CHAPTER 10

EXTERNAL TRADE AND CAPITAL

In this Chapter, I will learn

- BALANCE OF PAYMENT
- FOREIGN EXCHANGE
- PURCHASING POWER PARITY (PPP)
- CONVERTIBILITY
- BARRIERS TO TRADE
- ECONOMIC INTEGRATION
- RELATED TERMS

External sector deals with export and import of goods and services, and financial capital between nations. The countries export goods and services over which it has advantage over other countries and import goods and services in which it lacks advantage over others.

This chapter covers balance of payment, foreign exchange, purchasing power parity, convertibility, barriers to trade, economic integration and related terms.

BALANCE OF PAYMENT[1]

The balance of payment of a country is a systematic record of all its economic transactions with the outside world in a given year.[2] The term 'all transaction' means transaction of government as well as private. It is a double entry book keeping. Double entry book keeping means recording each transaction twice consisting of two opposite entries with equal values: one with a credit entry (signifying inflow) and the other with a debit entry (signifying outflow). For example while importing the goods the good imported inflows. It is credited as 'import'. At the same time equivalent amount of money needs to be paid. It is debited as 'payable' in the name of the person from whom the import was made.

It means the incomings are credited and outgoings are debited.

The balance of payment is explained in detail with the help of the table 10.1.

I. Current Account

The external transactions are classified as current account and capital account transactions. This classification is similar to to the classification of receipts and expenditure as revenue receipts and capital receipts and revenue expenditure and capital expenditure in public finance. Current account transactions are like revenue receipts and revenue expenditures and capital account transactions are like capital receipts and capital expenditures.

Current account transactions are single time and one way transactions. It means the transaction either receipt or payment happens once and the transaction ends there. For example if a person exports goods he gives the goods and receives money and the transaction comes to an end with respect to the particular good exported.

1. Export

Export means the receipts against export of merchandise goods to other countries. The export receipts of services are not included here.

2. Import

Import means the payment for import of merchandise goods from other countries. The payments for import of services are not included here.

1 The contents of this part is heavily drawn from Balance of Payments Manual for India, September 2010, RBI

2 M.L. Jhingan International Economics

3. Trade balance

The balance of trade is difference between export receipts and import payments.

Trade balance = Export - Import

4. Invisibles (net)[3]

The head of invisibles record the receipts and payments regarding services exports and imports and other current account payments viz.,

A. Non-factor services

B. Income and

C. Private Transfers.

A. Non-Factor Services

Non-factor services refer to all invisible receipts or payments not attributable to conventional factor of production, i.e labour (remittances from overseas migrants). Thus Non-factor services mean the export and import of services alone. The non-factor services includes Group of Services viz., Travel, Transportation, Insurance, Government Not Included Elsewhere (GNIE) and Miscellaneous Services, which encompass communication services, construction services, financial services, software services, news agency services, royalties, management services and business services etc. The software services comprise information technology (IT) and IT-enabled services (ITES).

3 Net means the difference between inward flow and outward flow.

B. Income

Income includes transactions regarding income from investments in the form of dividends, profit and interest from loans, rent from house property and income generated through employment.

Remittance is directly earned by labour which is a factor of production and incomes like dividend, profit and interest are earned by capital which is also a factor of production. So the income from both these heads is called factor income services.

C. Private Transfers

Private transfers include grants, gifts, etc., which do not have any quid pro quo. Without any quid pro quo means it need not be compensated. Once it is received it need not be repaid.

Current account balance

Current account balance is the sum of the items 3 and 4 viz, trade balance and net invisibles.

Current account balance = Trade balance + Net invisibles.

If the current account balance is positive, it is said to be surplus which means favourable current account balance. If the current account balance is negative, it is said to be deficit which means unfavourable current account balance.

II. Capital Account

Capital account transactions are two way and multiple transactions. It means paid

money can be recovered through periodical income and/or by disposal of the asset created. Likewise the received money needs to be repaid periodically and settled finally by repaying the full amount. For example from the loan paid to a foreigner periodical interest income can be received at the same time the paid principal amount can be recovered from the debtor.

i. External assistance (net)

External assistance means the transaction of official (government) bilateral and multilateral loans. The bilateral loans are loan transactions between two countries. Multilateral loans are official loan transactions between a country and multilateral bodies like World Bank, IMF and Asian Development Bank etc.

ii. External Commercial Borrowings(net)

Commercial borrowing means loan transaction by commercial enterprises. It is also called as External Commercial Borrowing (ECB).

ECB refer to commercial loans in the form of bank loans, buyers' credit, suppliers' credit, securitised instruments availed of from non-resident lenders with a minimum average maturity of 3 years.

Securitised instruments refer to debt securities like bonds and preference shares. Buyers' credit and suppliers'credit are called trade credits. Depending on the source of finance, such trade credits are classified as Suppliers' Credit or Buyers' Credit. Suppliers' credit relates to credit for imports into India extended by the overseas supplier, while buyers' credit refers to loans for repayment of imports into India arranged by the importer from a bank or financial institution outside India. It is to be noted that both of them are for the purpose of import and loan availed by importer. In the Supplier's credit only two parties namely exporter and importer are involved in the buyer's credit a third party namely bank or financial institution comes into the picture to finance the import.

ECB can be raised only for specific purposes, such as the import of capital goods, implementation of new projects etc; this restriction is called end use restriction.

The heading External Commercial Borrowings also covers Foreign Currency Convertible Bonds (FCCB) and Foreign Currency Exchangeable Bonds.

FCCB are bonds issued by an Indian company expressed in foreign currency. The principal and interest in respect of these bonds are payable in foreign currency.

A Foreign Currency Exchangeable Bond (FCEB) means a bond expressed in foreign currency issued by an issuing company. These are issued to persons who are residents outside India. These are exchangeable into equity share of another company, called the Offered Company. The principal and interest in respect of these bonds are payable in foreign currency. The word 'Exchangeable' refers to the facility to convert bond of one company into equity share of another company.

iii. Short-term debt

Short-term debts are trade credits for a maturity of less than three years.

iv. Banking Capital

Banking capital comprises three components:

(a) Foreign assets of commercial banks

(b) Foreign liabilities of commercial banks and

(c) Others

"Foreign assets" of commercial banks consist of

(i) foreign currency holdings, and

(ii) rupee overdrafts to non-resident banks.

"Foreign liabilities" of commercial banks consist of

(i) non-resident deposits and

(ii) liabilities other than non-resident deposits, which comprise rupee and foreign currency liabilities to non-resident banks and official and semi-official institutions.

"Others" under banking capital include transaction in balances of foreign central banks and international institutions like the IBRD, IDA, ADB, IFC, IFAD, etc., maintained with the Deposit Accounts Department (DAD) of the RBI as well as transaction in balances held abroad by the Embassies of India in London and Tokyo.

Non- resident deposits

The deposit received from non resident Indians come under this head. At present, there are three, types of NRI Deposit Schemes. They are:

Foreign Currency Non-Resident (Banks) - FCNR(B)

Non Resident External Rupee Accounts NR(E)RA

Non Resident Ordinary Rupee Account (NRO)

Foreign Currency Non-Resident (Banks) - FCNR(B)

These deposits are held in the following foreign currencies, US \$, Pound Sterling, Euro, Japanese Yen, Australian \$ and Canadian \$. Only term deposits of one to three years maturity is allowed. The interest rates are pegged to LIBOR[4]/ SWAP[5] of corresponding maturities.

4 LIBOR stands for London Interbank offer rate. It means the interest rate in the London call money market.

5 Swap is a common arrangement for exchanging one with another in financial market instruments like debt, share etc. Exchange can be between shares, between debentures etc,. Here SWAP is the exchange of loan in one currency to loan another currency. The interest rate difference between these loans is called SWAP rate, generally as SWAP. http://www.swap-rates.com/Definitions.html observes as, "Swap is a debit or credit paid or earned as a reflection of the varying interest rates applicable to currency pairs. When trading the USD for example, swap rates will be determined based on the interest rates of the countries being represented by this pair. Depending on whether you are long or short and which country has higher interest rates, you may be charged or credited interest. Essentially, when a trader holds a position over night they are subject to the interest rates applicable to the currency pair they are trading. 'Swap' is also commonly referred to as 'rollover rates'."

Non-Resident External Rupee Account NR(E)RA

These deposits are held in Indian Rupee. Term deposits with maturity of one to three years as well as saving deposits are allowed under this scheme. Its interest rate is also pegged to LIBOR/SWAP rate.

Non-Resident Ordinary Rupee Account (NRO)

It is the account held by Indians ordinarily living abroad. An Indian who was Indian resident but migrated abroad can shift his account to this category. It is held in Indian Rupee. NRO accounts can be opened as current, savings, recurring or fixed deposit accounts.

v. Foreign Investments

There are two types of foreign investments. One is foreign direct investment and another is portfolio investment. Portfolio investment is also called as rentier investment.

A. Foreign Direct Investment (FDI)

Investment through the mode other than the stock exchange is called foreign direct investment in India. There is prescribed size to treat an investment as foreign direct investment. FDI includes the following:

- Shares acquired by way of IPO
- Shares acquired by way of preferential allotment
- Shares acquired by way of offer for sale through private arrangement
- Transfer of shares by way of offer for sale through private arrangement

In all these purchases there is direct contact between the securities buyer and the seller company.

Aravind Mayaram Committee on FDI and FII has suggested that the investment in a company above 10 % needs to be treated as FDI.

Table 10.1 Balance of Payment

Sl No.	Item	2009-10	2010-11
I	Current account		
1	Exports	182442	256159
2	Imports	300644	383481
3	Trade balance	-118202	-127322
4	Invisibles (Net)	80022	79269
	A Services	36016	44081
	B. Transfer	52045	53140
	C. Income	-8038	-17952
	Current account balance	-38180	-48053
II	Capital account		
i.	External assistance	2890	4941
ii	External commercial borrowings	2000	12160
iii.	Short-term debt	7558	12034
iv.	Banking capital of which	2083	4962
	Non-resident deposits	2922	3238
v.	Foreign investment	50362	42127
	A. FDI	17966	11834
	B. Portfolio investment	32396	30293
vi	Other flows	-13259	-12484
	Capital account balance	51634	63740
	Capital account (including errors & omissions)	51622	61104
III	Errors & omissions	-12	-2636
IV	Overall balance	13441	13050
V	Reserves change (-indicates increase, +indicates decrease)	-13441	-13050

Source : Reserve Bank of India (RBI)
Notes : PR. partially revised, P. preliminary

B. Portfolio (or) Rentier Investment

Investment through stock exchange that is through secondary market is called port folio investment. Portfolio investment refers to investment in various financial instruments like shares, debentures of a company through secondary market. There are three major types of portfolio investment. They are:

- Foreign Institutional Investment (FII)
- Depository Receipts
- Offshore Funds

Foreign Institutional Investment

It is the portfolio investment by foreign institutions like Mutual funds, Insurance Cos, Pension funds etc., in shares and debentures.

Depository Receipts

Companies of a country can go abroad to sell their shares in foreign capital market. When a foreign investor buys shares of domestic companies abroad (in capital market), he is issued a receipt by a custodian Bank. This receipt represents a certain number of underlying shares of domestic companies and hence they are called Depository receipts.

The depository receipts raised by Indian companies in American market are called American Depository Receipts (ADRs) and those that are raised in some other countries are called Global Depository Receipts (GDR). The depository receipts raised by foreign companies in Indian market are called Indian Depository Receipts (IDRs).

Offshore Funds

These are money raised from offshore destination (low tax or no tax countries) like Cayman Islands, Isle Of Man, Mauritius and British Virgin Islands etc., by mutual funds and other investment funds.

vi. Other Flows

Other flows include, delayed export receipts, leads and lags in export receipts (the difference between the customs data and the banking channel data), funds held abroad, and other capital transactions not included elsewhere such as flows arising from cross-border financial derivative and commodity hedging transactions, and sale of intangible assets such as patents, copyrights, trademarks etc.,.

The difference between the customs data and the banking channel data arises because banking channels data relies on foreign exchange release/receipt returns which are actual cash outgo and cover all flow and customs data are based on bills of entries (import document filed with the customs), which might remain somewhat incomplete for a number of reasons in the short run. Defense imports are not reflected in the customs data.

Capital Account Balance

It is the sum of items i to vi above.

Capital account total (net) = External assistance (net) + Commercial Borrowings (net) + Nonresident deposits (net) + Foreign investments (net) + Other flows (net).

If the capital account balance is positive, it is said to be surplus. Surplus capital account balance means favourable capital account balance. If the capital account balance is negative, it is said to be deficit. Deficit capital account balance means unfavourable capital account balance.

IV. Overall balance

The overall balance is the sum of current account balance and capital account balance.

Overall balance = Current account balance + Capital account balance

If there is a positive balance it increases the reserve and vice-versa.

Capital account balance is calculated with and without errors and omission. Errors and omission means the difference between debit and credit entries of all transaction. Already it was said that each transaction is entered twice in double entry book keeping by recording each transaction twice consisting of two opposite entries with equal values: one with a credit entry (signifying inflow) and the other with a debit entry (signifying outflow).

Ideally speaking in this system both debit side and credit side should be equal but as the data is compiled from various sources some mismatch if found to happen. This is called errors and omission.

V. Reserves

Reserve means foreign exchange reserve. The sum of current and capital account balance is the balance of payment.

Balance of payment = current account balance + capital account balance

The balance is added to foreign exchange reserve if the balance of payment is in surplus. The balance is deducted if the balance of payment is in deficit. It means payment is made out of old balance (foreign exchange reserve).

The foreign exchange reserve consists of

Foreign Currency Assets

Gold Stock of RBI

SDR (Special Drawing Right) holdings of the government

Reserve Tranche

Foreign Currency Assets

Currencies of various countries are held in foreign exchange reserve. It is expressed in US $ or Indian Rupee terms after converting currencies of various countries by their respective exchange rate against US $ or Indian Rupee respectively. Apart from currency it also includes foreign currency deposits held by RBI with foreign central banks, the BIS and non-resident deposit taking institutions as well as deposit agreements with IMF Trust Accounts that are readily available to meet a BoP financing need. The securities issued by non-residents and financial derivatives having underlying foreign currency assets also form part of foreign currency assets.

Gold Stock of RBI

The RBI has gold stock as a back up to issue currency and to meet unexpected Balance of Payment problem. Its value is expressed in terms of US$ or Indian Rupee.

SDR Holdings

SDR is a reserve created by International Monetary Fund (IMF) to help countries that have Balance of Payment problem. The member countries have to contribute to this account. The contribution is in proportion of their IMF quota (membership fee). It is held with the government or the Central bank of the member countries. In India, it is with RBI's exchange reserve. The detailed explanation of SDR is followed by next topic namely Reserve Tranche.

Reserve Tranche

Tranche means portion or slice. Reserve tranche means a portion of fund. It consists of India's quota (member subscription fee) to IMF and lending to General Resource Account of IMF. General Resource Account is the pool of member counties' quota payment. A member is required to pay 25 per cent of its quota in SDRs or in foreign currencies acceptable to the IMF (i.e., hard currencies). This is termed "reserve position in the IMF or reserve tranche" and is part of the member country's reserve assets. If any money was lent in foreign currency or SDR over and above the quota to IMF's General Resource Account it also form part of reserve tarnche.

SDR

SDR has two dimensions. One, it is an exchange rate system and another it is a loan arrangement.

As an exchange rate system, the SDR is an average exchange rate derived from a basket of four currencies viz. US $, Euro, UK Sterling Pound and Japanese Yen. In this system, these four currencies are assigned different weightage as per their importance in world economy and an exchange rate is derived which is called as SDR. The exchange rate of a country is expressed against SDR. For example; ` 30 = 1 SDR. You may see quota of India in IMF as SDR 4158.2 million (or something else if altered). Here India's quota is expressed in SDR, in place of Indian Rupee or US $.

As a loan arrangement, the member countries are entitled to get loan from IMF's Special Drawing Account. This loan amount is up to 200% of the member's Quota with IMF. It is also known as paper gold. In this arrangement IMF does not lend directly. It is the member countries who are in strong position lend their SDR holdings to member countries who are in Balance of Payment problem.

FOREIGN EXCHANGE

Exchange Rate

It is the rate at which home currency is exchanged for one unit of foreign currency.

For example ₹ 50 = US $1. M.L. Jhingan defines exchange rate as follow. "The foreign exchange rate or exchange rate is the rate at which one currency is exchanged for another. It is the price of one currency in terms of another currency". The exchange rate varies (either depreciates or appreciates) depending upon the demand for and supply of currencies.

Depreciation

Increase in the exchange rate i.e. fall in the external value of domestic currency because of more demand for foreign currency (less supply of foreign currency) or more supply of (less Demand of) Domestic currency is called depreciation.

For example,

On day one the exchange rate is ₹ 50 = US $1

On day two the exchange rate is ₹ 52 = US $1.

It refers to Rupee depreciation.

Appreciation

Fall in the exchange rate i.e increase in the external value of domestic currency, due to more demand for home currency (or less supply of home currency) or less demand for (or more supply of) foreign currency is called Appreciation.

For example,

On day one the exchange rate is ₹ 50 = US $1

On day two the exchange rate is ₹ 48 = US $1.

It refers to Rupee appreciation.

Devaluation

Reduction in the external value of home currency is called Devaluation. For example changing the exchange rate from ₹ 50 = US $1 to ₹ 75 = US $1 is called devaluation. Devaluation is aimed at increasing export of the country. It is usually resorted to correct the deficit in the balance of payment.

How Export Increases

Both depreciation and devaluation helps to increase export. This can be clearly illustrated from the following example.

Consider price of rice per kg is ₹ 25. And consider that a foreigner wants to import rice from India. When the exchange rate is ₹ 50 = US $1 with US $1 foreigner can import 2 kg of rice.

After devaluation i.e. ₹ 75 = US $1 with $1 foreigner can import 3 kg. It means rice is available at a cheaper rate so he will buy more rice. So export increases. The reverse happens to import and hence the import will decrease. Devaluation also increases the profit of the exporter.

For example consider that a rice exporter earns ₹ 1 per kg as profit, before devaluation he earns ₹ 2 by exporting two kg and earn ₹ 3 after devaluation by exporting three kg. Opposite is the case with appreciation and revaluation.

Revaluation

Increase in the external value of currency is called Revaluation. For example changing the exchange rate from ₹ 50 = $1 to ₹ 25 = US $1 is called revaluation. Revaluation is aimed at decreasing export of the country. It is usually resorted to correct the surplus in the balance of payment. Surplus in the balance of payment of home country mean deficit for some other countries. To correct it revaluation is carried out. It is very rarely done.

Note: While depreciation and appreciation takes place automatically due to movement in the demand and supply of currencies in the market, devaluation and revaluation are done voluntarily either by the government or monetary authority.

PURCHASING POWER PARITY (PPP)

PPP, proposed by Gustav Cassel, is a method of determining exchange rate. Purchasing Power Parity means the equality of buying capacity. Based on the buying capacity (purchasing power) of respective currencies in their home country the exchange rate is determined.

For example if with ₹ 25 a bundle of goods can be purchased in India, which can be purchased by $1 in US then exchange rate is ₹ 25 = US $1.

Converting Prevailing (BOP based) Exchange Rate into PPP

PPP exchange rate can be calculated from the prevailing exchange rate using price index of two countries.

PPP exchange rate = Domestic price index/ Foreign Price index X Prevailing market exchange rate

= 25/50 X 50 = 25

Need for PPP

It is customary to compare level of development of different countries based on living standard of people. The standard of living is measured by proxy variable, namely per capita income. People in countries with high per capita income are considered to be enjoying high standard of living and such countries are considered developed countries. Later it was realized that standard of living is not in the amount of money they have but the amount of goods they can have with that money i. e. purchasing power of money.

To compare the income of the two countries, it is necessary to convert the income in different currencies into a single common currency. As of now, the common currency is US $. The conversion is done with the help of trade based prevailing exchange rate. The trade based exchange rate does not reflect the true purchasing power of different currencies because all the goods needed are not traded. So, the trade based exchange rate fails to reflect the purchasing power of money to buy non-traded goods. Apart from that, the trade is not a free flowing one. It is subject to many manipulations and obstructions and so is the exchange rate. To overcome

this problem, the PPP based exchange rate is used to convert the income of different currencies in to a common currency, namely US PPP$.

Apart from the above cited reasons, it is important to note that the price of goods and services in developed countries is very high compared to developing and less developed countries. It is like the difference in price of goods and services between urban and rural areas. It means, the purchasing power of money in developed countries is lower than that of developing and less developed countries. So, in developing and less developed countries, less money is enough to buy more goods than that is possible in developed countries. So, with less money they enjoy high standard of living.

The trade based exchange rate does not reflect this reality. So, the PPP based exchange rate is used to compare the standard of living of people and stage of development.

Take an example;

The per capita income of India in Indian ` is 400. The same in US dollar is $8 when trade based exchange rate is ` 50 = $1. The same in PPP based exchange rate is $16, if PPP based exchange rate is ` 25 = PPP US $1.

It is vivid that the PPP based exchange rate reflects higher standard of living than trade based exchange rate system.

It is important to note that the PPP$ is a unit of account and not a medium of exchange. It means the PPP$ can be used for measurement of income and cannot be used to purchase or sale of goods.

CONVERTIBILITY

As said in the previous passages, exchange rate is not free market determined. It is subject to some restrictions like trade. Removing these restriction leads to convertibility.

Facility of exchanging domestic currency for foreign currency at market determined exchange rate without restriction on either rate or quantum of money exchanged is called convertibility.

The committee on fuller capital account convertibility observes as, "Currency convertibility refers to the freedom to convert the domestic currency into other internationally accepted currencies and vice versa. Convertibility in that sense is the obverse of controls or restrictions on currency transactions. While current account convertibility refers to freedom in respect of payments and transfers for current international transactions, capital account convertibility (CAC) would mean freedom of currency conversion in relation to capital transactions in terms of inflows and outflows."

Convertibility in India

The convertibility in India is a gradual one. Like other reforms it was also introduced in 1990s.Convertibility in current account was introduced first and then it was introduced in the capital account.

Current Account Convertibility

Current account convertibility refers to the freedom of converting home currency into foreign currency with respect to transactions in current account.

Budget 1992 – 93 introduced Liberalized Exchange Rate Management System (LERMS). In this system, 60% of foreign exchange earnings are convertible at open market rate, and remaining 40% at RBI fixed rate.

In 1993 – 94, government introduced full convertibility in Trade account.

In 1994 – 95 budget, full convertibility in current account was introduced. But this was not satisfactory to the IMF. So government introduced further relaxations in August 1994. India got affiliation to the Article VIII of IMF.

Capital Account Convertibility

Capital account convertibility means the freedom to convert home currency into foreign currency regarding transactions in capital account.

The committee on fuller capital account convertibility observed as follows: "For the purpose of this Committee, the working definition of CAC would be as follows: CAC refers to the freedom to convert local financial assets into foreign financial assets and vice versa. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world. CAC can be, and is, coexistent with restrictions other than on external payments."

Fuller Capital account convertibility does not mean 100% freedom. There will be some restrictions. That is why committee on fuller capital account convertibility observed as above.

To bring capital account convertibility, the Government of India formed Capital Account Convertibility Committee – I (1996) and Committee on Fuller Capital Account Convertibility II (2006).

Capital Account Convertibility Committee

This committee was formed under the chairmanship of S.S. Tarapore the then deputy governor of RBI. It gave green signal to introduce Capital Account Convertibility. It recommended the introduction of CAC in a phased manner throughout the period of 1997–2000.

Government accepted it but, the East Asian crisis halted its implementation.

Committee on Fuller Capital Account Convertibility II

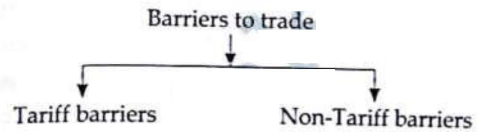
After a decade another committee was formed, again under the chairmanship of S.S. Tarapore in 2006. This time also, its approach was the same.

It recommended capital account convertibility implementation in a phased manner, in 3 phases from 2006 to 2011.

BARRIERS TO TRADE

The policy instruments which obstruct trade are called as barriers to trade. They are of two types namely tariff barriers and non-tariff barriers as shown in the following figure 10.1.

Fig 10.1



Tariff Barriers

Tariff means the duty on import and export of goods. M.L. Jhingan observes "But for practical purposes, a tariff is synonymous with import duties or custom duties".

The reason for imposing tariff on import and export is different. The tariff on import is to make the price of imported goods equal to domestic goods. It increases the price of imported goods. So import is discouraged. If it is imposed on export goods its aim is to discourage export and make the goods available in domestic market which otherwise may be exported. The common purpose for Tariff on import and export is to generate resource for government.

If tariff obstructs free flow of trade it is called tariff barrier.

Non-Tariff Barrier

The instruments and executive operations that obstruct free flow of trade other than tariff is called non tariff barriers. "Non-Tariff Barriers (NTBs) are obstacles to imports other than tariffs. They are administrative measures that are imposed by a domestic government to discriminate against foreign goods in favour of domestic goods." M.L Jhingan observes.

The major non tariff barriers are explained here.

a. Quota

It fixes a limit on the amount of trade that can take place. In this system only a fixed quantity is allowed to be exported to any country and imported from any country.

b. Production Subsidies

Production subsidies are given by government to producers of exportable goods for the production of goods and services. They are in the form of raw materials at low cost credit at low interest rates, and tax concessions etc...

c. Export subsidies

Export subsidies are given in the post production stage. They are in the form of transport subsidies and low cost shipment credits.

d. Health, sanitary & safety regulations

It refers to import restrictions on health and safety grounds. The countries that want to restrict import fix higher level of norms. The norms include for example the residue of pesticides in food products, level of germs etc.

e. Packaging requirements

By fixing packaging requirements high restriction is imposed on trade. The standards push up the cost of product.So the import comes down. Some times the cost of pack exceeds the cost of product because of higher packaging requirement.

ECONOMIC INTEGRATION

Economic integration means the cooperation that exists between countries in the trade and other economic front such as investment, monetary policy etc. The level of integration varies between countries. On the basis of level of integration there are various names for it. Though it is difficult to differentiate them it is explained in the following passage.

Preferential Trade Agreement (PTA)

It is an agreement between two or more countries where the agreeing parties reduce the level of tariff imposed on traded goods among themselves. It is the first level of economic integration. The aim is to bring down the level of tariff and thereby increasing the flow of trade. The parties to the agreement maintain their own tariff level with third parties.

Free Trade Agreement / Area (FTA)

Free trade agreement/area is an improved level of economic integration compared to preferential trade agreement. In this arrangement the parties to the agreement abolish tariff on most of the goods and services and keep tariff on some items at a minimal level. Some goods which are identified as "sensitive goods" are continued to be traded at existing tariff level.

In recent times, the free trade agreement is called with different names. They are: comprehensive economic cooperation agreement, comprehensive partnership agreement and economic cooperation framework agreement. But all of them are in the nature of Free Trade Agreement. It is evident from the following comment made by Korea Joongang Daily on India Korea Comprehensive Economic Partnership Agreement: "The agreement, which got its unusual name at the request of the Indian side, is equivalent to a free trade agreement"[6] . But it cannot be refuted that there are some variations in all these agreements. These agreements cover foreign investment front apart from trade and services.

In this arrangement also, the parties to the agreement follow their own independent trade relation with third parties.

Customs Union (CU)

It is a still higher level of integration. In this, the member countries abolish barrier to trade and service among them, and as a whole, they maintain a common tariff against third parties.

6 India to sign deal next week July 31 2009, Joongang daily

Common Market (CM)

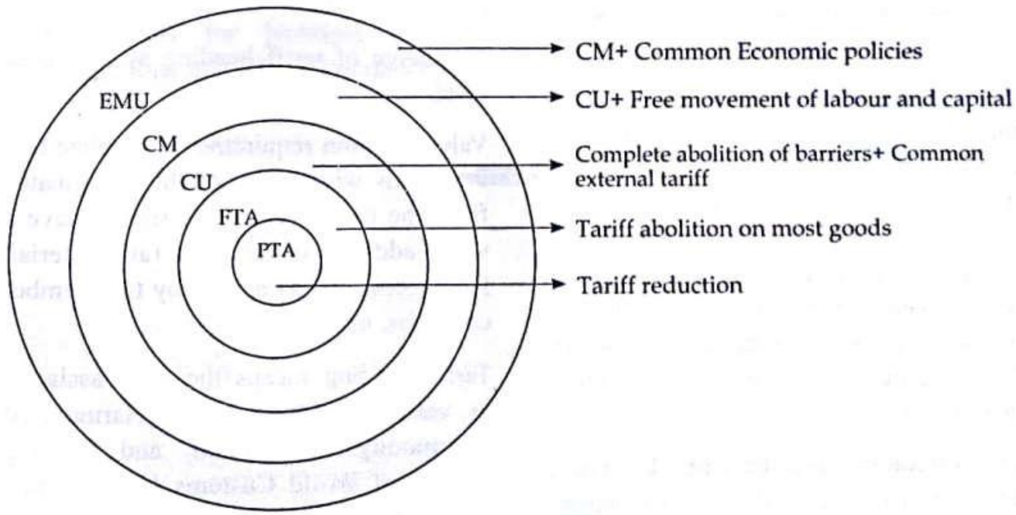
In addition to provisions of customs union, a free flow of labour and capital is also allowed in common market.

Economic and Monetary Union (EMU)

In this arrangement, in addition to common market's provision, the monetary and fiscal policies are hormonised among member countries. Common currency is an important feature of this union.

All the above economic integrations are illustrated in figure 10.2 below.

Fig 10.2



RELATED TERMS

Comparative Advantage

ComparativeAdvantage theory says that a country has to produce and export the goods in which it has comparative advantage. Let us see comparative advantage with an example.

The theory is explained with slight modification without affecting the essence of the theory. Assume that India and Bangladesh produce rice and wheat.

Assume that in India the cost of production of one kg rice is ₹ 25 and cost of production of wheat is ₹ 50. And in Bangladesh the cost of production of rice is ₹ 75 and of wheat is ₹ 100. It is tabulated in table 10.2.

Table 10.2 Cost of production

Produce	Cost of production in ₹	
	India	Bangladesh
Rice	25	75
Wheat	50	100

In both products, India has advantage compared to Bangladesh because both rice and wheat are cheaper in India. In case of rice, the cost of production in India is 50% of Bangladesh's cost of production. But in case of wheat, India's cost of production is 75% of Bangladesh's cost of production. It means, India has comparatively more advantage in rice production than that of wheat production. So, India has to specialise in rice production.

From Bangladesh's point of view, in the case of rice, the cost of production is 100% more than that of India. But, in the case of wheat the cost of production is only 50% more than that of India. So, though Bangladesh has disadvantage in both products, it has comparatively less disadvantage in production of wheat. So, Bangladesh has to specialise in wheat production.

Before trade, within India, with 1 kg of rice, a buyer can purchase only 0.50 kg of wheat. In Bangladesh, with 1 kg of rice, 0.75 kg of wheat can be purchased. Suppose, they enter into trade after specialistion and fix price at 1 kg of rice equal to 0.65 kg of wheat. By exporting 1 kg of rice, India can get 0.65 kg of wheat, i.e 0.15 kg more than what it would have got without trade. Bangladesh, with 0.65 kg of wheat, can get 1 kg of rice i.e., 0.1 kg less than what it would have offered without trade. So, trade benefits both.

Rule of Origin

It is a term used in all trade agreements. It is aimed at preventing third parties from routing their products through member countries to take advantage of low tariff and allowing only goods that are originated from parties to the agreement. Rule of origin is usually determined by two criteria namely,

i) value addition or local content requirement and

ii) change of tariff heading at four digit level.

Value addition requirements stipulate that the goods which are not fully originated from the partner countries should have a value addition in terms of raw material, labour cost etc, as agreed by the member countries, usually of 30%.

Tariff heading means the code assigned to various products under Harmonised Commodity Description and Coding System of World Customs Union which is called as Harmonised Coding System. The first four digits of the code are called Heading. The subsequent digits are called as sub heading. Change of tariff heading means, a product that does not originate from a country should be codified in different heading when exported, i.e., a product should be converted in to another product. For example, the code of live bovine animals is 0102. To be exported, it may be processed and converted as frozen meat of bovine animals, for which code is 0202.

Debt Service Ratio

The amount of a country's debt service (repayment of principal and interest) as a ratio of its total export earning is called Debt Service Ratio. It can be written in formulaic form as follows:

Debt service ratio = Debt service / Total export earning

NEER and REER

NEER stands for Nominal Effective Exchange Rate and REER stands for Real Effective Exchange Rate. Usually the exchange rate is determined for a domestic currency against a single foreign currency. In the effective exchange rate (EER) is fixed against a basket of currencies. For NEER and REER the basket is SDR currencies.

The way real GDP arrived from nominal GDP after correcting it for price change the REER is arrived from NEER.

NEER = Domestic currency exchange rate in terms of SDR/ Foreign Currency exchange rate in terms of SDR

REER = NEER X Domestic price index / Foreign price index

The price index is CPI (combined). The way it is calculated by the basket of SDR currencies there are two other EERs. One is based on top six trading partners' currencies and another is based on next thirty six top trading partners' currencies.