UNIT 15 ELEMENTS OF INTERNATIONAL ECONOMIC RELATIONS

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15.1 INTRODUCTION

Since historical times. commercial transactions between countries were part of the national life. Especially trade was at the centre of these transactions. The historical records show that many Asian and European countries were exchanging goods between them and trade was flourishing particularly since the mid-16th Centun. Even trade bctween many Asian countries was doing well, especially between India and Indonesia, and between Southeast Asian and East Asian countries such as Malaysia, Burma (now, Myanmar), Indonesia, Southern African countries, Caribbean Islands, West Pacific Islands. Similarly, there were monetary transactions between countries amounting to financial investments. The British India had invested in many commercial projects in Southcast Asia. Similarly, the European countries had invested in African countries. Hence international economic relation is not a new phenomenon beginning in the 20th Century. Only change one can notice is that the industrial revolution of the 19th Century and information and communication revolution of the 20th Century have altered the parameters of this relationships taking it to a new high.

Because of increasing cross-border economic transactions the world today is increasingly becoming interdependent where developed countries too understand the significance of developing and LDCs in their progress Their economic interactions are not out of compulsion or necessity but for securing each other's mutual interests. Even the international political relations and diplomacy between countries depend upon their mutual economic relations. More intense and regular are the economic relations, less possibility of friction of war. This has been well demonstrated by the Association of Southeast Asian Nations (ASEAN) since its establishment in 1967. For over the past thirty-five years since the ASEAN came into existence, all ten Southeast Asian countries are free from war-threat from each other. This miracle could happen through intense trade, movements of capital and labour. and financial assistance between them. Thus in the following discussion we highlight the basic principles of international economic relations by analysing the factors involved in it.

15.2 TRADE

Trade continues to be the foremost factor in international economic relations. Trade consists of two elements: i) merchandise trade and ii) trade in services. The principal components of merchandise trade are exports and imports of manufactured goods, agriculture products and mining products. The trade in manufactures (of world trade) accounts for almost 75 per cent of international trade and remaining 25 per cent is in primary products. Among the primary goods, trade in food products is the largest (9.3 per cent) followed by trade in fuels (7.6 per cent); trade in raw materials, ores and metals accounts for 5.7 per cent. In the manufacturing category, machinery and transport equipment accounts for 39 per cent of world trade. Automotive products are a major subcategory, absorbing 9.6 per cent of world trade. Other important categories of manufactures include trade in chemicals (9.3 per cent) and in textiles, clothing and miscellaneous consumer goods (15.6 per cent). The notable characteristic of current world trade is that trade in manufactures continues to be significant while trade in primary products continues to be sluggish.

Along with merchandise trade, trade in services is also an important component of the international trade. Services generally include the following items: wholesale and retail trade, restaurants and hotels, transport, storage, communication, financial services, insurance, real estate, business services, personal services, community services, social services, and government services. International trade in services broadly consists of commercial services, investment income, and government services, with the first two categories accounting for the bulk of services. Discussions of trade in "services" generally refer to trade in commercial services. Since the beginning of the 1980s the exports of commercial services is surpassing merchandise exports, mainly because of advancement in information and communication technology, rise in tourism and internationalisation of production activities. However, the nature of trade in "services" is such that it is extremely difficult to obtain accurate estimates of the value of ("services") transactions. Because there is no agreed definition of what constitutes a traded service: and the way in which these transactions are measured are less precise than is the case for merchandise trade. Estimates are obtained by examining foreign exchange records and/or through surveys of establishments. Since many service transactions are not observable (hence, they are sometimes referred to as the "invisible" in international trade), the usual customs records or data are not available for valuing these transactions.'

15.2.1 Why does International Trade Take Place?

International trade plays an important role in the economic development of any country, and it is considered as an "engine of growth". Rather its importance has increased manifold in recent times with the advent of wave of liberalisation since the beginning of 1980s. Here we would give brief explanation of the basis of trade by drawing upon approaches of trade theories.

Mercantilism

During the 17th and 18th centuries the economic doctrine of mercantilism prevailed, largely in the Europe and the West. The doctrine of mercantilism was highly nationalistic and viewed the well being of the nation to be of prime importance. It favoured the regulation and planning of economic activity as an efficient means of fostering the goals of the nation, and it generally viewed foreign trade with suspicion.

The most important way in which a country could grow rich, according to the doctrine of mercantilism, was by acquiring precious metals, especially gold. Single individuals, however,

were not to be trusted: they might also like gold, but perhaps they liked other things even more. Left to themselves, they might exchange gold for cloth or sugar, or indulge in whatever private pleasures they preferred, to the detriment of the stock of precious metals stored in the nation. To prevent such undertakings, the nation had to control foreign trade. Exports were viewed favourably as long as they brought in goods, solid gold, but imports were viewed with apprehension, as depriving the country of its true source of richness—precious metals. Therefore, trade had to be regulated, controlled and restricted, with no specific virtue being seen in having a large volume of trade.

It was against this background that the English classical economics was developed, for mercantilism was the credo that Adam Smith and David Ricardo rebelled against; English classical economics was an offspring of liberalism and the Enlightenment—of a general philosophy that stressed the importance of the individual and viewed the nation as nothing more than the sum of its inhabitants. For Smith and Ricardo, the supreme subjects of economics are the consumers. The enjoyment of consumer was viewed with favour.

The Theory of Absolute Advantage of Trade: Adam Smith

Adam Smith saw clearly that a countn could gain by trading. For instance, the tailor does not make his own shoes; he exchanges a suit for shoes. Thereby both the shoemaker and the tailor gain. In the same manner, Smith argued, a whole country can gain by trading with other countries.

Adam Smith cited an example, if it takes 10 labour units to manufacture 1 unit of good X in country A but 20 labour units in country B, and if it takes 20 units of labour to manufacture 1 unit of good Y in country A but only 10 labour units in country B, then both countries can gain by trading.

If the two countries exchanged the 2 goods at a ratio of 1 to 1, so that 1 unit of good X is exchanged for 1 unit of good Y, country A could get 1 unit of good Y by sacrificing only 10 units of labour, whereas it would have to give up 20 units of labour of it produced the good itself. Likewise country B would have to sacrifice only 10 units of Labour to get 1 unit of good X, whereas it would have to give up 20 units of labour if it produced itself, In nutshell, both countries could have more of both goods, with a given effort, by trading.

The Theory of Comparative Advantage: David Ricardo

David Ricardo did not object to Smith's analysis. It is obvious that if one country has an absolute advantage over the other country in one line of production and the other country has an absolute advantage over the first country in a second line of production, both countries can gain by trading. A great deal of trade, perhaps most trade, is governed by such differences.

But what if one country is more productive than another country in all lines of production? If country A can produce all goods with less labour cost than country B, does it still benefit the countries to trade'? Ricardo's answer was yes. So long as country B is not equally less productive in all lines of production, it sill pays both countries to trade. This Ricardo's argument formulated the foundation for favourable opinion for international trade. Ricardo's argument is still considered important and remains as the basis when two countries go for trade.

Ricardo used England and Portugal as examples in his demonstration, the two goods they produced being wine and cloth. He assumed that Portugal was more efficient in making both

cloth and wine. The Table 1 shows how Ricardo summed up tlic cost conditions in the two countries.

Table 1 : Cost **Comparisons**

	Labour cost **of** Production (in **hours)**	
	1 unit of wine	1 unit of cloth
Portugal	80	90
England	120	100

According to this model, Portugal has an absolute advantage in tlic production of wine as well as in the production of cloth, because the labour cost of production for each unit of the two commodities is less in Portugal than in England.

To demonstrate that trade between England and Portugal will. even in this situation, lead to gains for both countries, it is useful to introduce the concept of opportunity cost. The opportunity cost for a good X is the amount of other goods which have to be given up in order to produce one (additional) unit of X. Table 2 gives the opportunity costs for producing wine and cloth in Portugal and England. These costs have been constructed on the basis of the information given in Table 1.

Table 2 : Opportunity Costs

	Opportunity costs for	
	1 unit of **wine**	1 unit of cloth
Portugal	80/90 = 8/9	90/80 = 9/8
England	120/100 = 12/10	1001120 = 10/12

A country has a comparative advantage in producing a good if tlie opportunity cost for producing the good is lower at home than in the other country. Table 2 shows that Portugal lias the lower opportunity cost of the two countries in producing wine. while England has the lower opportunity cost in producing cloth. Thus Portugal lias a comparative advantage in the production of wine and England has a comparative advantage in tlic production of cloth.

What does it mean by 'comparative advantage'? In order to see about comparative advantage there must be at least two countries and two goods. We compare the opportunity costs of the production of each good in both countries. **As** long as the two countries' opportunity costs for one good differ. one country has a comparative advantage in the production of the other good, **As** long as this is tlie case. both countries will gain from trade. regardless of the fact that one of the countries might have an absolute disadvantage in both lines of production.

Comparative **Advantages and Gains from** Trade

Let us assume that Portugal and England do not trndc but produce and consume in isolation. The prices of cloth and wine in the two countries are then determined by their respective cost of production.

If in England it takes 120 hours of labour to make 1 unit of wine, while it takes only 100 hours to make 1 unit of cloth, obviously wine must then be more expensive per unit than cloth—1 unit of wine will cost 120/100, or 1.2, unit of cloth.

If in Portugal it takes 80 hours of labour to make 1 unit of wine and 90 hours to make 1 unit of cloth, cloth will be more expensive than wine—1 unit of wine will cost 80/90, or 0.89, units of cloth.

Let us now open the possibility of trade. If England could import 1 unit of wine at price less than 1.2 units of cloth: she would gain by doing so. If Portugal could import more than 0.89 units of cloth for 1 unit of wine, she, too, would gain. Therefore, if the international price of 1 unit of wine is somewhere between 1.2 and 0.89 units of cloth, both countries will gain by trading.

Let us assume further that in the international markets 1 unit of wine exchanges for 1 unit of cloth. It is then advantageous for England to export cloth and import wine, because in the absence of trade England would have to give up 120 hours of labour for every unit of wine she wants. By trading she can, instead, with 100 hours of efforts, produce 1 unit of cloth and then exchange this unit of cloth for 1 unit of wine. Under autarky i.e., a country producing and consuming in isolation, it would have to give up 120 hours of labour for every unit of wine she wanted, whereas with trade she only needs to give up 100 hours. With each 20 hours left over she can produce more cloth and enjoy a higher level of consumption—or the workers can rest, and trade will make possible more leisure with a given amount of consumption.

Portugal will also gain from trading. In isolation she would have give up 90 hours of labour to get 1 unit of cloth. Now she can make 1 unit of wine with the effect of 80 hours of labour and exchange this unit of wine for 1 unit of cloth in the international market. Every 10 hours of labour freed by this process can then be used for either increased production or increased leisure.

Thus trade offers each country the possibility of specialising in the line of its comparative advantage and then exchange these products for those in which she has a comparative disadvantage. Both countries can reallocate their factors of production to the line where their comparative advantage lies and then export this product and import the other product. In nutshell, with a given amount of resources each country can consume more by trading than in isolation.

After the theory of comparative advantage economists modeled many new theories but Ricardo's theory remained a landmark and the new theories mostly attempted to redefine the Ricardo's theory in changed situations. As the development advanced in many countries during the 20th Century, the role of factors of production altered in new situations and parameter to measure their significance also changed. Nevertheless, the basis of international trade continued to be the comparative advantage.

15.3 FACTOR MOVEMENTS: CAPITAL

Along with trade the two factors, capital and labour, have assumed equal importance as powerful agents of international economic relations since 1950s. Rather financial capital flows across the national borders have been increasing following the wave of globalisation in 1980s. The international labour mobility too has risen because of the rise of MNCs, TNCs and opening of new job opportunities with the growth of information and communication technology (ICT)

sector. Here we would touch upon the aforesaid issues in detail and would demonstrate their relevance to the trade.

Movements of capital through FDI and MNCs

The earlier trade theorists of the 18th and 19th centuries considered mobility of capital and labour only within the boundaries of a nation and ruled out their mobility between the nations. However, this assumption in the current period has undergone a change as large-scale capital and labour mobility has been taking place and changing the pattern of economic development in a significant way.

One needs to distinguish between two types of international movements of capital: one is foreign direct investment (FDI) and another is foreign portfolio investment. FDI refers to a movement of capital that involves ownership and control. In case of FDI the investor retains control over the invested capital and FDI and management go together. For instance, when Japanese citizens purchase common stock in a Malaysian firm, they become owners and have an element of control because common stockholders have voting rights. For classification purposes, this type of purchase is recorded as FDI if the stock involves more than 10 per cent of the outstanding common stock of the Malaysian firm. If a Japanese company purchases more than 50 per cent of the shares outstanding, it has a controlling interest and the "Malaysian" firm becomes a foreign subsidiary. The building of a plant in India by a Japanese company is also FDI, because obviously there is ownership and control of the new facility—a branch plant—by the Japanese company. FDI is usually discussed in the context of the multinational corporation (MNC), sometimes referred to as the multinational enterprises (MNE), the transnational corporation (TNC), or the transnational enterprises (TNE). All these terms refer to the same phenomenon—production is taking place in plants located in two or more countries but under the supervision and genera1 direction of the headquarters located in one country.

Foreign portfolio investment does not involve ownership or control but the flow of "financial capital" rather the "real capital". In case of portfolio investment the investor does not retain control over the invested capital—only he lends his capital in order to get a return on it but he has no control over the use of that capital. Examples of foreign portfolios investment are the deposits of finds in an Indian bank by a Japanese company or the purchase of a bond (a certificate of indebtedness) of an Indian company or the Indian govenunent by a citizen or company based in Japan. These flows of financial capital have their immediate impact on balances of payments or exchange rates rather than on production or income generation.

15.3.1 What Causes the Movements of Capital?

There is considerable mobility of capital across country borders in the world economy today. One can view the movements of capital between countries as fundamentally no different from movements between regions of a country (or between industries), because the capital is moved in response to the expectation of a higher rate of return in the new location than it earned in the old location, Economic agents seek to maximise their well-being. They seek higher rate of return on capital over time. We give in tho following lines some reasons for capital movements.

i) Growing Market for Products

Firms invest abroad in response to large and rapidly growing markets for their products. For instance, many firms from US, Japan. South Korea and Germany are investing in India and China mainly to seek advantage of rapidly growing markets of these two countries.

ii) **Changing Tastes and Wants**

The manufacturing and services production in developed countries is catering increasingly to high-income tastes and wants, the firms of these countries invest overseas if the recipient country has a high per capita income. However, per capita income must be kept distinct from total income (GDP); for example, firms in developed countries are keen to move into China because of its sheer market size and despite its relatively low per capita income.

iii) **Access to Raw Material**

The foreign firms invest in other countries to secure access to mineral or raw material deposits located there and then process and sell them in more finished form. For instance, a substantial share of US direct investment overseas (especially in developing countries) is in the petroleum industry.

iv) **Getting behind the Tariff Wall**

Tariffs and non-tariff barriers in the host country also can induce an inflow of FDI. If trade restrictions make it difficult for the foreign firm to sell in the host country market, then an alternative strategy for the firm is to "get behind the tariff wall" and produce within the host country itself.

v) Low **Relative Wages**

A foreign firm may consider investment in a host country if there are low relative wages in the host country. The existence of low wages because of relative labour abundance in the recipient country such as India, China, Vietnam, Indonesia is an attraction when the production process is labour-intensive. Many times the production process gets broken up in such a manner that capital intensive or technology-intensive production of components takes place within developed countries while labour-intensive assembly operations take place in developing countries.

vi) To **Protect Market Share**

Sometimes firms invest abroad for defensive purposes to protest market share. For instance, firm X, finds it essential to begin production in the foreign market location in order to preserve its competitive position because its competitors are establishing plants in the foreign market currently served by X's exports or because firms in the host country are producing in large volume and competing with X's goods.

vii) **For** Risk **Diversification**

Finns often invest abroad as a means of risk diversification. By doing so they can avoid recession prevailing in some part of the world. If a recession or downturn occurs in one market or industry. it will be beneficial for a firm not to depend upon one market.

viii) **Firm-Specific Attributes**

Foreign firms may find investment in a host country to be profitable because of some firm-specific knowledge or assets that enable the foreign firm to outperform the host country's domestic firms. Superior management skills or an important patent might be involved. An opportunity to generate a profit by esploiting such advantages in a new setting entices the foreign firm to make the investment.

15.3.2 Major Instruments of Portfolio Investment

There is a large variety of instruments through which portfolio flows are channelled. The principal instruments are venture capital funds, county funds, America depository receipts (ADRs) and global depository receipts (GDRs), convertible bonds and bonds with equity warrants. Countries may prefer to channel portfolio inflows through specific instruments in order to protect their markets from externally induced turbulence.

i) Venture Capital funds

The rational for venture capital is an imbalance created by an inadequate supply of capital on appropriate terms from existing financial institutions on the one hand, and a significant demand for funding for new or high risk ventures with prospects for high growth and profitability on the other. Venture capital financing provides early-stage financing, as well as financing for the expansion of established companies. Venture capitalists provide equity-type financing with a view towards participating in the high returns achieved by successful new ventures with high growth potential, particularly in the fonn of capital gains. Venture capital investing involves the participation of a venture capital institution in the investee company. Since the early 1980s, many specialised venture capital institutions have been formed in developing and the LDCs.

ii) International Equity Investment Funds

Investment funds can be managed or unmanaged. Managed funds actively trade their portfolio of securities, the composition of which will change over time. Unmanaged funds invest in a fixed portfolio of securities which does not change over the life of the fund. Among the various portfolio investment instruments, managed international investment funds have become the most popular vehicle for portfolio investment in the emerging markets. Investment funds can also be divided into closed-end and .open-end funds (commonly referred to as mutual funds or unit investment trusts). Closed-end funds are distinguished from open-end funds in that they issue a fixed number of shares at the time of their initial public offering.

iii) American Depository Receipts (ADRs) and Global Depository Receipts (GDRs)

An ADR is generally created by the deposit of the securities of a non-United States company with a custodian bank in the country of incorporation of the issuing company. The custodian bank informs the depository in the US that the ADRs can be issued. ADRs are US dollar denominated and are traded in the same way, as are the securities of the US companies. The ADRs holder is entitled to the same rights and advantages as owners of the underlying securities in the home country. Several variations on ADRs have developed over time to meet more specialised demands in different markets. One such variation is the GDR which are identical in structure to an ADR, the only difference being that they can be traded in more than one currency and within as well as outside the US

iv) Convertible Bonds and Bonds with Equity Warrants

A convertible bond is a bond which gives its holder the right to exchange the bond for a specified number of the issuing company's shares at any time up to and indicating the maturity date of the bond. Many convertible bonds include a call option which gives the issuing company the right to call the bond for redemption before the bonds maturity date. Once the company exercises the call, the bond holder is usually allowed approximately thirty days in which to either covert the bond into shares or surrender the bond and receive in return the call price in cash, The issuer will usually be obliged to pay a premium above the bond's par value in the event that they exercise the call.

An equity warrant is a security which gives the holder the right to buy (in return for cash) a specified number of shares directly from the issuing company at a specified fixed price for a given period of time, which is known as exercise period. The warrant can usually, but not always, be detached form the bond and sold as a separate security. This is not the case with convertible bonds. They also sometimes issue warrants as separate securities.

15.4 LINKAGES BETWEEN FDI AND PORTFOLIO INVESTMENT

As mentioned earlier portfolio investment is distinguished from FDI by the degree of management control that foreign investors exercise in a venture (or a firm): portfolio investors usually provide only financial capital by purchasing shares of a company without any involvement in the company's management. Portfolio investment has a shorter investment horizon than FDI, sometimes just a few weeks or months, although this horizon can extend to ten years or more. The type of investor is also different: while FDI investors are firms engaged in the production of goods and services, portfolio investors are more often either financial institutions, institutional investors (FIIs), or individuals, and arc interested only in the financial returns of their investments. However. in practice. these distributions are often less than clear-cut and are subject to a number of following qualifications.

The ownership threshold commonly used to distinguish FDI and portfolio investment is somewhat arbitrary. An investment is normally counted as FDl when it involves an equity capital stake of 10 per cent or more of the ordinary shares in an incorporated enterprise, or its equivalent for an unincorporated enterprise. This is held to indicate a lasting interest in, or a degree of control over, the management of the enterprise. An equity stake of less than 10 per cent is categorised as portfolio investment.

However, minority-share purchase can, in some circumstances, involve direct management participation, and in some cases lasting management control can take place with a less than 10 per cent equity stake. In the case of Japan, for instance, Japanese companies sometimes hold less than 10 per cent of the shares of foreign supplies of raw materials, but still have representation on the foreign company's board of directors and maintain a long term business relationship with these companies.

The role of venture capital investors is also less clear-cut. They provide equity capital for unquoted companies (on stock market) often at the start-up stage, and are often very closely involved in managing them, either directly or indirectly, by providing advisory services. Although their overriding motive is to achieve a capital gain, venture capital investors often wait several years before selling their equity stakes.

Flows of portfolio investment normally take place through transactions involving shares of companies quoted in stock markets, although some portfolio flows also take place in unquoted companies (for e.g., in the case of venture capital funds). The contribution of portfolio investment to the financing of domestic enterprises can be significant. It is most direct when the investment is made in the market for primary issues, in the local stock market, or in international market through international equity offerings or issues of depository receipts. Share purchases in the local secondary market contribute indirectly to the financing of local firms Portfolio investors are mostly attracted in the first place by "blue-chip" companies in emerging markets because they seek opportunities to take advantage of "price anomalies" by investing in companies that appear to be undervalued on the basis of, for e.g., the price-earnings ratio. However, these need

not necessarily, always be blue-chip conipanics, they can be companies with high growth potential.

Flows of portfolio investment are linked to the development of stock markets in recipient countries. Many venture-capital funds investments in unquoted companies are made with the expectation of reaping capital gains subsequent to the listing of such companies on the stock market once they become mature. With regard to mergers and acquisitions (M&Qs), there is a close relationship between FDI and portfolio investment. In many cases, cross border M&Qs arc considered as FDI transactions because they confer a lasting and significant management interest in the merged or acquired company. However. it is possible for such transactions to take place with a minority equity interest. in which case the transaction would be recorded as a portfolio flow.

15.5 FACTOR MOVEMENTS: LABOUR

Along with capital, the mobility of labour too has increased since the mid-1950s. Such mobility is playing important role in designing the economic relationship between two countries. For instance, a large number of ethnic Chinese migrated and settled in the Soutlieast Asia are playing influential role in economic activities of the Southeast Asian nations and are seen as a link between China and South East Asia. The settled ethnic Chinese forms a strong network to conduct economic transactions between China and Southeast Asia and most of the FDI inflows into China comes from Chinese Diaspora. In the following lines, we analyse the issues involved in labour mobility and its implications.

Causes of Labour Movements

Technically, the desire to migrate on the part of an individual (labour) depends on the expected costs and benefits of the move. Expected inconie difference between the old and new location; cost-of-living differences between the two locations, and other non- pecuniary net benefits in the new location such as health facilities, educational opportunities, or greater political or religious freedom figure into the decision to migrate. Even within this more general framework, expected wage or income differences are an important factor. For instance, large number of unskilled and skilled labour from India migrated to various countries of West Asia to earn higher wages. Similarly large number of Indian knowledge—labour such as doctors, engineers, management professionals, software experts, scientists and teachers migrated to the US and other developed countries since the early 1970s to earn comparatively higher wages as well as avail better work environment.

What is 'Brain Drain' ?

The movement of skilled labour. especially between developing and the industrialised countries, is a relatively recent phenomenon. However, an increasing number of highly educated people (physicians, research scientists, technocrats, university teachers, and other skilled professionals) from developing countries to the US. Canada, Western Europe, Australia, and New Zealand is more often referred to as the "brain drain." Higher salaries: lower taxes, greater professional and personal freedom found in these countries explain such migration.

The developing countries, because of brain drain, are in a quandary. The migration of skilled labour often represents a substantial static and dynamic cost to them. Developing countries often resort to restrict the out-migration of skilled labour. Until recently, for example, restrictions

of this kind were common in Eastern Europe. However, the loss in personal freedom associated with labour movement restriction makes such restrictions unappealing. Restriction of personal freedom also lead to lower production and a loss of professional leadership and entrepreneurship, which is important to these countries as they undergo economic reforms.

15.6 MONETARY AND CREDIT FACTOR

Closely related to the capital and labour movements is the issue of the "external financial assistance" or popularly known as "foreign aid". The aid factor in recent period has taken a back-seat in international economic relations with the rise of FDI and portfolio investment. Now the concern has shifted to interdependence of developed and developing and LDCs rather than dependence of developing and LDCs on the developed countries. The relationship between these countries is now based on principle of mutual benefit. The developed countries too need developing and LDCs for expanding their production and marketing base. The liberalisation and globalisation have opened up the markets. Many developing and LDCs are now following the policy of export-led growth. The policy of import-substitution is becoming past-day phenomenon. This changed situation is more suitable to the FDI and portfolio investment to play significant role than foreign aid and therefore there is less stress on the latter.

15.6.1 What is Foreign Aid?

Foreign aid or external financial assistance refers to only that part of the capital inflow, which is not based on normal market incentives but is made on concessionary terms. Thus, grants of freely convertible currency constitute aid in the full sense. Foreign loans contain only an element of aid. The difference between aid and loan can be identified on the basis of three factors, i.e. grace and maturity period, as well as interest rate. Normally in case of aid these factors are lower when compared with loan. However, in case of both, aid and loan, private foreign investment and short-term capital movements are excluded.

The need for foreign aid arises when domestic capital formation falls short of developmental-programme requirement. The developing and LDCs during the 1950s to 1970s were caught in a typical situation: mass poverty; unemployment, surplus labour in agriculture, high birth rate, famine and hunger. low agricultural productivity and inadequate industrialisation. Coupled with these problems the financial market and banking network was extremely insufficient to attract either FDI or portfolio investment. To overcome shortfall in domestic capital formation developing and LDCs approached the developed countries for assistance. They also approached the international and multilateral financial institutions such as the World Bank, Asian Development Bank, US Aid Organisation, etc. for help. Recognising their concerns the developed and the aforesaid organisations too came forward and provided the help. Their financial assistance was either in the form of aid or loans. The borrowed resources were mainly meant for three purposes, firstly to supplement national income by making available (the borrowed) foreign exchange to be deployed in developmcntal programmes; secondly for importation of strategic capital goods or foreign materials to be used to expand production base by utilising domestic raw materials that would otherwise remain unused: and thirdly to remove a balance of payments bottleneck which was almost the usual feature of the developing and LDCs.

15.6.2 Types of Foreign Aid

The foreign aid often invokes one question: whether the aid is tied or untied'? The tying of aid *inter alia* determines the cost of foreign aid. The aid may be tied by sources or end-use (via specification of commodities or projects). There are various methods by which aid can be tied

to tlze source but two methods namely, formal restrictions and indirect restrictions are more in practice. In case of formal restrictions, the recipient country has to spend the aid funds for importing goods and services only from the designated source(s). The US resorts to this method while allowing foreign assistance to developing countries. While in case of direct restrictions, three methods can be applied. First, the aid-flow becomes the part of an overall trade arrangement. Secondly, the aid-flow can be coupled with the provisions under which the aid is to be spent on donor countries goods and services and the donor country would make the reciprocal purchases from the recipient country on a preferential basis. Thirdly, the donor can finance only those commodities and/or projects of the recipient country where the donor country has the decided advantage in tendering or' supplying the specified items.

Aid can be project tied or non-project tied. When aid is given for a particular project, then it is called a project aid. If it is not for a specified commodity or project, it becomes a non-project aid. Project and non-project aid have their own merits and demerits. The greatest merit of the non-project aid is that the recipient country is free to utilise aid according to its priority programmes and as such it works as a stimulant in the overall process of economic growth. In case of project-tied aid tlze recipient country has no option but to utilise it on the programme for which it is sanctioned. From the point of developmental goal of the (recipient) developing country, aid should be untied and country's overall development programmes (instead of individual projects) should be the basis for allocating and controlling aid.

The tying of aid gives more benefits to the donor than recipient country. The tying of aid to purchases in the donor country is implicitly a form of protection, and it readily degenerates into a means of trade-promotion by the donor country (of its trade) instead of being a means of accelerating the development of tlze recipient country. That causes adverse effects to recipient country. The real value of aid is reduced to the extent that import prices from the donor country are above competitive world market prices. This may be of less concern when the recipient country receives aid in tlze fonn of a grant; but in the case of a loan, the extra cost of tying (represented by the difference between the purchasing power of untied aid and tied aid) may have a substantial effect in reducing the element of subsidy or the "grant component" in the loan.

The practice of aid tying is also undesirable because it distorts the recipient country's allocation of investment resources. When procurement (of machinery and material) is limited to the aid-supplying country, the recipient's development programme tends to become biased towards those projects that have a high component of the special import content allowed for under the conditions of tied aid. Aid tied to purchases in the donor country can also limit the choice of technology used in investment projects and may thereby cause the recipient country to adopt by necessity a technology that is less appropriate for its factor endowment that would be suitable if it could import freely.

15.7 SUMMARY

Trade, capital and labour movements and foreign aid constitute significant factors in international economic relations. Their importance, however, assume different degrees with the change in location, time and purpose. Traditionally trade continues to be one of the important factors. The basis of trade remains the theory of comparative cost advantage. Ricardo's principle essentially relies on free market economy where trade can bring benefit to both the trading partners. The differences in comparative cost of production and their relative opportunity cost determine the level of trade between two partners.

To seek higher returns of free trade and expand the basis of production beyond national boundaries movements of capital and labour are also burgeoning. Initially the capital moved from developed to developing countries to take advantage of abundant raw material and cheap labour. In the process developing countries were benefited with the absorption of new and advanced technology. Flow of capital helped developing countries to erect network of security market, i.e. stock exchange. This prompted the flow of portfolio investment from individuals and investment firms of developed to developing countries. Besides, there is an increased labour movement across the countries. The rise in labour movements is basically more from developing to developed countries to earn higher returns. The spurt in education and training of information and communication technology (ICT) in the developing countries helps skilled-labour to migrate to developed countries.

Foreign aid dominated the international economic relations (until the emergence of FDI and portfolio investment) for some of the developing and most of the LDCs. To those economies where trade expansion had limited scope because of small size of their economy, such .as Bhutan, Maldives and Nepal, external economic assistance is *sine* qua non in their development programmes. For instance, India's assistance to these three economies is quite substantial and especially the Bhutanese Five-Year Plans for the past fifty years are entirely dependent on the Indian assistance.

15.8 EXERCISES

1) What is the basis of the theory of absolute advantage of trade'?
2) What is comparative cost advantage'?
3) What is the difference between foreign direct investment and portfolio investment'?
4) What are the causes of movements of capital '?
5) What is the significance of foreign aid in developmental process'?
6) Why is the untied aid preferable to a tied aid'?