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Study Material

For

M.A. ECONOMICS

Lesson Nos. 1 to 21	**Course: 561**
Unit: I-IV	**MA-Sem IV**

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DETAILED SYLLABUS

Semester : IV	**Title : International Political Economy**
Credits : 4	**Maximum Marks : 100**
Course No.: 561	**(a) Semester Examination : 80**
Duration of Examination : 2:30 Hrs.	**(b) Internal Assessment : 20**

INTERNATIONAL POLITICAL ECONOMY

UNIT I : INTERNATIONAL POLITICAL ECONOMY

International Poltical Economy : Meaning, Traditional Schools of International Poltical Economy, The International Trade Systems, Meaning ; The Creation of the Post-war Trade System; Evolution of the Multilaterals Trade System; The Problem of Trade Cooperation: The politics of Trade Liberalization; Multilateral Institutions and Trade Cooperation; Protection: Protection and its Consequences; the structure of Protection in the Advanced Industrialized Countries; The Economic Consequences of Protection.

UNIT II : THE THEORY OF REGIONAL BLOCKS

Forms of Economic Cooperation ; Static and Dynamic effects of a Custom Union : Production effect; Consumption Effects. European Union (EU) and North American Free Trade Agreemtn (NAFTA). Economic Progress of SAARC/SAFTA, etc. for Asian Economic Cooperation; Problems and Prospects of forming customs union in The Asian Region : Globalization : meaning, essential conditions for Globalization; implications and impact of Gilobalization.

UNIT III : INTERNATIONAL TRADE AND FINANCIAL INSTITUTION

The International Monetary System : The rise and fall of Gold Standard and Bretton Wood System (the interwar periods); Present International Monetary System IMF: Objectives; functions; Conditionality clause of the IMF; The Collapse of Bretton Wood System; World Bank: and its contribution - limitations.

GATT and WTO : GATT and Trade Liberalization : The Doha Declaration : WTO and Developing : WTO and Developing Countries with Special reference of India: Trade Related Investment Measures (TRIMs). Trade related aspects of Intellectual property (TRIPs) and General Agreement of Trade in Services (GATS)

UNIT IV : CURRENT DEVELOPMENT AND PROBLEMS IN THE INTERNATIONAL ECONOMY

Asian Crisis and the lessons for the developing countries like India; Impact of Trade Reforms Since 1991 on Balance of Payments, Multinational Corporations: Definitions, benefits; domestic politics and MNCs; The Host Country Dilema; Regulating MNCs activity in Developing Countries; International Regulation of MNCs.

International Debt. Debt-Growth link; Magnitude of Debt Problem; Causes of Debt problem; Remedial and preventive measures; reasons for sharp rise in India's External Debt.

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MEANINIG AND TRADITIONAL SCHOOLS OF INTERNATIONAL POLITICAL ECONOMY

Structure

1.1 OBJECTIVES

After going through this unit, you would be able to :

- Know the meaning of International Political Economy
- Understand the different issue areas of IPE
- Explain the traditional schools of IPE

1.2 INTRODUCTION

We are living in an interconnected world. There are positive and negative externalities from and to the rest of the world. Such a life was unthinkable earlier, when people preferred to live peacefully in the regions they thought they were destined to . External forces had no impact on those living inside, nor did the insiders have any centrifugal effect of their economic and non-economic activities. But time has changed tremendously. In the present lesson, we'll know how International Political Economy became an important area of study.

1.3 MEANINGOF IPE

Since 1990s, significant changes have taken place in the global political economy, owing to many reasons. Economic reforms and the opening up of national economies to the globe brought change in the way problems were perceived earlier. Likewise, the task of solving those problems also underwent change, particularly with regard to perspectives. With more and more liberalisation and globalisation of the world economy and dismantling of barriers , new issues came up, both in terms of gains and losses. It was realised that no country can work in isolation, as it influences others and is influenced by others, irrespective of the size of the nation in question. Issues of concern included many, including the relationship between state and non-state actors, space for non-state actors in the hitherto state-centric world, repercussions of an activity in one part of the world elsewhere, scope for fusion of different fields for a comprehensive understanding of the problems confronting the world at large etc. These were some of the factors responsible for the emergence of the field of International political Economy.

According to Frieden and Martin, the field of International Political Economy is a new sub-discipline within Political Science. The first textbook in the field was published in 1977 (Spero 1977). One of the earliest works to recognise the integration of economics and politics was that of political scientist Kenneth N. Waltz. Who did it in his book Man, the State, and War. The events that unfolded in 1970s, (particularly oil price shocks and break down of Bretton woods system) compelled the scholars to give a serious thinking to the interconnectedness of Economics and politics.

That the field of International Political Economy is multidisciplinary becomes clear from its name. 'Internationalpolitical Economy' has three words. International means that the field doesn't just talk about one nation or its bilateral relationships , but the discussion of problems crosses borders. Political perspective, as experts put it, brings 'state' as an important actor. Apart from it, certain other actors play an important role. These include domestic pressure groups, NGOs, International Organisations, etc. How societies and states achieve their goals and serve their interests depends on the way rules are set by 'politics'. Many a time, transnational and international issues lead to interaction among states for effective and peaceful resolution of conflicts in which different nations are in conflict. Here, in fact, the field of International Relations holds importance, as certain factors make some countries more influential than others in the different fora where they interact. Depending on the relative role of state as the most important actor or otherwise, different schools of thought have emerged. Economy brings with it the evergreen concept of allocation of scarce resources between alternative uses. In our day to day life, we find different individuals, groups and nations struggling for the scarce resources. Some institutions are meant for the purpose of allocation.

Political scientist Charles Lindblom very rightly says :

"The economy is actually nothing more than a system for coordinating social behaviour! What people eat, their occupation, and even what they do when not working are all organized around different agricultural, labour and relaxation markets. In effect, markets often perform a social function of "coordination without a coordinator."

These three fields get merged to form the core of International political Economy.

Many scholars also include sociological perspective of a problem to be incorporated in any discussion on International political Economy, as according to them, states and markets don't exist in a 'social vacuum'. So the different social groups existing and working at local, national or international level and advocating certain things, while condemning certain policy decisions, have significant impact on the working of different dimensions of the interrelated world.

In this regard, the comment of Thomas Friedman, a New York Times columnist is worth serious consideration:

'The world has become an increasingly interwoven place, and today, whether you are a company or a country, your threats and opportunities increasingly derive from who you are connected to….We have gone from an international system built around division and walls to a system increasingly built around integration and webs.'

Veseth defines IPE "as a *problématique*, a set of problems that bear some relationship to one another. The IPE *problématique* is the set of international and global problems that cannot usefully be understood or analyzed as *just* International politics or *just* International economics. These problems fall necessarily in the expanding domain of International Political Economy."

According to Oatley Thomas, International Political Economy (IPE) studies the political battle between winners and losers of global economic exchange. It, he, says, is the study of how economic interests and political processes interact to shape government policies. He exemplifies it through US steel tariff policy of 2002. In 2002, Bush administration decided to impose tariffs on import of steel . This was a result of certain domestic pressure groups i.e. steel producers and steel workers, who suffered substantial loss and couldn't compete with the foreign producers of steel. The decision had many implications for different stakeholders. First of all, domestic steel producers and workers gained, but industries which used steel as an input were affected adversely, as earlier they used to get it at a comparatively cheap rate. Apart from these, the foreign steel producers who exported to US were also affected due to the building of tariff walls by US. Under these circumstances, whether the policy decision gets reversed or not depends on the interplay of different forces. To what extent can domestic steel consuming industries convince the government to reduce tariffs? What pressure can the foreign steel producers (who have been hurt) put on their concerned governments in this regard? To what extent can these countries threaten to retaliate? Can they approach the international organisations (WTO) regarding the justification of US tariff policy? Is US' policy found incompatible with WTO set standards? Finally, the policy outcome (reversal of decision or otherwise) depends on the relative strength of these pressure groups. In this way

,interaction takes place between economic interests and political processes for shaping government policies .

Though, many a time, International Political Economy (IPE) and Global Political Economy" (GPE) are used interchangeably, scholars distinguish these and use the term global political economy instead of "international political economy" while discussing problems that have worldwide implications instead of just for certain nations. These include climate change, hunger and threats to human security etc.

For a better understanding of issues of concern in IPE, it is essential to have a knowledge of economic theory, domestic politics, political interactions between governments and International Economic Organisations. In this regard, scholars like Frieden and Martin argue that domestic-international connection is the impact of domestic interests and institutions on international interaction and vice versa.

1.4 ISSUE AREAS OF IPE: Most of the scholars of International Political Economy study global economy under the following heads or issue areas :

- The International trade system
- The International monetary system
- Multinational corporations and
- Economic development.

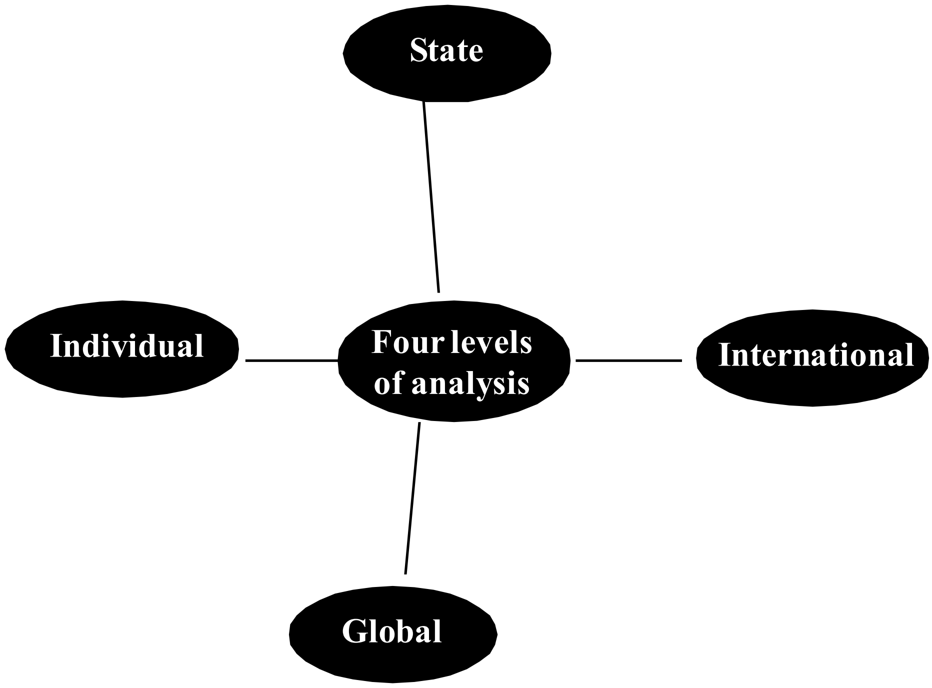
The international trade system under the aegis of GATT/WTO sets multilateral trade rules for member nations to be followed for smooth flow of goods (and services) between nations. The basic principle is of non-discrimination. However, the international trade scenario also depicts a case of growing number of Regional Trade Agreements (RTAs)which are based on preferential access and discrimination. There are different arguments for and against these RTAs. In other words, some scholars believe that these agreements are challenging the existence of multilateral trade system, others feel that these are mutually compatible and complementary. Still others feel that the stalling of talks at different rounds of WTO have motivated countries to go simultaneously for bilateral and other trade agreements, as these are easy to negotiate and countries can gain out of preferential trade among themselves.

The International monetary system makes it easy for the countries to conduct trade and pay for imports. In this regard, the system provides the foreign exchange required for the purpose. Post world war-II, many changes have been observed in the exchange rates. Till the proper functioning of Bretton woods system, it was a regime of fixed or stable exchange rates. Since 1970s, most of the governments have adopted a market based exchange rate, with rare government intervention. Also most of the restrictions on free flow of capital internationally have been dismantled.

In IPE, we also study what are the activities of MNCs and how governments regulate their activities.

In 'economic development', scholars study about the development strategies of a country and its justification. In other words, it throws light on experience of different methods of development by different countries and their success rate.

When the allocation of scarce resources takes place between different competing ends, there starts conflict. One set of people have one item on the priority list, whereas it is another for others. These competing demands get aggregated, reconciled and transformed into foreign economic policies. Whatever gets chosen in the process, some emerge as winners and some as losers. These are the distributional consequences. There are welfare consequences as well, which assess the impact on overall well being of the society. So International Political Economy examines how this political competition shapes the evolution of international trade and monetary systems, affects the ability of Multinational Corporations (MNCs) to conduct their operations and influences the development strategies governments adopt.

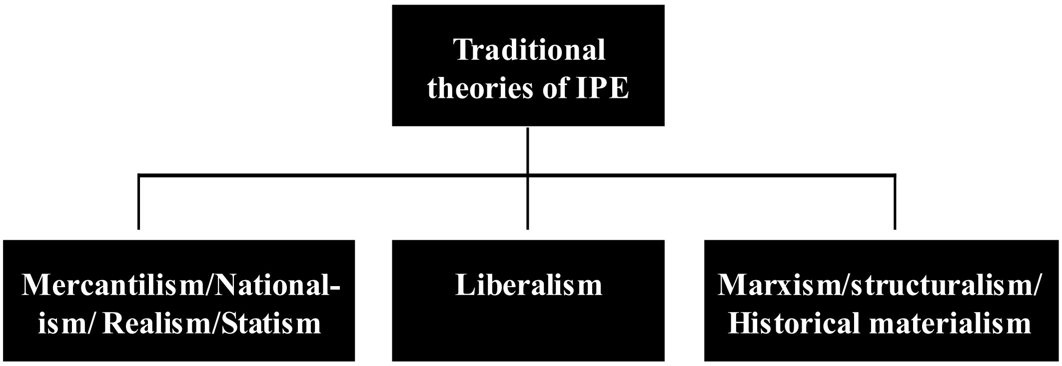


1.5 TRADITIONAL SCHOOLS OF INTERNATIONAL POLITICAL ECONOMY (IPE)

Like any other field of study, International Political Economy too has certain theories, which guide us in our journey of IPE. D. Ballam and M.Veseth argue that the knowledge of theories, institutions and relationships found in International Political Economy is indispensable even in understanding issues of our day to day life. Problems of the world, they say, are no more 'foreign affairs'. From their argument, it can be easily understood how deeply we are impacted by and how important it is to study International Political Economy.

Theories/ Analytical principles/ approaches to International Political Economy

Generally, scholars study IPE through three schools of thought: Mercantilism, Liberalism and Marxism. Let us now explain these one by one:



1.5.1 Mercantilism

Many scholars put the history of mercantilism from 15th century to early to mid 19th century. Others argue that most of the European economists having written between 1500 and 1750 can be classified as mercantilists. Most of the European nations are said to have encouraged it. The rise of imperialism is also credited to it. England and France were heavily influenced by it.

Mercantilism was a system of ideas, institutions, politics and economic practices that supported the absolutist (all powerful)state. (Source: Theories of development: contentions, argument, alternatives by Richard Peet and Elaine Hartwick, 2nd edition, p.25). It is also called the economic counterpart of political absolutism. Also called as economic nationalism, it is said to be most closely associated with the political philosophy of **realism**, in which great emphasis is laid on the role of state as a dominant actor and the use of hard power and soft power by it to serve its national interests.

The relationship between economic activity and state power gets reflected in Mercantilism which is based on three basic propositions:

i) **There is great connection between national power and wealth:**

National power, according to mercantilists, depends on wealth or economic means. So national power is directly related to national wealth. A country can wield more power if it posses more wealth. On the other hand, Power is required to acquire wealth. So these two things re-inforce each other.

ii) **Importance of trade:**

Mercantilists believed that the way to acquire wealth is through trade. Trade should result in a balance of trade surplus i.e. in which exports exceed imports.

iii) **Importance of some types of economic activity:**

They believed that some types of economic activity are more valuable than others and hence should be encouraged. For example, manufacturing is preferable to agriculture.

Given these three propositions, in general, the approach is to encourage exports through subsidies, discourage imports and hence prevent the export of gold and silver, maximising the use of domestic resources to produce finished goods, as they are more valuable as compared to raw materials. If imports can't be avoided, they should be allowed in raw materials and should be paid in terms of domestic goods and not gold or silver, as it would save the monetary reserves of the country. Trade they said, was a zero sum game. So one country could gain at the cost of the other.

Mercantilists give prime role to the state in allocation of resources. If the problem of allocation is left to the market, the results may not be desirable and uncoordinated decisions may lead to inappropriate economic structure. For example, the industries and goods which may not be important from national viewpoint and strengthening of national power may be selected and those having the potential to contribute to the state's wealth acquisition process might be ignored. In the process, balance of trade, which should be positive turns unfavourable. So what kind of economic activities are to be encouraged gets chosen by the state.

In contrast to the agricultural system of the physiocrats[1] or the laissez-faire of the nineteenth and early twentieth centuries, the mercantile system served the interests of merchants and producers such as the British East India Company, whose activities were protected or encouraged by the state. The government encouraged the new industries by exempting them from taxes. It also established monopolies over local and colonial markets.

There was great impact of this protectionist tendency on the shipping industry. Ships could be used only for merchant or military purpose. In France, the port duties were imposed on foreign vessels. It is also called colbertism.

In England, the protectionist tendency of mercantilist era took the shape of Navigation Act of 1651 and The Staple Act of 1663. These meant that trade between England and its colonies should be conducted though English or colonial vessels. By 1860, Mercantilism had lost influence in England. But protectionist tendency remained during Interwar period and mercantilism is said to have re-emerged after WW-II. Post 1970s, subsequent to the oil crisis, the pro- export and anti-import policy of some countries was named neo-mercantilism.

1.5.2 Liberalism

The aim of this school of thought was to counter and challenge mercantilism . It emerged in Britain during the eighteenth century. Some important contributors to this field were Adam Smith, David Ricardo. While advocating a liberal regime, they stated that all the three propositions of mercantilism were questionable. First, any economic activity can make a person rich, but may not raise the wealth status of state. Secondly, free trade is the best policy. All the countries gain out of trade, whether or not they get a balance of trade surplus. It has been explained very well in absolute and comparative cost advantage models of trade. Finally, it is not necessary that only a certain type of economic activity shall result in more wealth and hence is preferable. According to them, any activity in which a nation produces low cost goods at home is preferable to one in which high cost is involved. The latter can be imported.

Given these counter propositions as an attack on mercantilism, liberalists don't believe in the state as an efficient resource allocator. According to them, the decision making in this regard should be left to the demand and supply forces of market. It can promote social welfare. State can facilitate these transactions by assigning certain property rights. State can play an active role where market failure takes place, or market fails to allocate resources efficiently.

1.5.3 Marxism

According to Marx, "We are little more than tiny cogs in a huge machine, and it is the well being of the machine that takes precedence over the defence of truly human existence."

There are two conditions of capitalism: private ownership of means of production or capital and wage labour. The capitalist do not give full amount to the workers as their remuneration. They are just given subsistence wages. Rest is profit to the capitalist.

According to Marx, capital has a tendency to get concentrated in a few hands (capitalists), capitalism is associated with a falling rate of profit due to which the wages of workers are reduced further. There start developing inequalities between a small elite of capitalists and a big class of impoverished workers. The latter are then forced to cause a revolution and overthrow capitalism. It is replaced by socialism. Even the state is an agency promoting capitalism.

According to Marxist school, just as the capitalists exploit workers inside a country, rich countries exploit poor countries.

In this way, the three schools differ in the basic argument made regarding the allocation of society's resources.

1.6 LET US SUM UP

In this lesson, we studied about the meaning, issue areas and traditional approaches to the International political Economy.

1.7 REFERENCES AND SUGGESTED READINGS

- International Political Economy by Thomas Oatley

SELF ASSESSMENT QUESTIONS

- What do you understand by International political Economy? What are its issue areas?
- What are the three approaches to IPE? How do they differ?

THE INTERNATIONAL TRADE SYSTEM

Structure

2.1 OBJECTIVES

This lesson shall enable the learners to know :

- about the multilateral trade system (MTS)
- The basic components of MTS

2.2 INTRODUCTION

In the post WW-II period, many changes have taken place in the world trade, investment etc. In this lesson, you shall know more about the international trade system that emerged after world war-II.

2.3 THE MULTILATERAL TRADE SYSTEM

The post war period (world war II) has seen significant expansion in world trade. Credit for it goes primarily to multilateral trade system. The multilateral trade system, as we know, is based on non-discriminatory approach to trade liberalization. In fact the efforts to have such a system started during war period, when the planners started thinking about the final shape such a system would take in peace time. Despite the fact that the restrictive regime during war period travelled even beyond war time, these early developments led to the establishment of IMF and World Bank even before the war was over. The war time planners wanted to use a multilateral route to trade liberalization as opposed to bilateral used during war period (e.g. US trade agreements), as the moves in granting concessions[2] in the former were to take place simultaneously instead of sequentially. Moreover, they had a comprehensive approach to trade liberalization in mind, which could dismantle tariff as well as non-tariff barriers. This system had its first expression in Atlantic Charter and Lend-Lease Agreement between US and Great Britain. Many scholars agree that non-discrimination in GATT was taken from US' trade agreements, whereas for simultaneous negotiations ,British experience in this regard was relied upon.

At the conclusion of World War II, twenty-three[3] countries, led primarily by the United States, Canada, and the United Kingdom, negotiated the General Agreement on Tariffs and Trade.1 The basic aim was to do away with the protectionist tendency of most of the nations, including US's Smoot Hawley tariffs of 1930s and retaliation by others; and to have a stable and peaceful post war world .

The multilateral trade system (MTS) is a political process as well as a set of political institutions. As a political process, it is based on negotiations and interactions between governments, bargaining power between them, following of trade rules set under the system and governing their trade policies which affect international trade. As a political institution, there exists GATT/WTO which sets trade rules to be followed by member countries, facilitates trade internationally, administers the operation of Regional agreements, provides dispute settlement mechanism etc. No new sets of trade rules were introduced with the coming into being of WTO, as GATT was amended and revised many times before it could transform into WTO. There was, however, one basic difference with regard to WTO being an organization and GATT being a treaty.

2.4 BASIC COMPONENTS OF MTS

The multilateral trade system under the aegis of GATT/WTO has three basic components:

i) Intergovernmental bargaining process.

ii) Set of rules and principles governing international trade relations.

iii) Dispute settlement mechanism.

i) Intergovernmental bargaining process:

The Multilateral trade system has been providing a forum to different nations for negotiating with each other regarding trade liberalization. Trade liberalisation has taken place through different rounds, usually referred to as bargaining rounds, as the countries bargain while granting concessions to each other. Many a time, these rounds take so long to conclude. For example the Uruguay round of GATT started in 1986, but was concluded in 1994. Likewise, WTO's Doha round began in 2001, but is still not concluded. One of the most important reasons for their taking such a long time is the complexity of issues and different impact of the same issues on different countries due to different levels of development, among other things. So these rounds are also called as extended affairs.

Apart from trade liberalization through reduction of tariff barriers, attempt was also made to remove some non-tariff barriers. Tariffs at an average rate of 40% were imposed in post world war-II time. Soon, it got reduced. In 1970s, it fell to 9%

on an average. It has fallen further now. These reductions are however in manufactured goods. (see table 1.2)

Table: 1.1

Trade Negotiations within the GATT, 1947-1993

Name and Year of Round	Subjects Covered	Participating Countries
1947 Geneva	Tariffs	23
1949 Annecy	Tariffs	13
1951 Torquay	Tariffs	38
1956 Geneva	Tariffs	26
1960-1961 Dillion Round	Tariffs	26
1964-1967 Kennedy Round	Tariffs and anti dumping	62
1973-1979 Tokyo Round	Tariffs Nontariff measures Framework agreements	102
1986-1993 Uruguay Round	Tariffs	123
	Nontariff measures	
	Rules	
	Services	
	Intllectual Property rights	
	Textiles and Clothing	
	Agriculture	
	Dispute Settlement	
	Establishment of WTO	123

Source: World Trade Organisation 1995, 9.

Table:1.2

Average World Tariffs, 1947-2000

1947:	GATT Established	38%
1962:	Pre Kennedy Round	17%
1972:	Post Kennedy Round	9%
1987:	Post Tokyo Round	6%
1994:	Post Uruguay Round	4%

Source: World Trade Organisation 1995, 5.

ii) Set of rules and principles governing international trade relations

GATT/WTO is also used as a forum for countries to set certain rules to be followed in international trade relations. These trade related issues have been seriously considered over successive rounds. As the table 1.1 shows, non-tariff barriers were taken first of all in Tokyo round, whereas, Uruguay round saw substantial change. In other words, in The Uruguay round, certain new issues were introduced, including TRIPs (for protection of intellectual property rights), TRIMs (rules governing policies regarding MNCs) and GATS (to create new rules to govern trade in services).This was meant to keep pace with the changing time.

Four principles have been enshrined in the set of multilateral rules:

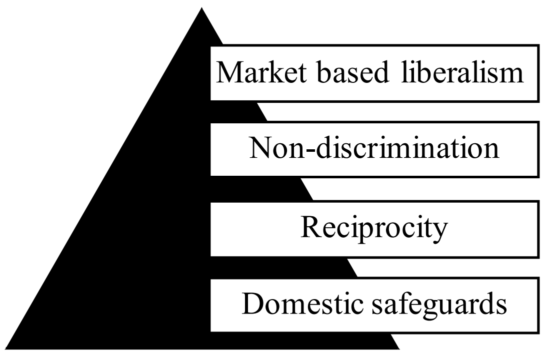


Fig: Basic principles of MTS rules.

- **Market based liberalism** This principle argues for a free trade policy as being the best policy. Every country, irrespective of its size gains out of trade. It works on the simple logic that a country should produce a commodity domestically, if it can produce it at a low cost. It should import a commodity if it can't produce it domestically at a low cost. In other words, the theories of absolute advantage model and comparative advantage model explain and justify why and in which commodities a country should trade and specialize. Heckscher- Ohlin model talks about factor endowments. In short, this principle advocates a world free of trade barriers of any kind, as that increases welfare of all.

- **Non-discrimination** Trade without discrimination is another core principle of multilateral trade system. Non-discrimination means no discrimination between trading partners, as well as equal treatment of foreigners and locals. The former is also referred to as the **Most-favoured-nation (MFN) principle which means that if a member country is giving any kind of favour to another member nation, it shall have to do the same for every other member country. It exists in article 1 of GATT and states: "Any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties."**

Article 1 of GATT deals with goods. As services hold great importance in today's time, MFN also finds its place in article 2 of GATS. With the inclusion of intellectual property rights, article 4 of TRIPS also incorporates MFN.

WTO, however, allows certain exceptions to MFN principle. These include Signing of a free trade Area by a member country (under article XXIV), which negates the principle of non-discrimination, as it is based on preferential access for members against non-members. Certain agreements (like Generalised System of Preferences of late1960s) also allow developed countries to give special concessions to some developing countries. Likewise, equal treatment of foreigners and locals means that a domestically produced good should not be given preference over a foreign good. This principle is known as National Treatment and is included in Article 3 of GATT, Article 17 of GATS and Article 3 of TRIPs.

- **Reciprocity** The third basic principle is reciprocity which means that countries should reciprocate in granting concessions . For example, if India reduces tariffs on a good it imports from Sri Lanka , Sri Lanka should offer tariff reduction on a product it imports from India, under the aegis of GATT/WTO. It should lead to roughly equal amount of exports for the countries involved.

- **Domestic safeguards** These allow a WTO member nation to introduce escape clauses i.e. to seek exemption from the basic principles of multilateral trade system. If country A feels that due to imports of a commodity X from country B, its domestic industry is being hurt, it can opt out of its commitments under WTO and impose tariffs and hence discriminate. But for this it needs to give strong justification.

iii) **Dispute settlement mechanism**

WTO has a body to settle disputes between member nations. For example, if a member feels that its trading partner is not following WTO principles of non-discrimination, reciprocity etc. it can approach the WTO Dispute Settlement Body. In case the trade policy of the other nation is found to be violating WTO rules, that country is told to revise its trade policy and make it WTO compliant.

2.5 LET US SUM UP

In this lesson, we discussed about the international trade system that emerged after the WW-II. The multilateral trade system has three basic components, about which we discussed in detail.

2.6 REFERENCES AND SUGGESTED READINGS

- International Political Economy by Thomas Oatley
- The WTO and GATT : a principled history, Brookings institution.

SELF ASSESSMENT QUESTIONS

- Write a note on the multilateral trade system (MTS).
- What are the three components of MTS?
- What are the four principles enshrined in the multilateral trade rules?

CREATION OF THE POST-WAR TRADE SYSTEM

Structure

3.1 OBJECTIVES

After going through this lesson, you shall be able to:

- Understand the creation of post war trade system
- Explain how the USA influenced the multilateral trade system
- Know how and why did American hegemony decline?

3.2 INTRODUCTION

It is a known fact that GATT or the basic pillar of multilateral trade system is a post WW-II development. Post world war-II, many political agreements took place . Gradually, there started dismantling of tariff walls and other barriers built during war period and great depression. When GATT was signed in Geneva[4] , agreement took place on 123 negotiations and 50,000 tradable items were covered.[5] But as Irwin puts it, no substantial improvement was made in trade liberalization initially, at least before late 1960s. US was an exception, as it granted most of the concessions during this time. In the present lesson, we shall throw light on some of the most important developments that took place in the multilateral trade system after WW-II.

3.3 US' INFLUENCE ON THE MULTILATERAL TRADE SYSTEM

As a political process, the MTS takes into consideration interests of the nations involved in bargaining. The system that evolved after world war–II too had influence of certain world powers, whose interests were involved in the final shape that the system got.

US is said to be the country having exerted most influence over 20th century commercial development. Even GATT is commented as the international counterpart to US tariff policy.[6]

US had a great influence on initial trade rounds of GATT. In 1934, president Roosevelt asked congress for the power to negotiate bilateral trade agreements. The US was to cut tariffs by as much as 50% in lieu of equivalent cuts by other countries. Roosevelt promised that no such reciprocal agreement would harm US economy. Escape clause was introduced in these agreements, which allowed US to withdraw tariff cuts, if domestic industry suffered. So before WW-II, US had negotiated 31 reciprocal trade agreements and extended concessions to many countries under MFN clause. In 1945, Congress passed another Trade Agreements act which again authorised the president to cut tariffs in GATT negotiations. But president Truman had to introduce some measures against possible injury to domestic industries due to imports in the form of Tariff Commission. Between 1947 and 1961, five bargaining rounds were completed in GATT. The largest cuts were made in 1947 and 1948. US showed protectionist tendency during 1950s due to foreign competition from Europe and Japan. The kennedy round of GATT came after the passage of US Trade Expansion act of 1962, but was completed in 1967. These were some of the instances which show how the negotiations in GATT were related to domestic polity of US. [7]

What were the basic factors contributing to the emergence of America as the undisputed leader just after the second world war? One basic reason was that, by the early 20th century, it had replaced Britain, the dominant economic power of the 19th century world. In fact, America overtook Britain In the end of 19th century. Britain, which produced about 20% of world's manufacturing output in the mid 19th century saw its share declining to as low as 9.9% in 1928. Table 3.1 shows in detail the increasing and decreasing shares of four major nations of the world from 1880 to 1928.

Table:3.1

Shares of World Manufacturing Production

	1880	**1900**	**1913**	**1928**
United States	14.7	23.6	32.0	39.3
Great Britain	22.9	18.5	13.6	9.9
Germany	8.5	13.2	14.8	11.6
France	7.8	6.8	6.1	6.0

Source: Kennedy 1988, 259.

Once America started dominating world economy, it started giving importance to a liberalized trade regime, to get market access for its exports. So it shed its policy of protectionism, it had stuck to hitherto. The growing dominance of America in world Economy is also referred to as American hegemony.

Before this, America followed a protectionist tendency. British dominance in the 19th century world economy posed a great threat to US economy. So tariffs were imposed to protect domestic industries. In 1920s, after world war-I, when some European nations wanted to reconstruct the world economy, US resorted to isolationism. When the great depression started, it imposed high tariffs. Other countries followed suit e.g. Britain's Imperial Preference System of 1932, use of quotas by France and the like. World trade suffered due to this. The failure of the London Economic Conference of 1933 due to the inward—looking economic position of the United States marks the low point of U.S. internationalism in the interwar period.(Baldwin 1986)

Table:3.2

Collapse of World Trade

(Average Monthly World Trade, $U.S. Millions)

1929	**2,858**
1930	**2,327**
1931	**1,668**
1932	**1,122**

Source: Kindleberger 1987, 140.

It was now that America realized the need for an open trade regime based on non-discrimination, as it was in its interests. Most of the warring nations had gone weaker. So America seemed to be the only leader which could guide others on the path of a liberal trade regime.

The American leadership became prominent in 1930s. In 1934, president Roosevelt asked the congress to authorize him to go for bilateral tariff agreements. He was authorized through Reciprocal Trade Agreements Act (RTAA) in which president Roosevelt could reduce tariffs by as much as 50% provided the concerned countries also reciprocated. Between 1934 and 1938, secretary of state Hull used the act to negotiate bilateral agreements with 19 countries. RTAA had a great impact on the world economy, as reciprocity and non-discrimination, upon which most of these agreements were based actually became the basis for multilateral trade system under GATT.

During the second world war, Roosevelt used lend lease agreement of 1940 to convince European nations for a stable, non-discriminatory, liberal post war international regime. Negotiations for such a world regime started in 1942 between US and Great Britain. Bilateral negotiations became multilateral in 1945. In 1947, GATT was born . In fact ,it was to be a part of International Trade organization (ITO).ITO was supposed to perform some basic functions of facilitating trade and to work out relationship between International trade and economic development and employment. It gave the states responsibility to take steps towards full employment and to go for intergovernmental consultation and coordination in this regard. Also developing countries were given certain exceptions to the GATT rules. US congress had strong reservations about employment and development aspects of ITO. Since president Truman didn't present ITO before senate for ratification, ITO dream of Havana charter remained confined to papers and could not become a reality. For GATT, no ratification was required. Hence it became the central pillar of multilateral world political economy.

Thus the multilateral trade system of the post war period reflected the interests of advanced countries like USA. ITO, which linked international trade to economic development could have adequately served the interests of developing countries. But when it was opposed by none other than US, developing countries criticized GATT for being a rich members 'club. So there were not many developing countries which participated in GATT negotiations.

In late 1940s, during cold war, situation was conducive to further strengthening of GATT. US in its Marshall plan tried to help West Europe's reconstruction and for importing certain important goods from US. It also wanted trade to be liberalized within Europe. In this regard, OEEC i.e. organization for European Economic Cooperation was established as a part of Marshall plan. The broad aim was to counter Soviet's influence and to contain communism.

Table 3.3 Key events[8] preceding the General Agreement on Tariffs and Trade (GATT)

1846 Parliament repeals the protectionist Corn Laws in England, committing the country to free trade.
1860 The Cobden–Chevalier Treaty between Great Britain and France is the first in a series of market-opening treaties among the powers of Europe that are linked through most-favoured-nation clauses.
1876 The limitations of the existing system of trade treaties are demonstrated when Austria-Hungary unilaterally raises its tariffs. France, Germany and Italy soon do the same.
1883 Adoption of the Paris Convention for the Protection of Industrial Property, which becomes the oldest part of WTO law via its incorporation into the Agreement on Trade-Related Aspects of Intellectual Property Rights.
1919 The Versailles Treaty establishes the League of Nations.
1927 The Geneva Convention on Import and Export Prohibition and Restriction is the most ambitious trade initiative of the League of Nations, but does not achieve the requisite 18 ratifications.
1930 The US Congress enacts the protectionist Hawley–Smoot Tariff Act, which is soon followed by similarly restrictive measures in many other countries.
1933 The London Economic Conference fails to develop a collective response to the Great Depression.
1934 The (US) Reciprocal Trade Agreements Act delegates tariff negotiating authority to the executive, leading to bilateral agreements that become the template for GATT.
1941 President Franklin D. Roosevelt and Prime Minister Winston Churchill sign the Atlantic Charter, pledging "to further the enjoyment by all States … to the trade … needed for their economic prosperity."

1944 Major conferences are held to develop plans for the United Nations (at Dumbarton Oaks) and the International Monetary Fund and World Bank (at Bretton Woods).
1945 Creation of the United Nations Organization at the San Francisco Conference.
1947 The 23 original contracting parties to GATT conclude their tariff negotiations.
1948 GATT provisionally enters into force on January 1; the Havana Charter for an International Trade Organization is signed in March but never enters into effect.

Table 3.4. Key events from the first Geneva Round to the start of the Uruguay Round

1947…… The General Agreement on Tariffs and Trade (GATT) is negotiated, with 23 original contracting parties. Countries cut tariffs on many goods in the first (Geneva) round of GATT negotiations.
1949……. Second (Annecy) round of GATT negotiations leads to tariff reductions and ten new accessions, and adopts the Florence Agreement on cultural goods, negotiated jointly with the United Nations Educational, Scientific and Cultural Organization (UNESCO).
1950……. President Truman withdraws the Havana Charter from congressional approval. The Third (Torquay) round of GATT negotiations is held.
1954-1955……..An effort to establish an Organization for Trade Cooperation as a replacement for GATT fails when the US Congress objects.
1956 Fourth (Geneva) round of GATT negotiations.
1960-1962……… Fifth (Dillon) round of GATT negotiations focuses primarily on issues related to the founding of the European Economic Community and its Common External Tariff.

1964 The first United Nations Conference on Trade and Development (UNCTAD) is held, creating a potential rival to GATT as a negotiating forum for North–South trade issues.
1964- 1967…… Sixth (Kennedy) round of GATT negotiations produces both tariff reductions and some non-tariff agreements. The United States fails to ratify the anti-dumping and customs valuation codes.
1973- 1979…….. Seventh (Tokyo) round of GATT negotiations produces tariff reductions and several non-tariff agreements.
1974….. The US Congress makes the first grant of "fast track" authority, a forerunner of the single undertaking that ensures it will treat the results of the next round expeditiously and indivisibly.
1975- 1985…………….. The Consultative Group of 18 (CG18), later expanded to become the CG22, serves as a kind of executive board for GATT.
1982…… The United States fails to convince its partners at a GATT ministerial conference to launch a round built around the new issues of services, investment and intellectual property rights.
1986 …….After four years of persuasion and pre-negotiation, the Uruguay Round is launched.

3.4 EVOLUTION OF THE MULTILATERAL TRADE SYSTEM

American Hegemony, which existed during and after war, and America's emergence as an economic superpower made it the natural leader of world economy. But in this dynamic world, nothing remains unchanged. American hegemony stated being challenged with the reconstruction of European and Japanese economies. The changed global balance of economic power thus changed the existing situation.

3.4.1 Hegemonic decline:

The basic reason, as mentioned above, due to which American influence diminished was the emergence of Europe and Japan as more competitive economies, as compared to US. During 1960s, the average annual rate of growth in Japan was more than 10%, as compared to 4% for US. The share of US and Japan in world manufacturing output changed from 40% and 5.5% in early 1960s to 24% and 19.4% in 1987, respectively. (Dicken 1999). So the economic gap between US and Japan got reduced. Japan was no more a weak economy, but had made great strides in growth rate and made its presence felt in the world economy.

Likewise, Europe too acted as a threat to US economy. Though the situation here differed from that of Japan, West Europe too strengthened itself via a different route i.e. of regionalism. West European countries negotiate though European Union and not individually. So EU has emerged as an important actor in the world political economy and has consolidated the fragmented economies of once warring nations and united them.

As Japan and EU continued to grow, American competitiveness was negatively affected. From 1970s to 1980s, US ran trade deficits. It became comparatively less competitive in high technology industries, in which Japan started replacing US as the most competitive economy. Between 1970 and 1989, whereas Japan's share in this market increased from 7% to 16%, that of US fell from 30% to 21%. (Tyson 1992).

This significant change in the global balance of economic power thus led to decline of American dominance, a characteristic feature of world political economy, immediately after WW-II.

3.5 MULTILATERAL TRADE SYSTEM AFTER HEGEMONY

Due to American Economy's diminished influence, few changes have become regular features of the multilateral trade system . These are:

i) Trade conflicts

ii) New protectionism

iii) Expanded membership in WTO

iv) Regional Trading Arrangements

Trade conflicts:

In 1980s and early 1990s, US and Japan were embroiled in disputes over Japan's Industrial policy that hurt high technology industries in America. It was observed that Japan used subsidies, tariffs, quotas, government procurement policies etc. to prevent US goods in this sector (in particular semiconductor and computer industries) from entering Japanese market. US felt it hard to enter Japanese market in high technology industries because there were strong linkages between industries that produced finished goods and those providing inputs for these.US retaliated by resorting to policy of 'aggressive bilateralism' under which it negotiated with Japan for opening its market to US exports. It also introduced section 301 in the Trade Act of 1974, which was revised in 1988 as super 301, to act against countries that used unfair trade practices.

US and EU have conflict over Common Agricultural Policy (CAP) of EU. Earlier, agriculture was excluded from GATT agreements, as industrialized countries didn't want to open their markets for the agricultural exports from developing countries, due to pressure of different such groups.CAP policy of EU is protectionist in nature and trade distorting and hence most of the nations are critics of it. There are also issues in manufactured goods.

New protectionism This period also saw the rise of protectionism. But unlike earlier protectionism, in which very high tariff walls could be imposed, in this phase of protectionism, Tariff negotiations were going on through different GATT rounds. So countries used non-tariff barriers like voluntary Export restraints (VER) of 1989 between US and Japan, In which Japan agreed to export 2.3 million units of cars to US ; also EU and US resorted to antidumping duties and countervailing duties. The share of trade in manufactured goods among industrialized nations that was subject to non-tariff barriers increased from 4% in 1974 to 17.4% in 1980 and further to 25% by early 1990s.(Greenaway 1983,OECD 1997) American and European auto producers were among the most protected (Gilpin 1987).

Expanded membership in WTO:

During 1980s, certain changes took place due to which more and more participation of countries in GATT became inevitable. First, due to re-orientation of trade policies of most developing countries, trade became too important an issue for them to be kept away from their development strategies. So the countries which were reluctant or not interested in participating in earlier GATT rounds or were passive bystanders started becoming active since mid 1980s. Another reason for this shift was the end of cold war and collapse of USSR in 1990s. The countries of erstwhile Soviet bloc now realized the desirability of moving to market led reforms and opening their economies to outside world. So WTO membership expanded substantially after mid 1980s.

With expanded membership, and with more participation of developing countries in different bargaining rounds, there have been more and more differences, as developing countries have certain special concerns. They have formed coalitions and have been voicing their opposition to agreements which they find unsuitable to them. For example, the developed nations are insisting on the inclusion of new issues like competition, investment rules etc. which has been opposed by them on the ground that old issues be settled first. It has also led to non-conclusion of some rounds. The latest example is of Doha round which was initiated in 2001 but is still not concluded.

Regional Trading Arrangements:

Not only are countries participating in multilateral trade liberalization, but also in regionalism i.e. negotiations also take place through regional agreements. A Free Trade Area or a customs Union is based on discriminatory trade policy, as members are given preferential market access over non-members. But this discriminatory provision is actually an exception to MFN principle of GATT (under article XXIV).

So the trend is that, countries are simultaneously undergoing tariff liberalisation regionally as well as multilaterally. It is far more easier to conclude an FTA than negotiating in a multilateral round, as less number of countries and preferential access make it possible to even convince the lobbyists usually opposing in opening of markets.

With the mushrooming of RTAs, two broad schools of thought have emerged regarding their impact on the existing multilateral trade regime under GATT/WTO. One considers RTAs as a threat to free trade policy ,whereas the other considers that it actually complements the existing system. It is a debatable issue.

Scholars also differ while comparing contemporary international trade system with the one in 1960s, when there was American hegemony. They argue that since the situation has changed totally e.g. America faces competition from other economies, cold war equations no more exist, and most of the countries are finding bilateral routes to trade liberalization the easiest , The current multilateral trade system is not the one in which America played a pro-active role .The system may get weakened in the years to come. On the other hand, another group of scholars argues that there is no immediate or future threat to the system, as so many improvements have taken place in the world economy. Through participation in different bargaining rounds, countries have been able to dismantle many barriers. Post Uruguay, tariffs on an average have fallen to <4%. Non-tariff barriers too have been addressed.

3.6 LET US SUM UP:

In this lesson, we learned about the creation of the multilateral trade system, the dominant role played by US in it, the so called decline of hegemony and the features of the system after hegemony decline.

3.7 REFERENCES AND SUGGESTED READINGS

- International trade policy by F.V. Meyer
- The International Economy by Peter Kenen.
- International Political Economy by Thomas Oatley.

SELF ASSESSMENT QUESTIONS

- What was the influence of US on the multilateral trade system that emerged after WW-II?
- Explain the decline of American hegemony in International economy.
- What are the basic features of the multilateral trade system having evolved after American hegemony's decline?

THE PROBLEM OF TRADE CORPORATION

Structure

4.1 OBJECTIVES

The main objectives of this lesson are to enable the learner to :

- Understand the domestic politics of trade liberalization.
- Analyse how trade cooperation takes place under multilateral institutions.

4.2 INTRODUCTION

So many years of experience with a liberalized trade regime is strong justification for countries to go for it. But why don't they go for it unilaterally? Free trade has always been advocated as the best policy. Why do they need a multilateral forum like WTO to liberalise trade? The simple reason is domestic politics. There are so many pressure groups which might not let the government open a particular sector to foreign competition. The government needs to give strong justification regarding how it shall prove to be beneficial to the society at large. It also needs to assure them of the gains likely to be accrued in exchange for the efforts made towards open trade. In this lesson, we shall discuss about the politics of trade liberalisation and multilateral institutions and trade cooperation.

4.3 THE POLITICS OF TRADE LIBERALIZATION

The basic logic behind trade theory is that a country should import more as it makes cheap goods available to domestic consumers. Exports should be just enough to be able to pay for these goods .Here unilateral trade liberalization makes sense. On the other hand, governments wish to export more and more and import as little as possible, as it shall save scarce foreign exchange reserves. Here, it is not possible to have unilateral liberalization. Here reciprocal agreements are best fitted to represent the path of liberalization. So government is said to invert the logic of trade theory.

In choosing a particular path of trade liberalization, the governments are influenced a lot by the domestic politics of trade policy, in which interests of domestic firms are involved. On the other hand, though consumers always gain by free trade , as they consume the goods at lowest possible price, their interests may not be considered with that seriousness in these policies. Only those industries get easily opened to free trade, which can compete in the international market. Domestic Industries where goods are produced at a disadvantage remain protected. For example, it is said about EU farmers, that during Uruguay round, when agriculture was to be liberalized, their opposition made EU assert in GATT forum that it won't go for liberalizing trade in agriculture. This is the role of domestic politics in the formulation of foreign trade policy.

Reciprocity has been a very important component of different bargaining rounds under the aegis of GATT. From the very beginning, each country has been presenting an offer sheet , in which it would give the list of industries in which it wished tariff liberalization should take place. In lieu of concessions given ,it gets tariff concessions from other members, usually equivalent to what it offers (Jacson 1998). For example in Uruguay round, developing countries agree to liberalise services and Intellectual property rights. These were not their strong sectors. But they agreed ,as the developed countries agreed to liberalise trade in textiles and agriculture, in which developing countries hold comparative advantage. Thus reciprocity, the give and take policy, continues in each round.

Apart from one political problem of domestic politics, another problem is of enforcement. Many a time, countries fail to conclude regional trade agreements as they think that the likely partner might not comply with the trade agreement (Keohane 1984; Oye 1986). Despite the fact that trade agreements bring mutual gains, countries are hesitant to sign them, as they are not certain about the other member's intention.

This can be easily understood with the help of prisoners' dilemma, a game theory model:

Table: 4.1

The Prisoners' Dilemma and Trade Liberalization.

Denmark

		Liberalize	Protect
France	Liberalize	**I,I**	**I,P**
	Protect	**P,I**	**P,P**

Preference Orders.

France: P,I > I,I > P,P > I,P.

Denmark: I,P > I,I > P,P > P,I.

Let us suppose that there are two countries, A and B, using tariffs to protect their sectors which are at a disadvantage. Let the sectors be automobile and agriculture, respectively. If a reciprocal agreement gets concluded, both will open their hitherto protected sectors and hence gain. But prisoners' dilemma doesn't let such an agreement get concluded. Let us explain how.

In the 2X2 matrix explained above, first we take the case of Country A. The figure shows the pay offs or gains to country A, due to different choice of strategies made by it or country B. Each country can either choose 'liberalise' (open the sector and eliminate tariff) or 'protect' (keep tariffs intact). A strategy combination like liberalise, liberalise shows that both A and B have chosen to liberalise, whereas liberalise, protect means that A is willing to liberalise but B is likely to keep its strategy 'protected". Here A is the row player and B is the column player.

Given this matrix, there are four outcomes:

i) L,L…….A eliminates tariff on automobile, B removes tariff on agriculture.

ii) L,P……A eliminates tariff on automobile, B retains tariff on agriculture.

iii) P,L……A retains tariff on automobile, B removes tariff on agriculture.

iv) P,P…… A retains tariff on automobile, B retains tariff on agriculture.

L,L strategy means that both the countries have agreed to remove tariff on each other's product. L,P means that country A does not get access to B but B can export agricultural good to A. P,L means that automobiles can be exported from A to B, but agricultural good can't be exported from B to A. P,P means that neither of the two opens its market for the other. Hence no trade takes place.

Now to understand which is the most preferred and the least preferred outcome for A, let us focus on the figure above. Of all the four outcomes, P,L is preferred the most, as A would get access to B but can deny access to B. L,L is ranked next in preference, as if A would liberalise, it expects B to reciprocate. P,P is the third most preferred option, as A denies access to B and B to A at the same time. The least preferred option is L,P which means that A is ready to open its market, but B keeps its market protected. The preference order is thus P,L>L,L>P,P>L,P.

P,L

$\downarrow$

Unreciprocated market access for A

L,L

$\downarrow$

Reciprocal tariff reductions

P,P

$\downarrow$

No tariff reductions

L,P

$\downarrow$

Unilateral tariff reduction by A

In case of B, the same matrix can be used to know about its most and least preferred outcomes, but the order gets reversed. For example, L,P means that A is liberalizing but B is not. So the preference order for A :P,L>L,L>P,P>L,P gets reversed for B .It is: L,P>L,L>P,P>P,L.

In the prisoners' dilemma depicted above, one strategy is dominant strategy for A and B. A dominant strategy for 'A' is the best strategy for A irrespective of what B chooses. So a dominant strategy gives the highest payoffs to A. In this case, let's start with the strategies of B. If B chooses Liberalise, 'L', A may respond by choosing either L or P. If it chooses L, outcome is L,L. If it chooses P, outcome is P,L. If we go through the preference order of A, we get to know that L,L is the 2^{nd} most preferred outcome for A, whereas P,L is the best outcome for it. Hence A shall go for P,L. Hence the strategy is 'protect'. If now B chooses 'protect', A may again respond by choosing L or P. The outcomes are: L,P and P,P. Now P,P is ranked 3^{rd} and L,P 4^{th} in preference order of A. So it would go for 'protect'. So the dominant strategy for A is 'protect' whether B chooses 'protect' or 'liberalise'. Since it is a symmetric game, for B also , the dominant strategy is 'protect'. So the game produces the outcome: protect, protect.

The outcome protect, protect means two things. It is Pareto sub-optimal, as liberalization is the best strategy and makes nations better off as compared to protection. Secondly, it is a Nash equilibrium. It means no nation shall be ready to unilaterally change its strategy from the current position to any other position. So the Reciprocal tariff reduction doesn't take place. This is because each fears getting the 'sucker payoff'. Suppose, in an agreement, A complies with the agreement and undergoes tariff liberalization, If B doesn't, B is said to play A for a sucker. A continues to import from B but can't export to B. There are therefore dark prospects for such an agreement to take place, despite its being the best option for the two nations. This is because of lack of enforcement mechanism and punishment for non-compliance. If such a system exists, countries can be expected to act responsibly towards compliance.

4.4 MULTILATERAL INSTITUTIONS AND TRADE COOPERATION

Generally, it is observed that because of difficulties of domestic politics and lack of enforcement, many a time, one time prisoners' dilemma game leads to non-conclusion of reciprocal agreements. But under multilateral trade regime, WTO does play the role conducive to liberalization. So under certain conditions, the prisoners' dilemma too can incorporate cooperation in it.

The first condition is that cooperation can emerge in iterated prisoners' dilemma i.e. when the game is played repeatedly by same set of actors (Taylor 1976, Axelrod 1984,Keohane 1984). Instead of a onetime choice of strategy and one time pay off, in a repeatedly played game, repeated choices and a stream of pay offs can be seen. Iteration makes the game be played rationally i.e. with a tilt towards 'liberalise' than 'protect'. But it depends on the fulfilment of the other two conditions.

Secondly, cooperation can also emerge if countries can, through reciprocity, convince others to liberalise, so that the outcome is the best possible i.e. 'Liberalise, liberalise'. Axelrod (1984) argues for a 'tit- for- tat' strategy in this regard. It means that each government shall play a strategy in a particular round depending upon the move of the other in the previous round. If one country opts 'protect' in previous round, the other shall reciprocate in next round by using 'protect'. On the other hand

,if it liberalises, the other country shall respond in next round by liberalizing. This tit for tat strategy means that if one government cooperates in this round, it expects the other to cooperate in next round. Thus they reward each other for cooperation and punish for defecting.

Thirdly, if countries are concerned about future pay offs from playing the game, they shall cooperate more and hence it becomes possible to cooperate in prisoners' dilemma.

WTO, the international trade institution, makes first two conditions possible. It encourages member country governments to negotiate with each other in different rounds. Each round is in fact one set of play. In different rounds, the repeated game is played by the same set of countries. Hence in this iterated intergovernmental trade interaction, negotiations take place between countries. Countries interact with each other through WTO. Also a review of trade policies of member countries is done regularly.

Member countries of WTO can also observe and monitor the trade policies of others through WTO's rules regarding review of their trade policies. If a member nation's trade policy is found inconsistent with WTO norms, others can observe and act accordingly through reciprocity. WTO rules don't allow discrimination, or non-compliance with MFN rules under normal circumstances. Exceptions are allowed, provided a country has strong justification for it. Likewise, safeguard clause can't be used unless justifiable. So there is great transparency in WTO rules which keeps member nations apprised of each other's actions.

Trade agreements' enforcement through WTO takes place with the help of Dispute Settlement Mechanism. If a member nation complains that another country is acting in a way that violates WTO rules, DSB, after full enquiry may conclude whether the complain is genuine or not. If it is found to be violating rules, the member nation has to alter its trade policy and make it WTO-compliant. EU's 1993 banana import regime was quite controversial and invited the wrath of countries affected negatively.

So whether it is domestic politics or international politics, if there are impediments to trade liberalization, multilateral institutions can very well handle the issue.

4.5 LET US SUM UP

This lesson was focused on the discussion about the problem of trade cooperation. We learned how domestic politics influences trade cooperation and how trade cooperation takes place under the aegis of WTO.

4.6 REFERENCES AND SUGGESTED READINGS

- International political economy by Thomas Oatley.
- The International Economy by Peter Kenen.

SELF ASSESSMENT QUESTIONS

- What do you mean by the domestic politics of trade cooperation? Explain.
- How does trade cooperation take place under multilateral institutions?

PROTECTION AND ITS CONSEQUENCES

Structure

5.1 OBJECTIVES

The main objectives of this lesson are to enable the learners to:

- Understand the concept of protection
- Know about the economic consequences of protection

5.2 INTRODUCTION

Domestic trade politics, as we know, holds great importance in the decision making process of a nation with regard to its trade policy. For example, a country shall go for protection of a sector in which the country doesn't possess advantage.

The domestic interest groups who want to stay insulated from the impact of foreign competition pressurize the government to impose tariffs on goods of that sector. On the other hand, liberalization also takes place, but only in those sectors where that country can compete internationally. So liberalization and protection are pursued simultaneously. In this lesson, we shall learn about protection and its consequences.

5.3 PROTECTION

Three basic questions arise in domestic politics of trade policy. First, to what extent and in which sectors do advanced industrialized countries go for liberalization? Second, what are the economic consequences of protection? Third, how can we explain liberalization and protection taking place at the same time?

Over the years, it has been observed that industrialized countries have been pursuing liberalization in capital intensive manufacturing and protecting labour intensive industries, agriculture and high technology industries. In response to second question, it has been argued that protection reduces national welfare. For getting an answer to third question, it is important to understand how the interests and institutions affect domestic politics of trade policy .

The two different approaches to domestic politics are society- centred approach and state- centred approach . The former argues that domestic interest groups affect the particular action taken by a nation i.e. whether it protects or liberalises. State- centred approach argues that a nation through these patterns tries to strengthen its position in the international system.

5.4 PROTECTION AND ITS CONSEQUENCES

"OECD estimates indicate that scrapping all tariffs on merchandise trade and reducing trade costs by 1% of the value of trade worldwide would add the equivalent of up to 2% to the present annual gross domestic product (GDP) in some areas." **(The Doha Development Agenda: Tariffs and Trade ,an OECD Policy Brief, 2003).**

As we have been discussing the structure of protection in advanced countries, there is a need to understand in what way is the structure of protection in these countries similar. If we take US,EU and Japan as representing the advanced countries, we get to know that in all of these, almost the same sectors get protected and liberalized. To make the things clear, all the advanced countries have a comparative advantage in capital intensive manufacturing. So they always support liberalizing this sector. On the other hand, labour intensive manufacturing, agriculture and high technology industries get protected, as they have a comparative disadvantage in these. They have been resorting to tariff as well as non-tariff barriers to protect these industries. The scenario in 1980s and 19990s was this:

MFN Tariff rates in advanced industrialized countries

	By value	By product category
Duty free	33%	14%
Low tariffs (<10%)	61%	68%
High tariffs (>10%)	6%	18%

Source: Finger and Olechowski 1987,40.

As the table above shows, if we consider by value, about 33% of the imports entered the markets of industrialized countries duty free. By value, only 6% of the imports were subject to a tariff of 10% or more. But when a different perspective is seen, i.e. from the category of product imported, about 20% of industries are protected by tariff of10% or more. Duty free access was there only in 14% of the industries.

As far as the sectors are concerned, as mentioned above, the most protected sectors are labour intensive manufacturing, agriculture and high technology industries. Both EU and US used both tariff as well as non-tariff barriers to protect their sectors, whereas Japan relied more on non-tariff barriers. In agriculture, protection provided through non-tariff barriers was equivalent to a tariff of 272.5%.Rice producers got protection equivalent to 737% tariff. In high technology industries, it was equivalent to tariff of 140%.(WTO 1998b).

The overall protection rate, which declined rapidly after 1986 to a low of 42 percent in 1995-97, began to rise after 1997 as world agricultural prices declined .

This recent increase is driven both by higher domestic prices compared with international prices and by increases in direct support. This overall cyclical movement is observed in most major countries and groups (European Union, Japan, and the United States). ….The European Union and the United States marginally reduced their overall support during 1986-2002. In the European Union the prices received by farmers were 65 percent higher than international prices in 1986-88 and 30 percent higher in 2000-02. Similarly, in the United States domestic prices declined from 16 percent higher than international prices to 9.3 percent higher.

Global Agricultural Trade and Developing Countries

Post Uruguay, many steps have been taken to bring trade reforms ;but from the non-conclusion of Doha round, we observe that the deadlock occurs due to rigid policies of these countries. It means protection is still an essential part of their trade policies.

5.5 THE ECONOMIC CONSEQUENCES OF PROTECTION

A liberal trade regime is always considered to be the best policy. The consumer gains a lot, as low cost goods become available to him through opening of trade with rest of the world. But once an economy is protected, certain sectors gain while others lose. Let us do a partial equilibrium analysis of imposition of tariff.

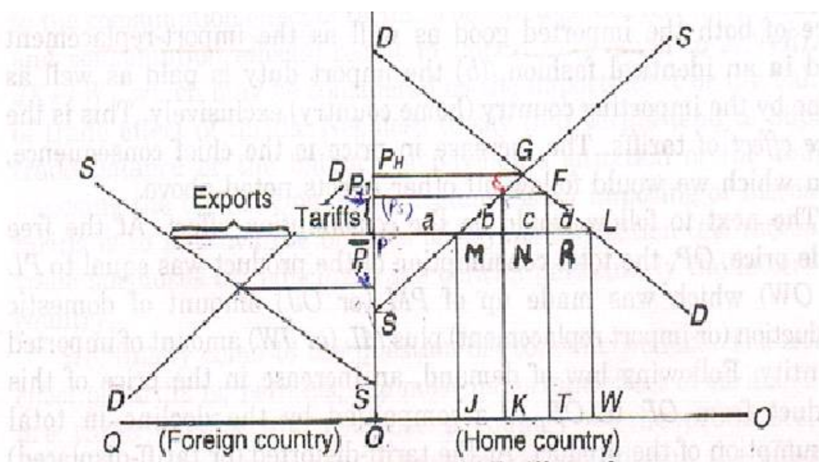


Diagram 1. Effects of Tariffs on the Home Country — Micro View.

In the diagram above, the left hand side shows demand- supply situation and price determination in foreign country (to be named hereafter as F).The right hand side shows those of the home country (H). PF and PH are prices in countries F and H respectively. Trade theory tells that trade shall take place if there are price differentials internationally. In the diagram, prices stabilise at P when exports of F equal the imports of H. It is equal to ML or JW. So at free trade price P, H country imports ML.

Suppose now, the country H goes for protection of this industry. Let tariff or import duty equal to P-Pt i.e. the distance between P and Pt be imposed. What are the economic consequences of this protection? Let's discuss.

Tariff imposition leads to six types of effects . These are:

1) Price effect

2) Consumption effect

3) Production effect or protective effect

4) Revenue effect

5) Import effect or balance of trade effect

6) Economic welfare effect or consumer surplus effect.

Immediately after imposition of tariff, price of the imported good increases from free trade price OP to tariff distorted price OPt. This is price effect which becomes the basis for all other effects.

As a result of increase in price, consumers always respond by consuming less, due to law of demand. As price increases from OP to OPt, consumption reduces from PL to PtF. This is consumption effect. So as a result of tariff imposition, consumption is reduced.

As a result of increase in price, supply of a commodity increase, due to law of supply. In the diagram, when price increase from OP to OPt, it not only increases for imported good, but also for import replacement good. So domestic production increases from PM to PtE. The increase by JK or MN is referred to as import substitution or protection effect.

Revenue effect refers to the revenue that accrues to the government from levying a tax etc. Post tariff imports are equal to EF. This multiplied by tariff imposed per unit, i.e. EN gives the area ENRF. So rectangle ENRF is the revenue effect of protection.

We now come to balance of trade effect or import effect or reduction in imports due to tariff. Imports fall from ML to EF. There is reduction in import area by two triangles depicted by areas b and d. Reduction by b is due to consumption effect of tariff, whereas reduction by d is due to production effect, as to that extent import substitution takes place.

Finally, we turn to welfare effect of protection. There are three main economic entities in a country: consumers, producers and the government. As it is clear from the diagram, tariff imposition affects these groups differently. Here, to know about the welfare effect, we need to know the consumer surplus and producer surplus before and after imposition of tariff. Under free trade, consumers consume OW quantity. Total utility is ODLW (demand curve taken as MU curve).Total price paid (disutility for parting with money) is OPLW. Consumer's surplus is ODLW-OPLW= DPL. Producer's surplus is OPMJ-OSMJ (revenue-cost)=SPM. Total economic welfare =DPL +SPM=SMLD.

What happens in the post tariff scenario? We will find that there is loss of consumer's surplus. It is now ODFT-OPtFT=DPtF. There is gain in producer's surplus. It increases to OPtEK-OSEK=SEPt.

The loss area in consumer's surplus is a+b+c+d. If we see carefully, we find that area a is loss to consumer, but gain to producer. It is therefore a simple re-distribution of income away from the consumer to producer, and not a net loss to the society or general loss of welfare. Likewise, area c is loss to consumer but accrues to the government as revenue. Areas b+d represent net loss to the society, as it is loss to the consumer but gain to nobody. It is also called as efficiency loss or dead weight loss due to imposition of tariff. It reduces consumer's welfare as well as that of the society. b and d are called consumption distortion loss and production distortion loss, respectively.

We have now understood the economic consequences of protection. So there is a distributive effect, as well as net loss to the economy, when a country resorts to protection.

5.6 LET US SUM UP

After going through this lesson, we understood the concept of protection and also knew about the economic consequences of protection.

5.7 REFERENCES AND SUGGESTED READINGS

- International Political Economy by Thomas Oatley
- International Economics by H.G. Mannur

SELF ASSESSMENT QUESTIONS

- What are the economic consequences of protection?
- Through a partial equilibrium analysis, explain the effects of tariff.

THE THEORY OF REGIONAL BLOCS

FORMS OF ECONOMIC COOPERATION

Structure

6.1 OBJECTIVES

The main objectives of this lesson are to enable the students to know about the various types of economic cooperation.

6.2 INTRODUCTION

There are different ways to trade liberalisation: Unilateral , multilateral and regional. The last shall be the focus of this lesson. There is hardly any country in the world, which has not negotiated or joined a regional trading agreement (RTA). A RTA is an arrangement among few nations, traditionally confined to geographically contiguous countries (but is no more an essential condition under new regionalism), in which members agree to give each other's products duty free access or reduce tariff substantially. Different factors have motivated the countries to go for RTAs despite the fact that almost all of them are members of WTO and are thus participating in multilateral trade system. In fact, RTAs are an important exception to non-discrimination principle of WTO. So countries can negotiate and be a part of RTAs, provided the WTO is notified from time to time. The number of these RTAs or trading blocs increased from 70 in 1990 to more than 300 till recently. In this lesson, we shall study about different forms of economic cooperation.

6.3 FORMS OF ECONOMIC COOPERATION

Regional economic arrangements are said to follow a hierarchy which begins with a free trade area and ends with an economic union, goes through customs union and common market. As countries move from a lower to a higher rung on the ladder of integration, deepening takes place, as more liberalisation is incorporated along with maintaining the basic structure. But it is not a universal truth. A regional agreement may skip a certain stage, whereas sometimes, a customs union is formed, instead of a free Trade Area.

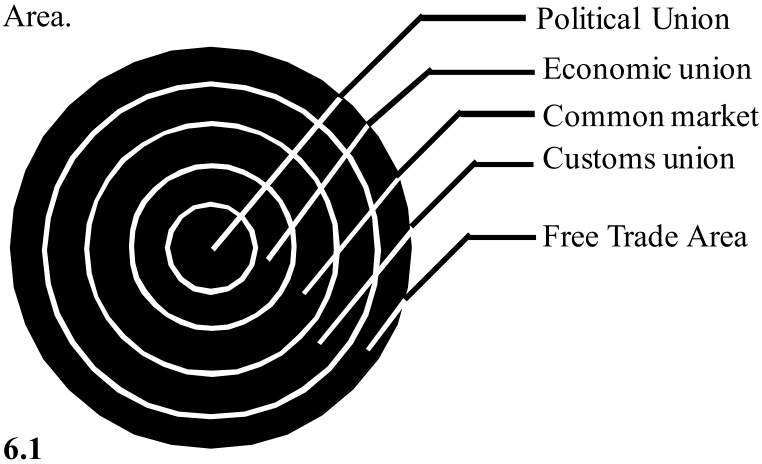


Fig. 6.1

Bela Balassa has discussed about the following forms of economic integration (also shown in the fig. 6.1 above):

6.3.1 Free Trade Areas : In a Free Trade Area, the member nations remove all the tariff barriers among themselves, but they are free to negotiate with no-members. So the governments are left with sufficient autonomy in decision making. That is why, they are the easiest to conclude and are the most popular as well. Some examples of Free Trade Areas are: NAFTA,AFTA,SAFTA etc.

6.3.2 Customs Union: A customs union possesses all the features of a FTA, but apart from removal of tariff among themselves, the member countries also agree to have a Common External Tariff (CET) for non-members. So it is more organised as compared to a FTA. But it is also more difficult to negotiate due to the lost autonomy. Some examples are: Andean Community, MERCOSUR,CARICOM etc.

6.3.3 Common market: Common market is one step ahead of customs union. In it, apart from free movement of goods and services, there is free movement of labour and capital. Non-tariff barriers are also removed and there is harmonisation of some economic policies e.g. Common Agricultural Policy (CAP) of EU. Post 1992 European Economic Community (EEC) is an example of common market.

6.3.4 Economic Union: The highest stage of economic integration reached so far is that of economic union. In an economic union, apart from a common market between member states, there is harmonisation of monetary, fiscal and social policies, common currency and banking system. Two examples of economic union are: BENELUX and EU. The next stage for EU may be a political union, the highest stage.

Apart from these basic types of integration, the literature talks of some other forms . Some Of these are:

6.3.5 Partial or sectoral integration: In case of a partial integration, tariff and other types of discriminatory practices are removed only for the specified goods. An example is European Coal and Steel community (ECSC), in which restrictive practices were removed for coal and steel.

6.3.6 Bilateral agreements: In case of a bilateral agreement, negotiations take place between two countries. In recent years, due to difficulty in negotiating with more members, countries are also signing bilateral agreements .

6.4 LET US SUM UP In this lesson, we have learned about the various forms of economic cooperation

6.5 REFERENCES AND SUGGESTED READINGS

- International Economics by H.G. Mannur
- Global Political Economy by John Ravenhill
- International Economics by Desai and Bhalerao

SELF ASSESSMENT QUESTIONS

- What are the various forms of economic cooperation? Explain with examples.
- What are the basic differences between a Free Trade Area and a customs union?

PARTIAL EQUILIBRIUM ANALYSIS OF A CUSTOMS UNION

OR STATIC AND DYNAMIC EFFECTS OF A CUSTOMS UNION

STRUCTURE

7.1 OBJECTIVES

The main objectives of this lesson are to introduce the concepts of trade creation and diversion to the students and to enable them to do a partial equilibrium analysis of a customs union.

7.2 INTRODUCTION

Before Jacob Viner's work: *the customs union issue,* the widely held notion was that member countries of a preferential arrangement, in particular, a customs union always gain out of it. Through his work, Viner undid that. In this lesson, we shall learn about Viner's (and the economists who came after him) contribution towards understanding the effects of a customs union.

7.3 PARTIAL EQUILIBRIUM ANALYSIS OF A CUSTOMS UNION

7.3.1 Trade creation and diversion Viner introduced two concepts of trade creation and diversion as the static effects of a customs union. Though his focus was on production effects alone, later economists like Meade (1955),Lipsey (1957) and others also discussed consumption effects. Let us now explain trade creation and diversion, first through tabular presentation and then diagrammatically.

Table-7.1 TRADE CREATION

Country	Cost of production (in dollars)	Imposition of 100% uniform import duty by A	Duty on imports from B are removed, but not from C
A (Home country)	50	50	50
B(Partner)	40	80	40
C (Non-member) or rest of the world	30	60	60

Source: Mannur

As is clear from the above table, country A is the home country. Column II shows that country C,B and A are placed in the order of efficiency. In other words, C is the most efficient, whereas B is intermediate and A is the least efficient with the highest cost of production. Under these circumstances, A imports from C.

In column III, it is shown that country A now imposes 100% uniform import duty on both B and C. Imports from C are no more competitive. So A produces domestically. Country B has still not entered in our discussion, since country A was not importing from it earlier also.

Now, see column-IV. Country A forms a customs union with B, thus removing import duty on B's exports to A. Duty is retained on C's product. In this artificially created situation, C is the least efficient, whereas country A finds it cheap to import from B. This is trade creation.

Trade creation is said to take place when low cost producers from a member country of a customs union replace inefficient domestic producers. This is the positive static effect and is said to promote welfare by improving resource allocation.

TABLE 7.2 TRADE DIVERSION

Country	Cost of production (in dollars)	Imposition of 50% uniform import duty by A	Duty on imports from B are removed, but not from C
A (Home country)	50	50	50
B(Partner)	40	60	40
C (Non-member) or rest of the world	30	45	45

Source: Mannur

Table 7.2 shows the same data for column-II. But in column-III, we find that tariff imposition is 50%, as compared to 100% earlier. Even after imposition of tariff, the most efficient country i.e. C can compete and export to A. Column-IV shows that as tariffs on B are removed and those on C are retained, A imports from less efficient country B at the cost of more efficient country C. This is trade diversion.

Trade diversion is said to take place when a less efficient regional partner replaces a more efficient non-regional partner. By discriminating against C, trade is diverted from BC to B, which is welfare reducing.

Diagrammatic presentation

Let us now explain the same concepts diagrammatically. DD and SS are the demand and supply curves of country A respectively.OP1,OP3 and OP4 are the prices in countries A,B and C respectively. The order is: OP1>OP3>OP4, which again makes clear that C is the most efficient country and A is the least.

Pre-customs union equilibrium

Before a customs union is formed, the tariff ridden or tariff displaced price in A is OP2, which is equal to the free trade price of C+ uniform import duty P2P4. Only country C can sell its product at this price, as B can't compete at this price. A imports RS(CD) from C and produces P2R domestically.

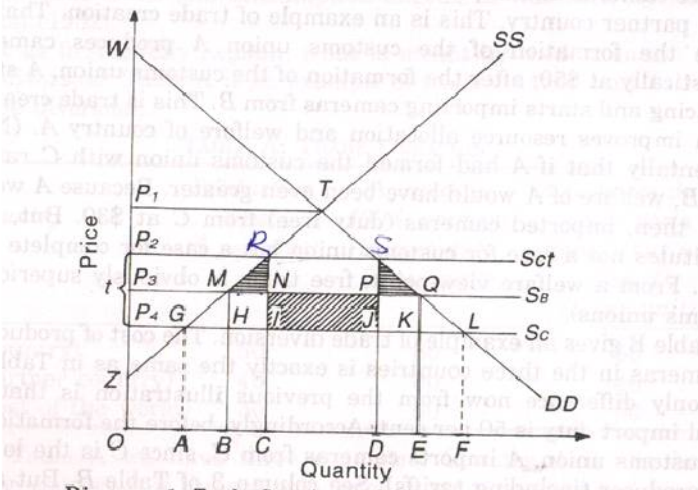


Diagram 1. Trade Creation and Trade Diversion Effects.

Post customs union equilibrium

As a result of formation of customs union, B starts exporting to A at duty free price of OP3 and eliminates C.

7.3.2 Welfare implications of forming a customs union

We can understand whether the formation of customs union has been net welfare increasing or decreasing by comparing the scenario before and after the customs union. We can also discuss different effects on the domestic economy (i.e. country A).

Effect	Before	After
Price effect	OP2	OP3
Production effect	P2R	P3M.
Consumption effect	P2S	P3Q
Welfare creation effect	—	MNR+SPQ
Welfare reducing effect	—	NIJP
Net welfare effect		Depends on whether MNR+SPQ>NIJP,<NIJP or=NIJP

Details are as shown below:

The decrease in country A's domestic production from P2R to P3M increase A's imports equal to MN(BC).This creates trade creation effect-I (RMN). The increase in country A's consumption from P2S to P3Q increases imports equal to PQ (DE). This is trade creation effect-II (SPQ).Together, they make the trade creation effect. This is welfare increasing. Welfare reducing effect takes into consideration trade (NP or CD) that has been diverted from country C to B. As the diagram shows, before the customs union:

Consumer surplus	OWSD-OP2SD=WSP2
Producer surplus	OP2RC-OZRC=P2RZ
Government surplus	RIJS (RIxRS)

Before the customs union is formed , for importing CD amount ,consumers paid CRSD. Out of this, RIJS goes as government surplus or tariff revenue. This is just a re-distribution of income from consumers to the government in the same country. The exporters from C got the rest i.e. CIJD. So CIJD was the actual cost of buying CD amount of imports. After customs union formation, for the same amount of imports, CDPN is paid to country B. There is increase equal to shaded rectangle NIJP. This is welfare loss to country A due to trade diversion.

Net welfare effect depend on whether trade creation=trade diversion,< trade diversion or> trade diversion. In the first case, there is no net change. The second and third cases show net welfare decreasing effect and net welfare increasing effect respectively.

So neither the earlier notion that a customs union is always good, nor that of Viner (originally)that it is always welfare reducing. It depends on the weightage of the particular effect.

7.3.3 Dynamic effects

Apart from the static effects explained above, many scholars including Bela Balassa have also paid attention to the dynamic effects of a customs union. Some of these are:

- As a result of the formation of customs union, the inefficient firms either get closed or have to restructure themselves to survive in the market.
- There is free movement of labour, capital and entrepreneurs, along with goods.
- As every country specialises in the product in which it has comparative advantage, division of labour takes place which brings economies of scale. These get transmitted to other firms within the region.
- There is positive impact on economic growth of the member countries.
- There is also positive impact on inward investment.

7.4 LET US SUM UP

In this lesson, we learned about the static and dynamic effects of a customs union.

7.5 REFERENCES AND SUGGESTED READINGS

- International Economics by H.G. Mannur
- Global Political Economy by John Ravenhill
- International Economics by Desai and Bhsalerao

SELF ASSESSMENT QUESTIONS

- Show and explain through partial equilibrium analysis the static and dynamic effects of a customs union.
- Is a customs union always welfare reducing? Justify your answer.
- Show diagrammatically the pre and post customs union equilibrium.

EUROPEAN UNION

Structure

8.1 OBJECTIVES

The main objectives of this lesson are to enable the learners to :

- Know about regional integration in Europe through European Union.
- Understand the motivating factors behind EU.
- Explain the progress made so far.

8.2 INTRODUCTION

European Union represents the most advanced example of regional integration. There is a common market, economic union, common currency, coordination in terms of many policies and many a time, the regional organisation representing all the member nations as a single entity. Over a period of time, EU has emerged as an important international actor. Before reaching the present stage, it has covered a long journey. In this lesson, we shall discuss about the factors behind the formation of a regional organisation in West Europe, the timeline of its regional integration, its progress so far etc.

8.3 BASIC FEATURES OF EUROPEAN UNION

European Union, with 7.3% of the world's population and current membership of 28 is said to represent the most extensive regional governance institution. The following features characterise the regional integration in EU

- Its institutions have supranational powers over the member states in many policy domains.
- Regionalism is more formal, as there are budgets, headquarters, courts, voting procedures, binding commitments by member states etc.
- Its success is an example set for other regions and is worth emulation.
- The process of integration chosen is the one in which steps in one area have spilled over into others over a period of time.
- The process of integration is a blending of functionalism and neo-functionalism, supranationalism and intergovernmentalism and widening (expansion of members) and deepening (coverage of more and more issues).
- It has altered global politics and governance.

8.4 MOTIVATING FACTORS BEHIND THE FORMATION OF EUROPEAN UNION

Why was European Union formed in the first place? Literature tells us that there are different motivating factors behind any nation's joining a regional organisation. The process of regional integration in west Europe started post world war –II. Most of the European nations were involved in wars and had lost a lot as a result of it. There was a great need to reconstruct these economies, which was not possible without getting united. England and France were rivals. There was great need for a change in the existing system, which could bring these nations together. Also the centre of gravity was moving away from Europe. US had emerged as a great ,rather the most powerful nation. Some scholars also attribute it to the 'good old' East-West conflict, which provided a double asset to the West European integration process. Besides, there was a need to strengthen the democratic forces, as compared to East's communism. This was external motivation.US' Marshall plan was another incentive. As per the Marshall plan, US would give aid to European nations in lieu of them having to submit a joint plan and to make joint efforts towards consolidation of the regional members by forming an organisation. In fact, Jean Monnet and Alcide De Gasperi dreamed of a United States of Europe. In this way, the different motivating factors were responsible for the regional integration to start in West Europe .

8.5 TIMELINE OF EUROPEAN INTEGRATION AND THE PROGRESS SO FAR

1951	Establishment of European Coal and steel Community (ECSC) (6 members)
1957	Treaties of Rome to establish European Economic Community (EEC) and European Atomic Energy community (Euratom) (6 members)
1962	Common Agricultural Policy (CAP) launched
1968	Completion of Customs Union
1973	First enlargement (3 members)
1979	Launch of European Monetary system First direct elections for European parliament
1981	Second enlargement (1 country)
1986	Single European Act (SEA), third enlargement (2 countries)
1992	Maastricht Treaty on European Union

1995	Fourth enlargement (3 countries)
1997	Treaty of Amsterdam
1999	Launch of common monetary policy and single currency (euro)
2002-03	Draft convention on the future of Europe
2004	Fifth enlargement (10 countries)

Source: (Karns and Mingst)

In 1950, the French foreign minister, Robert Schuman proposed to place Franco-German coal and steel production under a common high authority which would be a supranational authority. His proposal led to the establishment of European Coal and steel Community (ECSC) in 1951 by six members, France, West Germany, the Netherlands, Belgium, Luxembourg and Italy. It was rejected by Great Britain due to internal opposition.

The functionalism depicted through starting with ECSC yielded results that encouraged members to move ahead in other areas as well. In other words, ECSC led to increased production of coal and steel. So the six members expanded cooperation in atomic energy (Euratom) and agreed to form a common market for atomic energy. They also agreed to form a common market over 12 years through removing all the restrictions in internal trade, by having a common external tariff, reduction of barriers to free movement of people and goods and to have common agricultural and transport policies. The basic logic was that coal and steel sectors could not develop in isolation from other sectors. Progress was made in implementing what they desired. Customs union was completed in 1968. Efforts were also going on in harmonisation of health and other standards and towards common policies, starting with agriculture. The founding documents of these three organisations form the constitutional basis of the EU. Now, the governing institutions of the three have been merged.

As the former Danish prime minister and the then president of EEC put it, the EEC was an association of equals, a 'whole series of independent nations' engaged in the art of cooperation on a purely voluntary basis. But as compared to its counterparts elsewhere in the world, the community by adding a new dimension to it has taken it much forward i.e. through the 'principle of partial surrender of the sovereignty' (POPSOS) of member states. This makes regional integration model of West Europe a unique one.

In 1970s, the community gave a pause to further deepening and started to focus on enlargement. The first enlargement took place in 1973, with the accession of Great Britain, Ireland and Denmark. Further enlargement continued. For example, in 1981, Greece was added. In 1986,Spain and Portugal; in 1995,Austria,Finland and Sweden; and in 2004, Cyprus, Czech republic, Estonia, Hungary ,Latvia, Lithuania,Malta, Poland, Slovakia and Slovenia were given membership. In 2007, Romania and Bulgaria were added. In July 2013, Croatia became the 28th EU member.

In 1987, with the signing of Single European Act, an important step was taken with establishing the goal of completing a single market by Dec. 1992.Before the deadline, the twelve members signed the Maastricht treaty on European Union, that " called for a closer union among people of Europe". With Maastricht ,European Community was transformed into European Union. However, the Danish voters rejected the Maastricht treaty in a referendum and also in a referendum in France, it was only narrowly passed. It was only when Denmark was allowed to opt out of certain provisions that a second referendum was passed. However, this shows, according to many scholars, a 'democratic deficit' within EU.

The Maastricht treaty is based on three 'uneven but distinct pillars'. The original community became one of the three pillars of the new EU. In the first pillar, policies in economic and financial sectors were included. This was the communitarian pillar in which there were common funds for different economies programs. Two more pillars were added, Common Foreign and Security policy (CFSP) and Home Affairs and justice. The second and third pillars remained matters of intergovernmental agreement and have not been communitarized yet.

The treaty of Amsterdam that was signed in 1997, but came into force in 1999 included some more issues like social policy, immigration, asylum, environment, consumer protection etc. In 2001, Nice treaty was signed. It came into force in 2003. The aim was to bring reforms by amending Maastricht treaty and the treaty of Rome. The so called reform treaty or the treaty of Lisbon was signed in 2007 and came into effect in 2009. It amended the Maastricht treaty and renamed the treaty of Rome as treaty on the functioning of EU. Also there was a move from unanimity in decision making to Qualified Majority voting in at least 45 policy areas. Apart from this, the hitherto '3 pillar structure of EU' was changed into a consolidated legal personality.

Euro which was launched in 2002 has been adopted by 19 members. 26 nations are members of Schengen agreement of 1985 in which passport or other types of border control measures have been abolished.

In this way ,the process of regional integration in European Union with more than 60% of intra-regional trade has reached a height which every other regional group is aspiring for.

8.6 LET US SUM UP

In this lesson, we learned about the process and progress of regional integration in Europe. We have now understood how far EU has travelled for getting transformed from ECSC to this stage.EU has made remarkable progress in regional integration and has set an example for others.

8.7 REFERENCES AND SUGGESTED READINGS

- International Organizations by Karns and Mingst, chapter 5.
- Reliable online sources for the latest data.

SELF ASSESSMENT QUESTIONS

- Explain the basic features of European Union.
- What factors induced the European countries to go for regional cooperation?
- Explain the timeline of European regional integration.

NORTH AMERICAN FREE TRADE AGREEMENT

Structure

9.1 OBJECTIVES

The main objectives are to acquaint the learners with the basic issues and provisions of regional integration in NAFTA.

9.2 INTRODUCTION

NAFTA, the regional arrangement in North America was established in 1992 but came into force in 1994, between USA, Mexico and Canada. In 2012, NAFTA contributed 21% to the world GDP. It is a trilateral free Trade agreement. In fact it is an extension of US-Canada Free trade agreement. In this lesson ,we'll discuss more about it.

9.3 REGIONAL INTEGRATION IN NAFTA

Before NAFTA, USA and Canada had a Free Trade Agreement (1988). So US-Canada Trade was already duty free. So NAFTA was in fact an extension of US-Canada Free Trade Agreement. NAFTA has a long and detailed text with 295 articles. US-Canada Free there are two parallel agreements NAAEC and NAALC ,which deal with environment and labour respectively. The Free Trade Commission monitors the functioning and implementation of the agreement, recommends and provides for dispute settlement. However, the decision of the commission is not binding on the members.

9.4 BASIC PROVISIONS [9] OF NAFTA

Following are the basic provisions of NAFTA:

9.4.1 MARKET ACCESS

9.4.1.1 Tariffs: Dramatic Market Opening

Within 10 years of the January 1, 1994 implementation of NAFTA, all tariffs will be eliminated on North American industrial products traded between Canada, Mexico and the United States. A few tariffs on U.S. exports of agricultural products to Mexico will be phased out over 15 years. As provided in the U.S.-Canada Free Trade Agreement (CFTA), all trade between the United States and Canada will be duty-free by 1998. Most U.S.-Canada trade is duty-free already.

Prior to NAFTA, Mexican tariffs, which ranged from 0 to 25 percent, were 2.5 times U.S. tariff rates – and about the same as (pre-CFTA) Canadian rates. Without NAFTA, international trade rules would have permitted Mexico to raise its tariffs as high as 50 percent without paying compensation. Under the NAFTA however, tariffs on all goods entering Mexico from the United States will be eliminated.

On January 1, 1994, Mexico eliminated tariffs on nearly 50 percent of all industrial goods imported from the United States, including some of our most competitive products such as machine tools, medical devices, semiconductors and computer equipment, and telecommunications and electronic equipment. Within five years, sixty-five percent of all U.S. exports of industrial products to Mexico will enter Mexico tariff-free, including light trucks, most auto parts, and paper products.

9.4.1.2 Elimination of Non-Tariff Barriers

In addition to elimination of tariffs, Mexico will eliminate non-tariff barriers and other trade-distorting restrictions. Upon implementation, U.S. exporters started to reap the benefits from the removal of most import licenses, which had acted as quotas, essentially limiting the importation of products into the Mexican market. The benefits are two-fold: 1) exporters are able to ship more of their products into Mexico; and 2) exporting is more cost effective since exporters will no longer have to deal with the uncertainty and administrative burden associated with obtaining an import permit.

NAFTA also eliminates a host of other Mexican barriers, such as local content, local production and export performance requirements, that have acted to limit U.S. exports. Local content requirements condition permission to sell a product on the incorporation of a mandatory percentage of local parts or labour. In other cases, companies must produce locally if they want to sell to the domestic market, or they must export a certain percentage of production. NAFTA eliminates all these requirements.

9.4.2 Rules of Origin

NAFTA reduces tariffs only for goods made in North America. Tough rules of origin whether a good qualifies for preferential tariff treatment under NAFTA.

9.4.2.1 Strong Rules Benefit U.S. Workers and Firms

Goods traded duty-free under NAFTA must contain substantial North American content. Rules of origin reward companies using North American parts and labour. As duties are phased out, the incentive to use North American goods increases.

Rules of origin prevent “free riders” from benefiting through minor processing or transhipment of non-NAFTA goods. Mexico and Canada cannot be used as export platforms into the U.S. market.

9.4.2.2 NAFTA Rules Improve on the CFTA

NAFTA rules strengthen, clarify, and simplify rules contained in the U.S.-Canada Free Trade Agreement (CFTA), and therefore, NAFTA rules supersede the CFTA rules.

The improvements are summed up below:

- few NAFTA rules require cost accounting; those that do are based on simple formulas.
- most NAFTA rules are based on simple, predictable tariff classification principles.

9.4.2.3 Customs Administration

Under the NAFTA, Mexico, Canada and the United States have agreed to implement many uniform Customs procedures and regulations. These provisions benefit U.S. companies by ensuring predictability and transparency in the exporting process. Small to medium sized companies especially benefit, since they often have limited resources to devote to dealing with complex Customs procedures. Uniform procedures ensure that exporters who market their product in more than one NAFTA country do not have to adapt to multiple Customs regimes.

9.4.3 Safeguards

NAFTA provides timely, effective relief to American workers and firms needing time to adjust to injurious imports from Mexico. The provisions of the CFTA continue to apply to bilateral safeguard actions with Canada.

9.4.3.1 Two Important Safeguards

A bilateral safeguard permits “snap-back” to pre-NAFTA tariff rates for up to 3 years — or 4 years for extremely sensitive products — if increases in imports of

Mexican goods cause or threaten to cause serious injury to American firms or workers. "Snap-back" means resetting a tariff at its original level. A global safeguard retains our right to impose quotas or tariffs on Mexico and/or Canada as part of a multilateral safeguard action, when imports from that country account for a substantial share of total imports and contribute importantly to the serious injury or threat thereof.

Specific safeguards are also provided for certain agricultural products and textiles.

9.4.3.2 Protection Against Unjustified Actions

NAFTA protects U.S. jobs and firms against unjustified safeguard actions by Canada or Mexico by establishing clear procedures for taking safeguard actions. Any NAFTA partner taking a safeguard action must compensate the country whose imports are affected.

9.4.4 Investment

NAFTA eliminates investment conditions that restrict the trade of goods and services to Mexico.

9.4.4.1 NAFTA Provides Fairness for Investors

NAFTA ensures that U.S. investors in Canada and Mexico are treated the same as domestic firms.

9.4.4.2 NAFTA Removes Investment Barriers

Prior to NAFTA implementation, Mexico could review all investment proposals to determine if they were in the national interest. Under NAFTA, Mexico may review acquisitions above an initial threshold of $25 million, phased-up to $150 million over nine years (adjusted for inflation and economic growth). Mexico will continue to prohibit foreign investment in certain "Constitutional" activities (e.g., energy, railroads).

NAFTA gives U.S. companies the right to establish firms in Mexico and Canada or acquire existing firms, but it does not encourage U.S. firms to go abroad.

9.4.4.3 NAFTA Encourages Environmentally Sound Investments

NAFTA permits the imposition of stringent environmental standards on investments and discourages the lowering of environmental standards to induce investment.

9.4.5 Services

The U.S.-Canada Free Trade Agreement established the first comprehensive set of principles governing services trade. NAFTA broadens these protections and extends them to Mexico. Virtually all services are covered by NAFTA with the exception of aviation transport, maritime, and basic telecommunications.

9.4.6 Intellectual Property Rights

The NAFTA promotes export-driven growth in some of America's most competitive sectors, such as U.S. high technology and entertainment products, by providing the highest standards of protection for intellectual property available in any bilateral or international agreement. The NAFTA covers patents, trademarks, copyrights and related rights, trade secrets, semiconductor integrated circuits (mask works), plant breeder rights, geographical indications and industrial designs. NAFTA "locks in" and extends the protection contained in the world class intellectual property rights (IPR) laws adopted by Mexico in June and July 1991.

9.4.6.1 Increased Protection and Enforcement

NAFTA protects U.S. industry by reducing the risk that products of U.S. creativity and innovation could be unfairly exploited in Canada or Mexico.

9.4.7 Government Procurement

U.S. suppliers of oil and gas field equipment and services, heavy electrical equipment, communications and computer systems, electronic, steel and pharmaceutical products and medical equipment and construction services particularly benefit from the NAFTA's government procurement provisions.

9.4.7.1 Mexico Opens PEMEX and CFE Procurement

NAFTA gives U.S. suppliers immediate and growing access to the Mexican government procurement market, including government-controlled enterprises (*parastatals*) such as PEMEX (national oil company) and CFE (National electric company).

9.4.7.2 Coverage of Construction and other Services

The government procurement provisions of the NAFTA apply not only to goods, but to contracts for services and construction as well.

9.4.7.3 Commitment to Fair and Open Procurement Competition

NAFTA guarantees U.S. business fair and open competition for procurement in North America through transparent and predictable procurement procedures.

9.4.8 Standards-Related Measures

Standards-related measures cover both voluntary and mandatory technical specifications that lay out the characteristics of a product, such as quality, performance, labelling etc. NAFTA prohibits the use of standards and technical regulations as obstacles to trade. NAFTA enhances the ability of U.S. firms to effectively develop and market new products in Mexico and Canada, and ensures that the implementation of new regulations does not adversely affect the sale of existing products.

9.4.8.1 Equal Treatment and Transparency Aid U.S. Competitiveness

NAFTA requires that standards-related measures be applied in a non-discriminatory manner to both domestically produced and imported products. It ensures the standards development process in all three countries is open and transparent.

9.4.8.2 Temporary Entry for Business Persons

Expanded trade and the economic alliances developed with Mexican business as a result of the NAFTA will result in more business persons travelling to Mexico. The U.S. and Mexican governments have developed uniform and transparent procedures to facilitate temporary entry of business persons who conduct trade in goods and services as well as investment activities.

9.4.9 Dispute Resolution

NAFTA has several procedures to settle disputes involving the application or interpretation of the NAFTA.

9.4.9.1 Rapid and Effective Dispute Settlement

NAFTA creates a trilateral Free Trade Commission which will regularly review trade relations among the three countries and discuss specific problems. Dispute resolution will normally be completed in less than one year.

9.5 THE EXPERIENCE SO FAR

While signing NAFTA, Bill Clinton said, "NAFTA means jobs, good American jobs". The goal was to reduce barriers in trade and investment between the three nations. Immediately, tariffs were eliminated on half of Mexico's exports to USA and 1/3rd of US exports to Mexico. Except US agricultural exports to Mexico, in which tariffs were to be phased out in 15 years, in all other sectors, tariff elimination was to take place within 10 years.

NAFTA has helped boost Intra-regional trade between the three countries. It increased from $290 billion in 1993 to $1.1 trillion in 2012. However, it has been a mixed experience for the countries concerned.

Not many jobs could be generated. No deeper economic integration could take place. Most of the growth in trade was due to increased trade between US and Mexico. Some scholars even argue that the sectors excluded like telecom ,TV, transport etc. gained more than those included. Also, because of power asymmetries , the region is often described as a “US enterprise”(Poitras 2001) or “sum of two bilateral relationships” (Pastor).

9.6 LET US SUM UP

In this lesson, we learned about regional integration in NAFTA.

9.7 SUGGESTED READINGS AND WEB SOURCES

- International Orgaisations by Karns and Mingst, Chapter 5.
- Home page of NAFTA

SELF ASSESSMENT QUESTIONS

- Explain the basic provisions of NAFTA.
- What has been the experience of member countries with NAFTA?

SOUTH ASIAN ASSOCIATION FOR REGIONAL COOPERATION (SAARC)

Structure

10.1 Objectives

10.2 Introduction

10.3 South Asia: a brief note

10.4 South Asia's historical linkages

10.5 Genesis of SAARC

10.6 Members and observers

10.7 Basic features

10.8 Objectives

10.9 Milestones covered: SAPTA and SAFTA

10.10 Recent steps taken towards regional consolidation under SAFTA

10.11 Status of Intra-regional trade in South Asia

10.12 Progress made by SAARC

10.13 Reasons for failure to promote regional cooperation in South Asia

10.14 Let us sum up

10.15 References and suggested readings

10.1 OBJECTIVES

The main objective of this lesson is to make the learners well versed with the regional integration process in South Asia through the formation of SAARC and its journey so Far.

10.2 INTRODUCTION

Like regional groups in other parts of the globe, South Asia has SAARC to its credit. This regional association which was originally signed by seven members (and the eighth member was added only recently) has been trying to move up and up on the ladder of integration. SAPTA and SAFTA are two milestones covered. But to what extent they have served the purpose remains mired by controversy, as there are scholars who speak high as well as low of the progress made by the organisation so far. In this lesson, you will get to know more about the regional association.

10.3 SOUTH ASIA: A BRIEF NOTE

The modern region of South Asia, as defined by Sahasrabuddhe comprises of what is traditionally known as the Indian subcontinent and includes the territory between China in the north and the Indian Ocean in the south; and between Afghanistan in the west and Myanmar in the east. Most of the boundaries of this subcontinent are delimited by natural and geographical features.

Seeing that three largest nations of South Asia are among the ten most populous countries in the world, scholars like Debroy (2004) consider that SAARC would have been counted as the largest entity in the world on the basis of population criterion.

South Asians are known to share a common colonial past, diversity of political systems recently on the move to democracy and different economies in terms of levels of development. Economically, SAARC countries can be grouped as SAARC - LDCs and SAARC-non-LDCs. Bangladesh, Bhutan, Nepal, the Maldives and Afghanistan are categorised as LDCs or Least Developed Countries, while India, Pakistan and Sri Lanka are categorised as non-LDCs. This categorisation is based on the criteria for LDCs set by the Economic and Social Council of the UN (Gunasekera 2008). The Maldives and Sri Lanka come under the World Bank category of lower-middle income (LMI) countries and India and Pakistan come under the category of low income countries (LIC).

10.4 SOUTH ASIA'S HISTORICAL LINKAGES

South Asia, which has not been able to make much real progress in regional integration (except signing of agreements), and has been overwhelming with sorrow, despair, fear and failure was not always surrounded by such pessimism. There is ample evidence of intra-regional trade having gone from strength to strength in Pre-SAARC period. The following lines depict the scenario:

"The South Asian nations historically had strong trade and cultural ties among themselves for centuries, many of which were until 1947, part of British India. Much before the most successful regional bloc of the European Common Market was established in 1958, the three largest South Asian countries of India, Pakistan and Bangladesh had a common market with integrated monetary and communication system until 1947" (Sawhney and Kumar).

The bridge of hope and prosperity soon collapsed under the presence of heavy rainfall of political differences most visible during 2nd half of the 20th century. Despite natural ties, South Asia could only be numbered among the least integrated regions in the world. Steps to institutionalise it were then taken in 1985 with an attempt to reverse the negativities and to bring positive outcome.

Similar observations were made by Khan(1999,p.490) who said that the establishment of the SAARC is not a new concept, but in fact is an effort to restore the economic union which had functioned on the India-Pakistan sub-continent before it achieved independence in 1947.

Similarly, Pursell and Pitigala (2001) dwell on significant intra-regional trade between South Asian countries in the golden period of their relations. As much as 19% of their trade in 1948 was intra-regional. Thereafter it dwindled to 4 percent in 1960 and 2 percent in 1970. In 1999, it was 4% of their intra-regional trade.

The above discussion makes us understand that unlike some other regional associations, in which expansion and deepening have brought the once warring nations close and has led to the cohesion of the member economies, no such change is visible in the Indian sub-continent, through signing of SAARC or even SAPTA, SAFTA.

10.5 GENESIS OF SAARC

SAARC is a geopolitical organisation of eight members located in South Asia: India, Pakistan, Bangladesh, Bhutan, Nepal, Sri Lanka, Maldives and Afghanistan. South Asia represents 3% of the world area and 25% of the population, according to recent figures. India is the largest member. Except Afghanistan, all other members share borders with India. Afghanistan and Pakistan also share border with each other. South Asia is also the most militarised region in the world.

Though SAARC could see the light of the day in 1985, steps to initiate regional cooperation were taken quite early .The idea of regional cooperation in South Asia had come under discussion at three conferences: the Asian Relations Conference in New Delhi in April 1947, the Baguio Conference in the Philippines in May 1950, and the Colombo Powers Conference in April 1954. However, the real difference was made with the then president of Bangladesh Zia ur-Rehman's sharing of his paper on South Asia with other South Asian Heads in November 1980 (Khan et al,. 2007).

The adoption of Declaration on South Asian Regional Co-operation and launching of Integrated Program of Action (IPA) took place in the maiden meeting of South Asian foreign ministers in New Delhi in Aug. 1983. (Centre for non-proliferation studies 2007). The SAARC Charter was formally adopted on 8 December 1985 at Dhaka at the First Summit by the Heads of State or Government of Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. The Charter laid out that cooperation in the SAARC will be based on respect for the principles of sovereign equality, territorial integrity, political independence, non-interference in internal affairs of the Member States and mutual benefit. Decisions will be arrived at by consensus.

10.6 MEMBERS AND OBSERVERS

Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka are the eight member nations of SAARC. Afghanistan became the newest member of SAARC at the 13th annual summit in 2005. China and Japan were granted observer status at the same summit (Centre for Non-Proliferation Studies, 2007). In April 2006, the United States of America and South Korea made formal requests to be granted observer status. The European Union also indicated interest in being given observer status, and made a formal request for the same to the SAARC Council of Ministers meeting in July 2006. On 2 August 2006 the foreign ministers of the SAARC countries agreed in principle to grant observer status to the US, South Korea and the European Union. On 4 March 2008, Iran requested observer status followed shortly by the entrance of Mauritius. So there are nine observers of SAARC i.e. Australia, China, European Union, Japan, Iran, Mauritius, Myanmar, South Korea and United States. (Source: SAARC website, accessed July 8, 2011)

10.7 BASIC FEATURES

All activities that are undertaken within this framework are governed by the overarching principles of *sovereign equality, territorial integrity, political independence and non-interference in the internal affairs of other States*. On the one hand, mutual benefit is a primary consideration; the sovereign equality condition weighs in against powerful countries leveraging their power against weaker countries. On the other hand, member states can not involve themselves in bilateral conflicts within the region. Its charter states explicitly that *bilateral and contentious issues shall be excluded from the deliberations of SAARC (article X.)*

SAARC structures are intergovernmental in character, and any new area of cooperation is subject to the approval of SAARC heads of state or government.

10.8 OBJECTIVES

The Objectives of the Association as defined in the Charter are:

- To promote the welfare of the peoples of South Asia and to improve their quality of life;

- To accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realize their full potential;
- To promote and strengthen collective self-reliance among the countries of South Asia;
- To contribute to mutual trust, understanding and appreciation of one another's problems;
- To promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields;
- To strengthen cooperation with other developing countries;
- To strengthen cooperation among themselves in international forums on matters of common interests; and
- To cooperate with international and regional organizations with similar aims and purposes.

10.9 MILESTONES COVERED: SAPTA & SAFTA

SAPTA

When did South Asians think of moving towards SAPTA? One view is that the regionalism of economies through the creation of new trade blocs (NAFTA, APEC) and the deepening of the existing ones (EU) raised the fears of protectionism among the SAARC countries. The decreasing prospects of ODA from OECD and the protectionist and non-protectionist barriers on the region's exports to the OECD added urgency to the idea of creating a preferential trading regime in the region [10]. In South Asia, a Preferential Trading Arrangement (PTA) was born in the seventh SAARC summit. Under it, the member states were to cooperate through exchange of concessions.

SAPTA was the mildest form of a Regional Trade Arrangement (RTA), accommodated under an Enabling Clause (as embodied under 1979 Decision) of the

GATT/WTO Agreement (Mukherji, 2006). It dealt with trade in goods. The member nations could not only use the time frame as per their suitability, but could also choose items they wished to liberalise in.[11]

SAPTA consist of the arrangements relating to:

- **Tariffs**: customs duties included in the national tariff schedules.
- **Para-tariffs**: border charges and fees on foreign trade transactions which are levied on imports but not those indirect taxes and charges.
- **Non-tariff measures**: regulation or practice other than tariffs and para-tariffs to restrict imports.
- **Direct trade measures**: measures which are helpful to promote mutual trade in long and medium-term contracts containing import and supply commitments like buy-back arrangements, state trading operations and government and public procurement. [12]

In different Rounds of SAPTA, concessions have been granted to commodities defined at the level of chapter, heading, subheading and national lines. The member states have also adopted various combinations of commodity aggregations in HS while conferring concessions to other member countries in the region. (Mohanty, 2003).During first three rounds of SAPTA, the members gave concessions on 4952 items to each other. Of these, India gave concessions on 2402 items, Pakistan on 685 items Bangladesh on 572 items, Sri Lanka on 212 items, Bhutan on 266 items, Maldives on 390 items and Nepal gave on 425 items. The approach to tariff liberalisation under SAPTA was positive list approach.

SAFTA

9th and 10th SAARC summits were the incremental steps to signing of a free Trade Agreement. But it actually got signed in 12th SAARC summit in Islamabad in January 2004. It was to become effective w .e .f. January 01, 2006, though the tariff liberalisation started from July 01, 2006.

In the journey of SAARC, SAFTA is the highest level of integration reached so far. It is comprehensive in nature and is an improvement over its predecessor in more ways than one. Apart from other provisions, those like non-applicability of anti-dumping duty and safeguard clause against an LDC (provided its total exports do not exceed more than 5% of the recipient country's imports) [13] show that SAPTA had its limitations.

SAFTA builds on the provisions of SAPTA. SAFTA extends the scope of SAPTA to include trade facilitation elements and switches the tariff liberalization process from a positive to a negative list approach. For these countries SAFTA proposes that "until alternative domestic arrangements are formulated to address this situation, the Contracting States agree to establish an appropriate mechanism to compensate the Least Developed Contracting States…"[14]

Article 7 of the SAFTA Agreement (available on SAARC website) provides for a phased tariff liberalization programme (TLP) under which, in two years, NLDCS would bring down tariffs to 20%, while LDCS will bring them down to 30%. Non-LDCS will then bring down tariffs from 20% to 0-5% in 5 years (Sri Lanka 6 years), while LDCS will do so in 8 years. NLDCs will reduce their tariffs for L.D.C. products to 0-5% in 3 years. This TLP would cover all tariff lines except those kept in the sensitive list (negative list) by the member states.

Scholars like Pitigala (2005) consider both SAPTA and SAFTA as important steps taken towards removal of barriers to trade in South Asia. Tan et al (2007) while commenting on the positive prospects for economic integration express hope that it shall invite foreign investors.

10.10 RECENT STEPS TAKEN TOWARDS REGIONAL CONSOLIDATION UNDER SAFTA

As was mentioned in the articles of SAFTA, the sensitive list shall be reviewed every four years. The working group on reduction in the sensitive lists under SAFTA (phase-II) has completed its task of reducing the sensitive list by 20%. The extent of change in the sensitive list of each member shall become clear from the following table:

Member states	No. of products in earlier sensitive list	No. of products in revised list (Jan 2012)
Afghanistan	1072	858
Bangladesh	1233 (LDCs),1241 (Non-LDCs)	987,993
Bhutan	150	156
India	480(LDCs),868 (NLDCs)	25,614
Maldives	681	154
Nepal	1257(LDCs),1295 (NLDCs)	998,1036
Pakistan	1169	936
Sri Lanka	1042	837,963

Realising the need for further reduction in tariff in goods traded actively, an adhoc working Group has been constituted for phase-III also. It has been agreed to make the following changes in the time of tariff liberalisation

	Time	**Tariff reduction**
NLDC to NLDC	3 years	0-5%
Sri Lanka	6 years	Do
LDCs to others	8 years	Do
NLDC to LDC	3 years	—

Also in 2010, SAARC agreement on trade in services (SATIS) was signed, and is in force since 2012.

10.11. STATUS OF INTRA-REGIONAL TRADE IN SOUTH ASIA

Since the birth of the regional association, regional trade among its member countries has not shown significant positive change. While growth in exports within SAARC declined by 3.33 percent between 2000 and 2008, growth in SAARC countries declined by 1.2 percent, the total trade between SAARC nations and the rest of the world increased by 9.47 percent over the last decade. [15] The percentage of intra-regional trade between SAARC members is just 5%, compared to 25% within ASEAN, 43% within NAFTA, and 66% within the EU[16] SAPTA covered trade in only 15% of the importables between SAARC members. Under SAFTA, in the original sensitive list, about 53% of the total importables traded (by value) were excluded from tariff liberalisation.

Not only is there low Intra-regional trade[17], in South Asia we also find variation in bilateral trade between countries. According to one study, in 2005 trade between India and other SAARC members was as low as 3 percent, while trade between Nepal and other SAARC members stood at 35 percent. [18]

Bhutan and Nepal trade more within the region due to certain constraints. As data show, almost 95 percent exports and 75 percent imports of Bhutan take place with India. Similarly Nepal's trade relations with India show that India accounts for more than 50% of exports and imports of Nepal .These are few exceptions to the general trend (Ali and Talukder 2009).

Seeing these statistics, scholars observe and argue that the generally accepted theory of geographical proximity being a catalyst for regional cooperation does not seem to fit in South Asia. So "The south Asian countries are basically not natural trading partners" (Ali and Talukder 2009).

10.12 PROGRESS MADE BY SAARC

SAARC has few things to its credit, which are worth mentioning. Some of the achievements are:

- Steps towards food security

- Steps towards suppression of terrorism
- Group of Eminent persons' (GEP) report
- SAARC social charter
- Reports of Plan of action on poverty alleviation by the specialised commissions
- Emergence of professional SAARC groups

10.13 REASONS FOR FAILURE TO PROMOTE REGIONAL COOPERATION IN SOUTH ASIA

After perusing the SAARC documents, it seems that SAARC nations left no stone unturned in taking timely steps towards region building. SAARC might have been able to set a good example and acted as an archetype for the potential regional arrangements in this and other parts of the globe had the leaders been as committed to implementation as to declarations. This realization came only in recent summits and hence the move from 'Declarations to implementation'. So the buck stops here. The traffic of conventions, declarations and agreements is building up. But that they have actually translated into reality and fulfilment of objectives of SAARC charter is still questionable on more scores than one.

While relying on the literature, we can understand what factors have stalled the economic progress of South Asian region, even after signing of a Free Trade Area. Following are some of the most important reasons responsible for the failure of SAARC :

- There has been lack of political will on the part of member nations. There is no example of a regional organisation having made sufficient progress without commitment from the member states. Many a time, SAARC nations don't speak with a single voice in multilateral forums like WTO, which means SAARC doesn't represent all the South Asians as a single entity.

- Another reason, as scholars argue, is the 'consultative nature and the inbuilt limitations of SAARC Charter' (IDEA 2009). Many agreements don't get actualised into benefits.

- Many a time, the summits could not take place. "The fact that in twenty one years of its existence only 13 summits were held, speaks of the dissonance within SAARC. Differences in bilateral relations were often so contentious that summits could not be held every year. This in turn put off major decisions."[19] So summit diplomacy has lost its sanctity in SAARC. Many scholars call it a ritual.

- A lot e.g. whether summit will take place or not hangs on the bilateral relations between the two biggest members. Their interstate conflicts have ranged from brief skirmishes on the border to war of words between top leaders to the full fledged wars. If at all it (summit) takes place despite tense relations, they are seen as giving each other a wide berth. Regional cooperation is taken to a higher level provided their bilateral issues are solved on 'first things first' basis. They are so intent on these disputes that they forget the very objectives of SAARC and the denial of discussion of bilateral issues.

- Desai (2010),among other scholars explains what led to the non-inclusion of economic cooperation and trade issues being dropped from the initial agenda of the organisation. Mutual suspicions were responsible for it. SAARC moved to economic cooperation and trade issues only in 1990s.

- Much has been written on hegemony and its adverse effects on regional integration. In South Asia, due to the power imbalance in favour of India, and to borrow from Dubey (2008), because of a 'leadership vacuum,' many a time, there is a lack of consensus and hence the poor status of integration.

- Apart from the aforementioned obstacles to Intra-regional trade, there is much more to unfold. Issues range from trade facilitation, behind-the-border issues like the prohibitive number of documents required for cross border trade (Taylor and Wilson 2009) to bribery as found by Ahmed and Ghani (2007).

- Almost all the South Asian countries have been producing the same basket of goods traditionally and hence competing for the similar goods in the international market. However, things have started to change in recent years.

To conclude regarding low level of integration in South Asia, we can name political and economic factors as well as lack of trust and Indian hegemony, among others. If South Asian leaders can gather political will , South Asia shall be better integrated and shall contribute towards regional cooperation not only in South Asia, but Asia as a whole.

10.14 LET US SUM UP

In this lesson, we learned about different aspects of regional integration under SAARC, SAPTA and SAFTA in South Asia. We also got to know about progress made by SAARC so far and the main reasons for its failure to contribute positively to regional cooperation.

10.15 REFERENCES AND SUGGESTED READINGS

- SAARC home page
- PhD thesis of the script writer, along with the references included in this lesson.

PROBLEMS AND PROSPECTS OF FORMING A CUSTOMS UNION IN THE ASIAN REGION

Structure

11.1 OBJECTIVES The broad objectives of this lesson are:

- to acquaint the learners with the current status of regional integration in Asia under different associations,
- to make them understand the main players in regional integration in Asia
- to enable them to have an idea of what a customs union should look like in Asia

- to help them understand the basic challenges lying ahead in this endeavour.

11.2 INTRODUCTION

Our knowledge of preferential trading arrangements enables us to understand the basic features of a customs union. Apart from free trade among the partner countries, the member countries also agree to have a common external tariff (CET). It is this common external tariff against non-members that makes it difficult to be signed, as there occurs sufficient erosion of political autonomy regarding decision making. In this lesson, we shall study about the problems and prospects of forming a customs union in Asia.

11.3 TRENDS IN TRADE AND TRADE INTEGRATION IN ASIA

To be able to know whether there are bright or dark prospects of something, few things need to be noted. Take for example, the current level of integration. If we know about how well integrated is Asia, we can imagine whether it can move up on the ladder integration, i.e. move to a customs union or not. If yes, what is the expected time etc.

When scholars talk of trade integration, there are two ways, either market led or policy driven. In other words, market led integration means in which private sector plays a very important role, whereas in state-centric integration, it is the government's policy which influences trade. The market led integration also depends a lot on the multilateral framework created by the governments.

Let us discuss about the existing trade integration in Asia

i) Post 1990s scenario in Asian trade

ii) Rise of China as an important player

iii) Why the regional approach to trade?

Post 1990s scenario in Asian trade Relying on the reliable trade statistics shows that since 1990, Asian economies have significantly increased their share of global trade. In 2008, the emerging Asian(%) economies generated as much as one third of world trade, which increased from 21 percent in 1990 (IMF 2008). While trade with the rest of the world has also increased, the growth of trade within emerging Asia has been quite impressive. Intraregional trade between emerging Asian economies increased more than 9 times between 1990 and 2009 to close to 1,224 billion dollars (IMF DOT 2009). Both growth and volumes are remarkable when contrasted with the European Union (EU-15). In Europe, intraregional trade reached 3000 billion dollars in 2009, an almost threefold increase from 1990 (IMF DOT 2009).

In 2009, the share of intra-East and South-East Asian exports reached close to 41 percent of overall trade (UN ESCAP 2009: 9), not much lagging behind NAFTA (52.5 percent) or the European Union (EU-15, 59.2 percent). The number is even higher for imports, indicating closer integration. Intraregional import figures for this block reached 49 percent in 2009 (UN ESCAP 2009: 9), not significantly lower than EU's intraregional imports (64 percent) (IMFDOT 2009). In 2008, at 56 percent, the overall intraregional Asian trade reached almost a parity with that of EU (Pempel 2010: 214).

Rise of China as an important player Many scholars, while observing the latest trend of regional integration in Asia, attribute it to the growing importance of China as a regional player as well as by making its presence felt at global level. This becomes clear from the following arguments :

"Today China is an exporter of goodwill and consumer durables instead of revolution and weapons" (Shambough 2004: 65)."

"In the early 21st, the rise of China has been the most important development for all Southeast and East Asian countries and their economic cooperation endeavours" (Ravenhill 2008: 48).

It must also be noted that China was the first non-ASEAN country to sign ASEAN's Treaty of Amity and Cooperation (TAC). It signed the TAC at the ASEAN summit in Bali in 2003, and by signing this non-aggression treaty Beijing has contributed to relieving fears of China's military intentions (Narine 2007: 214).

This coupled with the huge trade potential of China and the fact that 50% of its trade is within the region (intra-regional) (GARNET 2010) further re-inforces the importance of China in the existing regional arrangements and makes a strong point for its being an active player, if new initiatives are taken. For example, from 1997-2007 China's share of intraregional trade has doubled. In 2009, share of China in intra-East and South-East Asian imports alone was close to 33 percent (UN ESCAP 2009: 8)

China has also become an important export destination for many Asian economies and has replaced OECD countries. Between 1990 and 2006, for the four most advanced newly industrialised countries of Asia (South Korea, Taiwan, Hong Kong, Singapore) China as an export destination grew from 7.9 to 25.4 percent, whilst exports to the rest of the world, including OECD countries, shrank from 57.0 to 38.3 percent. Even for ASEAN-countries, which directly compete with China, trade with China grew dramatically. In 1990, only 2.2 percent of exports from Indonesia, Malaysia, Thailand, the Philippines and Vietnam went to China, while in 2006 this figure had risen to 11.1 percent (IMF 2007: 44).

Why the regional approach to trade? The experience of different countries with multilateral rounds , in particular the Doha round, which is taking the longest time to conclude, has been bitter enough to induce them to go for trade liberalisation through the regional route. The regional arrangement among relatively likeminded countries, and in which reciprocal preferential access is granted is far more easy to conclude. So further mushrooming of these Regional Trade Arrangements (RTAs) is expected at least till the multilateral negotiations start being successful and adhere to the timeline of integration. As we know, multilateral trade system based in non-discrimination is the best policy. But there are always second best alternatives when the best is not attainable. Asian countries are no exception to the general trend of entering into such preferential arrangements .

11.4 FACTORS BEHIND A REGIONAL APPROACH TO TRADE INTEGRATION IN ASIA

Following are some of the most important observations regarding the factors which might have motivated the regional countries to make efforts towards regional cooperation.

- Since the old security threats no longer pose threat or have become less in intensity, there has been a move away from armed conflicts to peaceful resolution. This has been particularly the case with East Asian countries.
- Asian countries were not the ones having participated actively in the early waves of regionalism. But as these arrangements started growing in other parts of the globe and their impact on the member countries became public, they too gathered momentum along with other such countries having missed the first wave. Not only the success of West European integration and NAFTA was closely observed and motivated other countries to sign these agreements, there was also a fear of being left out. These were some of the motivating factors responsible for first regional initiatives taken in the Asian region. The efforts continued and ASEAN became AFTA, SAARC became SAPTA and then SAFTA. Now there is ASEAN+3,ASEAN+6, in which along the basic members of ASEAN , other countries too are included. Likewise, SAARC has included some observers, even from outside the region. There are now many sub-regional initiatives like Bay of Bengal Initiative for Multi sectoral Techno-Economic Cooperation (BIMSTEC), Bangladesh, Bhutan, India and Nepal (BBIN) etc.
- Asian regionalism gathered momentum in the real sense after the financial crisis of 1997. Before this , most of the Asian countries stuck to unilateral economic policies and there was no enthusiasm for regional arrangements. But the crisis changed the scenario as well as the notion that regional cooperation is not that important. They realised that economic instability is not good for regional stability. So since 1998, the East Asian economies have tried to be as integrated as possible. It has been observed that since 1998, in trade alone, there has been an 80 percent rise in the number of bilateral FTAs and a 90 percent increase in the number of plurilateral

(arrangements with more than two parties) FTAs in Asia (ADB Asia Regional Integration Center data 2010).

- Like an active player in trade, China has also participated actively in regional initiatives. According to the Asian Development Bank's Asia Regional Integration Center, as of July 2010, China was participating in a total of 25 FTA s (both bilateral and plurilateral). 15 of them are across and within the Asia-Pacific region. In 2010, China and the ASEAN countries also created the world's largest free trade zone by number of inhabitants, the ASEAN-China Free Trade Area ACFTA.(GARNET 2010)

Over the years, there has been deepening of ties between Asian economies which was initiated by market forces, but later supplemented and encouraged by political initiatives. Integration by market forces and integration by agreements are certainly not excluding each other, but are related and complementary (Aminian et al. 2008: 3).

11.5 LIKELY SHAPE OF A CUSTOMS UNION IN ASIA

Seeing this scenario of mushrooming RTAs in Asia and efforts to deepen ties, many scholars argue that there is huge potential for a customs union in Asia as the next step. Also scholars like Bhagwati name the phenomenon of mushrooming of RTAs with overlapping membership and with multiple problems of rules of origin as 'spaghetti bowl'. This term has been used in particular with East Asian countries, as they are the most active in these RTAs. Since most of these are FTAs, in which each country is free to impose its own tariff for non-members, there arises issue of rules of origin which are said to increase the cost to the country concerned, as rules of origin differ across different RTAs. Keeping this thing also in mind, many scholars argue that a customs union is highly desirable in Asia, as it would ensure the pan-Asian integration which has been rendered unimplemented given so many overlapping RTAS. However, different scholars differ in their approach and argument regarding which part of Asia and which main players shall be involved deeply in this process.

ASEAN centred regionalism

Though many scholars talk of an ASEAN centred regionalism, they differ in respect of the following:

Given the high level of economic interdependence that can be observed already, the likelihood of a formalised, de-jure integration project in Asia seems to be quite high. A potential venue for this pan-Asian project could be the ASEANChina FTA (ACFTA), which has come into effect in 2010. This large group, comprising more than 1.7 billion people, can over time alter the nature of economic relations in Asia and may possibly also change political and security relations in the entire region (Narine 2007: 205). This view projects ACFTA as the nucleus of an Asian integration project. (GARNET 2010)

Other scholars like Kawai and Wiganraja (2010) on the basis of a CGE exercise conclude the following:

(i) A region wide FTA, whether an EAFTA or CEPEA, offers larger gains to world income than the current wave of bilateral and plurilateral FTAs;

(ii) The CEPEA scenario, which is broader in terms of country coverage, offers larger gains to the world as a whole in terms of income (US$260 billion, measured in constant 2001 prices) than the EAFTA scenario; and

(iii) Third parties outside either an EAFTA or CEPEA lose little from being excluded from a region wide agreement.

They further make the following observations regarding the shape of an expected customs union, given the political economy considerations.

(i) an East Asia-wide FTA, either in the form of an EAFTA or CEPEA;

(ii) a Free Trade Area of the Asia–Pacific (FTAAP) among APEC economies; and

(iii) a Free Trade Area of Asia and Europe (FTAAE) among Asia–Europe Meeting (ASEM) countries.

They argue: “An East Asia-wide FTA—whether an EAFTA or CEPEA—addresses the noodle bowl problem among the production network countries, while an FTAAP or an FTAAE takes into account external markets as well”.

Recently (in Jan 2010), a Eurasian Customs Union was signed among Belarus, Kazakhastan and Russia (later joined by others). Though the member nations expect it to become an important player in the times to come, time only will tell whether it proves successful and whether or not a joint regional group of ASEAN centred countries and Eurasian countries is established.

11.6 LIKELY IMPACT

Trade creation and diversion effects

Like any other customs union, the potential customs union in Asia too would have two effects: trade creation and diversion.

In this regard, a study (GARNET 2010) first of all takes into consideration the size of potential ACFTA. “It constitutes 11 economies (ASEAN countries and China); together these countries have a combined population of close to 1.88 billion people and a combined gross national income of $4.27 trillion dollars. With its already large size ACFTA does not break the record of either the EU or NAFTA in size but is nevertheless deemed large enough to pass the test of size (Estrada et al. 2008: 6).”It means ,for trade creation to take place, the size is appropriate.

Secondly, pre-customs union tariffs must be high for trade creation to take place after its formation. According to Asian Development Bank “Despite an overall regional trend towards trade liberalization and China’s entry into the WTO, tariff barriers are high enough for trade creation after the union. At the dawn of ACFTA and before parties signed on to its framework agreement in 2002, tariff levels on ASEAN imports to China were as high as 9.4 percent in 2001".

Another issue is the level and variance of tariffs between members and non-members. The higher the level and variance of tariffs between members and non-members, the higher the chance of trade-diversion after a union. According to the WTO, tariffs of China and some ASEAN countries (Indonesia, Philippines, Thailand,

and Singapore) for imports from non-members range from zero to 15 percent - with agricultural products accounting for higher numbers. Given the high levels and also the broad range of tariffs, there is a good possibility that a customs union could also result in trade diversion (ADB 2008).

Wignaraja (2011) makes a case for the following benefits of a region wide FTA

• Increase market access for goods, services, skills and technology.

• Increase market size – specialization and economies and scale.

• Easier FDI flows by MNCs and technology transfer.

• Simpler tariff schedules, rules and standards.

• Offer an insurance against protectionist sentiments that pose a risk to Asia's trade and recovery.

11.7 CHALLENGES AHEAD

Before forming a customs union, some understanding of the challenges ahead can equip the potential members well for meeting those challenges. Some of the challenges are:

- As has been considered by some scholars, political economy plays an important role in the conclusion of a regional arrangement. The customs union is the most difficult to conclude, as there occurs sufficient loss of political autonomy of the member country, as major decisions are taken jointly. WTO (2011) data show that less than 10% of all preferential trading agreements were customs unions. This shall become difficult in Asia, where the countries still differ regarding the basic hub of regional integration, though bulk of them are in favour of an ASEAN centred regionalism.

- Not many studies have yet been done on all the likely models of region wide integration, which means that the trade creation and diversion effects have not been studied fully, without which customs union can't be concluded.

- The potential customs union may exclude certain countries who are not doing well in their existing regional arrangements. Its ambitious goals for an Asia-wide integration may not be achieved by countries like South Asia, which not only joined the regional integration process late, but are also struggling to get rid of bilateral conflicts, which have stalled the progress of the regional body SAARC. SAARC is having one of the lowest intra-regional trade.

- Potential members may also be apprehensive of China's dominance in this regional arrangement.

- Many scholars also throw light on the likely impact on the members' trade with their non-member (non-regional) trading partners. Many are proposing to include some of the most important external actors, which would take this group beyond Asia. This itself is a challenge

11.8 LET US SUM UP

After going through this lesson, we have understood what are the problems and prospects of forming a customs union in Asia.

11.9 REFERENCES TAKEN AND ESSENTIAL READINGS

- Trade integration in Asia: Is the region pursuing a convincing strategy for the 21st century? Nina Arbabzadeh and PD Dr. Heribert Dieter GARNET Working Paper No. 79/10 September 2010

- GARNET 2010

- Other studies cited in this lesson

SELF ASSESSMENT QUESTIONS

- What is the current status of regional integration in Asia? Also mention the most active players in this regard.

- In the light of multiple rules of origin of overlapping RTAs in the Asian region, justify the need for a customs union.

- What will be the likely shape and impact of a customs union in Asia, if it is ever established?
- What are the challenges of forming a customs union in Asia?

GLOBALISATION: MEANING, ESSENTIAL CONDITIONS, IMPACT AND IMPLICATIONS

Structure

12.1 OBJECTIVES

The main objectives of this lesson are to enable the learner to:

- Explain the meaning of globalisation
- Understand the conditions of globalisation
- Explain the impact of globalisation

12.2 INTRODUCTION

Due to dismantling of trade and other barriers, the world economy has come closer. There has resulted global division of labour. This transformation of the world economy, according to Oatley, is referred to as globalisation. The world economy has experienced the best and the worst with globalisation, the most recent in the latter category being the September,2001 attack on the World trade centre. In this lesson, we shall deal with this topic in detail.

12.3 MEANING OF GLOBALISATION

Economic globalisation is understood as the widening, deepening and speeding up of worldwide interconnectedness. Economic globalisation constitutes the dominant tendency in the contemporary world economy (Mcgrew).

The approaches to globalisation in global political economy are different from those in other social science fields. This will become clear from the following definitions:

“Economic globalisation is generally specified in reasonably precise terms as the emergence and operation of a single, worldwide economy”(Grieco and Ikenberry 2003)”.

“ The intensification of worldwide social relations which link distinct localities in such a way that local happenings are shaped by events occurring many miles away and vice versa” (Giddens 1990).

“The integration of the world economy” (Gilpin 2001).

“De-territorialisation or the growth of supra-territorial relations between people” (Scholte 2000).

“ A global economy in which distinct national economies and therefore domestic strategies of national economic management are increasingly irrelevant” (Hirst and Thompson 1999).

“The international integration of markets in goods, services and capital” (Garrett 2000).

As becomes clear from the above definitions, in a broader social science literature, globalisation is not confined to economy, but is multidimensional and spread across and affecting every sphere of life.

In general, we can say that globalisation means more interconnectedness. Many scholars like Keohane and Nye consider it a process than a fixed outcome. They refer to a fixed outcome or condition at a particular point of time as globalism.

12.4 CONDITIONS FOR ECONOMIC GLOBALISATION

While discussing the conditions or determinants or the causal factors behind economic globalisation, scholars usually follow different approaches. Here the focus shall be on understanding the conditions responsible for the current phase of economic globalisation. Let us explain the different causes of economic globalisation, by relying on the relevant literature.

There are three interrelated factors or forces which explain economic globalisation. They are: techniques (technological change and social organisation) ;economics (markets and capitalism) and politics (ideas, interests, institutions). They are so interrelated that, as Garrett states, the main problem for analysts is to unbundle them. Let us explain them one by one.

Technics A world which has to be interconnected requires advanced communications infrastructure. The reduced cost in transportation and communications technology has compressed time and space and as scholars call it, 'shrunk the globe'. The so called informatics revolution has caused a global shift in which there is a move towards post-Industrial or service based economies in the advanced world and a rise in industrial eco

Economics In this case, there are two approaches: that of orthodox economics, which explains globalisation in terms of market dynamics; and that of radical political economy, which explains it in terms of imperatives of capitalism.

The former approach considers globalisation to be a direct consequence of market competition whether in trade or production. So profit, wealth, market position etc. are the economics logics behind global economic integration. The latter approach which draws on Marxist theory attributes globalisation to certain factors like expansionary and universalising logics of capitalism. It means that capitalists desire for more and more capital accumulation. This is achieved through overproduction and the impoverishment of workers. Search goes on for new markets, sources of raw materials, cheap labour, and the government facilitates this.

Politics Politics which stands for ideas, interests and institutions forms the third logic of economic globalisation. There is a move towards market driven politics (Leys 2001) and by laying emphasis on laissez faire policy of capitalism, politics has provided ideological infrastructure. Governments have proved to be very important factors of economic globalisation, as almost all decisions regarding tariff removal or other reforms are taken by them. The hegemonic role and power of USA, in this phase of globalisation can't be underestimated.

12.5 IMPACT OF GLOBALISATION

In the discussion that will follow, we shall focus on economic globalisation, which resulted from reduced trade barriers as a result of multilateral trade system. In this regard, it is important to mention two very important components of globalisation, trade flows and MNCs. Let us discuss the impact of globalisation on nation states.

Impact on trade The reduced trade barriers have led to significant expansion in world trade. It has been observed that in the post war period, world trade grew much faster than the world output, and in particular since the beginning of 1990s(Irwin 2002,WTO 2006).In 1998, world exports, as a proportion of world output were three times greater than the figure in 1950.Despite the disturbances like September 2001 attack and different crises, world trade measured as a proportion of world output remained at levels well in excess of the high points of 1990s globalisation (Kearney and Foreign Policy globalisation index2003, WTO 2003a,WTO 2006a).The positive impact was felt both for merchandise trade as well as services trade.

The share of developing economies in world export market grew from 19.2% in 1970 to 32.1% in 2005.They have become important players in manufacturing as well as services trade. Despite the fact that the world trade is still geographically concentrated to a few advanced industrialised countries, and most of the developing countries' trade is accounted for by that of east Asian economies, the concentration has reduced over a period of time. New groups like BRICS have emerged, which are making a difference and making the presence of developing countries felt.

As per a report of UNCTAD (UNCTAD 2005),a new global division of labour is taking place, which means change in the countries' trade specialisation in the world economy. According to the global division of labour, a country should specialise in those goods, in which it holds comparative advantage. This has led to the following observations:

- The advanced industrialised countries hold comparative advantage in capital and human capital intensive goods like pharmaceuticals, computers and software, telecommunications equipment etc.
- The services trade of OECD economies have increased (WTO 2006a).
- Due to changing location of production, Newly industrialising economies (NIEs) of East Asia have emerged as world's factories.
- Apart from reduced costs of transportation, the communications revolution, liberalisation and the growth of TNCs has contributed to a new global division of labour.
- There has been significant expansion in south-South trade i.e. trade between developing economies. Most of this trade is, however ,among East Asian economies. Due to this growing importance of South, some scholars have argued "South is moving from periphery of global trade to centre".
- Competition has become more intensive as a result of globalisation. Due to increasing pressure of competition, the production has been relocated from an old to a new centre. For example, in 2003, 40% of manufacture imports into the OECD economies were produced in developing economies, as compared with 12% in 1973 (World Bank 2006).
- The contemporary global division of labour is different from that in the nineteenth century. It is much more diverse. Also unlike in the nineteenth

century, when production was localised, now different parts of the same good may be produced in different parts of the world e.g. a personal computer.

Impact on finance Since the liberalisation of national financial markets, the geographical scope of global capital flows has increased tremendously. A study shows that as compared to trade, which showed a compound growth rate of 10% from 1964-2001, trans border financial flows grew at a compound rate pf almost 19% (Bryant 2003). However, it is highly uneven, with emerging market economies having more access to global financial market, while the poorest still denied that. Capital flows to developing states have fluctuated considerably since the 1970s,peaking in mid 1990s, prior to the East Asian crash and subsequently falling back, although by 2006,they had rebounded to the previous peak of 1997 (IMF 2003b,World Bank 2006). There are more evidences of the financial integration having increased since the 1980s.

Part from financial integration, there has also been observed the process of financial deepening (measured in terms of contagion effects, or the synchronisation of financial markets and national business cycles) (Obstfeld and Taylor 2004). Also associated with financial deepening is another important process i.e. of institutionalisation e.g. there is expansion of multinational banking as well as global standard setting activities of IMF, BIS etc.

Impact on production The globalisation of production usually focuses on the role of FDI in production. Outsourcing production around the world has become very common now. Indeed, both investment in overseas production facilities (FDI) and production fragmentation (outsourcing of production to foreign independent third parties), have increased dramatically since the 1970s (UNCTAD 2002c, 2006b).

This process has been dominated and driven by TNCs which are important agents of globalisation and important determinants of the location and organisation of production and services in the world economy. Though like trade and finance, production activities of TNCs have remained geographically concentrated (,with most of the OECD nations important players in inflows as well as outflows), things have started to change recently and have start diffusing.

Labour migration No country remains untouched by international migration (IOM 2005). Labour flows, in terms of direction are said to represent the mirror image of capital flows i.e. South to North. (Held et al 1999). According to Chiswick and Hatton (2003), outward flows are a developing country phenomenon, and despite great restrictions, they are surprisingly ,on a scale of the mass migrations of the early twentieth century. Apart from unskilled labour, skilled labour from South to North is also increasing. The remittances brought by these migrants is adding to the foreign exchange reserves of the labour exporting countries. So we can argue that the global labour market is also getting integrated day by day.

The implications for the world economy are many , given the fact that the restructuring has taken place in the world production and trading etc. The transformation in the world economy is too significant to be ignored. However, some sceptics make the following arguments:

- Globalisation is exaggerated and far from historically unprecedented.
- The world economy was much more integrated and open during 1870-1914.
- Regionalisation and triadisation, not globalisation are the dominant tendencies in the contemporary world economy.
- Globalisation is an ideology that serves the interests of particular social and political forces.

12.6 LET US SUM UP

In this lesson, we have understood the meaning, conditions and impact of globalisation.

12.7 REFERENCES AND SUGGESTED READINGS

- Global Pol. Economy by John Raven Hill
- International pol. Economy by Thomas Oatley

SELF ASSESMENT QUESTIONS

- What is meant by globalisation? What are its essential conditions?
- What is the impact of globalisation on different aspects of economy? Explain.

INTERNATIONAL TRADE AND FINANCIAL INSTITUTIONS

THE INTERNATIONAL MONETARY SYSTEM

Structure

13.1 OBJECTIVES

The basic objectives of this lesson are :

- To enable the learner to understand and explain the international monetary system, its working, different stages through which it has passed etc.
- To enable the learner to know why the earlier systems collapsed and what are the basic features of the present system.

13.2 INTRODUCTION

The international monetary system is the structure of financial payments, settlements, practices, institutions and relations that govern international trade and investment around the world (Kenneth N. Matziorinis**).** International monetary system is the international counterpart of national monetary system. Each nation has a domestic monetary system, in which there is a central bank which issues currency, and commercial banks and other intermediaries to facilitate different transactions. International monetary system differs from it in the sense that while making international payments, each country needs to convert its currency into an internationally acceptable currency. For this, it gets the services of foreign exchange market. In this lesson, we shall discuss about the different stages through which this system has passed.

13.3 THE DIFFERENT PHASES OF INTERNATIONAL MONETARY SYSTEM

Monetary standard is an important component of monetary system. From the very beginning, different commodities have been used as money. There are many ancient examples of cattle, stones etc. being used as money. Precious metals too have a long history in this regard. Gold and silver have been used since centuries till they were abandoned and replaced by paper money. So the international monetary system has covered a long journey. It can be broadly divided into the following phases:

13.3.1 Gold standard (1815-1914)

A gold standard is a monetary standard in which gold is used to play the role of medium of exchange, store of value and unit of account. So it is an example of monometallic standard. The paper money had to be converted in terms of gold.

It has been thus defined:

According to D,H. Robertson, "Gold standard is a state of affairs in which a country keeps the value of its monetary unit and the value of a defined weight of gold at an equality with one another."

Coulborn thus defines it : "The gold standard is an arrangement whereby the chief piece of money of a country is exchangeable with a fixed quantity of gold of a specific quality."

Each country had set the value of its currency in terms of gold. The rate at which the domestic standard money was converted into gold was called 'mint price of gold'. It was popular in most countries of the world from 1870-1914.UK adopted it first of all as early as 1816. But it also abandoned it first of all in 1931. Germany, France and USA adopted it in 1873, 1878 and 1900 respectively. By 1936, all countries of the world had abandoned it.

The guarantor of the gold standard became the British government. It made the pound fully convertible to gold at a rate of .0204 troy ounces of pure gold.[20]

There were some special reasons due to which British currency was well placed to be the most important currency in the world. Some special circumstances had led to emergence of Britain as the undisputed leader in maritime, industrial and commercial power following Napoleon's defeat at the battle of Waterloo in 1815.[21] It had got the position of dominant naval force in the world as well as through her colonies, emerged as the principal trading nation in the world. Secondly, through certain positive changes due to the industrial revolution which began here in the 1770s and transformed

Britain's economy, Britain became the main manufacturing and financial centre of the world. Through improvements in technology and related fields, it became too important not to be considered as the centre of economic gravity in the world. .Another ground for Britain being dominant was innovations in science (Sir Isaac Newton and Charles Darwin) and the development of economic theory particularly in the area of trade. **David Hume, Adam Smith, David Ricardo having advocated** free trade policy did contribute to strengthening its position. Finally, Political stability and emergence of democratic forces further led to an open economy and society of Britain. Once favouring protectionism, it finally repealed Corn Law in 1840s thus putting into practice free trade policy. All these factors made Britain emerge as the main financial and trade centre during gold standard.

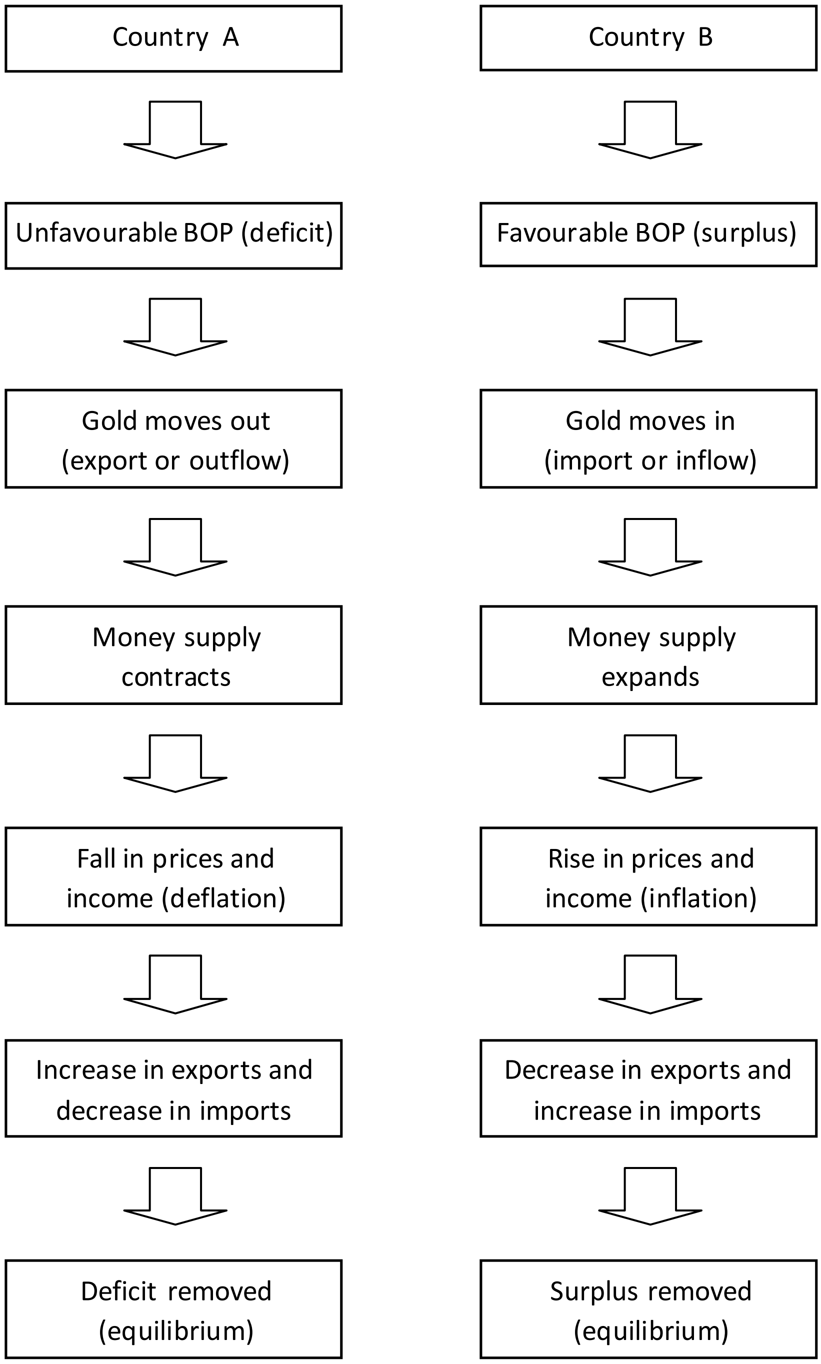
13.3.1.1 Functions of gold standard:

The gold standard had two main functions: to maintain internal price stability and foreign exchange rate stability. The former was achieved by linking the supply of money with gold reserves. As gold reserves of a nation are limited, no additional money supply can be generated. So price stability is ensured. As the people can buy gold from monetary authorities at a fixed rate, gold standard also helps maintain exchange stability in the following way :If the country in question has a balance of payments deficit i.e. is falling short of foreign currency, the importers can pay in the form of gold, hence the demand for foreign exchange can be reduced and exchange stability can be maintained.

13.3.1.2 Automatic working of gold standard

Let us now see how under the gold standard, balance of payments of all the countries could be achieved automatically, without the interference of the monetary authorities.

Let us assume that there are two countries: A and B. Let A suffers from BOP deficit, whereas B has BOP surplus. The self adjusting mechanism of gold standard, in which through movement of gold, balance shall be maintained, has been explained below.


Country A
Country B
Unfavourable BOP (deficit)
Favourable BOP (surplus)
Gold moves out (export or outflow)
Gold moves in (import or inflow)
Money supply contracts
Money supply expands
Fall in prices and income (deflation)
Rise in prices and income (inflation)
Increase in exports and decrease in imports
Decrease in exports and increase in imports
Deficit removed (equilibrium)
Surplus removed (equilibrium)

To explain it in other words, having a look at the above figure, we notice that four steps lead to final BOP equilibrium. These are: movement of gold, change in money supply, change in prices, and change in exports/imports and finally restoration of equilibrium. So under gold standard, which followed specie flow mechanism (explained above), world trade and financial regime was at its best. As there were no obstacles to free trade, or to export and import of gold, the world economy flourished a lot and was quite stable. So by following simple rules of the game, all nations benefited out of the liberal regime.

13.3.1.3 Conditions for the operation of gold standard.

According to Crowther , "The gold standard is a jealous God. It will work provided it is given exclusive devotion".

The following conditions or rule of the game had to be followed by the countries on gold standard:

- Rules to be followed The simple rules which would lead to smooth working of gold standard were : no restrictions on movement of gold, linking of money supply with gold reserves and cooperation of the monetary authority.
- The monetary authority should strive to maintain exchange rate stability.
- The automatic working is not possible without flexibility in prices and wages. As the figure above shows, in case of a BOP deficit, deflation is inevitable, whereas in case of BOP surplus, a country would experience inflation. These flexibilities shall finally restore BOP equilibrium.
- No restriction on trade.
- Political and financial stability and absence of large capital movements.

13.3.1.4 End of gold standard

The gold standard worked well till the first world war i.e. 1914. But the First World War in 1914 led to its abandoning, since the rules couldn't be followed. After the war was over i.e. in 1918, it was tried to revive it. So by 1925, it was re-established. But the great depression (1929-33) put a permanent set back to it . By 1937, it had disappeared from the world economy.

Following were the factors responsible for the breakdown of gold standard

- Rules were not followed after 1914.
- Free trade policy was abandoned due to protectionism during war.
- During the interwar period, few countries like USA and France accumulated too much of gold, which led to unequal distribution of gold reserves. Those with little or no gold had to abandon gold standard.
- There was large movement of capital , which also led to its breakdown. Victor nations of WW-I forced Germany to pay war reparations in gold (The Versailles treaty), there was large movement of refugee capital in search of security and excessive borrowing by UDCs. This external indebtedness resulted in complete breakdown of gold standard.
- After world war –I, there was the absence of an International monetary centre like London.
- There was lack of cooperation on the part of different nations.
- Great depression was a major cause of its breakdown.
- By this time economic nationalism had risen in most of the European countries, which increased protectionism. Restrictions were imposed. This interfered with the smooth working of gold standard.

13.3.2 The Bretton Woods system (1944-1970) :

The Bretton Woods system followed the breakdown of gold standard. It refers to the International Monetary System that emerged in post world war –II era. It was being planned long before the war was over. An agreement was drafted by British and US officials earlier but ratified in 1944 at the International Monetary and Financial conference, held at Bretton Woods, New Hampshire. Bretton Woods twins were born: IMF (International Monetary Fund) and IBRD (International Bank for Reconstruction and Development).The system came to be known as the Bretton Woods system.

As we are aware of the developments that preceded the Bretton Woods system, the world economy was no more stable or liberal post gold standard abandoning. Interwar years and great depression had pushed most of the countries to protectionism. Inflation in countries like Germany (> a trillion fold rise in prices in 1922-23) was unmanageable and disastrous. Some efforts to revive the gold standard didn't materialize, as the conditions conducive to its smooth working (before 1914) were missing now. The US and UK officials giving final shape to the upcoming monetary system had many challenges. They had to keep in mind the bitter experience of inter war years. Most of the nations facing BOP deficits in early 1930s had to abandon gold standard (fixed exchange rate) and let their currencies float, as this was the only option left, given the domestic policy constraints. In other words, domestic pressure groups didn't let the governments maintain external balance at the cost of domestic economy. But most of the nations, including USA and Britain were dissatisfied with the working of floating exchange rate of post gold standard collapse. It was also mentioned in a study by League of Nations in 1944. To meet these challenges of the existing situation, these officials had to balance certain things like exchange rate stability with minimum need for domestic economic adjustment (Oatley). So in the new system, they kept certain innovative features .

13.3.2.1 Basic features

Following were the basic features of Bretton Woods system

- **More exchange rate flexibility** As per the Articles of Agreement [22] of the IMF, the member countries had to peg their currencies to gold or the US dollar (Dollar was pegged to gold at $35 per ounce).A relatively fixed exchange rate, it allowed fluctuation in exchange rate within 1% of the band (fixed or central parity, which later increased to 2.25%) on either side. So the world economy had moved away from a rigidly fixed exchange rate of gold standard to a fixed-but adjustable exchange rate of Bretton Woods system. Some scholars also call this band system or Bretton woods system as 'snake in the tunnel' movement (though it is more true and is said generally about EEC's decision in May 1972 to hold their currencies to one another at 2.25% and to rest of the word at 4.5%). If a country had to change this exchange rate, it had to give justification to IMF regarding 'fundamental disequilibrium'(large imbalances) in its BOP position. If a country feels the need for devaluation, it needs to consult the IMF. If IMF finds that it shouldn't be devalued, but that country still devalues, it can't draw from stabilization fund.

- **IMF** It was further agreed that IMF shall be a reliable source of 'reserve credit'. It would serve as a central bank (early British plan drafted by Keynes) and issue its own currency, 'Bancor'.But USA didn't accept the idea. So finally, it was decided that IMF shall have a pool of currencies to help a member nation overcome BOP difficulties.

As mentioned earlier, IMF's consultation was required for a member's decision to devalue its currency. So IMF was there to monitor the macroeconomic policies and BOP positions of different countries. It had some authority over exchange rates and full control over stabilization fund. The basic purpose was to prevent two undesirable behaviours on the part of member countries: competitive devaluation (experienced during inter war years) and relying too much on stabilization fund for meeting bop deficit. There was no direct access to the fund, but was through IMF's conditionality clause, (except the first credit tranche).

- **Stabilisation fund** To serve the purpose of helping a member nation correct its BOP difficulties, a credit mechanism called stabilization fund was generated. So there was no frequent need for devaluing the currency for correcting BOP position. Each member had a fixed quota, which depended on that country's position in the global economy and decided the country's subscription to the fund, as well as the extent to which it can draw on the pool in case of need. It had to pay 25% of its quota in reserve assets (earlier in gold) and 75% in domestic currency. A member country could borrow 25% of its quota in a year, with a maximum of 100% of its quota (increased later due to introduction of special credit facilities by IMF) .The quota was divided into four 'credit tranches' of equal size (i.e. each equal to 25% of the quota). Drawings in the first were approved automatically, while in the higher credit tranches, certain conditions had to be fulfilled, generally referred to as 'conditionality clause'. The quotas have been revised many times.

- **Capital controls** It was observed by many governments that capital movements had destabilizing and 'disequilibrating' effects. The BOP deficit countries were losing capital to BOP surplus countries instead of the other way round. To check these disturbances due to capital flows, exchange restrictions were imposed after the collapse of gold standard . After the new system came into being, it was debated and resolved that in a liberal regime, exchange restrictions are not justifiable. It was agreed that capital controls should be imposed as far as convertibility in capital account is concerned, but countries should remove all restrictions on settlement of current account transactions.

13.3.2.2 The operation and collapse of Bretton Woods system

In the first decade after WW-II,USA had emerged as a dominant world economy. Immediately after war, many economies had to go for re-construction. At the end of 2nd world war, USA held between 60-70% of the world's gold. The dollar was fixed to gold at $35 per ounce of gold. To make international payments or for making other transactions, most of the countries turned to US dollar. So US dollar became the 'primary reserve asset' of other governments i.e. in terms of which other countries kept their foreign exchange reserves. The smooth working of the Bretton Woods system thus had US economy and currency as the basic pillar without which it would collapse. Many scholars agree that it was not until 1959 that the system started working in the real sense.

Let us discuss the various steps which finally led to the collapse of the Bretton Woods system

1. **From dollar shortage to dollar glut** Immediately after war, the system was desired to be implemented but couldn't be done due to the following reason: shortage of US dollars. In fact, most of the economies had been severely damaged and were urgently in need of reconstruction. For reviving their economies and for meeting basic needs, some essential goods had to be imported for which dollars were required. So the full working was not possible unless the dollar shortage was met . US, in its initial policy, deliberately ran BOP deficit. Through Marshall plan ,foreign aid and military expenditure were employed to transfer dollars from USA to West European countries. Also in late 1950s,private capital started flowing out of USA to Europe . Most of the dollar outflow was the inflow to European countries who used it to meet needs for imports. Thus the actual working of the system started in 1959.So the dollar shortage in a way meant that no other nation was in a position to challenge the competitiveness of US economy.

However, in 1958, US BOP deficit became a serious issue. Between 1958 and 1970, US ran average annual BOP deficit of $3.3 billion. The dollar shortage gave way to dollar glut or overabundance of dollars. Due to more accumulation of dollars elsewhere than in US, foreign claims on American gold became more than America's holding of gold. This was referred to as 'dollar overhang'. In 1948, US had $24.8 of gold holdings, against foreigners' holding of $7.3 billion. By 1970, the situation had changed drastically. American gold holdings were 11 $billion, whereas foreign claims against this gold was $47 billion .The persistent BOP deficit of USA could not meet the commitment that had sustained the system: to meet foreign claims on American gold reserves at official rate of $35 per ounce.

So gradually, the US dollar's role was diminished and faith in the existing system got shaken.US could correct the situation by pulling dollars back to US by running BOP surplus. But it would have affected international liquidity adversely.

To correct the liquidity problem, countries like France suggested that an alternative reserve asset should replace US dollar. To supplement the dollar, a new reserve asset, SDR, (special drawing right) was introduced in 1970. The SDR was to be allocated to a country depending upon its quota.

2. **Crises and collapse** There were two visible threats to the Bretton Woods system: breaking down of 'gold exchange standard' and adjustable peg exchange rate regime.

The problem of gold exchange standard, in which dollar was losing its place and confidence was being eroded needed reversal through different alternative options. It could be devaluation of dollar by US, reduced economic activity in US to reduce imports or increased economic activity in other countries to promote US exports.US expected retaliation (competitive devaluation) in case it went for unilateral devaluation. Another option was that other countries could go for revaluation of their currencies against dollar. But no one seemed to be interested in bearing the cost of adjustment, though it was a serious issue of restoring confidence in the international monetary system.

Inside US, neither the Nixon nor the Johnson administrations were willing to correct BOP deficit at the cost of domestic policy constraints. In 1969, Nixon blamed the exchange rate and trade policies of other countries for this situation of US.

Later, steps taken by some countries like Germany and Japan tried to postpone the 'crisis of confidence' in the dollar's convertibility into gold. Germany and Japan decided not to convert their reserves into gold. Also Germany entered into some offset negotiations with US. Also Germany couldn't keep supporting the fixed rate regime without inviting trouble (Inflation) which it wanted to avoid, given its bitter experience in this regard. Also France played spoilsport. It was not willing to adopt such policies and continued to demand gold.

Private speculation also increased. US found the situation unsustainable. Situation worsened and confidence in dollar continued to erode further.US had two options left: cut back the printing of dollars or end the currency's convertibility into gold. In August 1971, Nixon administration suspended the convertibility of dollar into gold and imposed a surcharge of 10% on imports. Dollar's convertibility into gold was abandoned. This move by US to terminate the convertibility of dollar into gold is also referred to as 'Nixon shock' .Some scholars call it the end of 'American Hegemony' in the world political economy, while others argue that America still plays a vital role in it.

An attempt by governments to prevent the full collapse of the system was made in Dec. 1971 at the Smithsonian institution, Washington D.C.(and hence the name) with the signing of Smithsonian agreement. Nixon called it the greatest monetary agreement. In it, US dollar was devalued by 8% against gold, (from $ 35 per ounce to $38 per ounce), while European currencies were revalued by 2%. Also the margin of fluctuation increased from 1% to 2.25%. But nothing could prevent the collapse.

The breakdown of this feature of the Bretton Woods system was predicted by Triffin in 1960, when he stated the following regarding the instability of gold exchange standard [23] "International liquidity in such a system (based on dollar as the central reserve currency) could be expanded only when the US provided the world with more dollars by running a BOP deficit. But the more it did so, the more it risked undermining confidence in the dollar's convertibility into gold". This has been referred to as 'Triffin dilemma'.

As mentioned earlier, the second feature that broke down was the adjustable peg system. In 1973, when the countries allowed the world's major currencies to float. But, as most of the nations had experienced floating exchange rate system during inter war years badly ,it was thought to be a temporary phenomenon. But policy makers and scholars reconsidered the merits of such a system in changed circumstances. It was the most appropriate in the given situation. So in 1976 (at Jamaica), an amendment was made in IMF articles to legalise floating exchange rates. It was declared that each country had the responsibility for maintaining the par value of its currency. In 1978, another amendment stated that a country can choose an exchange rate arrangement of its choice. If it wants to float, it can float; if I wants to maintain some pegged system, it can do so. Thus the post war monetary system came to an end.

13.3.3 Present International Monetary system

Post Bretton woods, no single system is popular. There is a mixture of different exchange rate arrangements. The apprehensions of different nations regarding floating exchange rate system have been reduced due to their recent experience which shows that it has not adversely affected the growth of international trade and investment. The countries no more need to put in place exchange restrictions to set BOP position right. The contemporary international monetary system can be discussed under the following headings:

13.3.3.1 International Financial Integration

After the collapse of Bretton Woods system, governments have removed most of the restrictions on international capital flows, with many repercussions for the International Monetary System. As we know, financial market facilitates the transactions between those who need funds, i.e. borrowers and those who have surplus funds or lending capacity. The lender always expects a return on his savings, whereas investor is ready to give a price for borrowing. If there are no hindrances to the smooth functioning of such a market, there is efficient flow of funds. Then there are national as well as international dimensions of the issue. While national financial market deals with such transactions among residents of a country, international system deals with cross border financial transactions. International financial integration shows how far the restrictive policies of the government have been eliminated.

During Bretton woods, most of the governments resorted to various restrictions on international capital flows to make the cross border financial transactions (i.e.

transactions in which borrowers and lenders belong to different countries) difficult. So if a person wanted to import a commodity, it was not so easy for him to get the foreign exchange required for payments. In some cases, such restrictions were meant to discourage capital outflows, but also inflows in certain cases (Germany\in late 1960s and early 1970s).Throughout the early post war period, these controls segmented national financial systems into distinct reservoirs (Bryant 1987).

In 1950s, Eurodollars were created. These were dollar denominated bank accounts and loans[24] managed by banks outside USA, and were an innovation of British banks. British banks had played a dominant position in international finance before 1914. They wanted to continue that in changed circumstances. Moreover, Soviet Union needed dollars to purchase things from the west. British banks allowed Soviet Union to open dollar denominated accounts in London and these were used by British banks to lend dollar denominated loans .It gave birth to 'Eurocurrency banking' or euro markets. The creation of this system (in which more currencies were added later in addition to dollar, and saw its expansion beyond London) did not reduce in any way the restrictions imposed by different nations on capital controls. Instead, it has been considered as having created a parallel universe. The British citizens were not allowed to have access to the euro market, whereas foreigners were allowed. So it too, in a way, prevented the capital flows.

However, this system had one impact on the governments' policies. This period marked the onset of revolution in information and communication technology (1970s and 1980s). It was very difficult for the governments to regulate their financial markets and stay isolated by putting strict barriers between national and international systems. Capital flows started increasing, due to more open communication between residents of different nations. Nations found it difficult because, capital has always a tendency to move towards high interest area. Some nations observed outflow, whereas some inflow, depending on the movement in the return on domestic currency in the domestic market as well as the euro market. So by late 1960s and early 1970s, the dikes imposed by governments were becoming irrelevant, if they had not disappeared totally.

Further impetus to this changing situation was given in 1980s, when most of the states saw change of power in favour of those who wanted reduced role of state and a liberal financial system. The first one to do so was Great Britain (in 1979, Thatcher of conservative party came to power). Soon others followed. So by 1990s, most of the industrialized nations had dismantled the capital controls. Also post 1980s, more and more developing countries are opening up for such transactions. So the extent of international financial integration has increased in developing countries as well, though it has been confined to a few nations.

13.3.3.2 Exchange rate arrangements in a world of mobile capital

The post Bretton woods system of reduced capital controls and increased capital flows has affected exchange rates tremendously. Instead of eliminating current account imbalances with some adjustments, governments now finance them due to more capital flows across borders. This has increased volatility in exchange rates and led to large currency movements called 'misalignments'. These are posing challenges to the global economy. So international financial integration has made exchange rate cooperation difficult.

a) Floating exchange rates

We are aware of the floating of major currencies in the post Bretton Woods period. It is managed float system, in which governments intervene in the market to influence currency values. Initially, most governments believed that this system will take care of all the current account imbalances.

The system was to work like this:

Current account deficit

↓

Imbalance in foreign exchange market

↓

Currency depr eciation

↓

Increase in exports

↓

Current account balance restored

Likewise, for a current account surplus country, it would be

Current account surplus

↓

Imbalance in the foreign exchange market

↓

Currency appreciation

↓

Increase in imports

↓

Current account balance restored

Had it been the case, current account adjustment would have been automatic. However, these expectations of most nations have not been met, as many countries including USA, Japan, Germany have been facing the issue of current account imbalances for many years. So currency movements have not resulted in automatic correction. Many experts attribute this situation to America's deficit. It has been observed that the international financial market has diverted funds from current account surplus countries to USA. It has thus been able to finance its \deficits, instead of resorting to 'adjustment', the real solution. This has led to increased indebtedness and adversely affected America's 'International Investment position'. Paying this debt would have many repercussions for the American Economy.

Such capital flows have also led to exchange volatility in the short run and exchange misalignments in the long run. The latter has been observed in case of the dollar, yen and German mark from 1979-1998.Misalignments have disastrous consequences, as no insurance is provided against currency movements for more than one year. It may also lead to some political decisions, on the demand of victimized domestic pressure groups. For example, in 1985, US passed an anti-Japan legislation, as dollar had appreciated so much that most of the industries saw their exports fall. It was attributed to Japan's policies, and hence the legislation.

b) **Managing exchange rates** To counter these fluctuations in currency movements, governments have been trying to manage these exchange rates in two ways:

i) **Exchange rate cooperation in the group of 5** Group of 5 refers to USA, Japan, Germany, Britain and France. In 1985, a pressure came from these countries for exchange rate cooperation among themselves, as USA had been sticking to a policy of 'being neglected' with regard to dollar's exchange rate. The first Reagan administration in early 1980s didn't consider the issue of growing current account deficit and that of capital inflows (to finance it) seriously. The dollar appreciation as a result of it was considered as a sign of strength of US economy. Soon protectionist tendencies increased. However, in the first year of Reagan's second term, it was realized that dollar policy needs reconsideration and a change to prevent further rise in its value. James Baker-III, who was appointed as secretary of the treasury too had reduction of dollar's value on his priority list.

The discussions among G-5 countries finally led to 'Plaza Accord ' of September 1985 at hotel Plaza in New York. It was agreed to reduce the value of dollar against Japanese yen and German mark by 10-12%. It required foreign exchange interventions by these governments whenever it was felt that dollar is moving up. Through this strategy, dollar had fallen about 40% by 1987.

Soon, the Plaza agreement was followed by further discussions for deeper exchange rate cooperation. It was agreed to have a target zone, a system of fixed but adjustable exchange rate, in which each currency shall have a central parity with margin of +/- 10%. So it could fluctuate 10% beyond the central parity. But when it exceeded this limit, governments would interfere in the foreign exchange market.

But none of these proposals proved effective. US pressurised the other countries to resort to expansionary fiscal policies. But they were not ready to do that, given their experience with its impact on domestic economy. Moreover, monetary policy would have been more appropriate in this regard. But since late 1980s, rarely have they used this coordinated foreign exchange market intervention (except in 1994 and 1995, when US dollar depreciated rapidly and in 2000, when the depreciation of Euro had to be slowed).

ii) Exchange rate cooperation in the EU: In what was called as a 'European wide exchange rate system', the EU countries tried to formalise and institutionalise the exchange rate cooperation among themselves. This was required, given that fact that most of the trade among European nations was within the region. So any fluctuation was going to affect their trade relations. Moreover, they were experiencing inflation in early 1970s, post Bretton Woods system, when they moved to floating exchange rate system, in which the constraint on monetary policy was removed. Too much money supply is inflationary. So they wanted to formulate a policy in which they could maintain a fixed exchange rate within the region, to control inflation.

Initially, it was attempted to have a 'regional exchange rate system' in 1973.However, France, Italy and Britain had withdrawn their currencies by 1976. In 1979, a second attempt was made in the form of 'European Monetary System'. In it, a central parity was established against a basket of currencies, called European Currency Unit' (ECU). The individual countries would have to engage in bilateral arrangements given this central parity. They were allowed fluctuations =+/- 2.25% beyond the parity.

But soon it was observed that the system had been centred on Germany, the country with the strongest currency and the lowest inflation at that time. German central bank Bundes bank was hesitant in participating in this system of fixed but adjustable exchange rate ,through interventions. It didn't want to use its monetary policy to support other countries with weak currencies, but in maintaining price stability at home. The onus of maintaining a fixed exchange rate through intervention lay with the high inflation countries, who maintained their currencies' exchange rates against the mark. They had to adopt restrictive monetary policy to contain inflation.

In 1981, newly elected French president Mitterand used an expansionary monetary policy. It led to inflation, deterioration in France's BOP deficit and weakening of France. But Mitterand blamed the policies of other countries for this and was not ready to reverse this policy. It put this system in danger. It was only 18 months later that he agreed to reverse his policy. However, situation was never so uncertain after this.

In 1988, the European countries wanted to embark on a new journey. They wanted to move up on the ladder of integration by forming a monetary union. Its basic components were a common currency and a central bank. More economic integration thus justified their cooperating deeply in exchange rate system as well.

In this way, exchange cooperation took place between advanced industrialized nations and among European nations.

c) **Capital flows and reforms**: It has been experienced by most of the nations that a fixed but adjustable exchange rate system is not effective in solving the exchange rate problems. It is increasingly unworkable in a world of mobile international capital (Fischer 2001;Summers 2000). They have been proved to be vulnerable to speculative attacks(large sudden sale of a currency in case of anticipated devaluation of that currency).This has been observed during the Bretton woods system itself, when it was observed in case of dollar, and later in most other currencies. In such circumstances, the government's intervention is required, when it needs to make necessary changes in the domestic policy to correct the BOP position. These attacks are influenced by one most important factor: government's intervention in re-aligning exchange rates. The governments are many a time, either not willing or not able to do the corrective adjustments at home.

Seeing the impact of these speculative attacks, many scholars feel that the fixed but adjustable peg system of exchange rate is not a viable policy option. Due to this, this system is becoming less and less popular day by day. Whereas, 62% countries of the world maintained this system in 1991, it reduced to just 34 in 1999.The shift is towards a floating or a permanently fixed exchange rate system. However, there doesn't seem to be a near possibility of a system like that in EU.

Some scholars therefore suggest accompanying exchange rate reforms with limited international capital flows (in short term), through a 'Tobin tax'. The idea was first proposed in 1972 by Nobel prize winner economist James Tobin and advocated later by some antiglobalisation groups to prevent international currency movements. It is a small tax on foreign exchange transactions. It, according to Tobin "puts sand in the wheels of International finance" by slowing cross border capital flows, rather than ending them. But it would amount to re-introducing capital controls, which might not make much sense in the changed global political-economic environment.

13.4 LET US SUM UP

To conclude, we can say that post Bretton Woods, no system is yet in place. In the initial years, there was a move towards managed float. Reduced capital controls have been proved to have destabilizing effect on the world economy. Most of the nations are finding it difficult to manage and cooperate in exchange rate management.

13.5 REFERENCES AND ESSENTIAL READINGS

- *The International Economy* by Peter .B. Kenen
- *Global Political Economy* by John Ravenhill , 2nd edition, p.222
- *The International Political Economy* by Thomas Oatley

SELF ASSESSMENT QUESTIONS

- Explain the automatic working of the gold standard. What were the conditions required for it, and why did it collapse?
- Explain the operation and end of the Bretton Woods system.
- Write a note on the contemporary International Monetary system.

INTERNATIONAL MONETARY FUND (IMF) AND WORLD BANK

Structure

14.1 OBJECTIVES

The main objectives of this lesson are:

- To enable the learner to understand the role of IMF and world Bank as international financial institutions.
- To enable the learner to know about the working of these institutions.

14.2 INTRODUCTION

We have learnt about the IMF's role in the International Monetary system in the last lesson. In this lesson, we'll be able to get a comprehensive view of the working of IMF and World Bank.

14.3 THE IMF

The International Monetary Fund came into existence in December 1945 as a result of UN monetary and financial conference of 44 countries in 1944 at Bretton woods. The number has now grown to 188. It was one of the two twins born at Bretton woods. IMF was assigned the task of finding a solution to the problem of International liquidity and exchange rate stability. The period from 1918-1939 has been characterised as one of monetary confusion and chaos, as countries retreated into protectionist tendencies and imposed different restrictions which adversely affected the international trade and investment flows. There also arose the issue of International liquidity. So there was a dire need for a system which could take care of this issue of augmenting international liquidity. IMF was the best choice at that time. From 1946 until 1973, the IMF managed the "par value adjustable peg" system. As we are aware, the U.S. dollar was fixed to gold at $35 per ounce. The currencies of other countries were fixed to dollar. In 1973, US delinked dollar from gold and thus the Bretton woods system of fixed exchange rate came to an end.

14.4 OBJECTIVES OF IMF

The IMF has six purposes [25] that are outlined in Article I of the IMF Articles of Agreement:

- promoting international monetary cooperation;
- expanding the balanced growth of international trade;

- facilitating exchange rate stability;
- eliminating restrictions on the international flow of capital;
- ensuring confidence by making the general resources of the Fund temporarily available to members; and
- adjusting balance-of-payments imbalances in an orderly manner.

14.5 OPERATION OR WORKING OF THE IMF

The IMF's working mechanism was deliberated before it was born. There were two rival plans, Keynes plan presenting British point of view and White plan presenting that of USA. Finally, the plan by White was accepted.

Under 'General Drawing Rights' provision, a member country can borrow from the fund if it faces a temporary deficit in the BOP. There are borrowing limits ,25% in a year of the member's quota and 125% in all. So if annual quota is exhausted, in 5 years, the total quota is exhausted. So IMF provides for meeting short term or temporary BOP difficulties in this provision. If it is not being addressed, it is presumed that it is a long term problem, to be addressed through a special provision, 'fundamental disequilibrium' clause.

Quotas

Every member of IMF has to contribute to it. A country's quota depends on the relative weight of that country in the world economy. The quota of a country decides its subscription (how much it should contribute), access to financing (how much it can get from the fund) and voting power of that country(the extent to which it can influence decision making in IMF).

The total of all member countries' quota subscriptions is 238 billion IMF Special Drawing Rights (SDRs), approximately $368 billion.(Source: IMF site).A country has to pay 25% of its quota, the so-called "reserve tranche," in the form of reserve assets or special drawing rights (SDRs). Rest of the quota is to be paid in domestic currency.

Voting and Influence at the IMF

The Executive Board or Board of Governors of the IMF can approve loans, policy decisions, and many other matters by a simple majority vote. However, a supermajority vote is required to approve major IMF decisions. The supermajority may require a 70% or 85% vote, depending on the issue. A 70% majority is required to resolve financial and operational issues such as the interest rate on IMF loans or the interest rate on SDR holdings. An 85% majority is required for the most important decisions, such as the admission of new members, increases in quotas, allocations of SDRs, and amendments to the IMF's Articles of Agreement. [26]

14.6 FUNCTIONS OF THE IMF

To promote international monetary stability [27], the IMF performs the following functions:

(1) surveillance of financial and monetary conditions in its member countries and in the world economy;

(2) financial assistance to help countries overcome major balance-of payments problems; and

(3) technical assistance and advisory services to member countries.

Surveillance

The IMF provides surveillance of the international monetary system "in order to ensure its effective operation" and to "oversee the compliance of each member with its obligations" to the Fund. In particular, "the Fund shall exercise firm surveillance over the exchange rate policies of member countries and shall adopt specific principles for the guidance of all members with respect to those policies."

However, generally, the IMF's recommendations after surveillance are not binding on the member nations, unless other members pressurize for the same. However, generally members agree to cooperate and not to adopt policies, as cause disruptions in the international monetary system. So they generally comply with IMF's rules in this regard.

After article-IV consultations with member countries, the IMF staff recommends regarding improvements if any to be made in that country's monetary or fiscal policy or exchange rate situation.

Financial Assistance

The IMF has been created to augment international liquidity. So whenever, a country is in temporary need of funds on account of BOP difficulties can resort to IMF. In severe conditions, other means as per fundamental disequilibrium clause need to be relied upon.

The IMF's lending policy uses repurchase clause. Article XIV:4 states that a country doesn't borrow from IMF, but borrows foreign currency required in lieu of its domestic currency. For example, if India needs pound, it would purchase the required currency and pay in terms of its domestic currency. As per the repurchase clause, the member country needs to repay the foreign exchange by repurchasing its domestic currency.

The IMF has different loan programs .These are:

- **The Stand-By Arrangement (SBA):** The provision was made in 1952,to provide additional reserves to a country if need arose. It has been providing most of the funds to middle-income countries and has addressed their short-term balance-of-payments problems. The repayment period is one to two years. But sometimes, governments take as long as four to five years.

- **Extended Fund Facility (EFF)**: The Extended Fund Facility (EFF) was created in 1974 to address 'more protracted BOP problems with roots in the structure of the economy'. Under normal circumstances, the loan is to be repaid in 4-7 years.

- **The poverty reduction and growth facility (PRGF)**:This facility was introduced in 1999. Before this, low income countries got financial assistance through Enhanced Structural Adjustment Facility (ESAF). In 1999, it was replaced by PRGF. It is \based on a poverty reduction strategy paper (PRSP) prepared by the country concerned in association with different organizations and on it a low interest rate of 0.5% and a repayment period of 10 years is given.

- **Supplemental Reserve Facility and Contingent Credit Line**: These two facilities were introduced in late 1990s after the Asian and other financial crises. Under it ,governments who either experience or are threatened by a currency crisis and are in short term need of large scarce funds, can avail the funds. Generally, governments are discouraged to borrow unless it is a real crisis.

- **Flexible Credit Line (FCL).**It was created in 2009, in the wake of financial crisis. It provides a credit line to countries that have strong economic fundamentals and policies, and that the credit line can be drawn on without new conditionalities being imposed.

- **Precautionary Credit Line (PLL)**: In 2010, the IMF introduced the Precautionary Credit Line, now known as the Precautionary and Liquidity Line (PLL), for countries whose financial situations would make them ineligible for the FCL. A country can request a PLL for six months with a limit of five times its quota. The only PLL program approved to date was for Macedonia in January 2011.

IMF's lending policy towards low income countries:

In its lending policy towards low income countries, IMF has certain programs for concessional lending. Conditionality in this regard puts emphasis on growth promoting reforms, and not on cutting expenditure. Some of these are the Extended Credit Facility (ECF) (for flexible medium-term support to low-income members with protracted balance of payments problem),the Standby Credit Facility (SCF) (to meet short-term and precautionary balance of payments needs) and the Rapid Credit Facility (RCF) (for providing funds within the shortest possible time with limited conditionality to meet urgent balance-of-payments needs). Besides, in 2010, the Fund created the Post-Catastrophe Debt Relief (PCDR) Trust Fund to provide debt relief to low-income countries hit by catastrophic natural disasters. The Policy Support

Instrument (PSI) supports those countries which are not in need of funds, but need advice and IMF's seal of approval for their policies for increasing their credibility in front of international investors.

Technical Assistance

The third function of IMF is to give technical assistance to IMF member countries. It gives technical assistance through the experts in fields of macroeconomic policy; tax and revenue policies; expenditure management; exchange rates; financial sector sustainability; and economic statistics. About 90% of IMF technical assistance goes to low and lower-middle income countries. [28]

Special drawing rights (SDR) :

In early 1960s, the Bretton woods system faced the first noticeable challenge. A need for augmenting international liquidity further was felt. The international liquidity comprised US dollar and gold reserves. It was insufficient, as trade had expanded substantially in post war years. Hence there was need for a new asset to supplement the existing availability of liquidity in the international market. As a result, SDR was born in 1970.A member's access to it depends on its quota in the general account. The SDR is credited to a member's account. Initially, the value of SDR was fixed as 1SDR= 1 dollar. But since 1971, it has been valued in terms of a basket of currencies. Conditions are less strict in case of borrowing through SDR.

14.7 CONDITIONALITY CLAUSE OF IMF

When IMF lends loans to member countries, it keeps certain conditions. It requires a member government to reach an agreement with IMF regarding the steps it would take to correct its BOP situation before it can get access to higher credit tranches. It forces the government to correct the imbalances causing BOP problems. Ex-ante conditionality requires the country to first take necessary steps towards reform before getting the assistance, whereas in ex-post conditionality, the member country can take these steps after getting assistance. Generally, the recipient country must follow some measures like trade liberalization, deregulated financial sector and privatization.

Conditionality [29] in its broad sense covers both the design of IMF-supported programs—that is, the macroeconomic and structural policies—and the specific tools used to monitor progress toward the goals outlined by the country in cooperation with the IMF. Conditionality helps countries solve balance of payments problems without resorting to measures that are harmful to national or international prosperity. At the same time, the measures are meant to safeguard IMF resources by ensuring that the country's balance of payments will be strong enough to permit it to repay the loan. All conditionality under an IMF-supported program must be "macro-critical"—that is, either critical to the achievement of macroeconomic program goals or necessary for the implementation of specific provisions under the IMF's Articles of Agreement (IMF fact sheet).When the member country selects and implements a program for showing compliance to IMF, it usually carries it in a Letter of Intent. The basic purpose of these conditions is to ensure that the country in question is on track with regard to reforms, can maintain macroeconomic stability and as a result can repay the loans. As a result, risk of lending to IMF also gets reduced.

For reviewing (and hence acceptance or modification) the policies of a member country, which is in need of funds, IMF seeks some commitments from the country concerned. These can take different forms:

- **Prior actions** The actions or measures, a country agrees to take before the IMF's Executive Board approves financing or completes a review. The program is checked for its compatibility with IMF conditions, or if need be necessary modifications are made.
- **Quantitative performance criteria (QPCs)** To complete the review, certain measurable conditions need to be fulfilled. QPCs always relate to macroeconomic variables under the control of the authorities, such as monetary and credit aggregates, international reserves, fiscal balances, and external borrowing. For example, a program might include a minimum level of net international reserves, a maximum level of central bank net domestic assets, or a maximum level of government borrowing.

- **Indicative targets** may be established in addition to QPCs as quantitative indicators to assess the member's progress in meeting the objectives of a program. Sometimes they are also set when QPCs cannot be, because of data uncertainty about economic trends.

- **Structural benchmarks** are (often non-quantifiable) reform measures that are critical to achieve program goals and are intended as markers to assess program implementation during a review. They vary across programs: examples are measures to improve financial sector operations, build up social safety nets, or strengthen public financial management.

Over the years, there has been a shift in the policy conditions kept by the IMF. Until 1980s, the focus was on macroeconomic stability. The countries in question were made to undergo Structural Adjustment Program, which many a time, proved harmful and difficult to implement for low income countries already undergoing crisis. So recently, there has been a shift in this regard. In 2002, a revision was made in guidelines on conditionality. To prevent further crises, certain conditions had to be met before the member country could approach IMF. So in 2009, <u>Flexible Credit Line</u> (FCL), which does not rely on traditional program conditionality but on rigorous pre-qualification criteria (also referred to as "ex-ante" conditionality) and the <u>Precautionary and Liquidity Line</u> (PLL, formerly the Precautionary Credit Line) combines elements of both ex-ante and ex-post conditionality. Further in September 2012, lending policy was reviewed and it was felt that it needs to be adapted in accordance with changed economic conditions.

14.8 THE WORLD BANK

The **World Bank** (WB), based in Washington, D.C, was one of the Bretton woods twins established in 1946. It has been assigned the task of financing the development projects in which private finance can't be accessed easily. The ownership lies with the members. Extent of ownership depends on the number of shares a member possesses. The amount of shares a member can purchase depends on its economic size and has a direct impact on decision making ,through a corresponding voting power. In other words, a large shareholder means more voting power. The

World Bank has three main branches: the International Bank for Reconstruction and Development (IBRD), the International Development Agency (IDA) and the International Finance Corporation (IFC).World Bank is a part of World Bank group (IBRD,IDA,IFC,MIGA and ICSID), but is different from it. Both IMF and WB serve the common objective of raising living standards of their member countries through different ways. World Bank promotes long-term economic development by contributing to different projects, whereas IMF ensures international financial stability.

IBRD, the first organ of World Bank, serves as a bank. By floating bonds which are purchased by private investors, it lends loans to developing countries to finance specific projects. The loans generally mature in 15-20 years. Interest rate is generally higher than the interest rate paid by it on bond based debt.

The International Development Association (IDA) was created in 1960 to give concessional (or below market interest rate) loans to the poorest member countries. Maturity period is usually 35-40 years, with zero interest rate. Unlike IBRD, it lends loans to poor countries with contributions from rich countries.

14.9 LENDING POLICY OF THE WORLD BANK

We can divide the lending policy of the World Bank into different periods, strarting from the initial days:

1944-68 : The post world war-II world economy had seen huge damage. Though there was a great need to reconstruct it through different funds, World Bank was sceptical of the repayment obligations of those countries. This period is referred to as that of 'fiscal conservatism'.Whatever loans were given were usually in infrastructure like sea ports, highways, power plants etc. So that the country asking for funds could have repayment capability.

1968-80: Gradually, there was a shift in the earlier stance.The shift was towards meeting the basic needs and meeting basic infrastructural needs like schools, hospitals and other social services to improve the living conditions of people.

Recent years: In recent years, due to more and more activism on the part of NGOs, environmental and other groups, inputs have been taken from most of them before formulating and implementing policies regarding lending.

There are two types of world Bank loans: investment loans and adjustment loans.Investment laons are long term loans meant to “create the social and physical infrastructure necessary for poverty reduction and sustainablre development” (World Bank, 2000a). Adjustment loans are short term loans given to support reforms in a particular sector of the economy.

14.10 CONTRIBUTION OF THE WORLD BANK

- Reconstruction and economic development after WWII
- Long-term economic development and poverty reduction
- Project financing, including infrastructure, energy, education, health

14.11 LET US SUM UP

In this lesson, we learned about the working of IMF and World Bank.

14.12 REFERENCES AND SUGGESTED READINGS/ ONLINE SOURCES

- www.imf.org
- Martin A. Weiss’ article: ‘International Monetary Fund: Background and Issues for Congress’, July 2014.
- Relevant sites for the World Bank.

SELF ASSESSMENT QUESTIONS

- Explain the working of the two Bretton Woods institutions.
- What is a SDR?
- Write a short note on IMF’s conditionality clause.
- Comment on the lending policies of IMF and World Bank.

GATT AND WTO

Structure

15.1 OBJECTIVES

The main objectives of this lesson are to make the learners understand GATT and WTO as the bodies governing multilateral trade. They will know how trade has been liberalised over a period of time.

15.2 INTRODUCTION

Discussions for a world in post war era were going on during world war II itself. Discussions pertained to policies to be taken regarding reconstruction and development of the war affected world. To address the issues of trade among nations and trade policies, it was proposed to have an International Trade Organisation. But not many nations found it suitable to their needs. So finally, at Havana conference of 1947, GATT was signed. Since then, GATT has seen massive expansion both in terms of issues covered as well as its membership. The members have to follow the trade rules set by the multilateral organization. New members can be admitted with the consent of 2/3rd members. In this lesson, we'll know more about GATT and WTO.

15.3 PRINCIPLES OF GATT

GATT is based on the following four basic principles :

1) Non-discriminatory trade among member countries.

2) Tariff to be the only instrument to influence international trade.

3) Before a country goes for adoption of a policy that may harm any other country's trade, proper consultation should be done.

4) Negotiations should be made for tariff reductions.

15.4 OBJECTIVES OF GATT

The general objectives of GATT are :

1) To raise the standard of living of people living in member countries.

2) To promote full employment and growth of the economies.

3) To expand world trade and output.

4) To enable full use of the world's resources.

Under GATT, we talk of non-discriminatory trade. It has to be reciprocal. In other words, each member country has to give concessions to the other member country, if the former has done that through tariff reduction. So it is mutually advantageous trade. Tariff reduction is gradual in nature. GATT strives to achieve the above general objectives through certain methods. They are:

1) **MFN** The principle of non-discrimination is depicted through Most Favoured Nation principle, which is placed in article I of GATT (1994). Each member country is required to treat each other member country as it would treat its most favourite trading partner. There are however, certain violations of or exceptions to it. For example, trade preferences that predated GATT i.e. those existing before April 10, 1947.Escape clauses have provisions, whereby, the countries can discriminate, on the basis of certain justifiable grounds. GATT article 24 allows arrangements of regional trading bodies. Enabling clause of 1979 allows developing countries to engage in partial trade preferences. Generalised System of Preferences (GSP) allows one way preference by developed to developing countries. Likewise there are safeguard measures to act against export subsidy, dumping etc.

2) **Quantitative restrictions on imports** Though generally prohibited, member countries can sometimes go for import quota imposition if they are facing balance of payments difficulties, their domestic industries are being hurt or other such grounds.

3) **Tariff negotiations and reduction** : As tariffs are impediments to free trade, GATT through different rounds, has encouraged the member countries to reduce tariff and give each other market access, based on reciprocity and mutuality of advantages. [30]

15.5 GATT AND TRADE LIBERALISATION

In eight rounds, GATT has liberalized trade though negotiations between member countries. Let us discuss the main issues covered by the member countries in these rounds:

In the first round held at Geneva in April 1947,the concessions exchanged through negotiations led to complete elimination of certain duties, reduction of duty preferences, binding of duties at the existing levels and the binding of duty free treatment. 123 sets of bilateral negotiations were agreed upon.

The second GATT conference was held at Annecy, in France in 1949. So far, 10 more countries had joined, increasing the number to 33. Also total 147 sets of bilateral negotiations were completed. Countries exchanged about 5000 tariff concessions.

The third conference was held in 1950, in Torquay, England, where countries exchanged some 8,700 tariff concessions, cutting the 1948 tariff levels by 25%. 6 new members joined. But this round can't be called a major success ,as out of 400 negotiations, only 147 could be completed.US ,which had offered a no. of concessions earlier didn't offer more concessions.

The fourth conference was held in 1955-56 in Geneva. It resulted in $2.5bn tariff reductions. But not many countries were satisfied at US' move of negotiating for concessions in which it granted concessions in 900 million dollars worth of imports and got concessions in exports worth 400 million dollars. So some countries withdrew from negotiations at this conference.

The fifth conference took place in 1960-62. It was named in honour of US Under Secretary of State Douglas Dillon who proposed the negotiations. It led to tariff concessions worth $4.9bn of world trade and involved negotiations related to the creation of the European Economic Community. It was in the fifth conference that the developing countries raised the issue that developed countries avoided negotiations over issues of great concern to developing countries. They felt that protectionism in agricultural sector in industrialised countries were harming the developing countries. So they were not able to get the full advantage of liberalization in trade under GATT. Their argument was also justified according to Haberler's report which was submitted in 1958. Haberler committee was assigned the task of examining and reporting on the working of GATT since 1947. It reported that protectionism in agriculture in industrialized countries harmed the developing world.

The Kennedy round (1964-67) The sixth conference took place at Brussels. It was named Kennedy Round in honour of the late US president, because a number of tariff concessions were offered by him during this round. This round resulted in tariff cuts worth $40bn of world trade. The main objective of this round was to reduce tariffs between the USA, EEC and EFTA. This round saw noticeable change in the trade policy of USA. So far, it stuck to protectionism. Before this, between 1934 and 1962,US did participate in tariff negotiations, but there was a provision related to 'peril point principle' . These peril points set the lower limit beyond which tariff couldn't be reduced by the president without the approval of congress. In the Trade Expansion Act of 1962, this got abolished. The US president could now reduce tariffs up to a maximum of 50%. This positive change made US offer many concessions.

US agreed to reduce tariffs on 2/3rd of her total imports by an average of 30% (In some cases, even 50%).ECM reduced tariff on an average by 35%, UK by 38%,Japan by 30% and Canada by 24%.These reductions in tariffs were to be gradual .5-15% was the range for tariffs for most of the industrial or manufactured goods.

But the developing countries were still dissatisfied with the tariff reductions, as most of these were related to industrial goods, in which the developed nations held comparative advantage. Also Kennedy round didn't negotiate with regard to non-tariff barriers.

Tokyo Round (1973-79) Though 99 countries representing about 90% of the world trade participated in this round, the climate was much different from that of the earlier rounds. Due to stagnation in the world economy, countries had turned protectionist. Non-tariff barriers were being imposed and the relations between major countries of the world i.e. the US, European Community and Japan were strained (Sodersten and Reed 1994).

However, efforts were made towards the ongoing process of tariff reduction. It was resolved that there should be more tariff cuts, liberalization of farm trade, reduce non-tariff barriers, prepare codes of conduct for acting against unfair trade practices and to give 'special and differential treatment' to exports from less developed countries. Discussions were held regarding subsidies, countervailing measures, technical barriers to trade, government procurement, anti dumping etc.

As a result of this round, tariff reductions worth more than $300bn dollars were achieved. Tariffs\were reduced on a number of agricultural and industrial goods, and about 33000 additional tariff lines were bound.(Hoekman and Kostecki 2001). On an average, there was a 37% reduction in Pre-Tokyo round tariff levels.

Uruguay round (1986-94) Uruguay round, the last round under GATT was launched in Punta Del Este, Uruguay. It is said to be the most ambitious of all the rounds. It took much longer to conclude because of complexity of issues and because the huge no. of participants made negotiations difficult. Not only were the issues related to trade in goods were to be deliberated, but also certain new issues were awaiting inclusion. It was for the first time that agriculture and textile and clothing were to be part of the multilateral agreement. It was agreed that agreement on textile and clothing would provide for the gradual dismantling of quotas imposed under Multi Fibre Arrangement (MFA, which governed world trade in textiles from 1974-2004) Also services, investment and intellectual property rights were to be introduced to world trade for the first time. GATS,TRIMS and TRIPS were the agreements related to the three respectively.

As a result of Uruguay round, the average tariff on manufactured goods of industrial countries got reduced by 40% from 6.4% to 4%. The average tariff in pre-GATT era was 35%. So there was significant reduction in the tariff rate.

The agenda of Uruguay round was drafted despite reluctance of developing countries to join. Developing countries were quite united till the midterm review in Geneva in 1989. After this, they were concerned about their individual issues. By the end of Uruguay round, participation of developing countries had increased tremendously, as during this time, they were moving from inward looking to outward looking policy. These reforms were due to IMF's and WB's conditionalities attached to their lending loans to these countries.

The Uruguay round was to be concluded in Brussels in 1990.But some differences among developed countries delayed the process. The then Director General

Arthur Dunkel submitted a document 'Draft Final Act of 1991'in Dec. 1991.It was popularly called a Dunkel Draft. Among other things, GATT was to be offered as a single undertaking. It means that except LDCs, all countries have to accept in entirety a common set of rules and disciplines affecting goods, services and intellectual property.

But differences between USA and EC on Agreement on Agriculture and Japan's Rice protection policy further delayed the things. Finally , at a meeting at Marrakesh, Morocco, in April 1994,WTO was born. This was the biggest achievement of the Uruguay round.

The results of Uruguay Round are embodied in 22,500 pages listing individual countries' commitments on specific categories of goods and services. These include commitments to cut and "bind" their customs duty rates on imports of goods. In some cases, tariffs are being cut to zero. There is also a significant increase in the number of "bound" tariffs — duty rates that are committed in the WTO and are difficult to raise. Developed countries' tariff cuts were for the most part phased in over five years from 1 January 1995. The result is a 40% cut in their tariffs on industrial products, from an average of 6.3% to 3.8%. The proportion of imports into developed countries from all sources facing tariffs rates of more than 15% were to decline from 7% to 5%. The proportion of developing country exports facing tariffs above 15% in industrial countries had to fall from 9% to 5%.Developed countries increased the number of imports whose tariff rates are "bound" (committed and difficult to increase) from 78% of product lines to 99%. For developing countries, the increase was considerable: from 21% to 73%. Economies in transition from central planning increased their bindings from 73% to 98%. [33]

15.6 INTRODUCTION TO WTO

On January 1, 1995, WTO came into existence. It replaced GATT. Apart from certain agreements which were part of GATT, some new issues were also to be covered by WTO. There were four annexures.

Annex 1	IA	Multilateral Agreements on Trade in Goods (GATT 1994)
	IB	General Agreement on Trade in Services (GATS)
	IC	Agreement on TRIPS
Annex 2		WTO's Dispute Settlement Mechanism
Annex 3		Trade Policy Review Mechanism
Annex 4		Plurilateral Trade agreements.

Annexure 1 contained issues regarding trade in goods. GATT 1947 which saw multiple amendments finally got incorporated as GATT 1994. GATT is now WTO's 'umbrella treaty' for trade in goods. Services were to be tackled through GATS. Intellectual property rights' related issues were to be addressed through TRIPS. Likewise, disputes between member countries of WTO were to be resolved though Dispute settlement mechanism. To monitor the trade policies of member countries for being consistent or otherwise with WTO rules, TPRM was devised. Finally, certain codes of Tokyo round that could not be multilateralised (or applicable to all) in Uruguay round remained confined to countries having signed them. They were part of Annexure 4. Except annex 4 (which dealt with plurilateral agreements and were binding only on signatories), all other issues in annex1-3 were binding on all the member countries.

WTO is an improvement over its predecessor, GATT.

- WTO and its agreements are permanent. Members have to ratify WTO agreements. GATT was adhoc and provisional.
- WTO has members, whereas GATT had 'contracting parties'. So GATT was a legal text.
- GATT dealt only with goods. WTO also covers issues like services, intellectual property rights etc.
- The Dispute Settlement Mechanism of WTO is faster and automatic, as compared to GATT.[31]

Membership:

Since April 26, 2015, there are 161 members of WTO. Yemen and Seychelles are 160th and 161st members respectively.(www.wto.org).

The top level decision making body is Ministerial Conference which usually meets once in two years. Its secretariat is based in Geneva, Switzerland.

15.7 FUNCTIONS OF WTO

- Administering trade agreements
- Acting as a forum for trade negotiations
- Settling trade disputes
- Reviewing national trade policies
- Assisting developing countries in trade policy issues.
- Cooperating with other international organizations like IMF and World Bank.

15.8 DOHA ROUND OF WTO

After the first, second and third rounds at Singapore, Geneva and Seattle respectively, the fourth ministerial conference of WTO took place in Doha, Qatar in November 2001. It has been named as Doha Declaration or Doha Development Agenda. Doha round re-asserts the 'single undertaking' nature of negotiations. But some agreements can be negotiated early. Through discussion of different issues, it was tried to integrate the developing countries into world trade. It has not been concluded yet. Total 21 subjects listed in Doha [32] Ministerial Declaration. Some of these are:

1) Implementation-related issues and concerns:

Implementation issues refer to those issues which were related to implementation of the Uruguay round agreement. It concerned the developing countries. Developing countries were not willing to participate and allow more issues, unless pending issues were discussed first. It was agreed that about 50 such issues related to agriculture, subsidies, textiles and clothing, technical barriers to trade, trade-related investment measures and rules of origin shall be addressed immediately, whereas rest of the issues shall be resolved in near future.

2) Agriculture:

Agriculture was not to be discussed for the first time. Negotiations on agriculture had already begun in early 2000, under Article 20 of the WTO Agriculture Agreement. Things had to be carried forward. Commitments regarding reform in the agricultural sector had to be confirmed. Liberalisation in agricultural trade related issues had to be strengthened .In this regard, countries were once again reminded of protectionism as an obstacle towards free trade .

The main issues to be addressed in agriculture were based on three pillars:

- market access: substantial reductions
- exports subsidies: reductions of, with a view to phasing out, all forms of these
- domestic support: substantial reductions for supports that distort trade

Special concerns of developing countries were considered through special and differential treatment. It was declared that special needs of developing countries like food security, rural development shall have to be met, despite commitments made by developing countries under WTO.

3) Services:

Like most other issues, negotiations were going on in services trade also. GATS was introduced in Uruguay round. Before Doha round, the services negotiations started officially in early 2000 under the Council for Trade in Services. In March 2001, the Services Council fulfilled a key element in the negotiating mandate by establishing the negotiating guidelines and procedures. In Doha round, further steps towards strict following of guidelines and timetable related to liberalization in services trade were taken.

4) Non-Agricultural Market Access:

During the Doha round, ministers also agreed to launch negotiations for liberalizing trade in non-agricultural products. The Declaration stated :The aim is "to reduce, or as appropriate eliminate tariffs, including the reduction or elimination of tariff peaks, high tariffs, and tariff escalation, as well as non-tariff barriers, in particular on products of export interest to developing countries". "Tariff peaks", which are relatively high tariffs, usually on "sensitive" products, (for industrialized countries, tariffs of 15% and above are generally recognized as "tariff peaks") and "tariff escalation", in which higher import duties are applied on semi-processed products than on raw materials, and higher still on finished products, have adversely affected the exports of developing countries. It works against processing industry of processed material exporting country.

It was agreed that special needs of developing and least developed countries should not be sacrificed towards fulfilment of these commitments. It was agreed that these countries need not reciprocate fully the tariff reduction commitments of other countries.

5) TRIPS:

Trade Related Intellectual Property Rights was also included for the first time in Uruguay round. During Doha round, more had to be discussed and modalities had to be worked out regarding implementation. For example, the issue of TRIPS and public health was discussed, whereby it was declared that governments would be given the rights to have access to existing medicines or for creation of new. Provisions for Compulsory licensing and parallel imports were made. The aim was that, protection of intellectual property notwithstanding, access to essential drugs shall not be denied. These were some of the issues regarding intellectual property. Issues also moved around patentability, geographical indications etc. The declaration also extended the deadline for least-developed countries to apply provisions on pharmaceutical patents until 1 January 2016.

6) Discussion of Singapore issues:

There are four Singapore issues, which were proposed by industrialised countries during the Singapore conference . These include: transparency in government procurement, trade and competition, trade and investment, trade facilitation and labour standards. 'Labour standards' was out rightly rejected, whereas for the other four, permanent working groups were established. During the Doha round, developed countries pushed hard for negotiations in these issues. These issues were on the Doha agenda till 31st July 2004. On 1 August, 2004, all except trade facilitation were dropped from Doha agenda.

7) Special and Differential Treatment:

"The WTO agreements contain special provisions which give developing countries special rights. These special provisions include, for example, longer time periods for implementing agreements and commitments or measures to increase trading opportunities for developing countries."

In the Doha Declaration, the member nations agreed that these provisions need to be reviewed to strengthen them and specify them. "More specifically, the declaration (together with the Decision on Implementation-Related Issues and Concerns) mandates the **Trade and Development Committee** to identify which of those special and differential treatment provisions are mandatory, and to consider the implications of making mandatory those which are currently non-binding."

15.9 POST 2001 DEVELOPMENTS IN DOHA ROUND

As mentioned earlier, Doha is still the ongoing round [34]. It has not been concluded yet. At the Doha meeting, trade ministers agreed that the 5th Ministerial, to be held in 2003, would "take stock of progress, provide any necessary political guidance, and take decisions as necessary," and that negotiations would be concluded not later than January 1, 2005.But so many deadlines have been missed so far.

Doha round has not been concluded due to certain issues causing conflict between member nations.

The Cancun Ministerial

The 5th Ministerial Conference was held in Cancun, Mexico, on September 10-14, 2003. Not much could be negotiated. According to Fergusson, following are the main reasons for which Cancun failure took place: differences remained over the Singapore Issues, rigidity on the part of few nations who only repeated their demands rather than talk about trade-offs and differences between developing and developed countries on many issues e.g. Special and Differential Treatment was interpreted differently by U.S.-EU (in agricultural proposal)and the Group of 20.

One achievement of Cancun ministerial was the creation of the 'Derbez text'. Ministerial chairman Derbez wanted trade ministers to facilitate in resolution of certain issues. So he invited trade ministers to resolve issues in five groups: agriculture, non-agricultural market access, development issues, Singapore issues, and other issues. The WTO Director-General served as a facilitator for a sixth group on cotton. After many discussions and deliberations, the outcome was a draft Ministerial Declaration. It was circulated for comment. Though it was criticized and rejected at that time, months later it was realized that it has the potential to resolve some crucial issues. For example, on issues in agriculture, the Derbez text relied on both the U.S.-EU and Group of 20 proposals. In many ways, it offered better terms for developing countries by proposing to eliminate export subsidies for products in which developing countries had export interests. In Singapore issues, it was decided to take up and start negotiating on government procurement and trade facilitation, but not investment or competition. These suited the interests of developing countries.

Negotiations which were suspended for the remaining part of 2003 resumed in early 2004, due to the efforts of then-U.S. Trade Representative (USTR) Robert Zoellick. He argued for increasing market access through elimination of agricultural export subsidies and for discussing only two Singapore issues, while dropping the other two (investment and competition).

On July 31, 2004, WTO members approved a Framework Agreement that includes major developments in the most contentious and crucial issue—agriculture.

The Hong Kong Ministerial

The WTO Director-General Pascal Lamy announced in November 2005 that "A comprehensive agreement on modalities would not be forthcoming in Hong Kong, and that the talks would "take stock" of the negotiations and would try to reach agreements in negotiating sectors where convergence was reported."

The only achievement of this ministerial was to be (conditional) agreement to eliminate export subsidies in agriculture by 2013.The so called Lamy 20-20-20 package (by Director General Pascal Lamy) required EU to cut its bound agricultural tariffs by 54% (proposed by G20),US to bind its trade distorting agricultural subsidy at max $20 billion and developing countries to keep the tariffs on imports of manufactures to a maximum of 20%.[35] Since no agreement could be reached, the ambitious task of liberalizing trade in agricultural and other products could not be accomplished.

Bali package

The ninth ministerial conference took place in Bali, Indonesia on 3-7 Dec. 2013. The most significant outcome of this conference was 'Bali package' which is a part of the ongoing Doha Development round. Like in other ministerial conferences, in this conference also , the member countries agreed that there is need to further reduce trade barriers. Developed countries were told to be more accommodating to exports from developing countries . They shall not be imposing import quotas on agricultural products from developing world. Instead, they shall be allowed to impose tariffs if imports exceed a specified limit. Bali package is the only example of a multilateral agreement (signed by all nations) signed under the aegis of WTO. About ten decisions were taken covering four areas. These are:

1) **Trade facilitation**: It reaffirms that non-discrimination principle of GATT 1994 is valid. It is binding on all countries. The LDCs shall be assisted in implementing these changes. Further discussions continued till the final text was agreed by consensus at the 9th Ministerial Conference, in Bali (Indonesia). According to paragraph 1 of the Modalities, the negotiations had to clarify and improve relevant aspects of Article 5 (Freedom of Transit), Article 8 (Fees and Formalities connected

with Importation and Exportation) and Article 10 (Publication and Administration of Trade Regulations) of the GATT 1994, with a view to further expediting the movement, release and clearance of goods, including goods in transit.[36] This is expected to reduce red tapism, which has been worrying and causing huge losses to traders worldwide.

2) **Agriculture :** There were many issues in agriculture negotiations in the Doha round. At Bali, four proposals were worked on. They are:

- export subsidies and other policies known collectively as "export competition"
- a proposal to deal with the way a specific type of import quota ("tariff quotas") is to be handled when the quota is persistently under-filled
- developing countries' food stockholding for food security
- a proposed list of general services of particular interest to developing countries that would be added to the "Green Box".

These four issues were actually the result of serious consideration by member countries of the need to revive the already prolonged Doha round. This was discussed at the last ministerial conference in 2011.It was also resolved that it is better to start with small package of issues, which all can agree upon, while rest of the issues in Doha round shall be resolved later.

Export subsidies

Export subsidies have been the bone of contention between developing and developed countries. Developing countries have been complaining that they have been given very less in terms of developed nations' commitments to export subsidies in lieu of their commitments towards trade facilitation. At Bali, there was no legal commitment regarding these issues. " But it contains some of the strongest statements of intent that have ever been made on the subject."

"If it is agreed, members would "exercise utmost restraint" in using any form of export subsidy. They would "ensure to the maximum extent possible" that progress will be made in eliminating all forms of export subsidies, that actual subsidies will be well below the permitted levels, and that disciplines will apply to export policies that may have the same effect as subsidies. These policies are grouped together as "export competition". They include subsidies and other advantages gained from government-supported export credit and insurance, food aid and exporting state trading enterprises."

Export subsidies' reduction commitment actually shows the efforts of some developing country groups like The G–20.

Tariff rate quota

Tariff quotas (also known as tariff-rate quotas, TRQs) are where import duties are lower on quantities within the quotas and higher for quantities outside. They were agreed in the 1986–94 Uruguay Round negotiations as a means of allowing exporters some access to other countries' markets when the normal (out-of-quota) tariffs on imports are high. At Bali, these was some Understanding on Tariff Rate Quota Administration Provisions of Agricultural Products, as Defined in Article 2 of the Agreement on Agriculture.

Stockholding for food security: interim 'due restraint'

Government's buying food from farmers at supported price to hold stocks is included in 'Amber Box'. Amber box is said to be trade distorting, as price and quantity are affected. Most of the developing countries have been buying from farmers at support price for stockpiling and to be given to poor people. The limit provided is 10% of the value of production ("de minimis"). Most of the developing countries have found it difficult to stay within this limit, as the issue of food security is involved. In November 2012, G-33 proposed that the agriculture agreement should be amended so that this support can be counted as green box and can be used without limit. It was also mentioned in annexure B of 2008 draft.

Although, food security is a genuine issue known to all, the matter could not be resolved before Nov. 2014(post Bali, General Council decision), when it was agreed that :"

Members would temporarily refrain from lodging a legal complaint ("due restraint", sometimes also called a "peace clause") if a developing country exceeded its Amber Box limits as a result of stockholding for food security. Work on finding a longer term solution would continue after the ministerial conference. Countries using these policies would provide up-to-date data and other information on what was involved, so that other countries could see what was happening."

However, it was agreed that the food thus released shall not affect trade and the provisions shall not be misused. The purpose was to address the issues of food security.

General services list At Bali, G-33 proposed the old demand of African group (since 2006) regarding expanding the list of "general services" under the "Green Box". Annex 2 of The agreement on agriculture defines the green box. Green Box has been thus defined: Green Box measures "shall meet the fundamental requirement that they have no, or at most minimal, trade-distorting effects or effects on production."

The issues wished to be included are: land rehabilitation, soil conservation and resource management, drought management and flood control, rural employment programmes, issuing land ownership titles and settlement programmes.

3) **Cotton:** The 2013 draft text for Bali " reiterates members' commitment to "on-going dialogue and engagement" to make progress in the negotiations on cotton according to the 2005 objectives, which were agreed at the Hong Kong Ministerial Conference. These objectives were repeated when ministers last met in 2011 in Geneva, including the commitment to make large ("ambitious") reductions in subsidies and trade barriers, to deal with this quickly ("expeditiously"), and for these reforms to apply "specifically" to cotton."[37]

In fact, in October 2013, the so called Cotton four group of countries i.e. four sub-Saharan cotton producers (— Benin, Burkina Faso, Chad and Mali —), who had been suffering due to export subsidies in cotton in developed countries proposed that reforms should take place in this sector. It was proposed in two stages, stage I in which all would agree in Bali and stage- II, in which efforts shall be made post Bali.

Stage I included issues of Market access and export subsidies in cotton. It was that LDCs shall be given duty-free and quota-free (DFQF)access to the markets of developed countries — and to those of developing countries declaring that they are able to do so — from 1 January 2015.Those developing countries not in a position to do so immediately shall take steps towards this. In export subsidies, it was agreed that any remaining export subsidies on cotton in developed countries would be eliminated immediately.

The issue of domestic support in cotton was to be tackled in stage-II. It was agreed that "Domestic support for cotton would be negotiated intensively in 2014 in order to reach agreement by the end of the year on substantial reductions. Members have already agreed to cut distorting subsidies for cotton by more than the reductions on other agricultural products (paragraph 11 of the 2005 Hong Kong Ministerial Declaration), but have not agreed on how to achieve that."

However, they failed to reach agreement on a final outcome . It is regretted in the draft text.

4) **Development and LDC issues**

Least-developed countries (LDCs) are the poorest members of the world community. They comprise about 12 per cent of the world's population but account for less than 2 per cent of world GDP and about 1 per cent of global trade in goods. Their participation in global trade in services is even less. [38]

The ministers realised the need for special assistance to LDCs in their development issues. The decision was actually based on a proposal by LDCs having four elements.

- a decision on the implementation of duty-free and quota-free market access for LDCs
- a decision on preferential rules of origin for LDCs
- a decision on the operationalization of the LDC services waiver

- a decision in the area of cotton [39], covering both trade and development assistance aspects.

Things have started moving forward with the signing of Bali package. It has become a small success story in the entire history of WTO.

That the first ever global agreement had made the difference in changing global economic climate becomes clear from the following comments of the Director-General Roberto Azevêdo : "For the first time in our history, the WTO has truly delivered. We're back in business … Bali is just the beginning." So the faith and credibility of the multilateral trade organisation has been restored.

15.10 LET US SUM UP

In this lesson, we learned that under the aegis of GATT, eight rounds were held. In each round, efforts were made to reduce tariff barriers and in the later rounds, non-tariff barriers too were considered for elimination. In other words, while the focus of first six rounds was on tariff barriers, in the seventh round, non-tariff barriers were discussed for removal. Eighth round added hitherto uncovered issues. At the end of Uruguay round, the average tariff was reduced to 4%. The Uruguay round resulted in the establishment of World Trade Organisation. The WTO too is continuing with trade liberalisation through different ministerial conferences. Doha is the ongoing round yet to be concluded, though many developments have taken place in this regard.

15.11 REFERENCES AND SUGGESTED READINGS

- Sources and endnotes provide a list of readings and online sources in this regard.

SELF ASSESSMENT QUESTIONS

- Is WTO an improvement over GATT? Justify.
- Explain the process of trade liberalisation through different rounds of GATT.
- What do you know about the Doha round? What developments took place in this round?

WTO AND DEVELOPING COUNTRIES; TRIPS,TRIMS AND GATS

Structure

16.1 Objectives

16.2 Introduction

16.3 WTO and developing countries

16.4 India and WTO

16.5 TRIPs, TRIMs and GATS

16.5.1 TRIPs

16.5.2 TRIMs

16.5.3 GATS

16.6 Let us sum up

16.7 References and essential readings

16.1 OBJECTIVES

The main objectives of this lesson is to enable the learners to understand the issues of concern to developing countries like India and the issues of TRIPs, TRIMs and GATS.

16.2 INTRODUCTION

In this lesson, we'll learn more about the issues of concern to developing countries like India in WTO. We'll also learn about TRIPs, TRIMs and GATS.

16.3 WTO AND DEVELOPING COUNTRIES

The Uruguay Round (1986-94) marked a transformation in the way different nations grouped among themselves. Till the Uruguay round, there were sharp boundaries between the North (developed) and South (developing) with regard to different issues. Just before this round, boundaries became fluid and during the round itself, different coalitions developed, not necessarily North-North or South –South in nature. Within developing countries, many groups were formed depending on their priorities. This changed scenario is said to have caused a shift in North-South politics in the GATT-WTO system.

But there are still some common issues which bind the developing countries together. Agriculture is one such issue, which has held importance in almost every round.

WTO has given ample opportunities to the developing countries to participate actively in the multilateral system and gain out of liberalized trade. Of more importance is the gain out of exports. These can be discussed [40] as:

- fundamental reforms in agricultural trade
- phasing out quotas on developing countries' exports of textiles and clothing
- reductions in customs duties on industrial products
- expanding the number of products whose customs duty rates are "bound" under the WTO, making the rates difficult to raise.
- phasing out bilateral agreements to restrict traded quantities of certain goods — these "grey area" measures (the so-called voluntary export restraints) are not really recognized under GATT-WTO.

Developing countries, which comprise about 2/3rd of WTO members, have been actively participating in the WTO since the Uruguay round. The WTO has some special provisions for developing and least developed nations. These are:

Meeting special needs :

Taking into consideration their different levels of development and priorities, WTO has the following measures to make the developing countries feel comfortable in the multilateral trade system:

• **extra time** for developing countries to fulfil their commitments (in many of the WTO agreements)

• provisions designed to increase developing countries' **trading opportunities** through greater market access (e.g. in textiles, services, technical barriers to trade)

• provisions requiring WTO members to **safeguard the interests** of developing countries when adopting some domestic or international measures (e.g. in anti-dumping, safeguards, technical barriers to trade)

• provisions for various **means of helping** developing countries (e.g. to deal with commitments on animal and plant health standards, technical standards, and in strengthening their domestic telecommunications sectors).

• the **Committee on Trade and Development** is the main body focusing on work in this area in the WTO, with some others dealing with specific topics such as trade and debt, and technology transfer. The General Agreement on Tariffs and Trade (GATT, which deals with trade in goods) has a special section (Part 4) on Trade and Development which includes provisions on the concept of non-reciprocity in trade negotiations between developed and developing countries — when developed countries grant trade concessions to developing countries they should not expect the developing countries to make matching offers in return.

• the **WTO Secretariat** provides **technical assistance** (mainly training of various kinds) for developing countries.

• Special and differential treatment for developing and least developed nations.

Some special provisions exist for the LDCs. Some of these are:

- "Plan of Action for Least- Developed Countries" (Singapore 1996), in which not only shall they be assisted to get well equipped for the multilateral system, but also a commitment from developed nations to improve their market access.
- "Integrated Framework"(in October 1997), a joint technical assistance programme by six international organizations — the International Monetary Fund, the International Trade Centre, the United Nations Conference for Trade and Development, the United Nations Development Programme, the World Bank and the WTO .
- A work programme (2002), in which more was added towards facilitating their participation in the system.

But on many occasions, it has been observed that developing countries are not satisfied with the working of the multilateral trade system under WTO. Their complaints are regarding the following issues :

1) High walls of Tariffs

Though through different rounds, tariffication (conversion of Non-tariff barriers to tariffs)has been encouraged, and it has been tried to dismantle tariff barriers as far as possible, there are issues regarding "tariff peaks" and "tariff escalation". While the former mean exceptionally high tariffs ,latter means more tariffs on processed goods, as compared to raw material. Tariff peaks on textile, clothing and fish have been obstructing the exports of developing countries. Likewise, tariff escalation discourages them to add value. Successful completion of Doha round may be able to address the issues adequately.

2) Erosion of preferences

Some developed countries have been unilaterally giving preferential access to the exports of few developing countries. Under WTO, there is general cut in tariff which are bound commitments. The countries getting preferential access may lose as a result of general cut in tariff rate. This is referred to as 'erosion of preferences'. This is another cause of worry to developing countries.

3) Lack of adequate infrastructure

Many a time, there is no dearth of policies, but their implementation requires adequate infrastructure like political willingness and stability, improvement in policy making and the like. Most of the less developed nations lack in basic infrastructure. To that extent, they can't benefit out of liberal trade regime.

4) Biased attitude of WTO

Scholars like Martin Khor argue that WTO's method of working is not fool proof. It still allows the rich nations to block exports from developing countries by imposing import quotas, antidumping duties and other barriers due to their strong bargaining power. Despite their commitments towards opening of agricultural sector, much less has been done to remove protectionism. He further comments: "one of the major categories of 'problems of implementation of the Uruguay Round' is the way the Northern countries have not lived up to the spirit of their commitments in implementing (or not implementing) their obligations agreed to in the various Agreements."

5) Decision making

Another issue of concern to developing countries is the non-transparent decision making process of WTO. They often criticize it on the ground that there are green room discussions and many a time, developing country delegations are not invited to high-level meetings.[41] At Cancun, a number of NGOs including the World Development Movement, Oxfam, and Third World Network, issued similar complaints and drafted a memo to the WTO calling for more transparent and democratic decision-making in the Doha Round.[42] Specifically, they ask that the WTO stop holding unrecorded informal meetings or 'mini-ministerial' meetings that developing countries are rarely invited to participate in, that meetings and their location be announced six hours before they are held, that all agenda additions or omissions be made as a whole group, and that small, under-financed developing country delegations receive special assistance to ensure that they can participate fully. However, during Cancun, none of the suggestions made by civil society groups were implemented.[43]

16.4 INDIA AND WTO

One of the founder members, India has been playing the role of an active member of WTO. It is an active member of coalitions developed inside WTO like: Asian Developing Members, G-20, G-33, NAMA-11 and W52 sponsors.

"India's applied tariffs have dropped from around 39% in the early days of the WTO to around 13.5% now. Indian exports have risen to ten times the level they were at in 1995. Countries look to India to raise issues of importance for developing countries. That role carries real responsibility. And I think we are seeing India take its rightful place at the centre of the world stage".

Mentioned above were the excerpts of a speech by: WTO Director General Azevado.[44]

Let us now discuss briefly about India's involvement in WTO.

Though India was a member of GATT 1948 and had participated in the earlier rounds also, like other developing countries, it too had not undergone reforms earlier. So the realization of a liberal trade regime was made after 1991 policy of reforms. When Uruguay round was launched, India formed a group with likeminded countries (GT) for non-inclusion of new issues or launch of a new round. By the time Doha round had been launched, developing countries including India had become too important to be ignored. They had started voicing their concerns and opposition assertively. Today, India is an economic power and a very important actor at international level.

Agriculture, NAMA (Non Agricultural Market Access) and Services are the main negotiations of the Doha round.

In agriculture, India has developed coalition G-20 with like minded countries. This group of developing countries was formed before the beginning of Cancun talks in September 2003. The aim was to enable WTO to take decisions which are not detrimental to the interests of developing countries. In NAMA, which deals with non-agricultural or industrial goods, ABI (Argentina, Brazil and India)has (since April 2005) been arguing for the application of a modified Swiss formula, as under the former Swiss formula, developing countries have to go for more tariff cuts than developed ones. In trade in services also , India feels the interests of developing countries are not fully addressed. [45]

Recently, India reinforced its stance at Bali. When most of the nations including US were desirous of signing of Trade Facilitation agreement, India took stand that it won't let it be signed unless its issues of food security are fully addressed. The issue was with regard to stockpiling of food grains. In the recently enacted Food Security act, India is bound to make itself food secure. But under WTO, stockpiling is counted under amber box which is subject to limits. India's stand led to a deadlock. Many nations thought India is not in favour of letting Doha round be concluded. But India was and is very particular about food security for its people.

The deadlock was broken in Nov. 2014(post Bali, General Council decision), when it was agreed :

"Members would temporarily refrain from lodging a legal complaint ("due restraint", sometimes also called a "peace clause") if a developing country exceeded its Amber Box limits as a result of stockholding for food security. Work on finding a longer term solution would continue after the ministerial conference. Countries using these policies would provide up-to-date data and other information on what was involved, so that other countries could see what was happening."

This is not only India's victory , but for many other developing countries, whose interests suffer as a result of certain decisions at WTO.

16.5 TRIPs, TRIMs and GATS

16.5.1 TRIPs

Before we understand TRIPs, it is important to know what it is for. It is an agreement regarding intellectual property rights. Intellectual property rights protect the interests of those whose many years of efforts result in some high technology product or a new medicine, which can add value to the existing life. The innovator should be incentivized by preventing others from using his creation, at least for a fixed period, or if necessary, with a price.

TRIPs was one of the agreements incorporated for the first time in the Uruguay [46]round of GATT. With the signing of it, intellectual property rules were introduced for the first time in the multilateral trade system. The TRIPs council monitors the policies of different countries in this regard. The aim is to internationalise the intellectual property rules. It lays down minimum levels of protection to be followed by the governments for intellectual property of fellow WTO members. In this process, however, a balance is maintained between the private interests (incentives to create) and public interests (ability to access these creations).There are short term as well as long term benefits. By the former is meant the limited period of time, during which the innovator is given the incentive. The long term benefit is for the society as a whole, especially when the invention enters public domain. TRIPs made some additions to the existing agreements on intellectual property under the aegis of World Intellectual Property Rights organisation (WIPR).

The agreement covers the five broad issues:

- how basic principles of the trading system and other international intellectual property agreements should be applied
- how to give adequate protection to intellectual property rights
- how countries should enforce those rights adequately in their own territories
- how to settle disputes on intellectual property between members of the WTO
- special transitional arrangements during the period when the new system is being introduced.

Following are the basic principles of TRIPs agreement:

- **Balance**: A balance is maintained between the interests of those who create (by giving protection to their creations) and the users by enabling them to have access to these.
- **Technology transfer**: Another principle is that intellectual property protection should lead to technology transfer so that the society at large gains out of it and welfare is promoted.

- **Equal treatment**: This principle states that as far as the protection is concerned, a country should follow national treatment clause and most favoured nation clause. The former means a country has to treat foreign nationals and its own nationals equally, with certain exceptions; whereas most favoured nation clause states that the country has to treat the nationals of all its trading partners equally.

- **Different legal systems:** The TRIPs agreement does recognize that different countries have different legal systems for the implementation of the agreement. So they are free to do so provided they stick to minimum standards of protection .

- **Same minimum standards** :The basic rules regarding protection, like the number of years need to be adhered to. Countries are also free to implement rules which go beyond TRIPs, sometimes called TRIPs plus, provided they are consistent with WTO rules. TRIPs plus provisions go for more stringent protection.

Following are the areas of intellectual property covered by TRIPs

- Copyrights and related rights
- Trademarks, including service marks
- Geographical indications
- Industrial designs
- Patents
- Layout designs of integrated circuits
- Undisclosed information, including trade secrets

Copyrights

As per the TRIPS agreement, computer programs will be protected as literary works under the Berne Convention. As we know, Berne convention existed much before WTO's coming to life. Authors of computer programs and producers of sound recordings must have the right to prohibit the commercial rental of their works to the public. A similar exclusive right applies to films where commercial rental has led to widespread copying, affecting copyright-owners' potential earnings from their films.

The agreement says performers must also have the right to prevent unauthorized recording, reproduction and broadcast of live performances (bootlegging) for no less than 50 years. Producers of sound recordings must have the right to prevent the unauthorized reproduction of recordings for a period of 50 years.

Trademarks

The agreement defines what types of signs must be eligible for protection as trademarks, and what the minimum rights conferred on their owners must be. It says that service marks must be protected in the same way as trademarks used for goods. Marks that have become well-known in a particular country enjoy additional protection.

Geographical indications

A place name is sometimes used to identify a product. This "geographical indication" does not only say where the product was made. More importantly, it identifies the product's special characteristics, which are the result of the product's origins.Well-known examples include "Champagne", "Scotch", "Tequila", and "Roquefort" cheese. Wine and spirits makers are particularly concerned about the use of place-names to identify products, and the TRIPS Agreement contains special provisions for these products. But the issue is also important for other types of goods.

Using the place name when the product was made elsewhere or when it does not have the usual characteristics can mislead consumers, and it can lead to unfair competition. The TRIPS Agreement says countries have to prevent this misuse of place names.

For wines and spirits, the agreement provides higher levels of protection, i.e. even where there is no danger of the public being misled.

Some exceptions are allowed, for example if the name is already protected as a trademark or if it has become a generic term. For example, "cheddar" now refers to a particular type of cheese not necessarily made in Cheddar, in the UK. But any country wanting to make an exception for these reasons must be willing to negotiate with the country which wants to protect the geographical indication in question.

The agreement provides for further negotiations in the WTO to establish a multilateral system of notification and registration of geographical indications for wines. These are now part of the Doha Development Agenda and they include spirits. Also debated in the WTO is whether to negotiate extending this higher level of protection beyond wines and spirits.

Industrial designs

Under the TRIPS Agreement, industrial designs must be protected for at least 10 years. Owners of protected designs must be able to prevent the manufacture, sale or importation of articles bearing or embodying a design which is a copy of the protected design.

Patents

The agreement says patent protection must be available for inventions for at least 20 years. Patent protection must be available for both products and processes, in almost all fields of technology. Governments can refuse to issue a patent for an invention if its commercial exploitation is prohibited for reasons of public order or morality. They can also exclude diagnostic, therapeutic and surgical methods, plants and animals (other than microorganisms), and biological processes for the production of plants or animals (other than microbiological processes).

Plant varieties, however, must be protectable by patents or by a special system (such as the breeder's rights provided in the conventions of UPOV — the International Union for the Protection of New Varieties of Plants).

The agreement describes the minimum rights that a patent owner must enjoy. But it also allows certain exceptions. A patent owner could abuse his rights, for example by failing to supply the product on the market. To deal with that possibility, the agreement says governments can issue "compulsory licenses", allowing a competitor to produce the product or use the process under license. But this can only be done under certain conditions aimed at safeguarding the legitimate interests of the patent-holder.

If a patent is issued for a production process, then the rights must extend to the product directly obtained from the process. Under certain conditions alleged infringers may be ordered by a court to prove that they have not used the patented process.

An issue that has arisen recently is how to ensure patent protection for pharmaceutical products does not prevent people in poor countries from having access to medicines — while at the same time maintaining the patent system's role in providing incentives for research and development into new medicines. Flexibilities such as compulsory licensing are written into the TRIPS Agreement, but some governments were unsure of how these would be interpreted, and how far their right to use them would be respected.

A large part of this was settled when WTO ministers issued a special declaration at the Doha Ministerial Conference in November 2001. They agreed that the TRIPS Agreement does not and should not prevent members from taking measures to protect public health. They underscored countries' ability to use the flexibilities that are built into the TRIPS Agreement. And they agreed to extend exemptions on pharmaceutical patent protection for least-developed countries until 2016. On one remaining question, they assigned further work to the TRIPS Council — to sort out how to provide extra flexibility, so that countries unable to produce pharmaceuticals domestically can import patented drugs made under compulsory licensing. A waiver providing this flexibility was agreed on 30 August 2003.

Integrated circuits layout designs

The basis for protecting integrated circuit designs ("topographies") in the TRIPS agreement is the Washington Treaty on Intellectual Property in Respect of Integrated Circuits, which comes under the World Intellectual Property Organization.

This was adopted in 1989 but has not yet entered into force. The TRIPS agreement adds a number of provisions: for example, protection must be available for at least 10 years.

Undisclosed information and trade secrets

Trade secrets and other types of "undisclosed information" which have commercial value must be protected against breach of confidence and other acts contrary to honest commercial practices. But reasonable steps must have been taken to keep the information secret. Test data submitted to governments in order to obtain marketing approval for new pharmaceutical or agricultural chemicals must also be protected against unfair commercial use.

Curbing anti-competitive licensing contracts

The owner of a copyright, patent or other form of intellectual property right can issue a license for someone else to produce or copy the protected trademark, work, invention, design, etc. The agreement recognizes that the terms of a licensing contract could restrict competition or impede technology transfer. It says that under certain conditions, governments have the right to take action to prevent anti-competitive licensing that abuses intellectual property rights. It also says governments must be prepared to consult each other on controlling anti-competitive licensing.

Enforcement: tough but fair

Having intellectual property laws is not enough. They have to be enforced. This is covered in Part 3 of TRIPS. The agreement says governments have to ensure that intellectual property rights can be enforced under their laws, and that the penalties for infringement are tough enough to deter further violations. The procedures must be fair and equitable, and not unnecessarily complicated or costly. They should not entail unreasonable time-limits or unwarranted delays. People involved should be able to ask a court to review an administrative decision or to appeal a lower court's ruling.

The agreement describes in some detail how enforcement should be handled, including rules for obtaining evidence, provisional measures, injunctions, damages and other penalties. It says courts should have the right, under certain conditions, to order the disposal or destruction of pirated or counterfeit goods. Wilful trademark counterfeiting or copyright piracy on a commercial scale should be criminal offences. Governments should make sure that intellectual property rights owners can receive the assistance of customs authorities to prevent imports of counterfeit and pirated goods.

Technology transfer

Developing countries in particular, see technology transfer as part of the bargain in which they have agreed to protect intellectual property rights. The TRIPS Agreement includes a number of provisions on this. For example, it requires developed countries' governments to provide incentives for their companies to transfer technology to least-developed countries.

Transition arrangements: 1, 5 or 11 years or more

When the WTO agreements took effect on 1 January 1995, developed countries were given one year to ensure that their laws and practices conform with the TRIPS agreement. Developing countries and (under certain conditions) transition economies were given five years, until 2000. Least-developed countries had 11 years, until 2006 — later extended to 2013 in general, and to 2016 for pharmaceutical patents and undisclosed information.

If a developing country did not provide product patent protection in a particular area of technology when the TRIPS Agreement became applicable to it (1 January 2000), it had up to five additional years to introduce the protection. But for pharmaceutical and agricultural chemical products, the country had to accept the filing of patent applications from the beginning of the transitional period (i.e. 1 January 1995), though the patent did not need to be granted until the end of this period. If the government allowed the relevant pharmaceutical or agricultural chemical to be marketed during the transition period, it had to — subject to certain conditions —

provide an exclusive marketing right for the product for five years, or until a product patent was granted, whichever was shorter.

Subject to certain exceptions, the general rule is that obligations in the agreement apply to intellectual property rights that existed at the end of a country's transition period as well as to new ones.

16.5.2 TRIMs

The Trade Related Investment measures agreement aims to prevent countries from using investment measures that are trade distorting in nature e.g. local content requirement. No member country can take steps as are non-consistent with or prohibited under article III(national treatment) and article XI(quantitative restrictions).It means that if foreign nationals are discriminated against or if quantitative restrictions are imposed, it is against WTO rules on trade and investment and hence a reversal is sought. It too was incorporated for the first time in Uruguay round, along with TRIPs and GATS. The TRIMs committee monitors the working of this agreement and keeps an eye on the investment policies of member countries.

In the Uruguay round, it was observed that there is a need for some more provisions in the existing investment rules of GATT, to avoid adverse effects of such measures on trade. Though there was conflict between the developed nations (who wanted to introduce many provisions apart from local content requirements, found to be inconsistent with WTO rules) and developing countries(who didn' want this), the agreement was finally signed. The final shape that the agreement took confined to interpretation of rules regarding national treatment (article-III) or quantitative restrictions (article-XI).Measures like export performance and technology transfer requirement didn't become part of it. The agreement is confined to trade in goods only.

The objectives of the Agreement, as defined in its preamble, include "the expansion and progressive liberalization of world trade and to facilitate investment across international frontiers so as to increase the economic growth of all trading partners, particularly developing country members, while ensuring free competition".

Article 2.1 of the TRIMs Agreement requires members not to apply any TRIM that is inconsistent with the provisions of Article III (national treatment of imported products) or Article XI (prohibition of quantitative restrictions on imports or exports) of GATT 1994. An Illustrative List annexed to the TRIMs Agreement lists measures that are inconsistent with paragraph 4 of Article III and paragraph 1 of Article XI.

Exceptions

There are certain exceptions to the general rules. For example, Article 3 of the TRIMs Agreement provides that all exceptions under GATT 1994 shall apply, as appropriate, to the provisions of the TRIMs Agreement.

Article 4 allows developing countries to deviate temporarily from the obligations of the TRIMs Agreement, as provided for in Article XVIII of GATT 1994 and related WTO provisions on safeguard measures for balance-of-payments difficulties.

Transition period

Members were obliged under Article 5.2 of the TRIMs Agreement to eliminate TRIMs which were notified under Article 5.1. Such elimination was to have taken place within two years after the date of the entry into force of the WTO Agreement in the case of a developed country Member, within five years in the case of developing countries and within seven years in the case of a least developed country Member.

16.5.3 GATS

The third main agreement signed during the Uruguay round was the GATS, to consider the issues of trade in services, as GATT dealt with trade in goods only. There was a great need for such an agreement, as services sector had started expanding fast. Experts feel that though services do not account for more than 20% trade (though 60% of global production and employment) , there are bright prospects for this sector to flourish further, as 'tradability' of services has increased due to reforms undertaken by many countries.

Exceptions: GATS is applicable to almost all services. There are two exceptions:

Article I(3) of the GATS excludes "services supplied in the exercise of governmental authority". These are services that are supplied neither on a commercial basis nor in competition with other suppliers. Cases in point are social security schemes and any other public service, such as health or education, that is provided at non-market conditions.

Further, the Annex on Air Transport Services exempts from coverage measures affecting air traffic rights and services directly related to the exercise of such rights.

Modes of supply

The GATS distinguishes between four modes of supplying services: cross-border trade, consumption abroad, commercial presence, and presence of natural persons.

Cross-border supply is defined to cover services flows from the territory of one Member into the territory of another Member (e.g. banking or architectural services transmitted via telecommunications or mail);

Consumption abroad refers to situations where a service consumer (e.g. tourist or patient) moves into another Member's territory to obtain a service;

Commercial presence implies that a service supplier of one Member establishes a territorial presence, including through ownership or lease of premises, in another Member's territory to provide a service (e.g. domestic subsidiaries of foreign insurance companies or hotel chains); and

Presence of natural persons consists of persons of one Member entering the territory of another Member to supply a service (e.g. accountants, doctors or teachers). The Annex on Movement of Natural Persons specifies, however, that Members remain free to operate measures regarding citizenship, residence or access to the employment market on a permanent basis.

Obligations under GATS agreement

(a) General obligations

MFN Treatment: Under Article II of the GATS, Members are held to extend immediately and unconditionally to services or services suppliers of all other Members "treatment no less favourable than that accorded to like services and services suppliers of any other country". This amounts to a prohibition, in principle, of preferential arrangements among groups of Members in individual sectors or of reciprocity provisions which confine access benefits to trading partners granting similar treatment.

Derogations are possible in the form of so-called Article II-Exemptions. Members were allowed to seek such exemptions before the Agreement entered into force. New exemptions can only be granted to new Members at the time of accession or, in the case of current Members, by way of a waiver under Article IX:3 of the WTO Agreement. All exemptions are subject to review; they should in principle not last longer than 10 years. Further, the GATS allows groups of Members to enter into economic integration agreements or to mutually recognize regulatory standards, certificates and the like if certain conditions are met.

Transparency: GATS Members are required, *inter alia*, to publish all measures of general application and establish national enquiry points mandated to respond to other Member's information requests.

Other generally applicable obligations include the establishment of administrative review and appeals procedures and disciplines on the operation of monopolies and exclusive suppliers.

(b) Specific Commitments

Market Access: Market access is a negotiated commitment in specified sectors. It may be made subject to various types of limitations that are enumerated in Article XVI(2). For example, limitations may be imposed on the number of services suppliers, service operations or employees in the sector; the value of transactions; the legal form of the service supplier; or the participation of foreign capital.

National Treatment: A commitment to national treatment implies that the Member concerned does not operate discriminatory measures benefiting domestic services or service suppliers. The key requirement is not to modify, in law or in fact, the conditions of competition in favour of the Member's own service industry. Again, the extension of national treatment in any particular sector may be made subject to conditions and qualifications.

16.6 LET US SUM UP

In this lesson, we understood what issues concern the developing countries like India and how far are they addressed under the aegis of WTO. We also learned about TRIPs, TRIMs and GATS, the three important agreements of Uruguay round.

16.7 REFERENCES AND ESSENTIAL READINGS

See the end notes pertaining to this lesson.

SELF ASSESSMENT QUESTIONS

- What are the special provisions in GATT/WTO for the developing and the least developed countries?
- What issues in WTO worry the developing countries?
- What has been the role of India in WTO? Justify with some recent developments in this regard.
- Write notes on TRIPs, TRIMs and GATS. What do these three agreements deal with?
- What are the main areas of intellectual property rights protected under WTO?
- What are the four modes of supply in GATS?

CURRENT DEVELOPMENTS AND PROBLEMS IN THE INTERNATIONAL ECONOMY

ASIAN CRISIS

Structure

17.1 OBJECTIVES

After going through this lesson, the learner should be able to:

- Have an understanding of the Asian financial crisis of 1997
- Learn what factors caused the crisis
- Know about its consequences and lessons for developing countries like India

17.2 INTRODUCTION

Just after the debt crisis, developing countries found it very difficult to invite new capital. It was only after the reforms had started, that capital again started flowing to these countries. Capital flows rose sharply in early 1990s and peaked in the mid decade and reduced thereafter. Before 1997, Asia was the largest recipient of capital (50% of total flow to developing countries), followed by Latin America. But the capital flows being of short nature, had many consequences, which we shall discuss in this lesson.

17.3 THE CAUSES AND CONSEQUENCES OF THE ASIAN FINANCIAL CRISIS

Causes

The Asian financial crisis was originally confined to four Asian nations Thailand, Malaysia, Indonesia and South Korea. The so called 'miracle economies' included SEA-3 and South Korea. Before the onset of crisis, their development models were appreciated worldwide. Korea's per capita income rose from $50 in 1950s to about $10,000 in mid 1990s.The Bank of Thailand was appreciated a lot for its sound management practices. There was a construction boom, stock market prices were moving up and as a result of the positive wave felt everywhere, foreign capital inflow increased tremendously. There was free movement of capital and pegging of domestic currencies to US dollar. These Asian countries underwent financial liberalization with a purpose. The purpose was to give the domestic banks more access to international financial market. The domestic (mainly Thai) banks would borrow from international market and lend to domestic (Asian) borrowers. They wanted to benefit out of interest rate differentials between the international market (low rate of interest) and the domestic market (high). In the process of borrowing and lending, they contracted short term loans denominated in dollars from international market and long term loans denominated in domestic currency in the domestic market.

The transactions of the above type were proving risky. The first risk i.e. exchange rate risk was that the domestic currency may be devalued. To that extent, the cost of servicing the foreign debt would increase. Secondly, what would happen if the foreign governments would disagree to renew the loans?. To simplify the things, the short term loans were tied to long term loans in the domestic market. If the intermediators were not allowed to get the loan renewed, they would have to pay the debt at a very short interval of time. This was very difficult, as domestic loans were of long term nature.

Crises are said to be positively related to the government policies to come to their rescue if loans are not repaid. There arises the problem of Moral Hazard when the banks take more risks because they know that the government will bail them out if they lose by lending. The Asian crisis too has been attributed to moral hazard. The banks took risk because they were aware of the weakness in the domestic financial regulations. Under such circumstances, banks tend to take more risk by lending more and more loans to high risk borrowers, as they are charged a high rate of interest as compared to low risk borrowers. The incentive is that the banks would earn more if such loans would be repaid, and not lose if not. In other words, in case of default by high risk borrowers, the government would give a high return on these loans. So they lend more and more to high risk borrowers, since they are not going to incur losses in either case. But taking such risks and working with an irresponsible behaviour because someone else is going to bear the loss increases the possibility of a crisis.

The Asian countries which were affected directly by the crisis had a system of weak regulation of financial intermediaries or at least implementation. In most of these countries, the financial institutions either had close links with the government or the people in power owned these. In Indonesia, seven state owned banks which controlled half of the assets in the banking system (Blustein 2001) had the relatives and friends of president Suharto. When two corporate groups rescued the Bank Duta after it lost $500 million, they were rewarded, as president Suharto's political foundation's deposits were lying in it. In Thailand, the government rescued the Bangkok Bank of Commerce in 1996 worth $7 billion. As a result of these unhealthy practices, domestic financial institutions continued to take more and more risks. Likewise, international lenders continued to lend to Asian banks. So the Asian financial and currency crisis has been attributed not only to policy failure not only on the part of national governments , but also on the part of IMF and World Bank by contributing to the moral hazard.

In late 1996 and early 1997, some conditions in the economic environment of Asian countries made their position vulnerable . The banks which were accustomed to unhealthy lending practices could not withstand that pressure. First, as most of the Asian countries had pegged their currencies to dollar, and as dollar started appreciating against Japanese yen in mid 1990s, Asian currencies too started appreciating. Due to appreciation in the value of the domestic currencies, there arose the problem of debt service, as export oriented firms, which exported to Japan, found it difficult. Second, real estate prices fell in late 1996, which caused debt service problem for the real estate developers. By 1997, Asian Banks saw their Non Performing loans growing like anything. As domestic banks were not repaid the loans by domestic borrowers, international lenders couldn't be repaid the loans taken by domestic banks. So domestic debt service problems caused international debt service difficulties.

In the spring of 1997, Finance One, one of the largest financial institutions of Thailand was found insolvent i.e. its liabilities exceeded its assets. On further investigation, it was found that it was not the exception. Most of the Asian banks were under the grip of insolvency. The situation led to the suspension of the working of 16 financial institutions in Thailand. There was a panicked withdrawal of funds from the Asian market in general and stock market in particular. The Panic started in Thailand in May 1997 and spread to other Asian countries (Phillipines, Indonesia, Malaysia, Taiwan, Hong Kong, South Korea). The Asian nations which were affected, finally abandoned fixed exchange rate and floated their currencies. A total of $60 billion was pulled from the region in the second half of 1997, roughly two-thirds of all the capital that had flowed in the year before(IMF 1999).

After the crisis, these Asian countries moved to IMF for financial assistance. The Phillipines was the first country to move and got $1.1 billion credit. The four countries affected the most were given financial support equal to $117.7 billion.

As the assistance provided by IMF is conditional in nature, the Asian countries were told to give attention to three broad areas: macroeconomic stabilization, financial sector reforms and structural reforms. Macroeconomic stabilization was meant to serve the purpose of restoring confidence in the countries concerned and to prevent the outflow of capital. Governments were told to tighten the monetary and fiscal policies. Financial sector reforms required the governments to close the insolvent institutions, do away with the existing system of close associations between government officials and financial institutions, recapitalizing the weak institutions and restructuring the financial sector by keeping more stringent norms, so that the bitter experience is not repeated. With regard to the structural reforms, the governments were required to liberalise trade, eliminate monopolies, stop uncompetitive practices and privatise state owned enterprises.

Consequences

The Asian financial and currency crisis (sometimes called twin crisis) had many repercussions for the political and economic spheres. Following are some of the most important consequences:

Economic recession: The crisis and the resulting tightening of policies by the governments (IMF conditionality) had a deep impact on the domestic economies. In Indonesia, output fell by more than 13% in 1998.

Poverty: Poverty i.e. the number of people living below the poverty line also rose sharply in the countries affected by the crisis. For example, in Indonesia, the percentage of people below the poverty line rose from 11% before the crisis to 19.9% after the crisis. In South Korea, it increased from 8.6% to 19.2% during this period.

Political unrest: As the public was hit hard, there was widespread movement against the existing regimes which had encouraged corruption, nepotism and cronyism. This was observed in Indonesia and Thailand and led to the replacement of the existing political heads by those more likely to undertake reform measures.

Effect on rest of the world: The Asian crisis didn't stay confined to the four economies. They not only spread to other countries of East Asia, but much beyond, even to Brazil and Russia though their fundamentals differed from these economies and were not directly affected. It not only affected international trade, which fell sharply (WTO 1999a), but also the reduced economic activity in East Asia led to drop in the prices of raw materials for African and South American exporters. So the whole world economy was affected by the Asian crisis.

The Asian crisis has been said to be different and unprecedented in many ways. First, it took place due to faulty practices of the banks and not the government's budget deficits or inflation. Second, the extent of assistance too was unthinkable. Consequences too were unprecedented, as it led to the overthrow of the existing regimes of most of the nations.

17.4 LESSONS FOR THE DEVELOPING COUNTRIES

As a result of this crisis, nations worldwide as well as the international financial institutions and many scholars (who earlier supported the opening up of developing countries' markets to foreign capital) have become cautious before recommending the policies practiced earlier. The developing countries like India can learn many lessons from this crisis, as many new things unfolded during this crisis. Let us discuss some of these:

First of all, this crisis undid the widely held notion that developing countries always benefit out of complete financial liberalization and full integration into the international financial system. Joseph Stiglitz once said "Financial liberalization might expose developing countries to unnecessary risks without commensurate returns"(Wessel and Davis 1998).Another critic of too much of exposure to short term capital flows is Jagdish Bhagwati who argues that cost-benefit analysis shows that there are more costs associated with it ,than benefits. So one should agree with the possibility of putting restraints on capital flows.

In this regard, the governments and international institutions like IMF have been reevaluating the costs and benefits of capital flows. 'Capital controls' has been considered seriously regarding its effectiveness in avoiding the crises of this type. Short term capital flow which is much more volatile as compared to long term capital has been reconsidered and the experience of countries like Chile has been observed with great interest. Chile has had a policy of capital controls to discourage short term flows and encourage long term flows. Besides, policy makers have become more aware of sound banking practices .If healthy practices are followed in banking and reforms are taken to strengthen their position, so that the situation doesn't become that vulnerable, such crises can be avoided in future. So the developing countries need to keep capital controls and encourage healthy banking practices.

The second lesson to be learned is regarding the way the crisis was managed. Many scholars have criticized the way IMF handled it. IMF has been criticised because of its recommended policies as conditionality for assistance. The policies like macroeconomic stabilization program, which asked the governments to tighten the monetary and other policies further deepened the recession. Scholars suggest that since the crisis had originated in unhealthy lending policies of banks and not in governments' budget deficits, the policy recommended was inappropriate. Not only that , when banks were closed forcibly, they caused panic .IMF has also been criticized for increasing the intensity of moral hazard, due to which over lending continued. So IMF was told to have a re-look at its current practices with regard to policy recommendations in conditionality attached and make it appropriate the country concerned.

So the developing countries need more and more foreign capital. But at the same time, they need to be cautious regarding which policies to adopt. They can't go for full financial sector liberalisation or lifting of capital controls, as it has more costs than benefits. Apart from this, once a crisis takes place ,immediate steps should be taken to restore confidence in the market, so that panic is avoided and capital outflow can be controlled.

17.5 LET US SUM UP

In this lesson, we got to know about the Asian financial crisis and its causes and consequences.

17.6 REFERENCES AND ESSENTIAL READINGS

International Political Economy by Thomas Oatley

SELF ASSESSMENT QUESTIONS

- What were the causes and consequences of the Asian financial crisis? What lessons can the developing countries draw from it?

IMPACT OF TRADE REFORMS SINCE 1991 ON INDIA'S BOP

Structure

18.1 OBJECTIVES

The main objective of this lesson is to make learners aware of the impact of India's trade reforms taken since 1991 on Balance of Payments.

18.2 INTRODUCTION

The Indian Economy passed through a critical phase in 1980s. External debt had become unmanageable. The different macroeconomic fundamentals were ringing alarm bells. India was caught in a vicious circle of external debt, as experts call it. The external debt increased from \$20.7 billion in 1980-81 to \$83.6 billion by 1990-91 and to \$85.4 billion by 1991-92. Its share in GDP had increased from 13.7 percent to 30.7 in 1980 to 31 percent in 1991 and to 35 percent in 1992 . The debt servicing as a proportion of current receipts had increased from 10.2 percent in 1980-81 to 35.3 percent in 1990-91. The foreign exchange reserves were just sufficient for three weeks of imports. The fragile economy gave rise to the Balance of Payments crisis of 1991. As debt was becoming a problem interfering with the basic functioning of the economy, it was imperative to introduce reforms to address the issue.In this lesson, we shall discuss about the reforms taken by the Government of India in 1991 and their impact on BOP.

18.3 IMPACT OF TRADE REFORMS SINCE 1991 ON BOP

The first thing the government did was to approach the IMF to come to its rescue. It requested for a loan and got $2.2 billion of loan in lieu of 67 tons of gold reserves. It created panic among the masses. However, the measures to counteract a serious crisis had started.

Reforms gathered momentum with P.V. Narsimha Rao taking over as the prime minister and Dr. ManMohan Singh as the finance minister. The government took keen interest in reforms because they were need of the hour and because of IMF's conditionality attached, according to which the debtor nations applying for loans need to undergo structural and other reforms to get the loans.

The liberalization, privatization, globalization (LPG) policy or the New Economic Policy, in which emphasis was put on deregulation, privatization, opening up of some sectors to foreign competition and dismantling of barriers, among others, had deep impact on the BOP position of the country.

Different scholars have tried to analyse the impact of trade reforms of 1991 on the different BOP indicators [46] like (1) trade openness, (2) terms of trade, (3) exports & imports, (4) role of invisibles, (5) trends in current account, (6) trends in capital account, (7) external debt, (8) exchange rate management, and (9) reserve management.

Trade Openness

Openness of a country means how receptive that country is towards exports from other nations. It has been observed that India's trade openness has increased as a result of trade reforms of 1991. Its openness becomes clear from the gradual dismantling of tariff barriers and reduction in the non-tariff barriers. For example, before 1990s, the maximum import duty rates on certain items were over 300 per cent. The "peak" rate of import duty on non – agricultural imports was gradually reduced from as high as 150 per cent in 1991 – 92 to 25 per cent in 2003 – 04. Finally, the peak rate of import duty on non – agricultural imports has also been brought down.

As per RBI's *Report*, India's total merchandise trade, an indicator of degree of openness of an economy, increased from about 11.8 per cent of GDP in 1980s to 17.4 per cent during the 1990s. The data from 2000 – 01 to 2006 - 07 shows that it went up to nearly 27 per cent. The average export – import ratio, increased from about 64 per cent in the decade of 1980s to 84 per cent in 1990s.The trade to GDP ratio during the period from 1980 - 81 to 1989 – 90 was 11.8 per cent, which went up to 17 per cent during the period from 1990 – 91 to 1999 – 2000. These data show that trade openness increased as a result of reforms in India.

Terms of trade

India's average gross barter terms of trade have declined from 145 in 1980s to 135 in 1990s and has been stable thereafter. However, the yearly data indicates that there was an improvement in the gross barter terms of trade in the first few years after the reforms. Similarly, India's net terms of trade, which measures the relative change in export and import prices have been generally fluctuating during the 1990s. But, a comparison between 1980s and 1990s shows that the net terms of trade have improved from 110 to 135. However, from 2000 – 01 to 2006 – 07 it has come down to 125.

Import purchasing power of exports as measured by the income terms of trade have consistently improved during the 1990s on account of strong export growth in volume terms. The income terms of trade, increased from on an average from 141.5 in 1980s to 439.5 in the 1990s and further to 1034.0 from 2000 – 01 to 2006 – 07. Some studies done for the period 1970 – 71 to 2001 – 02 show that shows that there has been a secular upward movement in terms of trade (in all the three measures : gross, net and income) during this period. Also the volatility has come down significantly since 1992 – 93 as compared to the period between 1970 – 71 to 1989 - 90, a period when the economy was relatively inward looking. So the overall impact on terms of trade was favourable.

Exports and Imports

In this regard, the discussion revolves around the growth rate of exports and imports, their composition and direction. As far as the growth rates are concerned, the average annual export growth rate rose from 16.8 per cent in 1980s to 17.45 in 1990s. From 2001 to 2007, it was 18.0 per cent showing a marginal improvement. On the other hand, average annual import growth rate rose from14.55 in 1980s to 18.75 in 1990s. From 2001 to 2007, it was 21.4 per cent, showing some improvement. However, as an economy is affected by many local and international factors, when it opens up, in second half of 1990s, a slowdown was observed in exports and imports due to Asian crisis, reduction in demand at global level etc.

With regard to composition of exports, the share of primary products in exports reduced from 36.80 per cent in 1980 – 81 to 24.0 per cent in 1990 – 91. It decreased to 17.70 per cent in 1999 – 2000.Further, by 2006 – 07 it fell to 15.5 per cent. The share of "manufactured goods" in India's total exports increased from 70.7 per cent during 1987 – 90 to 75.3 during 1992 – 97 and further to 77.4 per cent during the 1997 – 2002.The share of petroleum products increased from 0.4 per cent in 1980 – 81, to 2.9 per cent in 1990 – 91, and further to 14.8 per cent in 2006 - 07. The technology intensive and industrial products such as engineering goods have become important exportables. As far as the direction of exports is concerned, it has shown OECD,OPEC and developing countries as the most important destination in the decade following reform.

Since 1987 – 88, the importables have been re-classified: Bulk imports and Non – bulk imports. The data presented here is in accordance with the new classification. Following important changes have taken place in the structure and composition of imports in the post reform period:

Petroleum and petroleum products which are the most important item among bulk imports The share of this item was 42 per cent in 1980 – 81, which fell to 25.0 in 1990 – 91. In 1999 – 2000 its share marginally went up to 25.40 per cent. In 2006 – 07, its share went up to 30.76 per cent. Fluctuations in the value of these imports notwithstanding, there has been increase in the volume of such imports due to increase in domestic consumption and the stagnation in domestic crude oil production. As far as the non-bulk imports are concerned, the share of the most important item i.e. capital goods has remained almost stable during the post – reform period. For instance, its share was 15.2 per cent in 1980 – 81, which increased to 24.2 per cent in 1990 – 91. In 1999 – 2000 its share decreased to 18.05 per cent, however, by 2006 – 07, its share again went up to 25.35 per cent.

Role of Invisibles in the Post Reform Period

By invisible receipts is meant the income received in the form of travel, banking, consultancy, transportation, insurance, investment income, private transfers and official transfers. A positive net invisibles means invisible receipts are more than invisible payments. While a negative net invisibles means invisible receipts are less than invisible payments. Thus, it is the positive net invisibles which finance the trade deficit.

As per the data, in 1990-91, net invisibles as a percentage of GDP were negative i.e. – 0.1 per cent. However, immediately after reforms, it started increasing to 1.8 per cent in 1994 – 95, to 2.9% in 1999 – 2000,and to 5.8 per cent of GDP in 2006 – 07.

In this regard, the RBI's *Report on Currency & Finance 2001 – 02 – comments:* "One of the most significant developments in current account of balance of payments in the 1990s was the remarkable growth in service transactions with the rest of the world, which was made possible by the revolution in information and communication technology…Reflecting the strong growth emanating from software exports, the traditional sources of service exports, viz., travel and transportation have declined in relative importance. Following the heavy inflow of invisible receipts, India's current account deficit (CAD) narrowed down considerably during the decade of 1990s."

Trends in Current Account

It has been observed that during 1980s, India's CAD i.e. current account deficit was 3.1% of GDP. The BOP crisis of 1991 has been discredited to it, along with other factors. Immediately after reforms, through sound policies, it was brought down to around one percent. The policies taken were competitiveness of exports of both goods & services, market – based exchange rate regime, consolidation of external debt and a policy preference for non – debt creating capital flows. The CAD / GDP ratio reduced from 3.1 per cent in 1990 – 91 to 0.3 per cent in the year 1991 – 92. The average CAD / GDP ratio works out to be 1.02 per cent from the period 1991 – 92 to 2000 – 01. Further, there was a current account surplus for three consecutive years from 2001 – 02 to 2003 – 04, first time in post – independence period.

Trends in Capital Account

The BOP crisis of 1991 brought many lessons for the policy makers. It was observed that the methods of financing the current account deficit were not appropriate. So a committee of experts was set up to recommend the way to finance the deficit and to get out of the crisis.

The *High Level Committee on Balance of Payments, 1993* (Chairman: C. Rangarajan) recommended

(a) compositional shift in capital flows away from debt to non – debt creating flows

(b) strict regulation of external commercial borrowings, especially short –term debt

(c) discouraging volatile element of flows from non – resident Indians

(d) gradual liberalization of outflows, and

(e) dis-intermediation of Government in the flow of external assistance.

So India's policy immediately after 1991, i.e. in post reform period was to encourage long – term capital inflows and discourage short – term volatile flows.

There are four basic components of capital account : foreign investment, external assistance, external commercial borrowings and NRI deposits. The foreign investment/GDP ratio has been increasing in the post reforms period. The reliance on external assistance has come down. The general trend in the external commercial borrowings is that they have been high in the post reforms period. Focus is on productive projects like in infrastructure.

Some changes were made in the existing provisions with regard to NRI deposits. The aim was to have stable deposits. This was done through

- a policy induced shift in favour of local currency denominated deposits,
- rationalization of interest rates on rupee denominated NRI deposits,
- linking of the interest rates to LIBOR for foreign currency denominated deposits,
- de – emphasizing short – term deposits (up to 12 months) in case of foreign currency denominated deposits; and
- withdrawal of exchange rate guarantees on various deposits.

So since the reforms of 1991,there has been a shift from debt to non – debt flows, with the declining importance of external assistance, ECBs and NRI deposits and the increased share of foreign investment. In 1990 – 91, the proportion of non – debt creating capital inflows to total capital inflows was 1.5 per cent and that of debt creating inflows was as high as 83.0 per cent. But within a span of 10 – 12 years, the situation changed drastically. For example, in 2001 – 02, the proportion of non – debt creating inflows to total inflows was 77.0 per cent and that of debt creating flows was 9.0 per cent.

Impact of Reforms on External Debt

The following excerpts from the RBI's report *on Currency & Finance 2002 – 03* show the external debt position of India in the pre-crisis time: "The growth of external debt was particularly noticeable during the second – half of 1980s and the share of commercial debt in total external debt increased from 15.0 per cent in 1981 to 40.0 per cent in 1991. As a consequence of the increase in commercial debt, debt servicing as a proportion of current receipts increased from 10.2 per cent in 1980 – 81 to 35.3 per cent in 1990 – 91. Hence, the overhang of large external debt, particularly the short – term debt was one of the important triggering factors in the balance of payments crisis in 1991."

Since 1991, the approach to the debt management is mainly based on the recommendations of *Rangarajan Committee, 1993.* Following the recommendations of the *Rangarajan Committee(1993)* the external debt management strategy has been guided by :

- continuation of an annual cap, minimum maturity restrictions and prioritizing the use of ECBs;
- containment of short – term debt**;**
- restructuring of more expensive external debt
- measures to encourage non – debt creating financial flows in the form of foreign investments
- incentives and schemes to promote current exports and other current receipts; and
- conscious building – up of foreign exchange reserves to provide effective insurance against external sector uncertainties**.**

The external debt position of India has improved a lot, as a result of reforms taken.

Exchange Rate Management in the Post – Reform Period

In India, the broad objectives of exchange rate policy are:

- to reduce excess volatility
- to prevent the emergence of destabilizing speculative activities
- to help maintain adequate level of reserves, and
- to develop an orderly foreign exchange market.

Many changes have taken place in India's exchange rate policy to fulfill these objectives. India moved from a system of fixed exchange rates until March 1992 to a market determined regime since March 1993. As it was required under the macroeconomic stabilization programme, rupee was devalued in two stages in terms of US dollar in July 1991.

The journey from fixed to market determined regime took place in two stages and the sequencing was based on the *Report of the Rangarajan Committee, 1993.* Initially, under Liberalised Exchange Rate Management System (LERMS) of March 1992, a dual exchange rate system was followed under which 40 per cent of exchange earnings were to be surrendered to Reserve Bank at official exchange rate while the rest 60 per cent could be converted at market rate. Finally, on March 1, 1993, the unification of the exchange rate system of the Indian rupee took place which was an important step towards current account convertibility, which was finally achieved in August 1994 by accepting Article VIII of the Articles of Agreement of the IMF.

Management of Foreign Exchange Reserves in the Post Reform Period

The main objective of maintaining adequate reserves are:

- Maintaining confidence in monetary and exchange rate policies;
- Enhancing capacity to intervene in foreign exchange markets;
- Limiting external vulnerability so as to absorb shocks during times of crisis;
- Providing confidence to the markets that external obligations can always be met; and
- Reducing volatility in foreign exchange markets.

Until the BOP crisis of 1991, India's approach towards foreign exchange reserves was the import cover i.e. we should have sufficient foreign exchange reserves to be able to finance few months of imports. However, after the crisis, and as per the recommendations of the Rangarajan committee, an additional component was added, to aim for reduced volatility in the exchange rate. The *Rangarajan Committee, 1993* recommended that the foreign exchange reserves targets be fixed in such a way that they are generally in a position to accommodate three months of imports.

As a result of reforms taken, the foreign exchange reserves position of India improved substantially. The reserves increased from 4388 crores in 1990-91 to 14578 crore rupees in 1991-92. Reforms continued which further increased the reserves to 836597 crore rupees in 2006-07.

18.4 LET US SUM UP

In this lesson, we studied the impact of trade reforms of 1991 on India's BOP position.

18.5 REFERENCES AND ESSENTIAL READINGS

See the end notes section in the end.

SELF ASSESSMENT QUESTIONS

- What was the impact of India's trade reforms on Balance of payments?

MULTI NATIONAL CORPORATIONS (MNCs)

Structure

19.1 OBJECTIVES

The main objectives of this lesson are to introduce to the learners the meaning ,functioning and role of MNCs in the world economy. They shall also be made aware regarding the role of domestic politics in this regard.

19.2 INTRODUCTION

Many changes have taken place in the post war international economic system.

One such change is the role played by multinational corporations, which are based in one country ,but establish their production facility in a host country or acquire an entity, thereby getting the managerial control over it. They take important decisions regarding resources to be employed. A number of factors affect the host country's position, which may improve in case the MNC tries to take decisions in which local resources are used and hence they contribute to the local economy ; in the other case, certain decisions prove detrimental for the host economy, e.g. if employment, output, technology transfer etc. to the economy get adversely affected. Hence MNCs are in controversy, though there are two divergent opinions in this regard. One takes them as 'productive instruments of a liberal economic order', as they are involved in efficient allocation of resources globally, while the other considers them to be 'instruments of capitalist domination', as they are said to be ignoring the host country needs and weaken labour and environmental standards. However, both these consider them to be agents of globalization. In this lesson, we'll discuss about different aspects of the issue.

19.3 DEFINITION OF MNCs

A Multi National Corporation (MNC), also sometimes called as Trans National Corporation (TNC) is an " enterprise that controls and manages production establishments-plants- in at least two countries" (Caves 1996).

Their activities are spread across production, trade and investment. Most of the trade takes place between MNC parent and affiliate i.e. is intra-firm trade. Once a firm engages in FDI, it becomes a MNC. Through FDI, it establishes a new plant in a new country or purchases one. MNCS invest overseas for having access to critical markets, to get raw materials or to improve the production process. In this way, they act as agents of globalization.

19.4 DOMESTIC POLITICS AND MNCS

It is usually observed that the MNCs have objectives conflicting with those of the host country governments. Whereas the government aims to achieve objectives so as to improve the welfare of the people and hence has local economy in mind, MNCs aim to promote the global objectives of their stakeholders. When a MNC is established in a host country, it does contribute positively by bringing many resources to the country. However, decision making lies with the foreign managers which raises doubt in the mind of the host government regarding whether the resources shall be used in accordance with the objectives of the government. This is the domestic politics of MNCs.

The domestic politics of MNCs shall become clear from the following lines by a scholar : “The regime of nation states is built on the principle that the people in any national jurisdiction have a right to try to maximize their well being, as they define it within that jurisdiction. The MNC, on the other hand, is bent on maximizing the well being of its stakeholders from global operations , without accepting any responsibility for the consequences of its actions in individual national jurisdictions.” (Vernon 1998).

19.4.1 Host country dilemma: When foreign firms invest in the host country and significant control of the enterprise as well as the management control lies with the foreign firm, the host country faces a dilemma. On the one hand, this country needs foreign capital, technology and management skills etc. for the development of the economy and hence for improving the welfare of its people. On the other hand, it is apprehensive of the foreign firm’s attitude, as major decisions taken by it might not suit the country concerned. This is a dilemma which almost every host country faces. This is referred to as host country dilemma. The governments try to manage this dilemma.

MNCS bring many benefits for the host country. First, in the form of Foreign Direct Investment (FDI). As we know, in FDI which is a fixed investment, there are less risks as compared to other forms of capital flows. A domestic affiliate is established which is relatively stable and also does not raise the indebtedness of the host country .In this way, savings get transferred across borders and contribute to the host country’s economy. Secondly, there occurs transfer of technology from MNC to the host country. Transfer of technology is enabled because of their possession of some ‘intangible assets’ or the knowledge to produce something. The firms in which investment takes place get affected positively, and later on can learn to make things themselves. Not only those firms gain, but positive externalities are also created for many more firms which get the advantage of low cost inputs, produced as a result of efficiency generated due to the transfer of technology. Thirdly, managerial expertise from the MNC also gets transferred . As we know, MNCs have networks across the world. The managers who handle these firms are much more expert in the management skills and coordination, as compared to the managers of local firms. Local firms gain a lot by putting in practice the proper management practices. MNCs can also enable the host country firms to have access to the global market by increasing their export opportunities. In this way, MNCs prove beneficial for the host country.

Despite many benefits, there is no guarantee that the resources shall be used to the advantage of the host country. How much of capital and technology shall be transferred to the host country, how local inputs shall be combined and how the revenues thus generated be used are the basic decisions lying with foreign management. Problem arises when the host country agenda can't be met by the government.

Let us now discuss in what ways a MNC's activities actually prove detrimental to the host economy.

Sometimes instead of bringing capital, MNCs borrow from the host country. It leads to crowding out. In other words, the same scarce resources are to be used by different entities in competition. The extent of borrowing reduces to that extent the availability of funds with the local firms for investment.

Most of the times, MNCs charge a rent, royalty or licensing fee from the host country affiliates for the transfer of technology etc. This gets repatriated from the host country to the MNC.

Often, affiliates are made to purchase inputs from other subsidiaries of the MNC. The price thus determined is called transfer pricing. MNC parent has full control over the price to be charged from the affiliate, as it is a matter internal to the MNC parent. Many a time, it is found that the affiliate is overcharged for the import of inputs and the exports of this affiliate to other countries are under priced. This results in huge loss to the domestic economy.

Though there is some transfer of technology and managerial expertise to the host country, MNCs still try to keep them as close and secret to themselves as possible. So the transfer is limited.

Finally, a lot regarding the use of revenue generated by the affiliates depends on the MNCs' policies .If they are directed to serve some other purpose, host country's economic objectives can't be met.

The points discussed above explain the dilemma faced by a host country.

19.4.2 Overcoming the dilemma: regulating MNC activity To overcome this dilemma, governments in the host countries have been trying to take steps to make their objectives fulfilled. Say for example, FDI. They have been trying to direct foreign direct investment in accordance with their objectives. We can discuss two kinds of approaches, one by developing and the other by developed countries.

Developing countries: Most of the developing countries had been the former colonies and had just become independent (in the 1950s). Colonial power was related to foreign companies. They knew how miserable was the condition under colonialisation. The local people were ill-treated. Domestic economy was drained of the scarce resources. The memory was fresh in their minds. So in 1950s and 1960s, there remained skepticism on the part of these countries. Their approach towards foreign investment was to control existing investment and to manage the terms under which fresh investments were to take place.

During the 1960s and 1970s, desire for further economic autonomy made the governments go for nationalization of the existing affiliates of MNCs. Through nationalization, the control gets transferred to the government. The MNC is compensated. As far as new investments were concerned, more restrictions were placed. MNCs were excluded from the main sectors like public utilities, iron and steel, insurance and banking etc. The existing local affiliates were to be owned by local shareholders through joint ventures. Also, the repatriation of profits for technology transfer was limited. The basic purpose was to ensure that local control of the affiliate leads to more decision making in local hands. Apart from nationalization, another condition was 'performance requirement'. As per the performance requirement, a target is imposed on the local affiliate depending on the national objectives. It may be to purchase a specific quantity (percentage) of inputs from the domestic suppliers, to export a fixed percentage of its production or to promote research and development in the host country.

Developing countries were cognizant of the importance of foreign direct investment. So MNCs were regulated , their entry was not blocked. Apart from the nationalization strategy, regulation was also done to serve the objective of Import Substitution Industrialisation (ISI). This policy was restrictive in nature. Through these policies, terms were fixed for foreign investment so that national objectives are met. However, some developing countries had 'export oriented strategy'. They were more liberal. But still, approval was required. In this regard, two countries, Taiwan and South Korea are said to have attracted foreign investment as their strategy was aimed at promoting exports and not restricting imports. They created Export Processing Zones (EPZ) to facilitate foreign investment.

Since the 1980s, developing countries have understood the futility of imposing restrictions and hence have liberalized the terms for managing MNCs. It was experienced that restrictive investment regime of 1950s,and1960s had pushed MNCs away from host countries. So they have been trying to encourage foreign investment.

Advanced industrialized countries: As compared to the developing countries, the advanced countries have been more liberal towards inwards foreign investment, though approval was required and certain critical sectors were excluded from inward foreign investment here also.

Japan has been an exception. Until 1970, the industrial policy was such that imposed restrictions on inward investment, as compared to transfer of technology. In most of the cases, the foreign firms were pressurized to transfer technology to the local firms. If the foreign firm was not convinced or there was less possibility of this option, only then inward investment was allowed, and that too was not a 100% foreign subsidiary, but a joint venture. Restrictions have been relaxed since 1970s and 1980s. But still the existing system of firms is not conducive for attracting substantial foreign investment.

Likewise, there are many more examples of other advanced countries which lend evidence to the fact that they have been very strict at times towards foreign investment. Some important cases include: acquisition by General Electric (American MNC) of Machines Bull (French firm),proposed sale of Fairchild semiconductor (American firm) to Fujitsu (Japanese MNC). In both the cases, governments took strong action and prohibited all sorts of investment. In the latter case, though the deal couldn't materialize, the proposed deal made the Congress pass legislation (the Exon-Florio Amendment to the 1988 omnibus trade act) to block foreign acquisitions of American firms for national security reasons.

19.5 INTERNATIONAL REGULATION OF MNCs

There is lack of comprehensive rules on international investment. Some efforts have been made ,however ,from time to time to create these rules .There are rules within WTO as well as within OECD. There are international rules applicable to a few countries e.g. investment chapter of NAFTA. Due to conflicts of interest between capital exporting countries (developed)and capital importing countries (developing), these rules couldn't be created at an international level in the true sense.

Historically, FDI has been governed by international rules based on four legal principles:

- Private investments are private property to be treated at least as favourably as domestic private property.
- Governments have a right to expropriate foreign investment, but only for a public purpose.
- In case of expropriation, the host country should compensate the firm fully. In other words, "expropriation must be accompanied by adequate, effective and prompt compensation".(Akehurst 1984)
- Foreign investors have a right to appeal to their home country in case of dispute with the host country.

These rules were acceptable to both capital exporting as well as importing countries, throughout the 19th century. However, Latin American governments opposed this idea of interference by the foreign country in the host country for protection of their firms. By late nineteenth century, they invoked Calvo doctrine which argued that the foreign governments have no right to interfere in the host country to enforce their citizens' private claims.

The legal principles regarding foreign investment came under threat from capital importing countries . It started during inter-war period. The first incident took place in the soviet Union. After the 1917 revolution, Marxist-Leninist government came to power that rejected the idea of private property. There was a massive drive for nationalization due to which government's role increased .In Latin American countries, expropriation started in extractive industries and in public utilities. This broadened the notion of 'public purpose'. Apart from this, compensation too was interpreted differently. For example, in Soviet Union's case, it was argued that the foreign firms' compensation can be linked to the claims on western governments for damages caused in the civil war after the revolution.

The United States had emerged as the largest investor in the post war period. As a capital exporter ,it wanted to serve its interests by re-establishing the traditional legal basis for investment protection. It tried to incorporate it in the proposed ITO. However, many developing countries including India, Australia etc. opposed the idea and were able to create a set of articles which re-inforced the rights of host country and gave more importance to the role played by host government in regulating foreign investments within their borders than the goal that American business strived for. So the investment components of ITO in Havana Charter were criticized and rejected by the Congress. This resulted in the ITO being confined to papers.

As ITO could not see the light of the day, there couldn't be international rules governing foreign direct investment. Failure of ITO has been attributed mainly to the conflict between capital exporting countries and capital importing countries. The former, with MNCs' interest in mind, have been trying to establish rules that would govern host country behaviour. On the other hand, the latter with the host country economic and other objectives in mind, have been trying to regulate the behaviour of MNCs. It still continues and hence no such agreement has taken place.

During the 1960s and 1970s, developing countries have set the agenda for creating investment rules that reflect their interests. So regulation of MNCs became the focal point of New International Economic Order (NIEO).So the developing countries had two main objectives in mind: that the MNCs should contribute towards social and economic development of the country in which they invest and to write a code of conduct regarding the regulation of their behaviour.

The developing countries achieved a *United Nations resolution on permanent sovereignty over natural resources* in 1962.According to this resolution, the host country had full right over the natural resources within its territory and over the foreign firms extracting these resources. They were also allowed to determine what compensation should be given to the foreign firms in case of expropriation. Many a time, it was found that the compensation was quite less as compared to full compensation given under earlier rules.

Apart from this, the developing countries also wanted a code of conduct the regulate the behaviour of MNCs. It was to be in five broad areas. The five areas are:

- Non-interference by the MNCs in the internal affairs of the host country.
- The economic objectives of the MNCs should be in accordance with the host governments' objectives.
- Management and technological skills get transferred to the host country on favourable terms.
- The code would regulate the repatriation of MNCs' profits.
- The code would encourage the MNCs to re-invest in the host country.

However, the code of conduct had some basic features which again became a source of conflict between the capital exporting nations i.e. those involved in outward investment and the capital importing countries or those having inward investment. The developing countries wanted to make the code as a binding, whereas the advanced industrialized countries wanted to make it voluntary. Secondly, the developed countries wanted the code for both the MNCs as well as the host country. This was not acceptable to the host countries. Throughout the 1970s and early 1980s, governments worked on both these approaches. In 1982, both the codes were drafted. But they were never implemented ,nor rejected either. The situation remained uncertain till 1992, when a UN committee recommended that governments seek an alternative approach (Graham 1996).

By 1980s, the bargaining power had shifted back to the advanced countries. USA wanted to advantage out of it by further taking steps to regulate host country behaviour. In this regard, mention can be made of the Uruguay round negotiations during which USA tried to put on the agenda an agreement, TRIMs i.e. Trade related investment measures. TRIMs is a government policy toward FDI or MNC that has impact on the country's exports or imports. It is observed that many such policies distort trade .If a country uses trade balancing requirement, the firm needs to balance its imports of input with export. Through TRIMs, the objective to curtail certain powers of the host country was to be fulfilled. USA had a very big list of 13 such agreements which proved detrimental to the interests of MNCs and required to be stopped. The list included domestic sales requirements, exchange restrictions, export requirements, investment incentives, licensing requirements, remittance restrictions, technology transfer requirements and trade balancing requirements(Croome 1996). Many advanced countries, including Japan and EU supported USA. Implementation of such an expansive agreement would mean substantial reduction of power in the hands of host government, or more steps to regulate host country behaviour, to put it more appropriately.

This did not convince the developing countries, who opposed the very idea of such an expansive agreement. They just wanted to restrict the agreement, if any, to the investment policies or restrictions which had "significant and direct adverse trade effects" (Croome). They also put forward a list of 13 development objectives to justify their investment policies.

Finally, an agreement was reached due to flexibility on the part of both the groups. The developed countries agreed to focus on four such issues : domestic content rules, trade balancing requirements, restrictive foreign exchange policies and weak constraints on the ability to link investment incentives to export requirements. The developing countries had undergone liberalization, and to a significant extent, the anti-MNC attitude had changed. So they were more receptive to the idea of international rules of investment.

As an extensive agreement couldn't be reached, efforts were further made by the advanced countries to negotiate on a Multilateral Investment Agreement (MAI) in OECD in 1995.As OECD comprises only advanced nations, it was expected to be negotiated without much conflict among the participants. Most of the FDI takes place within advanced nations. This was another point of advantage as compared to negotiations under WTO. Further, it was open for membership to developing countries. There were some basic principles which were meant to give more security to foreign investors. These were national treatment and most favoured nation. Besides, the traditional legal basis of full compensation was also incorporated. Many more items were added which curtailed the ability of the host government to control the different economic activities of MNCs .

However, conflicts among OECD nations, opposition from developing countries and the anti-globalisation groups didn't let it materialize. So no multilateral agreement on investment could be signed.

19.6 LET US SUM UP

In this lesson, we studied about MNCs, domestic politics and MNCs and international regulation of MNCS.

19.7 REFERENCES AND SUGGESTED READINGS

- *International Political Economy* by Thomas Oatley

SELF ASSESSMENT QUESTIONS

- Define a MNC. How do they help the host country?
- What is host country dilemma? What is the role of domestic politics in this regard?
- Comment on the international regulation of MNCs.

INDIA'S EXTERNAL INDEBTEDNESS: ISSUES AND TRENDS

Structure

20.1 OBJECTIVES

The main objective of this lesson is to provide the students the knowledge regarding India's external debt position on the basis of latest data and different indicators.

20.2 INTRODUCTION

A close look at India's current position in external indebtedness shows that since the reforms of 1991, a lot has changed. Though India still relies on external borrowings for meeting various development requirements, its International position has changed as compared to what it was, say a decade ago. In this lesson, we shall explore this issue further. We shall see what are the trends in India's external indebtedness, what is the composition of borrowing etc.

20.3 BASIC FACTS (DATA) REGARDING INDIA'S EXTERNAL DEBT

Let us first discuss some basic facts [47] regarding India's external debt position:

1.India's external debt stock stood at US$ 440.6 billion at end-March 2014, increasing by US$ 31.2 billion (7.6 per cent) over the level at end-March 2013. The external debt- GDP ratio was 23.3 per cent at end-March 2014, as against 22.0 per cent at end March 2013.

2. At end-March 2014, long-term external debt was US$ 351.4 billion, showing an increase of 12.4 per cent over the level at end-March 2013. At this level, long-term external debt accounted for 79.7 per cent of total external debt at end-March 2014 vis-à-vis 76.4 per cent at end-March 2013.

3. The increase in long-term external debt during the year was primarily on account of rise in NRI deposits. A sharp increase in NRI deposits reflected the impact of fresh FCNR(B) deposits mobilised under the swap scheme during September-November 2013 to tide over the difficult BOP situation in the initial parts of the year.

4. Short-term external debt stood at US$ 89.2 billion at end-March 2014, showing a decline of 7.7 per cent over US$ 96.7 billion at the end-March 2013. This owed to the compression in import arising from the slowdown in aggregate demand and restrictions on gold imports. Thus, the share of short-term external debt in total external debt declined from 23.6 per cent at end-March 2013 to 20.3 per cent at end-March 2014.

5. Government (sovereign) external debt stood at US$ 81.5 billion at end-March 2014 vis -a-vis US$ 81.7 billion at end-March 2013 and constituted 18.5 per cent of the total external debt at end-March 2014 as against 19.9 per cent at end-March 2013. Government guaranteed external debt was US$ 9.9 billion at end-March 2014 vis-a-vis US$ 9.5 billion at end-March 2013.

6. The currency composition of India's external debt shows that debt denominated in US dollar continues to remain the predominant component accounting for 61.8 per cent of total external debt at end-March 2014, followed by debt denominated in Indian rupee (21.1 per cent), SDR (6.9 per cent) and Japanese yen (5.1 per cent).

7. The valuation effect reflecting the appreciation of US dollar in the international market moderated the increase in India's external debt. Excluding the valuation effect, the stock of external debt at end-March 2014 would have increased by US$ 40.6 billion over the level at end-March 2013.

8. Notwithstanding the increase in absolute terms and the changing composition, India's external debt has remained within manageable limits. As a proportion of GDP, external debt was 23.3 per cent and debt service ratio of 5.9 per cent in 2013-14. India's external debt is dominated by long-term debt.

9. India's key debt indicators compare well with other indebted developing countries. The World Bank's "International Debt Statistics, 2014" which presents the debt data for 2012, showed that India's position was third in terms of absolute external debt stock, after China and Brazil in 2012. The ratio of India's external debt stock to gross national income (GNI) at 20.8 per cent was the fourth lowest with China having the lowest ratio at 9.2 per cent. In terms of the cover provided by foreign exchange reserves to external debt, India's position was seventh highest at 71.4 per cent.

20.4 INDIA'S STATUS REGARDING DEBT SERVICING

To know about a country's external debt position, it is important to know how that country is placed in terms of debt servicing.

Debt service payments or servicing of external debt is defined as "the set of payments, inclusive of both principal and interest that are made to meet debt obligation to non-resident creditors". Debt service ratio, measured by the proportion of gross debt service payments to current receipts of Balance of Payments (BOP), serves as an important indicator of debt sustainability. A larger outgo on account of debt service payments could pre-empt a significant part of foreign exchange earnings, straining the exchange rate. A higher debt service ratio as well as large debt service payments also increase the risk of exposing the country to external shocks.

The recent trends in this regard are:

- Gross debt service payments amounted to US$ 32.3 billion during 2013-14, recording an increase of 3.1 per cent over the previous year. Principal repayments accounted for 65.4 per cent in the India's total debt service payments in 2013-14, while the rest 34.6 per cent was on account of interest payments. Increase in debt service payments was on account of higher interest payments for NRI deposits and larger repayment of external commercial borrowings during 2013-14. Debt service ratio stood at 5.9 per cent in 2013-14, same as in the previous year.

- India's debt service payments are dominated by the external commercial borrowings which accounted for 72.4 per cent of gross debt service payments during 2013-14.

20.5 INTERNATIONAL COMPARISION

The cross-country comparison of external debt of India vs. top twenty developing debtor countries based on World Bank's 'International Debt Statistics 2014' indicates that India continues to be among the less vulnerable countries and India's key debt indicators comparing well with other indebted developing countries. India's key debt indicators, especially debt to GNI ratio, debt service ratio and short-term to total external debt ratio continue to be comfortable.

20.6 SOVEREIGN EXTERNAL DEBT

Sovereign external debt refers to foreign debt contracted by the Government of India. Sovereign external indebtedness or the extent of external liabilities of the Government has assumed importance in the backdrop of sovereign debt crisis in the euro zone. Government of India, unlike several other economies, does not access international capital markets for funds and the bulk of government borrowings are primarily from multilateral and bilateral sources and are long-term in nature. The share of sovereign debt in India's total external debt has declined over the years, mainly because of the increasing contribution of private sector to the country's economy. As the government has been pursuing a prudent debt management policy, the Government of India has been borrowing only from the multilateral and bilateral sources.

The composition of sovereign External Debt (SED) was US$ 81.5 billion at end-March 2014 vis-a-vis US$ 81.7 billion at end-March 2013. Debt from multilateral sources has dominated India's SED on Government Account and has accounted on an average 69.6 per cent of total sovereign external debt under Government account during the period 2008 to 2014. The currency composition indicates that SDR continues to remain the predominant currency in sovereign external debt, primarily due to borrowings from IDA. The share of SDR stood at 37.4 per cent, followed by the US dollar (26.2 per cent), Indian rupee (16.3 per cent), Japanese yen (16.3 per cent) and the Euro (3.8 per cent) at end-March 2014.

Having a look at these indicators and basic facts, we can understand the present external debt position of India. Almost all the facts show that India is in a comfortable position with regard to external debt.

20.7 LET US SUM UP

In this lesson, we learned about the external debt position of India.

20.8 REFERENCES AND ESSENTIAL READINGS

The data has been taken from the Ministry of Finance, GOI. For full reference, see the end notes section.

SELF ASSESSMENT QUESTIONS

- Comment on the external debt position of India. What are the main observations and recent trends?

DEBT- GROWTH LINK

Structure

21.1 OBJECTIVES

The main objective of this lesson is to acquaint the learners with the knowledge of debt-growth link.

21.2 INTRODUCTION

By debt, we mean when we owe something to somebody. We talk of internal and external debt. External debt arises, when the country in question depends on outsiders for the funds required. In case of external debt repayment, debtors from the home country pay to the creditors from the foreign country .Many a time, the country is not in a position to repay the debt. It has many implications for the countries concerned as well as the world as a whole. The debt issue became serious since the debt crisis of 1980s. Since then ,a lot of research is going on the impact of external debt on an economy. In this lesson, we shall discuss about the different aspects of the debt issue.

21.3 DEBT GROWTH LINK

The accumulation of foreign debt, says Oatley "is not worrying in itself. Problems arise when the growth of foreign debt is not matched by growth of the country's debt service capacity". Debt service capacity refers to the capacity of a country to repay interest as well as principal. Many scholars have tried to examine and explain the relationship between external debt and economic growth of the country. One such theory is the debt overhang paradox. The theory was first discussed as early as 1977 by Myers. His concept was based on a company's decision of borrowing. Later writers like Krugman (1998) and Sachs (1984, 1986) examined it with regard to its impact on the debt situation of a country and its ability to meet debt servicing obligations. They also examined how debt relief would also prove beneficial to the creditor. Debt overhang is said to take place when a country is having more external debt than its repayment ability. The expected debt service is a positive function of the country's output level. In other words, higher the output level, more is the repayment ability of that country. Krugman (1988) and Sachs (1989) stated that debt overhang exists when the country's debt service burden is so heavy that a large portion of the current output accrues to foreign lenders and consequently creates disincentive to invest. Debt service is therefore considered as an implicit tax, thereby discouraging investment and reducing economic growth which makes it virtually impossible for highly indebted countries to escape poverty (Clements et al. 2005 et al. Fonchamayo 2009). The hypothesis suggests that if there is some likelihood in the future that external debt will be larger than the country's repayment ability, the expected debt-service costs would discourage further domestic and foreign investment and harm economic growth (Pattillio, 2002). It has been postulated that debt overhang occurs at the peak of the debt Laffer curve.

As it is considered as a tax, it discourages future public and private investment, as scarce resources that could have been used for investment are used unproductively for meeting debt obligations. This is the crowding out effect in which the volume of public and private investment decreases. It also affects adversely the quality of investment (Sichula). So the overall economic environment of the country under debt gets worsened, as there is no incentive to invest.

There are different variants of the model of debt-growth links. Some argue that the impact of debt on economic growth is via the reduction of investment. But the base for most of these models is the neoclassical growth model (Adegbite and Ayadi, 2008).Though different models differ in terms of variables taken, they reach almost the same conclusion: debt servicing of a highly indebted country has a negative impact on its economic growth. In their model, Elbadawi, Ndulu and Ndungu (1997) argued that it is not current but past debt inflow which is a cause of concern. Past debt accumulation had a negative impact on economic growth.

A counter measure is debt relief. There is evidential proof of the growth rate having fallen during 1980s,when Highly Indebted Poor Countries' (HIPC)debt accumulated and having moved up during 1990s, when debt reduced. Debt relief releases investable resources from unproductive to productive uses.

21.4 LET US SUM UP

In this lesson, we learnt how debt and growth are related to each other.

21.5 REFERENCES AND ESSENTIAL READINGS

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- International economics by Kindleberger

SELF ASSESSMENT QUESTION

- What is the link between external debt and growth of a country?

END NOTES

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