

UNIT – I

INTERNATIONAL BUSINESS – AN OVERVIEW

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INTRODUCTION

One of the most dramatic and significant world trends in the past two decades has been the rapid, sustained growth of international business. Markets have become truly global for most goods, many services, and especially for financial instruments of all types. World product trade has expanded by more than 6 percent a year since 1950, which is more than 50 percent faster than growth of output. The most dramatic increase in globalization, has occurred in financial markets. In the global forex markets, billions of dollars are transacted each day, of which more than 90 percent represent financial transactions unrelated to trade or investment. Much of this activity takes place in the so-called Euromarkets, markets outside the country whose currency is used.

This pervasive growth in market interpenetration makes it increasingly difficult for any country to avoid substantial external impacts on its economy. In particular massive capital flows can push exchange rates away from levels that accurately reflect competitive relationships among nations if national economic policies or performances diverge in short run. The rapid dissemination rate of new technologies speeds the pace at which countries must adjust to external

events. Smaller, more open countries, long ago gave up illusion of domestic policy autonomy. But even the largest and most apparently self-contained economies, including the US, are now significantly affected by the global economy. Global integration in trade, investment, and factor flows, technology, and communication has been tying economies together.

Why then are these changes coming about, and what exactly are they? It is in practice, easier to identify the former than interpret the latter. The reason is that during the past few decades, the emergence of corporate empires in the world economy, based on the contemporary scientific and technological developments, has led to globalization of production. As a result of international production, co-operation among global productive units, the large-scale capital exports, “the export of production” or “production abroad” has come into prominence as against commodity export in world economy in recent years. Global corporations consider the whole of the world their production place, as well as their market and move factors of production to wherever they can optimally be combined. They avail fully of the revolution that has brought about instant worldwide communication, and near instant-transformation. Their ownership is transnational; their management is transnational. Their freely mobile management, technology and capital, the modern agent for stepped-up economic growth, transcend individual national boundaries. They are domestic in every place, foreign in none—a true corporate citizen of the world. The greater interdependence among nations has already reduced economic insularity of the peoples of the world, as well as their social and political insularity.

DEFINITION OF INTERNATIONAL BUSINESS:

International business includes any type of business activity that crosses national borders. Though a number of definitions in the business literature can be found but no simple or universally accepted definition exists for the term international business. At one end of the definitional spectrum, international business is defined as organization that buys and/or sells goods and services across two or

more national boundaries, even if management is located in a single country. At the other end of the spectrum, international business is equated only with those big enterprises, which have operating units outside their own country. In the middle are institutional arrangements that provide for some managerial direction of economic activity taking place abroad but stop short of controlling ownership of the business carrying on the activity, for example joint ventures with locally owned business or with foreign governments.

In its traditional form of international trade and finance as well as its newest form of multinational business operations, international business has become massive in scale and has come to exercise a major influence over political, economic and social from many types of comparative business studies and from a knowledge of many aspects of foreign business operations. In fact, sometimes the foreign operations and the comparative business are used as synonymous for international business. Foreign business refers to domestic operations within a foreign country. Comparative business focuses on similarities and differences among countries and business systems for focuses on similarities and differences among countries and business operations and comparative business as fields of enquiry do not have as their major point of interest the special problems that arise when business activities cross national boundaries. For example, the vital question of potential conflicts between the nation-state and the multinational firm, which receives major attention is international business, is not like to be centered or even peripheral in foreign operations and comparative business.

SCOPE OF INTERNATIONAL BUSINESS ACTIVITIES

The study of international business focus on the particular problems and opportunities that emerge because a firm is operating in more than one country. In a very real sense, international business involves the broadest and most generalized study of the field of business, adapted to a fairly unique across the border environment. Many of the parameters and environmental variables that are very important in international business (such as foreign legal systems,

foreign exchange markets, cultural differences, and different rates of inflation) are either largely irrelevant to domestic business or are so reduced in range and complexity as to be of greatly diminished significance. Thus, it might be said that domestic business is a special limited case of international business.

The distinguishing feature of international business is that international firms operate in environments that are highly uncertain and where the rules of the game are often ambiguous, contradictory, and subject to rapid change, as compared to the domestic environment. In fact, conducting international business is really not like playing a whole new ball game, however, it is like playing in a different ballpark, where international managers have to learn the factors unique to the playing field. Managers who are astute in identifying new ways of doing business that satisfy the changing priorities of foreign governments have an obvious and major competitive advantage over their competitors who cannot or will not adapt to these changing priorities.

The guiding principles of a firm engaged in (or commencing) international business activities should incorporate a global perspective. A firm's guiding principles can be defined in terms of three broad categories: products offered/market served, capabilities, and results. However, their perspective of the international business is critical to understand the full meaning of international business. That is, the firm's senior management should explicitly define the firm's guiding principles in terms of an international mandate rather than allow the firm's guiding principles in terms as an incidental adjunct to its domestic activities. Incorporating an international outlook into the firm's basic statement of purpose will help focus the attention of managers (at all levels of the organization) on the opportunities (and hazards) outside the domestic economy.

It must be stressed that the impacts of the dynamic factors unique to the playing field for international business are felt in all relevant stages of evolving and implementing business plans. The first broad stage of the process is to

formulate corporate guiding principles. As outlined below the first step in formulating and implementing a set of business plans is to define the firm's guiding principles in the market place. The guiding principles should, among other things, provide a long-term view of what the firm is striving to become and provide direction to divisional and subsidiary managers vehicle, some firms use "the decision circle" which is simply an interrelated set of strategic choices forced upon any firm faced with the internationalization of its markets. These choices have to do with marketing, sourcing, labor, management, ownership, finance, law, control, and public affairs. Here the first two marketing and sourcing-constitute the basic strategies that encompass a firm's initial considerations. Essentially, management is answering two questions: to whom are we going to sell what, and from where and how will we supply that market? We then have a series of input strategies-labor, management, ownership, and financial. They are in their efforts to develop their own business plans. As an obligation addressed essentially to the query, with what resources are we going to implement the basic strategies? That is, where will we find the right people, willingness to carry the risk, and the necessary funds? A third set of strategies-legal and control-respond to the problem of how the firm is to structure itself of implement the basic strategies, given the resources it can muster. A final strategic area, public affairs, is shown as a basic strategy simply because it places a restraint on all other strategy choices.

Each strategy area contains a number of subsidiary strategy options. The decision process that normally starts in the marketing strategy area is an iterative one. As the decision maker proceeds around the decision circle, previous selected strategies must be readjusted. Only a portion of the possible feedback adjustment loops is shown here.

Although these strategy areas are shown separately but they obviously do not stand-alone. There must be constant reiteration as one moves around the

decision circle. The sourcing obviously influences marketing strategy, as well as the reverse. The target market may enjoy certain preferential relationships with other markets. That is, everything influences everything else. Inasmuch as the number of options a firm faces is multiplied as it moves into international market, decision-making becomes increasingly complex the deeper the firm becomes involved internationally. One is dealing with multiple currency, legal, marketing, economic, political, and cultural systems. Geographic and demographic factors differ widely. In fact, as one moves geographically, virtually everything becomes a variable: there are few fixed factors.

For our purposes here, a strategy is defined as an element in a consciously devised overall plan of corporate development that, once made and implemented, is difficult (i.e. costly) to change in the short run. By way of contrast, an operational or tactical decision is one that sets up little or no institutionalized resistance to making a different decision in the near future. Some theorists have differentiated among strategic, tactical, and operational, with the first being defined as those decisions, that imply multi-year commitments; a tactical decision, one that can be shifted in roughly a year's time; an operational decision, one subject to change in less than a year. In the international context, we suggest that the tactical decision, as the phrase is used here, is elevated to the strategic level because of the rigidities in the international environment not present in the purely domestic-for example, work force planning and overall distribution decisions. Changes may be implemented domestically in a few months, but if one is operating internationally, law, contract, and custom may intervene to render change difficult unless implemented over several years.

SPECIAL DIFFICULTIES IN INTERNATIONAL BUSINESS

What make international business strategy different from the domestic are the differences in the marketing environment. The important special problems in international marketing are given below:

1. POLITICAL AND LEGAL DIFFERENCES

The political and legal environment of foreign markets is different from that of the domestic. The complexity generally increases as the number of countries in which a company does business increases. It should also be noted that the political and legal environment is not the same in all provinces of many home markets. For example, the political and legal environment is not exactly the same in all the states of India.

2. CULTURAL DIFFERENCES

The cultural differences, is one of the most difficult problems in international marketing. Many domestic markets, however, are also not free from cultural diversity.

3. ECONOMIC DIFFERENCES

The economic environment may vary from country to country.

4. DIFFERENCES IN THE CURRENCY UNIT

The currency unit varies from nation to nation. This may sometimes cause problems of currency convertibility, besides the problems of exchange rate fluctuations. The monetary system and regulations may also vary.

5. DIFFERENCES IN THE LANGUAGE

An international marketer often encounters problems arising out of the differences in the language. Even when the same language is used in different countries, the same words or terms may have different meanings. The language problem, however, is not something peculiar to the international marketing. For example: the multiplicity of languages in India.

6. DIFFERENCES IN THE MARKETING INFRASTRUCTURE

The availability and nature of the marketing facilities available in different countries may vary widely. For example, an advertising medium very effective in one market may not be available or may be underdeveloped in another market.

7. TRADE RESTRICTIONS

A trade restriction, particularly import controls, is a very important problem, which an international marketer faces.

8. HIGH COSTS OF DISTANCE

When the markets are far removed by distance, the transport cost becomes high and the time required for affecting the delivery tends to become longer. Distance tends to increase certain other costs also.

9. DIFFERENCES IN TRADE PRACTICES

Trade practices and customs may differ between two countries.

BENEFITS OF INTERNATIONAL BUSINESS

SURVIVAL

Because most of the countries are not as fortunate as the United States in terms of market size, resources, and opportunities, they must trade with others to survive; Hong Kong, has historically underscored this point well, for without food and water from china proper, the British colony would not have survived along. The countries of Europe have had similar experience, since most European nations are relatively small in size. Without foreign markets, European firms would not have sufficient economies of scale to allow them to be competitive with US firms. Nestle mentions in one of its advertisements that its own country, Switzerland, lacks natural resources, forcing it to depend on trade and adopt the geocentric perspective. International competition may not be matter of choice when survival is at stake. However, only firms with previously substantial market share and international experience could expand successfully.

GROWTH OF OVERSEAS MARKETS

Developing countries, in spite of economic and marketing problems, are excellent markets. According to a report prepared for the U.S. CONGRESS by the U.S. trade representative, Latin America and Asia/Pacific are experiencing the strongest economic growth. American markets cannot ignore the vast potential of international markets. The world is more than four times larger than

the U.S. market. In the case of Amway corps., a privately held U.S. manufacturer of cosmetics, soaps and vitamins, Japan represents a larger market than the United States.

SALES AND PROFIT

Foreign markets constitute a larger share of the total business of many firms that have wisely cultivated markets abroad. Many large U.S. companies have done well because of their overseas customers. IBM and Compaq, for ex, sell more computers abroad than at home. According to the US dept of commerce, foreign profits of American firms rose at a compound annual rate of 10% between 1982 and 1991, almost twice as fast as domestic profits of the same companies.

DIVERSIFICATION

Demand for most products is affected by such cyclical factors as recession and such seasonal factors as climate. The unfortunate consequence of these variables is sales fluctuation, which can frequently be substantial enough to cause lay offs of personnel. One way to diversify a companies' risk is to consider foreign markets as a solution for variable demand. Such markets, even out fluctuations by providing outlets for excess production capacity. Cold weather, for instance may depress soft drink consumption. Yet not all countries enter the winter season at the same time, and some countries are relatively warm year round. Bird, USA, inc., a Nebraska manufacturer of go carts, and mini cars, for promotional purposes has found that global selling has enabled the company to have year round production. It may be winter in Nebraska but its summer in the southern hemisphere-somewhere there is a demand and that stabilizes the business.

INFLATION AND PRICE MODERATION

The benefits of export are readily self-evident. Imports can also be highly beneficial to a country because they constitute reserve capacity for the local economy. Without imports, there is no incentive for domestic firms to moderate

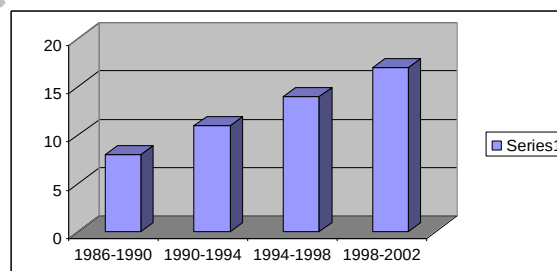
their prices. The lack of imported product alternatives forces consumers to pay more, resulting in inflation and excessive profits for local firms. This development usually acts as a prelude to workers demand for higher wages, further exacerbating the problem of inflation.

Import quotas imposed on Japanese automobiles in the 1980's saved 46200 US production jobs but at a cost of \$160,000 per job per year. This cost was a result of the addition of \$400 to the prices of US cars, and \$1000 to the prices of Japanese imports. This windfall for Detroit resulted in record high profits for US automakers. Not only do trade restrictions depress price competition in the short run, but they also can adversely affect demand for year to come.

EMPLOYMENT

Trade restrictions, such as high tariffs caused by the 1930's smoot-hawley bill, which forced the average tariff rates across the board to climb above 60%, contributed significantly to the great depression and have the potential to cause wide spread unemployment again. Unrestricted trade on the other hand improves the world's GNP and enhances employment generally for all nations.

Importing products and foreign ownership can provide benefits to a nation. According to the institute for international Economics-a private, non- profit research institute – the growth of foreign ownership has not resulted in a loss of jobs for Americans; and foreign firms have paid their American workers the same, as have domestic firms.



STANDARDS OF LIVING

Trade affords countries and their citizen's higher standards of living than otherwise possible. Without trade, product shortages force people to pay more for less, products taken for granted, such as coffee and bananas may become unavailable overnight. Life in most countries would be much more difficult were it not for the many strategic metals that must be imported. Trade also makes it easier for industries to specialize and gain access to raw materials, while at the same time fostering competition and efficiency. A diffusion of innovations across national boundaries is useful by-products of international trade. A lack of such trade would inhibit the flow innovative ideas.

FRAMEWORK FOR ANALYSING INTERNATIONAL BUSINESS ENVIRONMENT

Environmental analysis is defined as "the process by which strategists monitor the economic, governmental/legal, market/competitive, supplier/technological, geographic, and social settings to determine opportunities and threats to their firms".

"Environmental diagnosis consists of managerial decisions made by analyzing the significance of the data (opportunities and threats) of the environmental analysis".

The definition of environmental analysis given above has been made in the context of the strategic management process for an existing firm. It is, however, quite obvious that environmental analysis is the cornerstone of new business opportunity analysis too.

Indeed, today a much more greater emphasis is given than in the past to the fact that environmental analysis is an essential prerequisite for strategic management decision-making. For instance, in his recent editions of Marketing Management, Philip Kotler, the world-renowned professor and author, describes Marketing Environment Audit as the first component of a Marketing Audit, whereas in the earlier editions of this book, the definition of Marketing Audit does not have any reference to the environment.

It is now unquestionably accepted that the prospects of a business depend not only on its resources but also on the environment. An analysis of the strengths, weaknesses, opportunities and threats (SWOT) is very much essential for the business policy formulation.

Just as the life and success of an individual depend on his innate capability, including physiological factors, traits and skills, to cope with the environment, the survival and success of a business firm depend on its innate strength – the resources as its command, including physical resources, financial resources, skill and organization – and its adaptability to the environment.

Every business enterprise, thus, consists of a set of internal factors and is confronted with a set of external factors.

The internal factors are generally regarded as controllable factors because the company has control over these factors; it can alter or modify such factors as its personnel, physical facilities, organization and functional means, such as the marketing mix, to suit the environment.

The external factors, on the other hand, are by and large, beyond the control of a company. The external or environmental factors such as the economic factors, socio-cultural factors, government and legal factors, demographic factors, geo-physical factors etc. are, therefore, generally regarded as uncontrollable factors.

As the environmental factors are beyond the control of a firm, its success will depend to a very large extent on its adaptability to the environment, i.e. its ability to properly design and adjust the internal (the controllable) variables to take advantage of the opportunities and to combat the threats in the environment.

The business environment comprises a microenvironment and a macro environment.

MICRO ENVIRONMENT

“The micro environment consists of the actors in the company’s immediate environment” that effect the performance of the company. These include the

suppliers, marketing intermediaries, competitors, customers, and publics. “The macro environment consists of the larger societal forces that affect all the actors in the company’s micro environment namely, the demographic, economic, natural, technological, political and cultural forces”.

It is quite obvious that the micro environmental factors are more intimately linked with the company than the macro factors. The micro forces need not necessarily affect all the firms in a particular industry in the same way. Some of the micro factors may be particular to a firm. For example, a firm, which depends on a supplier, may have a supplier environment, which is entirely different from that of a firm whose supply source is different. When competing firms in an industry have the same microelements, the relative success of the firms depends on their relative effectiveness in dealing with these elements.

Suppliers

An important force in the microenvironment of a company is the supplier, i.e., those who supply the inputs like raw materials and components to the company. The importance of reliable source/sources of supply to the smooth functioning of the business is obvious. Uncertainty regarding the supply or other supply constraints often compels companies to maintain high inventories causing cost increases. It has been pointed out that factories in India maintain indigenous stocks of 3-4 months and imported stocks of 9 months as against an average of a few hours to two weeks in Japan.

Because of the sensitivity of the supply, many companies give high importance to vendor development. Vertical integration, where feasible, helps solve the supply problem.

It is very risky to depend on a single because a strike, lock out or any other production problem with that supplier may seriously affect the company. Similarly, a change in the attitude or behavior of the supplier may also affect the company. Hence, multiple sources of supply often help reduce such risks.

The supply management assumes more importance in a scarcity environment. “Company purchasing agents are learning how to “wine and dine” suppliers to obtain favorable treatment during periods of shortages. In other words, the purchasing department might have to “market” itself to suppliers”.

CUSTOMERS

As it is often, exhorted, the major task of a business is to create and sustain customers. A business exists only because of its customers. Monitoring the customer sensitivity is, therefore, a prerequisite for the business success.

A company may have different categories of consumers like individuals, households, industries and other commercial establishments, and government and other institutions. For example, the customers of a tyre company may include individual automobile owners, automobile manufacturers, public sector transport undertakings and other transport operators.

Depending on a single customer is often too risky because it may place the company in a poor bargaining position, apart from the risks of losing business consequent to the winding up of business by the customer or due to the customer's switching over the competitors of the company.

The choice of the customer segments should be made by considering a number of factors including the relative profitability, dependability, stability of demand, growth prospects and the extent of competition.

COMPETITORS

A firm's competitors include not only the other firms, which market the same or similar products, but also all those who compete for the discretionary income of the consumers. For example, the competition for a company's televisions may come not only from other T.V. manufacturers but also from two-wheelers, refrigerators, cooking ranges, stereo sets and so on and from firms offering savings and investment schemes like banks, Unit Trust of India, companies accepting public deposits or issuing shares or debentures etc. This competition among these products may be described as desire competition as the primary

task here is to influence the basic desire of the consumer. Such desire competition is generally very high in countries characterized by limited disposable incomes and many unsatisfied desires (and, of course, with many alternatives for spending/investing the disposable income).

If the consumer decides to spend his discretionary income on recreation (or recreation cum education) he will still be confronted with a number of alternatives to choose from like T.V., stereo, two-in-one, three –in-one etc. The competition among such alternatives, which satisfy a particular category of desire, is called generic competition.

If the consumer decides to go in for a T.V. the next question is which form of the T.V. – black and white or colour, with remote-control or without it etc. In other words, there is a product form competition. Finally the consumer encounters the brand competition i.e., the competition between the different brands of the same product form.

An implication of these different demands is that a marketer should strive to create primary and selective demand for his products.

MARKETING INTERMEDIARIES

The immediate environment of a company may consist of a number of marketing intermediaries which are “firms that aid the company in promoting, selling and distributing its goods to final buyers”.

The marketing intermediaries include middlemen such as agents and merchants who “help the company find customers or close sales with them”, physical distribution firms which “assist the company in stocking and moving goods from their origin to their destination” such as warehouses and transportation firms; marketing service agencies which “assist the company in targeting and promoting its products to the right markets” such as advertising agencies, marketing research firms, media firms and consulting firms; and financial intermediaries which finance marketing activities and insure business risks.

Marketing intermediaries are vital links between the company and the final consumers. A dislocation or disturbance of this link, or a wrong choice of the link, may cost the company very heavily. Retail chemists and druggists in India once decided to boycott the products of a leading company on some issue such as poor retail margin. This move for collective boycott was, however, objected to by the MRTP commission; but for this company would, perhaps, have been in trouble.

DEMOCRATIC

A company may encounter certain publics in its environment. "A public is any group that has an actual or potential interest in or impact on an organisation's ability to achieve its interests. Media publics, citizens action publics and local publics are some examples.

For example, one of the leading companies in India was frequently under attack by the media public, particularly by a leading daily, which was allegedly bent on bringing down the share prices of the company by tarnishing its image. Such exposures or campaigns by the media might even influence the government decisions affecting the company. The local public also affects many companies. Environmental pollution is an issue often taken up by a number of local publics. Actions by local publics on the issue have caused some companies to suspend operations and/or take pollution abatement measures.

GROWTH OF CONSUMER PUBLIC IS AN IMPORTANT DEVELOPMENT AFFECTING BUSINESS.

It is wrong to think that all publics are threats to business. Some of the actions of the publics may cause problems for companies. However, some publics are an opportunity for the business. Some businessmen, for example, regard consumerism as an opportunity for the business. The media public may be used to disseminate useful information. Similarly, fruitful cooperation between a

company and the local publics may be established for the mutual benefit of the company and the local community.

MACRO ENVIRONMENT

As stated earlier, a company and the forces in its microenvironment operate in a larger macro environment of forces that shape opportunities and pose threats to the company. The macro forces are, generally, more uncontrollable than the micro forces. A sketch picture of the important macro-environmental forces is given below.

ECONOMIC ENVIRONMENT

Economic conditions, economic policies and the economic system are the important external factors that constitute the economic environment of a business.

The economic conditions of a country-for example, the nature of the economy, the stage of development of the economy, economic resources, the level of income, the distribution of income and assets, etc- are among the very important determinants of business strategies.

In a developing country, the low income may be the reason for the very low demand for a product. The sale of a product for which the demand is income-elastic naturally increases with an increase in income. But a firm is unable to increase the purchasing power of the people to generate a higher demand for its product. Hence, it may have to reduce the price of the product to increase the sales. The reduction in the cost of production may have to be effected to facilitate price reduction. It may even be necessary to invent or develop a new low-cost product to suit the low-income market. Thus Colgate designed a simple, hand-driven, inexpensive (\$10) washing machine for low-income buyers in less developed countries. Similarly, the National Cash Register Company took an innovative step backward by developing a crank-operated cash register that would sell at half the cost of a modern cash register and this was well received in a number of developing countries.

In countries where investment and income are steadily and rapidly rising, business prospects are generally bright, and further investments are encouraged. There are a number of economists and businessmen who feel that the developed countries are no longer worthwhile propositions for investment because these economies have reached more or less saturation levels in certain respects.

In developed economies, replacement demand accounts for a considerable part of the total demand for many consumer durables whereas the replacement demand is negligible in the developing economies.

The economic policy of the government, needless to say, has a very great impact on business. Some types or categories of business are favorably affected by government policy, some adversely affected, while it is neutral in respect of others. For example, a restrictive import policy, or a policy of protecting the home industries, may greatly help the import-competing industries.

Similarly, an industry that falls within the priority sector in terms of the government policy may get a number of incentives and other positive support from the government, whereas those industries which are regarded as inessential may have the odds against them.

In India, the government's concern about the concentration of economic power restricted the role of the large industrial houses and foreign concerns to the core sector, the heavy investment sector, the export sector and backward regions.

The monetary and fiscal policies, by the incentives and disincentives they offer and by their neutrality, also affect the business in different ways.

An industrial undertaking may be able to take advantage of external economies by locating itself in a large city; but the Government of India's policy was to discourage industrial location in such places and constrain or persuade industries undertaking, a backward area location may have many disadvantages. However, the incentives available for units located in these backward areas may compensate them for these disadvantages, at least to some extent.

According to the industrial policy of the Government of India until July 1991, the development of 17 of the most important industries were reserved for the state. In the development of another 12 major industries, the state was to play a dominant role. In the remaining industries, co-operative enterprises, joint sector enterprises and small scale units were to get preferential treatment over large entrepreneurs in the private sector. The government policy, thus limited the scope of private business. However, the new policy ushered in since July 1991 has wide opened many of the industries for the private sector.

The scope of international business depends, to a large extent, on the economic system. At one end, there are the free market economies or capitalist economies, and at the other end are the centrally planned economies or communist countries. In between these two are the mixed economies. Within the mixed economic system itself, there are wide variations.

The freedom of private enterprise is the greatest in the free market economy, which is characterized by the following assumptions:

- (i) The factors of production (labor, land, capital) are privately owned, and production occurs at the initiative of the private enterprise.
- (ii) Income is received in monetary form by the sale of services of the factors of production and from the profits of the private enterprise.
- (iii) Members of the free market economy have freedom of choice in so far as consumption, occupation, savings and investment are concerned.
- (iv) The free market economy is not planned controlled or regulated by the government. The government satisfies community or collective wants, but does not compete with private firms, nor does it tell the people where to work or what to produce.

The completely free market economy, however, is an abstract system rather than a real one. Today, even the so-called market economies are subject to a number

of government regulations. Countries like the United States, Japan, Australia, Canada and member countries of the EEC are regarded as market economies.

The communist countries have, by and large, a centrally planned economic system. Under the rule of a communist or authoritarian socialist government, the state owns all the means of production, determines the goals of production and controls the economy according to a central master plan. There is hardly any consumer sovereignty in a centrally planned economy, unlike in the free market economy. The consumption pattern in a centrally planned economy is dictated by the state.

China, East Germany Soviet Union, Czechoslovakia, Hungary, Poland etc., had centrally planned economies. However, recently several of these countries have discarded communist system and have moved towards the market economy.

In between the capitalist system and the centrally planned system falls the system of the mixed economy, under which both the public and private sectors co-exist, as in India. The extent of state participation varies widely between the mixed economies. However, in many mixed economies, the strategic and other nationally very important industries are fully owned or dominated by the state.

The economic system, thus, is a very important determinant of the scope of private business. The economic system and policy are, therefore, very important external constraints on business.

POLITICAL AND LEGAL ENVIRONMENT

Political and government environment has close relationship with the economic system and economic policy. For example, the communist countries had a centrally planned economic system. In most countries, apart from those laws that control investment and related matters, there are a number of laws that regulate the conduct of the business. These laws cover such matters as standards of products, packaging, promotion etc.

In many countries, with a view to protecting consumer interests, regulations have become stronger. Regulations to protect the purity of the environment and

preserve the ecological balance have assumed great importance in many countries.

Some governments specify certain standards for the products (including packaging) to be marketed in the country; some even prohibit the marketing of certain products. In most nations, promotional activities are subject to various types of controls. Media advertising is not permitted in Libya. Several European countries restrain the use of children in commercial advertisements. In a number of countries, including India, the advertisement of alcoholic liquor is prohibited. Advertisements, including packaging, of cigarettes must carry the statutory warning that "cigarette smoking is injurious to health". Similarly, advertisements of baby food must necessarily inform the potential buyer that breast-feeding is the best. In countries like Germany, product comparison advertisements and the use of superlatives like 'best' or 'excellent' in advertisements is not allowed. In the United States, the Federal Trade Commission is empowered to require a company to provide the quality, performance or comparative prices of its products.

"What is being asked of the drug industry and of American business in general is a fuller disclosure of the relevant facts about products. For drugs, food additives, some cosmetic preparations, and so forth, a full disclosure requires more knowledge of the long-range side effects of materials ingested into the complex human body. For American industry as a whole, greater candour has been called for under such legislation as Truth in Lending and Fair Packaging Act, under administrative decrees such as the warning requirement on cigarette packages and advertising, under the threats of private damage suits using the common-law concepts of warranty, and under voluntary programmes such as unit pricing and listing nutritional content of foods. The increasing complexity of products and the variety of product choices suggest further moves away from 'caveat emptor' or 'let the buyer beware' doctrines, moves which on the whole

should prove a welcome although sometimes inconvenient challenge for business”.

There are a host of statutory controls on business in India. If the MRTP companies wanted to expand their business substantially, they had to convince the government that such expansion was in the public interest. Indeed, the “Government in India has an all-pervasive and predominantly restrictive influence over various aspects of business, e.g, industrial licensing which decides location, capacity and process; import licensing for machinery and materials; size and price of capital issue; loan finance; pricing; managerial remuneration; expansion plans; distribution restrictions and a host of other enactments. Therefore, a considerable part of attention of a Chief Executive and his senior colleagues has to be devoted to a continuous dialogue with various government agencies to ensure growth and profitability within the framework of controls and restraints”.

Many countries today have laws to regulate competition in the public interest. Elimination of unfair competition and dilution of monopoly power are the important objectives of these regulations. In India, the monopolistic undertakings, dominants undertakings and large industrial houses are subject to a number of regulations which prevent the concentration of economic power to the common detriment. The MRTP Act also controls monopolistic, restrictive and unfair trade practices which are prejudicial to public interest. Such regulations brighten the prospects of small and new firms. They also increase the scope of some of the existing firms to venture into new areas of business. The special privileges available to the small scale sector have also contributed to the phenomenal success of the Nirma.

Certain changes in government policies such as the industrial policy, fiscal policy, tariff policy etc. may have profound impact on business. Some policy developments create opportunities as well as threats. In other words, a development which brightens the prospects of some enterprises may pose a

threat to some others. For example, the industrial policy liberalizations in India, particularly around the mid-eighties have opened up new opportunities and threats. They have provided a lot of opportunities to a large number of enterprises to diversify and to make their product mix better. But they have also given rise to serious threat to many existing products by way of increased competitions; many seller's markets have given way to buyer's markets. Even products which were seldom advertised have come to be promoted very heavily. This battle for the market has provided a splendid opportunity for the advertising industry. Advertising billing has been increasing substantially.

That an estimated cost savings of about Rs. 200 crores per year have accrued to the Reliance Industries as a result of the changes in duties on some of the material inputs used by them is just an indication of the tremendous impact the fiscal and tariff policies can have on the business.

SOCIO-CULTURAL ENVIRONMENT

The socio-cultural fabric is an important environmental factor that should be analysed while formulating business strategies. The cost of ignoring the customs, traditions, taboos, tastes and preferences, etc., of people could be very high.

The buying and consumption habits of the people, their language, beliefs and values, customs and traditions, tastes and preferences, education are all factors that affect business.

For a business to be successful, its strategy should be the one that is appropriate in the socio-cultural environment. The marketing mix will have to be so designed as best to suit the environmental characteristics of the market. In Thailand, Helene Curtis switched to black shampoo because Thai women felt that it made their hair look glossier. Nestle, a Swiss multinational company, today brews more than forty varieties of instant coffee to satisfy different national tastes.

Even when people of different cultures use the same basic product, the mode of consumption, conditions of use, purpose of use or the perceptions of the product attributes may vary so much so that the product attributes method of presentation, positioning, or method of promoting the product may have to be varied to suit the characteristics of different markets. For example, the two most important foreign markets for Indian shrimp are the U.S and Japan. The product attributes for the success of the product in these two markets differ. In the U.S. market, correct weight and bacteriological factors are more important rather than eye appeal, colour, uniformity of size and arrangement of the shrimp which are very important in Japan. Similarly, the mode of consumption of tuna, another seafood export from India, differs between the U.S. and European countries. Tuna fish sandwiches, an American favourite which accounts for about 80 per cent of American tuna consumption, have little appeal in high tuna consumption European countries where people eat it right from the can. A very interesting example is that of the Vicks Vaporub, the popular pain balm, which is used as a mosquito repellent in some of the tropical areas.

The differences in languages sometimes pose a serious problem, even necessitating a change in the brand name. Preett was, perhaps, a good brand name in India, but it did not suit in the overseas market; and hence it was appropriate to adopt 'Prestige' for the overseas markets. Chevrolet's brand name 'Nova' in Spanish means "it doesn't go". In Japanese, General Motors' "Body by Fisher" translates as corpse by Fisher". In Japanese, again, 3M's slogan "sticks like crazy" translates as "sticks foolishly". In some languages, Pepsi-Cola's slogan "come alive" translates as "come out of the grave".

The values and beliefs associated with colour vary significantly between different cultures. Blue, considered feminine and warm in Holland, is regarded as masculine and cold in Sweden. Green is a favourite colour in the Muslim world; but in Malaysia, it is associated with illness. White indicates death and mourning in China and Korea; but in some countries, it expresses happiness and

is the colour of the wedding dress of the bride. Red is a popular colour in the communist countries; but many African countries have a national distaste for red colour.

Social inertia and associated factors come in the way of the promotion of certain products, services or ideas. We come across such social stigmas in the marketing of family planning ideas, use of bio-gas for cooking, etc. In such circumstances, the success of marketing depends, to a very large extent, on the success in changing social attitudes or value systems.

There are also a number of demographic factors, such as the age, and sex composition of population, family size, habitat, religion, etc., which influence the business.

While dealing with the social environment, we must also consider the social environment of the business which encompasses its social responsibility and the alertness or vigilance of the consumers and of society at large.

The societal environment has assumed great importance in recent years. As Barker observes, business “traditionally has been held responsible for quantities- for the supply of goods and jobs, for costs, prices, wages, hours of works, and for standards of living. Today, however, business is being asked to take a responsibility for the quality of life in our society. The expectation is that business- in addition to its traditional accountability for economic performance and results – will concern itself with the health of the society, that it will come up with the cures for the ills that currently beset us and, indeed, will find ways of anticipating and preventing future problems in these areas”.

As Stern succinctly points out, the “more educated the society becomes, the more interdependent it becomes, and the more discretionary the use of its resources, the more marketing will become enmeshed in social issues. Marketing personnel are at interface between company and society. In this position, they have the responsibility not merely for designing a competitive

marketing strategy, but for sensitizing business to the social, as well as the product demand of society”.

DEMOGRAPHIC ENVIRONMENT

Demographic factors like the size, growth rate, age composition, sex composition, etc. of the population, family size, economic stratification of the population, educational levels, languages, caste, religion etc. Are all factors that are relevant to business?

Demographic factors such as size of the population, population growth rate, age composition, life expectancy, family size, spatial dispersal, occupational status, employment pattern etc, affect the demand for goods and services. Markets with growing population and income are growth markets. But the decline in the birth rates in countries like the United States have affected the demand for baby products. Johnson and Johnson have overcome this problem by repositioning their products like baby shampoo and baby soap, promoting them also to the adult segment, particularly to the females.

A rapidly increasing population indicates a growing demand for many products. High population growth rate also indicates an enormous increase in labour supply. When the Western countries experienced the industrial revolution, they had the problem of labour supply, for the population growth rate was comparatively low. Labour shortage and rising wages encouraged the growth of labour-saving technologies and automation. But most developing countries of today are experiencing a population explosion and a situation of labour surplus. The governments of developing countries, therefore, encourage labour intensive methods of production. Capital intensive methods, automation and even rationalization are apposed by labour and many sociologists, politicians and economists in these countries. The population growth rate, thus, is an important environmental factor which affects business. Cheap labour and a growing market have encouraged many multinational corporations to invest in developing countries.

The occupational and spatial mobilities of population have implications for business. If labour is easily mobile between different occupations and regions, its supply will be relatively smooth, and this will affect the wage rate.

If labour is highly heterogeneous in respect of language, caste and religion, ethnicity, etc., personnel management is likely to become a more complex task. The heterogeneous population with its varied tastes, preferences, beliefs, temperaments, etc. gives rise to differing demand patterns and calls for different marketing strategies.

References to a number of demographic factors that have business implications have already been made under “socio-cultural environment”.

NATURAL ENVIRONMENT

Geographical and ecological factors, such as natural resource endowments, weather and climatic conditions, topographical factors, locational aspects in the global context, port facilities, etc., are all relevant to business.

Differences in geographical conditions between markets may sometimes call for changes in the marketing mix. Geographical and ecological factors also influence the location of certain industries. For example, industries with high material index tend to be located near the raw material sources. Climatic and weather conditions affect the location of certain industries like the cotton textile industry. Topographical factors may affect the demand pattern. For example, in hilly areas with a difficult terrain, jeeps may be in greater demand than cars.

Ecological factors have recently assumed great importance. The depletion of natural resources, environmental pollution and the disturbance of the ecological balance has caused great concern. Government policies aimed at the preservation of environmental purity and ecological balance, conservation of non-replenishable resources, etc., have resulted in additional responsibilities and problems for business, and some of these have the effect of increasing the cost of production and marketing. Externalities have become an important problem the business has to confront with.

PHYSICAL AND TECHNOLOGICAL ENVIRONMENT

Physical Factors, such as geographical factors, weather and climatic conditions may call for modifications in the product, etc., to suit the environment because these environmental factors are uncontrollable. For example, Esso adapted its gasoline formulations to suit the weather conditions prevailing in different markets.

Business prospects depend also on the availability of certain physical facilities. Some products, like many consumer durables, have certain use facility characteristics. The sale of television sets, for example, is limited by the extent of the coverage of the telecasting. Similarly, the demand for refrigerators and other electrical appliances is affected by the extent of electrification and the reliability of power supply. The demand for LPG gas stoves is affected by the rate of growth of gas connections.

Technological factors sometimes pose problems. A firm, which is unable to cope with the technological changes, may not survive. Further, the differing technological environment of different markets or countries may call for product modifications. For example, many appliances and instruments in the U.S.A. are designed for 110 volts but this needs to be converted into 240 volts in countries which have that power system. Technological developments may increase the demand for some existing products. For example, voltage stabilisers help increase the sale of electrical appliances in markets characterised by frequent voltage fluctuations in power supply. However, the introduction of TV's, Fridges etc, with in built voltage stabilizer adversely affects the demand for voltage stabilizers.

Advances in the technologies of food processing and preservation, packaging etc., have facilitated product improvements and introduction of new products and have considerably improved the marketability of products.

The television has added a new dimension to product promotion. The advent of TV and VCP/VCR has, however, adversely affected the cinema theatres.

The fast changes in technologies also create problems for enterprises as they render plants and products obsolete quickly. Product-market-technology matrix generally has a much shorter life today than in the past. It is particularly so in the international marketing context. It may be interesting to note that almost half of Hindustan Lever's 1980 export business did not exist in 1987. In fact, as much as a third of the company's 1987 turnover was from products and markets, which were under three years of age.

INTERNATIONAL ENVIRONMENT

The international environment is very important from the point of view of certain categories of business. It is particularly important for industries directly depending on imports or exports and import-competing industries. For example, a recession in foreign markets, or the adoption of protectionist policies by foreign nations, may create difficulties for industries depending on exports. On the other hand, a boom in the export market or a relaxation of the protectionist policies may help the export-oriented industries. A liberalization of imports may help some industries which use imported items, but may adversely affect import-competing industries.

It has been observed that major international developments have their spread effects on domestic business. The Great Depression in the United States sent its shock waves to a number of other countries. Oil price hikes have seriously affected a number of economies. These hikes have increased the cost of production and the prices of certain products, such as fertilizers, synthetic fibres, etc. The high oil price has led to an increase in the demand for automobile models that economise energy consumption. The demand for natural fibres increased because of the oil crisis.

The oil crisis also prompted some companies to resort to demarketing. "Demarketing refers to the process of cutting consumer demand for a product back to level that can be supplied by the firm". Some oil companies-the Indian Oil Corporation, for example-have publicized tips on how to cut oil consumption.

When the fertilizer price shot up following the oil crisis, some fertilizer companies appealed to the farmers to use fertilizers only for important and remunerative crops. The importance of natural manure like compost as a substitute for chemical fertilizers was also emphasized.

The oil crisis led to a reorientation of the Government of India's energy policy. Such developments affect the demand, consumption and investment pattern.

A good export market enables a firm to develop a more profitable product mix and to consolidate its position in the domestic market. Many companies now plan production capacities and investment taking into account also the foreign markets. Export marketing facilitates the attainment of optimum capacity utilization; a company may be able to mitigate the effects of domestic recession by exporting. However, a company which depends on the export market to a considerable extent has also to face the impact of adverse developments in foreign markets.

SUMMARY

International business is a necessity in today's world. The gains for greater awareness and knowledge of international business are immense for nations, multi-national enterprises, trading companies, exporters and even individuals. To go global, the first step would be to understand the international business environment. International business is nothing but extending the areas of activities of business across the boundaries. We have discussed about the importance of understanding international business environment in detail. The concepts of microenvironment and macro environment with reference to the political, legal, economical and cultural background are also discussed. Understanding international business environment requires greater research and information. The fulfillment of this research could happen with greater understanding of the framework for analyzing the international business environment.

REVIEW QUESTIONS

1. Define international business and discuss the scope of international business
2. What is meant by international business environment? Discuss briefly the importance of understanding the international business environment.
3. Discuss the concepts of micro and macro environment
4. Explain the framework for analyzing the international business environment in detail.
5. Companies cannot bypass the knowledge of operations of businesses internationally – Comment.

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UNIT II

Structure:

1. Introduction
- 2.0 Objective
- 3.0 Presentation of Contents
 - 3.1 International Economic Environment
 - 3.2 WTO
 - 3.3 United Nations Conference on Trade And Development
 - 3.4 International Monetary Fund (IMF)
 - 3.5 World Bank
- 4.0 Summary
- 5.0 Self Assessment Questions
- 6.0 Suggested Reading

1. Introduction

The economic environment has the most profound influence on the business. The globalization of economy has brought the nations together. We are moving towards a closely knot economy, from the era of protectionism and self-sufficiency. Therefore, there is a need to study the current economic environment and the variables that shape the same.

2. Objective

The objective of this unit is to acquaint the students with the economic environment and its various constituents that influence the international business environment. The impact of global trade and business institutions is also explained.

3. Presentation of Contents

3.1 International Economic Environment

The most radical changes have happened on the economic front in the last two decades, which have changed the entire mathematics of international business environment. The political events such as the disintegration of USSR have made the world a multi-polar entity. At the same time, the technological advances, particularly those in the field of information technology have made the world a

smaller place. The strengthening of the global economic institutions, particularly WTO have led to a major integration of the nations. However, the main driving force behind these developments remains the economic environment. Irrespective of the nature and size of business, no business entity is left insulated from the global changes. The competition is right on the door of every business. Therefore, anyone aspiring to excel in business needs to understand these economic environmental variables and master, with dexterity, the techniques to gain maximum advantage out of them. The most profound of the changes is the dislocation of local competition. Some of major changes in the past decades are:

- Capital movement rather than trade have become the driving force of the world economy.
 - Production has become disassociated from employment.
 - Primary products have lost their traditional association from the industrial economy.
 - The economics seems to have a greater influence on the politics, than vice versa.
 - The ideology of nation controlling the economy is primarily rejected.
- There is a realization of the benefits of free market economy.

The established principles of economics have been redefined and we understand the economics of interdependence and cooperation instead of protectionism. The old rules of competition are also undergoing a change. From a direct head on confrontation, the businesses are developing the niches where each of the players grows and excels.

Macroeconomic trends

This unit focuses only on the most recent economic situation, particularly the status in the last five years. The students are advised to refer to standard text books on the subject to have an overview of the economic situation of the yesteryears. Focusing on the years gone by shall divert the focus of this unit.

The present status of the world economy can best be defined as beginning on a strong note. As a number of major developed economies managed to rebound from the notable slowdown in late 2005, many developing countries maintained the momentum of broad and solid growth. A measurable moderation is expected, however, in the second half of 2006, with the annual growth of world gross product (WGP) for 2006 as a whole at about 3.6 per cent the same pace as in 2005 and marginally. The global projections are based on the weighted average of projected individual-country growth rates using the gross domestic product (GDP) valued in 2000 dollar prices for each country. Other global projections tend to use GDP valued in purchasing power parity (PPP) dollars. When using those weights, the United Nations global forecast for world economic growth would be 4.8 per cent for 2006.

Table 1.

Growth of world output, 2001-2006

Year	2001	2002	2003	2004	2005	2006	2006
World output	1.6	1.9	2.8	4.1	3.6	3.6	3.3
Developed economies	1.2	1.3	2.0	3.2	2.7	2.7	2.5
Northern America	0.8	1.7	2.7	4.2	3.5	3.1	3.1
Western Europe	1.9	1.2	1.2	2.4	1.6	2.3	2.1
Asia and Oceania	0.7	0.4	2.0	2.3	2.7	2.8	1.9
Economies in transition	5.7	5.0	7.0	7.6	6.3	6.0	5.9
Southern and Eastern Europe	4.8	4.8	4.6	6.6	4.6	4.8	4.4
Commonwealth of Independent States	6.0	5.1	7.6	7.8	6.8	6.3	6.2
Developing economies	2.7	3.9	5.2	6.9	6.1	6.2	5.6
Africa	3.6	3.3	4.7	5.0	5.3	5.9	5.5
East Asia	4.5	6.9	6.8	7.9	7.3	7.3	6.5

South Asia	4.1	5.6	7.0	7.0	6.7	6.3	6.4
Western Asia	0.3	3.0	4.7	6.5	5.1	5.2	5.1
Latin America and the Caribbean	0.3	-0.8	2.0	5.8	4.5	4.6	3.9
Landlocked countries	5.6	4.5	4.6	6.1	7.2	6.8	—
Least developed countries	6.5	6.3	6.7	6.7	6.9	7.3	6.6
Small island developing States	0.5	3.4	2.8	5.7	5.9	5.5	—
Sub-Saharan Africa	4.8	3.9	3.4	5.7	5.5	6.6	5.3

Source: Department of Economic and Social Affairs of the United Nations Secretariat.

World Economic Situation and Prospects as of mid-2006 higher than what was projected at the beginning of the year in *World Economic Situation and Prospects 2006*. A number of downside risks have heightened most recently and they will weigh on the world economy in the near to medium future. The large global imbalances remain the primary source of uncertainty for the stability of the world economy, but there are other sources of uncertainties that are not negligible, such as the persistence of higher oil prices, the cooling o. in the housing sector in a number of economies, the risk of avian influenza's turning into a pandemic, and the rising interest rates worldwide, as well as some geopolitical uncertainties. One salient feature of the global economic expansion of the past two years has been the improvement in the breadth of growth performance among developing countries: a large number of developing countries have registered solid growth. During 2004- 2005 about half of the 107 developing countries for which data were available had managed to register GDP per capita growth above 3 per cent, which by a rule of thumb is considered to be the threshold of the growth needed in order for a developing country to reduce poverty meaningfully.

Meanwhile, only about a dozen developing countries experienced a decline in per capita GDP during 2004-2005, the smallest number in decades. Such a trend is expected to continue in 2006. The employment situation worldwide is improving, but is far from satisfactory. Employment creation has lagged behind output growth in the global recovery of the past few years. Despite some noticeable improvement, most recently in 2006, unemployment rates in a large number of countries are still higher than their levels prior to the global downturn of 2000-2001. Many developing countries are also facing high levels of structural unemployment and underemployment, limiting the effectiveness of growth in reducing poverty. A gradual recovery in employment continues in most developed countries. In the United States of America, the average monthly increase in wage employment has strengthened in 2006, with the unemployment rate dropping below 5 per cent. In Eastern Europe, unemployment rates are still about 1 percentage point above their low levels of 2001, but a gradual improvement is discernible. The unemployment rate in Japan has been declining steadily, and labour markets in Australia, Canada and New Zealand are exceptionally strong.

The unemployment situation in developing countries and economies in transition is more pressing, in both cyclical and structural terms. Official unemployment data, which often cover only urban areas, in general, underestimate by a large margin the severity of unemployment and, particularly, the underemployment situation in most developing countries. Nonetheless, even by this measure, only a small number of countries in Asia, in Latin America and in the group of economies in transition registered a notable reduction in unemployment rates in 2005.

Unemployment rates for most Asian economies are still above their levels prior to the Asian financial crisis of the late 1990s. In China and many Asian economies, where people in rural areas still account for a large share of the population, surplus labour and high rates of underemployment in the rural areas

remain a long-term policy concern. In South Asia, for example, the formal sector is unable to absorb a rapidly growing workforce and unemployment is highest among the young — which is also the case for many other developing countries. Despite some improvement, unemployment rates in most Latin American countries and economies in transition are still high — near 10 per cent. Structural unemployment and underemployment problems are particularly acute in Africa despite its recent growth recovery. Official rates of unemployment are at 10 per cent or higher in some of these economies.

3.2 WTO

Introduction

The World War–II, which lasted from 1939 to 1945, left many countries in Europe and Asia totally ravaged. Their economies were shattered; there was tremendous stain on political and social systems resulting in wide spread annihilation and migration of people. Intentional peace was ruffled. Something had to be done to put these war-ravaged economies back in shape. Simultaneously, the various colonies in Asia and Africa were acquiring political freedom. And there was urgent pressure on them for rapid economic development and political stabilization. In this background the United Nations Organisation (UNO) was born on the collective wisdom of the world. Progressively, the UNO came to encompass the concerns for development in economic, commercial, scientific, social and cultural sphere of the member nations. It formed various forums and agencies. One such forum under the UNO was the General Agreement on Tariffs and Trade (GATT) which was established in 1947.

GATT emerged from the “ashes of the Havana Charter”. In International Conference on Trade and Employment in Havana in the winter of 1947-48, fifty-three nations drew up and signed a charter for establishing an International

Trade Organisation (ITO). But the US Congress did not ratify the Havana Charter with the result that the ITO never came into existence.

Simultaneously, twenty-three nations agreed to continue extensive tariff negotiations for trade concessions at Geneva, which were incorporated in a General Agreement of Tariffs and Trade. This was signed on 30th October 1947 and came into force from 1st January 1948 when other nations had also signed it.

The critical juncture was reached during the Uruguay Round of multilateral trade negotiations, which may be called the final act. It was signed by 12 countries in which India was signatory. Popularly known as Dunkel agreement, It finally emerged as the World Trade Organisation (WTO) on 1st January, 1995.

What is GATT

The General Agreement on Tariffs and Trade (GATT) is neither an organisation nor a court of justice. It is simply a multinational treaty which now covers eighty per cent of the world trade. It is a decision making body with a code of rules for the conduct of international trade and a mechanism for trade liberalisation. It is a forum where the contracting parties meet from time to time to discuss and solve their trade problems, and also negotiate to enlarge their trade. The GATT rules provide for the settlement of trade disputes, call for consultations, waive trade obligations, and even authorize retaliatory measures.

The GATT has been a permanent international organisation having a permanent Council of Representative with headquarters at Geneva. 25 governments have signed it. Its function is to call International conferences to decide on trade liberalizations on a multilateral basis.

GATT 'Rounds' of Global Trade Negotiations

The brief particulars of the various GATT 'Rounds' (conferences) for global trade negotiations are discussed below:

1. **First Round:-** The earlier rounds of GATT have achieved a limited measure of success. In the first round of talks held in Havana in 1947, 23 countries, which had formed GATT, exchanged tariff concessions on 45,000 products worth 10 billion US dollars of trade per annum.
2. **Second Round:-** Ten more countries had joined GATT when its second round was held in Annecy (France) in 1949. In this round, customs and tariffs on 5000 additional items of international trade were reduced.
3. **Third Round:-** The Third round was organized in Torquay (England) in 1950-51. 38 member countries of GATT participated in it and they adopted tariff reduction on 8700 items.
4. **Fourth Round:-** The fourth round of world trade negotiations were held in Geneva in 1955-56. In this round countries decided to further cut duties on goods entering international trade. The value of merchandise trade subjected to tariff cut was estimated at \$ 2.5b.
5. **Fifth Round:-** The fifth round took place during 1960-62 at Geneva. In this round the negotiations covered the approval of common external tariff (CET) of the European countries and cut in custom duties amounting to US \$ 5 billion on 4400 items. Twenty-six countries participated in this round.
6. **Sixth Round or the Kennedy Round:-** With the formation EEC, the US had been put at a disadvantage. As a reaction to this, the US Congress passed the Trade Expansion Act in October 1962 which authorised the Kennedy administration to make 50 per cent tariff reduction in all commodities. This paved the way for the opening of the Kennedy round of trade negotiations at Geneva in May 1964, which were to be completed by 30 June 1967.

This round had the participation of 62 countries and negotiated tariff reductions of approximately \$ 40 billion, covering about four-fifths of the world trade. The major industrial countries in this group applied substantial cuts on their dutiable imports, e.g. as much as 64 per cent cuts in the case of the United States, 3 per cent in case of Britain, 30 per cent in case of Japan, 24 per cent in case of Canada. They left the US and European tariff on the manufactured goods in the range of 5 to 15 per cent.

However, with regard to agricultural products, the negotiations had lesser success. They agreed on an average duty reduction of 25 per cent on agricultural items. Non-tariff obstacles, too remained untouched and scant attention was paid to the problems of developing countries.

An IMF study revealed that weighted average tariff for all industrial products had been reduced to 7.7 per cent, 9.8 per cent on finished manufactured products, 8 per cent on semi-finished products and 2 per cent on raw materials. Thus trade in industrial products after the completion of Kennedy Round was substantially free of restrictions.

7. **Seventh Round or Tokyo Round:-** The Seventh Round of Multilateral Trade Negotiations (MTN) was launched in September 1973 under the auspices of GATT. Its objectives were laid down in the Tokyo Declaration. The Declaration set out a far-reaching programme for the negotiations in six areas. These are (i) tariff reduction; (ii) reduction of elimination of non-tariff barriers; (iii) coordinated reduction of all trade barriers in selected sectors; (iv) discussion on the multilateral safeguard system; (v) trade liberalisation in the agricultural sector taking into account the special characteristics and (vi) special treatment of tropical products. It also emphasized that MTN must take into account the special, interests and problems of developing countries.

8. Eight Round or the Uruguay Round:- The Eighth Round of GATT negotiations which began at Punta Del Este in Uruguay in September 1986 ought to have been concluded by the end of 1990. But at the ministerial meeting in Brussels in December 1990, an impasse was reached over the area of agriculture and the talks broke down.

The talks were restarted in February 1991 and continued till August 1991. On 20 December 1991, Aurther Dunkel, the then Director-General of GATT tabled a Draft Final Act of the Uruguay Round, known as the Dunkel Draft Text. This was a “take-it-or-leave-it” document which was hotly discussed at various fora in the member countries through 1992 till July 1993 when the then Director General, Sutherland relaunched the negotiations in Geneva. On 31 August 1993, the Trade Negotiations Committee (TNC) passed a resolution to conclude the Uruguay Round by 15 December. On 15 December 1993 at the final session, Chairman Sutherland declared that seven years of Uruguay Round negotiations had come to an end. Finally, on 15 April 1994, 123 Ministers of member countries ratified the results of the Uruguay Round at Marrakesh (Morocco) and the GATT disappeared and passed into history and it was absorbed by the World Trade Organization (WTO) on 1 January 1995.

The Uruguay Round of trade negotiations undertaken by the GATT since its establishment in 1947 had a wide agenda. The GATT originally covered international trade rules in the goods sector only. Domestic policies were outside the GATT purview and it operated only at international border. In the Uruguay Round, the GATT extended to three new areas, viz. Intellectual property rights services and investment. It also covered agriculture and textiles, which were outside the GATT jurisdiction.

The final year embodying the results of the Uruguay Round of Multilateral Trade Negotiations comprises 28 Agreements. It had two components: the WTO Agreement and the Ministerial decisions and declarations. The WTO Agreement

covers the formation of the organisation and the rules governing its working. Its Annexures contain the Agreements covering trade in goods, services, intellectual property rights, plurilateral trade, GATT Rules 1994, dispute settlement rules and trade policy review.

The Uruguay Round was concerned with two aspects of trade in goods and services. The first related to increasing market access by reducing or eliminating trade barriers. Reductions in tariffs, reductions in non-tariff support in agriculture, the elimination of bilateral quantitative restrictions, and reductions in barriers to trade in services met this. The second related to increasing the legal security of the new levels of market access by strengthening and expanding rules and procedures and institutions.

WORLD TRADE ORGANISATION (WTO)

The WTO was established on January 1, 1995. It is the embodiment of the Uruguay Round results and the successor to GATT. 76 Governments became members of WTO on its first day. It has now 146 members, India being one of the founder members. It has a legal status and enjoys privileges and immunities on the same footing as the IMF and the World Bank. It is composed of the Ministerial Conference and the General Council. The Ministerial Conference (MC) is the highest body. It is composed of the representatives of all the Members. The Ministerial Conference is the executive of the WTO and responsible for carrying out the functions of the WTO. The MC meets at least once every two years.

The General Council (GC) is an executive forum composed of representatives of all the Members. The GC discharges the functions of MC during the intervals between meetings of MC. The GC has three functional councils working under its guidance and supervision namely:

- a) Council for Trade in Goods.

- b) Council for Trade in Services.
- c) Council for Trade Related Aspects of Intellectual Property Rights (TRIPs).

Director-General heads the secretariat of WTO. He is responsible for preparing budgets and financial statements of the WTO. WTO has now become the third pillar of United Nations Organization (UNO) after World Bank and International Monetary Fund.

Objectives Of WTO

In its preamble, the Agreement establishing the WTO lays down the following objectives of the WTO.

1. Its relation in the field of trade and economic endeavor shall be conducted with a view to raising standards of living, ensuring full employment and large and steadily growing volume of real income and effective demand, and expanding the production and trade in goods and services.
2. To allow for the optimal use of the world's resources in accordance with the objective of sustainable development, seeking both (a) to protect and preserve the environment, and (b) to enhance the means for doing so in a manner consistent with respective needs and concerns at different levels of economic development.
3. To make positive efforts designed to ensure that developing countries especially the least developed among them, secure a share in the growth in international trade commensurate with the needs of their economic development.
4. To achieve these objectives by entering into reciprocal and mutually advantageous arrangements directed towards substantial reduction of tariffs and other barriers to trade and the elimination of discriminatory treatment in international trade relations.
5. To develop an integrated, more viable and durable multilateral trading system encompassing the GATT, the results of past trade liberalisation efforts, and all the results of the Uruguay Round of multilateral trade negotiations.

6. To ensure linkages between trade policies, environment policies and sustainable development.

Functions of WTO

The following are the functions of the WTO:

1. It facilitates the implementation, administration and operation of the objectives of the Agreement and of the Multilateral Trade Agreements.
2. It provides the framework for the implementation, administration and operation of the Plurilateral Trade Agreements relating to trade in civil aircraft, government procurement, trade in dairy products and bovine meat.
3. It provides the forum for negotiations among its members concerning their multilateral trade relations in matters relating to the agreements and a framework for the implementation of the result of such negotiations, as decided by the Ministerial Conference.
4. It administers the Understanding on Rules and Procedures governing the Settlement of Disputes of the Agreement.
5. It cooperates with the IMF and the World Bank and its affiliated agencies with a view to achieving greater coherence in global economic policy-making.

Differences Between GATT And WTO

The WTO is not an extension of the GATT but succession to the GATT. It completely replaces GATT and has a very different character. The major differences between the two are:

1. The GATT had no status whereas the WTO has a legal status. It has been created by international treaty ratified by governments and legislatures of member states.
2. The GATT was a set of rules and procedures relating to multilateral agreements of selective nature. There were separate agreements on separate issues, which were not binding on members. Any member could stay out of the agreement. The agreements, which form part of the WTO, are permanent and binding on all members.
3. The GATT dispute settlement system was dilatory and not binding on the parties to the dispute. The WTO dispute settlement mechanism is faster and binding on all parties.

4. GATT was a forum where the member countries met once in a decade to discuss and solve world trade problems. The WTO, on the other hand, is a properly established rule based World Trade Organization where decisions on agreement are time bound.
5. The GATT rules applied to trade in goods. Trade in services was included in the Uruguay Round but no agreement was arrived at. The WTO covers both trade in goods and trade in services.
6. The GATT had a small secretariat managed by a Director General. But the WTO has a large secretariat and a huge organizational setup.

Implications for India

After the Uruguay Round, India was one of the first 76 Governments that became member of the WTO on its first day. Different views have been expressed in support and against our country becoming a member of the WTO.

Favourable Factors

1. Benefits from reduction of tariffs on exports.
2. Improved prospects for agricultural exports because the prices of agricultural products in the world market will increase due to reduction in domestic subsidies and barriers to trade.
3. Likely increase in the exports of textiles and clothing due to the phasing out of MFA by 2005.
4. Advantages from greater security and predictability of the international trading system.
5. Compulsions imposed on India to be competitive in the world market.

Unfavourable Factors

1. Tariff reductions on goods of export interest to India are very small.
2. Less prospects of increase in agricultural exports due to the limited extent of agricultural liberalisation.
3. There will be hardly any liberalisation of our textile exports during the next 10 years.
4. India will be under pressure to liberalize the services industries.
5. There will be only marginal liberalisation to the movement of labour services in which it is competitive.

6. Increased outflows of foreign exchange due to commitments undertaken in the fields of TRIPS, TRIMS and services.
7. Technological dependence on foreign firms will increase as the R & D required to take advantages of Uruguay Round agreement may not be undertaken on adequate scale due to paucity of funds.
8. Only a few large firms or transnational corporations may benefit and smaller firms may disappear.
9. Increasing intrusion in our domestic space in TRIPs, TRIMs and services and agriculture.
10. The Uruguay Round has paved way for similar other institutions in future through linkage between trade, environment, labour standard and treatment of foreign capital.
11. Trend towards neo-protectionism in developed countries against our exports.

To conclude, we may say that WTO membership is going to be beneficial to India in terms of global market thrown open to its goods and services. We must know how to take advantage of this situation. We should try to strengthen our position to sell our products abroad. For that we have to improve the quality of goods and services, cut down costs and wastage and improve our competitive strength.

Evaluation of WTO

WTO has been in action for about nine years now. During this period of time, the WTO has proved that it is very different from its predecessor, GATT, in the following ways:

- (a) GATT did not have any powers, whereas WTO with its dispute settlement mechanism has been an outstanding success. WTO has brought to book even USA in several cases.
- (b) GATT negotiating rounds took place once in a decade or so. What used to take decades to complete has been done in a few years by the WTO.

Following are the achievements of WTO in the short period it has been in existence:

1. WTO has helped in making greater market orientations a general rule.

2. Tariff based protection has become the rule.
3. Restrictive measures, which were being used for balance of payments purposes, have declined markedly.
4. WTO has brought services trade into the multilateral system. Many countries are opening their markets for trade and investment either unilaterally or through regional or multilateral negotiations.
5. Many underdeveloped countries have promoted economic growth in their countries. They have undergone radical trade, exchange and domestic reforms, which have improved the efficiency of resource use and opened new investment opportunities.
6. Bilateralism has been, to a great extent, placed under control by the extension of WTO provisions to services, TRIPS and TRIMS and by the unified dispute settlement mechanism, in which the possibility of unilaterally blocking the adoption of panel decisions no longer exists.
7. The Trade Policy Review Mechanism has created a process of continuous monitoring of trade policy developments, which by promoting greater transparency has assisted in the process of liberalisation and reform.

The WTO, however, has still to make progress on the following issues:

1. The trade reform process is incomplete in many countries, some tariff peaks remain, and negotiations are still proceedings in various areas, notably in basic telecommunications and financial services.
2. There have been at least some reversals in the overall liberalisation process in some developing countries. Examples may be increasing of antidumping measures, selective tariff increases and investment related measures.
3. The combination of globalisation and technological change creates a premium on high skill as against low skill. Concerns have been raised that this will amount to growing social divisions.
4. The major share of the benefits of the WTO has gone to the countries of the North. WTO has been much more beneficial to the developed countries where the benefits of free trade accrue primarily to the underdeveloped countries, the progress has been much slower.
5. The WTO has not done much for the development of non-tariff barriers to imports from the underdeveloped countries such as anti dumping duties.

6. “One size fits all” approach is increasingly getting embedded in the WTO rules and disciplines. The policies and rules appropriate or advantages to the industrialized world are getting established as common rules to be obeyed by the developing countries as well. As a result, the multilateral trade rules are increasingly becoming a codification of the policies, perceptions, laws and regulations of the industrialized countries.
7. As a result of pressures resulting from WTO, the interests of international trade, which are primarily the interests of transnational corporations take precedence over local concerns and policies even if such a course exposes the local population to serious health and security risks.
8. All the WTO members are not equally integrated in the multilateral system.
9. As brought out in the last Ministerial Meeting at Mexico in September 2003, the implementation related issues are becoming a source of serious concern.

The implementation issues cover a whole range of demands. The issues requiring WTO attention relate to:

- (i) TRIPS
- (ii) TRIMS
- (i) Anti-dumping
- (ii) Movement of natural persons
- (iii) Agriculture
- (iv) Textiles
- (v) Industrial tariffs including peak tariffs
- (vi) Services
- (vii) Rules to protect investments
- (viii) Competition policy
- (ix) Transparency in government procurement
- (x) Trade facilitation

WTO has now become a forum for perpetual negotiations on newer and newer subjects and for using trade rules to establish standards and enforce compliance even in non-trade areas. Everything now seems to require the hand of WTO, be

it foreign investment, environmental or labour standards, child labour, good governance or human rights.

However, efforts should be made to see that WTO is not expanded into a sort of world government covering every economic subject under the sun and then using the threat of trade sanctions to bring about a new World Order.

Trade Related Intellectual Property Rights

The Trade Related Intellectual Property Rights (TRIPs) Agreement covers the following seven categories of intellectual property:

1. **Copyright and Related Rights:** The members are required to comply with the Berne Convention for the protection of literary and artistic works. Computer Programmes are included in literary works. Authors of computer programmes and broadcasting organisations are to be given the right to authorize or prohibit the commercial rental of their works to public. This protection is extended for 50 years.
2. **Trademarks:** The owner of a registered trademark has the inclusive right to prevent all third parties not having the owner's consent from using in the course of trade identical or similar signs for goods or services. Registration and renewal of a trademark is for a period of not less than seven years.
3. **Geographical Indications:** Members are required to provide the legal means for interested parties to prevent the use of any indication which misleads the consumer as to the origin of goods and any use which would constitute an act of unfair competition. Additional protection is applied for geographical indications for wines and spirits.
4. **Industrial Designs:** Industrial designs are protected for a period of 10 years. Owners of protected designs would be able to prevent the manufacture, sale or importation of articles bearing or embodying a design, which is a copy of the protected design for commercial purposes.
5. **Patents:** Patents shall be available for any inventions, whether products or processes, in all fields of technology, provided they are new, involve an inventive step and are capable of industrial application. Patent owner shall have the right to assign or transfer by succession, the patent and to conclude licensing contracts. The Agreement requires 20 years protection. The Agreement requires both process and product patent. It provides for 20 years product patent and a successive 20 years process patent.

6. **Integrated Circuits:** The TRIPs Agreement provides protection to the layout designs (topographies) of integrated circuits for a period of 10 years. But the protection shall lapse after 15 of the creation of the layout design.
7. **Trade Secrets:** Trade secrets and know-how having commercial value shall be protected against breach of confidence and other acts. Test data submitted to governments in order to obtain marketing approval for pharmaceuticals or agricultural chemicals shall be protected against unfair commercial use.

This Agreement refers to the control of anti-competitive practices in contractual licenses pertaining to intellectual property rights. It provides for consultations between governments in order to protect intellectual property rights from being abused.

The Agreement requires a one-year transition period for developed countries to bring their legislation and practices into conformity with TRIPs. Developing countries will have 5 year transition period whereas the least developed countries will have a 11 year transition period. Those developing countries which do not provide product patent protection have been given 10 years.

Trade Related Investment Measures

This agreement calls for the removal of all trade related investment measures within a period of five years. These measures are confined to quantitative restrictions and national treatment. In particular, they relate to such measures as investment in identified areas, level of foreign investments for treating foreign companies at par with the national companies, export obligation, and use of local raw materials. It prevents the imposition of any performance clauses on foreign investors in respect of earnings of foreign exchange, foreign equity participation, and transfer of technology. It requires foreign investment companies to be treated at par with national companies. It requires free import of raw material, components and intermediates.

The Agreement recognizes that certain investment measures restrict and distort trade. It, therefore, requires mandatory notification of all non-conforming Trade Related Investment measures and their removal within seven years for developed countries, within five years for developing countries and within seven years for the least developed countries. It establishes a committee on Trade Related Investment Measures which will monitor the implementation of these commitments and report to the Council of Trade in Goods annually.

Agreement on Trade in Services

This Agreement covers all internationally traded services. Foreign services and service suppliers would be treated on equal footings with domestic and service suppliers. However, governments may indicate Most Favoured Nation (MFN) exemptions, which will be reviewed after 5 years, with a normal limit of 10 years.

It requires transparency, which includes the publication of all-relevant laws and regulations relating to services trade. International payments and transfers relating to trade in services shall not be restricted, except in the event of balance of payments difficulties where such restrictions will be temporary limited and subjected to conditions. Any liberalization of trade in services would be progressive in character. It would be through negotiations at five-year intervals in order to reduce or remove the adverse effects of measures on trade in services and to increase the general level of specific commitments by the governments.

WTO 6th Ministerial conferences - Hong Kong (13–18 December, 2005)

Ministers from the WTO's 149 member governments approved a declaration that many described as significant progress both since the July 2004 "package" and after six days of intensive negotiations in Hong Kong which the chairperson described as "working like a dog".

Despite the long hours and hard work, "it was worth it," WTO Director-General Pascal Lamy told a press conference late in the evening of the final day. "We

have managed to put the Round back on track after a period of hibernation.” Hong Kong’s Commerce, Industry and Technology Secretary John Tsang, who chaired the conference, outlined the achievements in the declaration:

- “We have secured an end date for all export subsidies in agriculture, even if it is not in a form to everybody’s liking.
- “We have an agreement on cotton.
- “We have a very solid duty-free, quota-free access for the 32 least-developed country members.
- “In agriculture and NAMA (non-agricultural market access), we have fleshed out a significant framework for full modalities.
- “And in services, we now have an agreed text that points positively to the way forward.”

The declaration was agreed after several days of meetings late into the night, the last two continuing to the morning. “It’s been a hard day’s night. And I’ve been working like a dog,” Secretary Tsang said, quoting John Lennon and Paul McCartney.

With the 44-page document now agreed, members face intense pressure in the new year to complete “full modalities” in agriculture and non-agricultural market access by the new deadline they have set themselves, 30 April 2006.

Compared to the draft forwarded to Hong Kong from Geneva, a number of issues have been settled or partly settled. The most straightforward is the agreement to end export subsidies in agriculture by 2013, but this was only agreed at the last minute, and members paid tribute to the European Union which had the greatest difficulty on this issue. The declaration makes clear that the agreed date is conditional. Loopholes have to be plugged to avoid hidden export subsidies in credit, food aid and the sales of exporting state enterprises.

For cotton the elimination is accelerated to the end of 2006. In addition, cotton exports from least-developed countries will be allowed into developed countries without duty or quotas from the start of the period for implementing the new agriculture agreement. Ministers have also agreed to aim to cut trade-distorting

domestic subsidies on cotton by more than would normally apply under the new agreement, and to do so more quickly.

The two sides negotiating this difficult subject paid tribute to each other for what they described as the spirit of compromise: United States and the four countries pushing for an agreement on cotton (Benin, Burkina Faso, Chad and Mali).

A number of other details have been agreed in agriculture, non-agricultural market access and services.

3.3 UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

Introduction

The International trade is considered to be the engine of economic growth. There has been continuous and rapid growth in world trade due to liberalisation of tariffs, quotas and other restrictions. The share of manufacturers in world trade has increased from about 50 per cent to 70 per cent over the last few decades. The developed countries dominate the world trade though the share of developing countries has increased over the years. World trade in services has been increasing fast. World trade has become increasingly multilateral due to the efforts of various international trading blocks, which exercise a significant influence on world trade.

The United Nations Conference on Trade and Development (UNCTAD) was established by U.N. General Assembly in 1964 in order to provide a forum where the developing countries could discuss the problems relating to their economic development. It was set up essentially because it was felt that the then existing institutions like IMF and GATT were not properly organized to handle the peculiar problems related to the developing countries. These institutions favored the developed countries and failed to tackle the special trade and development problems of less developed countries. With more than 170

members, UNCTAD presently is the only body where developed as well as erstwhile centrally planned countries are its members.

Since 1964, eleven rounds or conferences of UNCTAD have taken place, i.e. UNCTAD I held at Geneva in 1964, UNCTAD II at New Delhi in 1968, UNCTAD III at Santiago in 1972, UNCTAD IV at Nairobi in 1976, UNCTAD V at Manila in 1979, UNCTAD VI at Belgrade in 1983, UNCTAD VII at Geneva in 1987, UNCTAD VIII at Cartagena (Columbia) in 1992, UNCTAD IX at Midland (South Africa) in 1996, UNCTAD X at Bangkok in 2000, and UNCTAD XI at Sao Paulo (Brazil) in 2004.

Organisation Of UNCTAD

The UNCTAD was established as a permanent organ of General Assembly of the United Nations. However, it has its own subsidiary bodies and also a full time secretariat to serve it. It has permanent organ called Trade and Development Board as the main executive body. The Board functions between the plenary sessions of the conference. It meets twice annually. It is composed of 55 members on the basis of equitable geographical distribution.

The Trade and Development Board have four subsidiary organs to assist it in its functions. These are:

1. The Committee on Commodities.
2. The Committee on Manufacturers.
3. The Committee on Shipping.
4. The Committee on Invisible Items and Financing related to Trade.

Generally, these committees meet annually. However, they may be called in special session to consider urgent matters.

Functions of UNCTAD

The UNCTAD was instituted mainly to reduce and eventually eliminate the gap between the developed and developing countries and to accelerate the economic growth of the developing world. Its main functions are as follows:

1. To promote international trade between the developed and the developing countries with special emphasis on the development of underdeveloped countries.
2. To formulate principles and policies of international trade and related problems of economic development.
3. To make proposals for putting the said principles and policies into effect and to take such steps which may be relevant towards this end.
4. To negotiate multilateral trade agreements to review and facilitate the coordination of activities of other institutions within the fold of United Nations related to international trade and related problems of economic development.
5. To be available as a center for harmonious trade related development policies of governments, and regional economic groupings in pursuance of Article 7 of the charter of the United Nations.

Major Activities of UNCTAD

The major activities of UNCTAD as follows:

1. Research and support in connection with the negotiation of commodity agreements.
2. Technical elaboration of new trade schemes, such as a new import preference system.
3. Various promotional activities designed to assist developing countries in the area of trade and capital flows.

Basic Principles of UNCTAD

UNCTAD action programme and priorities have been laid down in the various recommendations adopted by the first conference in 1964. These recommendations are based on the following basic principles:

- (a) Every country has the sovereign right to freely dispose its natural resources in the interest of the economic development and well being of its own people and freely to trade with other countries.
- (b) Economic relations between countries, including trade relations, shall be based on respect for the principles of sovereign equality of states, self-determination of people, and non-interference in the internal affairs of other countries, and
- (c) There shall be no discrimination on the basis of differences in socio-economic systems, and the adoption of various methods and trading policies shall be consistent with this principle.

UNCTAD and GATT

The UNCTAD may be distinguished from the GATT as follows:

- 1. The UNCTAD is a formal, reflecting, deliberating, constructing and conciliating body while the GATT is a negotiating, committing and controlling organization.
- 2. The UNCTAD in essence is a dynamic, initiating body dedicated to economic growth and equity while the GATT poses a somewhat static view of commercial policy relations.

Appraisal of Recommendations of UNCTAD

UNCTAD-I

UNCTAD's action programme and priorities have been laid down in the various recommendations adopted by the first conference in 1964. It was realized that the prime responsibility for the economic advancement of developing countries lay on their shoulders only. The main purpose of the recommendations made by the conference was to adopt a new international division of labour and make the external sector conducive to the developing countries. As such, the conference made a standstill recommendations to the developed nations, not to erect further tariff walls and other barriers to the import of products of export interest to developing nations. Further, the developed nations were recommended to progressively reduce the exports from the developing nations without insisting on reciprocity of concessions. It also recommended to the developing countries

some positive measures of export promotion. Particularly, the conference suggested the recognition of international commodity agreements as an integral part of international trade policies, which aimed at securing remunerative, equitable and stable prices for the developing nations.

The conference further realized that the developing nations must progressively diversify their economies (from primary producing to industrial) and develop new lines of manufactured exports. Appreciating the difficulties of developing countries in this respect, the conference adopted certain guidelines for the elimination of tariffs and such other barriers in respect of manufactured exports from these countries.

The conference also recommended that each developed nation should transfer annually at least 1 per cent of its income to developing countries by way of foreign aid. The conference also put forward a number of recommendations to improve the invisible trade of developing countries through development of shipping, tourism etc.

Out of these laudable recommendations of UNCTAD, nothing was, however, substantially translated into practice. Though there has been some progress in the matter of international trade arrangements and a notion is created among the rich nations for giving tariff preference to the poor countries in the western markets, no action for the same has been taken so far. There has been a lot of disagreement prevailing among the rich countries in giving generalised preferences to the poor nations. In short, the first UNCTAD conference programmes made very slow progress in terms of concrete action.

UNCTAD-II

UNCTAD was formed as a plenary body of the U.N. members, which were to meet normally at intervals of not more than three years. However, the second meeting of UNCTAD took place four years after the first conference in Geneva. UNCTAD II was held in New Delhi from February 1st to March 28th, 1968. This

session had an ambitious agenda to confront the problems of the less developed countries and other major issues relating to world trade and development. The broad objectives of this conference were as follows:-

1. To reappraise the economic situation and its implications in implementing the recommendations of the UNCTAD-I.
2. To achieve specific results by initiating appropriate negotiations which ensure real progress in international co-operation for development, and
3. To explore and investigate matters requiring thorough study before fruitful agreements can be envisaged.

With these objectives in view, the various items on the agenda of the conference were grouped into the following major categories: -

1. Trends and problems in world trade and development.
2. Commodity problems and policies of different nations.
3. Problems of growth, development finance and aid to developing nations and synchronization of national and international policies in this regard.
4. Specific problems of developing nation regarding:
 - (a) Expansion and diversification of exports of finished (manufactured) and semi-finished goods.
 - (b) Invisible, including shipping.
5. Problems and measures of economic integration and trade development among developing nations.
6. Special measures for economic and social upliftment of the least developed among the developing nations.
7. General review of the work and functions of UNCTAD.

During the New Delhi round of UNCTAD, several aspects of trade preferences and concessions were discussed. The conference re-assumed that for prosperity as a whole, a generalised, non-reciprocal and non-discriminatory system of preferences in favour of the less developed countries should be implemented as soon as possible which would assist them in increasing their export earnings and thus contribute to the acceleration of their rate of economic growth. It has been realized by the developed countries that if export earnings of developing

countries decline, their external purchasing power is reduced. As a consequence, their importing capacity also declines and as a result, the exports of developed nations to these countries may fall and the world trade may experience a downturn. To avoid such a situation, it is imperative that export earnings of the developing nations should be augmented through a deliberate liberalisation policy adopted by the developed nations. Tariff and non-tariff barriers should be removed and free-trade should be encouraged by the developed nations. Further, to enhance and maintain world prosperity, developed nations should also give necessary technological and financial assistance to developing countries for their rapid economic expansion.

The final resolution of the conference, therefore, stressed that a mutually acceptable system of generalised, non-reciprocal and non-discriminatory preferences beneficial to developing countries should be immediately established. It is popularly known as Generalised Scheme of Preferences (GSP).

The objectives of such a system of preferences has been :

1. To increase export earnings of the less developed nations.
2. To promote their industrialization, and
3. To accelerate their rates of economic growth.

To meet this end, the conference established a special committee on preferences as a subsidiary organ of the Trade & Development Board, which was to pay special attentions to this matter. Further, during the conference, the developed nations reaffirmed their desire to transfer at least 1 per cent of their GNP resources to the developing countries through their aid programmes. The developed countries also agreed to provide concessional terms of official lending and to liberalize the terms of international lending and finance. The conference adopted a charter of development, which offers permanent protection against economic deterioration of developed nations and increased opportunities of development for the developing nations. With regard to commodity

agreements, it was decided that the conference should be reconvened before June 1968 to evolve an international agreement on cocoa. Similarly, it was laid down that Sugar Agreement should come into operation before January 1969.

The less developed nations conference, however, urged at the conference that the advanced countries should remove all trade barriers in their markets to the entry of poor nations commodities in primary, processed or semi-processed forms. But due attention was not paid to this plea.

The conference did not deal with the possibilities of agreed solutions to the problems of prices, trade liberalization and increased access to the markets of advanced countries for the products exported by the less developed nations. The conference, however, urged that the socialist countries should expand and diversify their trade with developing countries by according special preferences to the products of these countries. The permanent machinery of UNCTAD was entrusted with the responsibility of promoting trade relations between socialist and developing nations. The conference also stressed the need for trade expansions and economic integration among the developing countries. Thus, under the skeleton of UNCTAD, the 'declaration of intent' by the poor nations was matched by the 'declaration of support' by the rich nations.

It may, however, be said that the New Delhi session of UNCTAD could not make any significant achievements and concluded with disillusionment writ large all over. Most of the problems remained unsolved, as there was no consensus on them. In short, UNCTAD-II, though hopeful, had remained unsuccessful in achieving the goal.

UNCTAD-III

UNCTAD-III meeting was held at Santiago in Chile from 13th April to 17th May 1972. 120 member nations participated in the meeting of which 96 were developing countries, forming the so-called "G-77" or "Group of 77". At this

meeting, these underdeveloped nations vehemently attacked to developed world for their unsympathetic attitude towards helping the poorer nations through trade. Attention was drawn to the fact while the world trade had grown considerably during the last decade, the trade of the developing countries rose at a slower rate than that of the developed countries. The developed countries exports amounted to 67 per cent of the world exports in 1960, which further increased to 71 per cent in 1970, whereas, during the same period, the export share of the developing countries declined from 21 per cent to 18 per cent – that too mainly consisting of primary products. At the Santiago session, many important issues were discussed. Some of them are:-

1. Continuance of foreign aid,
2. Low-rated unconditional loans,
3. Some relief's in debt burden,
4. Shipping freights problem,
5. A link between the SDR's and development finance.

As such, the resolution of UNCTAD-III finally incorporated key issues like:

1. Transfer of technology,
2. International monetary reforms,
3. General preferences,
4. Reform of the UNCTAD machinery,
5. An international code of conduct of liner conference.

From the point of view of developed countries, UNCTAD-III was a successful event because on a number of key issues, developing countries could reach a compromise. From the view point of developing countries, however, UNCTAD-III was a big failure. Due to indifference of the developed nations, the G-77 did not succeed in establishing institution links between UNCTAD, on the one hand, and the IMF and GATT, on the other. Yet, there was some hope for monetary reform as a result of this meeting. A major issue, which was raised at the Santiago conference, was that of the problem of changes in shipping freights. It

was estimated that 1/3 of total deficit in the balance of payment of LDC's was due to high shipping freights. Further, at present the rich nations own 92 per cent of the world's merchant marine, when nearly 2/3 of weight originates from the developing countries. This definitely imposes a drain on their foreign exchange resources and puts up their cost of imports and exports. There has been a positive gain on the subject of shipping at the Santiago Session in so far on its greatest achievement has been the agreement reached on an international code of conduct. The two fundamental objects of code of conduct were:

1. Promotion of world trade, and
2. A new structure of world shipping in which the merchant marine of the developing countries would play an increasing and substantial role.

It was also stressed that the conference practices should not involve any discrimination against the trade and shipping interests of the developing countries. The developed countries, however, favored the principle of self-discipline and self-regulation, but the developing countries emphasized enactment of legislation in support of the code of conduct. Ultimately, it was resolved that a preparatory committee should be set up to study and recommend on the points of disagreement and evolve a code of conduct for submission to the General Assembly of UNCTAD. Further, it was decided in the resolution, that by 1980, the developing nations should at least own 10 per cent of the total world dead weight tonnage. The conference also specified that there should be a minimum interval of two years between freight hikes and that freight rates should be at as a low level as commercially feasible.

In short, it can be said that the urgent demands of the developing countries had been denied there was some hope of getting some benefits as an outcome of UNCTAD-III.

UNCAD-IV

In May 1976, the UNCTAD-IV meeting was held at Nairobi. In this conference, the widening gap between developed and developing nations was pinpointed and it was desired that the developed nations should be more generous in helping the poor nations. It was also suggested that some kind of taxes may be imposed by the advanced nations to raise funds for helping and assisting the developmental process of the countries belonging to the third world. Further, a common fund of 6 thousand billion dollars may be created for the purpose of stabilizing the prices of 10 primary products exported by the less developed countries. This fund was meant to make provisions to finance buffer stocks of such products for this purpose. The representatives of developing nations advocated the expansion of Generalised System of Preferences (GSP) by the indexation of export items.

The representatives of the developing countries did agree to give debt relief and set re-scheduling in favour of the poor countries. However, with respect to the integrated commodity programme, the participants of the conference failed to come to any settlement, so the matter was kept pending for the future conference.

UNCTAD-V

From May 7, 1979 a meeting of UNCTAD-V was held in Manila for nearly a month, 150 member countries participated in this conference. But on the core issues no concrete resolutions were passed. One major achievements has been the contribution by several countries to the creation of the commodity development facility, which aims at the development of product adaptation processing and marketing skills and infrastructure in the developing countries. However, some agreements were unanimously made on the issues like transfer of resources to developing countries, protectionism etc. Some ideas about monetary reforms were referred for future consideration. It also recommended

all members to refrain from exploiting resources until the adoption of an international regime by the U.N. conference.

UNCTAD-VI

In July 1983, the sixth session of the UNCTAD was held at Belgrade, its focus was on the attainment of a new international economic order. It reiterated its full support to earlier programmes approved in previous UNCTAD Sessions. Monetary issues such as SDR allocation, adequacy of fund resources, conditionality etc. were discussed. Question of improvement in the quality of aid was examined. Improvements in institutional arrangements were suggested. Developed countries in this session insisted on liberalisation of trade policies by the developing nations.

UNCTAD-VII

UNCTAD VII took place in Geneva during 1987. The UNCTAD VII also could not achieve any substantial progress. It only emphasized that external financing from official and private sources be increased on appropriate terms and conditions to facilitate growth in the developing countries. It recommended that a judicious combination of measures be worked out to reduce the debt burden, such as debt-equity swaps and other non-debt-creating flows. The Conference urged the developed countries to convert their official loans into grants. It also asked for concerned efforts to achieve the Internationally agreed target of 0.7 per cent of GNP being given as official development assistance by the developed to the developing countries.

UNCTAD VIII

UNCTAD VIII took place in Cartagena De Indios, Colombia, during Feb. 1992. The major issue at UNCTAD VIII was the role of UNCTAD itself. 170 members agreed on broad features of revitalizing UNCTAD and to make it more effective in dealing with development related issues. UNCTAD VIII agreed on a

new structure. It was agreed to create Trade and Development Board (TDB) which would meet twice a year in regular session, and in special session as required. An Executive Committee of the permanent representative to UNCTAD in Geneva was formed and was to meet periodically to guide UNCTAD work programme. Other decisions related to the creation of new standing committee on poverty alleviation, economic co-operation among developing countries and services, establishment of five adhoc working groups to support the committees and the TDB. The ad hoc working groups were to deal with the areas on Investment and financial flow, non-debt creating finance for development, new mechanics for creating or increasing investments and financial flow, non-debt creating finance flow development, trade efficiency, comparative experiences with privatization, expansion of trading opportunities for developing countries, interrelationship between investment and technology transfers. With new structure and sincere efforts, it was hoped UNCTAD may render some useful services in improving the conditions of developing nations in the progressive global economy soon marching towards the 21st century.

UNCTAD-IX

The UNCTAD-IX held at Midrand, South Africa in May 1996 urged its members to provide more resources for sustainable development and debt relief to developing countries and to carry on the issues relating to technology, services and commodities in the light of the W.T.O. agreement of 1994 and the General Agreement on Tariffs and Trade.

To ensure that all countries benefit from a mutually beneficial multilateral trading system through Partnership for Development, the member-States agreed upon the establishment of following common objectives and development of joint action:

- (a) Strengthening inter-governmental cooperation between developed and developing countries;

- (b) Enhanced cooperation between developing countries with special attention to LDCs;
- (c) More effective coordination and complementarity of multilateral institutions;
- (d) The mobilization of human and material resources towards development through dialogue and common action between Governments and civil society;
- (e) Partnership between the public and private sectors to achieve higher growth rates and greater development.

In order to achieve the slated objectives of UNCTAD IX, the Conference will strengthen its cooperation with WTO and other multilateral institutions to ensure that the developing countries participate in the global economy on a more equitable basis with regard to trade, investment, technology, services and development. It was also agreed that UNCTAD should identify and analyze the implications for development of issues relevant to a possible multilateral framework on investment.

The major problem with the UNCTAD has been trying to tackle too many problems at the same time. Partly it is due to the widely divergent interests of the developing country members of the UNCTAD. As a result due to the lack of any specific focus, it has not been able to achieve any tangible results. Experience shows that whenever UNCTAD discussed specific issues, it has been able to achieve significant success.

UNCTAD-X

The tenth session of UNCTAD was held in 2000 at Bangkok, Thailand. This conference was held against global recessionary conditions as well as fears on the part of many developing countries as to the adverse impact of globalization. The Bangkok Conference emphasized the need for increased policy coherence at the national and international levels. There should be complementarity between macroeconomic and Sectoral policies at the national level and between policies at the national and international levels. There is also a need for more effective

cooperation and coordination among multilateral institutions.

Many countries have difficulty in coping with the increased competition and lack the capacity to take advantage of the opportunities brought about by globalization. This requires a decisive effort in favour of those at the risk of marginalization.

UNCTAD endorsed its commitment to a multilateral trading system that is fair, equitable and rules-based operates in a non-discriminatory and transparent manner and provides benefits to all countries, specially developing countries. This will involve, among other things, improving market access for goods and services of particular interest to developing countries, resolving issues relating to the implementation of World Trade Organization (WTO) agreements, fully implementing special and differential treatment, facilitating accession to the WTO and providing technical assistance. A new round of multilateral trade negotiations should take account of the development dimension.

Specially, the Bangkok conference prepared a detailed Plan of Action which included inter alia, the following:

- Reducing tariff and non-tariff barriers in export sectors of interest to developing countries, particularly in developed country markets;
- Maintaining and further improving the level of tariff-free or reduced tariff access to markets through national GSP schemes for all beneficiaries.
- Maximizing market access benefits for the least developed countries, for example, developed countries granting duty-free and quota-free treatment for essentially all products originating in these countries.
- Impact of anti-dumping and countervailing duties actions;

UNCTAD should help developing countries in identifying:

- The priority sectors where early trade liberalization should take place;
- The main trade barriers that developing countries face in sectors which limit developing country ability to export their services;

- The preconditions, at the domestic level, which are necessary for developing countries to benefit from trade liberalization in the service sector in general.

UNCTAD-XI

Held at Sao Paulo (Brazil) in 2004, it agreed on the following:

- (a) There was need to focus on the ability of international trade to contribute to poverty alleviation, and instability in world commodity prices.
- (b) All countries at the international level should facilitate internal adjustments and remove external constraints to put the developing world on a firm and sustainable path to development.
- (c) Policy instruments and measures were adopted to eradicate poverty and hunger.
- (d) To generate and better utilize additional international resources, market access and technical assistance for the LDCs be established, so as to form a solid base for their development.
- (e) Attention be devoted to improve international capital flows for development as well as deal with the volatility of international capital markets.

Achievements of UNCTAD

Despite the disagreements over the years, UNCTAD has played a key role various sphere. The more important of these are as follows:

1. **Trade in Primary Commodities:-** The UNCTAD has been active in the International Commodity Agreement since its inception, LDC's (Last Developed Countries) wanted to expand their market for their traditional exports of primary commodities. Developed countries placed restrictions of the exports of the latter in such form as licensing, quotas, tariffs etc. and provided subsidies to domestic producers. Such trade restrictions tend to be higher for processed products than for unprocessed ones. Besides, exports from LDC's have been subject to wide fluctuations. Thus, there has been a continual deterioration in the terms of trade of primary products of the LDC's in relation to the export of manufactured products from the developed countries. Since UNCTAD-II, the LDC's have been insisting on International Commodity Agreements to stabilize the prices and markets for their exports of primary products. At UNCTAD IV in 1976, it was proposed to have an Integrated Program for

Commodities (IPC) and to create common fund for buffer stock financing. This fund was meant to provide a considerable benefit to the exporters and importers of developing countries. Exporters of primary products would be able to realize higher prices for primary products like rubber, cocoa, tin etc. Similarly, exporters of such primary products also would not be subjected to the uncertainties of price fluctuations which sometimes are the results of speculative activity.

2. **Trade in Manufactured Goods:** LDC's have strongly urged the developed countries to give them tariff preferences on their manufactured and semi-manufactured goods. At UNCTAD-I, the G-77 urged the develop countries to grant generalized system of preferences (GSP) to the exports of such goods to the developed countries. It was at UNCTAD-II that all members unanimously agreed for the early establishment of a mutually acceptable system of generalized, non-reciprocal and non-discriminatory preferences. Under GSP, most manufactured and semi-manufactured goods from LDC's to developed countries enjoy tariff reduction or exemptions from custom duties. A majority of developed countries grant duty free treatment for all or most products eligible for GSP. But there are certain limitations to the scheme of GSP :-
 - (a) Despite efforts made to expand the coverage of GSP, there are items like textiles, clothing, steel, footwear etc., which are excluded by a number of developed countries.
 - (b) Many developed countries have devolved their own schemes which subject the preferences to variety of restrictions.
 - (c) There is no long term guarantee in the case of GSP concessions which can be altered or withdrawn at short notice.
 - (d) Among the LDC's, the benefit of GSP have been consistently concentrated among a few more advanced developing countries.

Thus, the scope for the extension of GSP is quite limited, as producers in the LDC's have to face a tough competitive position in the world market.

3. **Development Finance:** UNCTAD is also endeavoring to reduce the debt burden of the developing countries. These countries have taken large amount of loans from bilateral and multilateral sources. As a result, the servicing of the accumulated debts, i.e. the interest payments and repayments, now account for a very substantial proportion from exports.

In fact, for some of the developing countries the outgo of foreign exchange on account of debt servicing is more than the current inflows of loans and credits. UNCTAD is trying to persuade the developed countries, to write off a part of the accumulated debts. Some of the developed countries, mostly Scandinavian group, have accepted the proposal.

4. **Technology Transfer:** In UNCTAD, measures were adopted to strengthen technology capability of LDC's. It was pointed out that better research facilities, training programmes and establishment of local and regional centers for technology transfer would serve the purpose. Thus, the UNCTAD VI held at Belgrade in June 1983 emphasized the need for transfer of technology to LDC's in order to promote their speedy and self reliant development. UNCTAD VI passed a resolution relating to the transfer of technology to LDC's on the lines of the policy paper approved at UNCTAD VI. The UNCTAD has simply laid down the broad principles for transfer of publicly funded technologies at the intergovernmental level. It may facilitate the process of technology transfer by freer access to sources of information, cutting down barriers to free flow of technology etc.
5. **Economic Co-operation:** UNCTAD-II held at Delhi in 1968 emphasized for the first time the need for promoting international co-operation and self-reliance among the LDCs. UNCTAD VI again emphasized the need for co-operative efforts among the LDCs through widening the scope of preferential trading arrangements, harmonizing industrial development programmes through infrastructural facilities particularly in respect of shipping services and simple payment mechanism under common clearing system. GSTP is major initiative of developing countries to expand mutual trade through grant of tariff and

non-tariff concessions and other measures such as long term contracts under UNCTAD.

Problems of UNCTAD

The following are the problems of UNCTAD:

1. UNCTAD has had problems from its inception, which have kept the organization from being fully effective in achieving its objectives. It has been dominated by two organisations: The U.N. type and G-77. The interest of each of the major political-economic classifications create so much friction that the rule-by-consensus method of negotiating issues results in few concrete accomplishments.
2. UNCTAD has failed to adopt or implement a trade policy for development.
3. UNCTAD seems to be an international organization which, rather than to do a proper job with short-meetings and clear focus on its objectives and international realities, appears to be among those institutions which huff and puff for weeks while revealing their own importance.

INTERNATIONAL COMMODITY AGREEMENTS (ICA)

International commodity agreements are inter-governmental arrangements concerning the production and trade of certain primary products. Many developing countries which have embarked upon ambitious development programmes are in need of large foreign exchange resources to finance some of their development requirements like capital goods imports. But they have been facing the important problem of wide-fluctuations in the export prices of the primary goods i.e. agricultural products and minerals, which form a major part of their total exports. Apart from making the export earnings unstable, it has also been causing a deterioration in their terms of trade. Hence, there has been a growing demand for adopting stabilization measures to protect especially the interests of developing countries. International commodity agreements, it is believed, can help stabilize prices of the respective commodities.

Objectives of ICA

The main objectives of the international commodity agreements are:-

1. **Price Stabilization:** Price stabilization is a very important purpose for which commodity agreements have been entered into.
2. **The Promotion of Health and Morals:** The outstanding example of international agreements for the purpose of promoting health and morals is the international regulation of trade in opium and narcotics.
3. **Security Objectives:** Inter governmental commodity agreements may also be useful as a preventive of war by preventing scramble for scarce strategic materials for national stock-piling or other security purposes.
4. **The Conservation of Resources:** The conservation of natural resources is a direct or indirect objective of nearly all international raw material schemes.
5. **The management of surplus:** Commodity agreements are sometimes entered into to manage the surplus during times of bumper crops, there may arise a problem of surplus. Such should be properly handled to avoid serious adverse effects on price and also to hold stock for the lean period.

Forms of Commodity Agreements

Commodity Agreements may take any of the four forms, namely, quotas, buffer stock, bilateral contract, and multilateral contract.

- I. **Quota Agreements:** International quota agreements seek to prevent fall in commodity price by regulating their supply under the quota agreement. Export quota are determined and allocated to participating countries according to some mutually agreeable formula and they undertake to restrict the export or production by a certain percentage of the basic quota as decided by the central committee or council. For instance, the coffee agreement among the major producers of Latin America and Africa limits the amount that can be exported by each country.

Quota agreements have already been tried in case of coffee and sugar, and commodities like tea and bananas have been suggested as prospective candidates for new agreements.

- II. Buffer Stock Agreements:** International Buffer Stock Agreements seek to stabilize the commodity prices by maintaining the demand-supply balance.

Buffer stock agreements stabilize the price by increasing the market supply by selling the commodity when the price tends to rise and by absorbing the excess supply to prevent a fall in the price. The buffer stock plan, thus, requires an international agency to set a range of prices and to buy the commodity at the minimum and sell at the maximum. The buffer pool method has already been tried in case of Tin, and Sugar, and commodities like Rubber, Tea and Copper have been suggested as prospective candidates for new agreements. The buffer stock arrangement, however, has certain limitations. It can be effected only in case of those products, which can be stored at relatively low cost without the danger of deterioration. Further, large financial resources and stock of the commodity are required to launch the programme successfully.

- III. Bilateral/Multilateral Contracts:** Bilateral contract to purchase and sell certain quantities of a commodity at agreed prices may be entered into between the major importer and exporter of the commodity. In such an agreement, an upper price and a lower price are specified. If the market price throughout the period of the agreement remains within these specified limits, the agreement becomes operative. But, if the market price rises above the upper limit specified, the exporting country is obliged to sell to the importing country a certain specified quantity of the commodity at the upper prices fixed by the agreement. On the other hand, if the market price falls below the lower limit specified, the

importer is obliged to purchase the contracted quantity at the specified lower price.

Such international sale and purchase contracts may also be entered into by two or more exporters and importers. The bilateral/multilateral agreements are usually concluded between the major suppliers and major importers of the commodities. The best example of this type of agreement are the International Wheat Agreement.

The contract has disadvantage of creating a two price system. It requires domestic controls of some sort and buffer stock to implement it. And it is quite apt to put the participating governments into the commodities business. In an extreme case, it may become nothing but a payment by the government of one country to that of another without even touching the producer or consumer.

The experience of the post-war market stabilization schemes indicates that a combination of different control techniques is likely to be more effective than reliance on a single technique alone.

3.4 INTERNATIONAL MONETARY FUND (IMF)

The International Monetary Fund, A Global Institution, is frequently in the news, but its role and functions are often misunderstood.

The Origins of the IMF

The IMF was conceived in July 1944 at an international conference held at Bretton Woods, New Hampshire, U.S.A. Delegates from 44 governments agreed on a framework for economic cooperation partly designed to avoid a repetition of the disastrous economic policies that had contributed to the Great Depression of the 1930s.

During that decade, as economic activity in the major industrial countries weakened, countries attempted to defend their economies by increasing restrictions on imports; but this just worsened the downward spiral in world

trade, output, and employment. To conserve dwindling reserves of gold and foreign exchange, some countries curtailed their citizens' freedom to buy abroad, some devalued their currencies, and some introduced complicated restrictions on their citizens' freedom to hold foreign exchange. These fixes, however, also proved self-defeating, and no country was able to maintain its competitive edge for long. Such "beggar-thy-neighbor" policies devastated the international economy; world trade declined sharply, as did employment and living standards in many countries.

As World War II came to a close, the leading allied countries considered various plans to restore international monetary. The country representatives drew up the charter (or Articles of Agreement) of an international institution to oversee the international monetary system and to promote both the elimination of exchange restrictions relating to trade in goods and services, and the stability of exchange rates.

The IMF came into existence in December 1945, when the first 29 countries signed its Articles of Agreement.

The statutory purposes of the IMF today are the same as when they were formulated in 1944. Since then, the world has experienced unprecedented growth in real incomes. And although the benefits of growth have not flowed equally to all—either within or among nations—most countries have seen increases in prosperity that contrast starkly with the interwar period, in particular. Part of the explanation lies in improvements in the conduct of economic policy, including policies that have encouraged the growth of international trade and helped smooth the economic cycle of boom and bust. The IMF is proud to have contributed to these developments.

In the decades since World War II, apart from rising prosperity, the world economy and monetary system have undergone other major changes—changes that have increased the importance and relevance of the purposes served by the IMF, but that have also required the IMF to adapt and reform. Rapid advances in

technology and communications have contributed to the increasing international integration of markets and to closer linkages among national economies. As a result, financial crises, when they erupt, now tend to spread more rapidly among countries.

In such an increasingly integrated and interdependent world, any country's prosperity depends more than ever both on the economic performance of other countries and on the existence of an open and stable global economic environment. Equally, economic and financial policies that individual countries follow affect how well or how poorly the world trade and payments system operates. Globalization thus calls for greater international cooperation, which in turn has increased the responsibilities of international institutions that organize such cooperation—including the IMF.

The IMF's purposes have also become more important simply because of the expansion of its membership. The number of IMF member countries has more than quadrupled from the 44 states involved in its establishment, reflecting in particular the attainment of political independence by many developing countries and more recently the collapse of the Soviet bloc.

The expansion of the IMF's membership, together with the changes in the world economy, has required the IMF to adapt in a variety of ways to continue serving its purposes effectively.

Countries that joined the IMF between 1945 and 1971 agreed to keep their exchange rates pegged at rates that could be adjusted, but only to correct a "fundamental disequilibrium" in the balance of payments and with the IMF's concurrence. This so-called Bretton Woods system of exchange rates prevailed until 1971 when the U.S. government suspended the convertibility of the U.S. dollar (and dollar reserves held by other governments) into gold.

At the same time as the IMF was created, the International Bank for Reconstruction and Development (IBRD), more commonly known as the World Bank, was set up to promote long-term economic development, including

through the financing of infrastructure projects, such as road-building and improving water supply.

The IMF and the World Bank Group—which includes the International Finance Corporation (IFC) and the International Development Association (IDA)—complement each other's work. While the IMF's focus is chiefly on macroeconomic performance, and on macroeconomic and financial sector policies, the World Bank is concerned mainly with longer-term development and poverty reduction issues. Its activities include lending to developing countries and countries in transition to finance infrastructure projects, the reform of particular sectors of the economy, and broader structural reforms. The IMF, in contrast, provides financing not for particular sectors or projects but for general support of a country's balance of payments and international reserves while the country takes policy action to address its difficulties.

When the IMF and World Bank were established, an organization to promote world trade liberalization was also contemplated, but it was not until 1995 that the World Trade Organization was set up. In the intervening years, trade issues were tackled through the General Agreement on Tariffs and Trade (GATT).

The Purposes of IMF

The purposes of the International Monetary Fund are:

- i. To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
- ii. To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
- ii. To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

- iii. To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- iv. To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustment in their balance of payments without resorting to measures destructive of national or international prosperity.
- v. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

Decisions making at the IMF

The IMF is accountable to its member countries, and this accountability is essential to its effectiveness. The day-to-day work of the IMF is carried out by an Executive Board, representing the IMF's 184 members, and an internationally recruited staff under the leadership of a Managing Director and three Deputy Managing Directors—each member of this management team being drawn from a different region of the world. The powers of the Executive Board to conduct the business of the IMF are delegated to it by the Board of Governors, which is where ultimate oversight rests.

The **Board of Governors**, on which all member countries are represented, is the highest authority governing the IMF. It usually meets once a year, at the Annual Meetings of the IMF and the World Bank. Each member country appoints a Governor—usually the country's minister of finance or the governor of its central bank—and an Alternate Governor. The Board of Governors decides on major policy issues but has delegated day-to-day decision-making to the Executive Board.

Key policy issues relating to the international monetary system are considered twice yearly in a committee of Governors called the **International Monetary and Financial Committee**, or IMFC (until September 1999 known as the Interim Committee). A joint committee of the Boards of Governors of the IMF

and World Bank called the **Development Committee** advises and reports to the Governors on development policy and other matters of concern to developing countries.

The Executive Board consists of 24 Executive Directors, with the Managing Director as chairman. The Executive Board usually meets three-times a week, in full-day sessions and more often if needed, at the organization's headquarters in Washington, D.C. The IMF's five largest shareholders —the United States, Japan, Germany, France, and the United Kingdom—along with China, Russia, and Saudi Arabia, have their own seats on the Board. The other 16 Executive Directors are elected for two-year terms by groups of countries, known as constituencies.

Unlike some international organizations that operate under a one-country-one-vote principle (such as the United Nations General Assembly), the IMF has a weighted voting system: the larger a country's quota in the IMF—determined broadly by its economic size—the more votes it. But the Board rarely makes decisions based on formal voting; rather, most decisions are based on consensus among its members and are supported unanimously.

The Executive Board selects the **Managing Director**, who besides serving as the chairman of the Board, is the chief of the IMF staff and conducts the business of the IMF under the direction of the Executive Board. Appointed for a renewable five-year term, the Managing Director is assisted by a First Deputy Managing Director and two other Deputy Managing Directors.

IMF employees are international civil servants whose responsibility is to the IMF, not to national authorities. The organization has about 2,800 employees recruited from 141 countries. About two-thirds of its professional staff are economists. Directors, who report to the Managing Director, head the IMF's 26 departments and offices. Most staff works in Washington, although about 90 resident representatives are posted in member countries to help advice on economic policy. The IMF maintains offices in Paris and Tokyo for liaison with

other international and regional institutions, and with organizations of civil society; it also has offices in New York and Geneva, mainly for liaison with other institutions in the UN system.

Funding of IMF

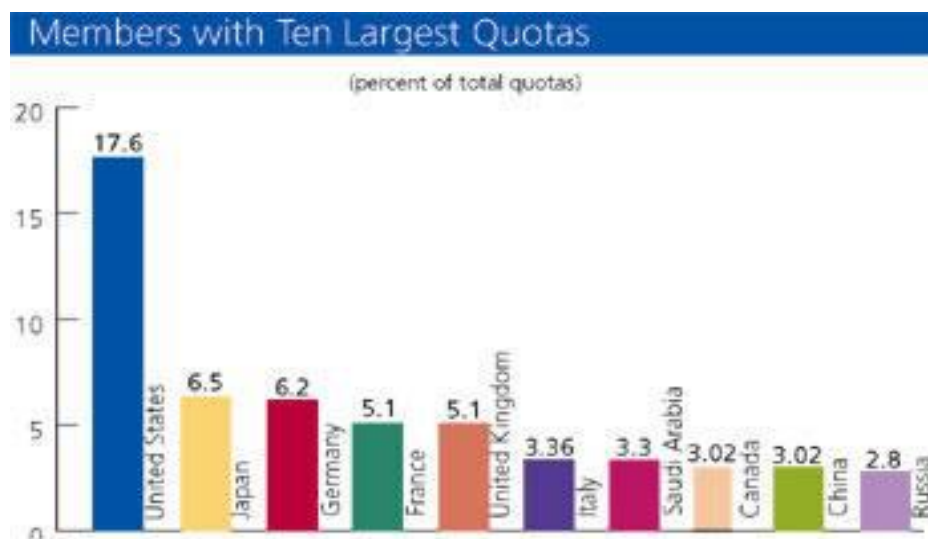
The IMF's resources come mainly from the quota (or capital) subscriptions that countries pay when they join the IMF, or following periodic reviews in which quotas are increased. Countries pay 25 percent of their quota subscriptions in Special Drawing Rights or major currencies, such as U.S. dollars or Japanese yen; the IMF can call on the remainder, payable in the member's own currency, to be made available for lending as needed. Quotas determine not only a country's subscription payments, but also the amount of financing that it can receive from the IMF, and its share in SDR allocations. Quotas also are the main determinant of countries' voting power in the IMF.

Quotas are intended broadly to reflect members' relative size in the world economy: the larger a country's economy in terms of output, and the larger and more variable its trade, the higher its quota tends to be. The United States of America, the world's largest economy, contributes most to the IMF, 17.5 percent of total quotas; Palau, the world's smallest, contributes 0.001 percent. The most recent (eleventh) quota review came into effect in January 1999, raising IMF quotas (for the first time since 1990) by about 45 percent to SDR 212 billion (about \$300 billion).

If necessary, the IMF may borrow to supplement the resources available from its quotas. The IMF has two sets of standing arrangements to borrow if needed to cope with any threat to the international monetary system:

- the General Arrangements to Borrow (GAB), set up in 1962, which has 11 participants (the governments or central banks of the Group of Ten industrialized countries and Switzerland), and
- the New Arrangements to Borrow (NAB), introduced in 1997, with 25

participating countries and institutions. Under the two arrangements combined, the IMF has up to SDR 34 billion (about \$50 billion) available to borrow.



Concept of SDR

The **SDR**, or special drawing right, is an international reserve asset introduced by the IMF in 1969 (under the First Amendment to its Articles of Agreement) out of concern among IMF members that the current stock, and prospective growth, of international reserves might not be sufficient to support the expansion of world trade. The main reserve assets were gold and U.S. dollars, and members did not want global reserves to depend on gold production, with its inherent uncertainties, and continuing U.S. balance of payments deficits, which would be needed to provide continuing growth in U.S. dollar reserves. The SDR was introduced as a supplementary reserve asset, which the IMF could "allocate" periodically to members when the need arose, and cancels, as necessary.

SDRs—sometimes known as "paper gold" although they have no physical form—have been allocated to member countries (as bookkeeping entries) as a percentage of their quotas. So far, the IMF has allocated SDR 21.4 billion (about \$32 billion) to member countries. The last allocation took place in 1981, when SDR 4.1 billion was allocated to the 141 countries that were then members of the IMF. Since 1981, the membership has not seen a need for another general allocation of SDRs, partly because of the growth of international capital markets. In September 1997, however, in light of the IMF's expanded membership—which included countries that had not received an allocation—the Board of Governors proposed a Fourth Amendment to the Articles of Agreement. When approved by the required majority of member governments, this will authorize a special one-time "equity" allocation of SDR 21.4 billion, to be distributed so as to raise all members' ratios of cumulative SDR allocations to quotas to a common benchmark.

IMF member countries may use SDRs in transactions among themselves, with 16 "institutional" holders of SDRs, and with the IMF. The SDR is also the IMF's unit of account. A number of other international and regional organizations and international conventions use it as a unit of account, or as a basis for a unit of account.

The SDR's value is set daily using a basket of four major currencies: the euro, Japanese yen, pound sterling, and U.S. dollar. On July 1, 2004, SDR 1 = US\$1.48. The composition of the basket is reviewed every five years to ensure that it is representative of the currencies used in international transactions, and that the weights assigned to the currencies reflect their relative importance in the world's trading and financial systems.

The IMF helps its member countries by:

- reviewing and monitoring national and global economic and financial

developments and advising members on their economic policies;

- lending them hard currencies to support adjustment and reform policies designed to correct balance of payments problems and promote sustainable growth; and
- offering a wide range of technical assistance, as well as training for government and central bank officials, in its areas of expertise.

Advice on Policies and Global Oversight

The IMF's Articles of Agreement call for it to oversee the international monetary system, including by exercising firm "surveillance"—that is, oversight—over its member countries' exchange rate policies. Under the Articles, each member country undertakes to collaborate with the IMF in its efforts to ensure orderly exchange arrangements and to promote a stable system of exchange rates.

More specifically, member countries agree to direct policies toward the goals of orderly economic growth with reasonable price stability, together with orderly underlying economic and financial conditions, and to avoid manipulating exchange rates for unfair competitive advantage. In addition, each country undertakes to provide the IMF with the information necessary for its effective surveillance. The membership has agreed that the IMF's surveillance of each member's exchange rate policies has to be carried out within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member.

The regular monitoring of economies, and associated provision of policy advice, that IMF surveillance involves can help signal dangers ahead and enable members to act in a timely way to avoid trouble.

The IMF conducts its oversight in three ways:

i) Country surveillance, which takes the form of regular (usually yearly) comprehensive consultations with individual member countries about their economic policies, with interim discussions as needed. The consultations are

referred to as "*Article IV consultations*" as they are mandated by Article IV of the IMF's charter. (They are also referred to as "bilateral" consultations, but this is strictly speaking a misnomer: when the IMF consults with a member country, it represents the entire membership, so that the consultations are really always multilateral). The IMF supplements its usually annual country consultations with additional staff visits to member countries when needed. The Executive Board also holds frequent, informal meetings to review economic and financial developments in selected member countries and regions.

ii) Global surveillance, which entails reviews by the IMF's Executive Board of global economic trends and developments. The main reviews of this kind are based on *World Economic Outlook* and *Global Financial Stability* reports prepared by IMF staff, normally twice a year, before the semiannual meetings of the International Monetary and Financial Committee. The reports are published in full prior to the IMFC meetings, together with the Chairman's summing up of the Executive Board's discussion. The Executive Board also holds more frequent, informal discussions on world economic and market developments.

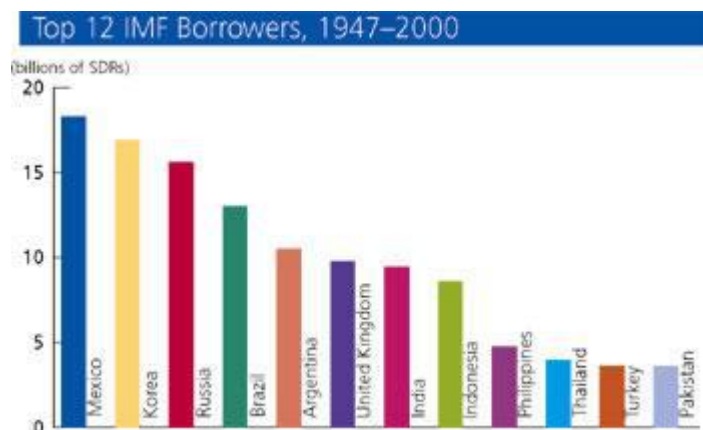
iii) Regional surveillance, under which the IMF examines policies pursued under regional arrangements. This includes, for example, Board discussions of developments in the European Union, the euro area, the West African Economic and Monetary Union, the Central African Economic and Monetary Community, and the Eastern Caribbean Currency Union.

IMF management and staff also participate in surveillance discussions of such groups of countries as the G-7 (the Group of Seven major industrial countries) and APEC (the Asia-Pacific Economic Cooperation forum).

Instruments of IMF lending and their evolution

The IMF provides loans under a variety of policies or "facilities" that have evolved over the years to meet the needs of the membership. The duration, repayment terms, and lending conditions attached to these facilities vary,

reflecting the types of balance of payments problem and circumstances they address.



Most of the IMF's financing is provided through three different types of lending policies:

Stand-By Arrangements form the core of the IMF's lending policies. First used in 1952, they are designed to deal mainly with short-term balance of payments problems.

Medium-term extended arrangements under the **Extended Fund Facility** are intended for countries with balance of payments difficulties related to structural problems, which may take longer to correct than macroeconomic weaknesses. Structural policies associated with extended arrangements include reforms designed to improve the way economy function, such as tax and financial sector reforms, privatization of public enterprises, and steps to enhance the flexibility of labor markets. The IMF has been providing concessional lending to help its poorest member countries achieve external viability, sustainable economic growth, and improved living standards since the late 1970s. The current concessional facility, the **Poverty Reduction and Growth Facility (PRGF)**, replaced the Enhanced Structural Adjustment Facility (ESAF) in November

1999, with the aim of making poverty reduction and economic growth the central objectives of policy programs in the countries concerned.

In the late 1990s, the IMF introduced facilities designed to help countries cope with sudden losses of market confidence, and to prevent "contagion"—the spread of financial crises to countries with sound economic policies. (See pages 30-33 for highlights of the IMF's evolving facilities.) The IMF also provides loans to help countries cope with balance of payments problems caused by natural disasters, the aftermath of military conflicts, and temporary shortfalls in export earnings (or temporary increases in cereal import costs) beyond their control.

Just as new facilities have been introduced to meet new challenges, redundant facilities have over time been terminated. Indeed, the Executive Board initiated in early 2000 a review of facilities. The review led to the elimination of four obsolete facilities. The Board's consideration of modifications to other nonconcessional facilities led to agreement to:

- adapt the terms of Stand-By Arrangements and Extended Fund Facility loans to encourage countries to avoid reliance on IMF resources for unduly long periods or in unduly large amounts;
- reaffirm the Extended Fund Facility as one confined to cases where longer-term financing is clearly required; and
- enhance monitoring of IMF-supported programs after their expiration, especially when a member's credit outstanding exceeds a certain threshold.

Selected IMF Lending Facilities

i) Stand-By Arrangements—form the core of the IMF's lending policies. A Stand-By Arrangement provides assurance to a member country that it can draw up to a specified amount, usually over 12-18 months, to deal with a short-term balance of payments problem.

ii) Extended Fund Facility—IMF support for members under the Extended Fund Facility provides assurance that a member country can draw up to a specified amount, usually over three to four years, to help it tackle structural economic problems that are causing serious weaknesses in its balance of payments.

iii) Poverty Reduction and Growth Facility—(which replaced the *Enhanced Structural Adjustment Facility* in November 1999). A low-interest facility to help the poorest member countries facing protracted balance of payments problems (see page 46, "A New Approach to Reducing Poverty"). The cost to borrowers is subsidized with resources raised through past sales of IMF-owned gold, together with loans and grants provided to the IMF for the purpose by its members.

iv) Supplemental Reserve Facility—Provides additional short-term financing to member countries experiencing exceptional balance of payments difficulty because of a sudden and disruptive loss of market confidence reflected in capital outflows. The interest rate on SRF loans includes a surcharge over the IMF's usual lending rate.

v) Emergency Assistance—Introduced in 1962 to help members cope with balance of payments problems arising from sudden and unforeseeable natural disasters, this form of assistance was extended in 1995 to cover certain situations in which members have emerged from military conflicts that have disrupted institutional and administrative capacity.

At present, IMF borrowers are all either developing countries, countries in transition from central planning to market-based systems, or emerging market countries recovering from financial crises. Many of these countries have only limited access to international capital markets, partly because of their economic difficulties. Since the late 1970s, all industrial countries have been able to meet their financing needs from capital markets, but in the first two decades of the IMF's existence over half of the IMF's financing went to these countries.

Technical Assistance and Training

The IMF is probably best known for its policy advice and its policy-based lending to countries in times of economic crisis. But the IMF also shares its expertise with member countries on a regular basis by providing technical assistance and training in a wide range of areas, such as central banking, monetary and exchange rate policy, tax policy and administration, and official statistics. The objective is to help strengthen the design and implementation of members' economic policies, including by strengthening skills in the institutions responsible, such as finance ministries and central banks. Technical assistance complements the IMF's policy advice and financial assistance to member countries and accounts for some 20 percent of the IMF's administrative costs.

The IMF began providing technical assistance in the mid-1960s when many newly independent countries sought help in setting up their central banks and finance ministries. Another surge in technical assistance occurred in the early 1990s, when countries in central and eastern Europe and the former Soviet Union began their shift from centrally planned to market-based economic systems. More recently, the IMF has stepped up its provision of technical assistance as part of the effort to strengthen the architecture of the international financial system.

Specifically, it has been helping countries bolster their financial systems, improve the collection and dissemination of economic and financial data, strengthen their tax and legal systems, and improve banking regulation and supervision. It has also given considerable operational advice to countries that have had to reestablish government institutions following severe civil unrest or war.

The IMF provides technical assistance and training mainly in four areas:

- strengthening monetary and financial sectors through advice on banking system regulation, supervision, and restructuring, foreign exchange management and operations, clearing and settlement systems for

- payments, and the structure and development of central banks;
- supporting strong fiscal policies and management through advice on tax and customs policies and administration, budget formulation, expenditure management, design of social safety nets, and the management of internal and external debt;
- compiling, managing, and disseminating statistical data and improving data quality; and
- drafting and reviewing economic and financial legislation.

The IMF offers training courses for government and central bank officials of member countries at its headquarters in Washington and at regional training centers in Brasília, Singapore, Tunis, and Vienna. In the field, it provides technical assistance through visits by IMF staff, supplemented by hired consultants and experts. Supplementary financing for IMF technical assistance and training is provided by the national governments of such countries as Japan and Switzerland, and international agencies such as the European Union, the Organization for Economic Cooperation and Development, the United Nations Development Program, and the World Bank.

3.5 WORLD BANK

Introduction

A need arises to finance various projects in various countries to promote the development of economically backward regions. The United States and other countries have established a variety of development banks whose lending is directed to investments that would not otherwise be funded by private capital. The investments include dams, roads, communication systems, and other infrastructural projects whose economic benefits cannot be computed and/or captured by private investors, as well as projects, such as steel mills or chemical plants, whose value lies not only in the economic terms but also, significantly in the political and social advantages to the nation. The loans generally are medium-term to long-term and carry concessional rates.

Even though most lending is done directly to a government, this type of financing has two implications for the private sector. First, the projects require goods and services which corporations can produce. Secondly, by establishing an infrastructure, new investment opportunities become available for multinational corporations.

The World Bank or the International Bank for Reconstruction and Development (IBRD) was established in 1945 under the Bretton Woods Agreement of 1944. An International Monetary and Financial Conference was held at Bretton Woods, New Hampshire during July 1-22, 1944. The main purpose of the conference was finalisation of the Articles of Association of IMF and establishment of an institution for the reconstruction of the war shattered world economies. Thus, the conference has given birth to World Bank or International Bank for Reconstruction and Development (IBRD). World Bank was established to provide long-term assistance for the reconstruction and development of the economies of the member countries while IMF was established to provide short-term assistance to correct the balance of payment disequilibrium.

The World Bank is an inter-governmental institution, corporate, in form, the capital stock of which is entirely owned by its members-governments. Initially, only nations that were members of the IMF could be members of the World Bank. This restriction on membership was subsequently relaxed. The World Bank makes loans at nearly conventional terms for projects of high economic priority. To qualify for financing, a project must have costs and revenues that can be estimated with reasonable accuracy. A government guarantee is a necessity for World Bank funding. The Bank's main emphasis has been on large infrastructure projects such as roads, dams, power plants, education and agriculture. However, in recent years the Bank has laid greater emphasis on quick loans to help borrower countries to alleviate their balance of payments problems. These loans are tied to the willingness of the debtor nations to adopt

economic policies that will spur growth, free trade, more open investment, and a more vigorous private sector. Besides its members subscriptions, the World Bank raises funds by issuing bonds to private sources.

Functions of the World Bank

The principal functions of the IBRD are set forth in Article I of the agreement and are as follows :

1. To assist in the reconstruction and development of the territories of its members by facilitating the investment of capital for productive purposes.
2. To promote private foreign investment by means of guarantee of participation in loans and other investments made by private investors and, when private capital is not available on reasonable terms, to make loans for productive purposes out of its own resources or from funds borrowed by it.
3. To promote the long term balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of members.
4. To arrange loans made or guaranteed by it in relation to international loans through other channels so that more useful and urgent projects, large and small a like, will be dealt first. It appears that the World Bank was created to promote and not to replace private foreign investment. In this respect the Bank considers its role to be a marginal one, to supplement and assist private foreign investment in the member countries.

Membership of the World Bank

All the members of the IMF are also the members of the World Bank. Any country can join as a member of the IBRD by signing in the Charter of the Bank as its subscriber. It had 184 members in 2003. Bank has the authority to suspend any member, if the country concerned fails to discharge its responsibilities to the IBRD. Similarly, every member is free to resign from the membership but it has to pay back all loans with interest on due dates. The member is also required to

pay its share of the loss on demand if the Bank incurs a financial loss in the year in which a member resigns.

Capital Structure of the World Bank

The World Bank or IBRD started with an authorised capital of US \$ 10 billion divided into 1,00,000 shares of US \$ 1,00,000 each. The subscribed capital at that time was US \$9.4 billion. The authorised capital was increased to 7,16,500 shares of the par value of SDR 1,00,000 each in 1985. In July 1992, the total authorised capital of the bank was \$14.1 billion with a capital increase of \$9.3 billion. This increase of 77,159 shares was subscribed by the republics of the former Soviet Union. The bank has raised capital worth \$23 billion in 2002.

The member countries contribute their share capital to the Bank as follows:

- (1) 2% of the share in the form of gold and US dollars. The World Bank utilizes this amount freely for granting loans.
- (2) 18% of the share capital in the form of own currency. This amount is also used by Bank for granting loans.
- (3) 80% of the share capital is payable at the request of the Bank. This amount is also used by Bank for granting loans. But it can use this amount in discharging its responsibilities.

Organisation Structure of the World Bank

The World Bank like IMF is also managed by a three-tier structure including Board of Governors, Executive Directors and President.

(1) Board of Governors: The Board of Governors has full authority and control over the Bank's activities. Normally, each country appoints its Finance Minister as a Governor and the Governor of its Central Bank as Alternate Governor on the Board of Governors for a period of 5 years. The strength of the voting rights to the Governors depends upon the subscribed capital by the member country. In

the absence of Governor, the Alternate Governor can exercise the voting right. Normally the Board of Governors meets annually.

(2) Executive Directors: The bank has 24 Executive Directors. They supervise the entire operations of the Bank. Out of these 24 Directors, are appointed by USA, UK, Germany, Finance and Japan. The remaining 19 Directors are elected by the remaining member countries. The Executive Directors normally meet regularly once in a month. The 24 Directors elect the President of the Bank who presides over the meetings of the Board of Executive Directors.

The Scope of Decisions of the Executive Directors Include:

- (a) Policy making within the framework of the Articles of Agreement.
- (b) Loans and credit proposals.

Function of Board of Executive Directors

- (a) To Present audited annual reports.
- (b) To prepare administrative budget.
- (c) To prepare and present to Board of Governors annual reports on the operation and policies of the Bank.

(3) President: Normally the president does not have any voting right except in case of exercising equal rights. He is assisted by senior Vice-Presidents and Directors of various departments and regions.

Funding Strategy of the World Bank

There are the four basic objectives of the World Bank's funding strategy:

- (1) To make sure availability of funds in the market.
- (2) To provide the funds at the lowest possible cost to the borrowers through appropriate currency mix of its borrowing and opting to borrow when interest rates are expected to rise.
- (3) To control volatility in net income and overall loan changes.

- (4) To provide an appropriate degree of maturity transformation between its lending and the borrowing. Maturity transformation depicts the Bank's capacity to lend for longer period than it borrows.

Bank's Borrowings

Bank's main function is to lend the money to the needy member. For lending activities, it needs money and therefore it has to borrow.

Sources: The bank borrows from the following sources:

- (1) The Bank borrows from international market both for long-term and short-term periods.
- (2) The Bank also borrows under currency swap agreements (CSA).
- (3) The Bank also borrows under the Discount-Note Programme by two methods. First, it places bonds and notes directly with its member countries. Second, it offer issues to investors and in public markets.

Two new borrowings instruments were evolved by the Bank. The first one is Central Bank Facility and US Dollar Dominated Facility. The second instrument is Floating Rate Notes. The World Bank borrows from the commercial banks and other financial institutions with the help of this instrument.

(a) Bank's Lending Activities

The Bank grants loans to members in any one or more of the following ways:

- (1) by participating or granting indirect loans out of its own funds;
- (2) by granting loans out of funds raised in the market of a member or otherwise borrowed by the Bank; and
- (3) by guaranteeing in whole or part, loans made by private investors through the investment channels.

The total outstanding amount of the total direct and indirect loans made or guaranteed by the Bank is not to exceed 100 per cent of its total unimpaired subscribed capital, resources and surpluses. Bank imposes following conditions in granting loans:

- (1) The bank is satisfied that the borrower is unable to borrow under reasonable conditions in the prevailing market conditions.
- (2) The project for which loan is required should be recommended by the competent authority in the form of a written report after careful examination of the project.
- (3) The loan is required for productive purpose.
- (4) The borrower or guarantor has reasonable prospects of repaying loans and interest on loans.
- (5) If the project is located on the territory of the member but itself is not a borrower, then the member or its central bank has to guarantee the repayment of loan, interest on loans and other charges on loan.

In 1991, the Executive Board of the Bank modified the repayment terms which include extension of repayment period from 3 to 5 years for middle income countries and review of repayment terms for middle income countries within 3 years. The cumulative lending of the Bank is of \$ 383 billion and in the fiscal year 2003, it has lended \$ 11.2 billion for 99 new operations in 37 countries.

Facilities to Member Countries

The Bank provides the following facilities to member countries:

(1) Structural Adjustment Facility (SAF): In order to reduce their balance of payment deficit and maintaining or regaining the economic growth of member countries, the World Bank has introduced SAF in 1985. These funds are used to finance the general imports with a few agreed exceptions such as luxury and military imports. These funds are released in two parts and in a series of upto five SAFs to a borrowing country. Generally, the bank imposes stiff conditions for these. These are provided to support to programmes running from 5 to 7 years.

(2) Enhanced Structural Adjustment Facility (ESAF): In order to increase the availability of concessional resources to the low income member countries, ESAF was established in December 1987. It provides new concessional

resources of SDR 6 billion which will be financed by special loans and contributions from developed and OPEC countries. The purposes for advancing the amount is same, i.e., to reduce balance of payment deficits of borrowing member countries and encourage growth. The interest rate charged by the Bank is 0.5 per cent to be repaid in ten semi-annual installments beginning after 5½ years of disbursements.

(3) Special Action Programme (SAP): The Special Action Programme (SAP) has been started in 1983 to strengthen the IBRD's ability to assist member countries in adjusting to the current economic environment. It has four major elements:

- (i) Provide lending for structural adjustment, policy changes, export-oriented production, full utilisation of existing capacity and maintenance of critical infrastructure.
- (ii) Provide advisory services regarding policies.
- (iii) Enlisting familiar efforts by other donors for fast disbursing assistance.

Other Activities of the World Bank

In addition to lending activities, the Bank also undertakes the following activities:

(1) Training: In 1956, the Bank set up a staff college to provide training to senior officials of the member countries. This college is known as Economic Development Institute (EDI). The Institute helps the officials in improving the management of their economies and to increase the efficiency of their investment programmes. The EDI also organises seminars in Washington and in different regions of the World in Cooperation with regional institutes.

(2) Technical Assistance: The World Bank also provides technical assistance to its member countries. This assistance include:

- (i) **Engineering – related:** It includes feasibility studies, engineering design and construction supervision;
- (ii) **Institution-related:** It includes diagnostic policy and institutional studies, management

The primary way of providing technical assistance is through loans made for supervision, implementation and engineering services, energy, power, transportation, water supply, etc. In 1975, the Bank created Project Preparation Facility (PPF) for meeting gaps in project preparation and for institution building. The Bank also acts as executing agency for project financed by the United Nations Development Programme (UNDP).

(3) Inter-Organisational Co-operation: The World Bank is also engaged in inter-organisational cooperation. It is based on formal agreement between it and international organisations, such as, the cooperative programmes between it and FAO, the UNESCO, the WHO, the GATT, the UNCTAD, the UNEP (United Nation Environment Programmes), The UNDP, The UNIDO (United Nations Industrial Development Organisation) the ILO, the African Development Bank, the Asian Development Fund, the International Fund for Agriculture Development (IFAD), etc.

(4) Economic and Social Research: In 1983, the Bank established a Research Policy Council (RPC). It provides leadership in the guidance, co-ordination and evaluation of all bank research. The Bank's own research staff undertakes research activities and also in collaboration with outside researchers.

(5) Operations Evaluation: The Bank has set up the Operations Evaluation Department (OED) to help borrowers in the post-evaluation of Bank assisted projects. Members of borrowers' staff visit this Department for seeking help in the preparation of project completion report.

(6) Settlement of Investment Disputes: The Bank has set up the International Centre of Settlement of Investment Disputes (ICSID) between states and

nationals of other states. The Bank has successfully mediated in solving many international investment disputes such as the River Water Dispute between India and Pakistan, and the Suez Canal dispute between Egypt and the U.K.

Criticism of the World Bank

The modus operandi of the Bank has been criticised on various counts by different quarters as follows:

1. It is alleged that bank charges a very high rate of interest on loans. For example, some of the loans which India has received in recent years bear an interest of 5.75 per cent including the commission at 1% which is put in the Bank's special reserve.
2. The Bank's insistence, prior to the actual grant of loan, on the country having the capacity to transfer or repay, is open to criticism. The Bank should not apply orthodox standards to judge the transfer capacity of any borrowing country. Transfer capacity follows rather than precede the loan.
3. The financial help given by the Bank does not amount to more than a drop in the big ocean of financial requirements so essential for various development projects.

India and the World Bank

India is the founder member of the Bank and held a permanent seat for number of years on its Board of Executive Directors. India is one of the largest receiver of assistance since 1949. Upto June 2002, cumulative lendings of the World Bank to India amounted to \$ 26.69 billion in 187 loans. The total amount borrowed by India from the World Bank and the IDA till June 2002 amounted to \$ 58.54 billion in 434 loans. This amounted to 11.6 per cent of the total loans and credits approved by the World Bank groups. During 2001-02, India received \$ 893 million from the World Bank accounting for 11.22 per cent of its total loans.

India is helped by the World Bank in its planned economic development through granting loans, conducting field surveys, sending study terms and missions and

through rendering expert advice. The Bank also provides training to Indian personnel at EDI. There is also a Chief of Missions of the Bank at New Delhi. He is representing the Bank for its aided projects in India for monitoring and consultations. The Bank has been helping India in various objects like development of ports, oil exploration including the Bombay high and gas power projects, aircrafts, coal, iron, aluminum, fertilizers, railway modernisation and technical assistance etc. It also helped India to solve its river water dispute with Pakistan. The benefits desired by India from the World bank are:

- (i) India has received a lot of assistance from the World Bank for its development projects.
- (ii) Aid India Club was founded in 1950 by the efforts of the World Bank with a view to help India. This club is now called India Development Forum. This Forum had decided to give loans amounting to \$ 600 crore to India for implementing its structural adjustment.
- (iii) The bank's role in solving the Indus water dispute between India and Pakistan has been invaluable.
- (iv) General loans have also been granted by the World Bank to India, to be utilised as per its own discretion.
- (v) As a member of the World Bank, India has become the members of International Finance Corporation, International Development Association and Multilateral Investment Guarantee Agency also.
- (vi) India has received technical assistance from time to time from the World Bank for its various projects. The Expert Team of the Bank has visited India and given valuable suggestions also.
- (vii) The massive population of India has always created problems in the economic development of the country. World Bank has been helping India in the population control programmes and urban development. For this purpose loans amounting to \$ 495 crore have also been given to India.
- (viii) World Bank has been giving financial assistance to NGOs operating in India e.g. Leprosy Elimination, Education Projects, Child development service projects etc.

On the other hand, critics argue that the World Bank have endangered the economic freedom of India. The basic points of criticism are as follows:

- (i) The World Bank has laid a great deal of emphasis on measures of economic liberalisation and more free play of market forces.
- (ii) A lot of stress has been laid on going very slow on the setting up of public sector enterprises including financial intermediaries and encouraging private sector.
- (iii) India's dependence on World Bank has been increasing which is adversely affecting its economic freedom.
- (iv) The attitude of World Bank reflects the preference for free enterprise and a market oriented economy. It shows dissatisfaction with the general performance of economies which are based on planning and regulation. At different occasions the Bank has tried to undermine the Significance of our Planning Commission.
- (v) The devaluation of Indian rupee in 1966 and 1991 was done at the insistence of the World Bank only.

India's main problem till now has been the government's incapacity to act rightly, firmly and effectively in time, on account of being more emotional to set ideologies and compromising attitude to safeguard the political party's interest more than the national interest.

Affiliates to the World Bank

The Bank has four affiliates. These are:

International Development Association (IDA)

The IDA was set up in 1960 as a subsidiary of the World Bank to provide "soft loans" to the member countries. Thus, the object of the IDA is to provide loans to member countries on liberal terms with regard to the rate of interest and the period of repayment. Another attraction of the IDA loans is that they can be repaid in the currency of the member country.

In approving an IDA credit, *three criteria* are observed:

1. **Poverty Test :** IDA's assistance is limited to the poorest of those countries classified as Part II countries, and which continue to face such severe handicaps as excessive dependence on volatile primary products markets, heavy debt servicing burden, and often, rates of population growth eat outweigh the gains of production.
2. **Performance Test:** Within the range of difficulties of establishing objective standards of performance, the following factors serve as the yardstick for an adequate performance test: satisfactory overall economic policies and past success in project execution.
3. **Project Test:** The purpose of the IDA is soft loans, not soft projects. IDA projects are appraised according to the same standard as that applied to the Bank projects – the test essentially requires that proposed projects promise to yield financial and economic returns adequate to justify the use of scarce capital.

The Objective of IDA are:

1. To provide development finance on easy terms to less developed member countries; and
2. To promote economic development, increase productivity and thus raise standards of living in the underdeveloped areas.

Since the IDA charges nominal rates of interest on its loans, it has also been nicknamed the “soft-loan windows”.

Membership: All the members of the World Bank are the members of the IDA. It had 164 members in June, 2003. There are two types of members. In IDA-Part I members are the developed countries which are 24 in number and therefore are called as G-24 countries. Part II members are the developing countries.

Organisation: The organisation of IDA is same as that of the World Bank. Generally, the staff of the World Bank operates this association with few separate sections.

Loans: IDA loans are known as IDA credits. Only a member country can borrow from IDA with a restriction that a member country is eligible to borrow from IDA only if its per capita income is less than US \$ 695 at 1990 price index. Those projects get assistance from IDA which are not financed by the World Bank. IDA observes the poverty criterion, performance criterion and project criterion while approving the projects.

Terms of Loans: Conditions for IDA loans are:

- (1) Repayment period is 35-40 years.
- (2) Grace period is 10 years.
- (3) Interest rate varies between zero to 0.5% which is waived now.
- (4) Administrative fee is 0.75% on the loan amount disbursed.

Gross disbursement by IDA during the year 2002-03 were \$8.1 billion. India received \$686.6 million interest free loan during the year 2002-03. The cumulative commitments of IDA were of \$ 142 billion and commitments of \$7.3 billion for 141 new operations in 55 countries were made in fiscal year 2003.

International Finance Corporation (IFC)

The International Finance Corporation (IFC) is the private sector arm of the World Bank family which was established in July 1956. It is the major multilateral agency promoting productive private investment in developing private investment in developing countries. It helps finance private sector projects to mobilise finance for them in the international financial markets, and provides advice and technical assistance to businesses and governments.

Membership

The Articles of Agreement of the IFC are similar to that of the World Bank. A country has to be a member of the World Bank in order to join the IFC. In June 2003, it had 175 members.

Objectives

The objectives for which the IFC was set up have been laid down in Article 1 of its Articles of Agreement as under:

“The purpose of the Corporation is to further economic development by encouraging the growth of productive private enterprise in member countries, particularly in the less developed areas, thus supplementing the activities of the International Bank for Reconstruction and Development. In carrying out this purpose, the Corporation shall:

- (i) in association with private investors, assist in financing the establishment, improvement and expansion of productive private enterprise which would contribute to the development of its member countries by making investments, without guarantee of repayment by the member Government concerned, in cases where sufficient private investment is not available on reasonable terms;
- (ii) seek to bring together investment opportunities, domestic and foreign private capital, and experienced management; and
- (iii) seek to stimulate, and to help create conditions conducive to the flow of private capital, domestic and foreign, into productive investment in member countries”.

IFC is the largest multinational source of loan and equity financing for private sector projects in the developing world. It offers a full array of financial products and services to companies in its developing member countries:

- long-term loan in major currencies, at fixed or variable rates.
- equity investment.

- quasi-equity instruments (subordinated loans, preferred stock, income rates).
- guarantees and standby financing.
- risk management (intermediation of currency and interest rate swaps, provision of hedging facilities).

IFC has approved \$3.9 billion in financing 204 project in various sectors in 64 developing countries in the fiscal year 2003. IFC invested in 11 projects involving an amount of \$48.1 million in India. It is composed to \$25.4 million in the form of loan and \$ 22.7 million in the form of equity.

In recent years, greater emphasis has been placed by the corporation on helping to develop resources and to increase the availability of foodstuffs.

The special feature of the IFC is that, unlike commercial financial institutions, it judges potential ventures in terms of both their financial viability and their contribution to the economic development of the country concerned. At the same time, unlike other official development institutions, it participates directly with the private sector in both the developed and developing worlds. Unlike both types of institutions, it provides both equity and fixed rate financing.

The Multinational Investment Guarantee Agency (MIGA)

The Multinational Investment Guarantee Agency was established in April 1988 as a new affiliate of the World Bank. It is a joint venture of the World Bank and IFC. It was created to assist the World Bank and the IFC in the areas where the Bank and the IFC do not reach. The authorised capital of MIGA is \$ 1.08 billion.

Objectives: The MIGA has the following objectives:

- (1) To encourage the flow of direct foreign investment into developing member countries.
- (2) To provide insurance cover against political risks to investors.

- (3) The guarantee programme of MIGA protects investors against non-commercial risks like danger involved in currency transfer, war and civil disturbances, breach of contract by governments, etc.
- (4) To provide promotional and advisory services.
- (5) To insure only new investments, expansion of existing investment, privatization and financial restructuring.
- (6) To establish credibility among investors.

Membership: Any country can become its full-fledged member by ratifying the convention and pay its capital subscription. By June 30, 2003, 162 countries had signed the MIGA convention. Of these, 136 countries had become its full-fledged members.

Activities: The MIGA provides promotional and advisory services to its developing member countries, such as organisation of investment promotion conferences, executive development programmes, foreign investment policy, round table conferences, etc. It also operates the Foreign Investment Advisory Service in policy, institutional and legal matters relating to direct foreign investment.

Progress: 226 contracts of guarantee for investments in 52 developing countries have been signed by MIGA. Its outstanding contingent liability was \$2.8 billion in 2000. The amount of insured projects of foreign investment was \$8.4 billion. It issued 68 investment guarantee contracts with \$862 million. It assisted private firms of 17 countries in making investment in 27 countries. Its cumulative guarantee till fiscal year 2003 was of \$12.4 billion and alone in fiscal year 2003, it issued guarantee worth of \$1.4 billion.

India became the 113th member country of MIGA in April 13, 1992.

The International Centre for Settlement of Investment Disputes (ICSID)

The international Centre for Settlement of Investment Disputes was established in 1966. It has 139 members till date. It helps in encouraging foreign investment by providing international facilities for conciliation and arbitration of investment disputes. Therefore, it is helping in fostering an atmosphere of mutual confidence between states and foreign investors. ICSID also conducts research and publishing activities in the areas of arbitration law and foreign investment law. It has registered 129 cases in total and in the fiscal year 2003, it had registered 26 cases.

4.0 Summary

Economic environment is one of the most important factors that influences the business environment. In the present times, there is a high degree of interdependence among nations. Liberalization of economy, worldwide, is creating several opportunities and the nations are becoming more open in their policies. Last few decades has witnessed a high growth in the international trade. However, the growth is skewed in favour of developed economies, in the services sectors and limited to the nations that have developed exclusive competitive advantages.

The General Agreement on Tariffs and Trade (GATT) was a multilateral treaty that laid down agreed rules for conducting international trade. It came into force in January 1948. Its basic aim was to liberalize trade and for 47 years it had been concerned with negotiating the reduction of trade barriers and with international trade relations. Overseeing the application of its rules was an important and continuing part of its activities. GATT also provided a forum in which countries could discuss and overcome their trade problems and negotiate to enlarge international trading opportunities. The rapid and uninterrupted growth in the volume of international trade till 1994 provided a good testimony for the success of the GATT.

The World Trade Organisation (WTO) came into effect on January 1, 1995 with the support of 85 founder members. India was one of them. It is third pillar of worldwide economic dimensions along with the IMF and the World Bank. GATT is replaced by the WTO. The WTO has taken charge of monitoring and administering the new global trade rules agreed in the Uruguay Round. The world income is expected to rise by over \$ 500 billion annually by the year 2005 A.D. through the WTO agreements and market access commitments. The expected annual trade growth will be a quarter higher in the same year than it would otherwise have been.

The WTO is an international trade organisation, having set of rules and principles, which were mutually designed and agreed upon to promote international trade in general and also to reduce tariff barriers and to remove import restrictions, in particular. It can be called as World Trade System. It is a new trade organisation with global recognition and succeeded GATT on renewed agreements. The WTO has a new vision with tougher and wider enforcement power to promote international trade. Divergent views have been expressed in support and against our country becoming a member of the WTO.

The UNCTAD secretariat has been doing yeoman's service to LDCs in trade, finance and debt problems vis-a-vis developed countries. The detailed reports prepared by UNCTAD before each conference have create a new climate of thought with regard to the problems and need of LDCs. These are again discussed at other international forums such as the IMF, World Bank, OECD, EEC, NAM etc. Often, positive measures follow, such as larger aid by the World Bank and OECD, giving more trade concessions by EEC to LDCs etc. As such, the UNCTAD reflects the sentiments, hopes and aspirations of LDCs in a world still dominated by the developed countries, both politically and economically.

It can be noted that although wide-range measures have been proposed and devised from time to time by the UNCTAD and Commodity Agreements, there have remained certain important shortcomings in the effective implementation and follow up. Nevertheless, it can be said that the increasing awareness among the developing countries has served the purpose of pressurizing the more powerful developed countries to listen and to accommodate the interest of the weaker developing countries to some extent, if not fully. This indeed, has been the success of UNCTAD and Commodity Agreements.

It may be said that the World Bank has not come upto the expectations of many nations. Nevertheless, it has been instrumental to a very large extent in initiating and accelerating the work of economic reconstruction and development in different countries. No doubt, India has derived immense benefit from the World Bank. The bank may have failed to finance most of the development projects, but it should be remembered that it has financed quite a large number of them which have proved a notable success. The Bank has also played a significant role outside financial matters by serving as a mediator between different countries on major economic and political issues. For instance, its help in the solution of the Indus Water dispute between India and Pakistan and the Suez Canal dispute between UK and UAE has been valuable.

The ADB has been playing an important role in providing finance in the form of loans and grants to its member developing countries of their development. There have been two factors for the increase in the Bank's lending operations. First, at the time of its establishment, India had agreed not to get loans from the Bank so that smaller developing member countries might be given larger aid. But when China became its member and started getting assistance from the Bank, India followed it. This has led to increase in the Bank's lending operations. The second factor has been introduction of non-project loans. These are given to member countries to solve their balance of payments problems with the

condition that the concerned countries should follow the policies laid down by the Bank. However, industrialised developing countries like China and India do not receive 'soft' loans from the Bank with a nominal rate of interest. The ADB's contribution to the economic development of the developing member countries of the region has been creditable.

5.0 SELF ASSESSMENT QUESTIONS

1. Explain the origin, objectives and function of the World Bank.
2. What are the objectives of the International Development Association? To what extent it has been successful in helping the developing economies?
3. What is Multinational Investment Guarantee Agency? Discuss its objectives and workings.
4. Discuss the objectives the Asian Development Banks. What has been its contribution to the regional development of India.
5. Explain the working and achievements of the Asian Development Bank.
6. What do you understand by GATT? Discuss its main objectives and principles.
7. Explain the main achievements and shortcomings of GATT.
8. What is WTO? Discuss its functions and objectives.
9. Bring out the arguments for and against India's membership of WTO.
10. Discuss the achievements and failure of WTO.
11. Write a detailed note on Doha Ministerial Conference, 2001.
12. Discuss the functions of UNCTAD. Explain its basic principles.
13. What are the achievements of UNCTAD? Also explain the problems of UNCTAD.
14. Explain the objectives of International Commodity Agreements (ICA). Discuss the various forms of commodity agreements.

6.0 FURTHER READINGS

- International Economies – D.N. Krithani.
- International Business – Roges Bennett
- International Business – P. Subha Rao

- WTO-Structure, Functions, Tasks and Challenges – Alok Roy
- Business Environment – C.B. Gupta
- International Business : Francis Cherunillam

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Unit -III

ORGANISATIONS ENGAGED IN INTERNATIONAL BUSINESS

- ❖ Multinational Corporations
- ❖ MNCs Critics and Defenders
- ❖ MNCs and Home Societies
- ❖ MNCs and Host Societies
- ❖ Technology Transfer

After learning this chapters nice these chapters you can

- ❖ know the types and importance of MNCs
- ❖ understand the home and host countries position with reference to MNCs
- ❖ Understand the technology transfer, its ways importance and its categories

Multinational Corporation

The multinational company (MNC) is a company involved in producing and marketing its outputs in several countries. The outputs may be goods, services, or various combinations of both. To develop the capacity to produce and market multination ally a firm must acquire managerial control over operating entities in a number of countries; in other words, it must establish subsidiary companies in all host economies and endow each with the necessary operating assets, such as factories, mines, department stores, hotels, banks, or whatever is required in the particular company's mines, field of activity.

The capacity to act simultaneously in numbers of countries of countries sets the MNC clearly apart from the domestic or unemotional company (UNC). The UNC has all its operating assets and organizational subunits (departments, divisions, subsidiaries) in its home country. It may on occasion engage in exporting or importing by transacting with foreign firms, but its own capacity to function is limited to the domestic market.

Some MNCs are motivated by profits, some by raw material, and some by markets, some by diversification, some by the stability that diversification of markets and operating environments may offer. Many pursue several or all of these objectives. Furthermore, the objectives vary with time, with place, and with circumstances. From the market perspective, some MNCs cater to individual consumers, some to government procurement, some to the industrial sector, and some to the military. Some MNCs operate in a competitive marketing atmosphere, other in oligopolistic rivalry, and some in monopolistic autonomy.

Neither in structure nor in behavior are all the MNCs alike. Rather, they are very highly differentiated and each variegated economic entities, each ranking as a complex organization and each possessing characteristics of its own.

Organizations that engage in international business vary considerably in size and the extent to which their business activities cross national boundaries. One special type of organization engaged in global business is the multinational corporation (MNC). An MNC is an organization that engages in production or service activities through its own affiliates in several countries, maintains control over the policies of those affiliates, and manages from a global perspective. With a global perspective, top managers allocate resources and coordinate activities to take the best possible advantage of favourable business conditions throughout the world.

Some other expressions are also coined to name enterprises engaged in global business.

WHAT 'S IN A NAME?

There is a debate about what to call a company, whose business ranges across national borders, tying together home and host countries through corporate policies and practices. Here are some of the terms used to describe these companies.

Transnational Corporation (TNC)

Because companies “transcend” or operate across national borders, some experts prefer the term transnational corporation, or TNC. The United Nations favour this term and has created a research centre for the study of Transnational Corporations.

Multinational Corporation (MNC)

The fact that companies operate in multiple countries has led some experts to adopt the term Multinational Corporation, or MNC. This term is very popular in the business press and in textbooks. It seems to be the most generic name to describe corporations operating around the world.

Multinational Enterprise (MNE)

Because some of the international giants are state-owned enterprise, rather than corporations, the term multinational enterprise, or MNE, has entered the vocabulary of international trade.

Global Corporation

This term became very popular in the 1990s. The term seems to have first been used to describe a small number of companies whose business was conducted in dozens of-perhaps more than 100-nations. Hence, Nestle has long been described as truly because the scope of its operations extends to more than 150 nations around his globe. The term is often applied to companies doing business in several areas of the world (e.g., Europe, Latin America, Asia-pacific, and North America).

Colossal is the right word to describe the pre-eminent position of MNCs in the world of business. There are about 35,000 MNCs around the world today, controlling over 170,000 foreign affiliates. It is estimated that roughly half of all cross-border corporate assets are accounted for just by the top 100 MNCs.

ABB is a typical MNC. ABB is a federation of national companies with a global coordination culture. It is a Swiss company having headquarters in Zurich, but only 100 professionals work at the headquarters. only two of the eight board

members are Swedes. Financial dates are reported in US dollars and English is ABB's official language.

It is argued that the MNC's reign as the pre-eminent vehicle of international trade is nearing its end. It is slowly being displaced by firms that represent a new type of international enterprise, which is called the global corporation. The MNC operates in a number of countries and adjusts its products and services to each. The global corporation, on the other hand, operates as if the entire world were a single entity. Global corporations essentially sell the same things in the same way every where. Thus, a global corporation, such as Sony, sells a standardized product—'walkman'—throughout the world, components of which may be made or designed in different countries.

Although multinational companies tend to be rather large engage in a substantial amount of cross-border transactions, an increasing number of medium and small business enterprises are also involved in international business. More than 75 per cent of Indian's total export earnings, for instance, come from small-scale units

INDIAN MNCs (LIST OF INDIAN ACQUIRERS OF FIRMS ABROAD)

- Tata motors to takeover Daewoo in South Korea for \$118 million
- Ambanis to takeover flag international for \$211 million
- Ranbaxy to takeover RPG Aventis a France based firm
- Wockhardt acquired CP pharmaceutical and Wallis Laboratories –both of Britain
- Hindalco took over mount garden and Nifty—copper mines in Australia
- Sundaram Fasteners has acquired Dana Spicer Europe, the British arm of an MNC.
- Amtek Auto has acquired the GWK group in the UK
- Kirloskar Brothers took over SPP pumps, UK

TYPES OF MNCs

Equity-based MNCs

Many older MNCs obtained their multinational capacities through direct foreign investments. They either built from ground up or bought the equity of the desired capital assets, such as assembly plants, pharmaceutical laboratories, department stores, banks, flour mill, or whatever operating facilities they use. Either way, they became owners of these operating entities.

Equity ownership provides the basis for managerial control over the foreign-based entities and opens the way for their affiliation or integration with one another internationally by the headquarters firm. The fact that all the older MNCs and many new ones have followed the equity ownership route has created the impression that direct foreign investment is the only way for a firm to multinationalize. This is not true. Direct foreign investments are synonymous with MNCs are no longer synonymous with direct investments.

The MNCs in which the managerial control derives from equity ownership of affiliated enterprises in different host economies fall into four main types:

- 1) **Resource-based companies.** The main mission of these companies is to produce raw materials, such as metallic ores, oil, rubber, and tropical plantation crops (bananas, coffee, dates). Many of these are among the very oldest MNCs, with roots in the colonial era.
- 2) **Public utility companies.** These companies, which include military arsenals, differ from other economic sectors in that they are either natural monopolies or they serve a monopolistic (single buyer) market such as the national airline of the host nation.
- 3) **Manufacturing companies.** These were the largest growth sector of multinational business from the 1950s to the 1970s. In many instances the host countries were instrumental in attracting the manufacturing MNCs. Foreign investment incentive programs have been the common device for luring inbound industrial incentive. Intricate schemes of tax privilege,

protection against import competition, relaxation of foreign exchange restriction, and government loan guarantees are parts of such arrangements.

- 4) **Service industry MNCs.** The largest components of this category are banks, carriers, retail stores (F. W. Woolworth, sears, Takashimaya), and firms that sell similar management services have followed the multinationalization of industrial companies.

Technology-Based MNCs

A new generation of MNCs has started to emerge in which the source of multinational managerial control is technology, including management expertise, instead of ownership of operating assets. These are known as no equity MNCs. The hotel, mining, and construction industries have pioneered this new generation of MNCs. They offer an increasingly viable alternative to the older, equity-based model.

Management Contracts

The main vehicles of the no equity MNC are long-term contracts with owners of suitable operating facilities, such as hotels or mining properties. Often the contracts are either formally or informally sanctioned by the host government. Under such a contract the owners will let the MNC take over possession and management of the business and the MNC will obligate itself to share profits with the owners by some agreed-upon formula.

The management contract model of the hotel industry has become the basis for a number of variations that are rapidly gaining status not only in other service industries but also in the manufacturing and high-technology sectors, where they the potential for even greater importance.

Production Sharing Arrangements

In mining, crude oil production, and other resource-based businesses, profit sharing may be replaced by output sharing. These arrangements provide that the MNC not only may produce in an extractive sector (iron ore, coal, petroleum), but also must meet specific obligations for the development of indigenous

supplier industries, for training engineers and managers and for keeping pace with developments in the industry concerned. This formula rests on an agreed sharing of the output of the venture. For instance, if the contract provides of 40:60 output sharing of a mining property, the MNC will retain 40 percent of the tonnage and turn over to the owners or, what is more typical, market on the owners' behalf the remaining 60 percent.

Industrial Lease Agreements

These are contracts under which an owner, sometimes a government corporation, leases a complete industrial facility, such as a factor or chemical laboratory, to an MNC. The rent consists normally of a fixed annual sum plus a scale of payments based on the output of the plant. Such lease arrangements are as yet limited to manufacturing activities in which there have been rapid technological advances or in which complex specialized facilities are required.

Technology Transfer Agreements

In the high technology industries (electronics, aircraft, computers, biochemicals) where the host government places the highest priority on indigenous production capability, the new mode is a joint venture between the MNC, whose responsibility it is to provide the technology, and one or several indigenous companies, which are responsible for financing, often with government assistance.

The communist countries (U.S.S.R., Poland, Rumania, and others) have spearheaded negotiations to obtain from Western firms technologies for high volume, low-cost products that are internationally competitive in quality. The agreements completed so far cover not only the transfer of hard technology (patent and trademark rights) but also efficient adaptation of a product to suit the strategic objectives of the host enterprise, effective development of actual production capacity by long-term enterprise-to-enterprise cooperation after the plant starts production, and marketing of the output outside the host country.

Though still modest in total business volume compared to equity-based MNCs, the industrial leases and technology transfer agreements signify the entrance of the technology-based MNC into the manufacturing sector, which the equity-based model has held as an exclusive domain in the past.

THE STRUCTURE OF MNCs

Regardless of which of these alternatives the contract provides, the organizational effect is the same. It transfers the management of the operation to the MNC and motivates the latter to maximize its productivity. This calls for the application of the most efficient alternatives in technology and management know-how available to the MNC.

Objectives to foreign ownership of major business firms have risen in many countries. Simultaneously, the national goals and economic development plans of host countries are placing greater priority on technology imports and modernization of management practices. These trends are favoring the new no equity model at the expense of the old ownership model for multinational growth.

The equity-based and technology-based models do not present an either/ or proposition. The two basic alternatives can be used separately or in combination with each other. In either case, the final outcome is the same; a cluster of production and marketing entities distributed multinationally but subject to managerial control and coordination by the head quarters company.

NINE-COUNTRY COMPLEX

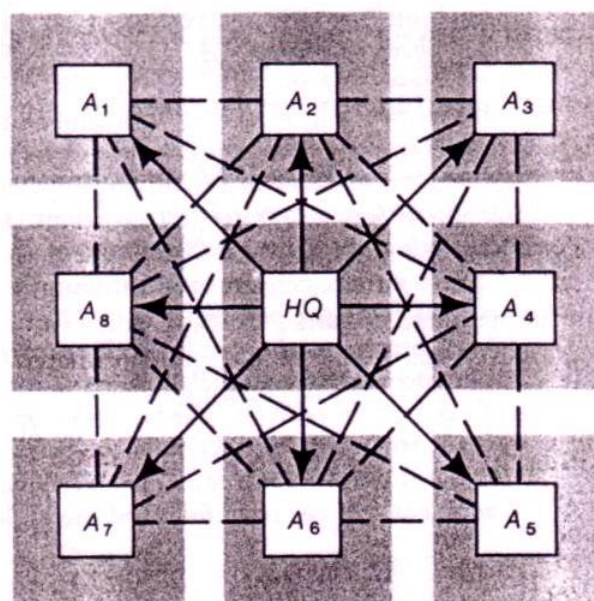


Fig I Spatial Model of Multinational Enterprises

MNCs Critics and Defenders

Because of their visibility across the globe, international businesses have invited criticisms. They have defenders too. Let us examine MNCs as they are perceived by critics. These critics are activist groups that attack MNCs on environmental and rights issues.

1. Challenge to Nation-state Sovereignty The developing countries want control of their economies and want to achieve their economic, political, and social objectives. The power of the MNCs can influence each of these objectives and in doing so may be obliged to give up some power and independence in exchange for the wealth an MNC may bring.

2. Inequities One of the most enduring and persistent complaints about alleged inequities by LDCs is that prices of raw materials extracted from their countries, while prices of imported manufactured goods from industrialized countries are

rising. This they say creates a growing inequity. Other perceived inequities include avoidance of taxes and giving the best management jobs to MNC home-country citizens.

3. Interference with Economic Objectives interference can occur in many ways. For example, an MNC may wish to locate a plant in an area of prosperity when the host country would prefer its location in an underdeveloped region. MNC demands of local support can add to host-country expenditures for infrastructure. Since MNCs typically do their research and development at home, hostn countries become technologically dependent on the MNCs for innovation. The MNCs have the strength to attract bank loans that otherwise might be available for local businesses.

4. Social Disruption The introduction of different mores, habits, behaviors, and ethical values, new products, management styles, distribution systems, more money, and technology, do affect local ways of thinking and doing things.

5. Environmental Degradation Many nations are becoming more concerned about the impact of MNCs on their environment. Environmental concerns are rapidly moving higher in the chain of priorities throughout the world.

6. Imperialism Many of the awakening nations look on foreign managers with fear and distrust as the embodiment of an old, not easily forgotten, exploitative colonialism.

7. Symbol of Frustration and Antipathy The LDCs have grievances about their position in the world that have nothing to do with the MNC but the MNC is a convenient visible target for their anger.

8. MNCs and Technology the technology brought in by MNCs is hardly suitable to less developed countries. Such technology is highly capita intensive but developing countries need a lab our intensive one. In addition, technology brought in by MNCs is highly expensive. The MNCs charge exorbitantly in the from of fee and royalty, which put a severe strain on the foreign exchange resources of a developing country. There are also instances of “technology is

dumping”, which implies that MNCs use obsolete technology with the help of turnkey projects shipped down from the principals of other countries. MNCs tend to make industries in developing countries permanently dependent on foreign expertise and technology.

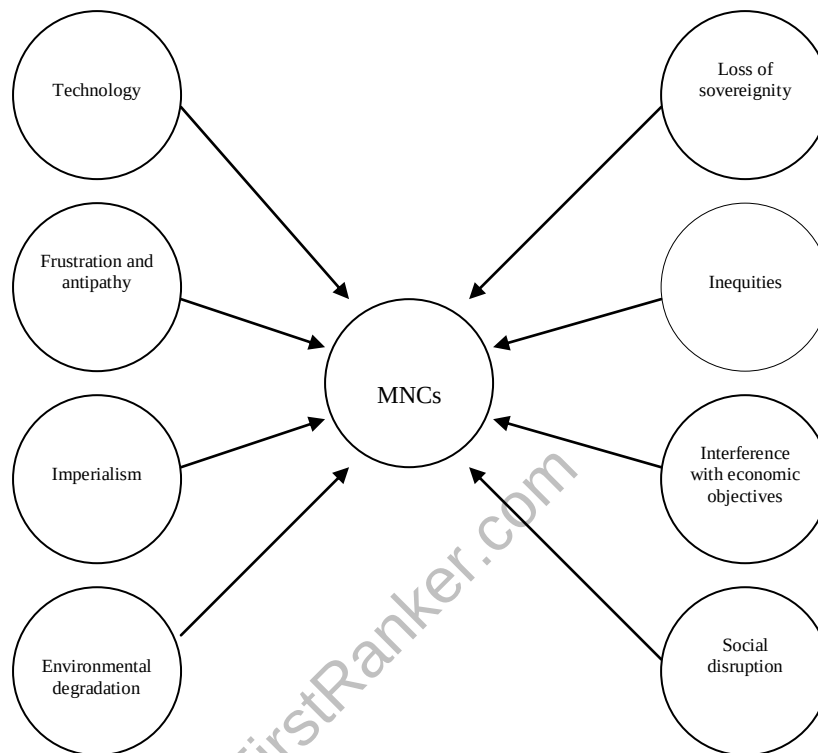


Fig 2. Grouse against MNCs
MNCs AND HOME SOCIETIES

Public attitudes toward MNCs are biased by a nation’s position as a home or host country. Historically, home countries have perceived MNC activities as desirable extensions of their domestic business systems. Conversely host countries have viewed MNCs as agents of foreign influenced and exploitation. This historic dichotomy is now shot through with conflicting perceptions of the

MNCs. Different segments of society, such as labor, investors, consumers, traders, and farmers, see their interests affected in different ways. As a result, a multisided controversy about the societal merits and demerits of MNCs has grown in both host and home countries.

Home country conflicts

The most aggressive challenge to the traditionally supportive home country policies towards MNCs has come from organized labor.

Labor Conflict

Multinationalization has created for management new mobility and flexibility that have greatly enhanced its bargaining power vis-à-vis labor. Since the sourcing base of the multinational firm knows no national boundaries – it can draw anywhere in the world the capital, technology, raw materials, ideas, and labor that it needs – management is not dependent on any one country's labor supply or labor union's policies, but can choose from among a number of potential hosts for any particular operation. In the short run, this new managerial latitude may be limited by the relative immobility of investment in given facilities – the sunk cost constraint – but in the long run nearly all operations can be transferred from one location to another. More significantly, all new investment, whether for replacement or for replacement or for expansion of plant capacity, is internationally footloose and will seek domicile wherever the comparative advantages happen to lie.

To labor unions this international mobility of the MNC portends an ominous doom. Though international in ideology, the unions have failed to acquire any international operational capabilities of their own. Their organization and policies have remained strictly national or sub national. Deriving their legitimacy and enforceable powers through national and local legislation, labour unions became an integral part of the nation state's internal apparatus. This worked in labor's favor so long as business consisted of MNCs. By effective organization and concentration of labor influences into large, well disciplined

unions, a sufficient counterweight to management power was created to allow unions to bargain from a position of strength.

Having focused its efforts on countervailing the powers of the domestic firm, labor scored impressively by achieving equivalence, if not dominance, at the bargaining table. But its narrow focus missed the broader scene. As the international expansion of business started converting UNCs into MNCs at an accelerating rate, labor's domestic entrenchment provided no possibility to match the expansion of managerial powers. Thus a disparity gap was opened. Given the continuation of the multinationalization of business, this gap is certain to widen as long as labor unions remain uninternational in scope and capacity.

This shift in the balance of power in management's favor signals to labor leaders a retreat to subservience and subordination that the movement can neither accept nor endure. To labor, therefore, the MNC is not a villain or culprit of the normal management sort, but an antagonist of an entirely new and mortally menacing variety. Against it, a total struggle seems to be American labor's resolute response. The unions attack MNCs as inherently inimical to the domestic economy and seek legislative remedies that would severely restrict multinational corporate operations. Labor's lobbying campaign charges the MNC with the following detrimental effects:

1. **Investment depression.** The MNC foreign investments deplete capital resources needed for domestic investment, thus undermining economic growth and new job creation in the United States.
2. **Technology drain.** The MNC exports U.S. technology in order to exploit low cost foreign labor, depriving the U.S. worker of his or her rightful opportunity to share in the utilization and rewards of this technology. Through technology transfers and foreign investments the MNC replaces U.S. workers with foreign workers; that is, it exports jobs.
3. **Export displacement.** The MNC displaces U.S. exports with foreign produced goods, thereby decreasing domestic employment and payrolls,

causing the U.S. trade balance to deteriorate, and depressing economic conditions at home.

4. **Low wage imports.** The MNC substitutes imports from its U.S.-affiliates in low wage countries for U.S.-made goods. These imports undermine U.S. wage standards, cause unemployment, and idle plant facilities.
5. **Tax evasion.** The MNC evades taxes by deferring profit repatriation, manipulating transfer prices, and circumventing government regulations. The revenues lost to the national treasury result in a higher tax burden on the general public.
6. **Payments disbalancing.** The MNC's activities have afflicted the United States with chronic balance of payments deficits, fueled inflation, debased the dollar as a stable currency, and contributed to international monetary disorders.

Offshore Plants

The recent proliferation of offshore manufacturing has become the focal point of the labor union's concern. Since the offshore plants represent clear-cut transfers of production rates to low wage countries, unions depict them as inherently symptomatic of all multinationalization projects of business. What the unions leave unsaid is that manufacturers "have transferred offshore production processes in which they have lost their international competitive advantage. It has been a relatively successful way for threatened firms to retain competitiveness and for developing countries to exploit their own comparative advantage.

For the MNCs the movement offshore is essentially a reactive strategy to low cost competition which, from management's perspective, can best be met by international restructuring of production: locating capital intensive, high-technology facilities in industrial countries and labor intensive, low-skill plants in less developed areas.

To remedy the situation, organized labor has lobbied for legislation to regulate MNC operations. It has called for (a) the creation of a federal investments commission to license and supervise transnational capital transactions; (b) restriction of outward transfers of technology, by subjecting patents to export licensing and prohibiting foreign production of a patented product; and (c) by eliminating the foreign tax credit and the deferred tax status of the affiliates profits.

Ideological Dilemma

International solidarity has long been an ideal of the labor movement. Workers' organizations everywhere confronted the same problems and strove for the same goals. Devoted to collective action as counterforce to exploitation, labor unions from the start aspired to cooperation and communication with their brothers, regardless of country.

Labor unions in countries hosting the affiliates of MNCs find the present protectionist offensive aimed more against them than against the MNCs. This confrontation between the home country and the host country unions remains an unpredictable source of conflict in multinational business relations.

MNC EFFECTS ON HOME COUNTRY

TRADE AND PAYMENTS

The mounting criticism of MNCs has produced a flurry of research projects aimed at determining how the creation of foreign affiliates affects the domestic economy. Several of these studies have been conducted to support some group's special interest or ideological assertions; however, sometimes the truth is better reflected by what the researchers failed to find than by what they did find.

MNCs AND HOST SOCIETIES

The presence of MNC affiliates is a profoundly significant reality in much of the world. Most host countries have wooed MNCs through investment incentives

and many other means. To push back the tyranny of material wants, low productivity, and aversion to change, various countries have sought the cooperation and capabilities of MNCs. Even the Soviet Union and other communist countries have started to seek ways to entice MNCs to cross their previously ironclad borders. Thus, the push toward the propagation and growth of the MNCs has been global in scope.

Increasingly, however, the MNC has become a source of controversy, at times acute resentment, in many countries. Canada, France, India, Iran, and some African states are widely publicized sites of recent dramatic clashes between governments and MNCs. Similar conflicts have surfaced elsewhere throughout the world.

ADAPTABILITY OF MNCs TO HOST ENVIRONMENTS

All MNCs are not equally likely to cause friction and tension in their host economies. Some adapt with relative ease and become closely integrated with their host environment, both economically and socioculturally; others remain isolated and insulated, often forming alien enclaves in the host society. There appears to be a causal relationship between the MNC's organizational structure that is, its organizational design as well as its underlying objectives and strategies –and its capacity for social adaptation to host country conditions.

In terms of inducement to social conflict, MNCs fall into three categories: home dominated, host dominated, and internationally integrated.

Home or Parent Dominated MNCs

These enterprises are organized and managed in such a way that the foreign based subsidiaries and other affiliates, whatever their specific legal form, serve primarily in a complementary support role. Their function is to help the parent company achieve its business objectives in the headquarters country. The subsidiaries have an entirely dependent role. Their local interests and needs, including social adjustment, are subordinated to and, if necessary, sacrificed for the parent company's home operations. Highly centralized, run by absentee

decision makers, and serving purposes external to the host countries, the home dominated MNC is very likely to cause host country conflict. Its insensitivity toward host nation needs is compounded by its ethnocentric managerial behavior.

This type of MNC has been particularly, but not exclusively, characteristic of extractive industries and notice entrants into multinational operations. Increasing self-assertion of host country governments has put home dominated MNCs under increasing pressure to reform or divest.

Federated or Host Dominated MNCs

In its pure form this model is an MNC whose headquarters is set up more like a holding company than a management center. The actual management authority, except for general policy guidelines, is delegated to individual subsidiaries. The company is highly decentralized; the subsidiaries are managerially autonomous or very nearly so. Each subsidiary is run by executives who are local nationals, who rely on local methods and decision-making processes, whose leadership style derives from the indigenous social norms, and whose personal standards and loyalties are identified with the host society. In brief, there is a tight integration of each affiliate with its host country.

The federated MNCs are the least susceptible to social conflict – they seem to be a sociologist's ideal. From an economic perspective they are far less perfect. The high degree of autonomy that each affiliate enjoys severely limits the MNC's ability to utilize its capacities as effectively as a more closely coordinated structure.

Internationally Integrated MNCs

These firms are organized to pursue objectives and activities that are worldwide in scope and concept. Their primary interests are not identified with the headquarters country or with any other particular nation. They are apolitical and anational institutions. To be sure, they must have nationality for the purposes of meeting statutory requirements as legal entities to be licensed to do business, but

this is nationality only in form; in substance they are transnational or perhaps even supranational. Their primary loyalty is to the company itself rather than to any nation. Their purposes, behavior, values, and operational incentives all derive from their own multinational structure, not from home country or host country policies or patriotisms.

The substantive essence of such companies lies in international specialization and managerial integration, a process often called international rationalization. These MNCs specialize production according to the principle of comparative advantage: acquiring inputs from countries with lowest relative costs, that is, locating production facilities for each component in the country best endowed with the necessary resources, and distributing outputs in the markets where the rewards are greatest. Thus, they possess a competitive advantage, a productive superiority, over domestic or uninational firms in both developed or developing countries. This productive superiority derives from the wider range of strategic choices; they are always able to choose the least costly production alternative and to combine it with the most profitable marketing alternative.

Because of their greater productive efficiency and profitability, the globally integrated MNCs represent the fastest growing segment of international business. The growth is propelled in part by the expansion of these companies themselves and in an increasing part by the adoption of the globally integrated model by other companies. The process of conversion from other structural forms of international business to the globally integrated mode is only beginning. Much further growth is certain to take place in the next several years. Only a return to ultraprotectionist trade barriers could thwart this trend. Consequently, the integrated MNC is the most likely to demand attention in any search for solutions to the problems of social responsibility of multinational firms.

Conflicts between the globally integrated MNCs and host nations arise from the fundamental fact that the inner logic of such transnational enterprises is violated

if identification of corporate interest with the national interest of any particular host state is imposed. The violation is interference with the international optimization process of the company, which tends to destroy its productive superiority, not to mention profitability.

AREAS OF CONFLICT

Although the MNC has no power over the host government, it may have considerable power under that government. By being able to influence certain factors, the MNC has the opportunity to help or harm national economics; in this sense, it may be said to have power against host governments. Critics of the MNC perceive these powers as potential perils to host societies.

The strategic aspects of a host country's national policy that are subject to the influence of the MNC include:

1. Planning and direction of industrial growth
2. National control of key industries
3. Financial policy
4. Export-import policy
5. Pricing policy
6. Research and development
7. Human resource policy

(1) Planning and Direction of Industrial Growth

Host nations have viewed with concern the tendencies of many MNCs to centralize strategic decisions in their headquarters. For the host governments this signifies loss of control over industrial strategy to the foreign-based MNC. The MNCs' allegiances are geocentric; their overall objectives are growth and profits globally rather than in the host economy. These objectives require efficiency in the functional areas of management – production, marketing, finance, and so on. Many MNCs have sought greater efficiency through centralization, with headquarters domination of affiliates as the unavoidable result.

Risks of Excessive Centralization Empirical evidence indicates that a high degree of centralization tends to lead to inflexibility of parent company policies. Decisions are made in headquarters regarding the product mix for each affiliate, extent of interaffiliate sales of semi finished and finished products, export pricing, interaffiliate sales, input procurement, packaging, long-rang planning, research and development, and, particularly, financial management. When the authority over these vital business decisions is located beyond their jurisdictions, local authorities counter with restrictions on affiliate activities. Clearly, centralization extracts a price from the MNC. A satisfactory method of calculating it is yet to be devised. When things are sorted out the price of centralization many well turn out to be far greater for many firms than the operational simplifications gained by it.

Government Goals Governments of all nations, particularly those of the less developed countries, are assuming more responsibility for the achievement of economic growth and social goals than formerly. To be successful they need a fairly high degree of certainty in the business sector. The presence of affiliates managed from foreign-based headquarters introduces uncontrollable factors that interfere with the government's planning and policies of economic development. With substantial segments of industry owned and directed from abroad and with home country governments bent on perceiving the affiliates as foreign extremities of their economies, the host governments see a serous challenge to their ability to affect the desired goals.

The more responsibility for economic growth and stability the government accepts, the greater its direct involvement in business regulation and direction, and the greater the possibility that the MNC will be perceived as a potential agitator of the national plants.

(2) National Control of Key Sectors

The MNCs' technological power and their tendency to cluster in key industrial sectors has given rise to another fear in the host countries. By permitting foreign investors to control key industries, nations are in the precarious position of losing control over strategic sectors. The fear of industrial domination is no chauvinistic fiction but in many instances an obvious truth.

Technology Gap The ability of the headquarters company to determine whether, when, and how the newest techniques are employed by affiliates has aroused fears in host nations of an increasing dependence on the MNC for technological progress. It has been argued that this dependence is attributable to a technology gap between the United States and other countries. A lesser commitment of European- and other non-U.S.- based companies to research and development is given as the cause of the gap. Researchers who have attempted to go beyond the expenditure figures discredit the technology gap theory by showing that technological inventions and innovations have come no less frequently from Europe than from the United States. Furthermore, the European inventions have tended to be major breakthroughs. The issue is by no means clear as far as Europe or Japan are concerned; however, there is no room for argument on this point in reference to the developing nations.

The necessity of relying on the home country's technology, in turn, leads to the fear of foreign control and ownership of industry. As a given industry sector becomes dominated by MNCs, the host country becomes dependent on the technological in-transfers of the foreign-headquartered MNC for its growth and product development. Once achieved, the dominant position of the MNC is believed to be self-perpetuating. Dominance itself provides the affiliate with resources to help perpetuate its role as the major innovator.

National policies aimed at greater independence in technology are a mixture of the desire for local research and development facilities and their ownership as well as the desire for technically advanced items produced locally. However, it appears that many countries have no feasible alternative to relying on foreign

technology. They need MNCs in order to avoid stagnation of the economy and bring about indigenous development.

Foreign Takeovers The strategy of some MNCs has been to place their direct investments in the host country into acquisitions of pre-existing indigenous firms. To the host country this strategy conjures visions of takeover by foreigners. In smaller or less industrialized countries the point is quickly reached when no nationally owned companies may be left in a particular industry. Thus, a foreign monopoly control is created. Larger nations, too, are sensitive to foreign takeovers.

A number of nations are reacted to such fears by restricting acquisitions to prevent the elimination of local competitors and by channeling foreign investments into the establishment of new firms that make a larger real contribution to the host economy and avoid the disturbance in the market that major acquisitions typically cause.

The possibility of the MNC eliminating indigenous competitors is real. With its superiority in resources (financial, managerial, and technical), the MNC is often at an obvious competitive advantage compared to the domestic firm. Oftentimes the MNC enters a host country in which it already possesses a strong market position built on imports. This makes it a much more formidable threat to local competitors.

(3) Financial Policy

As a matter of financial policy the MNC can choose to invest its profits either in the host country or elsewhere. The host country government naturally prefers domestic investment, but the power lies with the MNC to determine where the profits will be allocated.

Balance of Payments The MNC may help relieve a deficit in the host country balance of payments. No conflict arises in this situation. The firm may also contribute to the worsening of the host country balance of payments.

The MNC has been indicted for causing capital flows to fluctuate and even reverse. In addition, increased investment in the host economy very likely increases the market share held by the affiliate, which can conflict with host country interests. This makes the allocation of profits a very sensitive area. If the aren't decides to transfer the profits outside the borders of the host country, the latter gains no benefits from the investment potential of the firm. If the dividends to the parent company fluctuate from year to year, the payments position of the host country may be destabilized.

Borrowing Power The source of borrowed funds can also create conflict. This enables the MNC to import much larger sums than a unination company could. The potential threat to the balance of payments position of the host country is similarly greater.

Also, host government domestic monetary policy may be easily undermined by the countering efforts of the MNC. A typical example involves the MNC's extension of credit to a foreign subsidiary at a time when the host nation is attempting to dampen domestic purchasing power through import restrictions and exchange controls. Thus, the foreign-owned affiliate has the power, cash, and credit to avoid efforts by the state to constrain credit and investment.

Even though the magnitudes involved are not large in comparison to major elements in the balance of payments, and many countries have substantial earnings from overseas investments, these points are overlooked when attitudes toward foreign investment are formed within the host country. The exact impact of an inward foreign investment on a country's balance of payments is usually too complex to be easily explained.

(4) Export-Import Policy

The export-import activities of the MNC can also affect the host county balance of payments. Exports from affiliates may be subject to decisions made in the head office that seek to fit the affiliate's trade into the international marketing scheme of the MNC as a whole. This means the affiliate's exports could go to

the parent or other affiliates instead of to customers desired by the host government.

Another host country criticism of the MNC is that it may allocate export markets among its affiliates, thereby preventing them from exporting as they might otherwise and damaging the prospects for expansion of exports of the host country.

Importing policies may be similarly dictated by the home office. Affiliates may be directed to import from the parent itself or from other affiliates instead of using resources from the host country, thus further contributing to a trade deficit on the part of the host.

However much the MNC may contribute to economic growth and stability in the host country, the fact that the parent has the ability to alter the activities of the affiliates increases the uncertainty facing the host government. The fact that the MNC's decision center is outside the jurisdiction of the host government further compounds the uncertainty.

(5) Pricing Policy

The controversial aspects of MNC pricing relate in part to intracompany pricing or transfer pricing and in part to pricing policies for customers outside the company itself.

Leakages Through Transfer Pricing Transfer prices can be calculated so as to shift assets among the entities of the MNC through intracompany (interaffiliate) sales, royalties, technical assistance fees, and the allocation of headquarters expenses. The potential significance of these flows to the host country balance of payments is indicated by the fact that remittances by foreign affiliates to the headquarters of MNCs have been consistently far greater than the flow of funds from headquarters to the affiliates.

Transfer pricing is capable of serving various other objectives unless it is prevented from doing so by effective government regulations. If the host countries employ foreign exchange restrictions, the transfer price may be

designed to circumvent the restrictions. If a particular host country has high profit taxes, the transfer price may be used to reallocate the profits to a low tax country. When economic or political instability plagues a host country, transfer prices can be used to keep to a minimum the company's cash reserves in that country. Transfer prices can also be used to strengthen the competitive position of a company or to neutralize the competitive advantage of others. If used for these or similar purposes the transfer price becomes an obviously objectionable device.

Power to Undercut Local Competitors In market pricing, local industry often fears the ability of the MNC affiliate to cut prices to any level necessary to achieve either a foothold or to increase its market share. It is possible for a large MNC to absorb sizable per unit losses on its sales in a small host country without sacrificing its overall profitability. Thus, there is reason for the local people in such countries to be on guard.

Some MNCs have established a global single price policy; that is, the same price applies all over the world. By doing so the MNC denies itself the ability to respond to the demands of individual country markets or to utilize to its maximum advantage the oligopolistic market structure of most host countries. The problem becomes further complicated when trade barriers and government regulations create inducements for differentiating prices among host country markets.

(6) Research and Development

Research and development can cause a conflict of interests between the MNC and the host country in several ways. The first is the location of the research and development facilities. Most host countries urge MNCs to establish local research and development capacity. Having creative work going on helps to accelerate efforts in other areas of scientific research and innovation in the host society. MNCs, however, tend to concentrate research efforts in the home

country. Of host countries the most advanced nations are preferred because of their educational institutions and scientific talent. Whatever the scope of the affiliate's research and development program, growth of such a department is dependent on the home office. And whatever the pattern of relationships concerning research within the firm, it is not one that eliminates the dependence of the host economy on the parent company's technological priorities.

Even if research is done by the affiliate in the host country, the issue of ownership rights over the findings can cause conflict. Should the company decide to use the results of the research in some other country, the benefit to the local economy is minimized.

In sum, the MNC usually helps the host country reach a higher level of technology, but not as fast as the nation wants, nor is the technology necessarily the type that the host government deems appropriate for its needs. Further more, there is the problem of who controls the results of the research. So long as domestic ownership and control over key sectors and key technology have not been achieved, national governments feel threatened. The conflict over ownership of technology is taking on new dimensions as MNCs expand their research bases to host countries and as more and more host countries assume the dual role of both host and home country.

(7) Human Resource Policies

In the early stages of international growth, a firm tends to staff its foreign-based affiliates with headquarters country managers, that is, home country expatriates. The advantages here are twofold: first, simplicity of selection, appointment, and promotion, all of which can be done in a unilateralist frame of reference without disturbing the established practices and routines of the firm, and second, the relative uniformity of backgrounds of all managerial cadres throughout the multinational structure-everybody is the product of the same national and corporate cultures and has reached his or her position by playing by the same rules.

Third Country Expatriates Another source of executive talent is the third country expatriate, who may be defined as a manager who is a citizen of Country A and works in Country B for a company headquartered in Country C. Most of these are multilingual Europeans or Orientals with a European education. Many are refugees from communist countries. Third country nationals are reported to be more adept at integrating themselves into new situations and making friends in a foreign social setting than the unilingual U.S. expatriates.

A number of U.S. companies have expressed a definite preference for third country expatriates in overseas management positions. The versatility of third country executives may indicate high mobility toward top management positions. For example, one establishment MNC, Nestle of Switzerland, has long used non-Swiss in top corporate posts. Of the top eleven members of Nestle's present board of directors, six are non-Swiss.

All expatriates are a potential source of host country conflict. The local society generally views them with mixed reactions. The upper classes may resist the expatriate because he or she is an influential outsider who threatens the local power and prestige structures. At the same time, they realize the expatriate brings new technologies and behavior patterns that benefit their country and themselves. The lower classes resent the presence of expatriates because they are foreigners and because they hold prestigious high paying positions. Racial or religious biases tend to compound the resentments further. The MNC must learn to sense and be guided by the strength of these nationalistic and xenophobic feelings. Host society reactions will range from slowing of permits and documents in government offices to acts of terrorism and destruction of property.

Host Country Nationals Established MNCs have come to rely heavily on host country nationals as the source of executive personnel. The reasons for this switch have been the following: the need for understanding the local

environment, the rapid growth of overseas operations requiring speedy expansion of the management group, the increased ability to utilize individuals with different national backgrounds successfully in the corporate structure, and direct or subtle pressures by host country authorities to replace expatriate managers with indigenous employees.

While all host governments appear to favor their people strongly in executive assignments, they nonetheless can violently object to the salary policy of the MNC. In this area the MNC can be criticized if it holds fast to local salary standards, for underpaying local nationals in comparison with headquarters executives, and criticized if it exceeds the local standards, for undermining local firms and pirating their best people. This is a real dilemma.

Personnel Practices In the arena of employment policies, there are several potential conflicts. One is the attempt to impose the home country's methods, mannerisms, and behavior patterns on the host society through the operations of the affiliate. For example, an Italian affiliate of one MNC scheduled two hours for lunch and a half day of work on Saturday, as is customary in Italy. Taking for granted that shifting the working hours and workdays of the week would lead to greater productivity, the head office ordered the affiliate to drop the Saturday shift and to shorten the lunch time to 45 minutes. This change met such strong resistance from the Italian workers that productivity plummeted.

The hiring and firing policies of affiliate of most U.S.-based MNCs parallel those of the parent company; that is, firms shift management personnel, lay off redundant employees, and regroup and retrain labor to meet new tasks. These dynamic and sometimes harsh policies are contrary to the social values of many foreign countries, where customarily both managers and labor receive more stable treatment by the firm and are tied to the firm for extended periods of time. In the area of worker recruitment and training the MNC encounters several problems. In less-developed countries, the most common problem is the scarcity of skilled people – workers, managerial personnel, research and

development scientists, and technicians. If the firm imports the needed skills, the host country must forego both the training and the jobs for its own nations; for the MNC to undertake the required training programs locally is often financially prohibitive.

In certain host countries manual work cannot be included in any training programs for supervisory personnel because of the strong social stigma attached to it. The same may be true sales. There are difficulties in interesting educated nationals in sales positions in certain countries because in those countries sales work is low in social esteem.

Conflicts may arise also from the promotion policies of the MNC. Some countries have rigid social stratification in which on-the-job achievement and economic performance are not recognized. Merit-based promotion of the most competent or deserving personnel to management or supervisory positions, thus, flies in the face of expectations and notions of social propriety. Perhaps the best example of this problem would be the promotion of a member of a lower caste to a position of supervision over a member of a relatively higher caste in India. While less obvious, the same conflict is encountered in many other, particularly developing, countries in a more subtle context.

Transborder Data Flow

Recent advances in both computer and telecommunication technologies have led to their convergence into a new activity, telematics. Modern telecommunication facilities have overcome time and distance as major obstacles to the access of sophisticated computer services for the processing, storage, and retrieval of machine-readable information.

Data did, of course, move across national boundaries before the advent of telematics. But traditional media (such as postal, telephone, and telex services) are increasingly being replaced by the electronic transmission of data. The fusion of advanced electronic processing capabilities with modern telecommunications facilities and the speed, accessibility, and interactive

capabilities through which time and distance are overcome as obstacles to large-scale information mobility, give transborder data flow its potency.

MNCs play a central role in establishing the required telecommunications infrastructure; they produce the necessary computer hardware, software, and peripheral equipment; and they offer a growing range of data-processing services as well as access to an expanding amount of machine-readable data.

This situation poses a dilemma to all LCDs. On one hand they recognize the great significance of telematics for obtaining accurate economic and political information both in their domestic and international spheres; on the other hand they feel vulnerable because of their inability to match the MNC's capacity with their own facilities of telematics and transborder data transmission. The competitiveness of their domestic companies is thus threatened by the MNCs' growing superiority in identifying alternatives and reducing uncertainties, facilitating implementations, and effectively pursuing profitable business ventures. Beyond the activities of the MNCs, the host governments perceive the increasing role of telematics and transboundary data flows as negatively affecting all aspects of relations between the poor and the rich countries; to the extent that their ability to collect, store, process, and access information is inferior – and the lag has been increasing – they fear their ability to negotiate persuasively and interact effectively with other nations will be eroded.

Because of these concerns, less-developed host countries have started to promulgate regulatory measures requiring MNCs to share their telematic equipment and software technology with various indigenous installations for the production, processing, transmission, and dissemination of a wide variety of data: economic, scientific, political, social, and legal. It is highly doubtful that MNCs will be able to accommodate all these demands. The telematics issue is too new to allow any informed predictions as to the compromises that will be ultimately struck between the host governments and MNCs to resolve it.

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NATIONAL SOVEREIGNTY OF THE HOST COUNTRY

Erosion of national sovereignty appears to be the pervasive fear resulting from the expansion of the MNC. This loss may be the consequence of dependence on foreign technology, foreign industrial dominance, or the MNC's ability to effect its own desired results. Losing its sovereignty, the nation loses its power, and without power the existence of nationhood, even its identity, becomes problematic.

By increasing the international influences, the MNC may reduce choices open to the host government regarding the most appropriate means of guiding the domestic economy. The policies and activities of MNCs do affect the balance of payments, economic planning, competitive climate, development of technology, and many other aspects of host economics. Intensified by sensitized nationalistic sentiments, these effects reinforce the perception of peril to the host society. To alleviate host country fears, MNCs must learn to adjust their activities to the indigenous needs and sociocultural attitudes of host societies.

TECHNOLOGY TRANSFER

Technology is a new variable in the equation of economic relations. Traditional theory assumes that all nations have equal access to technology and, therefore, that there is no need to transfer technology from one country to another. Recent research findings have invalidated this assumption. In addition, they point to technology differences as primary cause of international inequalities in economic achievements. To reduce the inequalities, technology capabilities of the backward nations must be strengthened. The quickest way to do so is to transfer technology from the developed to the developing nations.

Definition

Technology is any device or process used for productive purposes. In its broadest sense, it is the sum of the ways in which a given group provides itself with good and services, the group being a nation, an industry, or a single firm.

There is a fundamental characteristic of technology that demands clear recognition. Unlike commodities and capital, technology is not depleted or its supply diminished when it is transferred or used. It is usable but not consumable. Once created, technology is inexhaustible until it becomes obsolete. Therefore; export of technology need not cause the source country to reduce its use of the technology. Indirectly, a decline may result if the recipient country creates an industry large to change the global supply and demand equilibrium of the goods produced by the technology involved. For most technology sought by the developing nations this is not the case.

Sources of Technology

Contrary to the classical assumption, technology is not a free good but a valuable property, nor is it evenly distributed around the globe. The supply schedules differ widely from country to country. To obtain new technology, a nation has three alternatives:

1. Produce the technology capability at home
2. Import it from abroad
3. Import goods containing the desired technology

For most LDCs, home production of technology is often uneconomic. Since much of what they are seeking already exists in the industrially advanced areas, they can fill their needs by importation. Normally, the importation can be effected at savings over the domestic cost of research and development (R&D). R&D expenditures devoted to projects duplicating existing know-how are obviously wasteful. Thus, economic rationale requires that LDCs concentrate their home production of new technology on any unusual requirements that cannot be met from import sources.

The access to technology depends on its ownership. Nonproprietary technology belongs to the public. It is there for the taking, but it is not free. The taker must have the ability to gather it from libraries, public research institutions, or wherever it may be found. To locate the sources and to sort out what is usable and unsuitable from any given application may involve considerable cost, which might be called the assembling and packaging of technology. Consulting firms specialize in this type of service. They very sources and consumers of technology but instead act as intermediaries between the sources and consumers of technology.

Proprietary technology is privately owned. It consists, trademarks, and secret processes. The most efficient and profitable technology, often also the newest, belong in this category. Access to proprietary technology is at the owner's discretion. It may or may not be for sale. If the sale creates potential competitors, the owners' interest is served by not selling it unless the expected loss from new competition is less than the price for which the technology can be sold.

Much proprietary technology is not for sale. It can move only with investments of owner firm. This is embodied technology, as distinguished from disembodied technology, which can be transferred without the original owner's investments. All nonproprietary technology is disembodied.

At the macro and micro levels, nations people, and Organizations increasingly depend on technology for prosperity and quality of life.

The competitive edge of an individual firm vastly depends on technology. One of the means of acquiring technology is through its transfer.

Technology transfer coves various activities, including the internal transfer of technology from the R&D or engineering department to the manufacturing department of a firm based in a country. It also includes the same transfer of technology from a laboratory or operations of a MNCs in one country to its laboratory or operations in another country. Finally, It includes the transfer of

technology from a research consortium supported by many firms to one of the members. Simply told, technology transfer is a process that permits the flow of technology from of technology from a source to a receiver .The source is the owner or the holder of the knowledge and it can be individual, a company, or a country. The source is the owner or the or holder of the knowledge and it can be individual, a company .or a country. The receiver is the beneficiary of the transfer technology. Technology is transferred through published material (such as journals, books): purchase and sale of machinery, equipment and intermediate goods, transfer of data and personal: and interpersonal communication.

Technology transfer comprises six categories:

1. **International Technology Transfer**, in which the transfer is across national boundaries. Generally, such transfers take place between developed and developing countries.
2. **Regional Technology Transfer**, in which technology is transferred from one another .
3. **Cross-industry or Cross-sector Technology Transfer**, in which technology is transferred from one industrial sector to another .
4. **Interfirm Technology Transfer** ,in which technology is transferred from one company to another.
5. **Intra-firm Technology Transfer**, in which technology is transferred within a firm ,from one location to another. Intrafirm transfers can also be made from one department to another within the same facility.
6. **Pirating or Reverse-Engineering**, whereby access to technology is obtained at the expense of the property rights of the owners of technology.

Modes of Transfer

Since technology defies delineation as a discrete variable, the analysis of its transfer is encumbered by such other factors as capital investments, economic organization, labor resources, entrepreneurship, and even en sociocultural systems. Lacking disaggregated data, different analysts have used different composites as paxies for data on technology flows. Many economists treat direct foreign investments and licensing agreements as synonymous with international technology transfers. Others tabulate scientific and professional conferences, technical assistance programs, exchanges of educators and students, plus many

other kinds of information flows. Obviously, all of these have some technology content, but few are pure technology.

Importing Nonproprietary Technology

Non proprietary technology can be transferred from one country to another in any number of ways. Technology in pure form can be imported if the transferee possesses the capacities to collect and employ it. LDCs many rely on indigenous enterprises or on foreign firms to do the importing. Since LDCs often lack indigenous firms who can affect the transfer, they rely heavily on foreign consultants.

Another way for an LDC to obtain nonproprietary is by importing the hardware required and then either implementing a training program for its use or dispatching managerial personnel to study how to use the hardware. Experience tends to favor home-based training programs, initially with expatriate instructors from developed countries and later with indigenous instructors, over the alternative of sending people from LDCs to learn abroad. The advantage is twofold:

1. The home-based program ensures better adaptation of the technology to local conditions.
2. Fallout from the program is minimized by reducing the risk of “brain drain,” which has ravaged many foreign-based programs.

Importing technology intensive goods is the third method of obtaining new technology.

Importing Proprietary Technology

An LDC's access to proprietary technology is far more complicated. To acquire embodied technology it must attract direct investments by the desired industry. The direct cost of such acquisition is any special incentives that the country is required to offer to interest the potential investor, who may have more profitable investment alternatives elsewhere. If the incentives offered exceed the investor's opportunity cost of forgoing its other alternative, parties, the LDC and the multinational corporation (MNC), benefit. The LDC has no concrete way of

assessing data and the MNC's opportunity cost: it lack both the necessary data and the expertise. This gives the MNC a strategic bargaining advantage and wide latitude for its demands for incentives.

Proprietary technology that are readily for sale can be transferred by exporting turnkey projects, licensing patents or trademarks, selling formulas or blueprints, organizing training programs, Or dispatching experts. The choice depends again on the seller's preference-which serves the MNC's objectives best. Owner willingness to sell proprietary technologies varies widely. Some technologies, such as that of the latest IBM computers or coca-cola syrup, are absolutely nonnegotiable. At the other extreme are the so-called shelved technologies, for which their owners are anxious to find any takers at all.

The shelved technologies are mainly by-products of corporate R & D activities. For example, in the process of seeking improvements in aircraft and spacecraft technologies, Boeing researchers have discovered numerous patent-able techniques and compounds for which the company has no anticipated use.

The Market Model

LDCs' comparative technology deficiencies require access to technologies that belong to private firms. The governments of developed nations can facilitate the international transactional transfer process. But they cannot force the transfer to take place without expropriating private property. LDCs' requests for treaty obligations or other official commitments by industrial national to guarantee an expeditious and an expeditious and inexpensive transfer of technology is, therefore, largely a misdirected rhetoric.

Right and Wrong Technology

Any manufacturing process can usually set up using alternative configurations of equipment. In selecting the optimal equipment configuration, we must look beyond the general goals of low cost and high productivity and consider each configuration's demands for labor skills and attitudes, supervision, industrial engineering for tools and manufacturing techniques, materials and supplies,

maintenance, product scheduling, inventory controls, and quality control procedures. Each of these ingredients is directly affected by the environment. The economic environment affects costs and availability of workers; the political environment establishes what is acceptable for a plant to make and how. Thus, it is imperative that a technical strategy be derived in part from a realistic assessment of the total environment in which it is to operate.

Nationalism

The technology supply of LDCs is powerfully influenced by the policies of public authorities. Some groups in developing countries oppose technology imports and insist on indigenous production of new technology. They argue that since technology and growth are closely linked, those nations who are behind in the production of technology are destined to perpetual backwardness. This is false reasoning.

As high technology applications—automation, computerization, and robotics—are replacing many traditional factory systems in industrial countries, much old equipment is surpluses as economically obsolete, though physically intact. Many LDCs' needs for industrial systems can be met by utilizing this technological slack. Indeed, a number of multinationals have already affected transfers of entire factories to their affiliates in LDCs. Automobiles, trucks, refrigerators, shoes, pharmaceuticals, and metal fabrication head the list, but there are more and more others. Such they benefit the multinationals by extending the productive life of their capital assets.

PARTIES IN THE TRANSFER PROCESS

International technology transfer has both horizontal and a vertical dimension, each with its own elements. From the horizontal perspective, the three basic elements in technology transfer are the home country, the host country and the transaction. The vertical dimension of technology transfer refers to the issues specific to the nation state, or to the industries or firms within the home and host countries.

In general, the various elements may be categorized as (i) home country, (ii) host country, and (iii) the transaction.

Home Country's Reactions to Technology Transfers

Home countries express apprehensions about the export of their technology. They have reasons to oppose the export of technology. They argue that the establishment of production facilities by MNCs in subsidiaries abroad decreases their export potential. Additionally, they claim, because some of the MNCs' imports stem from their subsidiaries, the volume of imports of the home country tends to increase. Given the decrease in exports and increase in imports, the balance of trade tends to be adverse to the home country. Besides, technology transfer tends to affect adversely comparative advantages of the country. Labour unions in the home country too oppose technology transfer on the ground that the jobs generated from the new technology will benefit the country citizens.

Host Country's Reactions to Technology Transfers

More serious are the reactions of the host country to transfer. The subject of technology transfers is highly sensitive, often evoking strong reservations against it from the country citizens. The criticisms against technology transfer are based on economic and social factors.

Economic Implications Economic implications include payment of fee, royalty, dividends, interest and salaries to technicians and tax concessions resulting in loss to the national exchequer. All these are payable to the transferring country and might prove very expensive to the host country. In addition to the payments just stated, the technology supplier often succeeds in extracting payments through various other techniques like over-pricing and buying intermediates at high prices. There are malpractices too, for example, tie-up purchase, and restriction on exports, and charging excessive prices.

Many times, the type of technology transferred by international business is not appropriate to developing countries. The technology that is developed is

inevitably the one most suitable for industrial countries which are appropriate to resources endowment of developed nations. Such technology are not in the interest of developing countries.

Social Implications The social and cultural implications of technology transfer are more serious than the economic significance. Along with the transfer of technology, there is the transmission of culture from the exporting countries. The Indians who work in firms using such imported technology get influenced and accustomed to the skills, concepts, policies, practices, thoughts, and beliefs. Then there are social problems like pollution, urbanisation, congestion, depleted natural resources, and similar other evils.

Transaction

This element focuses on the nitty-gritties of the transfer. The issues here relate to the terms and conditions of technology transfer.

INTERNATIONAL TECHNOLOGY ISSUES

The more important International technology issues are ways of technology acquisition, choice of technology, terms of technology transfer, and creating local capability.

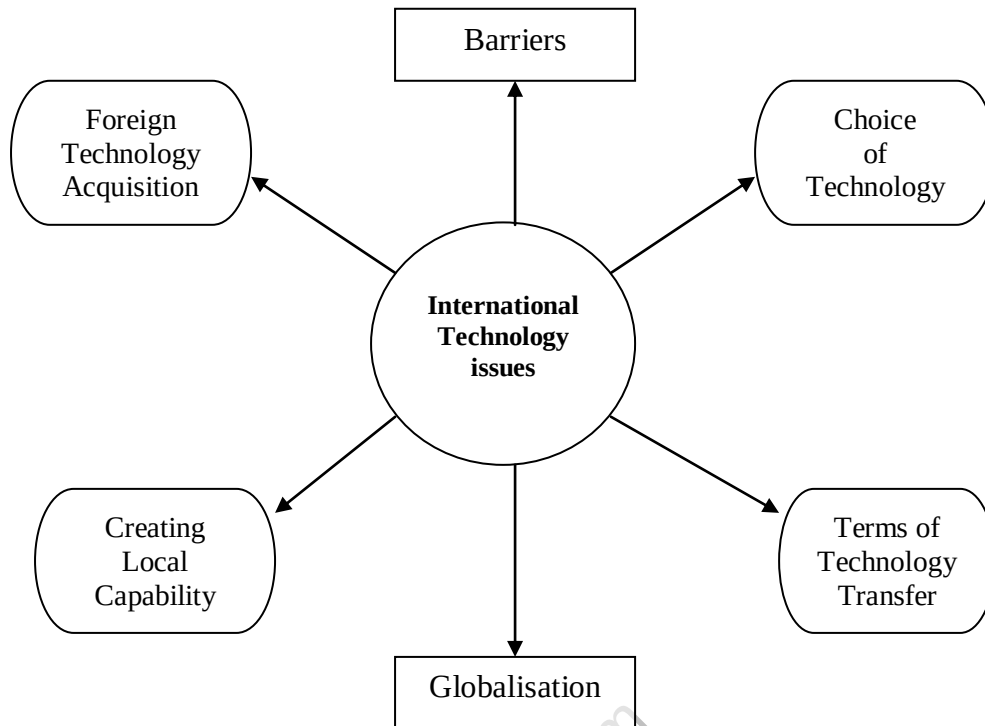


Fig. 3 Technology Issues

Foreign Technology Acquisition

One of the major issues in technology relates to the mode of acquisition. Developing new technology may conjure up visions of scientists and product developers working in R&D laboratories. In reality, new technology comes from many different sources, including suppliers, manufactures, users, other industries, universities, government, and MNCs . While every source needs to be explored, each firm has specific sources for most of the new technologies. For example, because of the limited size of most farming operations, innovations in farming mainly come from manufacturers, suppliers, and government agencies. In many industries, however, the primary sources of new technologies are the organizations that use the technology.

Broadly the acquisition routes are three: (i)internal, (ii)external, and (iii)combination.

(i) Internal Technology Acquisition This is result of technology development efforts that are initiated and controlled by the firm itself. Internal acquisition requires the existence of a technology capability in the company .This capability could vary from one expert who understands the technology application well enough to manage a project conducted by an outside research and development (R&D) group to full blown R&D department. Internal technology acquisition options have the advantages that any innovation becomes the exclusive property of the firm.

(ii) External Acquisition External technology acquisition is the process of acquiring developed by others for use in the company .External technology acquisition generally has the advantage of reduced cost and time implement and lower and risks. However, technology available from outside sources was generally developed for different applications.

(iii) Combined Sources Many of technology acquisition are combinations of external and internet activities. Combined acquisition seek to limitations and external sources, taking advantages of both the actions at the same time.

Making Decision

The technology manager must weigh the advantages and limitations of each specific route of technology acquisition and then make a decision about its choice.

Seizing Tacit Knowledge Taking advantage of knowledge available in- house is least expensive and has no risks. It will not leave when the knowledgeable person leaves the firm. Every firm will have employees who are knowledgeable and it is up to the company to identify and make use of the know-how.

Internal R&D Technology acquisition via internal R&D consists of having a research and development group within the firm. The group is responsible for creating the technology that the firm uses. This source of technology acquisition

enables the firm to become stronger, has the advantage to exclusivity, and may entail tax or other government incentives. Long time required, high cost and risk of failure are the demerits of this internal route of technology acquisition.

Internal R&D with Networking Internal R&D networking has all the same advantages and disadvantages discussed under internal R&D. the main difference is the fact that the R&D staff make a fairly concerted effort to keep abreast of the state of development of the technologies affecting their products. They network with technology creators at conferences and trade shows.

Reverse Engineering Reverse Engineering is the determining of the technology embedded in a product through rigorous study of its attributes. It entails the acquisition of a product that the firm believes would be an asset, disassembling it, and subjecting its components to a series of tests and engineering analysis to ascertain how it works and studying the engineering design criteria used in the product's creations.

Reverse Brain Drain This involves attracting expatriate entrepreneurs and experts who have gained adequate experience abroad to set up or develop enterprises in their countries of origin. Taiwan and China are known for this type of technology transfer.

Covert Acquisition with Internal R&D It entails finding out the technology developments being conducted by a competitor that are not open to the public. Most businesses do this to some extent by questioning suppliers about components being sold to the competitors or by socializing with the competitor's employees. The less scrupulous firms even become involved in industrial espionage using cameras, binoculars, and break-and-enter techniques to learn about the happening inside the competitor's plant.

Covert Acquisition This without internal R&D, guarantees that the product will be a copy (generally a poor one) of the competitor's product. The firm can introduce it at a lower price because there are no development costs to recover.

However, with the exception of the price, the product will have no other competitive advantage.

Technology Transfer and Absorption This route is similar to internal R&D with networking. The difference is that there is much more effort put into searching for, learning about, and translating, no-cost technology to the firm's applications. Internal technical ability is necessary to understand the technologies found and to develop them into solutions for the firm's application.

Contract R&D Firms resort to contract R&D for more than one reason. This is the ideal option for those that lack the necessary facilities and expertise to conduct the required work but still want to maintain control over the development and own the results exclusively. It is also a good choice for those that need a specialized set of equipment or expertise for occasional short term projects. This avoids the investment in these facilities and the on-going commitment to staff that would be underutilized. It allows short-term access to world class personnel and facilities for specialized projects that would otherwise be completely beyond the company's means. The advantages of this route are no investment in facilities, and low investment in staff. The disadvantages are: no hands-on-knowledge in house and difficulty in keeping information confidential.

R&D Strategic Partnership R&D strategic partnerships are almost the same as contracting R&D. They generally consist of a group of companies with a common need that collectively contract a research institution to conduct the work for them. This allows the firms to share the risk and costs. It also creates a situation where they can learn from each other as well as from the experts conducting the research.

The advantages of this route of technology acquisition are : shared risks, reduced cost, and possibility of learning from others. Need to share knowledge with others and the necessity of adopting research results to own application are the drawbacks of this route.

Licensing Another route of technology acquisition is licensing. Its major benefit is a significant reduction in time to market relative to other forms of technology acquisition that require development. It also enables the acquiring firm to share the financial risks of acquiring the technology with the provider because the bulk of the payments are generally in the form of royalty-a percentage of sales of product made using the new technology.

The circumstances under which licensing may be a preferred strategy are the following :

Where host countries restrict imports and/ or direct investment.

Where a specific foreign market is small.

Where prospects of technology feedback are high.

Where licensing is a way of testing and developing a market that can be later exploited by direct investment.

Where the pace of technology change is sufficiently. Rapid that the seller can remain technologically superior.

Where opportunities exist for licensing auxiliary processes without having a license of basic product technologies.

Where small companies have limited resources and expertise for direct foreign expansion.

Among the advantages of licensing technologies are costs and risks are less than internal R&D and time required to commercialise is less. The disadvantages are : exclusivity may be lost and internal capability may not be developed.

Purchasing A common and effective external technology acquisition method is purchasing. This is normally done in the form of buying a piece of production machinery with embedded technology. This is the quickest form of technology transfer because the technology is already packaged and is ready for use. It is

low risk because the equipment has been proven to be technically competent and there are already users to evidence the machine's capability.

Joint Venture Entering into a joint venture agreement with a technology provider is another form of external acquisition that can be very effective. Typically, this is a partnership between two firms, one with a technology and another with market access. It can take the form of the creation of a new firm with each of the partners owning shares in the new firm in proportion to the value of their contribution to the new firm. In this case production facilities are installed in the new firm with the partners bringing technology and market know – how along with capital investment into the new firm. The distribution and marketing of the product may use the system that the firm with market access has in place, or that firm's know-how may be used to create a dedicated system for the new firm. The advantages are the technology can be implemented immediately, as it is already proven. Risk involved is less and there are possibilities of learning from the provider of technology. The disadvantages are market risks are high and there are no chances of developing technical strengths.

Acquisition of a Technology Rich Firm The final form of external technology acquisition is the acquisition of a firm that has the know how which the acquiring firm desires. This can happen when one firm has a technological innovation that is impacting another company's innovation the second company negotiates to purchase the entire company. This can result from a defensive action or it can be deliberate strategy to acquire technology.

The outright purchase has advantages and disadvantages. On the positive side are: short time to market, low risk, and probability of buying good image. The problems are: possibility of acquiring negative baggage and merger problems.

Choice of Technology

The second major issue relating to technology transfer is its choice. It is argued that it is the industrialized countries that develop technology, and the know-how thus developed will be mainly useful to them. This means that the rich countries

become monopolists in developing, using and managing technology. This also means that the technologies tend to be designed for the production of high quality sophisticated goods on a large scale, using as much as possible capital and higher-level professional skills in place of sheer labour, and replacing natural resources by synthetics.

Terms and Conditions of Technology Transfer

The issue relating to terms and conditions of technology transfer and the question of the suitability of the transferred technology are related to each other. Some of the restrictive conditions, for example, make technology less suitable than it would otherwise be. This clearly applies to such restrictions as prohibitions on the adaptation of the imported technology, preventing the use of imported technology as a basis for local R&D development, and clauses stipulating that the results of local technological research and development based on the imported technology must be transferred to the owner or supplier of the technology.

Creating Local Capability

Creating local technological capability is essential to absorb imported technology. This stems from several reasons. Technology, it may be stated, is not simply a matter of blueprints, which can be transferred without any local effort, to any part of the world. Each time some technology is installed, some local adoption is required, which demands local technological capability. The greater the capacity, the more efficient the resulting operations. The need for local adaptation arises from the fact that the environment in which any technology operates is unique in any situation when it is installed and may even differ radically from the environment for which the know-how was developed in the first place. This is especially true when technology is transferred from MNCs to developing countries.

Globalisation :

The world economy is passing through structural changes. These changes are driven by globalization business as well as by the revolution in information, communication, and transportation technology. Now we have powerful technology in their hands, fundamentally transforming the way in which business is conducted around the globe.

The World Trade Organization (WTO) is contributing to globalization by removing trade barriers between countries and evolving mechanisms to manage technology better. The main provisions of the WTO that influence technology transfer are included under the following sections:

- Trade Related Aspects of Intellectual Property Rights (TRIPs)
- Trade Related Investment Measures (TRIMs)
- Subsidies and Countervailing Measures (SCMs)
- The Information Technology Agreements

Barriers to Technology Transfers

The final international technology issue relates to barriers. The problems encountered in transfer of technology are :

- A limited general understanding of the concept of technology, and the lack of a consistent framework for its study.
- Lack of systematic planning for technology transfer in developing countries or misunderstanding of its underlying philosophy.
- Lack of bilateral scientific/ technology advantages in the process of technology transfer (mutual benefits).
- Lack of systematic and integrated engineering and socio-economic approach to the technology transfer process.
- Lack of a relevant quantitative framework/approach to the analysis and evaluation of technology transfer to developing countries.

SUMMARY

MNCs have their business activities in cross national boundaries. MNCs has its own critics as well as the defenders too. Mainly the transfer of technology plays a vital role in MNCs and the nation's development. Since their inception the affiliates of MNCs have been a source of controversy in host countries. In the last few years the controversies have been complicated by the fact that an increasing number of host countries have started to acquire a dual status as some of their own firms multinationalize.

The most troubled MNCs are the home dominated ones, while the host dominated MNCs enjoy the greatest political tranquility. Neither can compete, however, with the internationally integrated MNC when it comes to productive efficiency and market power. Through international integration, MNCs locate their production facilities in the least cost countries and market their outputs in the most profitable countries.

Conflicts between MNCs and host nations often arise from differences between the internal structure of MNCs and the government of host nations. Other conflicts can be traced to the specific policies of MNCs, especially in highly centralized firms. Takeovers of local enterprises, financial policies, pricing, and export-import activities are typical areas of MNC government confrontations.

The employment of expatriate managers and technicians has met with increasing hostility in host nations. This has led to hiring and training of local nationals for management roles in affiliates. The compensation and promotion of local nationals in light of pay scales and opportunities elsewhere remain controversial issues.

SELF ASSESSMENT QUESTIONS

1. Define MNCs and explain the types of MNCs
2. List the MNCs critics and defenders
3. Centralization may decrease not only costs but also earnings of an MNC. Comment.

4. A number of MNC-host nation conflicts derive from central economic planning. Why?
5. Some MNCs expand by building new facilities; others by buying up existing firms. Which is preferable? Under what conditions?
6. Identify and analyze conflicts that arise from MNC financial policies and practices.
7. Explain international Technology issues
8. Describe the advantages and limitations in technology acquisition
9. Analyse the scope and mode of technology transfer
10. Enlist the barriers to technology transfer.

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UNIT IV

4.1 Nature of International Business Environment

Learning Objectives

4.1 Introduction

- 4.1.1 The Forces
- 4.1.2 Bases for going global
- 4.1.3 The Frame work for analyzing International Business Environment
 - a).Methods
 - b).The PEST Analysis
 - c) The Macro-Environment

4.2 Political Environment

- 4.2.1 Types of Political Systems
- 4.2.2 Political Risks Of Global Business
- 4.2.3 Forecasting Political Risks
- 4.2.4 Good Corporate Citizenship
- 4.2.5 Strategies To Lessen Political Risks
- 4.2.6 Government Encouragement Of Global Business
- 4.2.7 Instruments used by government for trade control
- 4.2.8 The Impact of the Political System on Management Decisions
- 4.2.9 Formulating and Implementing Political Strategies
- 4.2.10 Governmental Influence On Trade

4.3 Legal Environment

- 4.3.1 Origins of International Law
- 4.3.2 Sources of International Law
- 4.3.3 International Dispute Resolution
- 4.3.4 Types of Legal Systems

4.4 Technological Environment

- 4.4.1 Technological phases in production
- 4.4.2 Benefits of Technology in Management Decision Making
- 4.4.4 Effect of Technology on Strategy & Competition
- 4.4.5 Features of Technology
- 4.4.6 Diffusion of Technology
- 4.4.7 The Technological Cycle

4.4.8 Business Implications of Technology

4.5 Cultural Environment

4.5.1 The Concept Of Culture

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4.5.2 RECOGNITION OF INTERNATIONAL DIFFERENCES

4.5.4 The Elements of culture

4.6 Country Classifications

4.7 Economic Environment

4.7.1 Economic Environment

4.7.2 Classifying Economic Systems

4.7.3 Economic Trade Policies (Protectionism)

Learning Objectives

After reading this unit you should be able to

- Understand the nature of international business environment
- Understand the different forces acting upon international business
- Understand political environment and its implications on international business
- Ascertain the legal practices in different countries
- Understand what difference technology can create and know various technological tools used in international business
- Understand different cultures of the world and its impact on international business
- Understand different economic policies.

Introduction

Business has fascinated man down the centuries, starting from barter system to the global business. Business plays a pivotal role in the growth of the economy of any nation. Because of the explosion of knowledge and invention of Internet,

time and distance are shrinking globally and the world has become a global village.

In developing countries like India the traditional business are affected by MNC's and many Indian firms are forced to compete with the global firms, and it's the game of *The survival of the fittest*, and many local companies are forced to merge with global firms Eg. Vishya bank has merged with ING forming ING Vishya Bank, ICICI Bank has merged with Prudential forming ICICI Prudential Life insurance etc.

As part of their expansion in international markets Indian firms like M.T.R, Ranbaxy, Dabur, L.I.C, S.B.I etc are on their toes to globalize their operations.

In simple terms, the products which we use, in our day-to-day life are either imported from other countries are produced in India in collaboration with companies in other countries so international business is the process of exchanging goods and services internationally for value.

4.1 Nature of International Business Environment

The business operations performed without any barriers, with the implementation of L.P.G (Liberalization, Privatization, Globalization) there is boom in the global business and the trade barriers have been liberalized.

This has given rise to

- Attracted F.D.I Foreign direct investment
- Encouraged flexible import and export policies
- Import of jobs in the field of I.T enabled services (B.P.O)
- Increase in foreign currency reserves
- Improved standard of living
- Increase in purchasing power
- Improved quality of goods and services

Today, any company which is going globally need to assess different environmental factors like economic, technological, political, cultural, legal and design their operations.

To understand the international business environment we divide the terms

International

Integration and interrelation of different nations.

Business

Systematic effort of an organization to meet the needs of customers with goods and services for profit.

Environment

Environment is surroundings which we live in, the external forces acting upon the business is business environment.

The environment includes the factors outside the firm, which can lead to opportunities for or threats to the firm. These factors can be economic, technological, political, cultural etc.

Thus international business environment is the business operations in different countries with different external forces acting upon them.

Environment is further classified as domestic environment, foreign environment, and international environment

Domestic Environment

Forces within a country, which are very familiar and which are controllable or uncontrollable

Foreign Environment

Forces outside the country, which are not very familiar and which are controllable or uncontrollable

International Environment

Forces acting on business from different nations which are not familiar and which are controllable or uncontrollable

4.1.1 The Forces

Forces acting upon business are classified as follows

Internal Environmental Forces

Forces within the organization, which are controllable, like production, finance, marketing, human resources research and development etc

External Micro Environmental Forces

Forces outside the organization, which are controllable, like competitors, suppliers, creditors, consumers, financial institutions etc

External Macro Environmental Forces

Forces outside the organization, which are uncontrollable, like political environment, legal environment, technological environment, economic environment, cultural environment etc

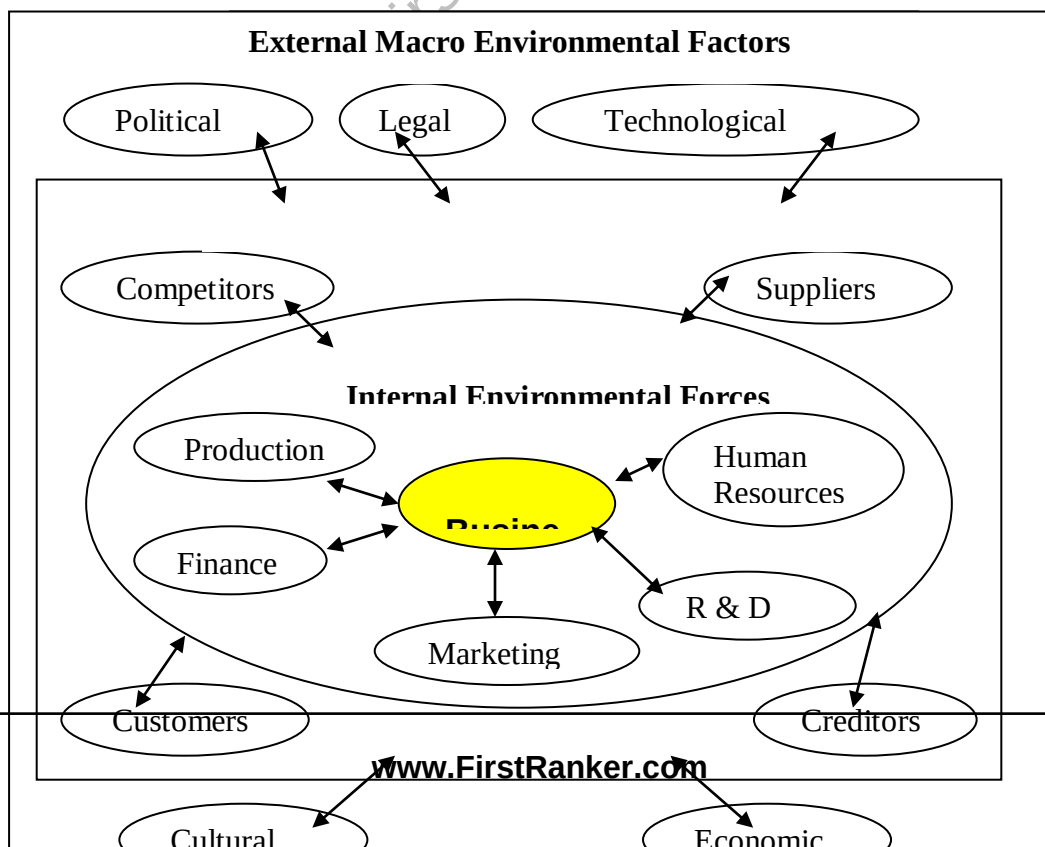


Fig 4.1 Environmental Forces acting on Business

4.1.2 Basis for going global

a) Availability of Highly Skilled & Cheap Labour

India is a country with the potential of highly skilled human resources with comparatively cheaper labour, which has attracted many M.N.C 's from U.S.A and U.K to outsource these resources from India which will cut short their heavy expenditure on wage and salary. Eg. T.I enabled services outsourced from India, business process outsourcing (B.P.O) , knowledge process outsourcing (K.P.O), recently legal process outsourcing (L.P.O)

b) Bigger Pie in Market Share

To increase the market share of the firm many companies are going global eg. In 1888, less than four years after William Hesketh Lever launched Sunlight Soap in England, his newly-founded company, Lever Brothers, started exporting the revolutionary laundry soap to India. By the time the company merged with the Netherlands-based Margarine Unie in 1930 to form Unilever, it had already carved a niche for itself in the Indian market. Coincidentally, Margarine Unie also had a strong presence in India, to which it exported Vanaspati (hydrogenated edible fat).

A year after the merger, Unilever set up the Hindustan Vanaspati Manufacturing Company, its first subsidiary in India and went on to strengthen its position by

establishing two more subsidiaries, Lever Brothers India Limited and United Traders Limited, soon afterwards. The three companies, which marketed Soaps, Vanaspati and Personal Products, merged in 1956 to form Hindustan Lever Limited

c) Sever Competition in Home Country

Due to many players in the home country and the increase in competition the weaker companies, which are unable to withstand competition has moved its operations to other countries

d) Quality Improvement and new product development

To improve the quality of existing products and developing new products the companies with joint collaboration with companies of other countries has gone globally eg. M.R.F a leader in Indian tyres market has entered into a technical collaboration with the B.F. Goodrich Tyre Company of USA, which was involved with the development of tyres for the N.A.S.A space-shuttle. With this began a significant exercise in quality improvement and new product development.

e) To Reach Higher Profits Level

To reach higher levels of profits the companies has expanded globally.eg The roots of Nokia go back to the year 1865 with the establishment of a forest industry enterprise in South-Western Finland by mining engineer Fredrik Idestam. Elsewhere, the year 1898 witnessed the foundation of Finnish Rubber Works Ltd, and in 1912 Finnish Cable Works began operations. Gradually, the ownership of these two companies and Nokia began to shift into hands of just a few owners. Finally in 1967 the three companies were merged to form Nokia Corporation. Today we find Nokia in every part of the globe.

f) Free Trade Policies

The North American Free Trade Agreement (NAFTA) has lifted all the trade barriers among U.S.A, Canada and Mexico which has enabled companies to expand their operations among those countries eg. General Motors has 284 operations in 35 states and 158 cities in the United States. In addition GM of Canada operates 21 locations, GM de Mexico operates 5 locations, and GM has assembly, manufacturing, distribution or warehousing operations in 49 other countries, including equity interests in associated companies.

g) Availability of Abundant Raw Materials

India is rich in natural resources like coal, iron etc which is attracting many foreign companies to establish their facility. Eg. Volkswagan and Nokia are planning to establish their facility in India

h) Government Regulations

Business firms prefer to enter the countries where there are flexible government policies, which will not change because of political instability. Countries like U.S.A has stable government policies which will attract business firms to enter into their country eg. All the U.S automobile industry is flooded by Japanese automobile companies like Toyota because of stable government regulations.

i) Availability of Technology

To keep abreast of world technology and to protect its competitive edge, Asian Paints has from time to time entered into technology alliances with world leaders in the paint industry. It has a 50:50 joint venture with Pittsburgh Paints & Glass Industries (PPG) of USA , the world leader in Automotive coatings, to meet the increasing demand of the Indian automotive industry.

j) Limited Home Market

Toyota motors of Japan has extended its base to U.S and India because of limited home market and U.S and India has got a greater demand for Japanese automobiles.

4.1.3 The Frame work for analyzing International Business Environment

a). Methods

There are three ways of scanning the International business environment:

- **Ad-hoc scanning** - Short term, infrequent examinations usually initiated by a crisis
- **Regular scanning** - Studies done on a regular schedule (say, once a year)
- **Continuous scanning** - (also called continuous learning) - continuous structured data collection and processing on a broad range of environmental factors .

Most commentators feel that in today's turbulent business environment the best scanning method available is continuous scanning. This allows the firm to act quickly, take advantage of opportunities before competitors do, and respond to environmental threats before significant damage is done.

b). PEST analysis

PEST analysis stands for "Political, Economic, Social, and Technological analysis" and describes a framework of macroenvironmental factors used in environmental scanning. It is also referred to as the STEP, STEEP or PESTLE analysis (Political, Economic, Socio-cultural, Technological, Legal, Environmental). Recently it was even further extended to STEEPLED, including ethics and demographics.

It is a part of the external analysis when doing market research and gives a certain overview of the different macroenvironmental factors that the company has to take into consideration. Political *factors* include areas such as tax policy, employment laws, environmental regulations, trade restrictions and tariffs and political stability. The economic factors are the economic growth, interest rates, exchange rates and inflation rate. Social factors often look at the cultural aspects and include health consciousness, population growth rate, age distribution, career attitudes and emphasis on safety. The technological factors also include ecological and environmental aspects and can determine the barriers to entry, minimum efficient production level and influence outsourcing decisions. It looks at elements such as R&D activity, automation, technology incentives and the rate of technological change.

The PEST factors combined with external microenvironmental factors can be classified as opportunities and threats in a SWOT analysis

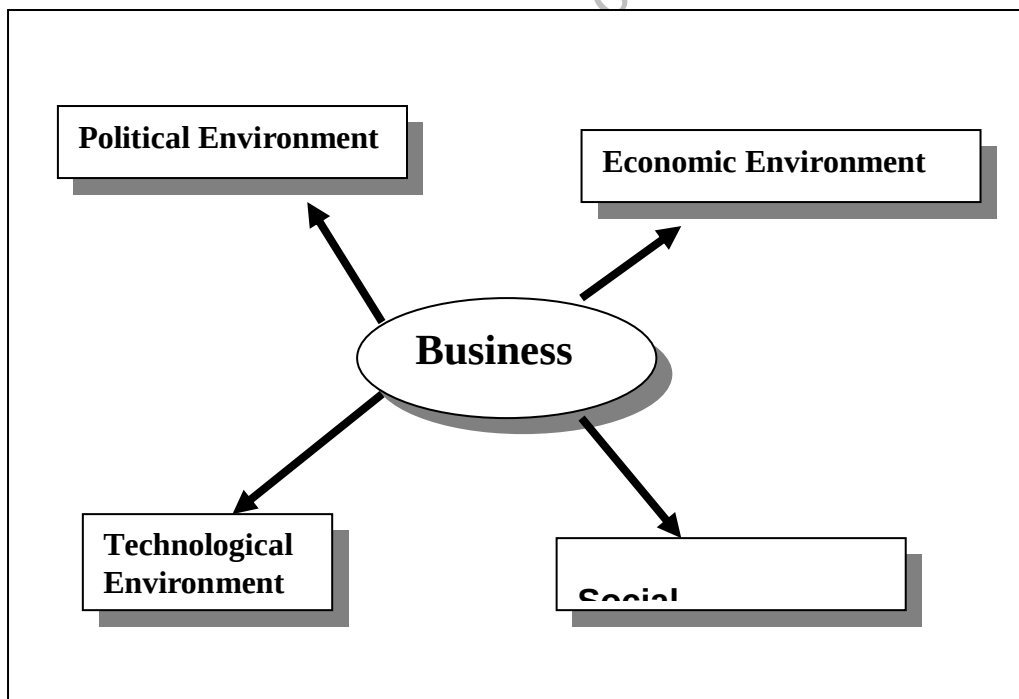


Fig 4.2 PEST analysis

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A PESTLE analysis of Tesco must consider all the factors affecting a large supermarket company.

A PESTLE analysis, in general, must create a good overall picture of the external impacts on an organisation by breaking them into useful, and obvious, categories.

In Jamie Oliver's world, a *pestle* is a bowl in which different ingredients are mixed together to create an overall good result. That's exactly what a PESTLE analysis aims to achieve. It looks at all the "ingredients" that affect a company and tries to mix them together to create a tasty dish. The external factors affecting a company range from the political to the environmental. The political impacts can be local, national or international. Many governments can be involved. For instance, Tesco might have to deal with British and Columbian politics in regards to its coffee supply.

Economic factors have a large impact. Fluctuations in the stock market, or tax increases, can seriously affect the bottom line of a company like Tesco

Sociological factors are more subtle, but still important.

Less subtle are the obvious impacts new technologies can have on a large corporation. For instance, online shopping has become a major factor in Tesco's recent success. The nexus of change created by all these factors lead to many legal problems, which keep the lawyers busy.

Last, but not least, any large organisation has a massive environmental impact. For instance, Tesco uses up vast amounts of fossil fuel in its transport network. Reducing this demand on planetary resources is a major challenge for Tesco and similar organisations.

Any **PESTLE Analysis for Tesco**, must consider each external factor in detail, and how their impact continually changes. Examples of possible drastic changes that could affect Tesco in the next few years or decades:

Political: government bans the sale of alcohol to people over the age of 21.

Economic: the government decides to put a tax on food.

Sociological: Tesco moves into Russia, tries to adapt to the different shopping patterns of the native population..

Technological: Hydrogen powered lorries impact on Tesco's distribution costs.

Legal: Mad cow disease has a long term impact. How can Tesco avoid paying large compensation claims?

Environmental: Climate change decimates Tesco's third world suppliers. How can it adapt?

Case Study 4.1

c) The Macroenvironment

Environmental scanning usually refers just to the macroenvironment, but it can also include industry and competitive analysis, consumer analysis, product innovations, and the company's internal environment. Macroenvironmental scanning involves analysing:

The Economy

- GNP or GDP per capita
- GNP or GDP growth
- Unemployment rate
- Inflation rate
- Consumer and investor confidence
- Inventory levels
- Currency exchange rates
- Merchandise trade balance
- Financial and political health of trading partners
- Balance of payments
- Future trends

Government

- Political climate - amount of government activity
- Political stability and risk
- Government debt
- Budget deficit or surplus
- Corporate and personal tax rates
- Payroll taxes
- Import tariffs and quotas
- Export restrictions
- Restrictions on international financial flows

Legal

- Minimum wage laws
- Environmental protection laws
- Worker safety laws

- Union laws
- Copyright and patent laws
- Anti- monopoly laws
- Sunday closing laws
- Municipal licences
- Laws that favour business investment

Technology

- Efficiency of infrastructure, including: roads, ports, airports, rolling stock, hospitals, education, healthcare, communication, etc.
- Industrial productivity
- New manufacturing processes
- New products and services of competitors
- New products and services of supply chain partners
- Any new technology that could impact the company
- Cost and accessibility of electrical power

Ecology

- Ecological concerns that affect the firms production processes
- Ecological concerns that affect customers' buying habits
- Ecological concerns that affect customers' perception of the company or product

Socio-Cultural**Demographic factors such as:**

- Population size and distribution
- Age distribution
- Education levels
- Income levels
- Ethnic origins
- Religious affiliations

Attitudes towards:

- Materialism, capitalism, free enterprise
- Individualism, role of family, role of government, collectivism
- Role of church and religion
- Consumerism
- Environmentalism
- Importance of work, pride of accomplishment

Cultural structures including:

- Diet and nutrition
- Housing conditions

Potential suppliers

- **Labour supply**
- Quantity of labour available
- Quality of labour available
- Stability of labour supply
- Wage expectations
- Employee turn-over rate
- Strikes and labour relations
- Educational facilities

Material suppliers

- Quality, quantity, price, and stability of material inputs
- Delivery delays
- Proximity of bulky or heavy material inputs
- Level of competition among suppliers

Service Providers

- Quantity, quality, price, and stability of service facilitators
- Special requirements

Scanning these macroenvironmental variables for threats and opportunities requires that each issue be rated on two dimensions. It must be rated on its potential impact on the company, and rated on its likeliness of occurrence. Multiplying the potential impact parameter by the likeliness of occurrence parameter gives us a good indication of its importance to the firm

Activity 4.1

Visit an MNC and study the method used by the firm to study the macroenvironmental forces acting on the firm and list the forces

4.2 Political Environment

The critical concern Political environment has a very important impact on every business operation no matter what its size, its area of operation. Whether the company is domestic, national, international, large or small political factors of the country it is located in will have an impact on it. And the most crucial & unavoidable realities of international business are that both host and home governments are integral partners. Reflected in its policies and attitudes toward business are a governments idea of how best to promote the national interest, considering its own resources and political philosophy. A government control's and restricts a company's activities by encouraging and offering support or by discouraging and banning or restricting its activities depending on the government. Here steps in international law. International law recognizes the right of nations to grant or withhold permission to do business within its political boundaries and control its citizens when it comes to conducting business. Thus, political environment of countries is a critical concern for the international marketer and he should examine the salient features of political features of global markets they plan to enter.

The Sovereignty Of Nations

From the international laws point of view a sovereign state is independent and free from external control; enjoys full legal equality; governs its own territory; selects its own political, social, economic systems; and has the power to enter into agreements with other nations. It is extension of national laws beyond a

country's borders that much of the conflict in international business arises. Nations can and do abridge specific aspects of their sovereign rights in order to coexist with other countries. Like the European Union, North American Free Trade Agreement (NAFTA) are examples of nations voluntarily agreeing to give up some of their sovereign rights in order to participate with member nations for common, mutually beneficial goals.

The ideal political climate for a multinational firm is stable, friendly environment. Unfortunately, that is never really the case, it's not always friendly and stable. Since foreign businesses are judged by standards as variable as there are nations, the friendliness and stability of the government in each country must be assessed as an ongoing business practice.

Stability Of Government Policies

The most important of the political conditions that concern an international business is the stability or instability of the prevailing government policies. Political parties may change or get reelected but the main concern for MNCs is the continuity of the set rules or code of behavior regardless of the party in power. A change in the government does not always mean change in the level of political risks. In Italy the political parties have changed 50 times since the end of World War II but the business continues to go on as usual inspite of the political turmoil. In comparison is India, where the government has changed 51 times since 1945 but however much of the government policies remain hostile to foreign investments. Conversely, radical changes in policies toward foreign business can occur in the most stable of the governments. Some of the African countries are among the unstable with seemingly unending civil wars, boundary disputes and oppressive military regimes. Like one of the region with the greatest number of questions concerning long-term stability is Hong Kong as since China has gained control, the official message is that nothing will change and thus everything is seemingly going smoothly but the political analysts say

that it is too early to say how will the business climate change, if it will. If there is potential for profit and if given permission to operate within a country, MNCs can function under any type of government as long as there is some long-term predictability and stability.

Political Parties

Particularly important to the marketer is the knowledge of all philosophies of all major political parties within a country, since anyone might become dominant and alter prevailing attitudes. In those countries where there are two strong political parties where usually one succeeds the other, it is important to know the direction each of the parties is likely to take. Changes in direction a country may take toward trade and related issues are caused not only by political parties but also by politically strong interest groups and factions within different political parties, which cooperate to affect trade policies.

4.2.1 Types of Political Systems

a). Democracy

Democracy is *for the people, by the people, and of the people*, its similar to participative management, in this system people are encouraged to participate in decision making, a peoples representative can be selected by the people through a process of election, and the responsibility of leading the nation is kept on the shoulders of the elected representative. Eg. India

b). Dictatorship

It is also called as authoritarianism, which is quite opposite to democracy, here the whole power is in the hands of the leader, and people should follow the leader, all the policies related to economy, business etc are governed by the leader. Eg Saudi Arabia

4.2.2 Political Risks Of Global Business**a) Confiscation**

The most severe political risk is confiscation, which is seizing of company's assets without payment.

b) Expropriation

Which requires reimbursement, for the government seized investment.

c) Domestication

Which occurs when host country takes steps to transfer foreign investments to national control and ownership through series of government decrees.

A change in the government's attitudes, policies, economic plans and philosophies toward the role of foreign investment is the reason behind the decision to confiscate, expropriate or domesticate existing foreign assets.

Assessing Political Vulnerability

Some products are more politically vulnerable than others, in that they receive more government attention. This special attention may result in positive or negative actions towards the company. Unfortunately there are no absolute guidelines for marketer's to follow whether the product will receive government attention or not.

Politically Sensitive Products

There are some generalizations that help to identify the tendency for products to be politically sensitive. Products that have an effect upon the environment exchange rates, national and economic security, and the welfare of the people are more apt to be politically sensitive. For products judged non essential the risk would be greater, but for those thought to be making an important contribution, encouragement and special considerations could be available.

4.2.3 Forecasting Political Risks

A number of firms are employing systematic methods of measuring political risk. Political risk assessment can:

- Help managers decide if risk insurance is needed
- Devise and intelligence network and an early warning system
- Help managers develop a contingency plan
- Build a database of past political events for use by corporate management Interpret the data gathered and getting forewarnings about political and economic situations

Reducing Political Vulnerability

Even though the company cannot directly control or alter the political environment, there are measures with which it can lessen the susceptibility of a specific business venture.

4.2.4 Good Corporate Citizenship

A company can reduce its political vulnerability by being a corporate citizen and remembering:

1. It is a guest in the country and should act accordingly
2. The profits are not it's solely, the local employees and the economy of the nation should also benefit.
3. It is not wise to try and win over new customers by totally Americanizing them.
4. A fluency in the local language helps making sales and cementing good public relationships.

5. It should train its executives to act appropriately in the foreign environment.

4.2.5 Strategies To Lessen Political Risks

MNCs can use other strategies to minimize political risks and vulnerability.

They are:

- Joint ventures
- Expanding the investment base
- Marketing and distribution
- Licensing
- Planned domestication
- Political payoffs

4.2.6 Government Encouragement Of Global Business

Foreign Government Encouragement

Governments also encourage foreign investment. The most important reason to encourage investment is to accelerate the development of an economy. An increasing number of countries are encouraging investments with specific guidelines toward economic goals. MNCs may be expected to create local employment, transfer technology, generate export sales, stimulate growth and development of the local industry.

National Government Encouragement

The US government is motivated for economic as well as political reasons to encourage American firms to seek opportunities in the countries worldwide. It seeks to create a favorable climate for overseas business by providing the assistance by providing the assistance that helps minimize some of the troublesome politically motivated financial risks of doing business abroad.

Basic ways government controls trade

Economic Rationales for Governmental Intervention

- Unemployment
- Protection of infant industry
- Using intervention to increase industrialization
- Economic relationships with other countries

Non-Economic Rationales for Governmental Intervention

- Maintaining essential industries
- "Unfriendly" countries
- Maintaining spheres of influence
- Preserving culture and national identity

4.2.7 Instruments used by government for trade control

Trade Restrictions / Trade Barriers

- Dumping
- Subsidies
- Countervailing Duties
- Tariffs
- Quotas
- VERs - Voluntary Export Restraints

Tariffs and the "Political Environment"

"The United Steelworkers union [in Canada] wants provincial governments to lobby Ottawa to protect the country's steel industry now that federal officials have decided against penalizing low-cost imports....A spokesperson for Finance Minister John Manley confirmed yesterday that the government had decided against imposing tariffs on steel imports" Canadian Press (as quoted by the Toronto Star 2003 Oct 7th) reported

This is a part of the "Political Environment" because if the Steelworkers do not get tariffs they may go on strike, or they may work to make sure the local Member of Parliament is not re-elected in that constituency. If the governing

party [in the case the liberals] really needs to hold that constituency they may give in

Non-Tariff Barriers

- Subsidies
- Aid (loans and grants)
- Customs valuation
- Quotas
- "Buy national" policies
- Standards
- Trade sanctions

The WTO Initiative

The WTO has become increasingly involved in dealing with the "challenging" area of non-tariff barriers. It is challenging because more and more countries are trying to show they will abide by bi-lateral and multi-lateral trade agreements so they cut tariffs - but at the same time, domestic political pressure cause the politicians to think of ways they can erect non-tariff barriers to still keep out lower priced foreign products, so that domestic industries can still sell competitively to their citizens.

Case: The Taipan's Dilemma

Hong Kong comprises Hong Kong Island, Kowloon Peninsula and the New territories. Mutual distrust and misunderstanding between the Chinese and foreigners. Trade with foreigners restricted to the port of Macao. Around the early 1830s, trade between Britain and China became particularly important (tea for opium). Three opium wars. Resulted for the British temporary ownership of Hong Kong. Lease expired June 30, 1997. The new arrangement, China assumed control of Hong Kong, two systems. Hong Kong will retain its separate political and economic status for 50 years. Democracy has never been a major part of the political landscape in Hong Kong. Given the political instability in Hong Kong, why don't more companies leave? Hong is the world's eighth-largest trading nation, boasts a higher per capita income than Britain, has one of the world's lowest tax rates. It was once a heaven for low cost manufacturing. Manufacturing jobs are moving to China. Singapore is trying to grab away business from Hong Kong.

Case Study 4.2**4.2.8 The Impact of the Political System on Management Decisions**

Managers must deal with varying degrees of governmental intervention and varying degrees of political stability.

Managers must understand the critical functions that a government performs in the economy.

In a democracy, for instance:

- a) Protect the liberty of its citizens
- b) Promote the common welfare of its citizens
- c) Provide for public goods
- d) Handle market defects ; and spillover effects

The political process also affects international business through laws that regulate business activity at both the domestic and international levels.

In addition government action is not always consistent.

For instance in the U.S. at least three government agencies share responsibility for regulating nonagricultural exports (The Department of Commerce; The State Department; and the Department of Defense).

4.2.9 Formulating and Implementing Political Strategies

Political action always is a sensitive area. However, there are certain steps that a company must follow if it wants to establish an appropriate political strategy:

- a) What is the specific issue facing the firm - protectionism, environmental rights, worker rights?
- b) Assess the potential political action of other companies and of special interest groups.
- c) Identify important institutions and key individuals
- d) Formulate strategies and implement

Case: United States - Japanese Auto Trade

Imports started in 1973

VERs: ceiling 1.68 million cars (Voluntary Export Restraints)

Arguments for helping the U.S. industry:

- The costs of unemployment are higher than the increased costs to consumers
- Help overcome temporary problems

Antiprotectionists: blame poor management and taxpayers should not be expected to reward the companies

Efforts to penetrate the Japanese market

Case Study 4.3

4.2.10 Governmental Influence On Trade

The Rationale For Governmental Intervention

a) Unemployment

Import restrictions may lead to retaliation by other countries, may decrease export jobs. Loss of jobs in industries that rely on imported Products

Cost of protectionism: higher prices, low quality, lack of Innovation

b) Infant Industry Argument

Production becomes more competitive over time because of increased economies of scale and greater workers efficiency

c) Industrialization Argument

Countries seek protection to promote industrialization Because:

- a) Brings faster growth than agriculture
- b) Diversifies the economy
- c) Brings more price increases than primary products do.

d) Shifting Workers from Agriculture into Manufacturing

- a) Output increases if the marginal productivity of agricultural workers is very low.
- b) Social concerns

e) Promoting Investment Inflows

Import restrictions increase direct investment

f) Diversification**g) Terms of Trade**

Deterioration of terms of trade may prompt countries to protect and promote industrialization

h) Import Substitution versus Export Promotion

Export-Led Development

i) Balance-of-Payments Adjustments

- Countries may choose to restrict the least essential Imports
- Export restrictions
- Import Restrictions may prevent dumping

j) Maintaining Essential Industries**k) Preserving Cultures and National Identity****Activity 4.2**

Visit an MNC and study the impact of political system on management's decision making

Activity 4.3

List out the instruments used by Indian government to control the trade

4.3 Legal Environment

All business occurs within a particular legal and regulatory environment the current legal environment in the United States spins on a variety of complex issues that have an impact on business: international trade, capital gains taxes, unemployment, aging baby boomers, technology, employment laws, and social concerns such as health care, child care, and job training. This legal tapestry means businesses must be even more vigilant to include consideration of the legal environment in their strategic planning. The legal environment is well recognized as one of the most significant influences with which strategic plans must contend.

4.3.1 Origins of International Law

There is no comprehensive system of laws or regulations for guiding business transactions between two countries. The legal environment consists of laws and policies from all countries engaged in international commercial activity. Early trade customs centered around the law of the sea and provided, among other things, for rights of shipping in foreign ports, salvage rights, and freedom of passage. During the Middle Ages, international principles embodied in the lex

mercatoria (law merchant) governed commercial transactions throughout Europe. Although laws governing international transactions were more extensive in some countries than others, the customs and codes of conduct created a workable legal structure for the protection and encouragement of international transactions. The international commerce codes in use today in much of Europe and in the United States are derived in part from those old codes.

4.3.2 Sources of International Law

The main sources of international commercial law are the laws of individual countries, the laws embodied in trade agreements between or among countries, and the rules enacted by a worldwide or regional organization—such as the United Nations or the European Union. There is no international regulatory agency or system of courts universally accepted for controlling international business behavior or resolving international conflicts among businesses or countries. International law can be enforced to some degree through (1) the International Court of Justice, (2) international arbitration, or (3) the courts of an individual country. However, the decisions of those tribunals in resolving international business disputes can be enforced only if the countries involved agree to be bound by them.

a) International Trade Agreements

Countries improve economic relations through trade agreements that cover a variety of potential commercial problems. This helps the investment and trade climates among countries. For example, virtually all industrialized countries have bilateral tax agreements to prevent double taxation of individuals and businesses. Two important trade agreements for the U.S. are the North American Free Trade Agreement (NAFTA) and the World Trade Organization (WTO)

b) North American Free Trade Agreement

NAFTA is a treaty that was ratified by the legislatures in Canada, Mexico, and the U.S. and went into effect in 1994. It reduces or eliminates tariffs and trade barriers among those nations. Although some tariffs were eliminated immediately, many are phased out through the year 2009. The industries most affected include agricultural products, automobiles, pharmaceuticals, and textiles. NAFTA will create the largest free trade area in the world; 360 million people. NAFTA includes a variety of issues not usually found in trade agreements, such as protection of intellectual property and the environment, and the creation of special panels to resolve disputes involving unfair trade practices, investment restrictions, and environmental issues. NAFTA could eventually include North and South America; 850 million people with over \$18 trillion in annual purchasing power.

c) World Trade Organization

For 48 years, GATT worked to reduce trade barriers imposed by governments. GATT focused on trade restrictions (import quotas and tariffs); it published tariff schedules to which its signers agreed. Tariff schedules were developed in multinational trade negotiations or “rounds.” In the most recent round—the Uruguay Round—124 nations participated. GATT was replaced by the WTO, one of the most significant developments of the last round. Since 1995, WTO has overseen the trade agreement and has a dispute-resolution system, using three person arbitration panels. The panels follow strict schedules for rendering decisions. WTO members cannot veto decisions, unlike before (unless they withdraw from the agreement). The latest round will eventually lower world tariffs by 40 percent. The U.S., Japan, members of the EU, and other industrialized nations agreed to eliminate all tariffs in 10 industries:

Beer

Construction equipment

Distilled spirits

Farm machinery

Furniture

Medical equipment

Paper

Pharmaceuticals

Steel

Toys

The WTO agreement provides world protection for intellectual property; 7 years of protection for trademarks, 20 years for patents, and up to 50 years for copyrights (generally moving to 75 years plus in most places). Only in the film and television industry was the U.S. not able to gain a barrier to trade reduction in Europe. France was particularly adamant about maintaining the barrier because of its concerns about the heavy cultural influence of such programming (and the demise of the not very successful French film industry).

d) Import Policy

Countries have long imposed restrictions or prohibitions on the importation and exportation of certain products. In addition, export laws and regulations are often enacted to encourage international business activity by domestic industries.

e) Taxes on Imports

Restrictions on imports may be imposed to generate revenue for the government or to protect domestic industries from foreign competition. Import licensing procedures, quotas, testing requirements, safety and manufacturing standards, government procurement policies, and complicated customs procedures are all ways to regulate imports. The most common means of regulating imports into a country is through tariffs.

Tariff Classes

A tariff is a duty or tax levied by a government on imports. Tariffs can be classified into:

Specific Tariffs which impose a fixed tax or duty on each unit of the product, **Ad Valorem Tariffs** which impose a tax based on a percentage of the price of the product. In the U.S. the duty or tax is published in the Tariff Schedules that apply to all products entering U.S. ports. Customs officials classify products and determine the tariff rates when products enter the country. Any tariff imposed must be paid before the good may enter the country. Most disputes that occur in this area arise over the classification of products under the tariff schedules.

f) Import Controls

The Department of Commerce, the International Trade Administration (ITA), and the International Trade Commission (ITC) have certain abilities to restrict foreign imports. The agencies are concerned with foreign companies that practice “dumping” or receive a subsidy from their governments to lower their costs of production. The agencies may also restrict imports in the absence of dumping or subsidies. As barriers to trade are lowered, some domestic industries and their workers face economic hardships due to foreign competition. The ITC can temporarily restrict imports to provide those industries with an opportunity to adjust to the new competitive environment created by the lower trade barriers. Antidumping Orders—Under both the WTO and U.S. antidumping laws, dumping “is the business practice of charging a lower price in the export market than in the home market, after taking into consideration important differences in the sale (such as credit terms and transportation) and the goods being sold.” This was first prohibited in 1916, when Congress enacted the Antidumping Duty Act. If a company is dumping goods in the U.S., an antidumping order will be issued. Goods from the company are subject to payment of an antidumping duty (tax). The amount of the duty is determined by comparing the market price in the company’s home market with the price charged in the U.S. The percentage

difference between the home and U.S. markets will form an ad valorem duty to be applied to the price when sold in the U.S. This duty is paid to Customs by cash deposit at the port, normally by the importer. Duty orders generally remain in place until the importer has demonstrated three consecutive years of “fair market value” sales and Commerce is convinced there is a low likelihood of “less than fair market value” sales in the future.

g) Export Regulation and Promotion

Most governments encourage exporting to stimulate domestic employment and bring in foreign exchange. This is believed needed to help prevent a trade deficit. at the same time, for policy reasons, it a governments may restrict exports of certain products.

Export Restrictions

The U.S. imposes restrictions on the sale of a good or a technology may

- a) Injure domestic industry (e.g., the export of a raw material in short supply),
- b) Jeopardize national security (e.g., selling military hardware to the wrong country)
- c) Conflict with national policy (e.g., selling goods to a country the government has embargoed because of terrorist activities).

Restrictions are managed by licensing according to terms of the Export Administration Act (EAA).Commerce imposes licensing requirements under strict standards. Licensing Agreements. The EAA allows Commerce to require the following export licenses, depending on the type of good or technology being exported:

- 1) A validated license, authorizing a specific export;
- 2) A qualified general license, authorizing multiple exports;
- 3) A general license that applies to most U.S. goods; and

4) Other licenses as may assist in the implementation of the Act.

The Commodity Control List lists products subject to licenses and the restrictions imposed. Goods not on the List are subject to a general license—which often only requires a Shipper’s Export Declaration filed with Commerce. A validated export license is required for the export of certain goods on the List because of national security. Commerce may impose controls “only to the extent necessary to restrict the export of goods and technology which would make a significant contribution to the military potential of any other country or combination of countries which would prove detrimental to the national security of the United States.” Application to Reexported U.S. Goods. Commerce’s licensing requirements apply to the reexport of U.S. goods. That is, an export license is needed to ship U.S.-origin controlled goods from say, India to Taiwan. This is to stop shipment of sensitive goods from the U.S. to a “safe” country and then to a controlled country.

Case: International Perspective: Controlling International Pirates

The U.S. International Trade Commission estimates that pirates (companies or individuals that copy or clone) cost U.S. industry more than \$100 billion in lost profits each year. Microsoft Corporation found an extensive network pirating its Windows software. The group was talented enough to even copy the hologram used to discourage pirating. Microsoft filed a lawsuit privately and elicited the assistance of the International Trade Commission to sanction Taiwan (the location of the pirating organization). For the computer industry, pirating is one of the most serious problems facing management.

Case Study 4.4

h) Foreign Corrupt Practices Act

Government is more involved in business in many countries than in the U.S. When approval of business action is at the discretion of a government official,

the likelihood of corruption rises. Scandals shook many countries in the 1990s, notably in Italy, Japan, and Korea. The Foreign Corrupt Practices Act (FCPA) prohibits U.S. companies from bribing foreign officials. A study of U.S. companies by the SEC found the practice was wide spread—over 400 companies (117 were *Fortune 500* companies) admitted making bribes to foreign officials.

Corruption

Many countries are rife with corruption; even the U.S. only gets a score of 7.5 on a 10 point scale used by experts on international corruption of government officials.

i) International Antibribery Movement

The U.S. encourages other countries to enact antibribery laws, but until recently has been the only nation with such a law. Numerous other nations have agreed in principle to the Convention on Combating Bribery of Foreign Officials, but while Congress ratified the treaty in 1998, other countries have been slow to act.

j) Antibribery Provisions

The FCPA prohibits U.S. companies from “corruptly” paying or offering to pay a “foreign official” to gain assistance in obtaining or retaining business. The Act also prohibits payments to a person—such as a foreign agent—when the payment will go to bribe an official. The ability to know of such payments by an agent is controversial. An exception is made for a payment that is a “facilitating or expediting payment ... the purpose of which is to expedite or secure the performance of a routine government action.” Routine actions may include processing visas and providing utilities. The basic test of whether the bribe is allowed focuses not on the person to whom payment is made, but on the purpose for which payment is made. It is complicated by the fact that payments are often made by local freight forwarders or other service organizations without the knowledge of the U.S. manager.

k) International Contracts

The basis for any international agreement is the contract between parties. International contracts often involve parties from differing cultural backgrounds who do not know each other well at the outset of negotiations.

i) Cultural Aspects

Sensitivity to cultural differences is important in international contracting.

Although language should not be a barrier, contract terms must be clearly defined and understood. Attitude toward relationships is a cultural difference in some countries. Contracts based on trust are often relatively short in length, with few contingencies expressly provided. The expectation is that issues can be worked out as they arise with the parties working to maintain the underlying relationship.

ii) Financial Aspects

In managing financial risks that may arise, care should be taken in the specification of the method of payment and the currency in which payment is to be made.

iii) Exchange Markets

Foreign exchange markets allow trading (buying and selling) currencies. In general, trade between countries can occur only if it is possible to exchange the currency of one country for the currency of another country. Exchange of money is not always simple. Losses in international business sometimes center on exchange risk—the potential loss or profit that occurs between the time the currency is acquired and the time the currency is exchanged for another currency.

iv) Financial Instruments Used in International Contracts

Although many financial instruments are available, two commonly used are bills of exchange and letters of credit.

A *bill of exchange* is a written instrument that orders the payment of a certain sum of money to the party specified by the bill. Payment is made at the time specified on the bill or understood from the form of the standardized bill used. A *sight bill* specifies immediate payment upon receipt of the goods by the buyer. A *time bill* specifies payment at a later date, usually 30, 90, or 180 days after the goods have been received by the buyer.

A *letter of credit* is an agreement or assurance by the buyer's bank to pay a specified amount to the seller upon receipt of documentation proving that the goods have been shipped and that any other contractual obligations on the seller have been fulfilled. The usual documentation required includes a certificate of origin, an export license, a certificate of inspection, a bill of lading, a commercial invoice, and an insurance policy. Letters of credit can be either revocable or irrevocable.

v) Repatriation of Monetary Profits

Repatriation refers to the ability of a foreign business to return money earned in the foreign country to its home country. It is often governed by a country's laws.

vi) Key Clauses in International Contracts

Certain clauses are often included in international contracts and have become standard items to consider.

a) Payment Clauses

How payment is to be received should be clearly specified. The problems of repatriation should be addressed. Problems with inflation and currency exchange risks, especially in unstable economies or in long-term agreements, should also be addressed in this clause of the contract.

b) Choice of Language Clause

A word or phrase in one language may not be readily translatable to another. A contract should have a choice of language clause, which sets out the language by which the contract is to be interpreted.

c) Force Majeure Clause

Force majeure is a French term meaning a “superior or irresistible force.” It protects the contracting parties from problems or contingencies beyond their control.

d) Forum Selection and Choice-of-Law Clauses

To reduce uncertainty in the event of a dispute, the parties select the court in which disputes are to be resolved and the law that is to be applied. This eliminates the possibility that the parties will go “forum shopping”—looking for the most favorable forum for the resolution of a dispute.

e) UN Convention on Contracts: Most major trading countries have agreed to the U.N. Convention on Contracts for the International Sale of Goods. Contracts that incorporate that law are subject to rules very essentially the same as the Uniform Commercial Code. See 71 F.3d 1024.

f) Loss of Investment

Governmental action can result in loss of investment through nationalization, expropriation, and confiscation. Investors concerned about such losses may purchase insurance.

g) Nationalization

Occurs when a country takes over, or nationalizes, a foreign investment. Compensation by the government is often less than the true value of the business. The stated purpose of nationalization is related to public welfare. Nationalization is not uncommon, averaging over 100 incidents per decade.

h) Insuring against Risk of Loss

Investors concerned with the risk of loss of investment may obtain insurance. An all-risk insurance policy can help in case of nationalization or upon occurrence of a specific problem. Outstanding risks such as currency blockages, embargoes, and a government's arbitrary decision to recall letters of credit may be insured through major insurers such as Lloyds of London. Some countries have agencies to assist in insuring their exporters from risk of loss. In the U.S., the Overseas Private Investment Corporation (OPIC) insures investors willing to invest in less-developed countries friendly to the U.S.

4.3.3 International Dispute Resolution

Contract disputes arise for any number of reasons. Disputes must be resolved as parties wish to enforce their rights under a contract.

a) Litigation

Parties in a contract dispute may seek relief in the court system of either country. Litigation is complicated; evidence, individuals, and documents central to the dispute are often located in two or more countries. If the action is in a foreign court, the U.S. participant may encounter a very different judicial system. Courts in some countries are influenced by political pressures. Another difficulty may be attempting to establish jurisdiction. U.S. courts require proof of "minimum contacts" within the country for the courts to have proper jurisdiction over a foreign defendant.

b) Arbitration

Courts are not effective in resolving many international disagreements. One of the most effective alternative techniques has been the arbitration process. Attempts to standardize arbitral rules resulted in creation of organizations such as the U.N. Commission on International Trade Law, the International Chamber of Commerce, the American Arbitration Association, the InterAmerican Commercial Arbitration Commission, and the London Court of Arbitration. In

over fifty countries, including the United States, enforcement of arbitral awards is facilitated by the 1958 U.N. Convention on the Recognition and Enforcement of Foreign Arbitral Awards. U.S. federal district courts have jurisdiction to entertain motions to confirm or challenge a foreign arbitration award involving a U.S. business.

c) International Court of Justice

Certain disputes may be taken to the International Court of Justice (ICJ) for resolution. The ICJ is headquartered at The Hague, Netherlands, and is a part of the United Nations. Only countries have standing to go before the Court; individuals and businesses have no standing to initiate a suit. The countries decide whether to pursue claims on behalf of their citizens. IJC decisions providing monetary judgments or injunctive relief may be referred to the United Nations Security Council for enforcement.

d) Doctrine of Sovereign Immunity

This allows a court to give up its jurisdiction over foreign parties that otherwise would be subject to the court's jurisdiction. This is based on traditional notions that a sovereign should not be subject to litigation in a foreign court. The application of the doctrine can have severe consequences on parties when the suit involves a commercial transaction. The Foreign Sovereign Immunities Act (FSIA) of 1976 is intended to provide a uniform rule for the determination of sovereign immunity in legal actions in U.S. courts and to bring the U.S. into conformity with other countries in its application of the doctrine.

4.3.4 Types of Legal Systems

a) Common Law System

Based on tradition, precedent, and custom and usage, and the courts fulfill an important role in interpreting the law according to those characteristics.

b) Civil Law System or a Codified Legal System

Based on a very detailed set of laws that are organized into a code. This code is the foundation for doing business. Over 70 countries operate on a civil law basis.

The two legal systems differ primarily in that common law is based on the courts interpretation of events, whereas civil law is based on how the law is applied to the facts. Ex: Contracts.

c) Theocratic Law System

Based on religious precepts. Islamic law

The U.S. has the most lawyers of any country in the world and is one of the highest in the number of lawyers per capita. Ex: 312 lawyers per 100,000 compared to 101 lawyers per 100,000 in Japan

Activity 4.4

Visit an MNC and study impact of legal system on business operations

4.4 Technological Environment

Technology has played a major role in the life of people, right from snail mail to e-mail the way we live has dramatically changed from the past decade. Technology has removed the global barriers like distance, time etc thanks to the latest technological developments like Internet, e-mail, video conferencing, cell phone etc that plays a major role in international business.

4.4.1 Technological phases in production

a) Cottage System

Before 1700s

b) Industrial Revolution 1770-1800s

Eight inventions were made

Substitution of machine power from man power

Establishment of factory system

c) Scientific Management

Developing science for each person's work

Selecting workers scientifically

Dividing work & responsibility

d) Human Relations Movement

Basic understanding of workers & their attitudes towards their work

e) Operations Research(O.R)

Mathematical techniques to solve management problems

First OR team formed by British army to solve complex problems in

World war II

f) Computers & Advanced Production Technology

Clerical Job

Decision Support System (DSS)

Executive Support System(ESS)

Artificial Intelligence

Neural Networks

g) Service Revolution

Design Engineers

Computer Operators

Production Planners

4.4.2 Benefits of Technology in Management Decision Making

The managerial decisions are of two types

a) Structured or programmed decisions

b) Un-structures or non-programmed decisions

Technology helps the manager to make decisions related to business in the following ways

a) Decision Support System

It is an information system which collects the information from various sources like government, customers and suppliers and global market and competitors and helps the manager to interact with the mathematical decision models to make decision.

b) Group Decision Support System

An expert system with set of hardware, software & procedures that support a group of people engaged in a decision-related meeting

c) Office Automation System

An office automation system uses computers or networks to carry out various office operations

d) Transaction Processing System

A system that handles the processing and tracking of transactions is called TPS

e) Management Information System

MIS is a set of software tools that enables managers to gather, organize, & evaluate information about a workgroup, department or entire organization

f) Expert System

Expert System is a specialized application that performs tasks that would normally be done by a human.

Ex: Medical diagnosis

Credit History

4.4.3 Communication Tools used in International Business

- a) Video Conferencing
- b) E-mail
- c) Internet
- d) Laptop
- e) Cell Phone

4.4.4 Effect of Technology on Strategy & Competition**a) Creating Barriers to entry**

The cutting edge technology used by MNCs has created barriers for the new entrants into the industry and also caused a major threat to the domestic industries this has given rise to the increase in competition and importance for companies to invest in research and development

b) Generating New Products

Technology has always created new to the world products and modified new products; there is a greater need for the business organizations to invest in large volumes in research and development to bring out new products

Some minor changes in features of the product with the same technology has given rise to new products eg. The modified features of the tape recorder has given rise to Walkman where both uses the same technology

c) Changing Relationships with Suppliers

The relationships maintained by the suppliers has dramatically changed from traditional procurement to e-procurement, e-supply chain management, global integration etc which has given rise to quality, efficiency, of production in less time.

d) Changing the Basis for Competition

Technology has formed as a main basis for competition, the superior technology used by the business firms has resulted in improved quality of producing goods, improved efficiency by automation and mechanization, Total Quality Management (TQM)

4.4.5 Features of Technology

a) Technology Brings Change

Technology brings change in every walk of life, like the way we cook, the way we commute, the way we communicate etc. technology has brought lot of changes in business from barter system to e-business

b) Technology Reduces Time

Technology has drastically reduced time between conceiving an idea and implementing that idea. The world has become a global village, which has no

barriers by the invention of internet technologies which has reduced time of transferring information in no time.

c) Technology Reduces Distance

With the invention of advanced transportation systems which has reduced the time to travel

e.g. By the invention of supersonic jets etc

d) Technology Improves Quality of Life

The quality of life of people has definitely improved, the advancements of medical technology the life expectancy rate is increased and the control of various diseases is possible

4.4.6 Diffusion of Technology

Diffusion is a process of spreading, if a bottle of perfume is opened the molecules will diffuse in the entire atmosphere similarly the technology will diffuse in the following ways

Joint Ventures

Two companies A and B can jointly work on a venture for a certain period by exchanging technology, human resources etc

Licensing

Companies in the domestic market can produce the products by license permission from MNCs

E.g. Coco-cola is produced in India by the way of license

Technological Transfer

Technology can be transferred from one country to another by way of collaboration many times we hear terms like German collaboration, Japanese collaboration etc

e.g. Maruti Suzuki is collaboration between Maruthi Udyog of India and Suzuki motors of Japan

4.4.7 The Technological Cycle

The technological cycle is an organized way to develop technology

- Needs analysis
- Design of Technology
- Development of Technology
- Implementation of Technology
- Maintenance of Technology

Phase 1: Need Analysis

Defining the problem and deciding whether to proceed and analyzing the current system in depth and developing possible solutions to the problem and selecting the best solution and defining its function

Phase 2: Designing Technology

The project team describes how the selected solution will work. Each system activity is identified

Phase 3: Development of Technology

Includes creating or customizing the technology for various parts of the system.

There are two alternative paths:

- 1.Acquisition
- 2.Local development

Technical & user documentation is written testing is also integral part of this phase

Phase 4: Implementation of Technology

The technology is installed in the user environment

Phase 5: Maintenance of Technology

Training & support to the users of technology, improvements to the technology are made regularly during the remaining cycle.

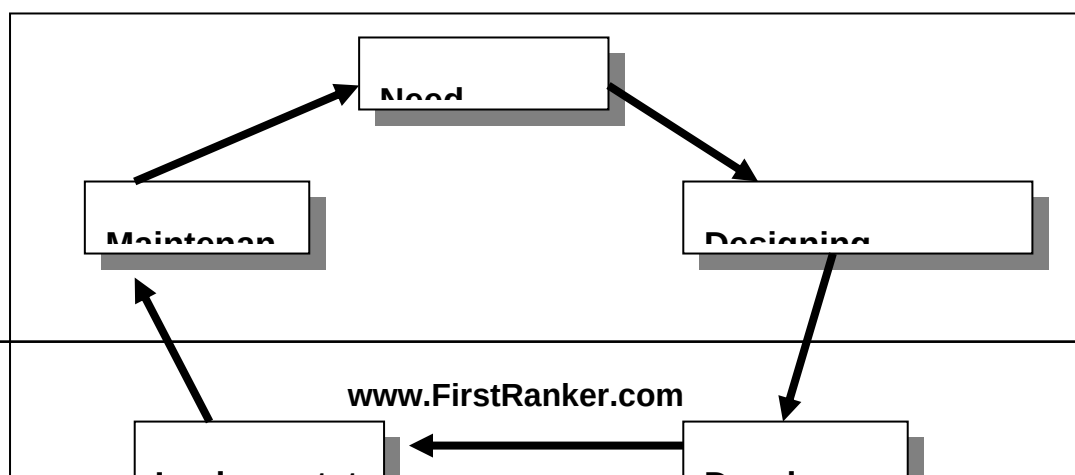


Fig 4.2 The Technological Cycle

4.4.8 Business Implications of Technology

- Launch new products and services to your sales force without taking them out of the field.
- Highlight introductions and product releases to employees, shareholders, and clients.
- Provide certification programs to geographically dispersed audiences.
- Conduct focus group sessions to help bring products to market faster.
- Create personalized sales presentations for your customers and reduce timely sales cycles.
- Provide a simple but effective way to get more out of training sessions by giving your audience something for their eyes as well as their ears.
- Great for Human Resources departments to get out information about policy and procedure changes. Ideal for new employee orientations and employment interviews.

4.5 Cultural Environment

When doing business abroad, a company first should determine whether a usual business practice in a foreign country differs from its home-country experience. Understanding the cultures of groups of people is useful because business employs, sells to, buys from, is regulated by, and is owned by people.

4.5.1 The Concept Of Culture

The word **culture**, from the Latin *colo*, *-ere*, with its root meaning "to cultivate",

generally refers to patterns of human activity and the symbolic structures that give such activity significance. Culture consists of specific learned norms based on attitudes, values, and beliefs, all of which exist in every society. Culture cannot easily be isolated from such factors as economic and political conditions.

4.5.2 Behavioral Practices Affecting Business

a) Group Affiliation

A person's affiliations reflecting class or status.

b) Role of Competence

Rewarded highly in some societies. Seniority in Japan

c) Gender Based Groups

There are strong country-specific differences in attitudes towards males and females.

d) Age-Based Groups

Many cultures assume that age and wisdom are correlated

e) Family-Based Groups

f) Importance of Work

Protestant ethic, belief in success and reward; work as a habit, high-need achiever.

g) Need Hierarchy

People try to fulfill lower-order needs sufficiently before moving on to higher ones. The hierarchy of needs theory is helpful for differentiating the reward preferences of employees.

h) Importance of Occupation

The importance of business as a profession

i) Self-Reliance

Uncertainty avoidance, trust, fatalism, individual versus group

j) Preference for Autocratic versus Consultative Management

4.5.3 Reconciliation Of International Differences

a) Stereotypes

A generalized picture of a person, created without taking the whole person into account; to make such a generalization.

When we stereotype a group of people, we depict all of the individuals within that group as having the same characteristics. Differences in our society are many, including age, religion, physical and mental abilities, gender, sexual orientation, income, family or social status, and physical appearance. Anyplace where differences are found leaves room for stereotypes. Stereotypes are generalizations about people usually based on inaccurate information or assumptions rather than facts. Stereotypes do not take into account the great diversity of people within a group of people. Nor do stereotypes consider the present circumstances of the individual. Even worse, stereotypes can lead to prejudicial or discriminatory behavior.

b) Cultural Shock

The term, culture shock, was introduced for the first time in 1958 to describe the anxiety produced when a person moves to a completely new environment. This term expresses the lack of direction, the feeling of not knowing what to do or how to do things in a new environment, and not knowing what is appropriate or inappropriate. The feeling of culture shock generally sets in after the first few weeks of coming to a new place.

c) Polycentrism

Polycentrism is the principle of organisation of a region around several political, social or financial centres. An example of a polycentric city is the Ruhr area in Germany: Today, the area is a large city that grew from a dozen smaller cities. As a result, the "city" has no single centre, but several.

A county is said to be polycentric if its population is distributed almost evenly among several centres in different parts of the county.

d) Ethnocentrism

The belief that one's own culture is superior to all others and is the standard by which all other cultures should be measured. Early social scientists in the nineteenth century operated from an ethnocentric point of view. So-called primitive tribes, for example, were studied by anthropologists to illustrate how human civilization had progressed from "savage" customs toward the accomplishments of Western industrial society. The feeling that one's group has a mode of living, values, and patterns of adaptation that are superior to those of other groups. It is coupled with a generalized contempt for members of other groups. Ethnocentrism may manifest itself in attitudes of superiority or sometimes hostility. Violence, discrimination, proselytizing, and verbal aggressiveness are other means whereby ethnocentrism may be expressed.

The view of things in which one's group is the center of everything, all others are scaled & rated with references to his own cultural value.

Symptom: "self reference criteria"

Example : criticism about diet patterns.

Danger : provoke retaliation

e) Geocentrism The view of things in which one looks at positive aspects of both home & host cultures & accept the differences.

e) Cultural Dimensions

Sl.No	Dimension	Criteria
1.	Low Context Vs High Context	Communication Style
2.	Doing Vs Being	Amount of action
3.	High Contact Vs Low Contact	Amount of physical contact

4.	Dionysian Vs Apollonian	Ways to handle emotion
5.	Masculine Vs Feminine	Attitude towards sex
6.	Collective Vs individualistic	Attitude about themselves
7.	High Vs Low Risk avoidance	Amount of anxiety
8.	High Vs Low Power distance	Attitude about power
9.	Universalistic Vs Particularistic	Obligation
10.	Regressive Vs Progressive	Time

4.5.4 The Elements of Culture

The major elements of culture are material culture, language, aesthetics, education, religion, attitudes and values and social organisation.

a) Material Culture

Material culture refers to tools, artifacts and technology. Before marketing in a foreign culture it is important to assess the material culture like transportation, power, communications and so on. All aspects of marketing are affected by material culture like sources of power for products, media availability and distribution. For example, refrigerated transport does not exist in many African countries. Material culture introductions into a country may bring about cultural changes which may or may not be desirable.

b) Language

Language reflects the nature and values of society. There may be many sub-cultural languages like dialects which may have to be accounted for. Some countries have two or three languages. In Zimbabwe there are three languages - English, Shona and Ndebele with numerous dialects. In Nigeria, some linguistic groups have engaged in hostile activities. Language can cause communication problems - especially in the use of media or written material. It is best to learn the language or engage someone who understands it well.

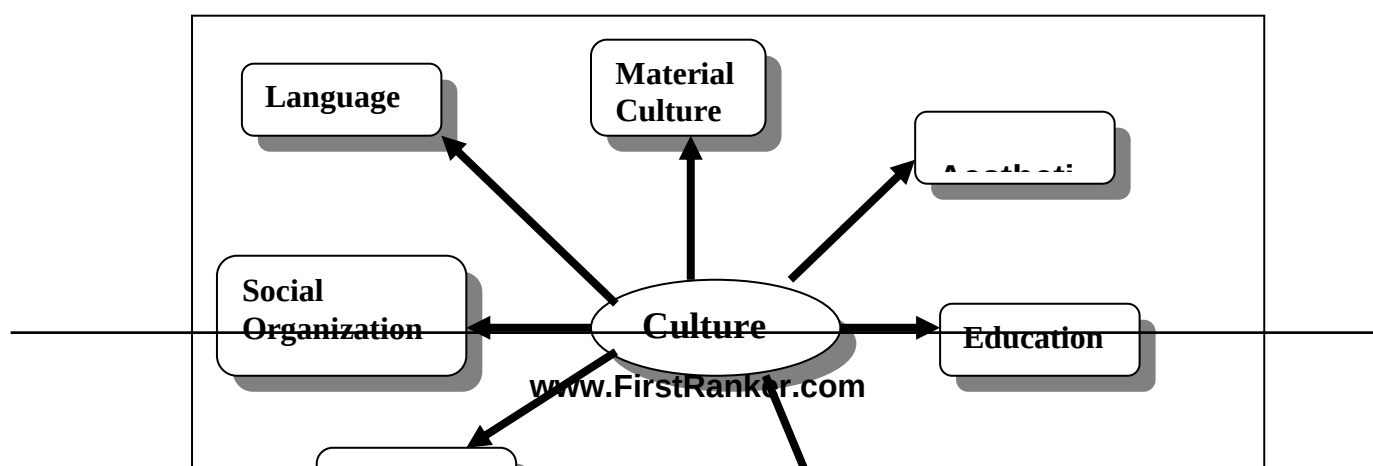


Fig 4.3 Elements of Culture

c) Aesthetics

Aesthetics refer to the ideas in a culture concerning beauty and good taste as expressed in the arts -music, art, drama and dancing and the particular appreciation of colour and form. African music is different in form to Western music. Aesthetic differences affect design, colours, packaging, brand names and media messages. For example, unless explained, the brand name FAVCO would mean nothing to Western importers, in Zimbabwe most people would instantly recognise FAVCO as the brand of horticultural produce.

d) Education

Education refers to the transmission of skills, ideas and attitudes as well as training in particular disciplines. Education can transmit cultural ideas or be used for change, for example the local university can build up an economy's performance.

The UN agency UNESCO gathers data on education information. For example it shows in Ethiopia only 12% of the viable age group enrol at secondary school, but the figure is 97% in the USA.

Education levels, or lack of it, affect marketers in a number of ways:

- Advertising programmes and labeling
- Girls and women excluded from formal education (literacy rates)
- Conducting market research
- Complex products with instructions
- Relations with distributors and,
- Support sources - finance, advancing agencies etc.

e) Religion

Religion provides the best insight into a society's behaviour and helps answer the question why people behave rather than how they behave.

A survey in the early 1980s revealed the following religious groupings (see table 3.1)³.

Table 3.1 Religious groupings

Groups	Million
Animism	300
Buddhism	280
Christianity	1500
Hinduism	600
Islam	800
Shinto	120

Religion can affect marketing in a number of ways:

- Religious holidays - Ramadan cannot get access to consumers as shops are closed.
- Consumption patterns - fish for Catholics on Friday
- Economic role of women – Islam
- Caste systems - difficulty in getting to different costs for segmentation/niche marketing
- Joint and extended families - Hinduism and organizational structures;
- Institution of the church - Iran and its effect on advertising, "Western" images

- Market segments - Maylasia - Malay, Chinese and Indian cultures making market segmentation
- Sensitivity is needed to be alert to religious differences.

f) Attitudes and values

Values often have a religious foundation, and attitudes relate to economic activities. It is essential to ascertain attitudes towards marketing activities which lead to wealth or material gain, for example, in Buddhist society these may not be relevant. Also "change" may not be needed, or even wanted, and it may be better to relate products to traditional values rather than just new ones. Many African societies are risk averse, therefore, entrepreneurialism may not always be relevant. Attitudes are always precursors of human behaviour and so it is essential that research is done carefully on these.

g) Social Organisation

Refers to the way people relate to each other, for example, extended families, units, kinship. In some countries kinship may be a tribe and so segmentation may have to be based on this. Other forms of groups may be religious or political, age, caste and so on. All these groups may affect the marketer in his planning.

There are other aspects of culture, but the above covers the main ingredients. In one form or another these have to be taken account of when marketing internationally.

Activity 4.5

Visit an MNC and study the impact of culture on business

4.6 Classifying Countries

A country's international competitiveness is a function of several factors, including factor conditions and demand conditions

Factors Conditions

Essential inputs to the production process (human resources, physical resources, knowledge resources, capital resources, and infrastructure)

Demand Conditions

Composition of home demand, the size and pattern of growth of home demand.

Gross National product (GNP): broadest measure of economic activity. Defined as the market value of final goods and services newly produced by domestic factors of demand.

Note: the production by domestic factors could take place at home or abroad.

a) Gross Domestic Product

Measures the value of production that occurs within a country's borders without regard to whether the production is done by domestic or foreign factors of production.

b) Per Capita GNP

Low-income (\$725 or less), Mozambique (\$80)

Middle-income (\$726-\$8,955) Colombia ((2,140)

High-Income (\$8,956 or more)

Ex: Luxemburg (45,360)

Japan (40,940)

U.S. (28,020)

Low-and middle-income countries is where the vast majority of the world's population lives.

North-South Dialogue

c) Relative Importance of High-Income Countries

They represent only 21% of the number of economies and 15.2% of the population, but they generate 79.5% of the world's GNP.

d) Relative Importance of Middle-Income Countries

They represent 28.1% of the world's population, 15.6% of its GNP, and represent 48.3% of the total countries.

e) Relative Importance of Low-Income Countries

Account for 30.6% of the number of economies in the world, 56.7% of the population, but only 4.9% of the GNP.

f) Purchasing Power Parity (PPP):

The basic idea is to identify the number of units of a country's currency required to buy the same amounts of goods and services in the domestic economy as one dollar would buy in the U.S.

Thus, even though per capita GNP is the primary measure of wealth in a country, purchasing power GNP is an alternative way to measure wealth that is more indicative of the purchasing power of a country's currency. Structure of Production: percentage of GDP generated by agriculture, industry, manufacturing, and services.

The key is to note that as income rises, the percentage of GDP devoted to agriculture falls, and the percentage devoted to services rises.

g) Other Indicators

i) Quality of Life

Life expectancy, educational standards, individual purchasing power, health, sanitation, and treatment of women (Canada, the U.S., Japan, Norway, the Netherlands)

ii) Capability Poverty Measures

Rate of female illiteracy, number of children in school, proportion of tended births. Widening Gap between the Rich and Poor; Income Distribution

Sector-Wise Distribution of GDP

GDP			
Country	Agriculture	Industry	Service
World	3.9	29.8	66.3
Australia	3.5	26.1	70.4
Brazil	7.4	28.3	64.3
China	15.9	50.9	33.2
Egypt Arab Republic	16.7	33.1	50.2
France	2.8	25.3	71.8
Germany	1.2	31.5	67.3
Hong Kong	0.1	14.3	85.6
India	24.9	26.9	48.2
Indonesia	17.0	47.0	35.9
Italy	2.9	29.2	67.9
Japan	1.4	31.8	66.8
Korea Republic	4.7	42.4	52.9
Malaysia	8.7	51.2	40.1
Mexico	4.1	27.9	68.0
Nepal	40.7	22.1	37.2
Netherlands	2.7	27.2	70.1
Nigeria	29.5	46.0	24.5
Norway	1.8	42.9	55.2
Philippines	15.9	31.1	52.9
Portugal	3.7	30.5	65.8
Russian Federation	6.4	39.0	54.6
Singapore	-	34.7	65.2
South Africa	3.2	30.9	65.9
Spain	3.7	30.3	66.0

Sri Lanka	19.5	27.5	53.0
Sweden	1.8	28.0	70.2
Thailand	10.3	40.5	49.3
Turkey	15.4	25.3	59.4
United Kingdom	1.1	28.7	70.3
USA	1.6	24.9	73.5

POPULATION			
(Million)			
	2001	2002	2003
World	6130.1	6214.8	6271.6
Australia	19.4	19.6	19.8
Brazil	172.4	174.4	176.5
China	1300	1280.4	1288.4
Egypt Arab Republic	65.2	66.3	67.5
France	59.2	59.4	59.7
Germany	82.3	82.4	82.5
Hong Kong	6.7	6.7	6.8
India	1000	1048.6	1064.3
Indonesia	209	211.7	214.4
Italy	57.9	57.6	57.6
Japan	127	127.15	127.2
Korea Republic	47.3	47.6	47.9
Malaysia	23.8	24.3	24.7
Mexico	99.4	100.8	102.2
Nepal	23.6	24.1	24.6
Netherlands	16	16.1	16.2
Nigeria	129.9	132.7	135.6
Norway	4.5	4.5	4.5
Philippines	78.3	79.9	81.5
Portugal	10	10.1	10.1
Russian Federation	144.8	144	143.4

Singapore	4.1	4.1	4.2
South Africa	43.2	47.6	45.2
Spain	41.1	40.9	41.1
Srilanka	18.7	18.9	19.1
Sweden	8.9	8.9	8.9
Switzerland	7.2	7.2	7.3
Thailand	61.2	61.6	62
Turkey	68.5	69.6	70.7
United Kingdom	58.8	59.2	59.2
USA	285.3	288.3	291

(Source: World Development Indicators Database: World Bank)

GNI (Formerly)GNP			
(Billion US\$)			
	2001	2002	2003
World	31400	31483.9	34491.4
Australia	385.9	386.6	430.5
Brazil	528.9	497.3	478.9
China	1100	1209.5	1417.3
Egypt Arab Republic	99.6	97.6	93.8
France	1400	1342.7	1523
Germany	1900	1870.3	2084.6
Hong Kong	170.3	167.6	173.3
India	477.4	501.5	567.6
Indonesia	144.7	149.8	172.7
Italy	1100	1097.9	1242.9

Japan	4500	4265.6	4389.7
Korea Republic	447.6	473	576.4
Malaysia	79.3	85.9	93.6
Mexico	550.2	596.7	637.1
Nepal	5.8	5.6	5.8
Netherlands	390.3	386.7	426.6
Nigeria	37.1	38.6	42.9
Norway	160.8	171.7	197.6
Philippines	80.8	81.4	87.7
Portugal	109.3	108.7	123.6
Russian Federation	253.4	307.9	374.9
Singapore	88.8	86.1	90.2
South Africa	121.9	113.4	125.9
Spain	588	594.1	698.2
Srilanka	16.4	15.8	17.8
Sweden	225.9	221.5	258.3
Switzerland	277.2	274.1	292.8
Thailand	118.5	122.2	136
Turkey	167.3	173.9	197.2
United Kingdom	1500	1486.1	1680.3
USA	9800	10110	10945.7

(Source: World Development Indicators Database: World Bank)

Surface Area

(Million Sq. KM)

World	133.80
Australia	7.70
Brazil	8.50
China	9.60
Egypt Arab Republic	1.00
France	0.55
Germany	0.36
India	3.30
Indonesia	1.90
Italy	0.30

Japan	0.38
Korea Republic	99.26
Malaysia	0.33
Mexico	2.00
Nepal	0.15
Netherlands	41.53
Nigeria	0.92
Norway	0.32
Philippines	0.30
Portugal	91.98
Russian Federation	17.10
South Africa	1.20
Spain	0.51
Srilanka	0.07
Sweden	0.45
Switzerland	41.29
Thailand	0.51
Turkey	0.78
United Kingdom	0.24
USA	9.60

(Source: World Development Indicators Database: World Bank)

4.7.1 Economic Environment

As a company considers where in the world to build factories and sells products, it must analyze the countries in which it may do business. Country analysis requires understanding national goals, priorities, and policies. It also involves understanding economic performance, as indicated by economic growth, inflation, and budget and trade deficits.

4.7.2 Classifying Economic Systems

Economic Systems usually are classified as capitalist, socialist, or mixed. No country is purely market or purely command.

As the economy moves to more balance, between market and command or between public and private ownership, it is considered mixed.

We can also classify economic systems according to two other criteria:

- Type of property ownership

- Method of resource allocation and control

a) Market Economy:

The individual and the company play important roles.

The market mechanism involves an interaction of price, quantity, supply and demand for resources and products.

The key factors that make the market economy work:

-consumer sovereignty

-freedom of the enterprise to operate in the market

In addition, freedom from government restrictions, and legal and Institutions frameworks to safeguard economic freedoms

b) Centrally Planned Economy:

The government coordinates the activities of the different economic sectors.

Goals are set for every enterprise in the country.

The government determines how much is produced, by whom, and for whom.

c) Mixed Economy

Partly Free, Mostly Not Free

Government intervention can be classified in two ways:

- Government ownership of the means of production

- Government influence in decision making

Ex: MITI was organized to guide industrial development through "strategic planing and authority over investment and production priorities."

d) Political-Economic Synthesis

Clearly, numerous combinations of political and economic systems are possible

Asian experience, Latin American experience, European, U.S.

Case: McDonald's Corporation

- Burgers round trip back to Russia
- Overseas moves compatible with McDonald's growth strategy
- From 1990-1995, 56% of the new restaurants have been opened overseas
- Of the 1,007 restaurants added in 1995, 45% were from 6 foreign markets (Australia, Canada, England, France, Germany, and Japan)
- Supply procurement, a major problem
- 27,000 Russian applicants for its 650 positions
- 30,000 people were served during the first day of operations
- strong investment in training

Case Study 4.5

4.7.3 Economic Trade Policies (Protectionism)

Protectionism is the economic policy of restraining trade between nations, through methods such as high tariffs on imported goods, restrictive quotas, and anti-dumping laws in an attempt to protect domestic industries in a particular nation from foreign take-over or competition. This contrasts with free trade, where no artificial barriers to entry are instituted.

The term is mostly used in the context of economics, where protectionism refers to policies or doctrines which "protect" businesses and living wages by restricting or regulating trade between foreign nations:

Subsidies - *To protect existing businesses from risk associated with change, such as costs of labour, materials, etc.*

Tariffs - *to increase the price of a foreign competitor's goods. (Including restrictive quotas, and anti-dumping measures.) on par or higher than domestic prices.*

Quotas - to prevent dumping of cheaper foreign goods that would overwhelm the market.

Tax cuts- *Alleviation of the burdens of social and business costs.*

Intervention - *The use of state power to bolster an economic entity.*

Protectionism has frequently been associated with economic theories such as mercantilism, the belief that it is beneficial to maintain a positive trade balance, and import substitution. There are two main variants of protectionism, depending on whether the tariff is intended to be collected (traditional protectionism) or not (modern protectionism).

Modern protectionism

In the modern trade arena many other initiatives besides tariffs have been called protectionist. For example some commentators, such as Jagdish Bhagwati, see developed countries' efforts in imposing their own labor or environmental standards as protectionism. Also, the imposition of restrictive certification procedures on imports are seen in this light.

Recent examples of protectionism are typically motivated by the desire to protect the livelihoods of individuals in politically important domestic industries. Whereas formerly blue-collar jobs were being lost to foreign competition, in recent years there has been a renewed discussion of protectionism due to offshore outsourcing and the loss of white-collar jobs. Most economists view this form of protectionism as a disguised transfer payment from consumers (who pay higher prices for food or other protected goods) to local high-cost producers.

Traditional Protectionism

In its historic sense, protectionism is the economic policy of relying on revenue tariffs for government funding in order to reduce or eliminate taxation on domestic industries and labor (e.g., corporate and personal income taxes). In

protectionist theory, emphasis is placed on reducing taxation on domestic labor and savings at a cost of higher tariffs on foreign products. This contrasts with the free trade model, in which first emphasis is placed on exempting foreign products from taxation, with the lost revenue to be compensated domestically.

Traditional protectionism sees revenue tariffs as a source of government funding, much like a sales tax, that can be used to reduce other domestic forms of taxes. The goal of traditional protectionism is to maximize tax revenue from the purchase of foreign products with the goal of being able to reduce or eliminate other forms of domestic taxation (income taxes, sales taxes, etc.) as a result. Tariffs were the predominant source of tax revenue in the United States from its founding through World War II, allowing the country to operate through most of that period without income and sales taxes. Traditional protectionism remains highly dependent on large amounts of imports. It also requires tariffs to be kept at reasonable rates to ensure maximum government revenue.

a) Dumping

A practice of charging a very low price in a foreign market for such economic purposes as putting rival suppliers out of business.

If a company exports a product at a price lower than the price it normally charges on its own home market, it is said to be “dumping” the product. Is this unfair competition? The WTO agreement does not pass judgement. Its focus is on how governments can or cannot react to dumping — it disciplines anti-dumping actions, and it is often called the “Anti-dumping Agreement”.

Legal Framework

Based on Article VI of GATT 1994

Customs Tariff Act, 1975 - Sec 9A, 9B (as amended in 1995)

Anti-Dumping Rules [Customs Tariff (Identification, Assessment and Collection of Anti Dumping Duty on Dumped Articles and for Determination of Injury) Rules, 1995] Investigations and Recommendations by Designated Authority, Ministry of Commerce Imposition and Collection by Ministry of Finance

b) Subsidies

In economics, a subsidy is generally a monetary grant given by government to lower the price faced by producers or consumers of a good, generally because it is considered to be in the public interest. Subsidies are also referred to as corporate welfare by those who oppose their use. The term *subsidy* may also refer to assistance granted by others, such as individuals or non-government institutions, although this is more usually described as charity. A subsidy normally exemplifies the opposite of a tax, but can also be given using a reduction of the tax burden. These kinds of subsidies are generally called *tax expenditures* or *tax breaks*.

Subsidies protect the consumer from paying the full price of the good consumed, however they also prevent the consumer from receiving the full value of the thing not consumed – in that sense, a subsidized society is a consumption society because it unfairly encourages consumption more than conservation. Under free-market conditions, consumers would make choices which optimize the value of their transactions; where it was less expensive to conserve, they would conserve. In a subsidized economy however, consumers are denied the benefit of conservation and as a result, subsidized goods have an artificially higher value than expenditures which do not consume. Subsidies are paid for by taxation which creates a deadweight loss for that activity which is taxed

c) Countervailing Duties

Means to restrict international trade in cases where imports are subsidized by a foreign country and hurt domestic producers. According to WTO rules, a country can launch its own investigation and decide to charge extra duties. Since countries can rule domestically whether domestic industries are in danger and whether foreign countries subsidize the products, the institutional process surrounding the investigation and determinations has significant impacts beyond the countervailing duties.

d) Tariffs

A tariff is a tax on imported goods. When a ship arrives in port a customs officer inspects the contents and charges a tax according to the tariff formula. Since the goods cannot be landed until the tax is paid it is the easiest tax to collect, and the cost of collection is small. Smugglers of course seek to evade the tariff.

An *ad valorem* tax is a percentage of the value of the item, say 10 cents on the dollar, while a *specific* tariff is so-much per weight, say \$5 per ton.

A "revenue tariff" is a set of rates designed primarily to raise money for the government. A tariff on coffee imports, for example (by a country that does not grow coffee) raises a steady flow of revenue.

A "protective tariff" is intended to artificially inflate prices of imports and "protect" domestic industries from foreign competition. For example, a 50% tax on a machine that importers formerly sold for \$100 and now sell for \$150.

Without a tariff the local manufacturers could only charge \$100 for the same machine; now they can charge \$149 and make the sale.

A *prohibitive* tariff is one so high that no one imports any of that item.

The distinction between protective and revenue tariffs is subtle: protective tariffs in addition to protecting local producers also raise revenue; revenue tariffs produce revenue but they also offer some protection to local producers. (A pure revenue tariff is a tax on goods not produced in the country, like coffee perhaps.)

Tax, tariff and trade rules in modern times are usually set together because of their common impact on industrial policy, investment policy, and agricultural policy.

There are two main ways of implementing a tariff:

***Ad valorem* tariff**

Fixed percentage of the value of the good that is being imported. Sometimes these are problematic as when the international price of a good falls, so does the tariff, and domestic industries become more vulnerable to competition. Conversely when the price of a good rises on the international market so does the tariff, but a country is often less interested in protection when the price is higher. They also face the problem of transfer pricing where a company declares a value for goods being traded which differs from the market price, aimed at reducing overall taxes due.

Specific tariff

Tariff of a specific amount of money that does not vary with the price of the good. These tariffs may be harder to decide the amount at which to set them, and they may need to be updated due to changes in the market or inflation.

Adherents of supply-side economics sometimes refer to domestic taxes, such as income taxes, as being a "tariff" affecting inter-household trade.

Quotas

A quota is a prescribed number or share of something.

In common language, especially in business, a quota is a time-measured goal for production or achievement. An assembly line worker might have a quota for the number of products made; a salesperson might have a quota to meet for weekly sales; In trade, a quota is a form of protectionism used to restrict the import of something to a specific quantity The number of cars imported from Japan may

have a quota of 50,000 vehicles per annum to protect auto manufacturers in the United States

IMF member's quota is broadly determined by its economic position relative to other members. Various economic factors are considered in determining changes in quotas, including GDP, current account transactions, and official reserves. When a country joins the IMF, it is assigned an initial quota in the same range as the quotas of existing members considered by the IMF to be broadly comparable in economic size and characteristics.

Quotas are denominated in Special Drawing Rights, the IMF's unit of account. The largest member of the IMF is the United States, with a quota of SDR 37.1 billion (about \$53.5 billion), and the smallest member is Palau, with a quota of SDR 3.1 million (about \$4.5 million).

e) VERs - Voluntary Export Restraints

A voluntary export restraint is a restriction set by a government on the quantity of goods that can be exported out of a country during a specified period of time. Often the word voluntary is placed in quotes because these restraints are typically implemented upon the insistence of the importing nations.

Typically VERs arise when the import-competing industries seek protection from a surge of imports from particular exporting countries. VERs are then offered by the exporter to appease the importing country and to avoid the effects of possible trade restraints on the part of the importer. Thus VERs are rarely completely voluntary.

Also, VERs are typically implemented on a bilateral basis, that is, on exports from one exporter to one importing country. VERs have been used since the 1930s at least, and have been applied to products ranging from textiles and footwear to steel, machine tools and automobiles. They became a popular form

of protection during the 1980s, perhaps in part because they did not violate countries' agreements under the GATT. As a result of the Uruguay round of the GATT, completed in 1994, WTO members agreed not to implement any new VERs and to phase out any existing VERs over a four year period. Exceptions can be granted for one sector in each importing country.

Some interesting examples of VERs occurred with auto exports from Japan in the early 1980s and with textile exports in the 1950s and 60s.

US-Japan Automobile VERs

f) Customs Valuation

The rates of customs duties leviable on imported goods (& export items in certain cases) are either specific or on ad valorem basis or at times specific cum ad valorem. When customs duties are levied at ad valorem rates, i.e., depending upon its value, it becomes essential to lay down in the law itself the broad guidelines for such valuation to avoid arbitrariness and to ensure that there is uniformity in approach at different Customs formations. Section 14 of the Customs Act, 1962 lays down the basis for valuation of import & export goods in the country. It has been subject to certain changes – basic last change being in July-August, 1988 when present version came into operation. Briefly the provisions are explained in the following paragraphs.

g) Trade Sanctions

Trade sanctions are trade penalties imposed by one or more countries on one or more other countries. Typically the sanctions take the form of import tariffs(duties), licensing schemes or other administrative hurdles. They tend to arise in the context of an unresolved trade or policy dispute, such as a

disagreement about the fairness of some policy affecting international trade (imports or exports).

For example, one country may conclude that another is unfairly subsidising exports of one or more products, or unfairly protecting some sector from competition (from imported goods or services). The first country may retaliate by imposing import duties, or some other sanction, on goods or services from the second.

Trade sanctions are distinguished from economic sanctions, which are used as a punitive measure in international relations (examples being recent US or multilateral sanctions against Cuba, Iraq, or North Korea).

Trade policy reviews: ensuring transparency

Individuals and companies involved in trade have to know as much as possible about the conditions of trade. It is therefore fundamentally important that regulations and policies are transparent. In the WTO, this is achieved in two ways: governments have to inform the WTO and fellow-members of specific measures, policies or laws through regular “notifications”; and the WTO conducts regular reviews of individual countries’ trade policies — the trade policy reviews. These reviews are part of the Uruguay Round agreement, but they began several years before the round ended — they were an early result of the negotiations. Participants agreed to set up the reviews at the December 1988 ministerial meeting that was intended to be the midway assessment of the Uruguay Round. The first review took place the following year. Initially they operated under GATT and, like GATT, they focused on goods trade. With the creation of the WTO in 1995, their scope was extended, like the WTO, to include services and intellectual property.

Activity 4.6

Collect and list all the trade policies of Indian government in relation to International Business

Self-Assessment Questions (SAQs)

1.External Macro Environment Forces involves _____ , _____ ,
_____ , _____

- a) Political, Economic, Marketing, Cultural
- b) Legal, Finance, Technological, Competitors
- c) Suppliers, Customers, Creditors, Competitors
- d) Political, Economic, Social, Technological

2.List the internal micro environmental forces

3.List the ways of scanning international business environment

4.Expand the following

- a) PEST _____
- b) GDP _____
- c) GNP _____
- d) BPO _____
- e) LPO _____
- f) KPO _____
- g) FDI _____
- h) LPG _____

- i) NAFTA _____
- j) MNC _____
- k) VER _____
- l) GATT _____
- m) WTO _____
- n) ICJ _____
- o) PPP _____
- p) IMF _____

5. List all the instruments used by government for trade control

6. The members of WTO have agreed to eliminate all tariffs in 10 industries list them?

7. List the strategies followed by MNCs to eliminate political risk?

8. List the conditions used in country classification?

9. The Economic System is classified into

10. The Political System is classified into

Summary

- International business provides both opportunities for growth and success and also poses threat to business
- There are five macro-environmental forces acting on international business, they are Political, Economic, Social, Technological, Legal etc
- There are three ways of scanning international business environment Ad-hoc Scanning, Regular Scanning, Continuous Scanning
- PEST analysis is the framework for analyzing international business environment.
- A stable political system is needed for the success of international business
- The political system is classified into two they are democracy and dictatorship
- MNCs can play the strategies like Joint ventures, Expanding the investment base, Marketing and distribution, Licensing, Planned domestication, Political payoffs to reduce political risk
- Government can actively control the trade by designing trade policies on Dumping, Subsidies, Countervailing Duties, Tariffs, Quotas, VERs - Voluntary Export Restraints
- Political Risks Of Global Business Confiscation, Expropriation, Domestication
- MNCs can play strategies like Joint ventures, Expanding the investment base, Marketing and distribution, Licensing, Planned domestication, Political payoffs to reduce political risk.
- The Legal system is classified into common law system, civil law system or codified legal system and theocratic law system
- The different cultural behaviour practices will affect international business
- Technology plays a major role in removing the barriers like distance and time to promote international business
- Countries can be classified as High-Income countries, Middle-Income countries and Low-Income countries
- Countries can be classified based on Gross Domestic Product, Gross National Product, Purchasing Power Parity
- Protectionism is the economic policy of restraining trade between nations, through methods such as high tariffs on imported goods, restrictive quotas, and anti-dumping laws in an attempt to protect domestic industries in a particular nation from foreign take-over or competition.

Answer Key for Self-Assessment Questions (SAQs)

1. Political, Economic, Social, Technological
2. Competitors, Suppliers, Customers, Creditors
3. Ad-hoc Scanning, Regular Scanning, Continuous Scanning
4. a) Political, Economic, Social, Technological
 - b) Gross Domestic Product
 - d) Gross National Product
 - e) Business Process Outsourcing
 - f) Legal Process Outsourcing
 - g) Knowledge Process Outsourcing
 - h) Foreign Direct Investment
 - i) Liberalization Privatization Globalization
 - j) North American Free Trade Agreement
 - k) Multi National Company
 - l) Voluntary Export Restraints
 - m) Generally Accepted Tariff and Trade
 - n) World Health Organization
 - o) International Court of Justice
 - p) Purchasing Power Parity
 - q) International Monetary Fund
5. Trade Restrictions / Trade Barriers
 - Dumping
 - Subsidies
 - Countervailing Duties
 - Tariffs
 - Quotas
 - VERs - Voluntary Export Restraints
6. Beer, Construction equipment, Distilled spirits, Farm machinery, Furniture
Medical equipment, Paper, Pharmaceuticals, Steel, Toys
7. Strategies To Lessen Political Risks
 - Joint ventures
 - Expanding the investment base
 - Marketing and distribution
 - Licensing
 - Planned domestication

- Political payoffs
- 8. Factors Conditions and Demand Conditions
- 9. Market Economy, Centrally Planned Economy, Mixed Economy
- 10. Democracy and Dictatorship

Keywords

- **Globalization**
- **Tariffs**
- **Ad Valorem Tariff**
- **Subsidies**
- **Dumping**
- **Polycentrism**
- **Ethnocentrism**
- **Stereotypes**
- **Cultural Shock**
- **Geocentrism**
- **Home Country**
- **Multi-National Company (MNC)**
- **Protectionism**
- **Technological Environment**
- **Economic Environment**
- **Political Environment**
- **Legal Environment**
- **Low-Income Countries**
- **Middle-Income Countries**
- **Litigation**
- **Arbitration**
- **Diversification**
- **Political Risk**
- **Macro Environment**
- **Micro Environment**

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Review Questions

1. Write short note on

- a) Polycentrism
 - b) Ethnocentrism
 - c) Stereotypes
 - d) Cultural Shock
 - e) Geocentrism
2. What do you understand by external macro environmental forces explain?
 3. Explain the reasons for going global?
 4. Give a note on PEST analysis?
 5. What is political environment? What are the political risks faced by global business?
 6. What do you mean by good corporate citizenship?
 7. Give a note on the instruments used by the government to control trade?
 8. What are the reasons for government's involvement in business?
 9. What do you understand by legal environment?
 10. Give a note on International Court of Justice (ICJ)?
 11. Give a note on effect of technology on strategy and competition?
 12. What is technological cycle explain?
 13. What are the behaviour practices affecting business?
 14. Write a note on classification of countries?
 15. What do you understand by protectionism?

Honesty and Hard Work gives Honor

UNIT V

FOREIGN INVESTMENT AND FDI

CONTENT OUTLINE

- Introduction
- The role of foreign investment
- Foreign Direct Investment (FDI)
- Foreign Portfolio Investment (FPI)
- Capital Inflows and Overheating
- Summary
- Review Questions

INTRODUCTION

Economic development remains an urgent global need. Globalization – which links countries closer than ever before with each other - reinforces this need. The countries have achieved impressive increases in income, over a billion people than a hundred countries still live in poverty. Economic inequalities within countries remain large, and there is little sign of convergence in incomes across countries. A number of developing countries face increasing marginalisation.

Globalisation accentuates the increasing importance of the international economics for developing countries. Flows of finance, information, skills, technology, and services between countries are increasing rapidly. FDI is one of the most dynamic increasing international resource flows to developing countries, FDI flows are particularly important because FDI is a package of tangible and intangible assets, and because firms – TNCs – deploying them are now important players in the global economy can affect development, by complementing domestic investment and by undertaking trade and transfers of knowledge, skills and technology. However, TNCs do not substitute for domestic effort: they can only provide access to tangible and intangible assets and catalyse domestic investment and capabilities. In a world of intensifying competition and accelerating technological change, this complementary and

catalytic role can very valuable. Since globalisation has its dangers, countries need to prepare their capabilities to harness its potential including through FDI. However, FDI on its own cannot counteract the marginalization of developing countries.

THE ROLE OF FOREIGN INVESTMENT

The factors that propel sustained economic development have not changed o time. They include the generation and efficient allocation of capital and labour, application of technology and the creation of skills and institutions. These fact determine how well each economy uses its endowments and adds to them. They also affect how flexibly and dynamically each country responds to changing economic conditions, However, the global context for development has changed enormous the past three decades. These changes affect not only the role of FDI in host countries, but also government policies on EDT. The following three are of particular significance.

i) The nature and pace of knowledge - and, particularly, technological knowledge - change

The creation and diffusion of productive knowledge have become central to growth and development. "Knowledge" includes not only technical knowledge (research and development, design, process engineering), but also knowledge of organisation, management and inter-firm and international relationships. Much of this knowledge is tacit. Today, the resources devoted to such knowledge exceed investment in tangible machinery and equipment in many of the world's most dynamic firms, and the costs of generating new knowledge are rising constantly. The importance of knowledge is not limited to modern or high-tech activities but pervades all sectors and industries, including traditional activities in the primary sector (for instance, vegetable and flower exports), manufacturing (such as textiles, clothing and footwear), and services (such as tourism and banking). As a result, achieving development objectives is, more than ever, a continuous learning process.

The sheer pace of technological change, in particular, is unprecedented and is accelerating. This means that enterprises that want to be competitive internationally need both the knowledge to use technologies efficiently and to keep pace with developments. Innovators need to invest more in creating new knowledge, but even followers need the capacity - difficult to acquire - to access and use this new knowledge, or in fortuitous circumstances, to identify windows of opportunity for technological leaps. The skills required for this are changing concomitantly, as are institutions and their relations with productive enterprises; one development is the closer linking of science with technology-generation in industry. An important result of this new "technological paradigm" is that research-intensive activities are growing more rapidly than others in production and trade; thus, sustained economic growth calls increasingly not just for the application of new technology to existing activities, but also for a shift of activities up the value-added chain.

The most profound technological changes today emanate from a merger of communications and information processing technologies. While the telegraph, telephone and computer were significant technological achievements; they pale in comparison with emerging technologies based on the interface between microprocessors and telecommunications. These are generic technologies that affect practically the whole range of economic and even social and cultural activities. Information can now be transmitted across the globe at very low cost.

ii) Shrinking economic space and changing competitive conditions

Technical progress in transport and communications has caused economic space to shrink dramatically. Countries now face much more intense and immediate competition than ever before. This leads to a significant restructuring of their comparative advantages and activities. The nature of competition itself is changing, with the rapid introduction of new products, shorter product cycles, flexibility of response to demand, and customer interaction becoming more important than traditional forms of competition based on lower costs. At the

enterprise level, this calls for new management and technical skills and organisational forms. In many instances, it leads to flatter hierarchies and greater use of networking and cooperation between related firms and also competing firms (for instance, component suppliers now play a much more direct role in new technology development). At the national level, it requires countries to be more open to international flows of information, and to improve national capabilities to absorb and use that information: to develop new skills, institutions and innovative capacities. Countries that can do that - either generally or in niche markets - can move up the value-added ladder.

iii) Changing attitudes and policy regimes

Most developing and transition countries have moved to market-oriented and private sector led economies. This shift reflects disillusionment with past strategies and growing difficulties in pursuing them in the new technological and competitive setting. The shrinking of economic space has itself rendered elements of traditional strategies absolute while the flow of information has made governments more aware of policies and performance in other countries. Policy benchmarking in all areas is becoming more common which, in turn, puts more pressure on countries to innovate in the policy arena. There is widespread reduction and removal of trade barriers, deregulation of internal markets, privatisation and liberalization of technology and investment flows at the national level. At the international level, regulation has intensified and is being harmonized. For instance, the TRIPS agreement of the Uruguay Round has introduced a common more rigorous system of intellectual property protection; the TRIMs agreement established disciplines over certain performance requirements; and quality requirements such as ISO standards are becoming prerequisites for participating in international production and trade.

Perhaps nowhere is the policy change more striking than in the changing attitude of governments to TNCs. Why have governments changed their attitudes to TNCs? There are several reasons for the change in attitudes towards TNCs and

the intensification of competition for PD Governments recognize that TNCs can provide a package of external resources that can contribute to development. There is also now an increasing number of TNCs from developing countries, reflected in the fact that the share of developing countries in PD outflows has increased from about two per cent at the beginning of the 1980s to approximately 15 per cent of a much higher total in the mid, 1990s; their home governments want access for their firms to foreign markets and locations. At the same time, many governments have improved their administrative capabilities and feel more comfortable in dealing with TNCs. Efficient FDI screening has been difficult even for countries with sophisticated bureaucracies, given the need to relate it to changing country and sectoral advantages, changing firm strategies and competition, and political pressures from other countries. On the aggregate level external financing has shifted from official to private sources, especially towards FDI. Finally, the liberalisation of FDI (and trade) policy is often part of the conditionality in IMF and World Bank adjustment programmes, and is promoted by many leading aid donors.

Reflecting this change of attitude, FDI is now not just permitted - it is avidly sought by governments and, indeed, many sub-national public sector entities at all levels, from provinces to individual communities. Apart from active promotion (which has led to the establishment of investment promotion agencies in a great number of countries, having their disposal an array of incentives), policy liberalisation is the principal tool. Liberalisation has been extended to such service industries as telecommunication, transportation and power generation and distribution, previously closed to foreign investors. Many developing countries and economies in transition have concluded bilateral treaties to protect FDI and avoid double taxation. A number of regional schemes (notably the European Union, NAFTA, ASEAN and MERCOSUR) have reduced barriers to FDI or are in the process of doing so, facilitating intra-regional investment trade flows. At the multilateral level, the General Agreement on Trade in Services has

contributed to the liberalisation of EDT in services, and the TRIMs Agreement has r the use of certain performance requirements. The FDI global regime that has emerged after these changes, though uneven, is much more friendly towards foreign investors than in the past.

CHANGING CONTEXT FOR TNCs

Knowledge-intensive production, technological change, shrinking economic space greater openness have also changed the context for TNCs. There are new opportunities and pressures - to utilise them. The opening of markets creates new geographical space TNCs to expand in and access tangible and intangible resources. It also permits wider choice in the methods firms can use (PDI, trade, licensing, subcontracting, franchising, partnering and so on) to operate in different locations. At the same time, advances in information, communication and transportation technologies, as well as in managerial and organizational methods, facilitate the transnationalisation of many firms, including SMEs. The combination of better access to resources and a better ability to organise production transnationally increases the pressure on firms to utilise new opportunities, lest their competitors do so first and gain a competitive advantage. Competition is everywhere - there are fewer and fewer profit reservations and market niches that remain protected from the fierce winds of competition. Indeed, a portfolio of locational assets - allowing firms to combine their mobile advantages most effectively with the mobile tangible arid intangible resources of specific locations - is becoming an increasingly important source of corporate competitiveness.

Firms have reacted accordingly. A highly visible group of large “traditional” TNCs continues to grow, often with turnovers larger than the national incomes of many developing countries. There are also many new entrants, such as large firms from developed countries that had confined themselves previously to domestic operations (e.g., telecommunications operators). Many are smaller firms from these countries that find it necessary to invest overseas to exploit

their ownership advantages or to see advantages and alliances. An increasing number are firms from developing countries both small and large. And some are large and small firms from economies in transition, countries that previously had isolated them largely from international investment. As a result, the number of TNCs has increased substantially, having reached at least 60,000 at the end of the 1990s. Their growth rate was faster than that of both domestic and foreign production.

The changing context and the quest for a portfolio of locational assets has brought about a change in corporate strategies. The following developments are particularly noteworthy:

A shift from stand-alone, relatively independent, foreign affiliates to integrated international production systems relying on specialised affiliates to service the entire TNC system. Within the framework of this international intra-firm division of labour, any part of the value-added chain of an enterprise can be located abroad while remaining fully integrated into a corporate network. Corporate strategies of this kind seek to exploit regional or global economies of higher degree of functional specialisation.

This shift broadens the range of resources sought by TNCs in host countries making firms more selective in their choices. However, it can also encourage in countries that cannot provide a wide range of resources but have specific assets that are sought by TNCs (eg. accounting or software skills).

A shift towards greater use of non-equity and cooperative relationships with other enterprises, such as alliances, partnerships, management contracts or subcontracting arrangements. These arrangements serve a variety of corporate objectives. They can provide better access to technologies or other assets firms wish to share the cost and risk of innovative activities. They can reduce production cost of labour-intensive products.

Emergence of a network type of organisation. This expands the scope of interactions between TNCs and enterprises from host countries, and also the forms of these interactions.

These changing corporate strategies bring with them a different pattern of international economic integration. Originally, this involved the integration of markets through length trade “shallow” integration. Integrated international production moves this integration to the level of production in all its aspects “deep” integration. In process, a significant part of international transactions becomes internalised, i.e. the form of transactions between various parts of transnational corporate systems located in different countries. It is estimated that more than one-third of world trade some four-fifths of technology flows are internalised within TNCs. The share of world production under the common governance of TNCs is estimated at one-quarter.

The ability of firms to allocate their economic assets internationally, and the international production system created in the process, have become themselves a part of the new global system. As a result, TNCs have indeed become important actors in the world economy and, hence, the development process - a fact reflected in the competition of all countries for EDT. Indeed, increasingly, the decision where to locate production facilities of any kind becomes crucial for development, because the decision where to locate becomes a decision where to invest and from where to trade. And it becomes an FIJI decision if the location chosen is abroad.

FOREIGN DIRECT INVESTMENT

Direct investment abroad is a complex venture. As distinct from trade, licensing or investment, EDT involves a long-term commitment to a business endeavour in a foreign country. It often involves the engagement of considerable assets and resources that need to be coordinated and managed across countries and to satisfy the principal of successful investment, such as sustainable profitability and acceptable risk/profitability ratios. Typically, there are many host country

factors involved in deciding where an FDI project should be located and it is often difficult to pinpoint the most decisive factor. However, it is widely agreed that FDI takes place when three sets of determining factors exist simultaneously: the presence of ownership-specific competitive advantages in a transnational corporation (MNC), the presence of locational advantages in a host country, and the presence of superior commercial benefits in an intra-firm as against an arm's-length relationship between investor and recipient

The ownership-specific advantages (e.g. proprietary technology) of a firm if exploited optimally can compensate for the additional costs of establishing production facilities in a foreign environment and can overcome the firm's disadvantages vis-a-vis local firms.

The ownership-specific advantages of the firm should be combined with the locational advantages of host countries (e.g. large markets or lower costs of resources or superior infrastructure). Finally, the firm finds greater benefits in exploiting both ownership specific and locational advantages by internalisation, i.e. through FDI rather than arm's length transactions. This may be the case for several reasons. For one, markets for assets or production inputs (technology, knowledge or management) may be imperfect, if they exist at all, and may involve significant transaction costs or time-lags. For another, it may be in a firm's interest to retain exclusive rights to assets (e.g., knowledge) which confer upon it a significant competitive advantage (e.g. monopoly rents).

While the first and third conditions are firm-specific determinants of FDI, the second is location-specific and has a crucial influence on a host country's inflows of FDI. If only the first condition is met, firms will rely on exports, licensing or the sale of patents to service a foreign market. If the third condition is added to the first, FDI becomes preferred mode of servicing foreign markets, but only in the presence of ownership specific advantages. Within the trinity of conditions for FDI to occur, locational determinants are the only ones that host governments can influence directly.

To explain differences in FDI inflows among countries and to formulate policies to capture inbound investment, it is necessary to understand how MNCs choose investment locations. The relative importance of different location-specific determinants depends on at least four aspects of investment: the motive for investment (e.g. resource-seeking or market seeking FDI), the type of investment (e.g. new or sequential FDI), the sector investment (e.g. services or manufacturing) and the size of investors (small and medium sized MNCs or large MNCs). The relative importance of different determinants also changes as the economic environment evolves over time. It is therefore possible that a set of host country determinants that explains FDI in a particular country at a given time changes as the structures of its domestic economy and of the international economy evolve. At the same time, there are also location determinants that remain constant. Therefore, there is a need to review the location-specific (host-country) determinants of FDI flows and stocks and to analyse how these have changed in a liberalising and globalising world economy. The review of host country determinants begins with the role of national policies and especially the liberalisation of policies (a key factor in globalisation) as FDI determinants. Then follows a review of business facilitation measures: as the world economy becomes more open to international business transactions, countries compete increasingly for FDI not only by improving their policy and economic determinants, but also by implementing pro-active facilitation measures that go beyond policy liberalisation. While not as important as the other two determinants, these measures are receiving increased attention. Economic determinants and, in particular, their changing significance in the context of liberalisation, global and issues related to the impact of international investment frameworks have been all the more topical as discussions and negotiations whether at the bilateral, regional or multilateral levels have gathered momentum and the possibility of a multilateral framework on investment has raised questions as to whether, why and how international investment agreements

matter for the location of FDI and the activities of MNCs. In particular, a key question (one similar to that faced by the creators of the post-Second World War multilateral trading system) is what effect, if any, a multilateral framework on investment might have for the growth and pattern of FDI.

THE NATIONAL FDI POLICY FRAMEWORK

As a general principle, host countries that offer what MNCs are seeking, and/or host countries whose policies are most conducive to MNC activities, stand a good chance attracting FDI.

But firms also see locational determinants in their interaction ownership-specific and internalisation advantages in the broader context of their corpora strategies. These strategies aim, for example, at spreading or reducing risks, pursuing, oligopolistic, competition, and matching competitors' actions or looking for distinct sources of competitive advantage. In the context of different strategies, the same motive and the corresponding host country determinants can acquire different meanings. For example, the market-seeking motive can translate, in the case of one MNC, into the need to enter new markets to increase the benefits arising from multi plant operations; in the case of another MNC, it can translate into the desire to acquire market power; and for N' another MNC, it can aim at diversifying markets as part of a risk strategy.

Core FDI policies consist of rules and regulations governing the entry and operations of foreign investors, the standards of treatment accorded to them, and the functioning of the markets within which they operate. These policies can range from outright prohibition of FDI entry to non-discrimination in the treatment of foreign and domestic firms and even preferential treatment of foreign firms. They typically satisfy various objectives reducing or increasing FDI, influencing its sectoral composition or geographical origin, encouraging specific contributions to the economy and affecting ways in which these contributions are made. To achieve these objectives, FDI policies are usually accompanied by other policies that also influence investors' decisions.

Among these supplementary policies used to influence locational decisions, trade policy plays the most prominent role. For example, to attract FDI and to maximise its contributions to their import-substituting development strategies, countries in Latin America used a mix of protectionist trade policies combined with policies allowing FDI manufacturing. Asian countries, in contrast, used both FDI and trade policies (e.g. exemptions from import duties) to encourage MNCs to contribute to their export oriented economic strategies. For example, Hong Kong, China pursued laissez-faire trade and FDI policies. On the other hand, the FDI policies of such economies as the Republic of Korea, Taiwan Province of China and Japan were embedded in a broader set of industrial policies guiding and selectively inducing MNCs to link up with local firms to help increase local innovative and export capacities.

Other related policies may include Privatisation policies and policies determined by the international agreements a country has signed:

i) . Privatisation is a special case of acquisition, as it involves purchases of firms from the state. It has two dimensions: an FDI-policy dimension and a competition F policy dimension. If privatisation welcomes foreign investors, it broadens the scope of FDI. The competition-policy dimension becomes relevant if, in industries characterised as natural or near-natural monopolies, the sale of a privatised company to a domestic or foreign investor only means the transfer of a monopoly from the state to a private agent.

ii) International investment agreements provide an international dimension to national FDI policies. Some of them focus on insurance and, protection, while others deal with broader issues.

Policies used intentionally to influence FDI and its location constitutes the “inner ring” of the policy framework for FDI. The features of such a framework vary among countries and also vary over time in the same country. This has become obvious since the broad-front advance of more market-based economic

policies began in the mid- 1980s. Core FDI policies themselves have become more liberal and, coupled with more liberal trade policies; have contributed to a more cohesive policy framework.

INCENTIVES TO ATTRACT FDI

Incentives are any measurable economic advantage afforded to specific enterprises or categories of enterprises by (or at the direction of) a government, in order to encourage them to behave in a certain manner. They include measures either to increase the rate of return of a particular FDI undertaking, or to reduce (or redistribute) its costs or risks. They do not include broader nondiscriminatory policies, relating to the availability of physical and business infrastructures, the general legal regime for FDI, the general regulatory and fiscal regime for business operations, free repatriation of profits or the granting of national treatment. While these policies certainly bear on the location decisions of TNCs, they are not FDI incentives per se. The main types of incentives used are fiscal incentives (e.g. reduction of the standard corporate income-tax rate, investment and reinvestment allowances, tax holidays, accelerated depreciation, exemptions from import duties), financial incentives (e.g. government grants, subsidised credits, government equity participation, government insurance at preferential rates) and market preferences (e.g. granting of monopoly rights, protection from import competition, closing the market for further entry, preferential government contracts). Other types of incentives frequently used include preferential treatment on foreign exchange and subsidised dedicated infrastructure and services.

ECONOMIC RATIONALE FOR INCENTIVES

The economic rationale behind incentives is to correct the failure of markets to reflect the wider benefits arising from externalities in production — for example, those resulting from economies of scale, the creation of widely diffused knowledge and the upgrading of skills of mobile workers. Incentives can thus be justified to cover the wedge between the private and the social

returns on an investment. In a more dynamic context of growth and development, incentives can be justified to correct the failure of markets to reflect the gains that can accrue over time from declining unit costs and learning by doing the classic infant-industry argument used in a very different context. Incentives can also be justified to compensate investors for lost return due to other government interventions (for example, duty remissions on imports or performance requirements) or for carrying certain public costs where a government lacks the institutional capacity to bear them itself. In sum, incentives can serve a number of development purposes. However, they also have the potential to introduce economic distortions (especially when they are more than marginal) that are analogous to subsidies on trade, and they involve financial and administrative costs. It is not in the public interest that the cost of incentives granted exceed the value of the benefits to the public.

COMPETITION FOR FDI WITH INCENTIVES

Governments use incentives to attract FDI, to steer investment into favoured industries, activities or regions, or to influence the character of an investment, as, for example, when technology-intensive investment is being sought. Today, most investment incentives are directed to domestic and foreign investors alike, although sometimes only foreign investors can access certain incentives (as when special incentive packages are geared towards large projects or specific foreign investors, or where advanced technologies are involved that can only be provided by foreign investors). The range of incentives available to foreign investors and the number of countries that offer incentives have both increased considerably since the mid-1980s, as barriers to PDJ and trade have declined. In addition, many countries are experiencing increasing incentives competition among regional or even local authorities to attract FDI. Also, incentives are becoming increasingly focused and targeted and are sometimes contingent upon certain conditions being met by the investor. In fact, countries often offer a broad array of options linked to different objectives. Thus further multiplying

the number of incentive programmes available to foreign investors. However, it is difficult to discern clear patterns across countries and regions on the type of industries or activities favoured by incentive programmes. An increasing number of countries target investment activity in industries involving technology and high value-added (such as electronics, robotics, computer software) and in infrastructure projects. While manufacturing industries are still the main focus of incentive programmes, some governments continue to offer incentives in agriculture, fisheries, mining and oil exploration. Some countries are also offering incentives to encourage companies to locate specific corporate functions within their territories (say, to set up regional headquarters). As a general rule, developed countries make more use of financial incentives than of fiscal ones, partly because fiscal incentives are less flexible and their adoption involves more difficult parliamentary procedures. However, this pattern is reversed in developing countries, presumably because these countries lack the resources needed to provide financial incentives. Market incentives have played an important role until recently, although market reforms and the introduction of competition policy in an increasing number of countries are narrowing the scope for these incentives.

Whatever the rationale for FDI incentives, they are ultimately successful only to the extent that they succeed in attracting investment to a country away from another; if it were otherwise, and the investment were to take place anyway, the incentive would be superfluous. In an open world economy, in which barriers to FDI are falling, many countries have increased their incentives with the intention of diverting investment away from competing host countries. Competition for FDI with incentives is pervasive not only among national governments but also among sub-national authorities. When governments compete to attract FDI, there will be a tendency to overbid, if bidders may offer more than the wedge between public and private returns. The effects can be both distorting and inequitable since the costs are ultimately borne by the public and

hence represent transfers from the local community to the ultimate owners of the foreign investment. In such competition for FDI, the poorer countries are relatively disadvantaged.

THE EFFECT OF INCENTIVES ON INVESTMENT DECISIONS

In spite of this competition, there is considerable evidence to suggest that incentives are a relatively minor factor in the locational decisions of TNCs relative to other locational advantages, such as market size and growth, production costs, skill levels, adequate infrastructure, economic stability and the quality of the general regulatory framework. For example, in many companies incentives are frequently not considered and simply made an already attractive country more attractive. Investment decisions are made mainly on the basis of economic and long-term strategic considerations concerning inputs, production costs and markets. However, as regards individual investment projects, there is increasing evidence that when the location is broadly determined, e.g. a member country of the European Union or a country with a large national market, then incentives can play a decisive role in choosing, e.g. between Scotland and Wales; Ireland and Scotland; or North of England and North of France.

Foreign investors may respond differently to different types of incentives depending on their strategies. Generally, the export-oriented investors seeking inexpensive labour valued fiscal incentives more highly than market protection or other incentives. Market seeking investors, on the other hand, value market protection more than fiscal incentives. In the case of regional incentives, financial incentives, particularly grants seem to have a greater impact on investors' decisions than fiscal incentives. In recent years, a wide variety of incentives are being offered for foreign investors to transfer advanced technologies and attract R&D facilities (including tax reductions, subsidised infrastructure and land and industrial parks); governments have also intervened through the creation of markets (with defence expenditures and government purchasing) and research funding. However, a fiscal incentives and financial aid

did not influence location, while the establishment of enterprise zones and research parks did.

In brief, while incentives do not rank high among the main FDI determinants, their impact on locational choices can be perceptible at the margin, especially for projects that are cost-oriented and mobile.

FOREIGN PORTFOLIO INVESTMENT (FPI)

While FPI has traditionally been concentrated in developed markets, new interest has been sparked by the so-called “emerging” capital markets. The emerging markets have at least three attractive qualities, two of which are their high average returns and their low correlations with developed markets. Diversification into these markets is expected to give higher expected returns and lower overall volatility.

Many individual investors, as well as portfolio and pension fund managers, are reexamining their basic investment strategies. The 1990s, fund managers realised that significant performance gains could be obtained by diversifying into high-quality global equity markets. These gains are limited, however, by the fairly high cross-correlations returns in these markets. The resulting investment strategy reflects current information.

In terms of portfolio theory, adding low-correlation portfolios to an optimisation enhances the reward-to-risk profile by shifting the mean-variance frontier to the left.

The portfolio optimisation problem requires important inputs—the expected returns and the variance-covariance matrix. In principal, all of these measures should be forward-looking. That is, the returns, volatilities, and correlations should be forecasted.

An upsurge in portfolio investment in developing countries has marked the end of the debt crisis, or perhaps even helped to end it. Using the World Bank’s definition of portfolio flows as consisting of bonds, equity (comprising direct stock market purchases, American Depositary Receipts (ADRs), and country

funds), and money market instruments (such as certificates of deposits (CDs) and commercial paper. Broadly speaking, there are six groups of investors in the emerging markets, each having a tolerance for different degrees of risks and returns:

- i) Domestic residents of developing countries with overseas holdings and other private foreign investors, who constitute the dominant category of portfolio investors who are currently active in the major emerging markets. These investors keep abreast of developments in their country on a regular basis and monitor change in government policy. Their investments in emerging markets are motivated by expected short-term high yields. Preference is given to instruments that are in bearer form and provide returns in hard currency. These external funds as “Hot Money” which are kept in the “Latin American Bank” which may or may not be beneficial to the long-term growth prospects of developing country depending on the manner in which they are invested.
- ii) Managed funds (closed-end country funds and mutual funds), whose portfolio managers buy and sell shares and high-yield bonds in one or more of the emerging markets for performance-based trading purposes.
- iii) Foreign banks and brokerage firms, who allocate their portfolio for inventory and trading purposes.
- iv) Retail clients of Eurobonds houses who are involved in emerging securities markets due to portfolio diversification motives. They are generally interested in high-yield, high portfolio investments in the emerging markets.
- v) Institutional investors (such as pension funds, life insurance companies), who have a longer time horizon for expected gains from their portfolio and look for stability and long-term growth prospects in the market in which they invest.
- vi) Non resident nationals of developing countries, who could be a potential source of portfolio investment from abroad (as opposed to flight capital).

The first three groups are active in the emerging securities markets primarily because of expectations of short-term returns and have been observed to move

funds among different branches frequently. Purely speculative traders also continuously move funds between the emerging markets and the developed markets (primarily the United States).

The lower degree of integration of the emerging markets in the global capital markets, often makes them better avenues for achieving higher yields relative to the more globally integrated developed securities markets. Since all listed companies in the ESMs are not very well researched by foreign investors and their market information may be limited, there exists the potential for finding undervalued stocks which may yield high returns to potential investors. In general, P/E ratios in several ESMs may be lower than those in developed markets. Therefore, one expects to see larger inflows of portfolio investments into the emerging markets from institutional investors worldwide.

The integration of international equity markets observed in recent years can be attributed to several factors:

- (a) the emergence of international banking syndicates and brokerage houses which have the necessary information technology and communication facilities to be able to place large international equity issues within shorter periods of time at lower syndication and distribution fees than domestic issues;
- (b) the introduction of foreign equity-based instruments, such as ADRs and Rule 144A issues in the United States, which have significantly reduced the regulatory and physical impediments that in the past hindered such investments; and
- (c) and widespread practice of multiple listing of shares across different stock exchange in different countries have become widespread. The globalisation of the international capital markets has resulted in global allocation of portfolios in a relatively inexpensive manner.

It should be understood, however, that at the earlier stages of “openness” of the ESMs, the return of flight capital that is observed is generally motivated by

short-term speculative motives. Significant movements of such funds in and out of these markets give rise to increased volatility in stock prices as well as potential problems for domestic monetary management. Rapid increases of international reserves due to these large capital inflows have to be dealt with carefully by policymakers. These rising international reserves will strengthen the domestic currencies of the countries where these large inflows occur and have lowered inflationary expectations. Investors have observed the underutilised capacity, especially in the infrastructure sector of the emerging markets, and expect increased demand for manufactured products as a result of “impending free trade agreements.”

It is crucial for developing countries that the experiencing such large capital inflows in the short term to endeavor to continue to attract these private financing flows in the long term. Given the increasing integration of the international financial markets and the increasingly advanced communication and information technology facilities that are emerging today, the task of maintaining “financial competitiveness” in the international capital markets is a challenge that the emerging markets must face. To this end, the role of appropriate market-oriented domestic policy reforms and an endeavour to maintain a sustained growth performance in the developing countries concerned will go a long way in keeping the repatriated capital within their boundaries. From the long-term point of view it has been observed that flight capital is the last to return. This makes the task at hand for the emerging markets very challenging.

If developing countries wish to attract a sustained inflows of portfolio investment from abroad rather than short-term speculative movements of funds in and out of their countries, it is crucial to address some of the major constraints that inhibit such flows. These constraints exist both on the demand as well as the supply side of ESM securities.

On the demand side for emerging market securities, the most important hurdle inhibiting institutional investors abroad from investing in these markets are

regulatory impediments imposed by source country governments and restrictions on investment practices imposed by the trustees of these institutions. Some governments have imposed restrictions on foreign investment by their institutional investors because they feel that possible large foreign exchange outflows may have an adverse impact on the country's balance of payments, by institutionalising capital flight. However, institutional investors need to be strictly monitored in the absence of a strong and transparent pension system and when pension fund managers lack a thorough understanding of the complexities of their investment in the international financial markets. The role of the domestic securities and exchange commissions and regulatory agencies for institutional investors in the emerging markets is crucial in maintaining a steady inflow of foreign capital and ensuring responsible behaviour on the part of domestic institutional investors.

Tight regulation of investment decisions by institutional investors (in both developed and developing countries) is not necessary for ensuring for safety of contractual savings.

In the United Kingdom, for example pension funds and life insurance companies are only expected to demonstrate that their portfolio of assets, when prudently valued, meet the requirements for technical reserves and solvency margins. This enables these institutions to appropriately manage their portfolios by ensuring flexibility in matching assets and liabilities. Excessively strict investment limits may undermine the private management of a portfolio and, in effect, result in government-directed investment. Nevertheless, pension funds and insurance companies of most developed countries are still subject to restrictive regulations on their foreign investment. These include Canada, Germany, and the Netherlands.

The introduction of Rule 144A ADRs in the U.S. stock exchanges has considerably simplified trading in foreign equities by eliminating costly settlement delays, registration difficulties, and divided payment problems.

Under Rule 144A, Qualified Institutional Buyers (QIBs) in the United States also no longer need to hold the securities they traded the private placement market for a two-year period before they can be sold. Foreign issues can now gain access to a relatively large number of U.S. institutional investors. The credit rating standards for public placements of bonds have also been relaxed.

On the supply side of the emerging market securities, institutional fund managers are concerned about the illiquidity of most of the emerging markets due to restrictions on direct entry by foreigners, the small number of players (and therefore inefficient market making), poor accounting practices, high transaction costs, and unreliable settlement systems. Almost all ESMs suffer from the shortage of good-quality, large capitalization shares. This results in quick overheating (i.e. rapid increases in market capitalization) once domestic and international interest is generated in these markets due to regulatory changes or other factors. The relatively small turnover of most stock in the emerging markets also makes it difficult for large foreign investors to consider substantial portfolio investment in these markets. In fact, larger institutional investors often prefer that companies they may invest in have a domestic market turnover of at least \$1 million per week. Custodial services in ESMs also continue to be a major constraint to increased participation by large foreign institutional investors.

Another concern among U.S. institutional investors is that the management staff of the newly privatised firms may not be sufficiently concerned about enhancing the value of their company's shares (i.e. there appears to be an "agency" problem). This will have adverse implications for attractiveness of these investments from the long-term point of view. Under these circumstances, short-term yields would be high (which may interest a different group of investors private investors and performance-based traders). Regulatory constraints and the lower level of sophistication of the capital markets in the developing countries

were cited by U.S. institutional investors as other impediments to greater portfolio flows to emerging markets. U.S. institutional investors are expected to take advantage of Rule 144A and significantly increase their investment in private equity and debt offerings by non-U.S. entities.

PORTFOLIO CAPITAL FLOWS: HOT OR COLD?

Much of the literature implicitly presumes that it is possible to distinguish hot from cold capital flows simply by knowing the nature of the financial instrument being traded or the identity of the transactor. Perhaps the most salient example of this is the presumption that short-term flows are hotter than long-term flows. The basic idea in the literature is that a hot money inflow is likely to disappear or even reverse itself in the near future, whereas a cold money inflow is more likely to persist. Short-term capital inflows are like cars sitting in the parking lot with the engine running.

The notion that one can make inferences about the characteristics of financial flows by just observing their label is not new in economic. There is much conventional wisdom that shows capital flows reflect speculative, unstable behaviour while flows reflect evaluations of long run profitability and are based on fundamental economic conditions. The flows of funds approach used by many central banks and others for an analysis of the domestic economy developments is based on labels which are deemed meaningful.

This view has also been an important part of the traditional analysis of international finance for many years. In fact, the structure of balance of payments accounts reflects an implicit theory that different types of capital flows have different economic implications. For example, the distinction between short-term “hot money” and long-term capital flows undoubtedly reflects the view that short-term capital movements are speculative and reversible while long-term capital flows are based on fundamentals and are reversed only when the fundamentals change. The fact that capital control

programmes in many countries distinguish between short-and long-term positions also points to the importance attached to this distinction.

Another important distinction found in balance of payments accounts is between official capital flows, including changes in international reserves, and private capital flows. A common view in the context of current capital inflows into developing countries which is based on labels is that such flows are fundamentally different from inflows to these same countries in the 1970s because the current inflows are private-to-private transactions not guaranteed by the government of any country.

Finally, it is often argued that direct investment has different implications for the host and recipient countries as compared to other capital flows. For example, direct investment capital flows are often associated with technology transfers and a range of costs and benefits for both countries. An implicit assumption behind these ideas is that the transactions reported in the balance accounts are closely related to the behaviour of interest in the real economy.

This reasoning based on the label of the flow at times underlies substantive policy measures. Once a flow is identified as “hot money,” it is then seen as requiring some policy response. At various times countries (especially developing countries) have responded with exchange rate management, (sterilised) intervention, fiscal contraction, borrowing taxes, absolute foreign borrowing constraints, and reserve requirements.

There are a number of good reasons to doubt, however, that the micro nature of international capital flows reveals much about the economic importance of such flows. Since many assets are (increasingly becoming) tradable, a distinction between flows based on their terms (for example, short versus long) is (increasingly becoming) less meaningful. A treasury bond with a 30-year maturity can easily be more liquid, and thus lead to a higher volatility of short-term flows than a 30-day time deposit at a commercial bank. And, a short-term asset, which is, rolled over can in many ways be identical to a long-term asset.

Furthermore, the explicit label given to a flow may not cover its implicit nature. For instance the inflows to developing countries in the 1970s were private capital flows in name, the universal government guarantees of both lenders and borrowers considerably subdued the discipline of the market. In effect the capital flows that helped generate the debt crisis of 1982 should have been considered official capital flows since the private parties undertaking the transactions relied on a government guarantee (and ex post, private claims indeed became the liability of the government). This presumably made private investors less careful than they would have been in the absence of guarantees.

This experience should act as a warning against evaluating capital flows according to their label (for example, the instrument traded or the transactor recorded in the balance of payments statistics). In the past few years inflows to developing countries have taken the form of non-guaranteed portfolio investments and direct investments. If the behaviour behind such investments is different in some important way, it follows that we may not be inviting another debt crisis even if conditions change as they did in 1982. But if the flows are to a significant extent guaranteed by the government, their label “private” may be meaningless. Clearly, in thinking about stability, an important attribute is thus the contingent liability of the government.

The starting point should then also be a clear methodology on how the hypothetical economic implications of different types of capital flows can be identified empirically. If credit markets were perfect and complete, the form of capital flows would not be important. A useful analog here is the Miller-Modigliani theorem from corporate finance. Under a set of strong assumptions, the structure of assets and liabilities among various types of debt and equity have no effect on the value of the firm because investors can offset the structure chosen by the firm in credit markets. If we think of the balance of payments accounts as records of how a country finances its international capital Position it follows that under the Miller-Modigliani assumptions, the structure of capital

flows and the structure of the gross international asset and liability positions would be unrelated to the country's net indebtedness.

It might be useful here to look at an analogous issue that has recently been carefully explored in a closed economy context. That issue is whether a "credit crunch" contributed to a downturn in economic activity. This is an interesting hypothesis because it explicitly rests on the view that one type of financial transaction, in this case loans by domestic banks to domestic non-financial firms, had important economic effects.

This view is an important part of the (new literature on business cycles, which links financial structures and real activity. This literature provides a useful analytical framework that can be adapted to a discussion of international financial flows. It points out that the importance of changes in bank credit for economic activity, as opposed to bank liabilities or money, is an empirical issue. If good substitutes for bank credit exist in an economy, it follows that a decline in bank credit that is not matched by a decline in money will have no effect on economic activity. Firms would easily substitute other forms of credit, for example commercial paper, to offset the reduction in bank credit. In contrast, if banks have special information about their customers that is not easily transferred to other lenders, a reduction of bank credit will not be easily offset by borrowing from other institutions or markets. In this case an interruption in bank credit could have a depressing effect on expenditures and output.

There are two important lessons from this,. First, meaningful tests of the importance of capital account transactions require a specification of the economic behaviour of interest. Second, a financial transaction is likely to have measurable effects on the specified economic behaviour in cases where the institutional environment, information structures, or other departures from complete markets limit the ability of investors to substitute one type of transaction for another in response to changing incentives.

The view that labels matter can take comfort from the fact that international financial markets are not complete and transactions are subject to a large number of distortions. Many of these are imposed by governments in the form of controls on types of transactions that are considered undesirable. Moreover, subsidies often take the form of a government guarantee of private liabilities, favourable tax treatment on earnings (direct investment), or access to special government facilities (debt equity swaps). Each of these distortions is designed to encourage or discourage a given type of capital transaction.

Furthermore, governments also intervene directly in international capital markets. Developing country governments borrow for long-term objectives and, increasingly, in middle-income countries, to offset short-run pressures on exchange rates and domestic interest rates. A difficulty thus arises in interpreting private capital flows that are sterilised by intervention transactions by the central bank as, to some extent, the composition of private capital flows is conditioned by governments' capital transactions. Clearly a country trying to maintain interest rates above its trading partners in some sense generates the private capital inflow by standing ready to match private inflows with official outflows in the form of increases in reserve assets. Such private inflows are "sustainable" as long as the official capital outflows are "sustainable."

In general, if international capital transactions are effectively distorted by taxes, subsidies and direct intervention, the structure of private capital flows might follow predictable patterns as long as the structure of distortions itself is stable. Over a period the financial transactions are motivated by a variety of economic forces. Over time the institutional framework changes, the behaviour of the official sector probably changes, the exchange rate regime changes, capital control programmes come and go, and banking markets (both on and offshore) develop, fail, and are recapitalised.

The final economic behaviour that seems to provide the most appropriate test for the importance of various capital flows is the net inter trade among countries,

conventionally measured by the current account. While there are other interesting candidates, for example, the exchange rate, questions about the sustainability of certain type of capital flows are motivated by concern about the sustainability of a path for changes in net indebtedness to the rest of the world, that is, the mirror image of the cumulative current account balance. Policymakers wish to assess the likelihood of sudden and destabilising changes in the total capital account not just its components.

On a macro level, national accounts identities state that the sum of all capital flows is equal to the difference between savings and investment. For a given savings investment imbalance, capital flows have to satisfy an adding-up constraint. Unless flows influence domestic investment or domestic savings (or a combination of the two), some substitution between the various flows has to occur, for a given current account, the volatility of one flow will on aggregate be canceled out. The extent of interaction between the various components and the possibility of systematic interactions between components thus needs to be addressed before making inferences from the parts to the whole.

A fundamental difficulty this is that the linkage between current account and any of the capital flows data series might be very weak. For one thing we know that gross capital inflows and outflows are several times larger than net capital flows. Yet it is the net flow that we are interested in when considering sustainability of current account position. It seems clear that the motivation for two-way flows of international capital are very different from the general view that developing countries should be net capital importers and that each type of transaction should show a net inflow.

For example, residents of a small open economy might hold most of their financial wealth in the form of foreign claims since this allows them to diversify their income streams and protect themselves from domestic taxation and income shocks. Offsetting this preference would be the tendency for foreign investors to purchase claims on the country again in order to diversify their risk. This

diversification motive for international capital movements might account for much of the recorded flows in balance of payments data.

Moreover, it might be the case that residents of wealthy countries prefer long-term investments such as bonds or loans while residents of developing countries prefer short-term investments such as bank deposits. In this case, we would expect to see short-term capital outflow from developing countries matched by long-term loans to residents of developing countries. These preferences imply nothing about the desired imbalance in the capital or current account.

In fact, the short-term positions of residents might be quite stable if there are relatively few alternative investments. In contrast, the long-term capital inflow to the developing country might take several alternative forms. In one year foreign investors might prefer equities, in another bank loans, and in another bonds. These preferences might in turn reflect subtle changes in tax rules (in the industrial countries) that the analyst would find difficult to identify. The point is that the pattern of financial intermediation might be quite stable for a while but that small differences in the institutional framework, due to either regulation or innovation in credit markets, might alter the form that the intermediation taken in balance of payments statistics.

In general, direct investment is a difficult capital flow to interpret. Balance of payments data on direct investment include short-and long-term capital transactions of a loosely defined set of reporters who own more than a given percent of the equity in a domestic or foreign chartered firm. Because direct investors hold factories and other assets that are impossible to move, it is sometimes assumed that a direct investment inflow is more stable than other forms of capital flows.

This need not be the case. While a direct investor usually has some immovable assets, there is no reason in principle why these cannot be fully offset by domestic liabilities. Clearly, a direct investor can borrow in order to export

capital, and thereby generate rapid capital outflows. In most developing countries, there are Laws against

This, so it would be surprising to see negative flows for foreign domestic investment in developing country. There could, however, be offsetting movements in other balance payments accounts or in errors and omissions.

On a micro level, there is also much (anecdotal) evidence that, from the point of view of foreign direct investors, flows with very different classifications are actually close substitutes. Multinationals often substitute between and among the various forms of intercompany transfers (retained earnings, provision of and repatriation of capital, and intercompany loans) and loans from local or foreign banks for example, to achieve higher profits net of overall taxes. In other cases, flows may be complementary, that is foreign investment may take place through a combination of FDI and portfolio equity investment.

THE POTENTIAL IMPACT OF A POSSIBLE MULTILATERAL FRAMEWORK (MFI)

The development of an MFI if such a framework were to be negotiated, would represent a change in the policy-framework cluster of determinants. Although such a framework might also affect some elements of business facilitation (such as investment incentives), it would not involve significant and direct changes in the principal economic determinants. Indeed, by making FDI policies potentially more similar, an MFI would underline the importance of economic (and business facilitation) factors in determining FDI flows.

The precise effect of an MFI on the policy-framework cluster of determinants would depend on its content, including definitions, scope and safeguards. Because an MFI is only a hypothesis, three scenarios, based on differing assumptions, are discussed below for purely analytical purposes. The specific implications of each scenario would vary from country to country in accordance with specific economic and developmental conditions and specific national stances vis-a-vis FDI.

If there were an MFI, how would it affect the volume and pattern of FDI flows? One conceivable outcome of an MET is that -it would help to increase FDI flows and perhaps affect other features of such flows as well. Such an outcome is based in part on the assumption that a multilateral agreement would not only consolidate recent changes towards more liberal policies by many countries but would incorporate “rollback” provisions requiring countries to commit themselves to reducing or eliminating existing barriers to PDI and strengthening investment protection and the proper functioning of markets. Even in the absence of further liberalisation, a multilateral framework could facilitate investment by providing stronger assurances as compared with unilateral or even bilateral measures when it comes to the protection of FDI and the stability of domestic FDI regimes. The presumably greater stability, predictability and transparency resulting from an MFI would create a generally more favourable climate for investors. The impact on inflows might be greatest for those countries that we not already signatories to bilateral, regional, multilateral or multilateral investment agreements, and countries whose current policies, even if favourable to FDI are not considered sufficiently predictable by investors. At the same time, whether or not FDI flows would actually increase and whether there would be a change in the quality and patterns of flows would depend on the precise content of an agreement, the nature of national commitments and exceptions to the generalised multilateral rules and, of course, the other EDT determinants that would come into play at that point.

A second conceivable outcome of an MFI is that it could actually reduce the quantity and quality of FDI flows, because the negotiation of an MFI would take several years creating uncertainties about the investment climate worldwide and thereby discouraging foreign investors. Further, even if negotiations did produce an agreement, the MFI that would result could conceivably enshrine a less liberal multilateral environment than has already evolved unilaterally or regionally. Such an MFI could also alter the patterns of PDI flows across

geographic regions and industries. In particular, an MFI might reduce FDI flows to countries that gain from the currently restrictive policies of their competitors for such investment and increase flows to otherwise desirable locations that are receiving little inward FDI because of uncertainties about policies.

A third conceivable outcome of a possible MFI is that it would have little or no impact on the quantity and quality of FDI flows, as it would not materially alter the policy framework for FDI. One reason why this might be the result is that there has already been significant liberalisation in many countries, in particular in many developing countries and countries in transition, during the 1980s and 1990s; and this liberalization has contributed to surge of FDI flows that reached a new record in 1997. Therefore, an MET that contains, for example, standstill provisions requiring countries to commit themselves not to introduce new barriers to FDI, lower standards of investment treatment or measures likely to impair the proper functioning of markets would essentially maintain the status quo, as far as the openness of economies to FDI, their treatment of foreign affiliates and the functioning of their markets are concerned. Moreover the extensive network of bilateral investment treaties, which numbered over 1,500 by the end of 1997 would provide protection for investors and could be easily extended to additional countries. Finally, on this view, there would be no significant effects on the geographic patterns of FDI flows, as they are largely influenced by other FDI determinants.

On balance, these considerations suggest that an MFI would improve the enabling environment for FDI, to the extent that it would contribute to greater security for investors and greater stability, predictability and transparency in investment policies and rules. This, in turn, could encourage higher FDI flows and potentially some redistribution of those flows particularly to countries whose investment climates would newly reflect the multilateral framework. How much difference an MFI would make, however, in terms of the quantity, quality and patterns of actual FDI flows difficult to predict because as in the

case of BITs, it is precisely the function of enabling framework to allow other determinants, and especially economic determinants to assert their influence.

Expectations about the impact of an MFI on FDI flows (if it were indeed to be negotiated) in comparison to the current regulatory framework and the direction in which it is developing should, therefore, not be exaggerated. There are, of course, other issues that need to be considered in connection with a possible MFI especially the possible role of such an agreement in providing a framework for intergovernmental cooperation in the area of investment.

Although the most profound shifts among FDI determinants result from integrated international strategies, especially complex strategies, the traditional economic determinants related to large markets, trade barriers and non-tradable services are still at work, and account for a large share of worldwide FDI flows. Data on the distribution of sales of foreign affiliates of United States TNCs in host countries are indicative in this regard: two-thirds of TNC activity is still of this type. These figures are higher in the services sector, including trading affiliates, and lower in manufacturing but they do not change the overall outcome.

Some of the largest national markets remain unmatched in size by the largest regional markets or even by entire continents. For example, the market the European Union during most of its existence has been smaller than the United States market; the market of the African continent (without South Africa) is smaller than that of the Republic of Korea; and the combined markets of the 14 Central and Eastern European countries are smaller than the market of Brazil. As regards trade barriers, even though the general trend has been towards the reduction or even abolition of tariffs and quotas, they continue to remain in force in several (especially developing) countries and in some industries in a much wider group of countries. These continue to generate import FDI and discourage efficiency-seeking FDI. In non-tradable services, as well as goods that are perishable or need to be adapted to consumer preferences or local standards, the

market-seeking motivation, and the corresponding locational attractiveness of host countries, remain as strong as ever. In fact, there has been an explosion of FDI in the services sector as a result of the general trend towards the liberalisation of FDI frameworks for services.

Still, although FDI remains strongly driven by its traditional determinants, the relative importance of different locational determinants for competitiveness-enhancing FDI is shifting. For example, again using United States data for foreign affiliates in manufacturing though it is still true that these affiliates are predominantly oriented towards domestic markets: their domestic sales have dropped from 64 per cent in 1982 to 60 per cent in 1993. A similar trend can be observed in tradable services (e.g. computer and data-processing services) in which domestic sales declined from 85 to 81 per cent over the same period. Perhaps more telling are data for United States foreign affiliates in the European Union, as the evolving policy framework there is more indicative of the EDI policy framework emerging globally: sales to local markets in that region declined from 76 per cent to 64 per cent between 1966 and 1993, while exports increased from 24 per cent to 36 per cent.

In their quest for competitiveness, TNCs assign a particularly important role to obtaining access to created (or strategic) assets: the principal wealth-creating assets and a key source of competitiveness for firms. Created assets can be tangible like the stock of financial and physical assets such as the communication infrastructure or marketing networks, or intangible. The list of intangible assets is long, but they have a common denominator: knowledge. They include skills, attitudes (e.g. attitudes to wealth creation and business culture), capabilities (technological, innovatory, managerial and leading capabilities), competencies (e.g. to organise income-generating assets productively), relationships (such as interpersonal relationships forged by individuals or contacts -with governments), as well as the stock of information, trade marks, goodwill and brainpower. These assets can be embodied in both

individuals and firms and the can sometimes be enhanced by clusters of firms and economic activities.

The importance of created intangible assets in production and other economic activities has increased considerably. A large proportion of the costs of many final goods and services, ranging from simple products such as cereals through books computers to automobiles, consists of the costs of such created assets as R&D, design, advertising, distribution and legal work. Less than 10 per cent of the production of automobiles now consists of labour costs; the rest relates to the contributions various created assets. Moreover, international competition increasingly takes place through new products and processes and these are often knowledge based. R&D activities leading to new products and processes are costly and risky. At the same time, markets for knowledge-based resources and assets are becoming more open and enterprises embodying these assets can be bought and sold. The result is that TNCs have taken advantage of these opportunities and used FDI as a major means of acquiring created assets and enhancing corporate competitiveness.

CAPITAL INFLOWS AND OVERHEATING

The key short-run macroeconomic concern associated with a surge in capital inflows that of an excessive expansion of aggregate demand that is, macroeconomic overheating. This outcome can be produced through the following transmission mechanism :

- i) If a country maintains an officially determined exchange rate, the commitment to defend the parity causes the central bank to intervene in the foreign exchange market to purchase the foreign exchange generated by the capital inflow. To do so, the central bank creates high-powered domestic money.
- ii) This expansion of the monetary base creates a corresponding expansion in broader measures of the money supply, lowering domestic interest rates and raising domestic asset prices.

iii) This action in turn triggers an expansion of aggregate demand. If the economy possesses excess capacity, the short-run implications maybe to increase domestic economic activity and cause the current account of the balance of payments to deteriorate. Eventually, however (and perhaps rather quickly if domestic excess capacity is limited), excess capacity will be absorbed and the expansion in demand will trigger acceleration in domestic inflation.

iv) If the exchange rate peg is maintained, rising domestic prices will cause real exchange rate to appreciate, abetting the current account deterioration associated with the expansion in aggregate demand.

POLICIES TO CONTROL OVERHEATING

To avoid potential overheating, developing countries can and have intervened every step in this transmission process. Policy can attempt to reduce the required scale of intervention in the foreign exchange market, restrict the monetary expansion associated with a given magnitude of intervention, and offset through other means the effects on aggregate demand of a given magnitude of monetary expansion. These policies are not exclusive, and most countries have brought a wide variety of these instruments into play.

Some policies have restricted the required scale of intervention in the foreign exchange market, either through reducing the capital account surplus of the balance of payments or through an offsetting increase in the current account deficit. The main instruments available to the authorities are the following:

The magnitude of gross capital inflows can be reduced by imposing a variety of direct or indirect controls on inflows.

Even if gross inflows are freely allowed, the liberalisation of capital outflows or the accelerated repayment of public debt can be undertaken to attempt to reduce net inflows.

The implications of a net capital account surplus on the foreign exchange market can be counteracted by accelerating trade liberalisation to increase the current account deficit.

The most extreme option in this category would be to eliminate all foreign exchange market intervention by floating the exchange rate. The resulting appreciation of the domestic currency would both reduce net inflows through the capital account and create a current account offset.

There are two policies that restrict the magnitude of the monetary expansion associated with a given amount of intervention in the foreign exchange market:

- i) Expansion of base money associated with a given amount of intervention can be restricted by sterilising the effects of intervention on the monetary base—that is, by contracting domestic credit to offset the expansion of the net foreign assets of the central bank, through mechanisms such as open market operations or transferring public sector deposits from commercial banks to the central bank.
- ii) Increasing reserve requirements on domestic financial institutions reduces the impact of the expansion of the monetary base on the growth of broader monetary aggregates

Sterilised intervention was the most widely and intensively used policy response to the arrival of capital inflows among the countries. But can sterilisation be effective? This essentially depends on relative substitutability among assets, both between domestic and foreign interest-bearing assets and among different types of domestic assets. If domestic interest-bearing assets are perfect substitutes among themselves, then the issue of whether sterilisation can work amounts to whether it is possible to prevent a change in demand for domestic interest-bearing assets from causing a change in their price through a suitable quantity response. Clearly, this will depend on the degree of substitutability between domestic and foreign interest-bearing assets. If they are close to perfect substitutes, then the quantity response would have to approach infinity to

prevent a price response. This is what is typically meant by the impossibility of sterilisation.

However, it is also possible for sterilisation to be ineffective in preventing a change in the price of domestic assets even if foreign and domestic interest-bearing assets are imperfect substitutes. This is the case when domestic assets are imperfect substitutes among themselves and a capital inflow represents an increased demand for a particular type of domestic asset that the central bank cannot provide, either directly or indirectly. In this case, sterilised intervention that keeps the monetary base constant, by issuing an asset other than that demanded by the agents generating the capital inflow, could not prevent relative price adjustments among domestic assets as portfolio equilibrium is restored. If such price adjustments cannot be avoided, then it may not be feasible to insulate aggregate demand. For example aggressive sterilisation in Mexico did not prevent the arrival of capital inflows from being associated with a stock market boom. One interpretation of this experience is that external creditors wished to acquire equity in Mexican firms, while the sterilisation instrument issued by the central bank consists of claims on the Mexican government. In this case the maintenance of portfolio equilibrium in the wake of increased external demand for Mexican equity would have required higher equity prices in Mexico even if the sterilisation of capital inflows had been complete.

Because sterilisation involves the issuance of additional domestic debt, and because its effectiveness depends on substitutability among domestic assets the form that it takes may matter for both its effectiveness and its desirability. Capital-importing countries have used three alternative sterilisation techniques:

- i) transferring public sector deposits out of the commercial banking system and into the central bank.
- ii) selling public sector bonds in secondary bond markets.
- iii) increasing the reserve requirements on domestic banks.

While these techniques share the common objective of stabilising the domestic money supply, the analysis below suggests that their macroeconomic effects may be quite different.

STERILISATIONS THROUGH TRANSFERS OF PUBLIC SECTOR

DEPOSIT

Consider the effects of a capital inflow triggered by a shift in private sector (domestic or foreign) preferences from foreign to domestic interest-bearing assets. To effect this portfolio reallocation, the private sector has to sell foreign exchange to the domestic central bank. When the public sector offsets a purchase of foreign exchange by transferring public sector deposits from commercial banks to the central bank, it leaves the stock base money unchanged but exchanges a claim on the domestic banking system for an external claim. At the same time the private sector changes its portfolio in the opposite direction.

There are two ways that the macroeconomic equilibrium can be affected by transaction, even if the monetary base is unchanged. First, if interest-bearing deposits in the domestic banking system are imperfect substitutes in private portfolios for other domestic interest-bearing assets, then private portfolio equilibrium will be disturbed unless the domestic asset for which there is increased demand happens to be deposits in the domestic banking system. If that is the case, then the private sector and government simply exchange claims on the banking system and there are no price implications the transaction. But if it is not the case, then relative domestic asset prices will have change to maintain portfolio equilibrium. If the initial asset shift was toward dome securities, for instance, the yield on such securities would presumably have to fall a interest rates on bank assets and liabilities would have to rise.

The second effect is a fiscal one. To the extent that the yield on domestic deposits differs from the yield on foreign exchange reserves, the solvency of the domes public sector will be affected by the transaction. In the particular case of sterilisation through shifts in public sector deposits, the liquidity services

provided by such deposits suggest that the public sector's net interest receipts could rise or fall as a result of sterilisation operation.

STERILISATION THROUGH OPEN MARKET OPERATIONS

Open market sterilised intervention requires the central bank to sell enough domestic bonds to purchase the foreign exchange associated with the inflow, thereby leaving the monetary base unchanged but increasing the stock of outstanding domestic public sector debt. The amount of new debt is therefore equal to the increase in demand interest-bearing claims on the domestic economy. The effect of the transaction on central bank's balance sheet is to leave its liabilities (the base) unchanged, but change the composition of its assets, reducing its claims on the domestic government and increasing its international reserves. From the standpoint of the nonfinancial public sector as a whole, sterilised intervention amounts to a portfolio transaction in which the domestic nonfinancial public sector issues interest debts denominated domestic currency in order to acquire a foreign interest-bearing claim.

Sterilised intervention through open market operations is not likely to be costless, however. The portfolio reallocation implied for the public sector involves issuing a high yielding liability (domestic currency debt) in exchange for a lower-yielding asset (international reserves). This interest differential leaves the public sector in a weakened financial position. The net adverse effect of such transactions on the public sector's solvency is overstated by the interest differential, however, because this differential exists in part to compensate creditors for the currency and country risk associated with holding domestic public debt. By issuing such debt in exchange for reserves, the public sector is receiving a benefit that partly offsets the interest penalty that is, the option to reduce the real value of its obligations by devaluing or defaulting. Nonetheless, these benefits may be worthless to a government that never intends to exercise these options (but is unable to convince its creditors of this fact). In this case,

sterilised intervention carries a fiscal burden, the cost of which depends on the ease with which an offsetting fiscal adjustment can be effected.

As in the previous case, the conditions required for sterilisation through open market operations to be effective in insulating the domestic economy are that domestic interest-bearing assets must be perfect substitutes among themselves or, if they are not, that sterilisation operations must be capable of supplying precisely those assets that are in increased demand.

STERILISATION THROUGH RESTRICTIONS ON DOMESTIC CREDIT GROWTH

Sterilised intervention through transfers of public sector deposits and open market bond sales operates by fixing the size of the monetary base. An alternative is to allow the base to expand as a result of central bank intervention in the foreign exchange market, but to restrict expansion of the money supply by raising reserve requirements on banks, thus causing the money multiplier to contract.

Again, the objective is to fix the price of domestic interest-bearing assets in the face of an increase in the demand for such assets. From a portfolio allocation perspective, this policy works, in principle, by having the private sector rather than the central bank issue the domestic interest assets that are in increased demand. When commercial banks face higher reserve requirements, they are forced to absorb the additional monetary base emitted by the central bank in the course of its foreign exchange operations, rather than acquire domestic interest assets in the form of credit extended to domestic agents. The contraction of credit on the part of commercial banks causes domestic agents who would otherwise have borrowed from these banks to instead issue securities. Since these securities are precisely the assets that are in increased demand by the non bank public, the supply of domestic interest-bearing assets expands to meet demand, so there is no change in the price of such assets.

However, bank borrowers squeezed out of credit markets by higher reserve requirements may not have access to securities markets and thus may be unable to supply the assets that are in higher demand. Borrowers with low net worth who lack other forms of collateral are able to obtain credit only from institutions that are highly specialised in evaluating and monitoring loans (banks). Such borrowers cannot securitise their liabilities. If this is the case, then there is a prima facie case for substitutability among the relevant domestic assets when sterilisation is pursued a policy of altering reserve requirements, suggesting that insulation of the economy is less likely to be achieved under this policy than through open market operations.

An additional difference between sterilisation through restrictions on domestic credit and through open market operations is fiscal cost. In the case of domestic credit restriction, the public sector still acquires interest foreign assets but does so by emitting non interest-bearing liabilities (that is, the monetary base). Thus, the public sector's fiscal situation actually improves when sterilisation is effected by increasing reserve requirements. This approach, however, implicitly taxes private agents. The requirement that banks hold a larger stock of non-interest bearing reserves imposes an explicit tax on them, which must be apportioned in some way among bank depositors, borrowers, and shareholders. The incidence of the tax will depend on the elasticity supply of bank deposits, as well as on the demand for bank loans.

OFFSETTING THE IMPACT OF MONETARY EXPANSION ON AGGREGATE DEMAND

If the arrival of capital inflows is permitted to result in the expansion of broad monetary aggregates, the expansionary effects on aggregate demand can be neutralised through fiscal contraction.

Fiscal adjustment was a key component of the stabilization and market-oriented reform programmes that many countries undertook prior to receiving capital inflow. Consequently, it is difficult to interpret a tight fiscal stance, or a further tightening of that stance, as a policy response to capital inflows rather than as a continuation of an ongoing adjustment process. Whatever the reason, a tighter fiscal stance during the inflow episode does help reduce aggregate demand pressures.

How successful are these policies in preventing the overheating associated with a surge in capital inflows? Once again, macroeconomic performance can be understood in terms of the transmission mechanism, that operates during the inflow episodes. According to this mechanism two conditions are necessary for capital inflows to have an expansionary impact on aggregate demand. First, a change in the net private capital inflow must represent an addition to the country's capital account surplus, rather than merely a change in the identity, whether private or public, of the country's external creditors. Second, the central bank must intervene actively in the foreign exchange market, purchasing the additional foreign exchange generated by the capital inflows.

POLICY REGIMES AND VULNERABILITY

In the context of financial integration, vulnerability refers to the possibility that a country may find itself confronted with a sudden, large, and relatively large reduction in net capital inflows. The challenge to policymakers is to identify and implement policies that can minimise (or at least do not magnify) vulnerability to external financial shocks. The creditors (both domestic and foreign) can be expected to take their capital out of a country when they think that a policy change could impair the value of their investment, then vulnerability will arise when the perception is created that a devaluation, nonpayment of public sector debt, or the imposition of restrictions on capital outflows is about to occur. Such expectations are likely to arise when the real exchange rate is perceived to be out of line, the government's debt obligations are large, fiscal adjustment is

perceived as politically or administratively infeasible, or the country's growth prospects are bleak. From the perspective of creditors, therefore, a high share of investment in absorption and a strong record of growth, a low stock of government obligations coupled with demonstrated fiscal flexibility (in the form of small deficits and low inflation), and a real exchange rate broadly perceived to be in line with fundamentals all augur well for future debt service. These characteristics are most directly associated with a country's ability to avoid vulnerability. From a policy perspective, countries need to have an active exchange rate policy that avoids substantial appreciation of the real exchange rate and responsible fiscal policies.

MACROECONOMIC MANAGEMENT WITH GROWING INTEGRATION

Short of the crisis situation associated with vulnerability, cross-border capital flows may exhibit substantial volatility that is temporary shocks to either capital inflows or out flows caused by changes in world economic conditions or by less extreme changes in portfolio managers' perceptions of domestic creditworthiness. This increased volatility may well be a fact of life for developing countries as they become more integrated with international financial markets, even after stock adjustment inflows associated with the transition have tapered off, and even if severe crises are avoided.

The most direct response to external financial volatility is to contain its impact by restricting the movement of capital that is, imposing capital controls. However, economists have long questioned both the effectiveness and the desirability of such restrictions. We take up each of these issues in turn.

CAPITAL CONTROLS ARE OF QUESTIONABLE EFFECTIVENESS

Although economists tend to have strong views about the effectiveness or ineffectiveness of capital controls, empirical evidence on the issue is ambiguous. Assessing the effectiveness of controls is complicated by a host of factors, including the definition of effectiveness itself (that is, what is the objective to be

achieved) and the conditions that determine the effectiveness of different types of controls. It may be argued that the effectiveness of capital controls can only be measured relative to the objective they are designed to achieve. There are three basic types of objectives: to preserve some degree of domestic monetary autonomy over a period of time, to restrict the magnitude of net capital flows into or out of the country, and to affect the composition of capital flows. However, because monetary autonomy cannot be achieved unless the magnitude of net flows is restricted, these three objectives boil down to two: restricting the size of net capital flows and affecting their composition.

CONDITIONS FOR EFFECTIVENESS OF DIFFERENT TYPES OF CONTROLS

The effectiveness of controls may depend on a variety of factors that not only differ across countries but also change over time as the process of financial integration proceeds. These factors include:

- **The state of technology.** This affects transaction costs in conducting arbitrage among different financial centers. The lower the costs, the more difficult it will be to implement effective controls.
- **The extent of international cooperation** in reporting cross-border claims. In the case of controls on outflows, for example, host countries may be unwilling to declare the assets of residents from capital-exporting countries, whether or not these residents try to circumvent foreign exchange regulations.
- The size of the misalignment motivating inflows or outflows. If effecting a capital inflow or outflow for an arbitrage operation involves a fixed cost imposed by the control regime, then the deterrent effect of this cost may be nullified if the arbitrage gains promise to exceed the cost.
- **The design of the controls** themselves, in particular their comprehensiveness. Controls that are not comprehensive for example, those that apply to only certain types of flows can be evaded by changing

the composition of flows. While such controls would be ineffective in preserving monetary autonomy (or limiting the total magnitude of flows), they may, however, still be able to alter the composition of flows.

- **The structure of the domestic financial system.** This may determine the effectiveness of partial controls that leave room for evasion by channeling flows through alternative domestic intermediaries.
- **The size of trade flows.** This would determine the scope for under and over invoicing, as well as for altering leads and for lags on trade credit. The type of cross flows targeted by the controls that is, controls on capital outflows may differ in effectiveness from controls on inflows, all other things (that is, potential arbitrage margins) being equal. One argument is that the residence of the capital-importing or exporting agent may matter. Domestic residents may be more prepared than foreign agents to evade restrictions, making controls on outflows less effective than controls on inflows.
- **The efficiency of the controlling bureaucracy.** In practice, restrictions on capital movements have taken many forms, ranging from the outright prohibition of a wide array of capital account transactions (such as those that have given rise to parallel foreign exchange markets in both industrial and developing countries) to prudential restrictions on the acquisition of foreign assets by domestic pension funds or of foreign liabilities by domestic banks. Different restrictions designed to achieve different objectives can be expected to vary in effectiveness, both in achieving their stated purposes and in the wider sense of financially insulating the domestic economy from external shocks. Some analysts have argued that controls of any type can be effective under any arbitrary set of circumstances, while others have argued that controls of any type can never be effective. Neither argument is valid. This means, in particular, that the size of capital flows in the presence of controls is not

a reliable indicator of the effectiveness of controls, since large flows may simply indicate large arbitrage opportunities.

ARE CAPITAL CONTROLS DESIRABLE?

Even if capital controls can be effective, that does not mean they should be used. Since effective controls distort private economic decisions, the benefits of imposing them should outweigh the costs. Arguments for restricting capital movements as a way to control volatility and achieve macroeconomic stabilisation under a high degree of financial integration are:

“Incredible” reforms. The first argument is that controls may be effective in coping with distortions that arise when the government implements an incredible stabilisation or trade liberalisation (one that observers do not believe it can carry out). Lack of confidence in the government’s ability to sustain its announced exchange rate or tariff policies may make external borrowing appear temporarily cheap, with potentially destabilising effects on the domestic economy. The best solution to this problem is for the government to take steps to achieve credibility—most commonly, by getting its fiscal accounts into order—since fiscal problems are often the cause of policy reversal. If this is not feasible, controls on capital movements may be a second-best policy.

Insulation from shocks arising in the international financial market. The second argument for capital controls on both inflows and out- flows is that they can insulate the domestic economy from identifiable external financial shocks—that is, they can limit the incidence of volatility by preserving some degree of financial autarky. Since controls directly address the source of the shock they may, it is argued, succeed in stabilizing the economy without introducing new distortions. This argument for quantitative controls however, is less persuasive than the first. From the country perspective, fluctuations in world interest rates are just an inter temporal dimension of what terms of trade fluctuations are intra temporally. If intra temporal price fluctuations do not require insulation, it is not clear why inter temporal fluctuations should do so.

Preservation of short-run monetary autonomy under perfect capital mobility, the effectiveness of monetary policy can be preserved only if exchange rate policy is flexible. In this case, however, unpleasant tradeoffs may arise between internal (inflation) and external (current account) balance targets. Tight monetary policy adopted to combat inflation, for example, would increase the domestic real interest rate while causing the real exchange rate to appreciate, possibly resulting in a deterioration of the trade balance. Capital controls would enable the monetary authorities to avoid this tradeoff between targets by making it possible to preserve monetary autonomy with an officially determined exchange rate. Thus controls would, in effect, provide a second independent macroeconomic instrument either monetary policy or the exchange rate-to simultaneously address the two targets of inflation and the external balance of payments. The benefits for macroeconomic management are large, however, only if other stabilisation instruments are not available. If fiscal policy is sufficiently flexible to be used for stabilisation purposes, for example, then price stability and satisfactory current account performance can be pursued through the combined use of fiscal and exchange rate policy.

Changing the composition of inflows. Finally, there is the argument that controls can be used to alter the composition of capital inflows. Even if controls can be used for this purpose, whether or not they should be depends on whether the composition of inflows matters. Unfortunately, there is currently no consensus on this issue.

A separate argument for being concerned with the composition of flows is that certain types of inflows may be driven by implicit government guarantees (for example, external borrowing by domestic financial institutions) and thus may not be welfare enhancing. But even if such flows could be discouraged by capital controls, it is not clear that the same implicit guarantees do not also apply to other types of flows (such as direct lending to domestic firms) through less direct means. If they do, then the case for altering the composition of flows

would have to rely on the differential welfare effects of direct government guarantees extended to financial institutions for different types of flows. This case seems plausible a priori.

Although many developing countries that maintained controls during the initial period of financial integration seem to have preserved a meaningful degree of monetary autonomy, the effectiveness of controls is likely to decrease as these countries become more integrated. As conditions change in these countries, the evidence from industrial countries may become more relevant for them, and controls will be able to preserve a degree of monetary autonomy for only a limited period of time. In addition, controls have not been able to prevent large capital outflows and inflows in response to large prospective arbitrage profits. Finally, the controls can be effective in altering the composition of flows.

With regard to the desirability of implementing controls, it can be concluded that,

Prudential restrictions on external borrowing and lending by domestic financial institutions may plausibly be warranted. These restrictions on capital movements have a clear second-best rationale, since they are directed at a specific distortion: the inability of the government to credibly commit to removing certain implicit guarantees.

Temporary restrictions on capital movements designed to address 'incredible liberalisation' or 'incredible stabilisation' problems are also warranted if credibility is not achievable, again on second-best grounds. Such restrictions may be of limited effectiveness, however, if the size of the perceived arbitrage margin is large.

Restrictions on capital inflows for more general macroeconomic stabilisation purposes may be motivated by the desire to insulate the domestic economy from "pure" external financial shocks or to preserve monetary autonomy in an effort to free up an additional policy instrument. The first goal is questionable, since it

is based on the premise that the government is better informed about the duration of shocks than the private sector. With regard to the second objective, the best solution to this problem may be to increase the flexibility of fiscal policy rather than adopt capital controls. At best, this objective provides an argument for retaining restrictions as a transitory device, until the fiscal system can be reformed to make fiscal policy an effective stabilisation tool.

EXCHANGE RATE POLICY

Different exchange rate systems can be and have been used by countries while becoming integrated with the rest of the world in particular, pure floating; managed, or dirty, floating; fixed exchange rate; or a currency (or quasi-currency) board. Each system has consequences for the effectiveness of monetary and fiscal policy. Thus, while in a pure floating system fiscal policy is less effective and monetary policy more effective, in a fixed exchange rate system the opposite results. Therefore, the advantages or disadvantages of each system vary from country to country depending on the nature—nominal versus real—of the shocks affecting each country and the ability of the authorities to have a flexible fiscal policy. Countries in which fiscal policy cannot be modified effectively in the short run should not relinquish monetary policy completely by adopting a fixed exchange rate system.

In the recent years an increasing number of economies have adopted ‘flexibly managed’ exchange rate systems, which give them the option of effectively using monetary policy at the cost of eroding their credibility regarding inflation targets. The few exceptions have been economies where the credibility of the government was extremely low: Hong Kong during the 1980s and Argentina and Estonia during the 1990s, who adopted currency boards because of the need to regain market confidence. The major difficulty facing these economies, however, is to maintain a flexible enough fiscal policy and build cushion such as a large stock of international reserves to improve the resilience of the economy to shocks.

In the aftermath of the Mexican crisis, many thought that the days of managed exchange rate systems were over. However, most countries were able to go through the Mexican crisis without modifying their exchange rate systems. The evidence to date shows that in capital markets have been selective since the Mexican episode and that fundamentals matter. Thus, there are indications that officially determined exchange rates can be managed successfully within a consistent macroeconomic policy framework.

Since managing the exchange rate indeed seems to be the preference of most developing countries, the issue of how to manage the rate in a financially integrated world become an important one. One way to approach this problem is to consider the exchange rate regime as consisting of a band around a moving central parity. The decisions that need to be made then consist of how to adjust the parity, how wide to make the band, and how to intervene within the band. The objective of central parity should be to maintain the competitiveness. This means adjusting the parity not only in accordance with the domestic foreign inflation differential but also in accordance with changes in underlying equilibrium real exchange rates, which are given by permanent changes in fundamental factors such as terms of trade, commercial policy, fiscal policy, and condition in external financial market. Since the central parity seeks to track the long-run equilibrium real exchange rate, the desirable width of the band depends on the value to the domestic economy of an independent domestic monetary policy. The larger the scope for the exchange rate to deviate from its central parity that is, the wider the band-the greater the scope for an independent domestic monetary policy, In turn, the usefulness of an independent monetary policy for reducing volatility depends on the availability of alternative stabilisation instruments (a flexible fiscal policy) and on the sources of shocks to the economy. The traditional analysis of this issue focuses on the implications of shocks in the domestic money (nominal) and goods (real) markets, the standard prescription being that, holding fiscal policy constant, domestic real shocks call

for exchange rate flexibility, while domestic nominal shocks call for fixed exchange rates. This suggests that if fiscal policy is not available (or is costly to use) as a stabilisation instrument, countries in which domestic real shocks predominate should adopt fairly wide bands, while those in which domestic nominal shocks are dominant should keep the exchange rate close to its central parity. With a flexible fiscal policy, however, domestic real shocks can be countered through fiscal adjustments, thereby diminishing the value of independent monetary policy as a stabilisation instrument. Thus the adoption of a fairly narrow band is more likely to be consistent with the stabilisation objective if fiscal policy is available as a stabilisation instrument.

Regarding intervention within the band, the logic of this analysis suggests that for a given band width, active intervention should accompany nominal shocks, whereas real shocks instead call for some combination of exchange rate and fiscal adjustment. 'Consider, however, an alternative source of shock that is, "pure" external financial shocks, say in the form of fluctuations in world interest rates. In this case, exchange market intervention policy determines the form in which the shock is transmitted to the domestic economy. If world interest rates fall, for example, and active (unsterilised) intervention keeps the exchange rate fixed at its central parity, domestic monetary expansion and lower domestic interest rates will ensure an expansionary shock. If, on the other hand, the central bank refrains from intervention, the domestic currency will appreciate in real terms and the domestic real interest rate will rise a contractionary shock. Purely from the perspective of stabilising domestic aggregate demand, the appropriate intervention policy within the band in this case depends on the direction in which it is feasible or desirable to move fiscal policy. If fiscal policy is literally inflexible, then the choice confronting monetary authorities is between real appreciation (under no intervention) or overheating (under full unsterilised intervention). To avoid both overheating and real appreciation

requires a mix of fiscal contraction and intervention to keep the nominal exchange rate close to its central parity.

Though crawling pegs remain a viable exchange rate option for developing countries that become integrated into world capital markets. However, this reduces the scope for deviating from fundamentals, as well as form commitment to the announced regime. Managed rates are certainly capable of generating macroeconomic volatility in this environment, but they have not generally done so.

The following conclusions can be drawn with regard to exchange rate management:

The central parity should be managed so as to track, to the extent possible, the underlying long equilibrium real exchange rate, This means not just offsetting inflation differentials but also adjusting the real exchange rate target to reflect permanent changes in fundamentals. Large and persistent temporary misalignments should be avoided, primarily because they threaten the sustainability of the regime and make speculative attacks more likely.

Small temporary deviations from the central parity can play a useful stabilising role when fiscal policy is inflexible and either real domestic shocks dominate or exchange rate flexibility is required to ensure that external shocks affect domestic demand in the right direction. In general, fiscal flexibility can substitute for exchange rate flexibility as a stabilising device.

MONETARY POLICY

Fixing an exchange rate target in the face of capital movements implies central bank intervention in the foreign exchange market, which has the effect of altering the stock of base money. Sterilised intervention is the indicated policy for a government attempting to simultaneously run an independent monetary policy (targeting either some monetary aggregate or some domestic interest rate) and fix the nominal exchange rate. However, if capital mobility is high, such an attempt may not be successful in the absence of capital controls.

The purpose of sterilised (as opposed to unsterilised) intervention is to prevent a change in the demand for domestic interest-bearing assets from causing too large a change in the price of those assets, essentially by meeting the demand shift with a supply response. Thus, sterilisation in response to capital inflows involves an increase in the supply of domestic debt in one form or another. As in the case of capital controls, the general issues that arise in this context are not only whether sterilised intervention can work to stabilise domestic aggregate demand but also, if it can, whether it is desirable. Even if sterilisation remains possible for financially integrating developing countries, its effectiveness in insulating domestic demand from external financial shocks is questionable. Sterilisation is most effective when domestic interest-bearing assets are close substitutes among themselves but are poor substitutes for foreign interest bearing assets. Under these circumstances, sterilised intervention can insulate domestic aggregate demand from transitory portfolio shocks. However, the conditions necessary for sterilised intervention to be effective imply that its effectiveness may depend on how it is attempted. Because bank borrowers may not have access to securities markets, for example, sterilising by raising reserve requirements on banks is likely to be less effective in insulating the domestic economy from portfolio disturbances than is sterilising through open market bond sales.

If sterilisation is possible, when is it beneficial? The answer is that sterilisation is beneficial whenever the prices of domestic assets need to be insulated from shocks; that is, whenever the economy experiences transitory shocks to portfolio preferences— domestic nominal shocks or external financial shocks—or when the authorities seek to accommodate a permanent change in portfolio preferences in a gradual fashion. When this happens, domestic aggregate demand can be stabilised by preventing changes in portfolio preferences from being transmitted to the real sector through changes in exchange rates and asset prices. On the other hand, domestic real shocks do not call for sterilised

intervention, since in this case the asset price adjustments triggered by the shock are likely to prove stabilising.

The point for policymakers is that sterilised intervention may be indicated when an economy experiences shocks to portfolio preferences. Even when it is desirable for stabilisation purposes, however, sterilisation may carry a fiscal cost, particularly for governments whose claimed intentions not to devalue or default on debt are not fully credible, resulting in high domestic interest rates. Thus, the use of this tool without impairing the government's solvency requires fiscal flexibility. Countries that lack such flexibility may be tempted to sterilise through changes in reserve requirements, despite the likelihood that the use of this tool will result in imperfect insulation, because the fiscal implications of doing so are less adverse than those of open market operations. This advantage, however, is at the cost of implicit taxation of banks and their customers.

FISCAL POLICY

From the standpoint of reducing volatility, the key characteristics of fiscal policy are short-run flexibility, the perceived solvency of the public sector, and its vulnerability to liquidity crises.

Short-run fiscal flexibility plays an important role in neutralising shocks

The importance of short-run fiscal flexibility can be observed from the reference case of a "pure external financial shock for a country with well-integrated financial markets. In this case, sterilised intervention is not an option, and thus the country has only one independent monetary policy instrument. Faced with an external financial shock, the domestic monetary authorities can choose a value for either the exchange rate or the domestic money supply (and thus the domestic interest rate), but not for both. Therefore, when both the level and the composition of aggregate demand are important, the authorities will find themselves one instrument short and may face an unpleasant choice between, say, stabilising domestic demand and safeguarding the competitiveness of exports. This tradeoff suggests an important role for short-run fiscal flexibility.

If fiscal policy can be counted upon to sustain the level of aggregate demand at its pre-shock value (by adopting a more or less expansionary stance as needed), then the choice of monetary response can be based on the desired composition of aggregate demand. In the absence of short-run fiscal flexibility, however, the nature of the monetary response may depend on tradeoffs between the level and composition of demand.

How can fiscal flexibility be achieved? There are at least two important constraints tending to limit the flexibility of fiscal policy. The first concerns inflexibility of fiscal instruments arising from inefficient tax systems that associate large excess burdens with policy-induced changes in tax revenues, as well as from political imperatives that tend to drive up the level of public expenditures. Structural measures that remove rigidities on either the expenditure or revenue side of the government's budget—such as privatisation of state enterprises and tax reform designed to widen the tax base and remove egregious distortions in marginal tax rates, as well as to improve the efficiency of tax administration—can thus make an important contribution to enhancing fiscal flexibility. The second restriction on fiscal flexibility arises from the behaviour of creditors. If fiscal profligacy during good times causes creditors to question fiscal solvency during bad times, then countercyclical fiscal measures will be ruled out by an inability to finance deficits during downturns. The upshot is that overly expansionary fiscal policy in response to positive shocks is likely to make fiscal policy procyclical in both directions by constraining fiscal flexibility when the economy is hit by adverse shocks. Thus a key step in achieving symmetric fiscal flexibility is the implementation of mechanisms that permit the fiscal authorities to restrain spending when times appear to be good.

Beyond the role of short-run stabilisation in response to external financial shocks, fiscal policy plays a more fundamental role in the context of increased financial integration, when both the direction and the magnitude of capital flows are likely to become very sensitive to perceptions of domestic public sector

solvency. Potential Solvency can generate large capital outflows and large interest rate premiums, as creditors try to avoid taxation of domestic assets while demanding compensation for exposing themselves to the risk of taxation they face by continuing to lend in the domestic economy. This situation is aggravated when the government makes explicit guarantees to creditors, however, since the value at the guarantees will fluctuate with the governments perceived financial ability to back them. The key point is that in the context of high financial integration, the stock dimension of fiscal policy, in the form of changes in the government's perceived net worth, may itself represent an important source of shocks to the domestic economy, transmitted through the terms on which both domestic and foreign creditors are willing to hold claims on the domestic economy.

The stock and flow dimensions of fiscal policy are not independent. A critical link between them is created by the fact that what matters for creditors is the perceived solvency of the public sector. For a government whose long-run fiscal stance is uncertain, short-run policy changes will be scrutinised for information about the government's longer-run intentions. Knowing this, governments may be reluctant to act in ways (may be perceived as sending the wrong signal to creditors, and this reluctance may limit the government's short-run policy flexibility. Thus, achieving a reputation for fiscal responsibility may maximise the government's short-run policy flexibility.

Debt management policies will determine the likelihood of debt run. Public sector solvency requires that the public sectors comprehensive net worth be positive. However, the need to preserve macroeconomic stability in a financially integrated environment may impose stricter conditions on the public sector's balance sheet than simply maintaining a positive value of comprehensive net worth. The composition of assets and liabilities may matter as well. In particular, a public sector that is solvent (that is, one that can credibly honour its obligation over a sufficiently long horizon) may nevertheless be vulnerable to

short-run liquidity crises. If the public sector is - perceived a unlikely to honour its short-term obligations, then creditors will be reluctant to take on the government's short-term liabilities, and in a vicious cycle, the government may then be unable to meet its short-run obligations. The likelihood of such a debt run depends on the maturity and currency composition of the public sector's liabilities relative to that of its assets that is, on the government's debt management policies.

In managing the composition of its debt, the government faces a difficult tradeoff between enhancing its credibility, on the one hand, and exposing itself to liquidity crises, on the other. The existence of long-term (fixed-interest) domestic-currency- denominated (nominal) debt provides the government with some financing options that it does not have if its debt is short-term and denominated in foreign currency that is it can effectively repudiate the long-term debt by inflating or devaluing, thereby reducing the debt's real value. Given the nominal interest rate on this debt, it may indeed be sensible for a welfare-maximising government to do so, since by acting in this way it would have the option of sustaining productive expenditures or reducing distortionary taxes. However, the prospect of the government exercising this option would raise domestic nominal interest rates, making it expensive for the government to borrow long-term in nominal terms. And even if the government never intends to behave in this fashion, the time inconsistency problem involved may make it very difficult for the government to convince its creditors of its intentions. To reduce its borrowing costs, the government may therefore be induced to borrow short-term and in foreign currency. By doing so, it eschews the option of gaining from devaluation or inflation at the expense of its creditors, and thus enhances the credibility of its promise to do neither. The problem is, of course, that in doing so it incurs liquid foreign currency-denominated liabilities, thereby making itself vulnerable to debt runs, as happened in the Mexican crisis.

The way out of this dilemma is to note when -it arises in acute form that is, when the government actually retains the discretion to act as creditors fear, when it lacks credibility on other grounds (for example, when it has a reputation for acting in a discretionary fashion), and when the government's revenue needs are high and conventional taxation is highly distortionary. In other words, the existence of long term nominal debt is only one factor in the government's decision to, devalue or inflate, and creditors can rationally expect the government to forgo the option of inflating away the real value of their assets if it is institutionally unable to do so, if it is perceived as placing a high value on the credibility of its policy announcements, or if inflating creates few net benefits from the government's perspective. Thus, the government can avoid making its borrowing costs overly sensitive to the composition of its debt by creating institutions that limit its discretion (for example, by increasing the independence of the central bank), by establishing a reputation for nondiscretionary behaviour, and by choosing levels of expenditure and mobilising sources of taxation that minimise distortions. Under these circumstances, the option to borrow long-term in domestic currency terms may be retained, and the likelihood that macro economic stability will be impaired by runs on government debt would be minimised.

In sum, when financial integration is high, short-run fiscal flexibility is very important, since it provides an additional instrument for stabilising domestic aggregate demand in response to external financial shocks, thereby freeing monetary or exchange rate policy to address other macroeconomic objectives. Moreover, a stable perception of fiscal solvency becomes crucial for preventing the domestic public sector itself from becoming an important source of macroeconomic shocks, transmitted through the terms on which creditors are willing to hold claims on the domestic economy. Indeed, the perception of public sector solvency may itself be the most important component in freeing up fiscal policy to play a short-run stabilising role. Finally, under high financial

integration, institutional arrangements that limit the government's ability to act in a discretionary fashion, or that enhance its incentives to avoid doing so, may preserve the government's access to low-cost long-term finance, thereby preventing the emergence of debt runs that could introduce an important source of macroeconomic instability even when the public sector is solvent.

SUMMARY

Today's multinational enterprises must deal with an international monetary system full of complexities, challenges and risks. Finance managers and treasurers in particular play a key role in managing worldwide money matters. It is important for international marketers to possess insight into multinational finance and accounting functions, because these functions usually have a significant impact business. Eventually, all business decisions that involve capital investment or other types of long-term financial commitment on the part of the parent corporation must be reviewed in the context of international finance and monetary policies. The financial strength of the company is deeply affected by the foreign investment that it decides to make when it starts going global. This chapter is an attempt to analyse the foreign investment decisions by the multinational corporations. This would lead many companies to look for foreign portfolio investment. These decisions would strengthen the company's financial investment globally. Also, the foreign direct investment by many companies largely affects the operations of the local businesses. The deeper insight in to the concepts of capital flows and overheating would help us to understand the financial operations of multinational corporations.

REVIEW QUESTIONS

1. Discuss the role of foreign investment
2. How will you determine whether the portfolio inflows are hot or cold?
3. Explain the concept of incentives in foreign investment.
4. What is Foreign Direct Investment? Discuss the foreign direct investment scenario in India.

5. Explain the role of exchange rate policy, monetary policy and fiscal policy in foreign investment.
6. What is foreign portfolio investment? Explain with examples
7. What is overheating of capital flows? Explain in detail.
8. Macro economic management is the fundamental for integration – Comment.

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