation and depreciation of exchange rate is that while devaluation is reduction of the external value of a currency as arbitrarily decided upon by the Government, depreciation stands for automatic reduction in the external value of a country's currency by market forces. However, both imply the same thing, i.e., lower value of the local currency in terms of foreign currencies. Both devaluation and depreciation produce similar effects-increase exports (by making local goods cheaper to foreigners), curtail imports (by making foreign good expensive) and ultimately correct an adverse balance of payments and make it favorable one.

4. *Exchange control*: Restrictions on the use of foreign exchange by the central bank are called exchange controls. When an exchange control is adopted, all the exporters have to surrender their foreign exchange earnings to the central bank. Under exchange control, the central bank releases foreign exchanges only for essential imports and ensures the rest of the balance. This is the most direct method of curbing imports.

   An exchange control can prevent a complete breakdown, but it cannot eliminate the condition of disequilibrium. Thus, an exchange control offers no permanent solution to the problem of persistent disequilibrium. It can, at best, be justified only as a temporary measure, while other more fundamental adjustments are made to restore equilibrium in the balance of payments.

3.11.2 Non-monetary Measures

Non-monetary measures are directly effective measures. But they work one way only. Tariffs and quotas, for instance, tend to restrict only imports. Export promotion measures, on the other hand, enhance exports only. The measures are explained below:

1. *Tariff (Import duties)*: Tariff is a fiscal device which may be used for correcting an unfavorable balance of payments position. It refers to custom duties levied on importers. A country having a deficit balance of payments position can restore and maintain equilibrium by means of imposing tariff restrictions upon imports.

2. *Imports Quotas*: Fixing of imports quotas is another and better device used for correcting an adverse balance of payments. Under the quota system, the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting imports through the quota system, deficit is reduced or eliminated and thereby the balance of payments position is improved.

3. *Exports promotion*: To correct disequilibrium in the balance of payment, it is necessary that exports should be increased. Government may adopt export promotion program which includes subsidies, tax concession to exporters, incentive for exports etc. Export or perish should be the slogan for any country facing the problem of fundamental disequilibrium in its balance of payments.

All these non-monetary measures are, however, considered more effective, significant and are normally applicable than monetary measures in correcting the adverse balance of payments.

3.12 Summary

- According to the Balance of Payments Manual of the International Monetary Fund (IMF), the balance of payments (BOP) is a statistical statement that systematically summarizes, for a specific time period, the economic transaction of an economy with the rest of the world.

- Transactions between the residents of a country and the rest of the world consist of: (i) those involving goods, services and income; (ii) those involving financial claims on the rest of the world and liabilities to the rest of the world and (iii) those (such as gifts) classified as transfers.

- Balance of payments is worth studying for a few reasons: *Firstly*, balance of payments provides detail information concerning the demand and supply of a country's currency. *Secondly*, a country's balance of payments data may signal as a potential business partner for the rest of the world. *Thirdly*, balance of payment data can be used to evaluate the performance of the country in

international economic competition. *Fourthly*, changes in a country's BOP may signal the imposition or removal of control over payments of dividends and interests, license fees, royalty fees, and other cash disbursements to foreign firms or investors.

- There are three main elements of the actual process of measuring international economic activity: (i) identifying what is and is not an international economic transaction; (ii) understanding how the flows of goods, services, assets and money debit and credit to overall BOP; and (iii) understanding the bookkeeping procedures for BOP accounting.
- The basic accounting convention for a BOP statement is that every recorded transaction is represented by two entries with exactly equal values. One of these entries is designated a credit with a positive arithmetic sign; the other is designated a debit with a negative sign. In principle, the sum of all credit entries is identical with the sum of all debit entries, and the net balance of all entries in the statement is zero.
- A country earns foreign exchange on some transactions and expends foreign exchange on others when it deals with the rest of the world. Credit transactions are those that earn foreign exchange (i.e., currency inflows are recorded as credits) and are recorded in the balance of payments with a plus (+) sign.
- Transactions that use foreign exchange are recorded as debits (i.e., currency outflows are recorded as debits) and are entered with a minus (-) sign.
- A country's international transaction recorded in BOP can be grouped into the following four components: The current account, The capital account, The errors and omissions, The reserve account.
- The current account measures the transfer of real resources (goods, services, income, and transfer) between an economy and the rest of the world. The current account is further subdivided into merchandise account and invisibles account.
- The capital accounts records the capital flows (or capital movements) into and out of the reporting country. Capital flows include both outflows and inflows. By capital outflow we mean all transactions which tend to enhance the net-claims position of the reporting country and capital inflow is defined as all transactions which tend to deteriorate it. Accordingly, capital outflows (or capital exports) refer to transactions giving rise to debit entries in the capital account of the

balance of payments and capital inflows (or capital imports) refer to transactions giving rise to credit entries.

- The balance of payments is theoretically constructed on the basis of double entry book keeping system which implies that the sum of total debits must necessarily be equal to the sum of total credits. In practice, however, the collection of statistical data for the construction of the balance of payments is inherently imperfect due to many reasons, e.g., unrecorded short term capital movements, cross- border financial transactions conducted electronically etc. Accordingly, in practice the sum of debits is unequal to the sum of credits. Thus, an additional entry is made in the balance of payments to restore the equality between the two sides- total debit and total credit. In the US it is called "errors and omissions". Recently the US Department of Commerce changed its name to "statistical discrepancy" in order to identify it clearly as a residual. The British call it "Balancing item".
- The official reserve account includes transactions undertaken by the authorities to finance the overall balance and intervene in the foreign exchange market. When a country makes a net payment to foreigners because of a balance-of-payments deficit, the central bank of the country should either reduce its official reserve assets (such as gold, foreign exchange, SDRs etc.) or borrow funds from foreign central banks. On the other hand, if a country has a balance-of-payments surplus, its central bank will either retire some of its foreign debts or acquire additional reserve assets from foreigners.
- Since the balance of payments statement is prepared in terms of debits and credits based on double-entry system of book-keeping, total of debit entries must be equal to total of credit entries, if all the entries are recorded correctly. This is because two aspects (debit and credit) of each transaction recorded are equal in amount but appear on the opposite sides of the different account. In this accounting sense, the balance of payments of a country must always balance.
- The transactions recorded in the balance of payments account can be divided into two major categories: autonomous transactions and accommodating transactions. Autonomous transactions are those which are undertaken for their own sake, usually in response to business considerations and incentives but sometimes in response to a political consideration as well. Their main distinguishing feature is that they take place independently of the balance-of-payment positions of the reporting country. All other transactions are called accommodating

transactions. Thus, accommodating transactions do not take place for their own sake.

- The following are the main types of disequilibrium in the balance-of-payments: Cyclical Disequilibrium, Structural Disequilibrium, Short-run Disequilibrium, Long-run Disequilibrium
- The International Monetary Fund (IMF) uses the term 'Fundamental Disequilibrium' to describe a persistent, long-run disequilibrium, especially deficits which exist continuously for a long period of time in a country's balance of payments. Unchecked series of short-run disequilibria in a country's balance of payments ultimately lead to the 'fundamental disequilibrium' in the long-run. There are deep-rooted causes and factors in a country's economy which are responsible for the emergence of fundamental disequilibrium in its balance of payments.
- Any disequilibrium in the balance-of-payments arises due to a large number of causes or factors operating simultaneously. Types of disequilibrium differ from country to country, while the different kinds of disequilibrium and their causes in the same country will differ at different times.
- The various measures that may be used for correcting an adverse balance of payments are two types: a) Monetary measures, and b) Non-monetary measures.

3.13 Self Assessment Questions

A. Objective type questions:

Choose the correct answer from the given four alternatives.

1. The balance of payments is prepared in accordance with the
   - a) single entry system of book-keeping
   - b) double entry system of book-keeping
   - c) cash basis accounting
   - d) accrual basis of accounting
2. All exports of goods and services are credited to
   - a) The current account
   - b) The capital account

c) The reserve account

d) The errors and omission account

3. All imports of goods and services are debited to the

a) The current account

b) The capital account

c) The reserve account

d) The errors and omission account

4. When a country earns foreign exchange, it is redeemed as a___________in BOP.

a) debit entry

b) credit entry

c) capital entry

d) none of these

5. Transactions that lead to outflow of foreign exchange are recorded as __________ in BOP.

a) credit entry

b) capital entry

c) debit entry

d) none of these

6. The balance of trade is the difference between

a) The value of visible exports of goods and the value of visible imports of goods.

b) The value of invisible exports of goods and the value of invisible imports of goods.

c) The value of visible exports of goods and the value of invisible imports of goods.

d) None of these.

7. The balance of current account represents the difference between
   a) The value of visible and invisible export items and value of visible and invisible import items.
   b) The value of invisible and invisible export items and invisible import items.
   c) The value of visible and invisible export items and invisible import items.
   d) None of these.
8. Autonomous transactions are those which are undertaken for
   a) their own sake
   b) other's sake
   c) balancing sake
   d) none of these.
9. The balance of payments is said to be in equilibrium when
   a) autonomous receipts and autonomous payments are not equal
   b) autonomous receipts and autonomous payments are equal
   c) there exist only Autonomous receipts
   d) there exist only autonomous payments
10. Cyclical disequilibrium takes place on account of:
    a) life cycle
    b) industry life cycle
    c) trade cycles
    d) none of these

Answers: 1 a); 2 a); 3 a); 4 b); 5 c); 6 a); 7 a); 8 a); 9 b); 10 c).

B. Short answer type questions:

1. What is balance of payments?
2. What is meant by fundamental disequilibrium in the balance of payments?
3. What do you mean by credit transaction and debit transaction in the context of balance of payments?

4. What do you mean by autonomous transactions and accommodating transactions?
5. What is balance of trade?
6. What do you mean by equilibrium in the balance of payments?
7. What is meant by equality of balance of payments?
8. What are the different types of disequilibrium in the balance of payments?
9. What is cyclical disequilibrium?
10. What is structural disequilibrium?
11. When does deficit in the balance of payments of a country arise?
12. State the monetary measures for correcting disequilibrium in the balance of payments.

C. Long answer type questions:

1. Explain the concept of balance of payments.
2. Why would it be useful to examine a country's balance of payments data?
3. Describe the balance of payments identity.
4. What are the implications and uses of the balance of payments statement?
5. Explain the major components of the balance of payments.
6. Discuss the methods of correcting disequilibrium in the balance of payments.
7. Discuss the causes of disequilibrium in the balance of payments of a country.
8. "The balance of payments always balance."-Explain the statement.
9. Explain the different types of disequilibrium in the balance of payments.
10. Explain monetary measures and non-monetary measures for correcting disequilibrium in the balance of payments.

Unit 4 ❑ Multinational Companies

Structure

4.1 Objectives

4.2 Basic Concepts

4.2.1 Types of MNCs

4.3 Reasons for the Growth of MNCs

4.4 How Multinational Corporations Enter a Foreign Market

4.5 Advantages and Disadvantages of MNCs

4.5.1 Advantages of MNC's for the host country

4.5.2 Disadvantages of MNC's for the host country

4.5.3 Advantages of MNCs for the home country

4.5.4 Disadvantages of MNCs for the home country

4.6 Multinational Companies in Emerging Economies

4.7 Summary

4.8 Self Assessment Questions

4.1 Objective

After learning this chapter you will know the basic concepts relating to Multinational Companies, their growth, different forms and advantages and disadvantages.

4.2 Basic Concepts

Multinational companies (also known as multinational enterprises) have been the most important type of firm operating in the economy. According to Sitkin and Bowen (2010), a firm that owns facilities in a single country but carries out transactions regularly outside its borders may qualify as multinational enterprises. According to Vernon and Wells Jr. (1986), MNCs represent a cluster of affiliated firms located in different countries that: 1. Are linked through common ownership, 2. Draw upon a common pool of resources, and 3. Respond to a common strategy, and respond to a common strategy.

Cavusgil, S. T et al.(2009) defines it as a large company with substantial resources that performs various business activities through a network of subsidiaries and ***affiliates*** located in multiple countries.

The term ***affiliates*** signify a numerous number of independent business partners of an MNC situated in different parts of the globe.

Normally, MNCs carry out R&D, procurement, manufacturing, and marketing activities in those countries, where they enjoy cost advantage.

MNC is also known as Global Companies, International Companies or Transnational Companies, however, these terms theoretically have different meanings.

4.2.1 Types of MNCs

Global Corporations: These companies produce in the home country and market these products internationally or vice versa (Punnett and Ricks,1997). Hence, certain operations are centralized and others are decentralized. Global Corporations develop knowledge in various countries, but their units do not share such knowledge across the globe.

International Companies: International Companies conducts the operations in one or more foreign countries, but with domestic orientation. These companies extend the domestic product, price, promotion and other business practices to the foreign markets.

Transnational Companies : Transnational Companies produces, markets, invests and operates in different countries.

Based on the strategic features, MNCs are grouped as ethnocentric, polycentric and geocentric. Ethnocentric firms are those that adopt home market-oriented policy and seldom distinguish between the domestic operation and global operation policies. Polycentric firms operate in a foreign country just to cater to the demand in those countries. On the other hand, the geocentric firms maintain a balance between home market and host market-oriented policies.

4.3 Reasons for the Growth of MNCS

Robert J. Carbaugh lists some factors responsible behind the growth of the MNC. [https://yourbusiness.azcentral.com/reasons-multinational-corporations-23250.html]

i) Economies of Scale

Converting a small manufacturer to a multinational may give the business an opportunity to achieve increased production efficiency. Because each manufactured unit shares fixed costs that are unrelated to the number of goods produced, the average cost per unit goes down as the number of units manufactured enhances.

ii) Non-Transferable Knowledge

Occasionally, MNCs sell its knowledge in the form of patent rights to earn royalty from others. This relieves the MNC of the need to make a foreign direct investment. On the contrary, MNC that has a Production Process or Product Patent can make a larger profit by carrying out the production in a foreign country itself.

iii) Market Growth

Becoming a multinational helps a small business to expand, which enables the company to exploit new growth markets. This opportunity is especially beneficial if the domestic demand for the company's products or services has saturated. In the article "Dealing With the New World of Multinational Competition" on the PricewaterhouseCoopers website, Harry G. Broadman and Sunita Saligram write that multinationals seek opportunities in emerging markets in particular because the average growth rate of the gross domestic product in these markets is twice that in developed countries, such as the United States.

[https://www.pwc.com/gx/en/governance-risk-compliance-consulting- services/resilience/publications/pdfs/issue1/dealing_with_new_world_multinational_competition.pdf]

iv) Product Sourcing

Operating as a multinational provides small business with the option of conducting some of the company's offshore sourcing through subsidiaries, rather than independent contractors. This provides the business with a better opportunity to control the quality of its products or its product's components. Relying on its own subsidiaries as a source of supply also provides a business with the opportunity to better ensure promised delivery dates of critical product components.

v) Bypass Host Country's protecting Mechanisms

National regulators generally discriminate against foreign subsidiaries unless the subsidiary is established enough regionally to be perceived as a domestic firm. Establishing foreign subsidiaries, therefore, could defend the business from bound governmental investigations, audits and prosecutions. The international subsidiary may be the way for a business to expand into foreign countries and bypass the protecting controls of the mercantilism country.

v) Limit Transport prices

High transportation prices will considerably raise the costs of merchandise offered by a business. Functioning as an international will cut back such prices by getting production provided from a manufacturer that's on the brink of the company's plants and therefore the product market. As a result, a domestic business could profit by investment in production plants in foreign countries and commercialism the factory-made merchandise on to shoppers in those countries, instead of mercantilism the products from the house country.

vi) Product Innovation

MNCs with their sound Research and Development, invent new merchandise and improve existing merchandise. Developing countries, normally, suffer from lack of funds to take a position in Research and Development programmes. Therefore, they invite MNCs to their countries.

4.4 How International Firms Enter an Overseas Market

1. Indirect Exporting

MNCs could use domestically based agents who performs for a commission basis while not taking title to product, or merchants who sell the merchandise of the corporate in international markets (after taking title to the goods). They will additionally use the distribution channels of others within the international markets. On the contrary, few companies together sell merchandise through a firm referred to as associate export management company. The most advantage of exploitation of this strategy is that the mercantilism company will utilize the experience of the organization that has information concerning the country to which the products ar being exported. The original company

may also have sensible links with the organization that organizes such export activities since each firms ar placed within the same country.

2. Direct Exporting

A company could adopt the direct mercantilism policy. the corporate develops overseas contacts, undertakes market research, handles documentation and transportation and decides the promoting combine. Conversely, associate MNC will use foreign-based agents or distributors. associate agent could conform to handle the merchandise solely, or together. Associate agent doesn't take title to the merchandise and works on commission. Taking the benefits of foreign-based agents and distributors MNC could transfer the title of the merchandise to distributors operative within the foreign market.

However, the distributor's profit or commission relies on sales generated and that they might not have an interest in developing long-run market positions for the corporate, they would not be willing to place in further efforts to sell new merchandise and can provide most attention to commercialism established merchandise of the corporate which is able to generate most profit or commission for them. They would think about themselves to be representatives of their customers than of the corporate and will be reluctant to convey market feedback to the corporate. the corporate has restricted management over agents and distributors.

Under this example, the MNC could establish a sales and promoting workplace within the foreign market and use its own salespersons. The employee pays attention to the event of the market and chances for feedback and alternative info from the market are higher. Thus, customers are taken care of higher and therefore the company's interest would be higher served. this can be a chic methodology, that the order sizes need to be massive.

3. Licensing

The retail merchant has exclusive rights to supply and market the merchandise within the such space for a restricted amount. The licensor sometimes gets royalties on the sale of the merchandise.

Under this technique, an overseas licensor provides a neighborhood retail merchant with access to technologies, patents, trademarks, ability or brand/company name in exchange for monetary or another type of compensation.

The advantage of licensing lies within the incontrovertible fact that the MNC (licensor) will enter a replacement market while not creating substantial investments. However, the corporate loses management over the assembly and promoting of the merchandise. It ought to be noted that the name of the licensor depends on the performance of the retail merchant.

One disadvantage of licensing is that the loss of product and method ability to 3rd parties (licensee), who could become competitors once the agreement is over.

4. Franchising

Franchising could be a style of contract wherever packages of services are offered by the franchiser to the franchisee reciprocally for a payment. Franchising is of 2 types:

In ancient franchising, the merchandise factory-made or provided by the franchisor take centre stage. The manufacturer licenses to the franchisee the proper to sell or distribute a selected product exploitation the franchisor's trademark and brand name. Whereas in a very business format franchise the franchisee's business is merely noted by the marks it shares with the franchisor and alternative franchisees.

Traditional franchising is mostly found in automobile, truck, living accommodations, and farm instrumentation dealerships; petrol service stations,etc. In business format franchising, the franchiser, like McDonald's, lends operative procedures, internal control, also because the product and brand name.

5. Joint Ventures

An MNC could enter into a joint-venture agreement with an organization from the target country market. two kinds of the venture are there: written agreement and Equity joint ventures. In written agreement joint ventures, no joint enterprise with a separate identity is created. Two or a lot of companies enter into a partnership to share the value and profit. The partnership will be shaped for finishing a project, or for a protracted term co-operative effort. In associate degree equity venture, a replacement company is created during which the foreign and native firms share possession and management.

6. Direct Investment

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. The **Organization of Economic Cooperation and Development (OECD)** defines control

as owning 10% or more of the business. An MNC may make a direct investment by creating a new foreign enterprise, which is called a **greenfield investment**, or by the acquisition of a foreign firm, either called an **acquisition** or **brownfield investment**.

4.5 Advantages and Disadvantages of MNCS

According to the ILO report on Multinational Enterprises and Social Policy, Geneva, 1973, "for some, the multinational companies are an invaluable dynamic force and instrument for wider distribution of capital, technology and employment; for others, they are monsters which our present institutions, national or international, cannot adequately control, a law to themselves with no reasonable concept, the public interest or social policy can accept".

MNCs help both the home country and the host country. There are some disadvantages too.

4.5.1 Advantages of MNC's for the host country

The possible benefits of an MNC to the host country may include:

1. **Improving the balance of payments**: FDI will usually help a host country to improve its balance of payments situation. The direct flow of capital into the country likely to result in import substitution and export promotion. Export promotion happens due to the multinationals using their production facility as a basis for exporting, while import substitution means that products previously imported may now be bought domestically.
2. **Providing employment**: FDI will usually result in employment benefits for the host country as it is expected that most employees will be locally recruited. These advantages may be comparatively greater assuming that governments will usually try to attract firms to areas where there is relatively high state of sensible labour supply.
3. **Source of tax revenue**: Profits of multinationals will be subject to local taxes in most cases, which will provide a valuable source of revenue for the domestic government.
4. **Technology transfer:** MNCs will bring with them technology and production methods that are probably not available to the host country. Workers will be

trained accordingly and domestic firms will see the benefits of the new technology. This is known as technology transfer.

5. **Increasing choice**: If the multinational manufacture for domestic markets as well as for export, then the local population will gain form a wider choice of goods and services and at a price possibly lower than imported substitutes.

6. **National reputation**: The presence of one multinational may improve the reputation of the host country and other large corporations may follow suite and locate as well.

4.5.2 Disadvantages of MNC's for the host country

The possible disadvantages of a multinational investing in the host country may include :

1. **Environmental impact**: Multinationals will want to produce in ways that are as efficient and as cheap as possible and this may not always be the best environmental practice. They will often lobby governments hard to try to ensure that they can benefit from regulations being as sloppy as possible and given their economic importance to the host country, this influencing will often be quite effective.

2. **Uncertainty**: MNCS can move and change at very short notice and often will. This creates uncertainty for the host country.

3. **Influence and political pressure**: MNC often enjoys disproportionate influence over government and other organisations in the host country. Given their economic importance, governments will often agree to changes that may not be beneficial for the long-term welfare of their people.

4. **Transfer pricing**: MNCs will always aim to reduce their tax liability to a minimum. One way of doing this is through transfer pricing. The aim of this is to reduce their tax liability in countries with high tax rates and increase them in countries with low tax rates. They can do this by transferring components and part-finished goods between their operations in different countries at differing prices. Where the tax liability is high, they transfer the goods at a relatively high price to make the costs appear higher. This is then recouped in the lower tax

country by transferring the goods at a relatively lower price. This will reduce their overall tax bill.

5. **Low-skilled employment**: The jobs created in the local environment may be low-skilled with the multinational employing expatriate workers for the more senior and skilled roles.

   Moreover, adopting the ethnocentric approach in staffing may affect the job market of the host country adversely.

6. **Health and safety:** Multinationals have been accused of cutting corners on health and safety in countries where regulation and laws are not as rigorous. Recently, in India Nestle was accused of some health-related problems with their popular product Maggie Noodles.

7. **Export of Profits**: Multinationals are likely to repatriate profits back to their 'home country', leaving little financial benefits for the host country.

8. **Cultural and social impact -** MNCs can dilute local customs and traditional cultures. For example, the sociologist George Ritzer coined the term ***McDonaldization*** to describe the process by which more and more sectors of American society as well as of the rest of the world take on the characteristics of a fast-food restaurant, such as increasing standardisation and the movement away from traditional business approaches.

4.5.3 Advantages of MNCs for the home country

The MNCs home country has the following advantages

1. MNCs create opportunities for marketing the products produced in the home country throughout the world.
2. They create employment opportunities for the people of the home country both at home and abroad.
3. It gives a boost to the industrial activities of the home country.
4. MNCs help to maintain a favourable balance of payment of the home country in the long run.
5. Home country can also get the benefit of foreign culture brought by MNC's.

4.5.4 Disadvantages of MNC’s for the home country

1. MNCs transfer the capital from the home country to various host countries, causing an unfavourable balance of payment.
2. MNCs may not create employment opportunities for the people of the home country if it adopts a geocentric approach.
3. As investments in foreign countries are more profitable, MNC’s may neglect the home countries industrial and economic development.

4.6 Multinational Companies in Emerging Economies

From the above discussion, it is revealed that MNCs play an important role in linking rich and poor economies, and in transmitting capital, knowledge, ideas and value systems across borders. MNCs’ interaction with various institutions, organisations and individuals is generating positive as well as negative spillovers for various groups of stakeholders in both home and host countries. In consequence, they are focal points in the popular debate on the merits and dangers of globalisation, especially when it comes to developing and emerging economies.

According to Meyer(2004), understanding the role of MNCs in emerging economies is essential both for policymakers and for MNCs themselves. Policymakers are influencing the regulatory regime under which both MNCs and local business partners operate. They are interested in understanding how foreign direct investment (FDI) influences economic development and national welfare. The expectation that FDI will be beneficial to the local economy, has motivated many governments to offer attractive incentive packages to allure investors. The motivation is that the social benefits of inward FDI would exceed the private benefits of FDI, and investors would take into account only the latter when deciding over investment locations.

The Fortune Global 500 top 10 list by annual revenue

1. WalMart Stores (US) - $485.8bn
2. State Grid (China) - $315.1bn
3. Sinopec (China) - $267.5bn
4. China Natural Petroleum (China) - $262.6bn
5. Toyota Motor (Japan) - $254.7bn

6. Volkswagen (Germany) - $240.2bn
7. Royal Dutch Shell (Netherlands) - $240bn
8. Berkshire Hathaway (US) - $223.6bn
9. Apple (US) - $215.6bn
10. Exxon Mobil (US) - $205bn

Source: Fortune, July 2017

Breakdown by country

As of November 2017, this is the list of the top 10 countries with the most Global 500 companies.

Rank	Country	Companies
1	United States	132
2	China (including Hong Kong and Macau)	109
3	Japan	51
4	France	29
5	Germany	29
6	United Kingdom	21
7	South Korea	15
8	Netherlands	15
9	Switzerland	13
10	Canada	11

Source: Fortune, November 2017

4.7 Summary

This unit introduces you with the concepts of MNC. We began our discussion with the definition of an MNC. Then we tried to categorise MNCs. Next, the different reasons for the growth of MNCs have been discussed. Along with the economies of scale other factors such as non-transferable knowledge, market growth, product sourcing, product innovation, etc play a vital role in the growth of MNCs. Moreover, various channels

through which MNCs can enter the domestic market have been introduced. Furthermore, the advantages and disadvantages of MNCs to the home and host countries have been discussed in brief.

4.8 Self Assessment Questions

Long answer type:

1. Discuss the factors behind the growth of MNCs.
2. Narrate the channels through which an MNC can enter into a domestic market.
3. What are the advantages and disadvantages of MNC to the home country?
4. What are the advantages and disadvantages of MNC to the host country?

Short answer type:

1. What are the types of MNCs?
2. Define a Multinational Company.

Objective type:

1. What is the Geocentric approach?
2. What is meant by an affiliate?

Unit 5 ☐ Global Strategic Management

Structure

5.1 Objectives

5.2 Introduction

5.3 Concept of global strategic management

5.4 Framework for global strategy

5.4.1 Global Strategic Ambition

5.4.2 Global Strategic Positioning

5.4.3 Global Business System

5.4.4 Global Organisation

5.5 Concept of Competitiveness

5.6 Theories of Competitiveness

5.7 Twelve Pillars of Competitiveness

5.8 Porter's Diamond Model of Competitive Advantage

5.9 Summary

5.10 Self assessment Questions

5.1 Objectives

After studying this unit, you will be able to:

- know the meaning of global strategic management
- understand the framework for global strategy
- get an idea of competitiveness
- figure out the theories of competitiveness
- comprehend the pillars of competitiveness
- know Porter's diamond model of competitive advantage

5.2 Introduction

The global strategic management is intended to provide theoretical insights of strategy in a global perspective and to give some guidance as to how to deal with the realities of international business. Accordingly, this section provides an overview of the framework for global strategy, concept of competitiveness and its determinants and Porter's diamond model of competitive advantage. These concepts will be helpful to understand the different topics in the subsequent units.

5.3 Concept of Global Strategic Management

Global strategic management has emerged as a new field due to the rapid globalization of business. Globalization does matter to strategy creation due to the following reasons: (i) Multinational enterprises must be internally differentiated to respond to the environmental differences that exist in different business and geographic markets. (ii) Globalization involves the integration of corporate activities across borders. (iii) Global companies must understand customers from the perspective of both domestic and international standards and must have the ability to know the multiple locations far from the home base. Thus, global strategic management is nothing but a blend of strategic management and international business which develops worldwide strategies for global corporations. In order to understand this topic very meaningfully one must have a clear idea about strategy, strategic management and international business. Let us explain these concepts at the outset.

William F Glueek (1972) defined strategy as "a unified, comprehensive and integrated plan designed to assure that the basic objectives of the enterprise are achieved." Three adjectives were used by Glueek to define a plan and to make the definition adequate. 'Unified' means that the plan joins all the parts of an enterprise together, 'comprehensive' means it covers all the major aspects of the enterprise and 'integrated' means that all parts of the plan are compatible with each other .Thus, strategy is a plan of action that is adopted in order to achieve the objective(s) of the firm .Various other actions of the firm flow from the strategy. Strategy is a 'mother' plan of action or action principle for the firm. A business strategy is global when a company competes in the key market of the world and when the business system is made of integrated and co-ordinated activities across borders.

Pearce and Robinson defined strategic management as "the set of decisions and actions resulting in formulation and implementation of strategies designed to achieve the objectives of the enterprise". In other words, strategic management is a stream of decisions and actions which leads to development of an effective strategy or strategies to achieve corporate objectives (Glueek & Jauch,1984).

International business refers to business activities that involve the transfer of resources, goods, services, knowledge, skills or information across national boundaries. It is a cross-border business conducted in foreign country by crossing national boundary.

As global integration takes place between countries and companies due to international business, the managers and the strategy researchers will have to find new ways to deal with globalization. The global strategic management is intended to provide theoretical insights of strategy in a global perspective and to give some guidance as to how to deal with the realities of international business.

5.4 Framework for Global Strategy

A global strategy is the means by which an organisation defines its long-term objectives for the world market; builds, integrates and co-ordinates its business system to gain and sustain a global competitive advantage and enables an organisation to manage its operations worldwide. A global strategy consists of four major components: global strategic ambition, global strategic positioning, global business system, and global organisation which are elaborated in the following sub-sections.

Note: This section has been adopted from "Lasserre, P. (2003). Global Strategic Management, Palgrave Macmillan, 36–60.

5.4.1 Global Strategic Ambition

The global strategic ambition expresses the role an organisation wants to play in the world market place and how it views the future distribution of its sales and assets in the key regional clusters of the world. There are generally five types of role that a company plays in the world market as either global player or regional player or regional dominant global player or global exporter or global operator. These roles are discussed below:

A company whose ambition is to be a global player aspires to establish a sustainable competitive position in the key markets of the world and to build an integrated business system of designs spread over those key markets. For example, SONY, Unilever, Ericsson, Procter & Gamble etc would qualify for such a description of their role.

A regional player defines its role as to capture a strong competitive advantage in one of the key regions of the world e.g., North America, Europe or Asia etc. and to be a marginal or relatively weak competitor in the other parts. Fiat in automobiles, NEC or Barclays would be examples of such an ambition.

A regional dominant global player is a company whose role is more than a regional player but it is not yet selling across the key markets of the world.

A global exporter is a company whose role is to sell products manufactured or services operated in its home country across the key markets of the world and who builds foreign operations only to support the export drive. The major aerospace or defence companies like Boeing, Airbus and Raytheon can be classified into this category despite the fact that they have some supporting assets (maintenance, sales offices, etc.) outside their home region.

A global operator is a company that procures a large fraction of its product components in factories located outside its base market and which concentrates its sales in its domestic market. In such a case the ambition would hardly qualify as a global: however, many managerial issues of integration and co-ordination of activities, both in-house factories or long-term subcontracting, would be quite similar to those that a global company would have to face.

In order to assess the degree of global ambition exhibited by companies, one should look at their distribution of sales, assets and personnel. Ideally, a pure global company would exhibit three major characteristics:

- First, it would have a distribution of its sales proportional to the distribution of markets in its industry.
- Second, it would have a distribution of its assets and work force proportional to the distribution of markets in its industry.
- Third, it would manage its activities on an integrated and co-ordinated way across the globe.

In order to evaluate the extent to which a company has followed a global ambition, one can use two globalisation indices: the Global Revenue Index and the Global Capability Index. The **Global Revenue Index** (GRI) is calculated by taking the ratio of the company distribution of sales in the major world regions to the industry distribution of demand in the same regions. The **Global Capability Index** (GCI) is calculated in a similar way, but instead of taking the distribution of sales, one takes the distribution of *assets for capital*

intensive industries or else of *personnel*. If one combines the GCI and the GRI in one chart, we obtain a mapping of the *global ambition of players.* A company low in both GRI and GCI would be a **Regional Player**, a company low in GRI and high in GCI would be a **Global Operator**, a company low in GCI and high in GRI would be a **Global Exporter** while a company high in both dimensions would be a **Global Player** and a company with an average score in both dimensions would be a **Regional Dominant Global Player**. As part of the strategy formulation process, companies can use the global indices to analyse their position and set their global ambition.

5.4.2 Global Strategic Positioning

Global positioning consists of two types of choices: (i) the *choice of countries* in which the company wants to compete and the role that those countries have to play in the global country portfolio; (ii) the various *value propositions* for the product or services of the company, corresponding to the type of segments and countries in which the company wants to compete.

Choice of countries

Depending on the industries, countries differ in the opportunities they offer to companies for their strategic development. Some countries, given their size, growth or the quality of their human, natural or locational resources, are critical for companies' long-term competitiveness. Those countries are qualified as **key countries**. For example, Europe, North America and Asia are the three regional clusters that a global player would consider, but within those clusters some countries are more important than others, and should be given priority. In Asia, for instance, in the automobile sectors, Japan, Korea and, in the future, China can be considered as key countries. In Europe, Germany and, to a certain extent, the United Kingdom or France are also key countries.

The second category of countries consists of countries that exhibit a high growth rate, making them strategically attractive in the near future. Those are the **emerging countries**. China, India, Brazil, Poland in the early twenty-first century generally qualify for that definition but, again, it is difficult to generalise since opportunities are industry-specific.

The **platform countries** constitute a third category. These are the countries which, because of locational advantage, good logistical, financial, regulatory and legal infrastructure or qualified personnel, can serve as a 'hub' for setting up regional centres, global factories that are 'platforms' for further development. Singapore, Hong Kong, Ireland or Taiwan present these characteristics.

A fourth category would be the **marketing countries**, where the attractiveness of the market is good, without being as strategically critical as for the key countries. The type of presence in such countries should be assessed on its own merits, depending on the political, economic and business context.

Countries with a strong resource base but limited market prospects would be classified as **sourcing countries**; for instance, Malaysia for rubber or Saudi Arabia for petroleum. Typically, a global company will control a portfolio of operations in these different categories of countries. The benefit of such categorisation is to establish *priorities* in investments and to guide *entry strategies*.

Value proposition

The value proposition is the definition of a customer's *value attributes* that the company is offering to the market. It implies:

- Choice of value attributes
- Choice of customer segments
- Choice of degree of world standardisation of the product/service offering.

Value attributes are the elements of the products or services that customers value when making their purchasing decision. Those include the product design, functionality, performance, quality, customisation and price, as well as the related service, the brand, the availability and other features. The set of those attributes for a particular group of customers and a particular product or service is the customer's value curve. Michael Porter has identified two 'generic' strategies corresponding to two types of value attributes:

(a) A proposition based on value-enhancing attributes such as performance, quality, service, customisation. Porter calls this type of value attribute as *differentiated.*

(b) A proposition based on price for standardised products or services. Porter calls this type c*ost leadership*. The same typology can apply to global positioning: the company can either position itself as a **global differentiator** or a **global cost leader**.

Customer segments are the groups of customers that have *similar value curves*. Those customer groups can be identified by income level, geographical location, age, socio-psychometric attributes in consumer goods and service industries or by industry, size, purchasing behaviour in business-to-business industries (B2B). The strategic choice at this level will be to decide whether the company concentrates its segmentation on one

or two customer groups, a positioning that Michael Porter qualifies as *Focused*, or whether it attempts to embrace many or all customer segments, a positioning qualified as *Broad*.

The third component of a value proposition is the choice between a standardised versus an adaptive-value proposition across countries. If one adopts a similar or standardised value attribute to the same type of customer segments across the globe, the approach will be qualified as *Standard*; if one tries to differentiate value attributes and segments according to the country or regions, the approach will be qualified as *Adaptive*.

Then the company's value proposition will consist of trying to identify the customer groups it wants to serve (Focused or Broad), the type of value attribute it wants to offer (Cost versus Differentiation) to those customers, and whether it is homogeneous or not across country (Standardised versus Adaptive). Coca Cola, Swatch or SONY, for instance, have a standard value proposition across the globe and serve similar segments. Unilever and Procter & Gamble adjust their value proposition and their segmentation in different countries.

The strategic choice of a value proposition dictates the type of capabilities that are needed to compete globally, and therefore the type of *business system* in which the company needs to invest.

5.4.3 Global Business System

A global business system decomposes the company value chain into elements which are spread and integrated across the world. It involves building and developing capabilities to compete successfully on the global market space in accordance with the positioning that has been already determined.

A company *value chain* is the set of activities that a company employs in order to design, produce and deliver the value proposed to the customer. Each company has a different value chain according to the type of industry in which it operates and the degree of vertical integration it has adopted.

However, one can distinguish three major generic components of a value chain:

(a) *Innovative activities*: R&D, knowledge, creation, design

(b) *Productive activities*: procurement, manufacturing, back office, operations, logistics

(c) *Customer relationship activities*: marketing, sales, distribution, customer services.

In each of these activities, the company deploys resources, assets and competencies.

Global capabilities are embodied in a business system deployed in various countries. In order to be competitive the company should be able to leverage some of its competitive advantages across countries. Competitive advantages are capabilities that are difficult to replicate or imitate and are non-tradable. Generally one can distinguish between two types of capabilities leading to competitive advantages:

(a) Capabilities leading to an increase in customer value through performance, quality and brand services, leading to a *Differentiated* value proposition

(b) Capabilities leading to a lower cost base, such as low-cost labour, low-cost sourcing, economies of scale in production, efficiency, leading to a *Cost leadership* value proposition.

Competitive advantage, in order to be valuable, needs to be long-lasting or sustainable. One can generally mention three ways of achieving sustainability:

(a) Customer loyalty

(b) Positive feedbacks

(c) Pre-emption of capabilities.

Customer loyalty creates sustainability when customers keep coming back to a company by choice, because the product or service provided to them is *unique* or more valuable than competition. It can also be due to a *brand* that has imprinted an association of uniqueness to the product or service in the mind of the customer. It can also be due to *high switching costs* that customers would incur if they changed products or services: in that case the customer is *locked-in*. Coca Cola is the most characteristic example of sustainable competitive advantages coming from a strong brand. A high switching costs example is given by Microsoft, whose operating system is so dominant that a customer wishing to shift to a competitive system like Linux or Apple would have tremendous application software adaptation costs.

Positive feedbacks are advantages that follow the logic of ‘success brings success’ and produce *increasing returns*. There are two kinds of positive feedback: ‘network externalities’ and ‘experience effects’.

Network externalities exist when the customer base of a product or service is such that it induces other products or service providers to adopt it in their own value proposition. For example, Microsoft Office followed the same path: more software available with Windows or more users of Microsoft Office attract more customers to buy Windows personal computers and to become users of Microsoft Office which in turn induces more Windows-based software, thereby attracting more customers.

Experience effects exist when accumulated volume reduces costs or increases customer benefits in such a way that the competitors, being ahead in accumulated volume, can use their lower cost base or customer value advantage to eliminate weaker competitors, which, in turn, helps them to accumulate more volume which then helps them to eliminate more competitors, etc. The Boston Consulting Group (BCC) in the early 1970s developed the theory of the 'experience curve', a modern version of the 'learning curve' discovered in the 1930s by aerospace engineers, demonstrating that the cost of production in standard products or services decreases by a fixed percentage each time the accumulated volume of production doubles. Based on this law, they suggested that, for standard products, competitive strategies should be based on a race for accumulated volume that would ultimately lead the larger competitor to achieve a *sustainable dominant profitable competitive position*. Although the experience curve theory has been criticised for its simplistic assumptions (it applies mainly to standard products in price-sensitive markets), it has proven to be a powerful competitive advantage in many industrial or service sectors such as chemical products, electronic components or automotive parts.

Pre-emption of capabilities is a type of competitive advantage based on the appropriation by one company of key resources or assets that competitors will find difficult to access, or to the development of competencies that are 'time incompressible'. Appropriation of resources or assets applies to the privileged access to natural resources such as location or mining concessions. It may apply to access to skills and talents when they are in limited supply, as is the case in many emerging markets such as the Internet-related sectors. It may apply to the right to do business, such as the obtaining of licences, as in telecommunications, or landing rights in air transport. *Patenting* is a form of pre-emption since it gives the patent holder a period during which it has the proprietary right to exploit the patent. It applies to distribution networks, partnerships or access to favourable locations, as in the retail or hospitality industries.

Building sustainability

One of the key elements of any strategy is to be able to *create* and *exploit* sustainable competitive advantages. For global firms, the central issue is to be able to utilise their existing advantages in multiple-country leverages in order to compete successfully with local players and other global competitors. This can be done in two ways:

(a) By being among the first competitors to enter a given market: *first-mover advantages*.

(b) By exploiting capabilities already built up in other countries in order to displace and dominate existing competitors: *leveraging advantages*.

During the process of globalisation, companies progressively split their value chain by spreading their activities across the world. The first stage is the *export stage* in which the only elements of the value chain which are set up in foreign countries are the sales, and even then not through direct investment but through local distributors, agents or licensing. The only possible direct investment at this stage, if the size of the market justifies it, is the creation of a representative office in one country or a regional office for a group of countries.

The second stage is to invest in *marketing subsidiaries* actively to manage the marketing mix. Those subsidiaries are staffed with expatriates plus local recruits and their role is to co-ordinate the activities of the distributors, organise the promotion, set up logistics and service centres and, in some cases, some operational facilities, such as testing laboratories or assembling operations to support the sales effort. Those marketing subsidiaries may eventually take over the local distributors. When the market justifies or when local governments require a localisation of value adding activities, companies invest in manufacturing or operational facilities for the service sectors. Some R&D facilities may be localised as well, in order to adapt products or services to local conditions. These foreign investments are made either as wholly owned subsidiaries or joint ventures or acquisitions of local firms. At this stage, as the number of those investments increases, the company is a multinational, managing a portfolio of relatively independent worldwide subsidiaries.

During the final stage of globalisation, multinational companies feel the competitive need to integrate and co-ordinate their worldwide operations to take advantage of economies of scale, transfer of know-how and resource optimisation. This leads to an

interlocked set of value chain activities which falls broadly into three categories: the activities which have a global role to serve the whole world (*global activities*, such as global research centres, or global plants), those which have a regional role (*regional activities*) and those which are purely local (*local activities*).

In the process of globalisation, companies may usually need to acquire and complement their capabilities by setting up *partnerships*. Strategic alliances for globalisation can take several forms:

(a) *Global alliances* whose role is to pool complementing capabilities to reach world markets, or to achieve a critical mass in R&D. The most usual examples of world market partnerships are the airlines alliances such as Star or One- World, or Concert in the telecoms sector between BT and ATT. R&D global alliances are frequent in aerospace, life sciences, electronic defence industries or oil exploration.

(b) *Partnerships for market entry*, joint ventures, franchises or licensing, whose role is to comply with local government requirements (as has been the case in China) or to facilitate entry or minimise risks in a particular country.

(c) *Acquisitions* that from an ownership point of view, are not partnerships, since one party takes over the other, but from a management point of view can be assimilated to an alliance since different national and corporate cultures have to be combined. Acquisitions may have either a global or a local scope.

5.4.4 Global Organisation

The final element of a global strategy is the design of an *organisational architecture* which is able to support and implement the global ambition, global positioning and global business system. Here, we will limit our comments to the key elements of choices that may be considered during the strategy formulation process.

Stopford and Wells (1972), Heenan and Perlmutter (1979), Prahalad and Doz (1987), and Bartlett and Ghoshal (2000) have identified different types of structures, systems and cultures in the management of global firms. These different organisational choices have been mapped by Doz and Prahalad in what they call the Integration/Responsiveness Grid. The choice of an adequate organisational model is contingent upon the following factors:

(a) The nature of the *competitive context in the industry*: The more ‘global’ is the industry, the more integrated and co-ordinated the activities and the more the

organisational structure should reflect this integration. The world functional or the global business structure or the matrix structure fulfils this requirement.

(b) The *strategic positioning* adopted by the firm: A standardised positioning using cost leadership as a competitive advantage will require a tightly integrated organisation such as the world functional or the global business structure.

Companies engaged in global business have to cope with a dual requirement:

(a) They need efficiently to introduce and leverage their competitive advantages across borders; consequently their organisational design demands a certain degree of *co-ordination and centralisation.*

(b) They need to adapt to local conditions; consequently their organisational design demands a certain degree of *decentralisation and local autonomy*.

Organisational design reflects the way companies put this dual demand into action through the implementation of three interlocked elements:

(a) *Organisational structure*: how roles, responsibilities and powers are assigned.

(b) *Organisational processes*: how decisions are made, resource allocation commitments decided, policies enacted and rewards, sanctions and control exercised. Organisational processes include information processes, decision-making processes, planning and control processes and performance evaluation processes.

(c) *Organisational culture*: the shared values and the dominant logic of doing business'; the 'dos' and 'don'ts' and what kind of behaviour is rewarded or sanctioned'.

Based on the work of prior research, three generic organisational models are identified:

- Global hub: a worldwide functional or global product structure
- Confederation: a multinational geographical structure
- Multidimensional: a matrix or transnational structure.

A variety of structures is derived from these three generic models. It can be argued that there is no single best structure and that the adoption of a particular structure is contingent upon the competitive imperative.

5.5 Concept of Competitiveness

In order to understand the concept of competitiveness, let us consider some definitions of competitiveness offered by the experts and forums in this field:

Krugman [1990, 1994]: If competitiveness has any meaning, it is simply just another way to express productivity. The ability of a country to improve its living standard depends almost entirely on its ability to raise its productivity. Competitiveness is meaningless word when applied to national economies.

Porter [1990]: The only meaningful concept of competitiveness at the national level is national productivity. Competitiveness is an ability of an economy to provide its residents with a rising standard of living and a high employment on a sustainable basis. Porter (1990) suggests that competition and the seeking of competitiveness can be a win-win game, favouring all parties taking part in the race.

OECD [1992]: The OECD defines competitiveness as the degree to which a state may produce goods and services that should pass the test of international competition, and in the same time to maintain and develop its incomes at national level.

World Economic Forum [1996]: Competitiveness is the ability of a country to achieve sustained high rates of growth in GDP per capita.

European Commission [2001]: Competitiveness of a nation is the ability of an economy to provide its population with high and rising standards of living and high rates of employment on a sustainable basis.

Adamkiewicz-Drwi^{33}o [2002]: The competitiveness of a company means adapting its products to the market and competition requirements, particularly in terms of product range, quality, price as well as optimal sales channels and methods of promotion.

Ajitabh, Momaya [2004]: Competitiveness of a firm is its share in the competitive market.

Porter et al. [2008]: The most intuitive definition of competitiveness is a country's share of world markets for its products. This makes competitiveness a zero-sum game, because one country's gain comes at the expense of others.

Chao-Hung, Li-Chang [2010]: A firm's competitiveness is its economic strength against its rivals in the global marketplace where products, services, people and innovations move freely despite the geographical boundaries.

Altomonte et al. [2012] : External or international competitiveness is the ability to exchange the goods and services that are abundant in home country for the goods and services that are scarce in this country.

From the analysis of the above definitions, it follows that competitiveness can be viewed from two perspectives- micro and macro. In the microeconomic approach, the competitiveness of goods and the competitiveness of firms are analysed. The competitiveness of goods and services mainly depends on their quality and price. These two elements have the greatest influence on the sales volume. However, other activities like market research, advertising, customer relations, distribution channels, customer support also contribute to the competitiveness.The competitiveness of firms is based on their ability to make profits, which, on the other hand, is largely determined by the competitiveness of their goods and services. Other factors contributing to the competitiveness are: the ability to increase the market share, corporate image and brands, the ability to access financial resources (Szentes, 2012; Wach, 2014).

The concept of macro-level competitiveness or national competitiveness is twofold. On the one hand, macro competitiveness shows the ability of a country to sustain a high level of national income and a favourable position in the world economy. On the other hand, it shows the ability of a country to create a business environment in which the local firms and businesses are able to compete internationally. Porter (1990) went even further by saying that the competitiveness of a nation is equal to the competitiveness of its firms.

The two best known measurement methods developed by the World Economic Forum (WEF) and the International Institute for Management Development (IMD) reflect this interdependency between micro and macro-level competitiveness. The Global Competitiveness Index (GCI, developed by WEF) is based on 12 pillars all consisting of several factors, but the pillars either characterise the macro competitiveness (e.g. institutions, infrastructure, macroeconomic environment, market size, education, health care), and micro competitiveness (e.g. labour market, financial market, market of goods, technology and

innovation). The World Competitiveness Index (WCI, developed by IMD) has 4 main factors, but again, these factors are either macroeconomic in nature (e.g. economic performance, government intervention and infrastructure), or can directly be related to the businesses (Business efficiency).

5.6 Theories of Competitiveness

Theories of competitiveness range from the macro-perspective to micro- perspective. An overview of these theories has been provided in the Table 4.1.

Table 4.1: Theories of Competitiveness

Concept/Theory	Representative	Main Issues
Classical concepts and theories		
Concept of invisible hand	Adam Smith	Each party involved in international free trade can gain benefits by specializing in the production of goods in which it holds an absolute advantage. So, let every country export those goods it produces at the lowest costs and import those goods it produces at the highest costs.
Comparative advantage concept	David Ricardo	A country can benefit from foreign trade even if it lacks any absolute advantage over its trade partners in the goods' production. It only needs to have relative advantage in any good in order to sell it abroad.
Heckscher-Ohlin trade theory (natural resource abundancetheory)	Eli Heckscher Bertil Ohlin	A country will specialize in producing and exporting those commodities which require relatively intensive use of locally abundant factors of production. Relatively capital-abundant country will export capital-intensive commodities while relatively labour-abundant country will export labour-intensive commodities.

Neoclassical, Austrian and institutional concepts and theories of competitiveness		
Theory of effective (workable) competition	John M. Clark	Competitive advantage is driven by innovations introduced by the company. Innovations motivate firms to compete aggressively in order to obtain competitive advantage, which in turn leads to technological progress and economic growth at the macro-level.
Theory of marketing behaviour	Wroe Alderson	There are six potential sources of a firm's competitive advantage: market segmentation, a way of communication (i.e. promotion and advertising) and reaching out to the customers (choice of distribution channel), product development, process improvement, and product innovations.
Austrian schooltheory	Ludwig von Mises	Market competition is an automatic dynamic process and not a specific market structure. The tendency towards market equilibrium is the result of entrepreneurial activity. An enterprise wins or loses in competition depending on the strength of its capabilities and the degree it offers match the market needs.
Evolutionary economics	Joseph A. Schumpeter	Crucial to long-term survival of firms in the marketplace is their constant adjustment to changing environment, mainly due to searching out new innovative recombination of the garnered resources.
Theory of entrepreneurship and innovations	Joseph A. Schumpeter	The company's ability to innovate is a key for achieving competitive advantage over its rivals. The ability to create new solutions and

		the predisposition to take risks associated with testing them in the market underline the competition process and entrepreneurship. Differences both in the level of innovative capacity and entrepreneurship result in differences in the competitive position of any economic agent.
Institutional economics streams	Friedrich List Max Weber James Buchanan	In addition to economic factors, one's competitiveness is affected by social institutions such as public authorities, trade unions, financial institutions, socio-political organizations, ownership and organizational structures and mental habits, rules and codes of conduct.
Contemporary concepts and theories of competitiveness		
Krugman's concept of competitiveness	Paul R. Krugman	Productivity growth is the main driver of competitiveness. International competitiveness of countries is associated with their high standard of living
Porter's theory of competitiveness	Michael E.Porter	Competitiveness depends on long run productivity, which requires a business environment that supports continual innovation in products, processes and management. The four underlining conditions driving the global competitiveness of country's companies include: factor endowments, demand conditions, related and supporting industries (clusters), and the firm's strategy, structure and rivalry.

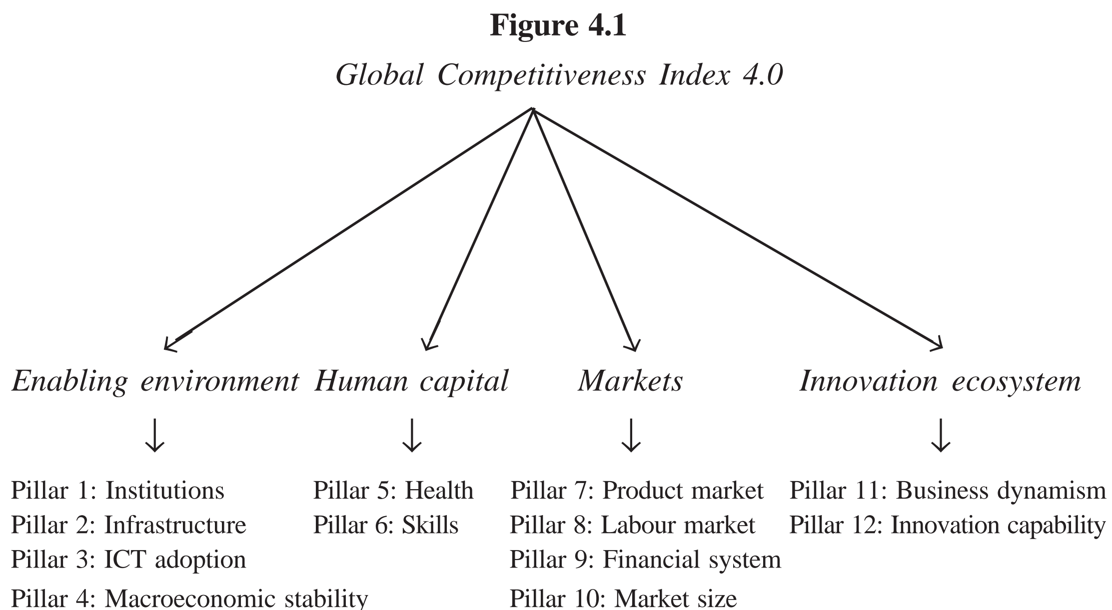
Note: This section has been adopted from "Competitiveness in The Economic Concepts, Theories and Empirical Research" by Tomasz Siudek and Aldona Zawojska; *Oeconomia 13 (1) 2014, 91–108*

5.7 Twelve Pillars of Competitiveness

This section presents a short description of each pillar of the Global Competitiveness Index. World Economic Forum (WEF) defines competitiveness as the set of institutions, policies, and factors that determine the level of productivity of a country. The level of productivity, in turn, sets the level of prosperity that can be reached by an economy. The productivity level also determines the rates of return obtained by investments in an economy, which in turn are the fundamental drivers of its growth rates. In other words, a more competitive economy is one that is likely to grow faster over time.

The Global Competitiveness Index 4.0 evaluates the factors that collectively determine the level of a country's productivity—the most important driver of long-term improvements in living standards. The factors are organized into 12 pillars, and for presentation purposes they are grouped into four categories (*viz.* Enabling environment, Human capital, Markets and Innovation ecosystem) as shown in Figure 4.1

Figure 4.1



The development of the GCI 4.0 has been guided by the emergence of new fundamental changes in the functioning of national economies with the advent of the Fourth Industrial Revolution (4IR). According to WEF, successful economies in the 4IR era need to:

- Be **resilient**, building buffers and economic mechanisms to prevent financial crises or mass unemployment and to respond to external shocks.
- Be **agile**, embracing change rather than resisting it. Companies, public policy-makers and workers should be able to quickly adapt how they operate and to take advantage of the opportunities to produce goods or provide services in new ways.
- Build an **innovation ecosystem** where innovation is incentivized at all levels and all stakeholders contribute to create the best conditions for new ideas to emerge, to be financed and commercialized as new products and services.
- Adopt a **human-centric approach** to economic development. This means that human capital is essential for generating prosperity and any policy that adversely affects human factors' potential will reduce economic growth in the long run. As a consequence, policy-making will have to ensure that the speed of change and the introduction of new technologies ultimately translate into better living conditions.

WEF opines to look at the 12 pillars through the lens of the four meta- concepts: resilience, agility, innovative ecosystems and a human-centric approach. Looking at the GCI from this perspective enables to interpret the pillars as 4IR-readiness measures.

The concept of **resilience** is reflected in the Financial system pillar (pillar 9), which includes measures to minimize the risk of a financial meltdown and resources to adjust to external shocks. By the same token, the Macroeconomic stability pillar (pillar 4) captures the extent to which a country's public sector can provide appropriate counter-cyclical measures and invest in projects that the private sector cannot finance. Similarly, the Skills pillar (pillar 6) captures workers'capacity to learn and adapt to changing circumstances.

The concept of **agility** is present in the domestic market competition and entrepreneurial culture sub-pillars of the GCI because they imply greater capacity for "creative destruction, allowing innovative companies to emerge against incumbents and rewarding a risk-taking attitude. In addition, the concept is present in the public-sector performance sub-pillar: low levels of bureaucracy make it easier for businesses to re-organize and re-invent themselves when legal formalities are not taxing. Labour market flexibility (another sub-pillar) implies agility through easier re-allocation of talent across sectors and firms.

The **innovation ecosystem** encompasses all pillars. Although business dynamism and innovation capability are the factors impacting innovation more directly, these need to be

complemented by high levels of human capital (health, education and skills); optimal allocation of skills (labour market functioning); and availability of venture capital and ad-hoc financial products (financial system development). A strong innovation ecosystem also presumes sound infrastructure, ICT readiness and institutions that allow ideas to flow and protect property rights, and a large market size that incentivizes the generation of new ideas.

The **human-centric approach** to development is embodied by the health (pillar 5) and skills (pillar 6) pillars, which together account for one-sixth of the total GCI score and take a broad approach to human capital: health is thought of as a state of complete physical, mental and social well-being, not merely the absence of disease or disabilities; education measures the skills humans need to thrive in the 4IR. The labour market pillar (pillar 8) includes measures of talent reward and respect of workers' rights, while the innovation capability pillar (pillar 12) includes measures that capture human collaboration, interaction and creativity.

Let us give an overview of these twelve pillars of competitiveness:

Pillar 1: Institutions

Pillar 1 captures security, property rights, social capital, checks and balances, transparency and ethics, public-sector performance and corporate governance. By establishing constraints, both legal (laws and enforcement mechanisms) and informal (norms of behaviours), institutions determine the context in which individuals organize themselves and their economic activity. Institutions impact productivity, mainly through providing incentives and reducing uncertainties.

Pillar 2: Infrastructure

Pillar 2 captures the quality and extension of transport infrastructure (road, rail, water and air) and utility infrastructure. Better-connected geographic areas have generally been more prosperous. Well-developed infrastructure lowers transportation and transaction costs, and facilitates the movement of goods and people and the transfer of information within a country and across borders. It also ensures access to power and water—both necessary conditions for modern economic activity.

Pillar 3: ICT adoption

Pillar 3 captures the degree of diffusion of specific information and communication technologies (ICTs). ICTs reduce transaction costs and speed up information and idea

exchange, improving efficiency and sparking innovation. As ICTs are general purpose technologies increasingly embedded in the structure of the economy, they are becoming as necessary as power and transport infrastructure for all economies.

Pillar 4: Macroeconomic stability

Pillar 4 captures the level of inflation and the sustainability of fiscal policy. Moderate and predictable inflation and sustainable public budgets reduce uncertainties, set returns expectations for investments and increase business confidence—all of which boost productivity. Also, in an increasingly interconnected world where capital can move quickly, loss of confidence in macroeconomic stability can trigger capital flight, with destabilizing economic effects.

Pillar 5: Health

Pillar 5 captures health-adjusted life expectancy (HALE)—the average number of years a newborn can expect to live in good health. Healthier individuals have more physical and mental capabilities, are more productive and creative, and tend to invest more in education as life expectancy increases. Healthier children develop into adults with stronger cognitive abilities.

Pillar 6: Skills

Pillar 6 captures the general level of skills of the workforce and the quantity and quality of education. While the concept of educational quality is constantly evolving, important quality factors today include: developing digital literacy, interpersonal skills, and the ability to think critically and creatively. Education embeds skills and competencies in the labour force. Highly educated populations are more productive because they possess greater collective ability to perform tasks and transfer knowledge quickly, and create new knowledge and applications.

Pillar 7: Product market

Pillar 7 captures the extent to which a country provides an even playing field for companies to participate in its markets. It is measured in terms of extent of market power, openness to foreign firms and the degree of market distortions. Competition supports productivity gains by incentivizing companies to innovate; update their products, services and organization; and supply the best possible products at the fairest price.

Pillar 8: Labour market

Pillar 8 encompasses "flexibility", namely, the extent to which human resources can be reorganized and "talent management", namely, the extent to which human resources are leveraged. Well-functioning labour markets foster productivity by matching workers with the most suitable jobs for their skill set and developing talent to reach their full potential. By combining flexibility with protection of workers' basic rights, well-functioning labour markets allow countries to be more resilient to shocks and re-allocate production to emerging segments; incentivize workers to take risks; attract and retain talent; and motivate workers.

Pillar 9: Financial system

Pillar 9 captures the depth, namely the availability of credit, equity, debt, insurance and other financial products, and the stability, namely, the mitigation of excessive risk-taking and opportunistic behaviour of the financial system. A developed financial sector fosters productivity in mainly three ways: pooling savings into productive investments; improving the allocation of capital to the most promising investments through monitoring borrowers, reducing information asymmetries; and providing an efficient payment system. At the same time, appropriate regulation of financial institutions is needed to avoid financial crises that may cause long-lasting negative effects on investments and productivity.

Pillar 10: Market size

Pillar 10 captures the size of the domestic and foreign markets to which a country's firms have access. It is proxied by the sum of the value of consumption, investment and exports. Larger markets lift productivity through economies of scale: the unit cost of production tends to decrease with the amount of output produced. Large markets also incentivize innovation. As ideas are non-rival, more potential users means greater potential returns on a new idea. Moreover, large markets create positive externalities as accumulation of human capital and transmission of knowledge increase the returns to scale embedded in the creation of technology or knowledge.

Pillar 11: Business dynamism

Pillar 11 captures the private sector's capacity to generate and adopt new technologies and new ways to organize work, through a culture that embraces change, risk, new business models, and administrative rules that allow firms to enter and exit the market

easily. An agile and dynamic private sector increases productivity by taking business risks, testing new ideas and creating innovative products and services. In an environment characterized by frequent disruption and redefinition of businesses and sectors, successful economic systems are resilient to technological shocks and are able to constantly re-invent themselves.

Pillar 12: Innovation capability

Pillar 12 captures the quantity and quality of formal research and development; the extent to which a country's environment encourages collaboration, connectivity, creativity, diversity and confrontation across different visions and angles; and the capacity to turn ideas into new goods and services. Countries that can generate greater knowledge accumulation and that offer better collaborative or interdisciplinary opportunities tend to have more capacity to generate innovative ideas and new business models, which are widely considered the engines of economic growth.

Note: This section has been adopted from "The Global Competitiveness Report 2018" by Klaus Schwab (ed.), World Economic Forum, 37–42.

5.8 Porter's Diamond Model of Competitive Advantage

In 1990, Michael Porter in his well-known book, *The Competitive Advantage of Nations*, attempts to determine why some nations succeed and others fail in international competition. Porter and his team look at 100 industries in 10 nations and make an important contribution to existing literature on trade. Porter's work is based by a belief that existing theories of international trade tell only part of the story. The essential task of Porter is to explain why a nation achieves international success in a particular industry. Why does Japan do so well in the automobile industry? Why does Switzerland excel in the production and export of watch? Why do Germany and the United States do so well in the chemical industry? Why do Italian companies do so well in the tile industry? These questions cannot be answered easily by the Heckscher-Ohlin theory and the theory of comparative advantage offers only a partial explanation. The theory of comparative advantage would say that Switzerland excels in the production and export of watch because it uses its resources very productively in this industry. Although this may be correct, this does not explain why Switzerland is more productive in this industry than Great Britain, Germany or Spain. Porter tries to solve this puzzle.

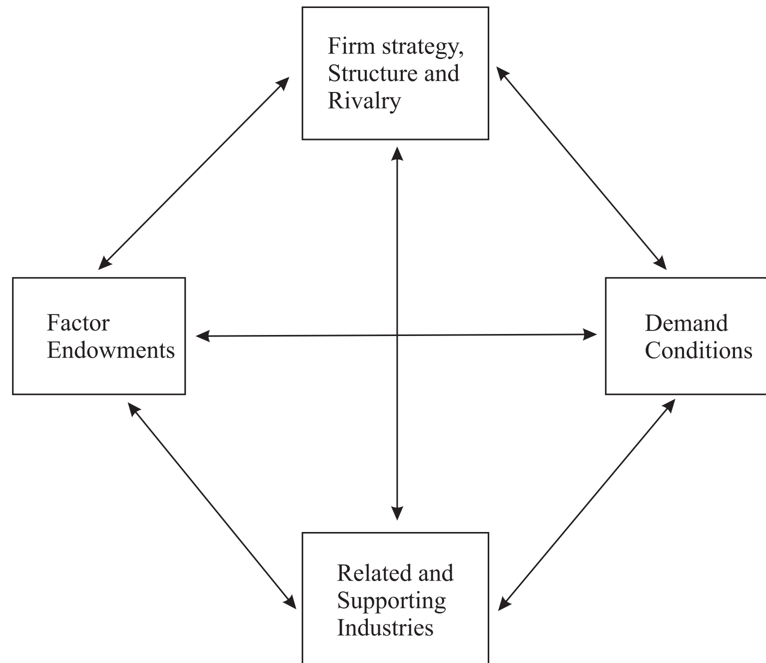


Figure: 4.2: Porter's diamond: Determinants of National Competitive Advantage

Porter theorizes that four broad attributes of a nation shape the environment in which local firms compete and these attributes promote the creation of competitive advantage. In the format of a figure this looks like a diamond and hence it is termed as Porter's diamond (refer to Figure 4.2).

Porter's four attributes of national competitive advantage are as follows:

1. *Factor Endowments:* It implies a nation's position in factors of production such as skilled labour or the infrastructure necessary to compete in a given industry. The argument of factor endowments is similar to Heckscher-Ohlin theory. Actually Porter does not propose anything radically new, but he analyses the characteristics of factors of production. He recognizes hierarchies among factors, distinguishing between basic factors (e.g., natural resources, climate, location, and demographics) and advanced factors (e.g., communication infrastructure, sophisticated and skilled labour, research facilities and technological know-how). He argues that advanced factors are the most significant for competitive advantage. Unlike the naturally endowed basic factors, advanced factors are a product of investment by individuals, companies and governments. Thus, government investments in basic and higher education, by improving the general

skill and knowledge level of the population and by stimulating advanced research at higher education institutions, can upgrade a nation's advanced factors. For example, in India it is the large production of engineering graduates that has given the country to its' competitive advantage in IT services.

The relationship between advanced and basic factors is complex. Basic factors can provide an initial advantage that is subsequently reinforced and extended by investment in advanced factors. Conversely, disadvantages in basic factors can create pressures to investment in advanced factors. For example, Japan, a country that lacks arable land and mineral deposits and yet it through investment has built a substantial endowment of advanced factors. Porter notes that Japan's large pool of engineers has been vital to Japan's success in many manufacturing industries.

2. *Demand Conditions:* It implies the nature of home demand for the industry's product or service. According to Porter, the home demand plays an important role in upgrading competitive advantage. Firms are typically more sensitive to the needs of their closest customers. Thus, the characteristics of home demand are particularly important in shaping the attributes of domestically made products and creating pressures for innovation and quality. Porter argues that a nation's firms gain competitive advantages if their domestic customers are sophisticated and demanding. Such consumers pressure local firms to meet high standards of product quality and to produce innovative products. Porter notes that Japan's sophisticated and knowledgeable buyers of cameras helped to stimulate the Japanese camera industry to improve product quality and to introduce innovative models.

3. *Related and Supporting Industries:* It implies the presence or absence of supplier industries and related industries that are internationally competitive. The benefits of investments in advanced factors of production by related and supporting industries can spill over into an industry, thereby helping it to achieve a strong competitive position internationally. For example, Swedish strength in fabricated steel products (e.g., ball bearings and cutting tools) has drawn on strengths in Sweden's steel industry. Similarly, Switzerland's success in pharmaceuticals is closely related to its previous international success in the technologically related dye industry. One consequence of this process is that successful industries within a country tend to be grouped into clusters of related industries. This was one of the most pervasive findings of Porter's study.

4. *Firm Strategy, Structure and Rivalry:* It implies the conditions governing how companies are created, organised and managed and the nature of domestic rivalry. Porter makes two important points here. First, different nations are characterized by different management ideologies, which either help them or do not help them to build national competitive advantage. For example, Japanese are known for manufacturing, Germans for engineering and Americans for research and development. When Americans try to compete on manufacturing, the chances are that they may not succeed like Japanese. Thus, Just-in-Time and lean manufacturing would not be expected to benefit American firms as much as the design and development and introduction of new products into the market. A nation has to check as to which strategy is more suitable to it.

   Porter's second point is that there is a strong association between vigorous domestic rivalry and the creation and persistence of competitive advantage in an industry. Vigorous domestic rivalry induces firms to look for the ways to improve efficiency, which makes them better international competitors. Domestic rivalry creates pressures to innovate, to improve quality, to reduce costs, and to invest in upgrading advanced factors. All this helps to create world-class competitors.

Porter speaks of these four attributes as constituting the diamond. He argues that firms are most likely to succeed in industries or industry segments where the diamond is most favourable. He also argues that the diamond is a mutually interacting system. The effect of one attribute is contingent on the state of others. For example, Porter argues that favourable demand conditions will not result in competitive advantage unless the state of rivalry is sufficient to cause firms to respond to them. Unless the demand conditions are favourable, the factor endowments will not produce the competitive advantage. If supporting industries do not exist adequately, a nation with all other determinants available to it, will not develop competitive advantage.

Porter maintains that two additional variables can influence the national diamond significantly: chance and government. Chance events, such as major innovations, can reshape industry structure and provide the opportunity for one nation's firms to replace another's. Government, by its choice of policies, can detract from or improve national advantage. For example, regulation can alter home demand conditions, government investments in education can change factor endowments, etc.

If Porter is correct, we would expect his model to predict the pattern of international trade that we observe in the real world. Countries should export products from those

industries where all four components of the diamond are favourable, while import in those areas where the components are not favourable. However, Porter's theory has not yet been subjected to independent empirical testing. Much about the theory rings true, but the same can be said for the new trade theory, the theory of comparative advantage and the Heckscher-Ohlin theory. It may be that each of these theories, which complement each other, explains something about the pattern of international trade.

5.9 Summary

- Global strategic management is nothing but a blend of strategic management and international business which develops worldwide strategies for global corporations. The global strategic management is intended to provide theoretical insights of strategy in a global perspective and to give some guidance as to how to deal with the realities of international business.
- William F Glueek (1972) defined strategy as "a unified, comprehensive and integrated plan designed to assure that the basic objectives of the enterprise are achieved."
- Pearce and Robinson defined strategic management as "the set of decision and action resulting in formulation and implementation of strategies designed to achieve the objectives of the enterprise".
- Conducting business by crossing national boundary (i.e., international business) could itself be a strategy for a firm. Firm can take its unique product in terms of design, utility, quality or cost or skills or core competence or brand to other countries where these are not available. Accordingly, these firms grow considerably higher in all dimensions and earn greater profit than the domestic market.
- A global strategy consists of four major components: global strategic ambition, global strategic positioning, global business system, and global organisation.
- The global strategic ambition expresses the role an organisation wants to play in the world marketplace and how it views the future distribution of its sales and assets in the key regional clusters of the world. There are generally five types of role that a company plays in the world market as either global player or regional player or regional dominant global player or global exporter or global operator.

- A company whose ambition is to be a global player aspires to establish a sustainable competitive position in the key markets of the world and to build an integrated business system of designs spread over those key markets. For example, SONY, Unilever, Ericsson, Procter & Gamble etc would qualify for such a description of their role.
- A regional player defines its role as to capture a strong competitive advantage in one of the key regions of the world e.g., North America, Europe or Asia etc. and to be a marginal or relatively weak competitor in the other parts. Fiat in automobiles, NEC or Barclays would be examples of such an ambition.
- A regional dominant global player is a company whose role is more than a regional player but it is not yet selling across the key markets of the world.
- A global exporter is company whose role is to sell products manufactured or services operated in its home country across the key markets of the world and who builds foreign operations only to support the export drive. The major aerospace or defence companies like Boeing, Airbus and Raytheon can be classified into this category despite the fact that they have some supporting assets (maintenance, sales offices, etc.) outside their home region.
- A global operator is a company that procures a large fraction of its product components in factories located outside its base market and which concentrates its sales in its domestic market.
- In order to evaluate the extent to which a company has followed a global ambition, one can use two globalisation indices: the Global Revenue Index and the Global Capability Index. The Global Revenue Index (GRI) is calculated by taking the ratio of the company distribution of sales in the major world regions to the industry distribution of demand in the same regions. The Global Capability Index (GCI) is calculated in a similar way, but instead of taking the distribution of sales, one takes the distribution of *assets for capital intensive industries* or else of *personnel*.
- Global positioning consists of two types of choices: (i) the *choice of countries* in which the company wants to compete and the role that those countries have to play in the global country portfolio; (ii) the various *value propositions* for the product or services of the company, corresponding to the type of segments and countries in which the company wants to compete.

- A global business system decomposes the company value chain into elements which are spread and integrated across the world. It involves building and developing capabilities to compete successfully on the global market space in accordance with the positioning that has been already determined.
- A company *value chain* is the set of activities that a company employs in order to design, produce and deliver the value proposed to the customer. Each company has a different value chain according to the type of industry in which it operates and the degree of vertical integration it has adopted.
- The final element of a global strategy is the design of an *organisational architecture* which is able to support and implement the global ambition, global positioning and global business system.
- Competitiveness can be viewed from the two perspectives- micro and macro.
- In the microeconomic approach, the competitiveness of goods and the competitiveness of firms are analysed. The competitiveness of goods and services mainly depends on their quality and price. These two elements have the greatest influence on the sales volume. However, other activities like market research, advertising, customer relations, distribution channels, customer support also contribute to the competitiveness. The competitiveness of firms is based on their ability to make profits, which, on the other hand, is largely determined by the competitiveness of their goods and services. Other factors contributing to the competitiveness are: ability to increase the market share, corporate image and brands, ability to access financial resources (Szentes, 2012; Wach, 2014).
- The concept of macro-level competitiveness or national competitiveness is twofold. On the one hand macro competitiveness shows the ability of a country to sustain a high level of national income and a favourable position in the world economy. On the other hand it shows the ability of a country to create a business environment in which the local firms and businesses are able to compete internationally. Porter (1990) went even further by saying that the competitiveness of a nation is equal to the competitiveness of its firms.
- The Global Competitiveness Index 4.0 evaluates the factors that collectively determine the level of a country's productivity—the most important driver of long-term improvements in living standards. The factors are organized into 12 pillars, and for presentation purposes they are grouped into four categories (*viz.* Enabling environment, Human capital, Markets and Innovation ecosystem). **Pillar**

1: Institutions captures security, property rights, social capital, checks and balances, transparency and ethics, public-sector performance and corporate governance. **Pillar 2: Infrastructure** captures the quality and extension of transport infrastructure (road, rail, water and air) and utility infrastructure. **Pillar 3: ICT adoption** captures the degree of diffusion of specific information and communication technologies (ICTs). **Pillar 4: Macroeconomic stability** captures the level of inflation and the sustainability of fiscal policy. **Pillar 5: Health** captures health-adjusted life expectancy (HALE)—the average number of years a newborn can expect to live in good health. **Pillar 6: Skills** capture the general level of skills of the workforce and the quantity and quality of education. **Pillar 7: Product market** captures the extent to which a country provides an even playing field for companies to participate in its markets. **Pillar 8:Labour market** encompasses "flexibility", namely, the extent to which human resources can be reorganized and "talent management", namely, the extent to which human resources are leveraged. **Pillar 9: Financial system** captures the depth, namely the availability of credit, equity, debt, insurance and other financial products, and the stability, namely, the mitigation of excessive risk-taking and opportunistic behaviour of the financial system. **Pillar 10: Market size** captures the size of the domestic and foreign markets to which a country's firms have access. It is proxied by the sum of the value of consumption, investment and exports. **Pillar 11: Business dynamism** captures the private sector's capacity to generate and adopt new technologies and new ways to organize work, through a culture that embraces change, risk, new business models, and administrative rules that allow firms to enter and exit the market easily. **Pillar 12: Innovation capability** captures the quantity and quality of formal research and development; the extent to which a country's environment encourages collaboration, connectivity, creativity, diversity and confrontation across different visions and angles; and the capacity to turn ideas into new goods and services.

- Porter theorizes that four broad attributes of a nation shape the environment in which local firms compete and these attributes promote the creation of competitive advantage. In the format of a figure this looks like a diamond and hence it is termed as Porter's diamond. Porter's four attributes of national competitive advantage are as follows: *Factor Endowments, Demand Conditions, Related and Supporting Industries, Firm Strategy, Structure and Rivalry.*

- *Factor Endowments:* It implies a nation's position in factors of production such as skilled labour or the infrastructure necessary to compete in a given industry.
- *Demand Conditions:* It implies the nature of home demand for the industry's product or service. According to Porter, the home demand plays an important role in upgrading competitive advantage. Firms are typically more sensitive to the needs of their closest customers.
- *Related and Supporting Industries:* It implies the presence or absence of supplier industries and related industries that are internationally competitive. The benefits of investments in advanced factors of production by related and supporting industries can spill over into an industry, thereby helping it to achieve a strong competitive position internationally.
- *Firm Strategy, Structure and Rivalry:* It implies the conditions governing how companies are created, organised and managed and the nature of domestic rivalry.
- Porter speaks of these four attributes as constituting the diamond. He argues that firms are most likely to succeed in industries or industry segments where the diamond is most favourable. He also argues that the diamond is a mutually interacting system. The effect of one attribute is contingent on the state of others. For example, Porter argues that favourable demand conditions will not result in competitive advantage unless the state of rivalry is sufficient to cause firms to respond to them. Unless the demand conditions are favourable, the factor endowments will not produce the competitive advantage. If supporting industries do not exist adequately, a nation with all other determinants available to it, will not develop competitive advantage.
- Porter maintains that two additional variables can influence the national diamond significantly: chance and government. Chance events, such as major innovations, can reshape industry structure and provide the opportunity for one nation's firms to replace another's. Government, by its choice of policies, can detract from or improve national advantage. For example, regulation can alter home demand conditions, government investments in education can change factor endowments, etc.

5.10 Self Assessment Questions

A. Objective Type Questions:

Choose the correct answer from the given four alternatives.

1. Global strategic management is
   - a) a blend of strategic management and international business which develops worldwide strategies for global corporations.
   - b) a blend of management and international business which develops worldwide strategies for corporations.
   - c) a blend of management and international business which develops worldwide strategies for local corporations.
   - d) a blend of strategic management and international business which develops worldwide strategies for local corporations.
2. A global strategy consists of four major components:
   - a) strategic ambition, strategic positioning, business system, and organisation
   - b) global strategic ambition, global strategic positioning, global business system, and global organisation
   - c) global strategic choice, global strategic goal, global business objective, and global organisation
   - d) ambition, positioning, business system, and organisation
3. A global player aspires to establish a sustainable competitive position in the key markets of the world and to build an integrated business system of designs spread over those………….
   - a) local market
   - b) option market
   - c) key markets
   - d) stock market
4. The Global Revenue Index (GRI) is calculated by taking the ratio of……
   - a) the company distribution of sales in the major world regions to the industry distribution of supply in the same regions

b) the company distribution of production in the major world regions to the industry distribution of demand in the same regions

c) the company distribution of sales to the demand

d) the company distribution of sales in the major world regions to the industry distribution of demand in the same regions

5. A company *value chain* is the set of activities that a company employs in order to……………….

a) design, produce and deliver the value proposed to the customer

b) design the value proposed to the customer

c) Design and produce the value proposed to the customer

d) design, produce and deliver the value proposed to the government

6. The Global Competitiveness Index 4.0 evaluates the factors that collectively determine……………………………….—the most important driver of long-term improvements in living standards.

a) the level of a company's productivity

b) the level of a country's productivity

c) the level of a state's productivity

d) the level of a family's productivity

7. The factors of the Global Competitiveness Index 4.0 are organized into

a) 10 pillars

b) 15 pillers

c) 12 pillars

d) 20 pillars

8. Porter theorizes that ……………broad attributes of a nation shape the environment in which local firms compete and these attributes promote the creation of competitive advantage.

a) seven

b) six

c) five

d) four

9. Porter's four attributes of national competitive advantage are as follows:
   a) Factor Endowments; Demand Conditions; Related and Supporting Industries; Firm Strategy, Structure and Rivalry.
   b) Service Endowments; Demand Conditions; Related and Supporting Industries; Firm Strategy, Structure and Rivalry.
   c) Factor Endowments, Demand Conditions, Firm Strategy, Structure and Rivalry.
   d) Factor Endowments; Supply Conditions; Related and Supporting Industries; Firm Strategy, Structure and Rivalry.
10. Porter maintains that two additional variables can influence the national diamond significantly:
   a) probability and uncertainty
   b) chance and government.
   c) industry and economic
   d) company and government

Answer: 1 a); 2 b); 3 c); 4 d); 5 a); 6 b); 7 c); 8 d); 9 a); 10 b);

B. Short Answer Type Questions:

1. What do you mean by global strategic management?
2. What is strategy?
3. What do you mean by global positioning?
4. What do you mean by global exporter?
5. What is meant by global operator?
6. What is Global Revenue Index?
7. What is Global Capability Index?
8. What are the attributes of national competitive advantage?
9. What do you mean by Regional player?
10. What are the pillars of the Global Competitiveness Index 4.0?

C. Long Answer Type Questions:

1. What is global strategic management? Discuss its structure.
2. Discuss the different aspects of global strategic ambition.
3. Narrate the different facets of global strategic positioning.
4. Explain the concepts of global business system and global organisation.
5. Write a short note on competitiveness
6. Explain the factors of the Global Competitiveness Index 4.0.
7. Briefly discuss the 12 pillars of competitiveness.
8. Explain the Porter's four attributes of national competitive advantage.

Unit 6 ❑ Strategy and Organisation of International Business

Structure

6.1 Objectives

6.2 Introduction

6.3 International Business as a Strategy

6.4 Motivation of Internationalization

6.5 Pressures in Internationalization

6.6 Strategy and the Firm

6.6.1 The Firm as a Value Chain

6.6.2 The Role of Strategy

6.6.3 Pressure for Cost Reductions and Local Responsiveness

6.7 Strategic Choices

6.8 Market Entry Strategy

6.8.1 International Location Selection (where)

6.8.2 Timing of Entry (when)

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6.9 Organisation Structure of International Business

6.9.1 Vertical Differentiation: Centralization and Decentralization

6.9.2 Horizontal Differentiation: The Design of Structure

6.9.3 Integrating Mechanisms

6.10 Summary

6.11 Self assessment questions

6.1 Objectives

After studying this unit, you will be able to:

- understand motivation and pressures of internationalization
- know the role of strategy in the context of value chain of the firm
- get an idea of strategic choices
- comprehend the market entry strategy
- explain organisation structure of international business

6.2 Introduction

From the discussion in Unit 5 you are already aware of the different facets of the global strategic management which are intended to provide some guidance as to how to deal with the realities of international business. Following those ideas, this section provides an overview of the motivation and pressures of internationalization, role of strategy in the context of value chain of the firm. Besides, market entry strategy and organisation structure of international business are discussed in details in this unit. These concepts will be helpful to understand the realities of international business in a very meaningful way.

6.3 International Business as a Strategy

Conducting business by crossing national boundary (i.e., international business) could itself be a strategy for a firm. Firm can take its unique product in terms of design, utility, quality or cost or skills or core competence or brand to other countries where these are not available. Accordingly, these firms grow considerably higher in all dimensions and earn greater profit than firms operating only in the domestic market.

Let us take the example of McDonald's. Due to the brand of McDonald's it charges higher prices for its product in the developing countries than its domestic market or developed countries. This situation is also true for other chains like Pizza Hut. These chains offer standardized products, service and good hygiene to the customers and they enjoy competitive advantages due to their image. When customers enter a McDonald's or a Pizza Hut, they perceive that they are visiting a place of American origin. Actually these brands are selling American abroad-particularly in developing countries. Local

responsiveness or costs are not the constraints for the sale of these brands. Lower pricing strategy may not be suitable strategy in these chains as it may hurt the big 'American' image. However, these chains may have core competencies or excellent management skills, but these are not playing dominant roles as compared to brand image in the developing countries.

The same situation may not prevail in the developed foreign countries such as the European countries. In these countries, the core competencies and management skill of these chains are also equally important along with the brand image. The pricing strategy is not the same as in underdeveloped countries. These chains sell their different strengths selectively in different countries. It could be the superior product quality and service to UK or France; it could be typical American-ness to South Asia. A good product could be replicated; technological and management skills can also be learnt. But, core competencies and brand images are very difficult to match.

6.4 Motivation of Internationalization

Except for a few 'born-global' firms (e.g., the dot.com start-ups that arose around the year 2000), most of the world's leading MNEs are born in a home market where they grow before venturing abroad. The actual decision to internationalize and the way this is done, are often referred to as a strategic 'mode of entry' choice. By internationalization we mean the decision to enter into foreign markets. Internationalization studies revolve around schools of thought that try to explain why and how companies go abroad.

Generally, the motivations for internationalization include market motives, economic motives and strategic motives. The motives will vary from one business activity to another, producing multiple motivations for the international firm with a broad scope of activities in different parts of the globe.

Market Motives

Market motives can be offensive or defensive. An offensive motive is to seize market opportunities in foreign countries through trade or investment. Amway, Avon and Mary Kay all entered China in the early 1990s in search of opportunities in China's direct marketing business.

A defensive motive is to protect or hold a firm's market power or competitive position in the face of threats from domestic rivalry or changes in government policies. Dell, the world's leading personal computer-systems company, invested in Europe, Asia, Latin America and Africa partly because of strong competition in the U.S. domestic market. Similarly the voluntary restriction of exports to the United States of Japanese automobiles in 1980's prompted Toyota, Honda and Nissan to build the car manufacturing plants in the United States. Similarly, the North American and Asian companies in computer and electronics industries have invested heavily in European countries in order to bypass various barriers against import from non-European Union members.

Economic Motives

Firms go international to increase their return through higher revenues and/or lower costs. International trade or investment is a vehicle enabling the company to benefit from the differences in costs of labour, natural resources and capital, as well as the differences in regulatory treatments, such as taxation, between domestic and foreign countries. For example, many companies have expanded into Asia, seeking cheap labour or cheap resources. Firms such as Boeing, Microsoft, Compaq, Intel, Kodak, Coco-Cola established production facilities in China's special economic zones and open coastal cities in order to attain a significantly lower taxation rate than that applicable in the United States.

Strategic Motives

Firms often participate in international business for strategic reasons. They may intend to capitalize on their distinctive resources or capabilities already developed at home (e.g., technologies and economies of scale). By deploying these resources or capabilities abroad or increasing production through international trade, firms may be able to increase their cash inflows. Firms may also go international to be the first-mover in the target foreign market before a major competitor gets in. This may create some strategic benefits for the company such as technological leadership, brand image, customer loyalty and competitive position. Additionally, firms may benefit from vertical integration involving different countries. For example, a company in the oil exploration and drilling business may integrate "downstream" by acquiring or building an oil refinery in a foreign country that has a market for its refined products.

Note: This section has been adopted from "Shankar and Luo (2004). "International Business". Wiley. 11-12.

6.5 Pressures in Internationalization

Various trends have converged in recent years as pressures in internationalization. The following are particularly notable:

- *Worldwide reduction in barriers to trade and investment:* The tendency of national governments to reduce trade and investment barriers has accelerated the process of internationalization. For example, tariffs on the import of industrial and medical equipment and countless other products have declined nearly to zero in many countries, encouraging freer international exchange of goods and services.
- *Market liberalization and adoption of free markets:* These events open roughly one-third of the world to freer international trade and investment. China, India and Eastern Europe have become some of the most cost effective locations for producing goods and services worldwide.
- *Industrialization, economic development and modernization:* Many emerging markets, rapidly developing economies in Asia, Latin America and Eastern Europe have now moved from being low value-adding commodity producers to sophisticated, competitive producers and exporters of premium products such as electronics, computers and aircraft.
- *Integration of world financial markets:* Financial market integration makes it possible for internationally active firms to raise capital, borrow funds and engage in foreign currency transactions.
- *Technological Advances:* The most important driver of internationalization has been technological advances in information, communication, manufacturing and transportation.

Information Technology

Information Technology (IT) is the science and process of creating and using information resources. Its effect on business has been revolutionary. Geographically distant subsidiaries of a multinational firm are now interconnected by intranets that facilitate instant sharing of data, information and experience across company operations worldwide.

Communications

The internet and internet-dependent system such as intranets, extranets, social media and e-mail connect billions of people and companies. Marketers use the internet to promote the widest range of products and services to customers worldwide.

Manufacturing

Computer-aided design (CAD) of products, robotics and production lines have transformed manufacturing, mainly by reducing production costs. Revolutionary developments facilitate low-scale and low-cost manufacturing; firms can make products cost effectively even in short production runs. Such developments benefit international business by allowing firms to adapt products more efficiently to individual foreign markets, profitably target small national markets and compete more effectively with foreign competitors that enjoy cost advantages.

Transportation

Firms consider the cost of transporting raw materials, components and finished products when deciding either to export or manufacture abroad. If transport costs to an important market are high, management may decide to manufacture merchandise in that market. The development of fuel-efficient jumbo jets, giant ocean-going freighters and new transportation technology have greatly reduced shipping times and costs.

Note: This section has been adopted from Cavusgil et al. (2009). *"International Business: Strategy, Management and The New Relations"*. Pearson. 61- 67.

6.6 Strategy and the Firm

A firm's strategy can be defined as the actions that managers take to attain the goals of the firm. For most firms, the preeminent goal is to maximize long-term profitability. A firm makes a profit if the price it can charge for its output is greater than its average costs of producing that output. Profit (Ð) is thus, defined as the difference between total revenue (TR) and total cost (TC), or:

$$\Pi = TR - TC = (P \times Q) - (C \times Q) = (P - C) \times Q = \pi \times Q$$

where P = Price, Q= number of units sold, C = cost per unit, π = profit per unit of output.

Two basic conditions determine a firm's profit (Π): the amount of value customers place on the firm's goods and services (sometimes referred to as perceived value) and the firm's cost of production. In general, the more value customers place on a firm's products, the higher the price the firm can charge for those products. The value of a product to a consumer is V; the price that the firm can charge for that product given competitive pressures and its ability to segment the market is P; and the unit cost of producing that product is C. The firm's profit per unit sold (π) is equal to P-C, while the consumer's surplus is equal to V-P. The difference between V and P is, in part, determined by the intensity of competitive pressure, the higher the price that can be charged relative to V.

The value created by a firm is measured by the difference between V and C (V-C); a company creates value by converting inputs that cost C into a product on which consumers place a value of V. A company can create more value for its customers either by lowering production costs, C, or by making the product more attractive through superior design, functionality, quality, and the like, so that consumers place a greater value on it (V increases) and consequently, are willing to pay a higher price (P increases). A firm has high profits when it creates more value for its customers and does so at a lower cost. We refer to a strategy that focuses on lowering production cost as a low cost strategy. We refer to a strategy that focuses on increasing the attractiveness of a product as a differentiation strategy. Michael Porter has argued that low cost and differentiation are two basic strategies for creating value and attaining a competitive advantage in an industry. According to Porter, superior profitability goes to those firms that can create superior value, and the way to create superior value is to drive down the cost structure of the business and/or differentiate the product in some way so that consumers value it more and are prepared to pay a premium price. Superior value creation relative to rivals does not necessarily require a firm to have the lowest cost structure in an industry, or to create the most valuable product in the eyes of consumers. However, it does require that the gap between value (V) and cost of production (C) is greater than the gap attained by competitors.

6.6.1 The Firm as a Value Chain

The firm as a value chain is composed of a series of distinct value creation activities including production, marketing and sales, materials management, R&D, human resources, information systems, and the firm infrastructure. These value creation activities can be categorized as primary activities and support activities.

Primary Activities

Primary activities have to do with the design, creation, and delivery of the product; its marketing; and its support and after-sale service. The primary activities are broken into four functions: research and development, production, marketing and sales, and service.

Research and development (R&D) is concerned with the design of products and the production process. Although we think of R&D as being associated with the design of physical products and production process in manufacturing enterprises, many service companies also undertake R&D. For example, banks compete with one another by developing new financial products and new ways of delivering those products to customers. Online banking and smart debit cards are two recent examples of new product development in the banking industry. Earlier examples of innovation in the banking industry included automated teller machines, credit cards and debit cards.

Production is concerned with the creation of a good or service. For physical products, when we talk about production we generally mean manufacturing. For services such as banking or retailing operations, "production" typically occurs when the service is delivered to the customer. For example, when a bank originates a loan for a customer it is engaged in "production" of the loan.

The marketing and sales functions of firm can help to create value in several ways. Through brand positioning and advertising, the marketing function can increase the value (V) that consumers perceive to be contained in a firm's product. If these create a favorable impression of the firm's product in the minds of consumers, they increase the price that can be charged for the firm's product. Marketing and sales can also create value by discovering consumer needs and communicating them back to the R&D unit of the company, which can then design products that better match those needs.

The role of the enterprise's service activity is to provide after-sales service and support. This function can create a perception of superior value (V) in the minds of consumers by solving customer problems and supporting customers after they have purchased the product.

Support Activities

The support activities of the value chain provide inputs that allow the primary activities to take place. The materials management (or logistics) function controls the transmission of physical materials through the value chain, from procurement through production and into distribution. The efficiency with which this is carried out can significantly lower cost (lower C), thereby creating more value.

Similarly, the human resources function can help create more value in a number of ways. It ensures that the company has the right mix of skilled people to perform its value creation activities effectively.

Information systems refer to the normal electronic systems for managing inventory, tracking sales, pricing products, selling products, and dealing with customer service inquiries and so on. Information systems when coupled with communications features of the internet can alter the efficiency and effectiveness with which a firm manages its other value creation activities.

The final support activity is the company infrastructure. By infrastructure we mean the context within which all the other value creation activities occur. The infrastructure includes the organizational structure, control system and the culture of the firm. Because top management can exert considerable influence in shaping these aspects of the firm, top management should also be viewed as part of the firm infrastructure. Through strong leadership, top management can consciously shape the infrastructure of a firm and through that the performance of all other value creation activities within it.

6.6.2 The Role of Strategy

Many international markets are now extremely competitive due to the liberalization of the world trade and investment environment. In industry after industry, capable competitors confront each other around the globe. To be profitable in such an environment, a firm must both reduce the costs of value creation (lower C) and differentiate its product offering so that consumers value that product more (raise V) and are willing to pay more for the product than it costs to produce it. Thus, strategy is often concerned with identifying and taking actions that will lower the costs of value creation and/or will differentiate the firm's product offering through superior design, quality, service, functionality and so on.

6.6.3 Pressure for Cost Reductions and Local Responsiveness

Firms that compete in the global marketplace typically face two types of competitive pressure. They face pressure for cost reductions and pressures to be locally responsive.

Pressure for Cost Reductions

Increasingly, international businesses are facing pressures for cost reductions. Responding to pressures for cost reduction requires a firm to try to lower the costs of value creation by mass producing a standardized product at the optional location in the

world, wherever that might be, in order to realize location economy and experience curve effects. Cost reduction pressures can be particularly intense in the industries producing commodity-type products where meaningful differentiation on non-price factors is difficult and price is the main competitive weapon.

Pressure for Local Responsiveness

Pressure from local responsiveness arises from a number of sources including:

i. *Differences in consumer tastes and preferences*: Strong pressures for local responsiveness emerge when consumer tastes and preferences differ significantly among countries, as they may be for historic and cultural reasons. In such cases, products and/or marketing messages have to be customized to appeal to the tastes and preferences of local consumers. This typically creates pressure to delegate production and marketing functions to national subsidiaries.

ii. *Differences in infrastructure and traditional practices:* Pressures for local responsiveness emerge when there are differences in infrastructure and/or traditional practices among countries. In such circumstances the product may need to be customized to the distinctive infrastructure and practices of different nations. This may necessitate the delegation of manufacturing and production functions to foreign subsidiaries.

iii. *Differences in distribution channels:* A firm's marketing strategies may have to be responsive to differences in distribution channels among countries. This may necessitate the delegation of marketing functions to national subsidiaries.

iv. *Host government demands:* Economic and political demands imposed by host-country governments may necessitate a degree of local responsiveness. For example, the politics of healthcare around the world requires that pharmaceutical firms manufacture in multiple locations. Pharmaceutical firms are subject to local clinical testing, registration procedures, and pricing restrictions, all of which require that the manufacturing and marketing of a drug should meet local requirements. Because Government and Government agencies control a significant proportion of the health care budget in most countries, they can demand a high level of local responsiveness.

Note: This section has been adopted from "Hill et al.(2010). *"International Business". Tata McGraw-Hill Publishing Company Limited. 405-421.*

6.7 Strategic Choices

Firms use four basic strategies to enter and compete in the international environment: an international strategy, a multidomestic strategy, a global strategy and a transnational strategy. In this section we describe each strategy, identify when it is appropriate, and discuss the pros and cons of each.

International Strategy

Firms that pursue an international strategy try to create value by transferring valuable skills and products to foreign markets where indigenous competitors lack those skills and products. Most international firms have created value by transferring differentiated product offering developed at home to new market overseas. Accordingly, they tend to centralize product development functions at home (e.g., R&D). However, they also tend to establish manufacturing and marketing functions in each major country in which they do business. But while they may undertake some local customization of product offering and marketing strategy, this tends to be limited. In most international firms, the head office retains tight control over marketing and product strategy.

International firms include the likes of McDonalds, IBM, Kellogg's, Procter and Gamble, Wall-Mart and Microsoft. Microsoft, for e.g., develops the core architecture underlying its product at its Redmond campus in Washington state and also writes the bulk of the computer code there. However, the company does allow national subsidiaries to develop their own marketing and distributional strategy and to customize aspects of the product to account for such basic local differences as language and alphabet.

An international strategy makes sense if a firm has a valuable core competence that indigenous competitors in foreign market lack and if the firm faces relatively weak pressures for local responsiveness and cost reduction (As is the case for Microsoft). In such circumstances, an international strategy can be very profitable. However, when pressures for local responsiveness are high, firms pursuing this strategy lose to firms that emphasize customizing the product offering and market strategy to local conditions.

Multidomestic Strategy

Firms perusing multidomestic strategy orient themselves toward achieving maximum local responsiveness. The key distinguishing feature of multidomestic firms is that they extensively customize both their product offering and their marketing strategy to match different national conditions. Consistent with this, they also tend to establish a complete

set of value creation activities, including production, marketing, and R&D, in each major national market in which they do business. As a consequence, they are generally unable to realize value from experience curve effects and location economies. Accordingly, many multidomestic firms have a high cost structure. They also tend to do a poor job of leveraging core competencies within the firm.

A multidomestic strategy makes most sense when there are high pressures for local responsiveness and low-pressures for cost reduction. The high cost structure associated with the duplication of production facilities makes this strategy inappropriate in industries where cost pressures are intense. Another weakness associated with this strategy is that many multidomestic firms have developed into decentralized federation in which each national subsidiary functions in a largely autonomous manner.

Global Strategy

Firms that pursue a global strategy focus on increasing profitability by reaping the cost reduction that comes from experience curve effects and locations economies. That is, they are pursuing a low-cost strategy. The production, marketing, and R&D activities of firms pursuing a global strategy are concentrated in a few favorable locations. Global firms tend not to customize their products offerings and marketing strategies to local condition because customization raises cost (it also involves shorter production runs and the duplication of functions). Instead, global firms prefer to market a standardized product worldwide so that they can reap the maximum benefits from the economies of scale that underlie the experience curve. They also use their cost advantage to support aggressive prices in world markets.

This strategy makes most sense where there are strong pressures for cost reductions and where demands for local responsiveness are minimal. Increasingly, these conditions prevail in many industries. In the semiconductor industry, for example, global standards have created enormous demands for standardized global products. Accordingly, firms such as Intel, Texas instruments etc. pursue a global strategy. However, these conditions are not found in many consumer goods markets, where demands for local responsiveness remain high (e.g., processed food product). The strategy is inappropriate when demands for local responsiveness are high.

Transnational Strategy

Christopher Bartlett and Sumantra Ghoshal have argued that in today's environment, competitive conditions are so intense that to survive in the global market place, firms

must exploit experience-based cost economies and location economies; they must transfer core competencies within the firm, and they must do all of these while paying attention to pressure for local responsiveness. They note that in the modern multinational enterprise, core competencies do not just reside in the home country. Valuable skills can develop in any of the firm's worldwide operations. Thus, Bartlett and Ghoshal maintain that the flow of skills and product offerings should not be all one way, from home firm to foreign subsidiaries, as in the case of firms pursuing an international strategy. Rather, the flow should also be from foreign subsidiary to home country and from foreign subsidiary to foreign subsidiary- a process they refer to as global learning. Bartlett and Ghosal refer to the strategy pursued by firms that are trying to simultaneously create value in these different ways as a transnational strategy.

A transnational strategy makes sense when a firm faces high pressure for cost reduction, high pressure for local responsiveness, and where there are significant opportunities for leveraging valuable skills within a multinational's global network of operations. In some ways, firms that pursue a transnational strategy are trying to simultaneously achieve cost and differentiation advantages.

Note: This section has been adopted from "Hill et al.(2010). *"International Business"*. Tata McGraw-Hill Publishing Company Limited. 422-425.

6.8 Market Entry Strategy

International entry strategies concern where (location selection), when (timing of entry) and how (entry mode selection) international companies should enter and invest in a foreign territory during international expansion. These entry strategies are important because they determine an MNE's investment environment, operation treatment, resource commitment and evolutionary path.

6.8.1 International Location Selection (Where)

International location selection involves country selection and region selection (e.g., state, province or city) for an MNE's foreign direct investment project(s). Locational determinants can be categorized into the following groups: (1) cost tax factors; (2) demand factors; (3) strategic factors; (4) regulatory/economic factors; and (5) socio-political factors.

Cost/Tax Factors

1. *Transportation costs:* For country selection, MNEs should consider the costs

incurred in transporting materials from a home (or foreign) country to a host country or transporting products from a host country to a home or international market.

2. *Wage rate:* Labour costs constitute a substantial proportion of total production costs. Foreign production is more likely to occur when production costs are lower abroad than at home.

3. *Availability and costs of land:* Availability of suitable plant sites, the cost of land, space for expansion and local government policy on renting or purchasing land have been recognised by international managers as critical factors in the early stages of project development and late stages of project operation.

4. *Construction costs:* This cost accounts for a substantial part of capital investment. Different sites vary in the cost of construction materials, labour, land, equipment rental and quality of construction.

5. *Cost of raw materials and resources:* MNEs are increasing the percentage of local outsourcing in total production. The localisation reduces foreign exchange risks from devalued currencies and improves relationship with local governments and indigenous firms. Under these circumstances, the costs of local materials and resource needed in production will affect the firm's gross profit margin.

6. *Financing costs:* the cost and availability of local capital are a major concern for MNEs because local financing provides much of the capital needed for mass production and operations. Financing by local banks and financial institutions also helps an MNE mitigate possible financial risks arising from fluctuations in foreign exchange rates and uncertain foreign exchange policies as well as political risks in a host country.

7. *Tax rates:* Both statutory and effective tax rates influence the firm's profitability. The statutory tax rate determines the general level of the tax burden shouldered by firms. The effective tax rate on corporate income, which is statutory corporate rate adjusted for all other taxes and subsidies affecting an MNE's taxable income, determines the company's net return from its operations.

8. *Investment incentives:* Many countries, especially developing ones, are competing to attract FDI to support their domestic economies. In so doing, they offer preferential incentives to foreign investors.

9. *Profit repatriation:* Repatriation restrictions have a negative impact on the net income or dividends remitted to foreign headquarters. Restrictions can involve a remittance tax on the cash repatriated to a home country or a ceiling on the cash amount.

Demand Factors

1. *Market size and growth:* Although different MNEs may not emphasize the same level of marketing in a host country, it is rare for them not to consider local consumers.
2. *Presence of customers:* MNEs may find it desirable to locate their manufacturing sites in the area where they have longstanding customers. The closer operations are to major buyers, the better the cost efficiency and marketing effectiveness.
3. *Local competition:* The intensity of competition in a host country or specific region is important because it directly impacts a firm's market position and gross profit margin from local sales.

Strategic Factors

1. *Investment in infrastructure:* Today, MNEs attach increasing importance to infrastructure conditions. This is especially true for companies investing in knowledge or technology-intensive projects.
2. *Manufacturing concentration:* One of the major determinants of location selection is the strength of existing manufacturing activities. Cost saving can result from manufacturers locating in close proximity. A country or region with a strong concentration of manufacturing activity in certain industries or products is more likely to have an adequate labour pool and supply network supporting production or operations.
3. *Industrial linkages:* The nature and quality of the complementary industries and special services (distribution, consulting, auditing, banking, insurance, marketing services, etc.) are also important as MNE operations interact actively with these sectors in a host country.
4. *Workforce productivity:* As a result of increasing technological permeation and process innovation, international production requires high workforce productivity and superior labour skills. The labour requirement of new systems and techniques are driving the need for a better educated direct-labour workforce.

5. *Inbound and outbound logistics:* Typical inbound (input) logistics include proximity to suppliers and sources of raw materials and inputs. Since MNEs have a tendency to rely more on local input sources, this type of logistics should be among the critical considerations for international managers. Outbound (market) logistics are based largely on proximity to major buyers and end consumers. This factor can heavily influence the effectiveness of customer responsiveness. When the firm pursues market penetration and product specialization strategies, the firm's profitability will be strongly associated with market logistics.

Regulatory/Economic Factors

1. *Industrial policies:* In many countries, industrial policies are used to control new entrants (both foreign and local firms), net profit margins, degree of competition, structural concentration and social benefits. In selecting a location, MNEs need to make sure that the target country or region allows foreign business entry and that industrial policies are reasonably favourable or at least not a hindrance.
2. *FDI policies:* In determining a foreign location (country and region), MNEs need to learn how FDI policies there will impact their plans and playoffs.
3. *Availability of special economic zones:* One way many countries (especially in the developing world) attempt to attract FDI is through the establishment of special zones such as free trade zones (FTZs), special economic zones (SEZs), economic and technological development zones (ETDZs), high-tech development zones (HTDZs), open economic regions (OERs), bonded areas and so on. In general, these zones provide preferential treatment in terms of taxation, import duties, land use, infrastructure access and governmental assistance to MNEs.

Sociopolitical Factors

1. *Political instability:* This factor reflects uncertainty over the continuation of present political and social conditions and government policies that are critical to the survival and profitability of a firm's operations in the host country. Changes in government policies may create problems related to repatriation of earnings or, in extreme cases, expropriation of assets.
2. *Cultural barriers:* Another trigger of uncertainty is differences in culture between the home and host countries. This factor determines a firm's receptivity and adaptability to the social context of a host country.

3. *Local business practices:* Culture-specific business practices often constitute key forms of knowledge that MNEs must acquire. In fact, a prominent logic behind formation of international co-operative ventures with developing country enterprises is to gain such country-specific knowledge.
4. *Government efficiency and corruption*: International managers often perceive the "soft" infrastructure (e.g., regulatory environment and government efficiency) as having a greater and more enduring impact on firm operations than the "hard" infrastructure (e.g., transportation and communication).
5. *Attitudes towards foreign business:* Social and governmental attitudes towards foreign business often have visible or invisible influences on MNE operations and management. If the society and government of a host country are somewhat friendly to foreign business, MNEs will benefit from the congenial environment.
6. *Community characteristics*: Site selections must include considerations of community environment aspects such as community size, educational facilities, housing facilities, police and fire protection, climate, suitability for expatriates and their families, facilities for children, the social environment for spouses, hotel accommodations, crime level and other quality of life indicators. This environment is highly relevant because it affects costs, quality and security of living for foreign expatriates and their families.
7. *Pollution control:* Environment protection laws and regulations in the target location influence the choice and cost of investments. Before making a location decision, an MNE should appraise these laws and regulations, access whether the firm is able to comply with them and evaluate whether it is financially feasible to invest in pollution control.

6.8.2 Timing of Entry (When)

Timing of entry involves the sequence of an MNE's entry into a foreign market vis-à-vis other MNEs (i.e., first mover, early follower, and late mover). Timing of entry is important because it determines the risks, environments, and opportunities the MNE may confront.

Early-Mover Advantages

When entering a foreign market, pioneering MNEs (first mover or early followers) generally have advantages such as greater market power, more preemptive opportunities,

and more strategic options over late entrants. These advantages might be ultimately reflected in higher economic returns compared with later movers.

First, pioneering investors tend to outperform later entrants in acquiring market power. Early movers are able to invest strategically in facilities, distribution networks, product positioning, patentable technology, natural resources, and human and organizational expertise. If imitation of its product is expected to be expensive or involves a long time lag, a preemptive investment can be leveraged into significant long-run benefits for early movers. Moreover, market pioneers may benefit from the advantages of holding technical leadership, seizing scarce resources, and creating buyer switching costs.

Second, early movers gain from preemptive opportunities. Early movers have the right to preempt marketing, promotion and distribution channels, while gaining product image, organizational reputation and brand recognition.

Third, early movers benefit from many strategic options. Pioneer investors often have more strategic options in selecting industries, locations and market orientations (e.g., import-substitution, local market-oriented, export-market oriented etc.) in addition, early movers are often given priority access to natural resources, scarce materials, distribution channels, infrastructure etc.

Early-Mover Disadvantages

Early movers, however, also suffer from some disadvantages compared to late entrants. Pioneer investors may be confronted with greater environmental uncertainty and operational risks. Environmental uncertainty generally comes from (1) underdeveloped FDI laws and regulations in a host country (2) the host government's lack of experience in dealing with MNEs and (3) infant or embryonic stages of the industry or market in a host country. Operational risks originate from (1) a shortage of qualified supply sources and other production inputs such as talented managers and R&D workforce; (2) under-developed support services such as local financing, foreign exchange, arbitration, consulting, and marketing; (3) poor infrastructure in transportation, utilities, and communications; and (4) an unstable market structure in which market demand and supply are misaligned and local governments often interfere with MNE operations.

In contrast with early movers, late investors do not suffer, or suffer less, from the preceding uncertainties and risks. When late movers arrive, the host-country environment is usually more stable, regulatory conditions are more favorable, and the market infrastructure is already developed.

Early movers also tend to pay higher costs in learning and adapting to local environments and in countervailing imitation. Many early movers are compelled to invest more in building industrial infrastructure (e.g., supply bases and distribution networks) and technological or service standards.

Finally, early movers may have to fight followers who imitate their strategies or innovations or infringe on their industrial (e.g., trade mark and brand) or intellectual property rights (e.g., patent, expertise, software). This cost is especially high when early movers invest in a country with underdeveloped and under-enforced legal systems in protecting these rights.

6.8.3 Entry Mode Selection (how)

An MNE seeking to enter a foreign market must make an important strategic decision concerning which entry mode to use. Entry modes are specific forms or ways of entering a target country to achieve strategic goals underlying international presence in that country. Entry mode choices fall into three categories: *trade-related, transfer-related, and FDI-related.* Along this sequence, the levels of resource commitment, organizational control, involved risks, and expected returns all increase. Within each category, these levels differ somewhat between specific modes.

Trade-Related Entry Modes

Trade-related entry modes include exporting, subcontracting, and countertrade.

Exporting

It is natural for most firms to get their start in international expansion through exporting in which the firm maintains its production facilities at home and sells its products abroad. Through exporting, the firm gains valuable expertise about operating internationally and specific knowledge concerning the individual countries in which it operates. Export offers the advantage of not requiring a very substantial presence in foreign countries. Generally, exporting is a type of international entry open to virtually any size or kind of firm, whereas other types of entry modes tend to demand greater resources and involve more risks. Over time, accumulated experience with exporting often prompts a firm to become more aggressive in exploiting new international exporting opportunities or consider FDI in the country to which it previously exported.

International Subcontracting

Subcontracting is the process in which a foreign company provides a local manufacturer

with raw materials, semi-finished products, sophisticated components, or technology for producing final goods that will be bought back by the foreign company. In most subcontracting businesses, local manufacturers are responsible only for processing or assembly in exchange for processing fees. In this situation, the local manufacturer does not own the property rights of materials or parts supplied by the foreign counterpart. Nike, for example, is still using subcontracting as its primary mode in China, Vietnam, Thailand, Indonesia, and Bangladesh. The company provides raw materials and technology, maintains proprietary rights over materials and products, controls production processes and product quality, and pays processing fees to local factories.

Countertrade

Countertrade is a form of trade in which a seller and a buyer from different countries exchange merchandise with little or no cash or cash equivalents, changing hands. Because of this nature, it is also viewed as a form of flexible financing or payment in international trade. Countertrade has evolved into a diverse set of activities that can be categorized as four distinct types of trading arrangements:

- Barter
- Counterpurchase
- Offset
- Buyback (or compensation)

Barter is the direct and simultaneous exchange of goods between two parties without a cash transaction. Barter trade occurs between individuals, between governments, between firms, or between a government and a firm, all from two different countries. Barter may be the oldest form of trade but it is certainly not history.

A *counterpurchase* is a reciprocal buying agreement whereby one firm sells its products to another at one point in time and is compensated in the form of the other's products at some future time (e.g., Russia purchased construction machinery from Japan's Komatsu in return for Komatsu's agreement to buy Siberian timber).

An *offset* is an agreement whereby one party agrees to purchase goods and services with a specified percentage of its proceeds from an original sale. Like counterpurchase, offset involves three contracts including sales, protocol, and purchase. Unlike counterpurchase whereby exchanged products are normally unrelated, products taken back in an offset are often the outputs processed by this party in the original contract.

Finally, *buyback* (or compensation arrangement) occurs when a firm provides a local company with inputs for manufacturing products (mostly capital equipment) to be sold in international markets, and agrees to take a certain percentage of the output produced by the local firm as partial payment.

Transfer-Related Entry Modes

Transfer-related entry modes are those associated with transfer of ownership or utilization of specified property (technology or assets) from one party to the other in exchange for royalty fees. They differ from trade-related entry modes in that the user in a transfer-related mode "buys" certain rights of transacted property (e.g., use of technology) from the other party (owner). These modes are extensively employed in technology-related or intellectual/industrial property right-related transactions. This category includes the following entry modes:

- International leasing
- International licensing
- International franchising
- Build-operate-transfer (BOT)

International Leasing

International leasing is an entry mode in which the foreign firm (lessor) leases out its new or used machines or equipment to the local company (often in a developing country). International lease arises largely because developing country manufacturers (lessee) do not have financial capability or lack foreign currency to pay for the equipment. In many cases, the leased equipment sits idle in the developed country but is in good operational condition, thus having a market in developing countries.

International Licensing

International licensing is an entry mode in which a foreign licensor grants specified intangible property rights to the local licensee for a specified period of time in exchange for a royalty fee. Such property rights may include patents, trademarks, technology, managerial skills, and so on. They allow the licensee to produce and market a product similar to the one the licensor has already been producing in its home country without requiring the licensor to actually create a new operation abroad.

International Franchising

International franchising is an entry mode in which the foreign franchisor grants specified intangible property rights (e.g., trademark or brand name) to the local franchisee, which must abide by strict and detailed rules as to how it does business. Compared to licensing, franchising involves longer commitments, offers greater control over overseas operations, and includes a broader package of rights and resources. Production equipment, managerial systems, operating procedures, access to advertising and promotional materials, loans, and financing may all be part of a franchise. The franchisee operates the business under the franchisor's proprietary rights and is contractually obligated to adhere to the producers and methods of operation prescribed in the business system. The franchisor generally maintains the right to control the quality of products and services so that the franchisee cannot damage the company's image. In exchange for the franchise, the franchisor receives a royalty payment that amounts to a percentage of the franchisee's revenues.

Build-Operate-Transfer (BOT)

Build-operate-transfer (BOT) is a "turnkey" investment in which a foreign investor assumes responsibility for the design and construction of an entire operation, and, upon completion of the project, turns the project over to the purchaser and hands over management to local personnel whom it has trained. In return for completing the project, the investor receives periodic payments that are normally guaranteed. BOT is especially useful for very large-scale, long-term infrastructure projects such as power-generation, airports, dams, expressways, chemical plants, and steel mills.

FDI-Related Entry Modes

In contrast to the preceding trade-related and transfer-related entry modes, FDI-related entry modes involve ownership of property, assets, projects, and businesses invested in a host country. Accordingly, firms undertaking FDI will control overseas operations and economic activities. FDI-related entry modes are more sophisticated than trade-related modes, and involve higher risk and longer-term contribution than both trade- and transfer-related choices. Compared with the later, FDI-related modes underline the firm's long-term strategic goals of international presence and necessitate continuous contribution and commitment to investments and operations abroad. FDI-related entry modes include:

- Branch office
- Cooperative joint venture

- Equity joint venture
- Wholly-owned subsidiary
- Umbrella holding company

The Branch Office

A branch office is a foreign entity in a host country in which it is not incorporated but exists as an extension of the parent and is legally constituted as a branch. Corporate law in many countries allows foreign companies to open branches that engage in production and operating activities. Unlike representative offices which by law are prohibited from engaging in direct, profit-making business activities (they instead serve as liaisons, establishing contacts with governments and handling market research and consulting activities), branch offices are entitled to run businesses within a specified scope or location. A foreign subsidiary can also open a branch office in another region of the host country to expand its operations there. Branch offices are particularly utilized by transnational banks, law firms, and accounting or consulting companies.

The Cooperative (or Contractual) Joint Venture

The cooperative joint venture (also known as contractual joint venture) is a collaborative agreement whereby profits and other responsibilities are assigned to each party according to a contract. These do not necessarily accord with each partner's percentage of the total investment. Each party cooperates as a separate legal entity and bears its own liabilities. Most cooperative joint ventures do not involve constructing and building a new legally and physically independent entity. As such, cooperative joint ventures normally take the form of a document (cooperative agreement), whereas equity joint ventures take the form of a new entity.

The Equity Joint Venture

The most common foreign entry for MNEs has been through equity joint ventures. An equity joint venture entails establishing a new entity that is jointly owned and managed by two or more parent firms in different countries. To set up an equity joint venture, each partner contributes cash, facilities, equipment, materials, intellectual property rights, labour, or land-use rights. According to joint venture laws in most countries, a foreign investor's share must exceed a certain threshold of the total equity.

The Wholly-Owned Subsidiary

The wholly-owned subsidiary is an entry mode in which the investing firm owns 100 percent of the new entity in a host country. This new entity may be built from scratch by the investing firm (i.e., greenfield investment) or in acquiring a local business (i.e., cross-border acquisition). This mode offers foreign investors increased flexibility and control. It allows international managers to make their decisions without the burden of an uncooperative partner. Wholly-owned subsidiaries also allow foreign investors to set up and protect their own processes and procedures, which leads to more careful strategic and operational oversight.

The Umbrella Holding Company

The umbrella holding company is an investment company that unites the firm's existing investments such as branch offices, joint ventures, and wholly-owned subsidiaries under one umbrella so as to combine sales, procurement, manufacturing, training, and maintenance within the host country. Many foreign countries are now seeking better integration of these functions for a broad range of products and services within a single but important country (such as China and Brazil). Such coordination becomes necessary as each production division sets up its own foreign subunits separated from other division's foreign subunits in the same host country.

Note: This section has been adopted from Shankar and Luo (2004). *"International Business"*. Wiley. 260-283.

6.9 Organisation Structure of International Business

Organizational structure means three things: (1) the location of decision-making responsibilities within the structure, which is referred to as vertical differentiation; (2) the formal division of the organization into subunits, which is known as horizontal differentiation; and (3) the establishment of integrating mechanisms.

6.9.1 Vertical Differentiation: Centralization and Decentralization

A firm's vertical differentiation determines where in its hierarchy the decision-making power is concentrated. Are production and marketing decisions centralized in the offices of upper level managers, or are they decentralized to lower level managers? Where does the responsibility for R&D decisions lie? Are strategic and financial control responsibilities

pushed down to operating units, or are they concentrated in the hands of top management? And so on. There are arguments for centralization and other arguments for decentralization also.

Arguments for Centralization

There are four main arguments for centralization. *First*, centralization can facilitate co-ordination. *Second*, centralization can help to ensure that decisions are consistent with organizational objectives. *Third*, by concentrating power and authority in one individual or a management team, centralization can give top-level managers the means to bring about needed major organizational changes. *Fourth*, centralization can avoid the duplication of activities that occur when similar activities are carried on by various subunits within the organization.

Arguments for Decentralization

There are five main arguments for decentralization. *First*, top management can become overburdened when decision-making authority is centralized, and this can result in poor decisions. Decentralization gives top management time to focus on critical issues by delegating more routine issues to lower level managers. *Second*, motivational research favours decentralization. Behavioral scientists have long argued that people are willing to give more to their jobs when they have a greater degree of individual freedom and control over their work. *Third*, decentralization permits greater flexibility—more rapid response to environmental changes- because decisions do not have to be "referred up the hierarchy" unless they are exceptional in nature. *Fourth*, decentralization can result in better decisions. In a decentralized structure, decisions are made closer to the spot by individuals who (presumably) have better information than managers several levels up in a hierarchy. *Fifth*, decentralization can increase control. Decentralization can be used to establish relatively autonomous, self-contained subunits within an organization. Subunit managers can then be held accountable for subunit performance. The more responsibility the subunit managers have for decisions that impact subunit performance, the fewer alibis they have for poor performance.

Strategy and Centralization in an international Business

The choice between centralization and decentralization is not absolute. Frequently it makes sense to centralize some decisions and to decentralize others, depending on the type of decisions and the firm's strategy. Decisions regarding overall firm strategy, major financial expenditures, financial objectives, and the like are typically centralized at the

firm's headquarters. However, operating decisions, such as those relating to production, marketing, R&D, and human resource management, may or may not be centralized depending on the firm's international strategy.

6.9.2 Horizontal Differentiation: The Design of Structure

Horizontal differentiation is concerned with how the firm decides to divide itself into subunits. The decision is normally based on the basis of function, type of business, or geographical area. In many firms, just one of these predominates, but more complex solutions are adopted in others. This is particularly likely in the case of international firms, where the conflicting demands to organize the company around different products and different national markets (to remain locally responsive) must be reconciled. In this section we look at different ways firms divide themselves into subunits.

The Structure of Domestic Firms

Most firms begin with no formal structure and are run by a single entrepreneur or a small team of individuals. As they grow, the demands of management become too great for one individual or a small team to handle. At this point the organization is split into functions reflecting the firm's value creation activities (e.g., production, marketing, R&D, sales). These functions are typically coordinated and controlled by top management. Decision making in this functional structure tends to be centralized. Further horizontal differentiation may be required if the firm significantly diversifies its product offering, which takes the firm into different business areas.

The International Division

When firms initially expand abroad, they often group all their international activities into an international division. This has tended to be the case for firms organized on the basis of functions and for firms organized on the basis of product divisions. Regardless of the firm's domestic structure, its international division tends to be organized on geography.

Worldwide Area Structure

A worldwide area structure tends to be favoured by firms with a low degree of diversification and a domestic structure based on function. Under this structure, the world is divided into geographic areas. An area may be a country (if the market is large enough) or a group of countries. Each area tends to be a self-contained, largely autonomous entity with its own set of value creation activities (e.g., its own production, marketing, and R&D, human resources and finance functions). Operations authority and strategic

decisions relating to each of these activities are typically decentralized to each area, with headquarters retaining authority for the overall strategic direction of the firm and financial control.

Worldwide Product Division Structure

A worldwide product division structure tends to be adopted by firms that are reasonably diversified and, accordingly, originally had domestic structures based on products divisions. As with the domestic product divisional structure, each division is a self-contained, largely autonomous entity with full responsibilities for its own value creation activities. The headquarter retains responsibility for the overall strategic development and financial control of the firm.

Global Matrix structure

Both the worldwide area structure and the worldwide product divisional structure have strengths and weaknesses. The worldwide area structure facilitates local responsiveness, but it can inhabit the realization of location and experience curve economies and for transferring core competencies, but it is weak in local responsiveness. Other things being equal, this suggests that a worldwide area structure is more appropriate if the firm's strategy is multi-domestic, while a worldwide product divisional structure is more appropriate for firm perusing global or international strategies.

6.9.3 Integrating Mechanisms

In the previous sub-sections, we have explained that the firms divide themselves into subunits. Now we need to examine some means of coordinating those subunits. One way of achieving coordination is through centralization. If the coordination task is complex, however, centralization may not be very effective. Higher-level managers responsible for achieving coordination can soon become overwhelmed by the volume of work required to coordinate the activities of various subunits, particularly if the subunits are large, diverse, and/or geographically dispersed. When this is the case, firms look toward integrating mechanisms, both formal and informal, to help for achieving coordination.

Strategy and Coordination in the international Business

The need for coordination between subunits varies with strategy of the firm. The need for coordination is lowest in multidomestic companies, is higher in international companies, higher still in global companies and highest in international companies.

Multidomestic firms are primarily concerned with local responsiveness. Such firms are likely to operate with a worldwide area structure in which each area has considerable autonomy and its own set of value creation functions. Since each area is established as a stand-alone entity, the need for coordination between areas is minimized.

Formal Integrating Mechanisms

The formal mechanisms used to integrate subunits vary in complexity from simple direct contact and liaison roles, to teams, to a matrix structure. In general, the greater the need for coordination, the more complex the formal integrating mechanisms need to be.

Direct contact among subunit managers is the simplest integrating mechanism. By this 'Mechanisms', managers of the various subunits simply contact each other whenever they have a common concern. Direct contact may not be effective if the managers have differing orientation that act to impede coordination.

Liaison roles are a bit complex. When the volume of contacts among subunits increases, coordination can be improved by giving a person in each subunit responsibilities for coordinating with another subunit on a regular basis. Through these roles, the people involved establish a permanent relationship.

When the need for coordination is greater still, firms tend to use temporary or permanent teams composed of individuals from the subunits that need to achieve coordination. They are typically used to coordinate product development and introduction, but they are useful when any aspect of operations or strategy requires the cooperation of two or more subunits. Product development and introduction teams are typically composed of personnel from R&D, production, and marketing. The resulting coordination aids the development of products that are tailored to consumer needs and that can be produced at a reasonable cost.

When the need for integration is very high, firms may institute a matrix structure, in which all roles are viewed as integrating roles. The structure is designed to facilitate maximum integration among subunits. The most common matrix in multinational firms is based on geographical areas and worldwide product divisions. This achieves a high level of integration among the product divisions and the areas so that, in theory, the firm can play close attention to both local responsiveness and the pursuit of location and experience curve economies.

Informal integrating Mechanism: Management Networks

In attempting to alleviate or avoid the problems associated with formal integrating mechanisms in general, and matrix structures in particular, firms with a high need for integration have been experimenting with an informal integrating mechanism: management networks that are supported by an organization culture that values teamwork and cross-unit cooperation.

A management network is a system of informal contacts among managers within an enterprise. The great strength of a network is that it can be used as a non-bureaucratic conduit for knowledge flows within a multinational enterprise. For a network to exist, managers at different locations within the organization must be linked to one another at least indirectly.

Two techniques being used to establish networks are information systems and management development policies.

Firms are using their computer and telecommunications networks to provide the physical foundation for informal information systems networks. Electronic mail, videoconferencing, and high-speed data systems make it much easier for managers scattered over the globe to get to know one another. Without an existing network of personal contacts, however, worldwide information systems are unlikely to meet a firm's need for integration.

Firms are using their management development programs to build informal networks. Tactics include rotating managers through various subunits on a regular basis so that they build their own informal network and using management education programs to bring managers of subunits together in a single location so that they can become acquainted. Both of these tactics are used at Unilever to build its informal management network.

Note: This section has been adopted from "Hill et al.(2010). *"International Business"*. Tata McGraw-Hill Publishing Company Limited. 438-451.

6.10 Summary

- Internationalization refers to the decision to enter into foreign markets. Internationalization studies revolve around schools of thought that try to explain why and how companies go abroad.
- The motivations for internationalization include: market motives, economic motives and strategic motives. The motives will vary from one business activity to another,

producing multiple motivations for the international firm with a broad scope of activities in different parts of the globe.

- Various trends have converged in recent years as pressures in internationalization. The following are particularly notable: worldwide reduction in barriers to trade and investment, market liberalization and adoption of free markets, industrialization, economic development and modernization, integration of world financial markets, technological advances.
- The firm as a value chain is composed of series of distinct value creation activities including production, marketing and sales, materials management, R&D, human resources, information systems, and the firm infrastructure. These value creation activities can be categorized as primary activities and support activities.
- Many international markets are now extremely competitive due to the liberalization of the world trade and investment environment. In industry after industry, capable competitors confront each other around the globe. To be profitable in such an environment, a firm must both reduce the costs of value creation (lower C) and differentiate its product offering so that consumers value that product more (raise V) and are willing to pay more for the product than it costs to produce it. Thus, strategy is often concerned with identifying and taking actions that will lower the costs of value creation and/or will differentiate the firm's product offering through superior design, quality, service, functionality and so on.
- Firms that compete in the global market place typically face two types of competitive pressure. They face pressure for cost reductions and pressures to be locally responsive.
- Firms use four basic strategies to enter and compete in the international environment: an international strategy, a multidomestic strategy, a global strategy and a transnational strategy.
- International entry strategies concern where (location selection), when (timing of entry) and how (entry mode selection) international companies should enter and invest in a foreign territory during international expansion. These entry strategies are important because they determine an MNE's investment environment, operation treatment, resource commitment and evolutionary path.
- International location selection involves country selection and regional selection (e.g., state, province or city) for an MNE's foreign direct investment project(s).

Locational determinants can be categorized into the following groups: (1) cost tax factors; (2) demand factors; (3) strategic factors; (4) regulatory/economic factors; and (5) socio-political factors.

- Timing of entry involves the sequence of an MNE's entry into a foreign market vis-à-vis other MNEs (i.e., first mover, early follower, and late mover). Timing of entry is important because it determines the risks, environments, and opportunities the MNE may confront.
- An MNE seeking to enter a foreign market must make an important strategic decision concerning which entry mode to use. Entry modes are specific forms or ways of entering a target country to achieve strategic goals underlying international presence in that country. Entry mode choices fall into three categories: *trade-related, transfer-related, and FDI-related.*
- Trade-related entry modes include exporting, subcontracting, and countertrade.
- Transfer-related entry modes are those associated with transfer of ownership or utilization of specified property (technology or assets) from one party to the other in exchange for royalty fees. They differ from trade-related entry modes in that the user in a transfer-related mode "buys" certain rights of transacted property (e.g., use of technology) from the other party (owner). These modes are extensively employed in technology-related or intellectual/industrial property right-related transactions. This category includes the following entry modes: International leasing, International licensing, International franchising, Build-operate-transfer (BOT)
- FDI-related entry modes are more sophisticated than trade-related modes, and involve higher risk and longer-term contribution than both trade- and transfer-related choices. Compared with the later, FDI-related modes underline the firm's long-term strategic goals of international presence and necessitate continuous contribution and commitment to investments and operations abroad. FDI-related entry modes include: Branch office, Cooperative joint venture, Equity joint venture, Wholly-owned subsidiary, Umbrella holding company
- Organizational structure means three things: (1) the location of decision-making responsibilities within the structure, which is referred to as vertical differentiation; (2) the formal division of the organization into subunits, which is known as horizontal differentiation; and (3) the establishment of integrating mechanisms.

6.11 Self Assessment Questions

A. Objective Type Questions:

Choose the correct answer from the given four alternatives.

1. The tendency of national governments to reduce trade and investment barriers has accelerated
   - a) Global economic integration.
   - b) Global political integration.
   - c) Local economic integration.
   - d) Local political integration.
2. Conducting business by crossing national boundary (i.e., international business) could itself be a/an
   - a) objective for a firm
   - b) strategy for a firm
   - c) strategy for a state
   - d) strategy for a country
3. The firm as a value chain is composed of series of distinct value creation activities including production, marketing and sales, materials management, R&D, human resources, information systems, and the firm infrastructure.
   - a) production, marketing and sales
   - b) production, marketing and sales and materials management
   - c) production, marketing and sales, materials management, R&D, human resources, information systems, and the firm infrastructure.
   - d) production, marketing and sales, materials management, R&D, and human resources.
4. Firms that pursue ………………………………..try to create value by transferring valuable skills and products to foreign markets where indigenous competitors lack those skills and products.
   - a) a global strategy

b) a local strategy

c) a multinational strategy

d) an international strategy

5. Firms that pursue …………………..focus on increasing profitability by reaping the cost reduction that comes from experience curve effects and locations economies.

a) a global strategy

b) a local strategy

c) a multinational strategy

d) an international strategy

6. International entry strategies concern where (location selection), when (timing of entry) and how (entry mode selection) international companies should enter and invest in a ……………………..during international expansion.

a) local territory

b) foreign territory

c) regional territory

d) national territory

7. International ………………is an entry mode in which the foreign franchisor grants specified intangible property rights (e.g., trademark or brand name) to the local franchisee, which must abide by strict and detailed rules as to how it does business.

a) exporting

b) joint venture

c) franchising

d) countertrade

8. …………………….. is a form of trade in which a seller and a buyer from different countries exchange merchandise with little or no cash or cash equivalents.

a) exporting

b) joint venture

c) franchising

d) countertrade

9. ………………………..is a "turnkey" investment in which a foreign investor assumes responsibility for the design and construction of an entire operation, and, upon completion of the project, turns the project over to the purchaser and hands over management to local personnel whom it has trained.

a) Build-operate-transfer (BOT)

b) joint venture

c) franchising

d) countertrade

10. …………………………are more sophisticated than trade-related modes, and involve higher risk and longer-term contribution than both trade- and transfer-related choices.

a) Build-operate-transfer (BOT)

b) FDI-related entry modes

c) franchising

d) countertrade

Answer: 1 a); 2 b); 3 c); 4 d); 5 a); 6 b); 7 c); 8 d); 9 a); 10 b);

B. Short Answer Type Questions:

1. What do you mean by international leasing?
2. What is international franchising?
3. What do you mean by BOT?
4. What do you mean by international subcontracting?
5. What is meant by countertrade?
6. What is offset?
7. What is barter?
8. What do you mean by cooperative joint venture?

9. What do you mean by wholly – owned subsidiary?
10. What do you mean by umbrella holding company?

C. Long Answer Type Questions:

1. Why do firms expand internationally?
2. Discuss the different pressures of internationalization.
3. Narrate the different facets of strategic choices.
4. Explain the pressures for cost reduction and local responsiveness.
5. Write a short note on the firm as a value chain.
6. Explain the factors of the international location selection.
7. Briefly discuss the early-mover advantages and disadvantages.
8. Explain the different types of entry mode selection.
9. Discuss the different types of trade – related entry modes.
10. Narrate the different types of transfer – related entry modes.

Unit 7 ❑ Regional Economic Integration

Structure

7.1 Objectives

7.2 The European Union (EU)

7.2.1 Introduction

7.2.2 Goals of the EU

7.2.3 Institutions of EU

7.3 Association of Southeast Asian Nations (ASEAN)

7.3.1 Introduction

7.3.2 Aims and Purposes

7.3.3 Fundamental Principles

7.3.4 India- ASEAN Relations

7.4 South Asian Association for Regional Co-operation (SAARC)

7.4.1 Introduction

7.4.2 Objectives

7.4.3 Principles

7.4.4 Organizational Structure

7.4.5 SAARC Preferential Trading Arrangement (SAPTA)

7.4.5.1 Overview

7.4.5.2 Objective

7.4.5.3 The basic principles

7.4.5.4 Main components

7.5 Summary

7.6 Self Assessment Questions

7.1 Objectives

After studying this chapter students will be aware of three political as well as economic unions, namely, European Union, ASEAN and SAARC, operating in three different parts of the globe. This unit briefly discusses their objectives, structure and different dimensions.

7.2 The European Union (EU)

7.2.1 Introduction

The European Union is a political and economic union having 28 member states that are located mainly in Europe. It covers an area of 4,475,757 km² and an estimated population of over 510 million.

The EU has its roots to the years after the end of World War II, when the leaders of six war worn countries- Germany, France, Belgium, Italy, Luxembourg, and the Netherlands sought to establish peace and prosperity through economic and political cooperation. They signed the Treaty of Paris, in 1952, founding the European Coal and Steel Community (ECSC). Signing the Treaty of Rome in 1957 led to the formation of the European Economic Community (EEC). Eventually, the EU was formed on 1 November 1993, Maastricht, Netherlands. Its Headquarter is situated at City of Brussels, Belgium. Membership to EU is open to any country with a democratic government, a good human rights record, and sound economic policies. The member states delegate sovereignty to the EU institutions to represent the interests of the European Union in general. If a member state decides to withdraw, it needs to notify the European Council of its intention. According to the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. On 1st July 2013, Croatia became 28th member of EU. On the contrary following a referendum on 23 June 2016 in favour of withdrawing from the European Union, commonly known as BREXIT, British Prime Minister Theresa May invoked Article 50 on 29 March 2017. The United Kingdom is thus scheduled to withdraw from the EU on 29 March 2019.

7.2.2 Goals of the EU

The goals of the European Union are to:

- promote peace, its values and the well-being of its citizens

- offer freedom, security and justice without internal borders
- sustainable development based on balanced economic growth and price stability, a highly competitive market economy with full employment and social progress, and environmental protection
- combat social exclusion and discrimination
- promote scientific and technological progress
- enhance economic, social and territorial cohesion and solidarity among EU countries
- respect its rich cultural and linguistic diversity
- establish an economic and monetary union whose currency is the euro.

The EU has taken some steps to become a full-fledged economic union:

1. Market access: Most of the tariffs and other barriers have been removed.
2. Common market: Free movement of factors of production, i.e., labour, capital and technology among the member countries.
3. Trade rules: Members removed customs procedures and regulations, which rationalizes transportation and logistics within Europe.
4. Standards harmonization: The EU is harmonizing technical standards, regulations, and enforcement procedures that relate to products, services, and commercial activities.

7.2.3 Institutions of EU

The main institutions that administer the EU are listed in Article 13 as:

The European Parliament: It consists of 749 members. Article 14 limits the number to 751 and also states that no member state shall have more than 96 MEPs. It can be noted that only Germany has 96 MEPs at the moment. The Parliament elects its own President and officers from within itself. It also elects the Commission President but does so following a proposal from the European Council. Its main function is to exercise law-making functions along with the Council.

The European Council: It consists of Heads of State or Government of member states, plus its President and the President of the Commission. Its main function is to define the general policy of the Union.

The Council: It is the law-making body, along with the European Parliament.

The Court of Justice of the European Union: It consists of a number of different courts, some specialised, with judges appointed by member states.

The European Central Bank: Together with national central banks it constitutes the European System of Central Banks.

The Court of Auditors: It consists of one appropriately qualified national of each member state, appointed by the Council on proposals from member states. They are appointed for six years at a time.

7.3 Association of Southeast Asian Nations (ASEAN)

7.3.1 Introduction

The ASEAN was formed on 8 August 1967 in Bangkok, Thailand, with the signing of the Bangkok Declaration by five countries, namely, Indonesia, Malaysia, Philippines, Singapore and Thailand. Consequently, Brunei Darussalam joined on 7 January 1984, Viet Nam on 28 July 1995, Lao PDR and Myanmar on 23 July 1997, and Cambodia on 30 April 1999, making up the ten Member States of ASEAN.

7.3.2 Aims and Purposes

The aims and purposes of ASEAN are:

1. To accelerate the economic growth, social progress and cultural development in the region through joint endeavours 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 promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries of the region and adherence to the principles of the United Nations Charter.
3. To promote active collaboration and mutual assistance on matters of common interest in the economic, social, cultural, technical, scientific and administrative fields.
4. To provide assistance 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 utilisation 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 promote Southeast Asian studies.
7. To maintain close and beneficial cooperation with existing international and regional organisations with similar aims and purposes, and explore all avenues for even closer cooperation among themselves.

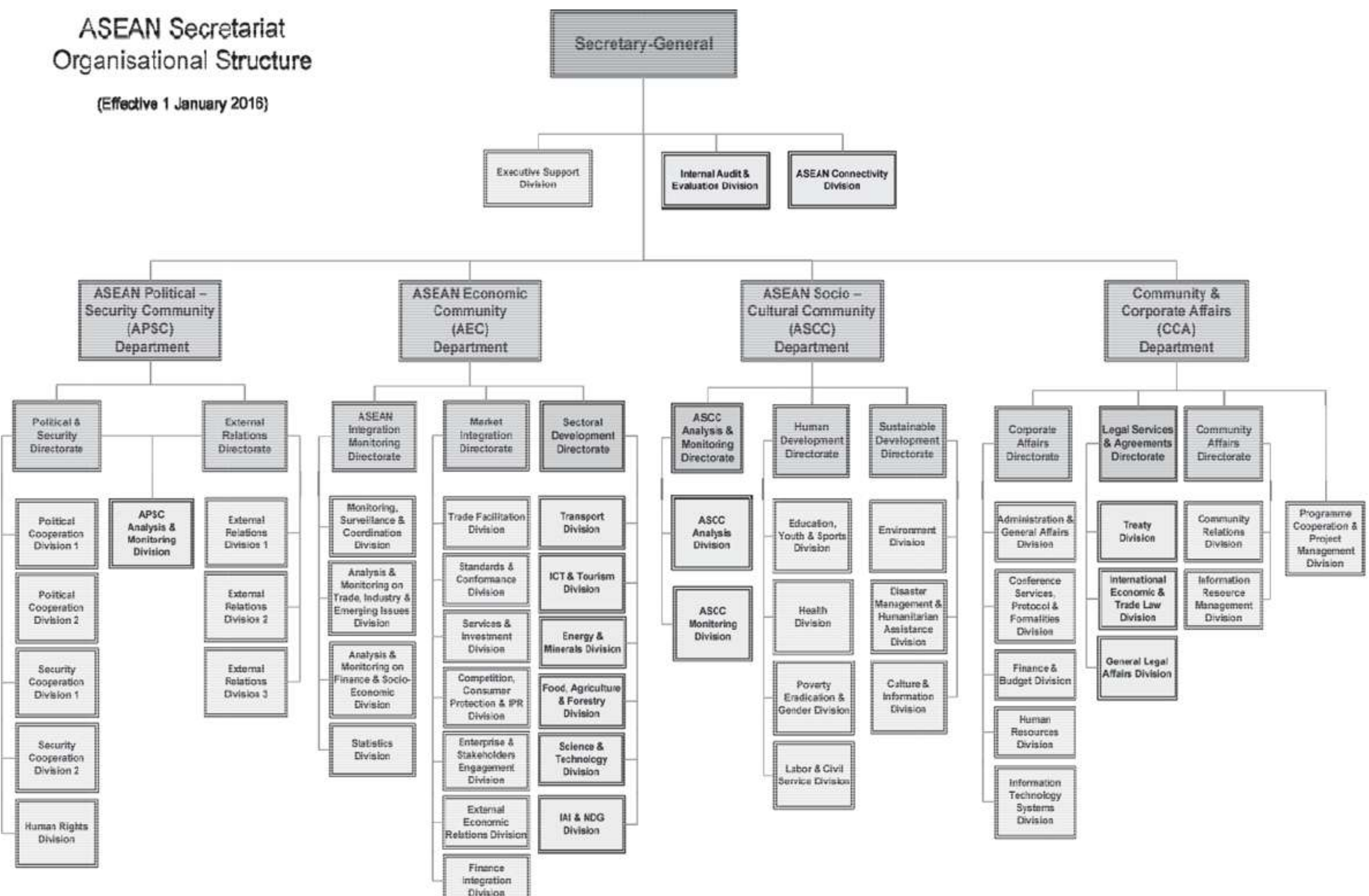
7.3.3 Fundamental Principles

The Member States of ASEAN has adopted the following fundamental principles, as contained in the Treaty of Amity and Cooperation in Southeast Asia (TAC) of 1976:

1. Mutual respect for the independence, sovereignty, equality, territorial integrity, and national identity of all nations;
2. The right of every State to lead its national existence free from external interference, subversion or coercion;
3. Non-interference in the internal affairs of one another;
4. Settlement of differences or disputes by peaceful manner;
5. Renunciation of the threat or use of force; and
6. Effective cooperation among themselves.

7.3.4 India- ASEAN Relations

India's relationship with ASEAN is a key pillar of Indian foreign policy and the foundation of its Act East Policy. India became a Sectoral Partner of the ASEAN in 1992, Dialogue Partner in 1996 and Summit Level Partner in 2002. There are, in total, 30 Dialogue Mechanisms between India and ASEAN, cutting across various sectors. India and ASEAN observed 25 years of their Dialogue Partnership, 15 years of Summit Level interaction and 5 years of Strategic Partnership throughout 2017 by undertaking a wide range of over 60 commemorative activities, both in India and through its Missions in ASEAN Member States, which concluded in the ASEAN-India Commemorative Summit on the theme "Shared Values, Common Destiny" on 25 January 2018 in New Delhi. At the ASEAN-India Commemorative Summit, PM and the ASEAN Leaders jointly adopted



Source: https://asean.org/asean/asean-structure/organisational-structure-2/.

the Delhi Declaration and decided to identify Cooperation in the Maritime Domain as the key area of cooperation under the ASEAN-India strategic partnership.

The main forum for ASEAN security dialogue is the ASEAN Regional Forum (ARF). India has been attending annual meetings of this forum since 1996 and has actively participated in its various activities. The ASEAN Defence Ministers' Meeting (ADMM) is the highest defence consultative and cooperative mechanism in ASEAN. The ADMM+ brings together Defence Ministers from the 10 ASEAN nations plus Australia, China, India, Japan, New Zealand, Republic of Korea, Russia, and the United States on a biannual basis.

Economic Cooperation: India-ASEAN trade and investment relations have been growing steadily, with ASEAN being India's fourth-largest trading partner. India's trade with ASEAN stands at US$ 81.33 billion, which is approx. 10.6% of India's overall trade. India's export to ASEAN stands at 11.28% of its total exports.

ASEAN accounting for approximately 18.28% of investment flows into India since 2000. FDI inflows into India from ASEAN between April 2000 to March 2018 was about US$68.91 billion, while FDI outflows from India to ASEAN countries.

ASEAN and India have been also working on enhancing private sector engagement. ASEAN India-Business Council (AIBC) was set up in March 2003 in Kuala Lumpur as a forum to bring key private sector players from India and the ASEAN countries on a single platform for business networking and sharing of ideas. [source: http://mea.gov.in/aseanindia/20-years.htm]

7.4 South Asian Association for Regional Co-operation (SAARC)

7.4.1 Introduction

Organization of South Asian nations, founded in 1985 and dedicated to economic, technological, social, and cultural development emphasizing collective self-reliance. The Secretariat of the Association was set up in Kathmandu on 17 January 1987. Its seven founding members are Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka. Afghanistan joined the organization in 2007. Meetings of heads of state are usually scheduled annually; meetings of foreign secretaries, twice annually. Headquarters are situated in Kathmandu, Nepal.

The areas of cooperation are agriculture; education, culture, and sports; health, population, and child welfare; the environment and meteorology; rural development (including the SAARC Youth Volunteers Program); tourism; transport; science and technology; communications; women in development; and the prevention of drug trafficking and drug abuse. The charter stipulates that decisions are to be unanimous and that "bilateral and contentious issues" are to be avoided.

7.4.2 Objectives

The objectives of the Association are as follows:

a) To promote the welfare of the peoples of South Asia and to improve their quality of life.

b) To accelerate economic growth, social progress and cultural development in the region and to provide all individuals with the opportunity to live in dignity and to realize their full potential.

c) To promote and strengthen collective self-reliance among the countries of South Asia.

d) To contribute to mutual trust, understanding and appreciation of one another's problems.

e) To promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields.

f) To strengthen cooperation with other developing countries.

g) To strengthen cooperation among themselves in international forums on matters of common interests.

h) To cooperate with international and regional organizations with similar aims and purposes.

7.4.3 Principles

Cooperation within the framework of the Association is based on respect for the principles of sovereign equality, territorial integrity, political independence, non-interference in the internal affairs of other States and mutual benefit.

Such cooperation is to complement and not to substitute bilateral or multilateral cooperation.

Such cooperation should be consistent with bilateral and multilateral obligations of Member States

General Provisions:

Decisions at all levels in SAARC shall be taken on the basis of unanimity

Bilateral and contentious issues shall be excluded from the deliberations of the Association.

7.4.4 Organizational Structure

The SAARC comprises five layers of organizational structure:

1. **Council:** At the top, there is the Council represented by the heads of the government of the member countries. The council is the apex policy-making body. It meets once in 2 years time.
2. **Council of Ministers:** It is to assist the council. It is represented by the foreign minister of the member countries. Its functions include:
   a) Formulation of policies
   b) Review of functioning
   c) Deciding new areas of cooperation
   d) Chalk our additional mechanism
   e) Decide about general issues of commonality of interest of the SAARC member.
3. **Standing Committee:** It is comprised of the foreign secretariat of the member government. Its major functions are:
   a) To monitor and co-ordinate the programmes
   b) To determine inter-sectored priorities
   c) To mobilise cooperation within and outside the region
   d) To deal with the modalities of financing.
4. **Programming Committee:** It consists of the senior official of the member governments. Its functions include:
   a) Scrutinizing the budget of the secretariats
   b) Finalizing the annual schedule

c) External activities assigned by the standing committee

d) Analyses the respects of the technical committee.

5. **Technical Committee:** It consists of the representatives of the member nations. Its functions are:

   a) To formulate projects and programmes

   b) To monitor and execute the projects

   c) To submit reports.

Under the new SAARC Integrated Programme of Action (SIPA), the number of Technical Committees has been reduced from eleven to seven mainly through the amalgamation of the different sectors covered by the various Technical Committees and eliminating overlapping, duplication and waste. The prime objective of the reorganization has been to enhance clarity in terms of the goals and targets of the activities undertaken, as well as to improve the Committees quality and efficacy. The seven Technical Committees under SIPA now cover 1. Agriculture and Development 2. Communications and Transport 3. Social Development 4. Environment, Meteorology and Forestry 5. Science and Technology 6. Human Resources Development, and 7. Energy.

6. **Secretariat:** The SAARC Secretariat is located in Nepal. Its main functions are:

   a. Coordination, execution and monitoring of SAARC activities.

   b. Servicing the SAARC meetings.

   c. Performing as a communication link between the SAARC and other international forums.

The secretariat is headed by the Secretary-General appointed by the Council of Ministers. These are seven Directors (One from each member nation) and the general service staff.

7.4.5 SAARC Preferential Trading Arrangement (SAPTA)

7.4.5.1 Overview

The Agreement on SAARC Preferential Trading Arrangement (SAPTA) which envisages the creation of a Preferential Trading Area among the seven-member states of the SAARC,

namely Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka was signed in Dhaka on April 1993. The idea of liberalizing trade among SAARC countries was first initiated by Sri Lanka at the sixth Summit of the South Asian Association for Regional Co-operation (SAARC) held in Colombo on December 1991. It was agreed that SAPTA is a stepping stone to higher levels of trade liberalization and economic co-operation among the SAARC member countries.

7.4.5.2 Objective

The objective of the SAPTA is to promote and sustain mutual trade and the economic co-operation among the member states through the exchange of trade concessions. SAPTA, therefore, is the first step towards higher levels of trade and economic co-operation in the region.

7.4.5.3 The basic principles

- Overall reciprocity and mutuality of advantages
- Step by step negotiations and periodic reviews so as to improve and extend the preferential trade arrangement, in stages
- Inclusion of all products, manufactures and commodities in their raw semi-processes and processed forms
- Special and favourable treatment to the Least Developed Contracting States

7.4.5.4 Main components

- Tariff
- Para Tariff
- Non Tariff

Direct Trade Measures

SAPTA specified four negotiating approaches namely, product by product basis, across the board tariff reduction, sectoral basis and direct trade measures. However, it was agreed that tariff concessions would initially be negotiated on a product - by- product basis. The agreement also provides for negotiation of tariff concessions to be an ongoing process. The SAPTA envisages that concessions on tariff, para-tariff and non-tariff measures will be negotiated step -by step improved and extended in successive stages.

National Schedules of Concessions

The process of negotiation on the schedule of concession, which forms an integral part of the Agreement, commenced in 1993. For this purpose, the Inter-Governmental Group on Trade Liberalization (IGG) was set up. The IGG met on six occasions in various capitals. At the sixth meeting held in Katmandu on 20th and 21 st April 1995, the delegations held intensive rounds of bilateral and multilateral negotiations and agreed on the National Schedule of concessions to be granted by individual member states to other member states under the SAPTA Agreement.

Four rounds of trade negotiations were concluded under SAPTA covering over 5000 commodities. Each Round contributed to an incremental trend in the product coverage and the deepening of tariff concessions over previous Rounds.

During the first and second rounds, trade negotiations were conducted on a product by product basis. In the third and the fourth rounds, negotiations were conducted on chapter wise.

Maintenance of SAPTA Concession

The Agreement on the South Asian Free Trade Area (SAFTA)which was implemented with effect from 1st January 2006 will supersede the SAARC Preferential Trading Arrangement (SAPTA). On the issue of maintaining SAPTA concessions for LDCs, the Committee agreed that once the Non-LDCs member states complete the Trade Liberalization Programme (TLP) for LDC member states, SAPTA concessions would cease for LDC member states. However, if any item on which SAPTA concessions are available to LDC, appear in the sensitive lists of non-LDC, they shall maintain the same level of concession through derogation. The Committee has further agreed that if the items under TLP enjoy tariff preferences under SAPTA, the Non-LDCs shall reduce their tariff on those items to a rate not higher than the rate applicable for LDCs under SAPTA on the date agreed for base rate for TLP. It was also agreed at the first SAFTA Ministerial Council Meeting held in April that LDCs should also maintain concessions under SAPTA for Non-LDCs until the completion of TLP irrespective of whether the products are in the sensitive lists or not.

7.5 Summary

The EU, ASEAN and SAARC are three important organizations operating in three different parts of the globe. Foundation of the European Coal and Steel Community (ECSC) in 1952 and signing the Treaty of Rome in 1957 led to the formation of the European Economic Community (EEC). Eventually, the EU was formed on 1 November 1993. It ensures that most of the tariffs and other barriers have been done away with, free movement of production factors-labour, capital and technology among the member countries, elimination of customs procedures and regulations, which rationalizes transportation and logistics within Europe.

The ASEAN, was established on 8 August 1967 in Bangkok, Thailand to accelerate the economic growth, social progress and cultural development in the region, to promote regional peace and stability, to provide assistance to each other in the form of training and research facilities in different areas and to collaborate for the utilization of agriculture and industries, the expansion of trade, the improvement of transportation and communications facilities and the raising of the living standards of the member countries.

Organization of South Asian nations, founded in 1985 and dedicated to economic, technological, social, and cultural development emphasizing collective self-reliance. The 11 stated areas of cooperation are agriculture; education, culture, and sports; health, population, and child welfare; the environment and meteorology; rural development.

7.6. Self Assessment Questions

Long Answer Type Questions:

1. Discuss different institutions of European Union.
2. What are the aims and purposes of ASEAN?
3. Enumerate the objectives and principles of SAARC.
4. Discuss in brief the organizational structure of SAARC.
5. Write a note on SAPTA

Short Answer Type Questions:

1. What are the steps of EU?

2. What are those steps EU has taken to become a full-fledged economic union?
3. What are the principles of ASEAN?

Objective Type Questions:

1. What is the full form of ECSC?
2. Where the headquarter of EU is situated?
3. What is the full form of SAPTA?
4. What is meant by SIPA?

Unit 8 ❑ International Financing and International Economic Institutions

Structure

8.1 Objectives
8.2 International Financial Market
8.3 Market Access
8.4 Intergovernmental Organizations (IGO)
8.4.1 Euro Market
8.4.2 International Monetary Fund (IMF)
8.4.3 World Trade Organization (WTO)
8.4.4 World Bank
8.4.5 Asian Development Bank (ADB)
8.5 Summary
8.6 Self Assessment Questions

8.1 Objectives

After studying this chapter students will be aware of different international economic institutions. After having a preliminary idea regarding international financial markets and different modes used in accessing domestic markets by foreign investors, they will learn about the Euro Markets, IMF, WTO, World Bank and ADB.

8.2 International Financial Market

The International Financial Market is the place where financial wealth is traded between individuals and countries. To procure funds MNC is in a better position than the domestic firm as the former has greater access to the international financial market. The international financial market may be divided into two segments. International money market is concerned with short term funds. On the other hand, International capital market deals with long

term funds. International financial market may also be categorized from the point of view of resource providing agencies. They are as follows:

a) Official Sources:

   i) Multilateral agencies like international development banks, such as the World Bank, IFC etc., regional development banks, such as the Asian Development Bank, etc.

   ii) Bilateral Agencies or different governmental agencies.

b) Non-Official Sources:

This channel comprises the borrowing and the lending streams such as Euro-currency market or international banks in one hand and divergent types of financial instruments in the international securities market on the other hand. Moreover, Swap is also very common in the international financial market. Different other derivative instruments are also being used in the market.

8.3 Market Access

Market access is the ability of a company or country to sell goods and services across borders. Market access can be used to refer to domestic trade as well as international trade although the latter is the most common context. Market access is sometimes misunderstood with free trade. But they are not the same. Tariffs, duties and quotas put a barrier to free trade. Second, through complex negotiations participants typically push for market access that favours their particular export industries and attempting to limit market access to import products that could potentially compete with sensitive or politically strategic domestic industries. Market access is seen as an early step towards deepening trade ties. Market access is increasingly the stated goal of trade negotiations as opposed to true free trade. Apart from export and import foreign investments in the following three forms also play significant roles:

Foreign Direct Investment (FDI): FDI is investing directly in another country. A foreign company which is based in some other country like the USA invests in India either by setting up a wholly-owned subsidiary or getting into a joint venture with some company based in India and then conducts its business in India.

Examples: Various software companies like IBM India which is initially based in the United States but has opened its subsidiaries in a different part of India, Honda is yet another example in which Honda of Japan had joint ventured with Maruti Udyog Ltd.

SBI life insurance is a joint venture life insurance company between State Bank of India (SBI) and BNP Paribas Assurance of France.

Foreign Portfolio Investment (FPI): FPI is also direct investment but investment in only financial assets such as stocks, bonds etc. of a company located in another country. In the case of FPI, portfolio investment is an investment made by an investor who is not involved in the management and day-to-day decision making a company as in FDI.

Example: Any foreign company invests in the shares of Infosys (based in India).

Foreign Institutional Investment (FII): FII is an investor or group of investors who bring FPIs. Institutional investors include hedge funds, insurance companies, pension funds and mutual funds. They participate in the secondary market of the economy. To participate in the market of India, FIIs must register themselves with the Securities and Exchange Board of India (SEBI).

8.4 Intergovernmental Organizations (IGO)

In the field of international business, there are many Intergovernmental Organizations (IGO). IGOs are there because many issues of international business cannot be dealt with in a national framework. Out of many such IGOs three most important IGOs that originated from the 1944 Bretton Woods conference are the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD) or World Bank and the General Agreement on Tariffs and Trade (GATT), which gave birth of World Trade Organization (WTO).

There is no dearth of studies trying to unearth the motivation behind the birth of the above IGOs. Researchers usually are of the opinion that these are the platforms where cross-border concerns could be handled. This was in reaction to the beggar-thy-neighbour policies [where one country purposefully tries to improve its economic position at the expense of its trading partners by keeping exchange rates artificially low, taxing imports, etc.] that some countries adopted in the 1930s, protectionism whose negative effects on world trade deepened the Great Depression.

8.4.1. Euro Market

According to the Cambridge Business English Dictionary, Euro market can be viewed from two different angles. From the viewpoint of Finance, it is a large financial market for Eurocurrencies On the contrary, from the angle of Commerce it is defined as the

single market that includes all the countries in the EU which allow free trade between member countries and agrees to abide by a set of rules for trading with other countries. The Euro market is a massive market comprising many member nations of the EU and facilitates the free movement of goods and services. Putting differently, efficient trade mechanisms such as low tariffs, quotas etc. are kept in place and have a centralized monetary policy with most of them using a common currency - Euro. The euro market is a vital player in international trade.

Figure adapted from the IMF website.

The Eurocurrency market consists of banks (called Eurobanks) that accept deposits and provide loans in foreign currencies. Eurocurrency may be any deposit of a currency in a country other than that of the currency's origin. For example, a deposit of USD in a

bank in Europe is a deposit of Eurodollars. The entire market for loans and deposits in Euro currency is the Euro currency Market. The Eurocurrency Market, instead of having buyers and sellers, has lenders and borrowers. It is noteworthy that the prefix "Euro" is historical in nature, indicating that the market was initially centred in Europe. A Euro currency is a freely convertible currency deposited in a bank located in a country which is not the native country of the currency. The deposit can be placed in a foreign bank or in the foreign branch of a domestic US bank. In the Eurocurrency market, short-term claims on commercial banks held by investors are transformed by intermediaries into long-term claims on final borrowers. Eurocurrency market is a chain of deposits and a chain of borrowers and lenders. The majority of Euro currency transactions involve transferring control of deposits from one Eurobank to another Eurobank. Loans to non-Eurobank borrowers account for less than half of all Eurocurrency loans. Usually, Euro banks are able to pay higher rates on deposits and charge lower rates on loans than purely domestic banks. This is possible because they can often avoid government regulations such as reserve requirements and the need to pay deposit insurance. This downs the cost of operations for Euro banks and these lower costs can be passed through to the clients. Euro currency loans are generally huge and the customers are well-known firms. Thus, the banks do not face much default risk and can charge lower margins on the large loans. The main feature of Euro currency loans is that they are usually floating rate (this also referred to as rollover pricing or as cost-plus pricing) and are typically set as a percentage over LIBOR.

Eurobonds may be defined as bonds sold outside the country whose currency they are dominated in. They are similar to public debt sold in domestic capital markets. However, the Eurobond market is entirely free of official regulation and is self-regulated by the Association of International Bond Dealers. Borrowers in the Eurobond market are well known and have good credit ratings. The Eurobond market has grown rapidly in the last two decades, and it exceeds the Eurocurrency market in size.

8.4.2 International Monetary Fund (IMF)

International Monetary Fund (IMF) is an international agency of 189 members. It has its headquarters in Washington, D.C. The Fund's aim is to stabilize currencies by monitoring the foreign exchange systems of member countries, and lending money to developing economies. The IMF's primary goal is to ensure the stability of the system of exchange rates and international payments which permits members to transact with each

other. The Fund's mandate was updated in 2012 to incorporate all macroeconomic and financial sector issues that bear on international stability.

Objectives: Briefly, the objectives of the IMF are to:

a) promote international financial cooperation;

b) facilitate the expansion and balanced growth of international trade;

c) promote exchange stability;

d) assist in the establishment of a multilateral system of payments; and

e) make resources available to members experiencing a balance of payments difficulties.

IMF Fast Facts

Membership: 189 countries

Headquarters: Washington, D.C.

Executive Board: 24 Directors each representing a single country or a group of countries

Staff: Approximately 2,700 from 148 countries

Total quotas: US$668 billion (as of 9/13/16)

Additional pledged or committed resources: US$ 668 billion

Committed amounts under current lending arrangements (as of 9/8/16): US$159 billion, of which US$144 billion have not been drawn.

Biggest borrowers (amounts outstanding as of 8/31/16): Portugal, Greece, Ukraine, Pakistan

Biggest precautionary loans (amount agreed as of 9/8/16): Mexico, Poland, Colombia, Morocco

Surveillance consultations: 130 consultations in 2013 and 132 in 2014, and 124 in 2015

Capacity development: 274 person-years in FY2013, 285 in FY2014, and 288 in FY2015

Organization and Finance:

Management

At the top of IMF's organizational structure is the Board of Governors. It consists of one Governor and one Alternate Governor from each member country (generally from the central bank or the ministry of finance). The Board of Governors meets once a year at the IMF–World Bank Annual Meetings. Governors sit on the International Monetary and Financial Committee (IMFC) and normally meet twice a year. The IMF's day-to-day work is supervised by its 24 member Executive Board, that represents the entire membership. This work is guided by the IMFC and supported by the IMF staff. Managing Director is the head of the staff and Chairperson of the Executive Board of IMF. The Managing Director is appointed by the Executive Board for a renewable term of five years. To assist the Managing Director there are Deputy Managing Director and three Deputy Managing Directors. According to the IMF's Articles of Agreement, the Managing Director shall be the chief of the operating staff of the Fund and shall conduct, under the direction of the Executive Board, the ordinary business of the Fund. Subject to the general control of the Executive Board, he shall be responsible for the organization, appointment, and dismissal of the staff of the Fund.

Governance Structure

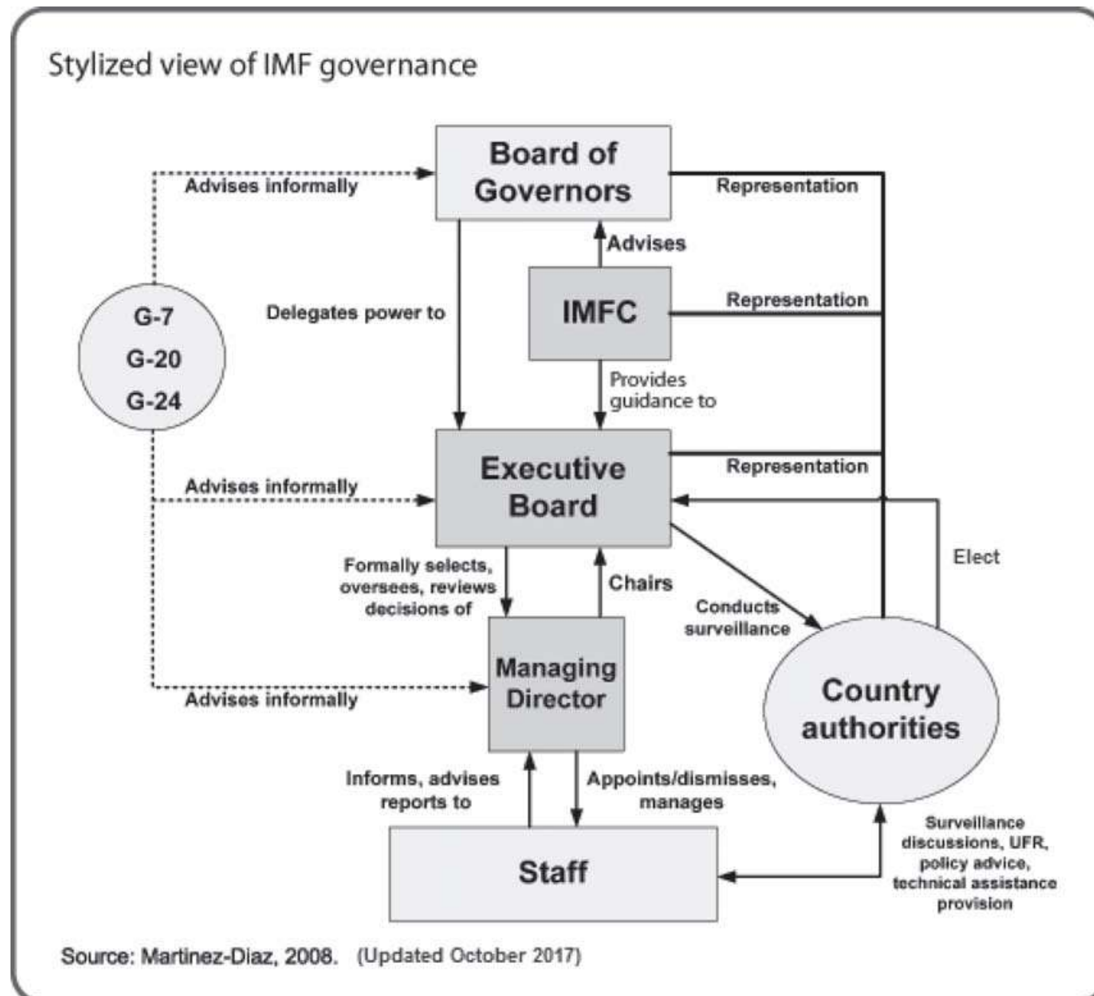
The present governance structure of the organization can be seen in the following pictorial representation (adopted from the IMF website).

Quotas

IMF's main source of financing is quotas. Each member of the IMF is assigned a **quota**. This is based on its relative position in the global economy.

The IMF regularly conducts general reviews of quotas in order to assess the adequacy of overall quotas and their distribution among members. The 14th review (the latest) was concluded in 2010 and the quota increases became effective in 2016.

Each member of the IMF is assigned a quota expressed in special drawing rights (SDRs) The member's capital subscription to the IMF is equal to its quota. Members pay up to 25 per cent of their quota in the form of reserve assets and the remainder in their own currency. A member borrows from the IMF by purchasing reserve assets using its own currency and repays the IMF by repurchasing its own currency using reserve assets. The total quota or capital subscription of all members are currently SDR 212.8 billion.



Other Functions of Quotas. Quotas determine the size of the IMF and play a central role in the IMF's operations. Other functions of quota are as follows:

a) **Lending Capacity.** Quota subscriptions by members provide by far the bulk of the reserve assets available to the IMF to finance its lending operations. Therefore, quotas to a large extent determine the lending capacity of the IMF.

b) **Voting Power.** Quotas largely determine the distribution of the voting power of the IMF and, therefore, the relative influence of individual members in decision-making at the IMF.

c) **Access Limits.** The limit of members' access to IMF resources is stated as a per cent of quota . Hence, quotas determine the maximum level of a country's

access. These access limits vary according to the type of borrowing arrangement between the member and the IMF. For example, under the credit tranches and the Extended Fund Facility, borrowing is subject to an annual limit of 100 per cent of quota and a cumulative limit of 300 per cent of quota.

Special Drawing Rights (SDR)

Special drawing rights (SDR) are the international type of monetary reserve currency created by the International Monetary Fund (IMF) in 1969. It is essentially an artificial currency used by the IMF and is a basket of national currencies. This operates as a supplement to the existing reserves of member countries. It is created due to the limitations of gold and dollars as the sole means of settling international accounts. SDRs increase international liquidity by supplementing the standard reserve currencies. SDRs are allocated by the IMF to its member countries and are backed by the full faith and credit of the member countries' governments.

The SDR was initially defined as equivalent to 0.888671 grams of fine gold (equal to one US $ that time). After the collapse of the Bretton Woods system, the SDR was redefined as a basket of currencies. Currently, there are five currencies in the basket. The current position of SDR is as follows:

Currency	Weights determined in the 2015 Review	Fixed Number of Units of Currency for a 5-year period Starting Oct 1, 2016
U.S. Dollar	41.43	0.58252
Euro	30.93	0.38671
Chinese Yuan	8.33	1.0174
Japanese Yen	8.09	11.900
Pound Sterling	10.92	0.085946

(Source: IMF)

Surveillance

Every year, the IMF sends economists to each of its member countries to examine fiscal and monetary policy, exchange rate, general macroeconomic stability, and any related policies, such as labour policy, trade policy, and social policy like pension system. This

process is in accordance with Article IV consultation. The purpose of this consultation is to provide an outside check on national decisions that might have an effect on the international economic system. IMF executive board discusses the report produced by the economists and gives it to the leaders of the country in question as to the official opinion of the IMF. A version of the report is also published and available as an IMF Public Information Notice (PIN).

IMF also publishes its analysis of the world economic system in its World Economic Outlook twice per year and the Global Financial Stability Report, which focuses specifically on the international capital markets, also twice per year.

Financial Assistance

The IMF provides credits and loans to member countries having problems with the **balance of payments** to pay off their obligations and readjust their economic policies. To receive assistance the member-country must agree, through a "letter of intent," to implement changes in its fiscal and monetary policies that IMF experts have determined are necessary.

The loans are disbursed in phases after ensuring that the receiving country moves forward with the reforms required to avail it. Loans are generally granted for relatively short periods of time (for just a few months), or for as long as ten years, depending on the type of loan. The receiving country must pay back loans on time, on a rigorous schedule, because the loans are intended to be temporary assistance.

The IMF provides assistance through several lending programs :

a) **Stand-by arrangements** are loans granted for specific amounts over 12 to 18 months to deal with short-term problems.

b) **The Extended IMFs Facility** is used to help a member-country deal with what are called "structural" economic problems resulting from a history of poor economic planning. The IMF attaches strong conditions to loans through this facility, which are granted for three to four-year terms.

c) The **Poverty Reduction and Growth Facility** is granted at low-interest rates to poor countries.

d) The **Supplemental Reserve Facility** grants short-term loans during crises but adds a surcharge to discourage too much borrowing.

e) **Contingent Credit Lines** are granted during waves of crises that can spread from one country to another, called “contagions.”

f) **Emergency Assistance** is granted to countries facing military conflicts or other sudden disasters.

Technical Assistance

The IMF provides technical assistance on fiscal and monetary policy, regulatory procedures, tax policy, and collection of statistics, among other issues. Objectives of these programmes are : strengthening developing countries’ abilities to reform and properly manage their macroeconomic policies. The IMF dispatches its own experts and private consultants on training missions to educate government officials and also runs the IMF Institute in Washington, D.C. to provide courses for officials.

India and the IMF

a) India joined the IMF on December 27, 1945, as one of the IMF’s founder members.

b) India accepted the obligations of Article VIII (Agreement on current account convertibility) on August 20, 1994.

c) India subscribes to the IMF’s Special Data Dissemination Standard. Countries belonging to this group make a commitment to observe the standard and to provide information about their data and data dissemination practices.

Financial Assistance

IMF credit has been beneficial in helping India respond to the emerging balance of payments problems on two occasions. In 1981-82, India borrowed SDR 3.9 billion under an Extended Fund Facility, the largest arrangement in IMF history at that time. In 1991-93, India borrowed a total of SDR 2.2 billion under two stand-by arrangements, and in 1991 it borrowed SDR 1.4 billion under the Compensatory Financing Facility.

Technical Assistance

IMF has provided India with technical assistance in different areas, including the development of the government securities market, foreign exchange market reform, public expenditure management, tax and customs administration, and strengthening statistical systems in connection with the Special Data Dissemination Standards. Since 1981 the IMF has provided training to Indian officials in national accounts, tax administration, the balance of payments compilation, monetary policy, and other areas.

8.4.3 World Trade Organization (WTO)

The World Trade Organization is an intergovernmental organization that regulates international trade. It is the only international organization dealing with the global rules of trade between nations. Its main function is to ensure that trade flows as freely as possible. The WTO officially commenced on 1 January 1995 under the Marrakesh Agreement, signed by 124 nations on 15 April 1994, replacing the General Agreement on Tariffs and Trade (GATT), which commenced in 1948. Its headquarter is located in **Geneva, Switzerland.** Current member of this organization is 164 accounting for about 95% of world trade. Apart from these, 25 others are negotiating members.

Roberto Azevêdo is the sixth Director-General of the WTO. His appointment took effect on 1 September 2013 for a four-year term. In February 2017, WTO members agreed to appoint Mr Azevêdo for a second four-year term, starting on 1 September 2017.

Structure

In WTO decisions are made by the entire membership typically by consensus. A majority vote has never been used in the WTO and was extremely rare under the WTO's predecessor, GATT. The WTO's agreements have been ratified in all members' parliaments.

The WTO's top-level decision-making body is the Ministerial Conference which meets at least once every two years. Under this is the General Council (normally ambassadors and heads of delegation in Geneva, but sometimes officials sent from members' capitals) which meets several times a year in the Geneva headquarters. The General Council also meets as the Trade Policy Review Body and the Dispute Settlement Body. At the next level, the Goods Council, Services Council and Intellectual Property (TRIPS) Council report to the General Council.

A large number of specialized committees, working groups and working parties deal with the individual agreements and other areas such as the environment, development, membership applications and regional trade agreements.

Secretariat

The WTO Secretariat, based in Geneva, has around 640 staffs and is headed by a director-general.

The Secretariat's main duties are:

a) to supply technical support for the various councils and committees and the ministerial conferences;

b) to provide technical assistance for developing countries;

c) to analyze world trade, and to explain WTO affairs to the public and media;

d) to provide legal assistance in the dispute settlement process and advises governments wishing to become members of the WTO.

WTO's main activities are:

a) Negotiating the reduction or elimination of obstacles to trade (import tariffs, other barriers to trade) and agreeing on rules governing the conduct of international trade (e.g. anti-dumping, subsidies, product standards, etc.).

b) Administering and monitoring the application of the WTO's agreed rules for trade in goods, trade in services, and trade-related intellectual property rights.

c) Monitoring and reviewing the trade policies of members, as well as ensuring transparency of regional and bilateral trade agreements.

d) Settling disputes among members regarding the interpretation and application of the agreements.

e) Building capacity of developing country government officials in international trade matters.

f) Assisting the process of accession of those countries who are not yet members of the organization.

g) Conducting economic research and collecting and disseminating trade data in support of the WTO's other main activities.

h) Informing the public about the WTO, its mission and its activities.

Differences between GATT and WTO

From 1948 to 1994, the GATT provided the rules for world trade and presided over periods that saw some of the highest growth rates in international commerce. It seemed well-established but throughout those 47 years, it was a provisional agreement and organization. Creation of WTO marked the biggest reform of international trade since the end of the Second World War. Whereas the GATT mainly dealt with trade in

goods, the WTO and its agreements also cover trade in services and intellectual property. The birth of the WTO also created new procedures for the settlement of disputes.

GATT	WTO
1. It is a set of rules.	1. It is a permanent institution.
2. It was designed with an attempt to establish an International Trade Organization.	2. It has its own purpose.
3. It was applied on a temporary basis.	3. Its activities are permanent.
4. It was originally a multilateral instrument, but plurilateral agreements were added at a later stage	4. Its agreements are multilateral.

GATS, TRIMs, TRIPs

GATS (General Agreements on Trade in Services)

Trade-in services have rapidly grown field in the global scenario, particularly in developing countries. The rapid growth and change have prompted the members of the WTO to bring in changes in rules and regulations on trade in services. As a result, GATS was introduced on 1st January 1995. One of the important agreements of WTO contains two main parts: i) the framework of an agreement containing rules and regulations, and ii) the schedule of Nations who gave the commitment on access to their domestic markets by foreign suppliers. Each WTO member lists in its national schedule those services, which it wished to guarantee access to foreign suppliers. All member countries are considered as MFNs (Most Favoured Nations) i.e, all commitments apply on a non-discriminatory basis to all member countries. Moreover, National treatment implies treating foreigners and locals equally. Imported and locally produced goods should be treated equally, at least after the foreign goods have crossed the border. The same should apply to foreign and domestic services, and to foreign and local trademarks, copyrights and patents. National treatment only applies once a product, service or item of intellectual property has entered the market. Therefore, charging customs duty on an import is not a violation of national treatment even if locally-produced products are not charged an equivalent tax.

Coverage of GATS:

The GATS covers all internationally traded services except services provided by the Government and services in Air transport sector. The GATS defines that trade in services can be made in four ways, these are:

1. Services supplied from one country to another (e.g. International telephone calls).
2. Consumers from one country making use of another country (e.g. Tourism).
3. A company from one country setting up subsidiaries or branch to provide services in another country (e.g. Banking).
4. Individual travelling from their own country to supply services in other countries (e.g. Actress or construction worker).

Benefits of Services Liberalisation:

1. An efficient services infrastructure provides a base for economic success. Services such as telecommunications, banking, insurance and transport supply strategically important inputs for all sectors.
2. People can have access to world-class services.
3. Trade liberalisation in services leads to low cost. For example, telecommunications.
4. Faster innovation takes place with liberalised services e.g. ATM, Phone banking, Internet banking etc.
5. Greater transparency and predictability benefit is there for customers. This makes possible for the people to make their investments in the service sector.
6. More FDIs are attracted in the countries, which will bring the new skills and technologies into the country. The domestic employees can learn the new skills from the MNCs.

Trade-Related Investment Measures (TRIMs)

It refers to certain condition or restrictions imposed by a Government in respect of foreign investment in the country. The TRIM provides that the foreign capital would not be discriminated by the member Governments.

Features of TRIMs

1. Abolition of the restriction imposed on foreign capital.
2. Offering equal rights to the foreign investor on par with the domestic investor.

3. No restrictions on any area of investment.
4. No limitation or ceiling on the quantum of foreign investment.
5. Granting of permission without restrictions to import raw materials and other components.
6. No force on foreign investors to use total products and or materials.
7. Export of the part of the final product will not be mandatory.
8. Restriction on repatriation of dividend interest and royalty will be removed.
9. Phased manufacturing programming will be introduced to increase the domestic content of manufacturer.

Trade-Related Intellectual Property Rights (TRIPs)

Intellectual property rights are the rights given to persons over the creations of their minds. They usually give the creator an exclusive right over the use of his/her creation for a certain period of time. It includes

a. Protection of patent
b. Copyright
c. Industrial design
d. Geographical indication.
e. Trademarks
f. Trade secrets
g. Layout design (topographies of integral circuits)

TRIPs agreement are of the following:

i) TRIPs agreement includes nuclear energy, methods of agricultural and horticulture and biological processes and products for patentability.
ii) It provides for granting product patent to food, medicine, drugs and chemical products.
iii) The duration of patents will be of 20 years of both for product patents and process patents.
iv) There is no specific provision for licenses of right or revocation of patents.

v) There is a provision for the protection of plant variety by individual countries and to have an effective unique system of their own.

Geographical Indications:

A geographical indication (GI) is a sign used on products that have a specific geographical origin and possess qualities or a reputation that are due to that origin. In order to function as a GI, a sign must identify a product as originating in a given place. In addition, the qualities, characteristics or reputation of the product should be essentially due to the place of origin. Since the qualities depend on the geographical place of production, there is a clear link between the product and its original place of production.

Dumping

Dumping is, in general, a situation of international price discrimination, where the price of a product, when sold in the importing country, is less than the price of that product in the market of the exporting country.

Different types of dumping

Persistent-dumping

This is international price discrimination that goes on indefinitely. Exporting firms benefit from this when demand in a foreign market is more elastic than the demand in the company's home market.

Predatory-dumping

Used by manufacturers as a means of eliminating competition in a foreign market. High domestic prices are used to supplement the reduced revenue of exporting cheaper goods. By exporting goods at cheap prices exporters are able to drive off any competition in the area. Once the competition has been eliminated, the firm can then raise the price of the product and generate more revenue. The importing country usually complains, because its market might end up being controlled by a foreign monopoly.

Sporadic dumping

This occurs when there is a temporary surplus of a specific product. Businesses will dump surplus goods in foreign markets without having to reduce prices in their domestic market. The domestic market refers to the market within a country's borders.

Anti-dumping measures

To curb dumping, the importing country imposes tariff duty, import quota, import embargo and voluntary export restraint.

On 26 October 2017, India has imposed anti-dumping duty on stainless steel from US, EU and China. India has also imposed anti-dumping duty on certain stainless steel products from the European Union and other countries including China and Korea, in order to protect the domestic industry from cheap imports. The duty was imposed by the Revenue department following the recommendation by the Directorate General of Anti-Dumping and Allied Duties (DGAD).

- The levied duty will range between 4.58 per cent and 57.39 per cent of the landed value of cold-rolled flat products of stainless steel.
- The anti-dumping duty will be in effect until 10 December 2020.
- The direction, however, exempts certain grades of stainless steel from the duty.
- The duty will be levied on the imports of stainless steel products from China, Taiwan, South Korea, South Africa, Thailand, the United States and the European Union.

8.4.4 World Bank

World Bank was originally known as the International Bank for Reconstruction and Development (IBRD). The initial purpose of the World Bank was to provide funding for the reconstruction of World War II affected Japan and Europe. Now, it is an agency that provides loans and technical assistance to low and middle-income countries with the goal of reducing poverty. The World Bank Group comprises five institutions managed by their member countries. They are :

a) **The International Bank for Reconstruction and Development**

The International Bank for Reconstruction and Development (IBRD) lends to governments of middle-income and creditworthy low-income countries.

b) **The International Development Association**

The International Development Association (IDA) provides interest-free loans called credits and grants to governments of the poorest countries.

Together, IBRD and IDA are called the World Bank.

c) **The International Finance Corporation**

The International Finance Corporation (IFC) is the largest global development institution focused exclusively on the private sector. It helps in developing countries to achieve sustainable growth by financing investment, mobilizing capital in international financial markets, and providing advisory services to businesses and governments.

d) **The Multilateral Investment Guarantee Agency**

The Multilateral Investment Guarantee Agency (MIGA) was established in 1988 to promote foreign direct investment into developing countries to support economic growth, reduce poverty, and improve people's lives. MIGA fulfils this mandate by offering political risk insurance (guarantees) to investors and lenders.

e) **The International Centre for Settlement of Investment Disputes**

This facilitates international facilities for conciliation and arbitration of investment disputes.

Fact Sheet

Formation	July 1945
Type	Monetary International Financial Organization
Legal status	Treaty
Headquarters	Washington, D.C., U.S.
Membership	189 countries (IBRD) 173 countries (IDA)
Key people	Jim Yong Kim, president
Parent organization	World Bank Group

Objectives

The World Bank provides low-interest loans, interest-free credit and grants to improve education, health, and infrastructure. It also helps to modernize a country's financial sector, agriculture, and natural resources management.

The Bank's stated goal is to "bridge the economic divide between poor and rich countries." It does this by turning "rich country resources into poor country growth." It has a long-term vision to "achieve sustainable poverty reduction."

To achieve this goal, the Bank works in six areas:

1. Overcome poverty by enhancing growth, especially in Africa.
2. Help reconstruct countries emerging from war, the biggest cause of extreme poverty.
3. Provide a customized solution to reduce poverty from middle-income countries.
4. Spur governments to prevent climate change. It helps them control communicable diseases, especially HIV/AIDS, and malaria. It also manages international financial crises and promotes free trade.
5. Work with the Arab League to improve education, build infrastructure, and provide micro-loans to small businesses.
6. Share its expertise with developing countries. Publicize its knowledge via reports and its interactive online database.

The World Bank Group has set two goals for the world to achieve by 2030:

a) End extreme poverty by decreasing the percentage of people living on less than $1.90 a day to not more than 3%

b) Promote shared prosperity by fostering the income growth of the bottom 40% for every country

Organization

The World Bank functions as a cooperative. The member countries are represented by a Board of Governors which is the ultimate policymaker at the World Bank. Generally, the governours are member countries' ministers of finance or ministers of development. They meet once a year at the Annual Meetings of the Boards of Governors of the World Bank Group and the International Monetary Fund.

The governors delegate specific duties to 25 Executive Directors, who work on-site at the Bank. The five largest shareholders appoint an executive director, while other member countries are represented by elected executive directors.

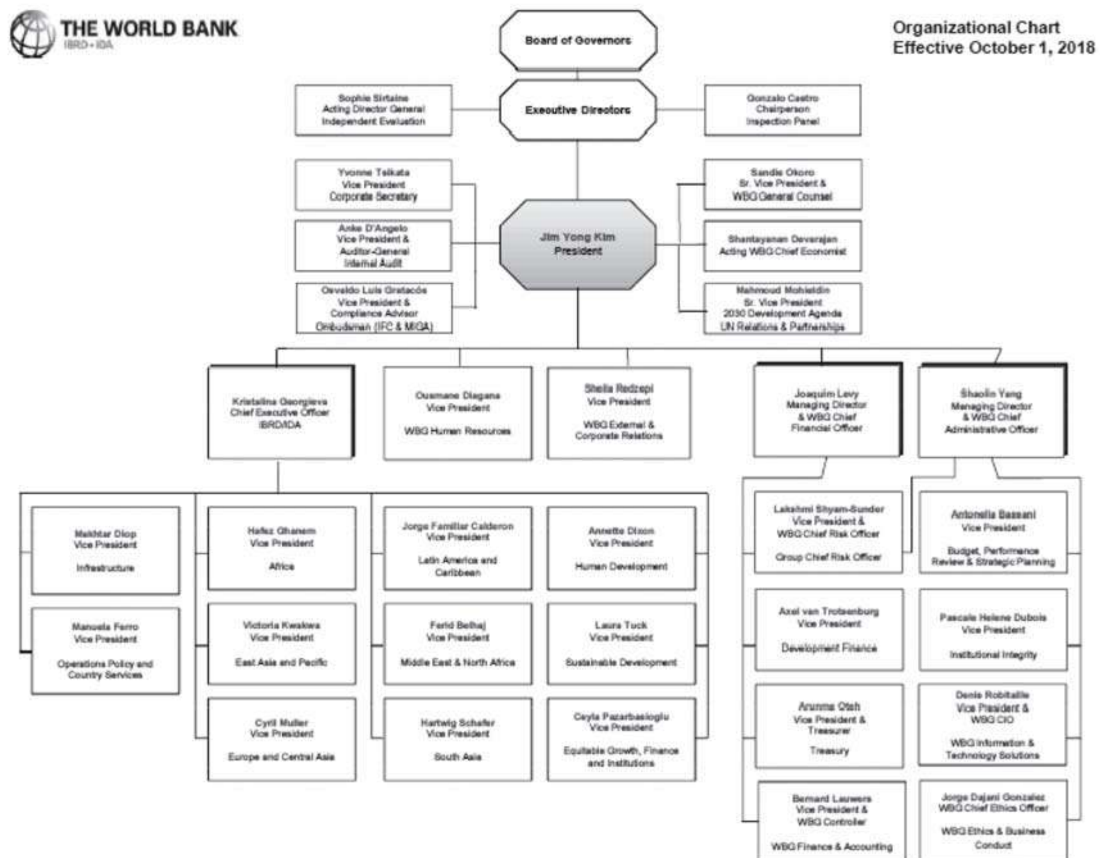
World Bank Group President chairs meetings of the Boards of Directors and is responsible for the overall management of the Bank. The President is selected by the Board of Executive Directors for a five-year, renewable term.

The Executive Directors make up the Boards of Directors of the World Bank. They generally meet at least twice a week to oversee the Bank's business, including approval

of loans and guarantees, new policies, the administrative budget, country assistance strategies and borrowing and financial decisions.

The day to day operations of the World Bank is carried under the leadership and direction of the president, management and senior staff, and the vice presidents in charge of Global Practices, Cross-Cutting Solutions Areas, regions, and functions.

The latest Organization Chart of the Bank is as follows:



Source: http://pubdocs.worldbank.org/en/404071412346998230/wbg-org-chart.pdf

India's Association with the World Bank

India was one of the 17 countries, prepared the agenda for the Bretton Woods Conference (June 1944). It was also one of the 44 countries which signed the final agreement for the establishment of the World Bank. The name "International Bank for Reconstruction and Development" was first suggested by India to the drafting committee.

India has been accessing funds from the World Bank (mainly through IBRD and IDA) for various development projects.

The World Bank Group's support for India's development agenda has contributed to improving outcomes in a range of sectors. Some results are as follows:

a) Education: Between 2000-01 and 2017-18 elementary school enrolment raised by more than 33 million, rising from 156.6 million in 2000-01 to 189.9 million in 2017-18. Over two-thirds of India's states have achieved universal primary enrollment. There is now a primary school within one kilometre of all habitations.

b) **Rural Livelihoods**: Since 2011, the World Bank-supported National Rural Livelihoods Mission has mobilized 50 million poor rural women into self-help groups and their federations. These groups have leveraged $30 billion from commercial banks. Over 3 million women now benefit from technical services in agriculture and nearly 2.8 million poor women have been elected to local government institutions. Poor rural women have not only benefitted from greater and more predictable access to a range of financial services, but they have also gained skills, support in business development, and been linked to markets. In Bihar, some women-owned collective enterprises have recorded a turnover of nearly $2 million.

c) **Rural Water Supply and Sanitation**: Since 2000, World Bank projects have contributed over $3.4 billion in financing for rural water supply and sanitation. This has helped about 36 million people in 40,000 villages—with populations ranging from 150 to 15,000—gain better access to drinking water. World Bank support in Uttarakhand, which contributed to establishing 24/7 water supply, received the Right to Information award for good governance and transparency. An independent impact assessment found 98 per cent user satisfaction and 90 per cent sustainability for this operation.

d) **Rural Roads**: Since 2004, World Bank support of $2 billion has helped build and improve around 40,000 km of all-weather rural roads in some of India's poorest and most inhospitable regions. The roads are revitalizing the rural economy and improving the quality of rural life in about 30,000 habitations by connecting them to schools, health centers, markets, and jobs.

e) Health: World Bank support to India's health sector began in 1972. Over the years, it has focused on helping India meet the health MDGs, improve child nutrition, and tackle the long-standing burden of disease. Over the last 2 decades, Bank projects have increasingly focused on improving the quality of health services provided by the public sector.

In Uttar Pradesh, one of the poorest states in India, around 50 district hospitals have seen quality improvements and 19 of them have been accredited. In Karnataka and Tamil Nadu between 2004 and 2016, Bank health projects have contributed to a reduction of more than 40% in rates of maternal and infant mortality. Since 1990, mortality from TB has halved, and the prevalence of the infection has fallen by 55 per cent. More than 20 million people have been treated through Bank-supported programs since 1997, and 3.5 million deaths averted. India's response to HIV/AIDS is a global success story. Prevalence among adults has continued to fall, with new infections coming down by two thirds between 2007-15.

f) Agriculture: Bank-supported watershed projects have helped raise farm yields and incomes for roughly 2 million farmers in the dry rain fed areas of Karnataka, and for more than 500,000 families in Himachal Pradesh and Uttarakhand. World Bank-financed operations in five states to rehabilitate irrigation systems, particularly community tanks, and to develop institutions at community and state levels to manage and maintain these systems. These operations led to over 2 million of land having improved irrigation, and corresponding improvements in productivity, and over 50% increase in paddy production. Successive operations in Uttar Pradesh have led to over 120,000 of sodic land reclaimed, with cropping intensity on these lands increasing from 25 per cent to 206 per cent.

g) Energy: A series of investments amounting to over US$ 2.5 billion since 1993 and intensive capacity-building support, the World Bank has helped POWERGRID, India's state-owned power transmission company emerge as the world's third-largest transmission utility.

Overall, Bank financing to Power grid and Haryana Power operations directly resulted in over 5,000 km of transmission lines being installed. India's focus on renewable energy can have far-reaching, global implications for the battle against climate change. The Bank's $625 million Solar Rooftop program has already financed around 500 MW of commercial and industrial installations (out of which 80 MW are already installed) and will help mobilize another commercial financing to the sector.

8.4.5 Asian Development Bank (ADB)

The Asian Development Bank is a regional development bank established on 19 December 1966, as a financial institution that would be Asian in character and foster

economic growth and cooperation in one of the poorest regions in the world. A resolution passed at the first Ministerial Conference on Asian Economic Cooperation held by the United Nations Economic Commission for Asia and the Far East in 1963 set the foundation to form the Bank. During the 1960s, ADB focused much of its assistance on food production and rural development.

ADB's headquarter is in the Ortigas Center, located in the city of Mandaluyong, Metro Manila, Philippines. The Bank also maintains 31 field offices around the world to promote social and economic development in Asia. ADB has 67 shareholding members including 48 from the Asia and Pacific region.

Organization

Board of Governors

ADB's highest policy-making body is the Board of Governors, which comprises one representative from each member nation – 48 from the Asia-Pacific and 19 from outside the region.

Board of Directors

The Governors elect 12 members to form the Board of Directors, which performs its duties full time at the ADB headquarters. The Directors supervise ADB's financial statements, approve its administrative budget, and review and approve all policy documents and all loan, equity, and technical assistance operations.

Management

The ADB's President is the chairman of the Board of Directors and heads a management team comprising six Vice-Presidents, who supervise the work of ADB's operational, administrative, and knowledge departments.

As a multilateral development finance institution, ADB provides loans, technical assistance and grants.

Member governments are ADB's shareholders. ADB directly assists private enterprises in developing member countries through equity investments and loans.

ADB maximizes the development impact of its assistance by

a) facilitating policy dialogues,

b) providing advisory services, and

c) mobilizing financial resources through co-financing operations that tap official, commercial, and export credit sources.

Operational Priorities

To achieve its vision, ADB focuses on seven operational priority areas. Bank's support in these areas is delivered through both public and private sector operations, advisory services, and knowledge support.

- addressing remaining poverty and reducing inequality
- accelerating progress in gender equality
- tackling climate change, building climate and disaster resilience, and enhancing environmental sustainability
- making cities more livable
- promoting rural development and food security
- strengthening governance and institutional capacity
- fostering regional cooperation and integration

ADB and India

Since commencing operations in India in 1986, ADB has committed 209 sovereign loans totalling $35.9 billion.

From the website of ADB one can get two current projects of ADB relating to India. They are as follows:

The Country Partnership Strategy (CPS), 2018–2022 for India aims to support the government's goal of faster, inclusive, and sustainable growth accompanied by rapid economic transformation and job creation. The new CPS articulates ADB assistance through the three strategic pillars: boosting economic competitiveness to create more and better jobs, providing inclusive access to infrastructure networks and services, and addressing climate change and increasing climate resilience. ADB's annual lending to India is proposed to be raised to a maximum of $4 billion to support the country's transformation toward upper middle-income status.

The country operations business plan (COBP), 2018–2020 aims to support the government's endeavour towards achieving faster, inclusive and sustainable growth through programs supporting the provision of inclusive access to infrastructure, boosting competitiveness and job creation, and helping address climate change issues.

8.5 Summary

The International Financial Market is the place where financial wealth is traded between individuals and countries. The international financial market may be categorized from the point of view of resource providing agencies. These are official and unofficial sources. Different accesses are there through which a domestic economy can procure coveted funds. Such as FDI and FII. In the field of international business, there are many Intergovernmental Organizations (IGO). Out of many such IGOs three most important IGOs that originated from the 1944 Bretton Woods conference are the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD) or World Bank and the General Agreement on Tariffs and Trade (GATT), which gave birth of World Trade Organization (WTO). This unit discusses different facets of IMF, IBRD, WTO along with The Euro Markets and ADB.

8.6 Self Assessment Questions

A. Long Answer Type Questions:

1. Write a note on the Euro Market.
2. Write in brief about quota and SDR?
3. How does the IMF provide assistance through several lending programs?
4. Discuss in brief the organizational structure of WTO.
5. Write notes on GATS, TRIPS and TRIMS.
6. What is dumping? What are the types of dumping? How dumping is curtailed?
7. "The World Bank Group comprises five institutions managed by their member countries."- Discuss.
8. What are the objectives and goals of the World Bank?
9. Write a note on the World Bank's relationship with India.
10. Write a note on ADB.

B. Short Answer Type Questions:

1. What are the sources of an international fund?
2. What is meant by FDI, FII and FPI?

3. What are the objectives of the IMF?
4. How does the IMF provide technical assistance to members?
5. Differentiate between WTO and GATT.
6. What is GI?
7. Write a short note on the Multilateral Investment Guarantee Agency (MIGA).
8. Write a note on the ADB's relationship with India.

C. Objective Type Questions:

1. What are the full forms of FDI, FII, and FPI?
2. Expand: IMF, IBRD, IFC, ADB, WTO, GATT?
3. Where are the headquarters of IMF, World Bank and WTO located?

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