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SELF-LEARNING MATERIAL

MASTER OF COMMERCE

MCM- 401 : INTERNATIONAL BUSINESS

w.e.f Academic Session: 2023-24

CENTRE FOR DISTANCE AND ONLINE EDUCATION

UNIVERSITY OF SCIENCE & TECHNOLOGY MEGHALAYA

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Techno City, 9th Mile, Baridua, Ri-Bhoi, Meghalaya, 793101

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University of Science and Technology Meghalaya

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MCM 401

International Business

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MCM 401: INTERNATIONAL BUSINESS

UNIT 1

INTERNATIONAL TRADE THEORY

1.1 Absolute Advantage theory

The principle of absolute advantage theory depicts the ability of a party(an individual, firm or country) to produce a good or service more efficiently than its competitors. The Scottish economist Adam Smith first described the principle of absolute advantage in the context of international trade in 1776, using labour as the only input. This theory depicts that different countries produce some goods more efficiently than other countries; thus global efficiency can increase through free trade. According to this theory, each country's resources would shift to the efficient industries because the country could not compete in the inefficient ones. Through specialization, countries could increase their efficiency because of three reasons:

1. Labour could become more skilled by repeating the same tasks.
2. Labour would not lose time in switching from the production of one kind of product to another.
3. Long production runs would provide incentives for the development of more effective working methods.

The base of the theory is that one nation gains the cost of another. This theory explains that country should export those goods which can be produced more efficiently at home and should import the goods which can be produced more efficiently abroad. This theory is based on the assumption that there are two countries, two commodities and one factor. The theory is that nation should produce goods in which it has greatest relative advantage.

1.2. Law of Comparative Cost Advantage

This theory was developed by David Ricardo in 1817. The theory focuses that countries should specialize in a certain class of products for export but import the rest- even if the country holds an absolute advantage in all products. David Ricardo developed the theory of comparative advantage or comparative cost which is the basis of international trade. Comparative advantages arise from the differences in the productivity and the theory is based on the principles of opportunity cost. Although India has an absolute advantage in the production of both tea and wheat, India has a comparative advantage only in the production of wheat. This is because its advantage in wheat is comparatively greater than its advantage in tea. In this situation India can concentrate on wheat.

According to the Comparative Cost Theory, countries in the long run will tend to specialize in the business (production and marketing) of those goods in whose business they enjoy comparative low cost advantage and import other goods in which the countries have comparative cost disadvantage, if free trade is allowed. This specialization helps in the mutual advantage of the countries participating in international business. He used two countries, two-commodity model. The conclusions of his model are:

Trade between two countries is profitable when a country produces one good at a lower cost than another country and that other country produces another good at a lower cost than the former country. 2. Trade between two countries is also profitable when one country produces

more than one product efficiently, but when it produces one of these products comparatively at greater efficiency than the other product. 3. Both the nations can engage in international trade when one country specializes in production in which it has greater efficiency than the other. Assumption of the Theory The following are the assumptions of the comparative cost advantage theory:

There are only two countries.

2. They produce the same two commodities.

3. There are similar tastes in both countries.

4. The only element of cost of production is labour.

5. The supply of labour is unchanged.

6. All units of labour is homogenous.

7. Prices of two commodities are determined by labour cost i.e. the no. of labour units employed to produce each.

8. Production is the subject to the law of constant returns.

9. Technological knowledge is unchanged.

10. Trade barriers between the two countries takes place on the basis of the barter system.

11. Factors of production are perfectly mobile within each country but are perfectly immobile between countries.

12. There is free trade between the two countries, there being no trade barriers or restrictions in the movement of commodities.

13. Trade is free from cost of transportation.

14. All factors of production are fully employed in both the countries.

15. The international market is perfect so that the exchange ratio for the two commodities is the same.

1.3. Opportunity Cost Theory

Opportunity Cost Theory (Gottfried Haberler, 1936) According to the opportunity cost theory, the cost of a good is the amount of a second good that must be given up to release just enough resources to produce one additional unit of the first good. Consequently, the nation with the lower opportunity cost in the production of a commodity has a comparative advantage in that commodity.

1.4 Production Possibility Curve with increasing costs:

The Production Possibilities Curve (PPC) is a model used to show the trade-offs associated with allocating resources between the production of two goods. The PPC can be used to illustrate the concepts of scarcity, opportunity cost, efficiency, inefficiency, economic growth, and contractions.

1.5. Community Indifference Curve

A community indifference curve is an illustration of different combinations of commodity quantities that would bring a whole community the same level of utility. The

model can be used to describe any community, such as a town or an entire nation. In a community indifference curve, the indifference curves of all those individuals are aggregated and held at an equal and constant level of utility.

The community indifference curves are derived by the aggregation of the indifference curves of all the individuals in the society. Since all combinations on a social indifference curve yield the same level of satisfaction, the increase in the quantity of one commodity must correspond with some decrease in the quantity of other commodity. Consequently,the community or social indifference curve slopes downwards from left to right as shown in Fig. 4.2.

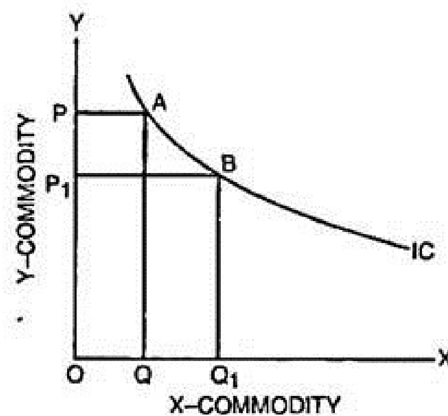

Fig. 4.2

In Fig. 4.2, IC is the community indifference curve. The two

combinations A and B of commodities X and Y are supposed to give equal satisfaction to the community. Combination A includes OQ of X + OP of Y and combination B includes OQ_1 of X + OP_1 of Y. In combination B, as society increases the consumption of X by QQ_1, it reduces at the same time, the consumption of Y by PP_1 so that compensating variation in satisfaction takes place and both the combinations A and B are equally preferred.

1.6. Equilibrium in isolation:

In isolation, a nation is in equilibrium when it reaches the highest indifference curve with given production frontier. It is at the point where a CIC is tangent to the nation's PPF. The common slope of the two curves at the tangency point gives the internal equilibrium relative commodity price and reflects the nation's comparative advantage.

The tangency point can be on lower indifference curves, but it would not maximise the nation's welfare; on higher curves, the nation would not achieve the level of welfare with the existing resources and technologies.

Assumptions:

1) To get the point of equilibrium if a nation does not trade, then PPF and the indifference curve are used.
2) When there is no trade, the nation is in equilibrium if it reaches its highest attainable indifference curve.

3) Equilibrium therefore occurs at the point of tangency between the highest attainable indifference curve and the PPF.
4) At this point, the slope of the indifference curve=slope of the PPF.

Check your progress

Multiple Choice Questions:

1) The Theory of Absolute Cost Advantage is given by:

a) David Ricardo b) Adam Smith

c) F.W Taylor d) Ohlin and Heckscher

2) The theory of comparative cost advantage is given by:

a) David Ricardo b) Adam Smith

c) F.W Taussig d) Ohlin and Hecksher

3. Opportunity cost

a) The additional benefit of buying an additional unit of a product

b) The cost which we forego, or give up, when we make a choice or a decision.

c) A cost that cannot be avoided, regardless of what is done in the future.

d) The cost incurred in the past before we make a decision about what to do in the future.

4. The slope of the indifference curve is equal to which of the following?

a). One b) Marginal utility

c. Marginal rate of substitution d. None of these

5. An indifference curve is related to which of the following?

a. Choices and preferences of consumer b. Prices of goods X and Y

c. Consumer's income d. Total utility from goods X and Y

6. Zero sum game theory applies

a. Mercantilism b. Absolute cost advantage theory

c. Factor equalization theorem d. New Trade theory

7. The concept of opportunity cost is employed under

a. Modern theory of trade b. Factor equalization theorem

c. Comparative cost advantage theory d. Absolute cost advantage theory

8. Countries with abundant of capital should focus on

a. Labour intensive goods

b. Capital intensive goods

c. Distribute between labour and capital intensive goods

d. Importing more machinery

9. Economies of scale and network effects resulting in exports of goods is related to

a. New Trade theory

b. Factor equalization theorem

c. Comparative cost advantage theory

d. The Heckscher-Ohlin theory

10. The Ricardian theory of comparative advantage relies on which one of the following assumptions?

a) Production technologies in both countries exhibit diminishing return to scale.

b) Factors of production can be easily and costlessly moved from one sector to the other as the country specialises through trade and there is a fixed supply of the factors of production.

c) The underlying market structure during production is based on imperfect competition.

d) There is technical innovation and there is technological spill over.

Answer:

1. b), 2. a), 3. b), 4. c), 5. a), 6. a) 7. c) 8. b) 9.a) 10 b)

Descriptive questions

1) Explain the absolute advantage theory with assumptions?

2) Explain the comparative cost theory of international trade. What are its assumptions and limitations?

3) Elaborate community indifference curve?

4) Explain production possibility curve with diagram?

5) Elaborate equilibrium in isolation?

UNIT 2

BALANCE OF PAYMENTS

2.1. Balance of Payment

A Balance of Payment Account is a systematic record of all economic transactions between residents of a country and the rest of the world carried out in a specific period of time. In other words, 'Balance of Payment Account is a summary of international transactions of a country for a given period' (i.e., financial year) with rest of the world. It records a country's transactions with the rest of the world involving inflow and outflow of foreign exchange. In short, BOP Account is a summary statement of transactions in foreign exchange in a year. Simply put, BOP account is a statement of a country's sources and uses of foreign exchange in which main sources are: exports, transfers and remittances from abroad, borrowings from abroad, foreign investments whereas uses of foreign exchange are: imports, transfers to abroad, lending abroad and purchase of assets, etc.

2.2. Disequilibrium in the Balance of Payments

Balance of payments disequilibrium is said to occur when there is an excess of debits over credits in the current account the is not balanced by an autonomous capital inflow, but requires some accommodating transaction, such as the loss of foreign exchange reserves, official borrowing, or the deprecation of devaluation of the domestic currency**.** Causes of Disequilibrium in the Balance of Payments. The disequilibrium in the balance of payments may be caused by a number of factors. These factors can be divided into three groups:
(i) Economic factors: Economic factors include the following:

- Large-scale development expenditure that may cause large imports.
- Cyclical fluctuations in general business activity such as recession or depression that may disrupt exports. High domestic prices may discourage exports and induce imports.
- Net source of supply, new and better substitutes to existing products and change in costs will bring about a change in trade flows and hence balance of payments over a period of time.

(ii) Political factors : Political disturbances, like a frequent change of the government, lack of adequate support to the government in parliament, instability of the government etc. generally:

- encourage outflows of capital, and
- discourage inflows of capital.

(iii) Social factors: Changes in tastes, preferences and fashions may affect imports and exports.BOP disequilibrium when on negative side showing a deficit undermines the economy if fundamental of a country. Therefore, the foremost objective of the central bank is to achieve stability in balance of payments.

2.3. Types of Disequilibrium:

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

1) Cyclical disequilibrium
2) Structural disequilibrium
3) Short-run disequilibrium
4) Long-run disequilibrium

5) Monetary disequilibrium
1) Cyclical Disequilibrium:
a) It occurs on account of trade cycles.
b) Depending upon the different phases of trade cycles like prosperity and depression, demand and other forces vary, causing changes in the terms of trade as well as growth of trade and accordingly a surplus or deficit will result in the balance of payments.
c) Cyclical fluctuations cause disequilibrium in the balance of payments because of cyclical changes in income, employment, output and price variables.
d) When price rise during prosperity and fall during a depression, 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.
e) Since deficits and surplus alternatively take place during the depression and prosperiety phase of a cycle, the balance of payments equilibrium is automatically set forth over the complete cycle.

ii) Structural Disequilibrium:
a) 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.
b) Suppose the foreign demand for India's jute products declines 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.
c) If it is not easily possible, India's exports may decline whereas with imports remaining the same, disequilibrium in the balance of payments will arise. Similarly, if the supply condition of export items is changes i.e., supply is reduced due to crop failure in prime commodities or shortage of raw materials or labour strikes, etc in the case of manufactured goods, then exports may decline to that exten and structural disequilibrium in the balance of payments will arise
d) Moreover, a shift in demand occurs with the changes in tastes, fashions, habits, income, economic progress, etc. Propensity to import may change as a result.
e) Demand for some imported goods may increase, while that for certain goods may decline leading to a structural change.
f) Furthermore, structural changes are also produced by variations in the rate of international capital movements. A rise in the inflow of international capital tends to have a direct impact on a country's balance of payments.

iii) Short-run Disequilibrium:
a) A short-run disequilibrium in a country is a temporary disequilibrium lasting for a short period of time. When a country borrows or lends, it 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 positon will be automatically corrected and poses no serious problem.
b) It may also emerge if a country's import exceeds its exports in a given year.
c) It will be a temporary one if it occurs once in a way, because later on, the country will be in a position to correct it easily by creating the required credit surplus by exporting more to offset the deficit.
d) When such disequilibrium (arising from imports exceeding exports or even vice versa) occurs year after year over a long period, it becomes chronic and may seriously affect the country's economy and its international economic relations.
e) A persistent deficit will tend to deplete its foreign exchange reserves and the country may not be able to raise any more loans from foreigners.

iv) Long-run Disequilibrium:

a) The long-term disequilibrium refers to a deep-rooted, persistent deficit or surplus in the balance of payments of a country.
b) It is secular disequilibrium emerging on account of the chronologically accumulated short-term disequilibrium-deficits or surpluses.
c) It endangers the exchange stability of the country concerned.
d) Especially, 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.
e) 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, innovations, etc.
f) A newly developing economy, for instance, in its initial stages of growth needs huge investment exceeding its savings. In view of its low capital formation, it has also to import a large amount of its capital requirements from foreign countries and its imports thus tend to exceed its exports. These become a chronic phenomenon. And in the absence of a sufficient inflow of foreign capital in such countries, a secular deficit balance of payments may result.

vi) Monetary Disequilibrium: Monetary equilibrium is partial equilibrium in the money market. An example of this is that at a certain rate of interest demand for and supply of money are equal (the liquidity preference theory of the rate of interest with the LM-curve as its geometric image).

2.4. Methods to Correct Disequilibrium in Balance of Payments

1) Trade Policy Measures: Expanding Exports and Restraining Imports:
Trade policy measures to improve the balance of payments refer to the measures adopted to promote exports and reduce imports.

Exports may be encouraged by reducing or abolishing export duties and lowering the interest rate on credit used for financing exports. Exports are also encouraged by granting subsidies to manufacturers and exporters.

Besides, on export earnings lower income tax can be levied to provide incentives to the exporters to produce and export more goods and services. By imposing lower excise duties, prices of exports can be reduced to make them competitive in the world markets.

Expenditure-Reducing Policies:
The important way to reduce imports and thereby reduce deficit in balance of payments is to adopt monetary and fiscal policies that aim at reducing aggregate expenditure in the economy. The fall in aggregate expenditure or aggregate demand in the economy works to reduce imports and help in solving the balance of payments problem

The two important tools of reducing aggregate expenditure are the use of:

(1) Tight monetary policy and
(2) Concretionary fiscal policy.

2) Tight Monetary Policy:

Tight monetary is often used to check aggregate expenditure or demand by raising the cost of bank credit and restricting the availability of credit. For this bank rate is raised by the Central Bank of the country which leads to higher lending rates charged by the commercial banks. This discourages businessmen to borrow for investment and consumers to borrow for buying durable consumers goods.

3) Contractionary Fiscal Policy:

Appropriate fiscal policy is also an important means of reducing aggregate expenditure. An increase in direct taxes such as income tax will reduce aggregate expenditure. A part of reduction in expenditure may lead to decrease in imports. Increase in indirect taxes such as excise duties and sales tax will also cause reduction in expenditure.

Expenditure – Switching Policies: Devaluation:
A significant method which is quite often used to correct fundamental disequilibrium in balance of payments is the use of expenditure-switching policies. Expenditure switching policies work through changes in relative prices. Prices of imports are increased by making domestically produced goods relatively cheaper. Expenditure switching policies may lower the prices of exports which will encourage exports of a country. In this way by changing relative prices, expenditure-switching policies help in correcting disequilibrium in balance of payments.

2.5. BOP Crisis in 1990

The statement that files all the legal transactions between the government anatomies, entities, or individuals of one country to another is known as the balance of payment. The main reason behind the BOP crisis is that it occurs when a particular country is unable to pay for the essential imports or the services of its external debit payments. For a particular country, the balance of payment determines or specifies whether the country has a shortage or excess of funds. Hence, it automatically becomes a significant statement for the country.

Reasons for Balance of Payment Crisis in India

The balance of Payment Crisis hit India in 1991. It occurred due to the imbalance in the economy of the country. The imports increased dramatically. India was importing more goods than it was exporting. This caused massive inflation. The following points below analyze the reasons and causes for the balance of payment crisis 1991 in India.

1) The Government of India exceeded the earnings of the expenditure. This increased the fiscal deficit. In 1980-81, the gross fiscal deficit was 9% which increased to 12.7 % of GDP in 1990-91. This also increased the government's internal debts. The GDP increased by 18 % from 1985-86 to 1990-91 (35 % to 53 %).
2) During this period, the country was importing more goods than it was exporting. Hence, the current account deficit became large. The increase in the current account deficit was caused by the increase in the rate of crude oil that was the result of the Gulf War. Despite significant borrowing from the IMF (International Monetary Fund), forex reserves of India were severely depleted.
3) By the time (June 1991), India had less than 1 billion dollars in foreign exchange reserves. This was not enough to cover the imports for three weeks. It made India insufficient to conduct international trade and it was about to default on its

international debt obligations. Furthermore, the investors withdrew their funds. Lack of assurance made them withdraw their funds.

4) The inflation rates touched the sky, it increased dramatically. The short-term credit dried up too as the exporters feared that they wouldn't be paid.

Measures Taken by Government to Overcome Balance of Payment Crisis 1991

The Government took certain special measures and steps to overcome the BOP crisis in India. They were: Monetary measures, reforms in the industrial policy, and reforms in the trade policy.

Monetary Measures

1) The rupee was devalued in 1991. The new government's first decisive step concerned the exchange rate.
2) The Reserve Bank of India approximately shipped 47 tonnes of gold to the Bank of England. It was collateral that would help India to obtain foreign currency from Japan and England.
3) Simultaneously, the RBI (Reserve Bank of India) sold around 20 tonnes of gold to a Swiss bank to obtain foreign currency. However, this was done under a condition i.e the gold would be repurchased after six months.
4) The government compressed the imports using various monetary methods. This took a certain amount of pressure from foreign exchange.

Reforms in Trade Policy

1) There were specific reforms made in the public sector.
2) The control on the export laws and licensing was loosened.
3) The value of the rupee was devalued by 20 % to make the exports more competitive.

Reforms in Industrial Policy

1) Both the License Raj and Inspector Raj were removed.
2) The Industrial Licensing Act was also repealed.
3) To encourage investment, certain steps were taken.
4) Similarly, to alleviate the domestic supply constraints, reforms were taken.

Outcome of BOP Crisis

The BOP Crisis 1991 came about due to the failure of the Indian Government to manage the balance between imports and exports. India had been facing a BOP crisis since the mid-1980s. However, it was not until the late 1980s that the situation worsened. The Government had to stabilize the economy and prevent a major breakdown.

1) Due to this, there were two significant devaluations of the Rupee in 1992 and 1993. The Rupee was devalued by 40% in 1992 and 20% in 1993. The balance of payments crisis in India in 1991 was caused by the country's foreign exchange reserves falling to a level where the Government could no longer service its external debt.

2) India's foreign exchange reserves fell below the critical level, and it became impossible for India to finance its trade deficit. In addition, political instability and poor governance added fuel to the fire. The economic reforms initiated by Rajiv Gandhi failed miserably because there was no political consensus on these reforms.

   The Balance of Payment Crisis 1991 in India is one of the leading causes of the current economic crisis. Financial discipline and economic prudence were already the two critical issues for the Indian economy before the balance of payment crisis arose.

Check your progress

Multiple Choice Questions:

1. Balance of Payments is an accounting statement that records monetary transactions between ________.
   a. Residents of a nation and the rest of the world
   b. Non-residents and the rest of the world
   c. Residents of a nation and non-residents
   d. None of the above
2. Balance of Payments uses the _________ system of accounting.
   a. Single-entry
   b. Double-entry
   c. Cash basis
   d. Accrual basis
3. The 'resident', whose monetary transactions get recorded under the Balance of Payments system, includes _______.
   a. Government agencies
   b. Individuals
   c. Firms
   d. All of the above
4. The components of a Balance of Payment account are ____________.
   a. Capital Account
   b. Current Account
   c. Both a and b
   d. None of the above
5. The Balance of Payment account records the inflow of foreign exchange on the ____.
   a. Debit side
   b. Credit side
   c. Both a and b
   d. None of the above
6. Balance of trade is the ___________.

a. Difference between export and import of services
b. Total of export and import of services
c. Difference between export and import of goods
d. Total of export and import of goods

7. Which of the following is not a component of the Balance of Payments?
   a. Real account
   b. Current account
   c. Capital account
   d. None of the above
8. Import and export of goods are known as _____.
   a. Nominal trade
   b. Invisible trade
   c. Visible trade
   d. None of the above
9. Import and export of services are known as ________.
   a. Nominal trade
   b. Invisible trade
   c. Visible trade
   d. None of the above
10. Import of machinery and equipment is recorded under __________ of the ______ account.
    a. Credit side, capital
    b. Debit side, capital
    c. Debit side, current
    d. Credit side, current

Answer:

1. a) 2. b) 3. d) 4. c) 5. b) 6. c) 7. a) 8. c) 9. b) 10. c)

Descriptive type questions:

1. What is balance of payment? What are its features?
2. Explain disequilibrium in BOP?
3. Explain the types of disequilibrium?
4. What are the methods of correcting disequilibrium?
5. Explain BOP crisis in 1990?

UNIT 3

INTERNATIONAL TRADE POLICY

3.1. Tariffs

A tariff refers to the tax imposed by the government on imported goods from other countries. Tariff is imposed majorly to protect the domestic producers, but the government also imposes tariffs to reduce imports from other countries, thereby promoting the use of domestic products.

Types of Tariffs

Primarily the charges are subdivided into four different types:

1. **Ad valorem Tariff**: It is imposed as a percentage of the total value of goods purchased from a foreign country. The tax liability increases with an increase in the value of goods.
2. **Specific Tariffs**: It is levied as a particular dollar amount on the number of units purchased from a foreign nation. The tax amount depends on goods quantity and not on goods value.
3. **Compound Tariffs**: It is a blend of ad valorem and specific taxes. It is imposed both on goods quantity and on goods value. A dollar amount is charged depending on the number of units. In addition, a percentage of the total value of imported products is levied.

4. Tariff-rate Quota: Imported goods are taxed at a certain rate up to a particular limit. Thus, applicable tax varies depending on the quantity. For example, a 5% tariff is levied on brown sugar consignments smaller than 1000 kgs. A 10% tax is imposed on Brown sugar imports ranging between 1000kgs and 10,000 kgs.

Partial equilibrium analysis of a tariff:
When a small country imposes tariff on import of the product that competes with the product of the small domestic industry, the tariff can neither affect the international prices (as the country is small) nor can it affect the rest of the economy (as the industry is small). In such conditions, the partial equilibrium analysis that concerns the market for a particular product becomes the most appropriate.
Assumptions:

(i) The demand and supply curves of the given commodity are concerned with home country that imposes import tariff.

(ii) The given demand and supply curves remain constant.

(iii) There is no change in consumers' tastes, prices of other commodities and money income of the consumers.

(iv) There is an absence of technological improvements, externalities and other factors that result in changes in cost conditions.

(v) No tariff is imposed by the home country on the import of materials that are required for producing the given commodity.

(vi) Imported product and home-produced product are perfect substitutes.

(vii) There is no change in the foreign price of the commodity.

(viii) There is an absence of transport costs.

(ix) The foreign supply curve of commodity is perfectly elastic.

(x) Domestic production of commodity takes place at increasing costs.

3.2. Effect of a Tariff on Consumer and Producer Surplus

The increase in the price of imported commodity due to the imposition of tariff leads to a reduction in consumer surplus and an increase in producer surplus. • The consumer surplus is the difference between what consumers would be willing to pay for each unit of the commodity and what they actually pay.

3.3. Cost and benefit analysis of a tariff

The costs of a tariff come from the higher price to consumers, but this is partly offset by the tariff revenue that goes to the government. This tariff revenue is a benefit and can be redistributed to consumers or spent on goods from which consumers derive a benefit. But there are also efficiency costs associated with tariffs—deadweight losses, as we call them. These are the real costs of the tariff, and they arise because the marginal cost of production does not equal the marginal benefit to the consumer.

Consumer surplus is the area under the demand curve and above the equilibrium market price. It represents the total amount consumers would have been willing to pay for the product but did not have to pay at the equilibrium price. It is a measure of consumer welfare. The tariff raises the market price and reduces this consumer surplus by the amount LFGJ. This area measures by how much domestic consumers are worse off as a result of the price increase caused by the tariff. But this is not the net loss for the whole domestic economy, because the government obtains some tax revenue and domestic producers get more revenue and profit.

Government revenue accrues from the domestic sales of imports. On imports of (Q'D - Q'S), tax revenue is EFHI. Then, domestic producers obtain an additional profit of LECJ—the excess of additional revenue over their cost per additional bottle. If we are not concerned about who gains and who loses, it is clear that there is a net loss to the domestic economy equal to the areas A and B.

3.4. Rate of effective protection:

The effective rate of protection (ERP) is a measure of the total effect of the entire tariff structure on the value added per unit of output in each industry, when both intermediate and final goods are imported. The effective protection rate, which is defined as the difference between value added at domestic prices and value added at world market prices as a

percentage of value added at world market prices, is functionally related to the custom duty and sales tax on imports, excise duty and sales tax on domestic production

3.5. Voluntary Export Restraint (VER)

A voluntary export restraint (VER) is a trade restriction on the quantity of a good that an exporting country is allowed to export to another country. This limit is self-imposed by the exporting country.VERs came about in the 1930s and gained a lot of popularity in the 1980s when Japan used one to limit auto exports to the U.S.12 In 1994, World Trade Organization (WTO) members agreed not to implement any new VERs and to phase out existing ones.A voluntary export restraint (VER) is a self-imposed limit on the quantity of a good that an exporting country is allowed to export. VERs are considered non-tariff barriers, which are restrictive trade barriers—such as quotas and embargoes. They are related to a voluntary import expansion (VIE), which is meant to allow for more imports, and can include lowering tariffs or dropping quotas. Voluntary export restraints (VERs) fall under the broad category of non-tariff barriers, which are restrictive trade barriers, such as quotas, sanctions, levies, embargoes, and other restrictions. Typically, VERs are a result of requests made by the importing country to provide a measure of protection for its domestic businesses that produce competing goods, though these agreements can be reached at the industry level, as well.

VERs are often created because the exporting countries would prefer to impose their own restrictions than risk sustaining worse terms from tariffs or quotas. They've been in use since the 1930s, applied by large, developed economies to a wide range of products, from textiles to footwear, steel, and automobiles, and became a popular form of protectionism in the 1980s.

After the Uruguay Round and the updating of the General Agreement on Tariffs and Trade (GATT) in 1994, WTO members agreed not to implement any new VERs, and to phase out any existing ones within one year, with some exceptions.3

Advantages and Disadvantages of a Voluntary Export Restraint (VER)

With functioning VERs, producers in the importing country experience an increase in well-being as there is decreased competition, which should result in higher prices, profits, and employment.

Limitations of a Voluntary Export Restraint (VER)

VERs reduce national welfare by creating negative trade effects, negative consumption distortions, and negative production distortions. There are ways in which a company can avoid a VER. For example, the exporting country's company can always build a manufacturing plant in the country to which exports would be directed. By doing so, the company will no longer need to export goods, and should not be bound by the country's VER. The option to build manufacturing facilities overseas and bypass exporting rules is one of the main reasons why VERs have historically been ineffective in protecting domestic producers.

3.6. Dumping:

Dumping occurs when a country or company exports a product at a price that is lower in the foreign importing market than the price in the exporter's domestic market.The biggest advantage of dumping is the ability to flood a market with product prices that are often considered unfair.Dumping occurs when a foreign producer sells a product in the United States at a price that is below that producer's sales price in the country of origin or at a price that is lower than the cost of production.

Export subsidy

Export Subsidy is a government policy to encourage export of goods and discourage sale of goods on the domestic market through direct payments, low-cost loans, tax relief for exporters, or government-financed international advertising. An export subsidy reduces the price paid by foreign importers, which means domestic consumers pay more than foreign consumers. The World Trade Organization (WTO) prohibits most subsidies directly linked to the volume of exports, except for LDCs. Incentives are given by the government of a country to exporters to encourage export of goods.

Export subsidies are also generated when internal price supports, as in a guaranteed minimum price for a commodity, create more production than can be consumed internally in the country. (These price supports are often coupled with import tariffs, which keeps the domestic price high by discouraging or taxing imports on the difference between the world price and the mandatory minimum.) Instead of letting the commodity rot or destroying it, the government exports it. Saudi Arabia is a net exporter of wheat, Japan often is a net exporter of rice.

At the WTO's Tenth Ministerial Conference, which was held in Nairobi, Kenya from 15 to 19 December 2015, the WTO member states agreed to eliminate export subsidies for agricultural products; least-developed nations had until the end of 2018 to eliminate agricultural export subsidies (until 1 January 2017 in relation to cotton exports), while developed nations agreed to eliminate most such subsidies immediately.

Strategic trade policy:

Strategic trade policy refers to trade policy that affects the outcome of strategic interactions between firms in an actual or potential international oligopoly. A main idea is that trade policies can raise domestic welfare by shifting profits from foreign to domestic firms.It is a condition that alters a strategic relationship between firms, implying that strategic trade policy focuses primarily on trade policy in the presence of oligopoly. The key point is that strategic relationships between firms introduce additional motives for trade policy, over and above terms of trade and other effects that arise in all market structures.

Check your progress

Multiple Choice Questions:

1. Which of the following is not a trade barrier?

   a. Subsidies — b Embargo

   c Export Security — d Tariff Barriers

2. A specific tariff is:

   a. Any tax on a particular imported good (as opposed to one on all imports).

   b. An import tax that must be paid in kind (giving the government the good itself).

   c. A requirement to pay the government a specified fraction of the monetary value of an imported good.

   d. A tax on imports defined as an amount of currency per unit of the good.

   e. The revenue that the government earns by auctioning off import quotas.

   Ans: d

3. A tariff on imports benefits domestic producers of the imported good because

   a. They get the tariff revenue.

   b. It raises the price for which they can sell their product on the domestic market.

   c. It prevents imports from rising above a specified quantity.

   d. It reduces their producer surplus, making them more efficient.

   e. All of the above.

   Ans: b

4. When a large country levies a tariff on imports

   a. The world price falls.

   b. Demanders of the good on the domestic market are hurt

   c. Foreigners are hurt.

   d. The domestic price rises by less than the tariff.

   e. All of the above.

5. A VER is imposed by:

   a. The domestic government — b. The foreign government

   c. The domestic producers — d. The domestic consumers

6. FDI and producing in a foreign country may be preferable to exporting:

   a. Since most managers of domestic plants wish to leave to other countries.

   b. Since machinery and buildings are usually more extravagantly built in foreign countries.

c. Since production is increased due to high labour skills.

d. In order to serve consumer tastes and preferences in the foreign market.

7. A VER is:

a. A tariff that is imposed by the exporting country.

b. A tariff that is imposed by an importing country.

c. A voluntary quota imposed by the importing country.

d. A voluntary quota imposed by the exporting country.

8. Non-tariff barriers include all of the following except:

a. Buy domestic requirements.

b. Tariffs

c. Technical standards.

d. Labour standards.

9. _____refers to the tax imposed on imports.

a. Imported Tax
b. Tariffs
c. Subsidies
d. Import Quotas

10. _____ means selling the products at a price less than on going price in the market.

a. Quota
b. Tariff
c. Subsidy
d. Dumping

Answer:

1. c) 2. d) 3. b) 4. e) 5. b) 6. d) 7. d) 8. b) 9. b) 10. d)

Descriptive Type Questions:

1. Define tariff? What are the types of a tariff?

2. What are the effects of a tariff on consumer and producer surplus?

3. Explain dumping with its limitations?

4. What are the cost and benefit analysis of tariff?

5. What are the rate of effective protection?

UNIT 4

WORLD TRADE ORGANIZATION

The World Trade Organization (WTO) is an international organization that deals with the global rules of trade between nations. It was established on January 1, 1995, replacing the General Agreement on Tariffs and Trade (GATT), which had been in existence since 1948. The WTO serves as a forum for negotiating trade agreements, handling trade disputes, and monitoring and facilitating the implementation of agreed-upon rules.

Key functions and features of the WTO include:

1. Trade Negotiations: The WTO provides a platform for member countries to negotiate trade agreements. These negotiations cover a wide range of issues, including tariffs, non-tariff barriers, intellectual property, services, and agriculture.

2. Dispute Settlement: The WTO has a dispute settlement mechanism that allows member countries to resolve trade disputes in a systematic and transparent manner. This process is designed to enforce compliance with agreed-upon rules and prevent unilateral actions.

3. Trade Policy Review: The WTO conducts regular reviews of the trade policies of its member countries. This process helps ensure transparency and encourages members to adhere to their commitments.

4. Trade Facilitation: The WTO works to simplify and harmonize customs procedures and other trade-related regulations to facilitate the smooth flow of goods across borders.

5. Special and Differential Treatment: The WTO recognizes the varying levels of development among its member countries and provides special and differential treatment to developing nations to help them integrate into the global trading system.

6. Technical Assistance and Capacity Building: The organization offers technical assistance and capacity-building programs to help developing countries enhance their ability to participate effectively in international trade.

7. Trade and Development: The WTO addresses issues related to trade and development, aiming to ensure that the benefits of globalization are more widely shared and that developing countries have opportunities to participate in global trade.

The WTO operates on the principle of consensus among its member countries, and decisions are made through negotiations and discussions.

4.1 GATT TO WTO

The GATT was established in 1947 as an international agreement aimed at promoting free trade by reducing tariffs and other barriers to trade. It was a provisional arrangement and lacked a permanent institutional structure. As a result, there was a need for a more comprehensive and permanent organization to oversee global trade.
The Uruguay Round of multilateral trade negotiations, which began in 1986 and concluded in 1994, led to the establishment of the World Trade Organization (WTO). The WTO officially

replaced the GATT on January 1, 1995. The transition from GATT to WTO represented a significant development in the international trading system.

Key differences between GATT and WTO include:

Institutional Structure: GATT had a more informal and temporary structure, while the WTO was designed to be a permanent organization with a more comprehensive framework for international trade.

Dispute Settlement: The WTO introduced a more robust and binding dispute settlement mechanism compared to the GATT. This mechanism allows member countries to bring trade disputes to a panel for resolution, and the decisions are binding.

Scope of Agreements: The WTO agreements cover not only the trade in goods but also trade in services (General Agreement on Trade in Services - GATS) and intellectual property rights (Agreement on Trade-Related Aspects of Intellectual Property Rights - TRIPS), providing a more comprehensive framework for global trade.

Decision-Making Process: The decision-making process in the WTO is more democratic, with decisions made by consensus among member countries.

Overall, the transition from GATT to WTO marked a shift toward a more institutionalized and comprehensive approach to global trade governance, addressing not only traditional trade in goods but also services and intellectual property. The WTO continues to play a crucial role in shaping international trade policies and resolving disputes among its member countries.

4.2 FUNCTIONS AND PRINCIPLES OF WTO

The World Trade Organization (WTO) serves as an international organization that facilitates and regulates trade among its member countries. It operates based on certain functions and principles. Here are the key functions and principles of the WTO:

Functions of the WTO:

1. Negotiation:
   - Facilitate trade negotiations among member countries to reduce trade barriers.
   - Conduct rounds of negotiations (e.g., Uruguay Round, Doha Development Agenda) to address various aspects of trade, including tariffs, subsidies, and non-tariff barriers.
2. Implementation:
   - Oversee the implementation of agreements reached during trade negotiations.
   - Monitor the compliance of member countries with their commitments under the various agreements.
3. Dispute Settlement:
   - Provide a structured and transparent dispute settlement mechanism to address trade disputes among member countries.
   - The Dispute Settlement Body (DSB) reviews cases brought by member countries and issues binding rulings.
4. Trade Policy Review:
   - Conduct regular reviews of the trade policies and practices of member countries to ensure transparency and encourage adherence to agreed-upon rules.
5. Capacity Building:
   - Provide technical assistance and capacity-building programs to help developing countries participate effectively in international trade.

Principles of the WTO:

1. Non-Discrimination:
   - Most-Favored-Nation (MFN) principle: Treat all member countries equally, granting the same favorable trade terms to one country as those granted to any other.
   - National Treatment: Treat foreign and domestic products and services equally once they enter the domestic market.

2. Reciprocity:

- Members agree to make concessions in trade negotiations, expecting reciprocal concessions from other members.

3. Transparency:

- Promote transparency in trade policies and practices by requiring members to notify the WTO of their trade-related measures and policies.

4. Predictability:

- Establish a stable and predictable trading environment by providing a forum for negotiation and resolution of trade issues.

5. Promotion of Fair Competition:

- Encourage fair competition by addressing unfair trade practices, such as dumping and subsidies.

6. Special and Differential Treatment:

- Recognize the need for special treatment of developing countries, allowing them more flexibility in implementing certain agreements and giving them longer timeframes for compliance.

7. Good Governance:

- Foster good governance in international trade by providing a rules-based system and dispute settlement mechanism.

These functions and principles collectively contribute to the WTO's goal of facilitating open, fair, and predictable international trade, while also recognizing the diverse needs and circumstances of its member countries.

4.3 DISPUTE SETTLEMENT MECHANISM

The World Trade Organization (WTO) Dispute Settlement Mechanism (DSM) is a crucial component of the WTO system. It provides a structured and transparent process for resolving trade disputes among member countries. The DSM aims to enforce the rules and agreements negotiated under the WTO and ensure that member countries abide by their trade obligations. Here's an overview of the key features of the WTO Dispute Settlement Mechanism:

Key Features:

1. Request for Consultations:

- Dispute resolution begins with consultations between the parties involved. If consultations do not resolve the issue within a specified timeframe (usually 60 days), the complaining party can request the establishment of a dispute panel.

2. Establishment of a Dispute Panel:

- A Dispute Settlement Body (DSB) oversees the process and establishes a panel to examine the dispute. The panel is composed of independent experts who have expertise in trade and legal matters.

3. Panel Proceedings:

- The panel reviews the arguments and evidence presented by the parties involved in the dispute.

- The panel issues an interim report to the parties, giving them an opportunity to comment before the final report is issued.

4. Panel Report:

- The panel's final report is submitted to the DSB. It includes findings of fact, conclusions, and recommendations for resolving the dispute.

- The report is typically adopted by the DSB, but parties can appeal the findings.

5. Appellate Body Review:

- If a party decides to appeal, an Appellate Body, which is a standing body of seven members, reviews the legal aspects of the panel report.

- The Appellate Body's report is binding on the parties and the DSB.

6. Dispute Settlement Body's Decision:

- The DSB adopts the final report, including any Appellate Body recommendations, and monitors the implementation of the ruling.

7. Implementation:

- If a party fails to comply with the DSB's decision, the complaining party can seek authorization from the DSB to take retaliatory measures, such as imposing tariffs or other trade sanctions.

8. Timeframes:

- The DSM is designed to be efficient, with specific timeframes for each stage of the process to ensure timely resolution of disputes.

The DSM has played a significant role in maintaining the stability and predictability of the international trading system, fostering a rules-based approach to dispute resolution among WTO member countries. However, it's worth noting that there have been challenges and concerns about the functioning of the Appellate Body, which faced issues related to its composition and operations in recent years. Efforts to address these concerns and reform the dispute settlement system have been part of ongoing discussions within the WTO.

Key Features:

Binding Nature: Decisions of the dispute settlement process are binding on the parties involved.

Timely Resolution: The DSM is designed to provide a more efficient and timely resolution of disputes compared to traditional legal processes.

Transparency: Proceedings and decisions are generally transparent, allowing WTO members and the public to access relevant information.

The effectiveness of the WTO Dispute Settlement Mechanism has been crucial in maintaining a rules-based international trading system and promoting fair competition among member countries. However, it's worth noting that the Appellate Body has faced challenges, and efforts have been made to address concerns and ensure the continued functioning of the dispute settlement process.

Examples of Notable Trade Disputes:

United States vs. European Union (Airbus-Boeing dispute): This long-standing dispute involves subsidies provided to aircraft manufacturers Airbus (Europe) and Boeing (United States). Both sides have won and lost certain aspects of the case, and the dispute remains ongoing.

United States vs. China (Various disputes): The U.S. and China have engaged in several WTO disputes, covering issues such as agricultural subsidies, intellectual property rights, and market access. Resolutions in these disputes have varied, reflecting the complexity of U.S.-China trade relations.

India vs. United States (Solar cells dispute): India challenged certain measures of the United States regarding domestic content requirements for solar cells and solar modules. The WTO dispute settlement process led to a panel finding that the U.S. measures were inconsistent with its obligations.

These examples highlight the diverse nature of trade disputes brought to the WTO and the importance of the dispute settlement process in resolving conflicts and maintaining a rules-based international trading system.

4.4 RECENT TRADE ROUNDS AND POSITION OF INDIA

In the context of international trade, "trade rounds" typically refer to a series of negotiations and discussions among member countries aimed at liberalizing and facilitating global trade. These negotiations are often organized under the auspices of international institutions, with the most well-known being the World Trade Organization (WTO).

Trade rounds involve multiple rounds of negotiations where countries discuss and negotiate trade agreements to reduce barriers such as tariffs, quotas, and other trade restrictions. Each round usually has a specific agenda and goals, and negotiations may cover various aspects of trade, including goods, services, and intellectual property.

One of the most significant series of trade rounds in recent history was the Uruguay Round, which concluded in 1994 and led to the establishment of the WTO. The Doha Development Agenda, launched in 2001, was another attempt to address various trade issues, particularly those affecting developing countries. However, the Doha Round faced challenges and has not been successfully concluded.

The concept of trade rounds reflects the ongoing nature of international trade negotiations, as countries continually seek to update and expand trade agreements to address emerging issues and adapt to changing economic conditions.

The Doha Development Agenda was launched in 2001 as the latest round of trade negotiations. The Doha Development Agenda, often referred to as the Doha Round, was a set of trade negotiations launched by the World Trade Organization (WTO) in 2001 in Doha, Qatar. The primary focus of the Doha Round was on addressing the concerns of developing countries and promoting global economic development through trade.

Here are some key aspects of the Doha Round:

Development Focus: The Doha Round aimed to place a strong emphasis on development issues, seeking to improve the trading prospects of developing nations. The agenda included discussions on agriculture, non-agricultural market access (NAMA), services, and intellectual property rights, among other topics.

Agriculture: Agricultural subsidies and market access were significant issues in the negotiations. Developing countries, including India, advocated for the reduction of agricultural subsidies by developed nations, aiming to level the playing field and allow for fair competition in global agricultural markets.

Market Access: Non-agricultural market access (NAMA) negotiations addressed tariff reductions and trade barriers for industrial goods. Developing countries sought improved access to markets for their manufactured products.

Services: Discussions on trade in services aimed to promote the liberalization of services sectors, benefiting both developed and developing countries. However, challenges arose in finding common ground on the extent of liberalization and the protection of national interests.

Intellectual Property Rights: The Doha Round addressed issues related to intellectual property rights, with a focus on striking a balance between protecting intellectual property and ensuring that it does not hinder access to essential medicines and technologies in developing countries.

Despite the initial optimism, the Doha Round faced challenges, including disagreements among member countries on key issues. The negotiations were complex, and progress was slow. Over the years, various attempts were made to revive and conclude the Doha Round, but a comprehensive agreement was not reached.

In 2015, the WTO members agreed to conclude the Doha Round and move toward a new phase of negotiations. The Doha Round's lack of conclusion marked a shift toward a more decentralized approach, with countries pursuing trade agreements through regional and bilateral arrangements instead.

India has been an active participant in the Doha Development Agenda negotiations, advocating for the interests of developing countries. Its position has often centered around issues such as agricultural subsidies, market access for goods and services, and special and differential treatment for developing nations.

India's position in international trade:

World Trade Organization (WTO): India has been actively involved in WTO negotiations, advocating for the interests of developing countries. The Doha Development Agenda (DDA) has been a significant focus, and India has been a key participant in discussions related to agriculture, intellectual property, and services.

Regional and Bilateral Agreements: In addition to multilateral negotiations at the WTO, India has been engaging in regional and bilateral trade agreements. The Regional Comprehensive Economic Partnership (RCEP) was a notable example. However, India withdrew from RCEP negotiations in 2019, citing concerns about protecting its domestic industries and farmers.

United States-India Trade Relations: Bilateral trade relations between India and the United States have been a subject of discussion and negotiation. Trade tensions, including issues related to tariffs, intellectual property rights, and market access, have been points of contention. Resolving these matters has been an ongoing process.

Post-COVID Economic Recovery: The COVID-19 pandemic has significantly impacted global trade dynamics. Countries, including India, have been exploring trade policies to navigate the economic challenges posed by the pandemic and foster post-pandemic recovery.

Check your progress

Multiple-Choice Questions (MCQs)

1. The primary goal of GATT was to:

a) Promote environmental conservation

b) Facilitate international finance

c) Reduce trade barriers and tariffs

d) Regulate global telecommunications

2. In which year was the WTO officially established?

a) 1992

b) 1995

c) 2000

d) 2005

3. The WTO agreements cover which of the following areas?

a) Trade in goods, services, and intellectual property

b) Environmental conservation

c) Education policies

d) Health regulations

4. The Doha Development Agenda (DDA) is associated with:

a) Climate change negotiations

b) Sustainable development goals

c) World Trade Organization

d) United Nations Security Council

5. What is the primary function of the WTO?

a) Providing humanitarian aid

b) Promoting global peace

c) Facilitating international trade

d) Regulating global energy resources

6. Which round of trade negotiations led to the establishment of the WTO?

a) Havana Round

b) Tokyo Round

c) Uruguay Round

d) Kennedy Round

7. The WTO's dispute settlement mechanism is designed to:

a) Encourage trade barriers

b) Resolve trade disputes between member countries

c) Promote unfair trade practices

d) Ignore international trade conflicts

8. What is the highest decision-making body of the WTO?

a) General Assembly

b) Ministerial Conference

c) Executive Board

d) Secretariat

9. Which of the following principles is a fundamental principle of the WTO?

a) Most Favored Nation (MFN)

b) Unilateralism

c) Bilateralism

d) Isolationism

10. The Trade-Related Aspects of Intellectual Property Rights (TRIPS) agreement is administered by:

a) World Health Organization (WHO)

b) World Intellectual Property Organization (WIPO)

c) World Trade Organization (WTO)

d) United Nations Educational, Scientific and Cultural Organization (UNESCO)

Answers:

1. c) Reduce trade barriers and tariffs

2. b) 1995

3. a) Trade in goods, services, and intellectual property

4. c) World Trade Organization

5. c) Facilitating international trade

6. c) Uruguay Round

7. b) Resolve trade disputes between member countries

8. b) Ministerial Conference

9. a) Most Favored Nation (MFN)

10. c) World Trade Organization (WTO)

Descriptive Questions

1. Explain the main objectives of the World Trade Organization (WTO) and how it differs from its predecessor, the General Agreement on Tariffs and Trade (GATT).

2. Discuss the role of the WTO in promoting free and fair international trade.

3. Describe the process of dispute settlement within the WTO. Provide examples of notable trade disputes that have been resolved through this mechanism.

4. Describe the key principles that govern the functioning of the WTO and their significance in promoting international trade?

UNIT 5

FOREIGN EXCHANGE MARKETS

The foreign exchange market, often referred to as the forex market or FX market, is a global decentralized or over-the-counter (OTC) market for the trading of currencies. It is the largest and most liquid financial market in the world, where currencies are bought and sold against each other based on exchange rates.

Key features of the foreign exchange market include:

1. Decentralization: Unlike stock exchanges, the forex market doesn't have a centralized location. Instead, it operates 24 hours a day, five days a week, across different financial centers worldwide.

2. Participants: Various participants engage in the forex market, including central banks, financial institutions, corporations, governments, and individual traders. The market is accessible to anyone with an internet connection, making it highly inclusive.

3. Currency Pairs: Currencies are traded in pairs, such as EUR/USD (Euro/US Dollar) or USD/JPY (US Dollar/Japanese Yen). The first currency in the pair is the base currency, and the second is the quote currency. The exchange rate represents how much of the quote currency is needed to purchase one unit of the base currency.

4. Liquidity: The forex market is highly liquid due to its size and the vast number of participants. This liquidity ensures that traders can buy or sell currencies with minimal price fluctuations.

5. Market Participants:

- Banks: Central banks and commercial banks participate in the forex market for various reasons, including managing their foreign exchange reserves and facilitating international trade.

- Institutional Investors: Hedge funds, mutual funds, and other large financial institutions engage in currency trading for investment purposes and portfolio diversification.

- Corporations: Companies involved in international trade use the forex market to hedge against currency risk arising from fluctuations in exchange rates.

- Retail Traders: Individual traders participate in the forex market through online trading platforms, aiming to profit from price movements.

6. Speculation and Hedging: Participants engage in forex trading for speculation, seeking to profit from anticipated currency price movements. Additionally, many market participants use the forex market to hedge against currency risk associated with international transactions.

7. Major, Minor, and Exotic Pairs: Major currency pairs involve the most widely traded currencies (e.g., EUR/USD, USD/JPY). Minor pairs include currencies from smaller economies, excluding the US dollar. Exotic pairs involve one major currency and one from a developing or smaller economy.

Understanding the dynamics of the foreign exchange market is crucial for international trade and financial management. Traders analyze various factors, including economic indicators,

geopolitical events, and market sentiment, to make informed decisions about currency trading.

Classification of Currency Pairs:

The classification of currency pairs into major, minor, and exotic categories in the foreign exchange market is based on various factors, including liquidity, economic importance, and trading activity. Here are the key differences between major, minor, and exotic currency pairs:

1. Major Currency Pairs:

- Definition: Major currency pairs are the most traded pairs in the foreign exchange market and involve the world's most influential and widely used currencies.
- Examples:
  - EUR/USD (Euro/US Dollar)
  - USD/JPY (US Dollar/Japanese Yen)
  - GBP/USD (British Pound/US Dollar)
  - USD/CHF (US Dollar/Swiss Franc)
  - AUD/USD (Australian Dollar/US Dollar)
  - USD/CAD (US Dollar/Canadian Dollar)
- Factors for Classification:
  - Economic Importance: Major currency pairs involve currencies from countries with large and stable economies.
  - Global Trade and Finance: These pairs are extensively used in global trade and financial transactions.
  - High Liquidity: Major pairs are highly liquid, meaning they have a high trading volume and narrow bid-ask spreads.
  - Central Role in Forex Markets: Major currencies play a central role in determining exchange rate trends and are often used as benchmark currencies.

2. Minor Currency Pairs (Cross-Currency Pairs):

- Definition: Minor currency pairs do not include the US Dollar but involve other major currencies. They are also known as cross-currency pairs.
- Examples:
  - EUR/GBP (Euro/British Pound)
  - EUR/AUD (Euro/Australian Dollar)
  - GBP/JPY (British Pound/Japanese Yen)
  - NZD/CAD (New Zealand Dollar/Canadian Dollar)
- Factors for Classification:

- Economic Significance: Minor pairs include currencies from countries with significant economic importance but not as dominant as those in major pairs.

- Trading Activity: While less liquid than major pairs, minor pairs are still actively traded in the forex market.

- Diversification: Traders often use minor pairs for diversification purposes, especially when seeking exposure to currencies beyond the major ones.

3. Exotic Currency Pairs:

- Definition: Exotic currency pairs involve one major currency and one currency from a smaller or emerging market economy.

- Examples:

  - USD/TRY (US Dollar/Turkish Lira)

  - EUR/TRY (Euro/Turkish Lira)

  - USD/SEK (US Dollar/Swedish Krona)

  - USD/SGD (US Dollar/Singapore Dollar)

- Factors for Classification:

  - Less Liquid: Exotic pairs tend to have lower liquidity compared to major and minor pairs, leading to wider bid-ask spreads.

  - Emerging Markets: Exotic pairs often include currencies from emerging market economies.

  - Higher Risk: Due to lower liquidity and potentially higher volatility, exotic pairs are considered riskier and may require careful risk management strategies.

  - Limited Availability: Some exotic pairs may not be available on all trading platforms.

In summary, the classification of currency pairs is based on the importance of the currencies involved, their role in global trade and finance, and the level of liquidity in the forex market. Major pairs are the most liquid and involve dominant currencies, minors exclude the US Dollar, and exotics involve major currencies with currencies from smaller or emerging market economies. Traders consider these classifications when making decisions based on factors like liquidity, risk tolerance, and market exposure.

5.1: FOREIGN EXCHANGE MARKET MECHANISM

The foreign exchange (forex) market operates through a mechanism that facilitates the exchange of currencies between participants. This mechanism involves several key components and processes:

1. Participants:

- Banks: Central banks and commercial banks play a central role in the forex market. Central banks may engage in forex activities to manage their country's monetary policy and foreign exchange reserves, while commercial banks facilitate currency transactions for their clients.

- Institutional Investors: Large financial institutions, such as hedge funds and mutual funds, participate in the market for investment purposes and portfolio management.

- Corporations: Companies engaged in international trade use the forex market for currency conversion and hedging against exchange rate fluctuations.

- Retail Traders: Individuals participate in the forex market through online platforms, buying and selling currencies for speculative or investment purposes.

2. Currency Pairs:

- Currencies are traded in pairs, where one currency is exchanged for another. Each currency pair consists of a base currency and a quote currency. The exchange rate indicates how much of the quote currency is needed to purchase one unit of the base currency.

3. Interbank Market:

- The primary forex market is the interbank market, where major banks and financial institutions trade currencies directly with each other. This market is decentralized, with trading occurring electronically over-the-counter (OTC) rather than on a centralized exchange.

4. Quotes and Pricing:

- Currency prices are quoted in pairs, with the bid and ask prices representing the buying and selling prices, respectively. The spread is the difference between the bid and ask prices. The pricing mechanism is influenced by various factors, including supply and demand, economic indicators, geopolitical events, and market sentiment.

5. Electronic Trading Platforms:

- Forex trading is facilitated through electronic trading platforms provided by financial institutions. These platforms connect buyers and sellers in real-time, allowing for quick and efficient execution of trades. Retail traders typically access the market through online brokers.

6. Liquidity Providers:

- Major financial institutions act as liquidity providers in the forex market. They contribute to the market's liquidity by quoting prices and facilitating transactions. High liquidity ensures that participants can buy or sell currencies without significant price fluctuations.

7. Role of Brokers:

- Retail traders access the forex market through brokers, which act as intermediaries between the traders and the interbank market. Brokers provide trading platforms, leverage, and other services. They may either pass client orders directly to liquidity providers or act as market makers.

8. Central Clearing:

- While the interbank market operates on a decentralized basis, central clearing mechanisms are used in some cases to streamline the settlement process. Clearinghouses may act as intermediaries to ensure the smooth settlement of trades.

9. Regulation:

- Forex markets are subject to regulatory oversight in many jurisdictions. Regulatory authorities aim to ensure fair and transparent market practices, protect investors, and maintain market stability.

Understanding the mechanisms of the foreign exchange market is essential for participants to navigate and make informed decisions in this dynamic and complex financial environment. Traders and investors analyze various factors to predict currency price movements and manage risks effectively.

5.2: EXCHANGE RATE DETERMINATION

Exchange rate determination refers to the process by which the value of one currency is established in terms of another currency. Exchange rates are influenced by a variety of factors, and their determination involves both short-term and long-term dynamics. Here are some key factors that contribute to exchange rate determination:

1. Supply and Demand:

- The most fundamental factor influencing exchange rates is the basic economic principle of supply and demand. If there is a higher demand for a currency than its supply, its value tends to appreciate, and vice versa.

2. Interest Rates:

- Central banks set interest rates, and these rates can significantly impact exchange rates. Higher interest rates in a country can attract foreign capital seeking better returns, leading to an appreciation of the currency. Conversely, lower interest rates may result in depreciation.

3. Inflation Rates:

- Inflation differentials between countries can affect exchange rates. Generally, countries with lower inflation rates will see an appreciation in their currency value compared to countries with higher inflation rates.

4. Economic Indicators:

- Various economic indicators, such as GDP growth, employment rates, and trade balances, can influence exchange rates. Strong economic performance is generally associated with a stronger currency.

5. Political Stability and Economic Performance:

- Countries with stable political environments and positive economic outlooks tend to have stronger currencies. Political instability or economic uncertainty can lead to a depreciation of a currency.

6. Trade Balances:

- The balance of trade, which is the difference between a country's exports and imports, can impact exchange rates. A trade surplus (more exports than imports) can strengthen a currency, while a trade deficit can lead to depreciation.

7. Speculation:

- Traders and investors often engage in currency speculation based on their expectations of future exchange rate movements. Speculative activities can influence short-term fluctuations in exchange rates.

8. Central Bank Interventions:

- Central banks may intervene in the foreign exchange market to influence their currency's value. Interventions can include buying or selling currencies to stabilize or adjust exchange rates.

9. Global Events and Sentiment:

- Geopolitical events, global economic conditions, and market sentiment can impact exchange rates. News and events that create uncertainty may lead to increased volatility in currency markets.

10. Market Liquidity and Participants:

- The level of liquidity in the foreign exchange market and the types of participants involved, such as central banks, institutional investors, and retail traders, can affect exchange rate movements.

Exchange rate determination is a complex process that involves the interaction of multiple factors. Moreover, these factors are interrelated, and changes in one can influence others. As a result, exchange rates can be subject to fluctuations over time based on shifts in economic conditions and market dynamics. Traders, investors, and policymakers closely monitor these factors to make informed decisions and predictions about currency movements.

5.3: CONVERTIBILITY OF RUPEE AND ITS IMPLICATIONS

The term "convertibility" refers to the ease with which a currency can be converted or exchanged into another currency or a store of value, typically without significant restrictions or limitations. The convertibility of a currency, such as the rupee, plays a crucial role in shaping a country's economic landscape. It influences international trade, foreign investment, monetary policy, and financial stability. The decision to move towards full convertibility is a complex one, involving careful consideration of the benefits and challenges associated with increased integration into the global financial system.

India has traditionally followed a path of cautious and gradual convertibility rather than opting for full capital account convertibility. The country has moved towards liberalizing its foreign exchange policies over the years, but some controls and restrictions still exist.

Current Account Convertibility:

India has achieved a significant level of current account convertibility. This means that transactions related to trade in goods and services, as well as normal short-term capital flows, are relatively unrestricted.

Capital Account Convertibility:

India has not fully embraced capital account convertibility. Capital account convertibility involves the freedom to convert local financial assets into foreign financial assets and vice versa. India has maintained certain controls and restrictions to manage capital flows and stabilize its financial system.

Implications of Convertibility of the Rupee:

International Trade:

Current account convertibility facilitates international trade by allowing businesses to engage in cross-border transactions more freely. The ease of trading in goods and services contributes to economic growth.

Foreign Direct Investment (FDI):

Convertibility can attract foreign direct investment by providing a transparent and accessible financial environment. Investors may be more willing to invest in a country with a convertible currency.

Access to Global Capital Markets:

Full capital account convertibility allows a country to access global capital markets more extensively. This can be beneficial for raising funds through the issuance of international bonds and participating in global financial markets.

Exchange Rate Stability:

Convertibility, particularly in the capital account, can expose a currency to fluctuations in the foreign exchange market. Managing exchange rate stability becomes crucial in the context of increased capital flows.

Monetary Policy Autonomy:

Full capital account convertibility may limit a country's ability to conduct independent monetary policy, as capital flows can influence domestic interest rates and money supply.

Financial System Stability:

Convertibility can impact the stability of a country's financial system. Sudden outflows or inflows of capital may affect domestic financial institutions and markets.

Speculative Activities:

Freely convertible currencies may be more susceptible to speculative activities in the foreign exchange market, leading to short-term volatility.

Balance of Payments:

Convertibility affects a country's balance of payments. While unrestricted capital flows can help address external imbalances, they can also lead to challenges in managing the balance of payments.

Policy Considerations:

Governments and central banks carefully consider the implications of convertibility and may implement policies to manage its impact on the economy. This includes adopting measures to ensure financial stability, monitor capital flows, and address potential risks.

In the case of India, policymakers have been cautious in moving towards full capital account convertibility to avoid potential risks and maintain stability in the financial system. The pace and extent of convertibility are influenced by various economic factors and policy considerations.

Check your progress

Multiple-Choice Questions (MCQs)

1. What is the primary function of the foreign exchange market?
   a. Stock trading
   b. Currency trading
   c. Commodity trading
   d. Real estate trading
2. Which term describes the rate at which one currency can be exchanged for another?
   a. Interest rate
   b. Exchange rate
   c. Inflation rate
   d. GDP growth rate
3. What is the role of central banks in the foreign exchange market?
   a. Currency speculation
   b. Currency issuance
   c. Currency trading
   d. Currency manufacturing
4. In the context of currency pairs, the first currency listed is known as the:
   a. Base currency
   b. Quote currency
   c. Secondary currency
   d. Counter currency
5. Which factor does NOT influence exchange rates?
   a. Interest rates
   b. Political stability
   c. Demand for goods and services
   d. Stock market performance
6. What is the main advantage of a highly liquid foreign exchange market?
   a. Increased transaction costs
   b. Reduced market volatility
   c. Limited trading opportunities
   d. Slower order execution
7. Which participant engages in currency trading to manage the country's foreign exchange reserves?
   a. Retail traders
   b. Commercial banks
   c. Central banks
   d. Hedge funds
8. What is the purpose of hedging in the foreign exchange market?
   a. Speculating on currency prices
   b. Minimizing currency risk
   c. Maximizing currency exposure

d. Ignoring currency fluctuations

9. Which market structure characterizes the foreign exchange market?
   a. Centralized
   b. Decentralized
   c. Monopolistic
   d. Oligopolistic

10. What does the term "pip" refer to in the context of currency trading?
   a. Percentage increase in profit
   b. Price index point
   c. Precise investment position
   d. Percentage in points

Answers:

1. b. Currency trading
2. b. Exchange rate
3. b. Currency issuance
4. a. Base currency
5. d. Stock market performance
6. b. Reduced market volatility
7. c. Central banks
8. b. Minimizing currency risk
9. b. Decentralized
10. d. Percentage in points

Descriptive Questions:

1. Explain the concept of currency pairs in the foreign exchange market. Provide examples and discuss the significance of the base and quote currencies.

2. Discuss the factors that influence exchange rate determination. How do interest rates, inflation, and economic indicators impact the value of a currency in the foreign exchange market?

3. Describe the differences between major, minor, and exotic currency pairs. What factors contribute to the classification of currencies into these categories in the foreign exchange market?

4. Describe the key components of the foreign exchange market mechanism. How do participants, such as central banks, commercial banks, and retail traders, interact within this decentralized market?

5. Discuss the difference between current account convertibility and capital account convertibility with respect to the rupee. What are the implications of achieving full convertibility in both accounts for the Indian economy?

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