CHAPTER TWO

THE
THEORETICAL DISCUSSION
OF
INTERNATIONAL ECONOMIC
RELATIONS

2.1 Introduction

International Economics deals with transactions between countries in the fields of goods and services, financial flows, technology transfer and factor movements. It also studies government policies affecting trade, monetary arrangements, International negotiations, regional Institutions (EFTA, LAFTA, SAARC, BRICS, IBSA, etc), and International financial Institutions (IMF, IBRD, IDA, ADB, WTO, etc). It is conventionally divided into two subject areas, pure theory and trade policy. In the former, attention is focused on real magnitudes such as gains from trade, terms of trade, pattern of trade, etc. while the latter deals with policy issues like custom duties & other regional associations and their implication. Generally, International economic relations cover the following four aspects.

(1) International or Foreign trade

(2) Foreign aid

(3) Foreign collaboration and

(4) International & Regional Financial Institutions

2.1.1 International or Foreign trade

Foreign trade had a major role in progress, providing access to markets hitherto unexploited[65]. Foreign trade plays an extremely vital role in the economic development of a country. There are some major advantages of it. It is a source of material means, technical knowledge, managerial talents and entrepreneurship. Besides, it is a transmitter of capital and imports and indicator of healthy competition. In fact, it introduces fundamental changes in a country's economic characteristics, proportions and relationships. It promotes capital formation and brings internal and external economies.

The economic progress of most of the advanced countries, like UK, France, Netherland, Belgium, Germany, Italy & Japan etc of the world is attributable to their ever-expanding external trade. UK has achieved its material prosperity largely through foreign trade. U.K.'s population more than trebled during the nineteenth century, despite

65. G.V. Haberler, (1959), International trade and economic development anniversary commemoration lectures at the national bank of Egypt, Cario, P. 10-14 heavy emigration. The national income increased more than seven- fold at current prices owing to expanding foreign trade. In the economic advancement of France, an important part was played by foreign trade. The material prosperity of the west European countries like Netherlands, Belgium, Germany and Italy has been achieved through foreign trade. However, Germany registered a stable foreign trade during the later half of the nineteenth century.

Japan has reconstructed its economic development through foreign trade. Japan followed the general European pattern and had a rapidly growing foreign trade ratio. Japan's industries depend on foreign trade both for the supplies of raw materials and for the sale of manufactured goods. A good number of other countries such as the United States, Canada and Australia, however, showed a steady or falling foreign trade ratio. For the developing countries, role of foreign trade is of crucial importance for rapid industrialization .This is turns will rather the problems of unemployment and poverty in these countries. Industrialization has become a panacea for their economic and social ills. The road to industrialization is beset with the host of problems. A major obstacle is the lack of availability of capital goods, equipment and know how on a massive scale. In order to meet these developmental requirements, developing countries in general and India in particular are facing balance of payment problems. As industrialization proceeds, total volume of imports increases to the extent that import bill outstrips total export earnings. Thus, foreign trade helps in the process of growth and also serves as a limiting factor (due to adverse balance of payments problems). Haberler has rightly observed, " My over all conclusion is that international trade has made a tremendous contribution to the development of less developed countries in the nineteenth and twentieth century and can be expected to make an equally big contribution in the future, if it is allowed to proceed freely"[66].

There is a close relationship between the economic growth of a country and its foreign trade. The classical and neoclassical economists regarded foreign trade as an 'Engine of Growth'. Modern economists like R. Prebisch, H.W.Singer and G.Myrdal favour the classical views subject to the condition that the problems of unfavorable

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66. G.M. Meier, (1970), Leading Issues in Economic development, Oxford University Press, London, P.412

effects of international factor movement and the international operation of demonstration effect are overcome.

2.1.2 Export-Import and International trade

Exports and imports are an underlying factor of international trade. Composition of trade refers to the goods that are exchanged by a country. It determines the relative position of a country in the comity of nations. It indicates through imports what types of goods a country lacks and how much of them it needs or is able to get. And exports bring out the fact about the goods that a country has and how much of these she can and is willing to sell. Thus, in this context, it is necessary to discuss commodity composition which for the sake of convenience may be studied under two aspect- structure of Export and structure of Import.

2.1.3 Structure of Exports

Exports play a crucial role in the development process. Baldwin and Meier aptly describe export sector as a propulsive sector[67]. It widens the market, provides economies of scales and sets the pace for the multiplier–acceleration process in the economy. External demand through a diversified export sector enables countries to benefit from rapidly growing external markets and to overcome a slack which may be caused by a slowdown in the growth of domestic markets. The long run trends in manufacturing output, investment and exports are all likely to be closely correlated[68]. In this inter-related function, the growth of the export sector is crucial.

For clear understanding of the role of exports in economic growth, it may be useful to distinguish three important aspects, namely that of a leading, balancing and lagging sectors of the economy. If foreign trade is a leading sector of an economy, then it will help in developing growing points which will accelerate growth. If the stimulus to economic development comes from abroad, exports rise and provide an incentive for the establishment and the expansion of other activities. Growing exports will give rise to new

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67. G.M. Meier and R.E, Baldwin, (1962), Economic Development: Theory History and policy, Asia publishing House, Bombay. P.229

68. Ibid, P.230

demand in the expansion of production and as a result factor income will increase. Further, pressure on domestic capacity may stimulate technology change, which, in turn, will provide investment opportunities to entrepreneurs. Thus, through stimulating investment and technical change, the expansion of exports can lead to economic growth. Foreign trade as a balancing sector of an economy will enable adjustment between production and consumption or between supply and demand. If adjustment of trade ignoring changes in stocks, keeps pace with domestic transformation, trade is filling the gap between consumption and production. Finally, if foreign trade is a lagging sector of the economy, the stimulus to development is internal and trade may also slow down growth. In this case if there is any export, this would be at the expense of the domestic requirements[69].

Normally, a high rate of growth of total real product is associated with the high rate of growth of exports. But with increasing exports, the available markets for selling them are also necessary because in the absence of exports markets, excess supply of the commodity within the domestic markets would create defection in the commodity market and would tend to reduce investment and hamper economic growth. With the increasing level of exports, a country will enjoy the greater advantage of international division of labor which will help to increase the efficiency of that particular industry. This will be followed by the technological change which is important for accelerating economic growth. International competition will put pressure on export industries to keep costs low and consequently strive for more efficient operation. The sector in which a country enjoys comparative advantage becomes the most efficient sector of the economy and increasing exports trend to encourage investment, which increases productivity. Thus, exports industries tend to stimulate additional investment in the existing set up as well as an encouraging investment in ancillary industries established to supply and service the operations of the main export industries. In contrast to this, low rates of growth of real product cannot encourage foreign investment within the country, but a rapid growth in exports may serve as an inducement to foreign investment. In addition to stimulating domestic and foreign investment, a growing export sector may also encourage an

69. A. Halder, (1976), 'India's exports pattern' Minerva associates publications private limited, Calcutta, P.6.

increased flow of technological and market innovations as well as managerial skills.

2.1.4 Structure of Imports

Import provides the required technique and capital goods which the economy is incapable of producing itself. Growth emanating from imports is almost true for all economies. An economy which decides to embark on a programme of development is required to expand its productive capacity at a fast rate. Imports of machinery and equipment which cannot be produced in the initial stages of development by an economy are essential. The imports which help to create new capacity are called 'developmental imports'. Imports, for instance, required for the setting up of steel plants. Locomotive factory and hydro-electric projects are of developmental nature. Moreover a developing country which sets in motion the process of industrialization requires the imports of raw materials and intermediate goods for the optimum utilization of the capacity created in that sector. Imports which are made in order to make a full use of productive capacity are called maintenance imports. Developmental imports are vital for a developing economy and many of the industrial projects are also held up for lack of maintenance imports. It can be said that the availability of imported goods is a determinant of the rate of economic growth and can also be a limiting factor. The volume of imports required for development is determined by the following variables:

(i) Import content of investment.
(ii) Techniques of production required for development.
(iii) Export earnings.
(iv) Foreign exchange reserves. and
(v) Foreign aid flow.

The volume of imports required for development is a dependant variable. It varies primarily and jointly with the import content of investment and technique of production required for development. Export earnings put a limitation on imports. In most development countries, however, the availability of import-goods is not only a determinant of the rate of economic growth, but also one of the principal limiting factors. The necessity of the regulation of imports stems from the need to protect the external payment position, which is usually severely strained by the import requirements of massive investment programmes. Investment plans in nearly all developing countries involve sizable import content. If the period within which a given level of development to be realized is short, the scope for substitution between domestic and foreign resources is little, and consequently, the import content will be higher. Foreign loan cannot be relied upon to bridge an indefinite payment gap; the payments liabilities so generated soon become a major element in the gap, unless. Therefore, investment and production plans are effectively oriented towards import substitution and the expansion of exports. The acute pressures on the balance of payments tend to become chronic and the shortage of foreign exchange turns out to be the principal factor inhibiting the growth process.

2.1.5 Import growth and Income relationship

Imports depend upon a country's Gross National Product **(GNP)** and increase in income is always related to increase in imports. There is a tendency of imports growing relatively to income growth. Moreover, import content of investment of a developing country is invariably high. "In planned economies also the development effort is likely to increase imports faster than income, because investment as a proportion of income is stepped up and the import content of investment is high in the early stages of development"[70]. Import tends to grow faster than income if the marginal propensity to import is above the average propensity to import. A number of studies have stressed the relationship between income growth, capital requirements and growth of total imports.

2.1.6 Industrialization and Import substitution

Import substitution has been a major plan of promoting industrialization in a number of developing countries. It along with export expansion, yields considerable gains for industrialization. Chenery maintains that "Import substitution has been a vital growth factor"[71]. It works as a hedge against foreign exchange uncertainties and as a potential source of domestic economic growth. Import substitution refers to the finding of new uses for products that would replace imports. The process of increasing domestic production of particular goods to replace imports is one of the broader concepts of import

70. Economic and Scientific Research foundation, New Delhi, Structure of Indian imports (1957-64), 1966, P.9.
71. H. B. Chenery, (1960), 'Pattern of Industrial Growth' American Economic Review, vol. L, No.4, P.651.

substitution policy. Import substitution takes place primarily in manufacturing sector, as domestic requirements, manufactured consumer goods and also of production imports in other sectors have to progressively meet by indigenous manufactures. Thus, import substitution involves, on the one hand, substantial capital imports into the manufacturing sector as the base of manufacturing activity is widened and depends, and on the other, a decline in the relative importance of consumption imports and intermediate imports for other sectors. Apart from the steep increase in capital imports for the manufacturing sector and the general decline of consumption imports (other than food). This tendency is also illustrated by the decline in the capital imports for the transport sector. And in the intermediate imports of all sectors except agriculture which reflects the substantial progress to domestic production" [72]. It is obvious; therefore, that import substitution has taken a prime role in promoting the industrialization of many developing countries.

Thus, we can say that composition of commodities invariably changes in the process of growth. In the beginning, composition of imports changes and as growth picks up and export structure is diversified, composition of exports also changes. These changes are caused by development need and are also the product of development. Through imports of capital goods and technical know-how, developing countries can secure the advantages of an early start form developed countries. In the way, not only imports and exports increase but the commodity composition is considerably changed.

2.1.7 Direction of Trade

Trade is a multilateral sector; it includes production, consumption, exchange, import, export, investment & aid etc. Economic growth depends on it very much, so the trade policies & direction of trade were modified from time to time. The changes in the direction of trade bring to light the changes that take place in a country's trade relations with other countries. These changes invariably are the outcome of the fundamental changes taking place in the economy of a country. The earlier relations between developed and developing countries were directed by political considerations. The developing countries, in general, were under the control of the U.K. and other West

72. Economic and Scientific Research Foundation OP. Cit., P.27.

European countries and the USA and before their political independence most of the trade was concentrated with their colonial power or was conducted through that country. These developing countries were colonial markets and used to supply raw material and other essential items to the dominating country. With political independence and particularly after initiating a long-term development program, these countries developed trade relations with other countries. The development needs of these developing countries could not be met by any single developed country. There was no alternative but to purchase machinery and other capital equipments from developed countries other than their former ruler.

Similarly, after political independence, it was not necessary for the new nations to sell their products in the old traditional markets. The need of the hour was to explore all possible markets where they could sell their products. Exports had to be increased to pay for ever expanding imports. In a few limited markets, there was very little scope for earning exchange. Most of the developing countries were facing the same difficulty. As a result, trade among developing countries expanded.

There was another contributory factor. Developed countries formed regional blocks. High tariffs were levied on the products of non-member countries including developing countries. East European countries including the USSR also provided vast market for these developing countries. The developing countries, therefore, developed trade relationship with the USSR and other East European countries. As a result, a fundamental change took place in the direction of trade in most of the developing countries. This change in direction of trade was the outcome of development requirements and to boost exports on a regional as well as global basis.

Schumpeter has pointed out in this connection that new markets also create ‘spontaneous and discontinuous’ disturbances to initiate and accelerate the process of growth. Thus, the volume of trade, commodity, composition and direction of trade, all influence the process of growth and are influenced by the growth efforts. It is difficult to establish a quantitative relationship between trade and growth. It may, however, be said that trade will promote growth and its multiplier effects cannot be denied. The fact is that in international trade, out of the large number of commodities, some are directly linked to growth efforts like imports of machinery etc. and others are required to meet domestic demand[73].

2.1.8 Terms of Trade

The terms of trade the ratio of an index of a country's export prices to an index of its import prices. An improvement in the terms of trade (that is an increase in the ratio of export price to import price) promotes a country's development by increasing the country's purchasing power in international markets. An improvement in the terms of trade brings an inflow of foreign capital by a rise in export prices. In contrast, a deterioration in terms of trade caused by a fall in the export prices reduces the country's purchasing power in international market, decreases the capacity for development in so for as more resources must now be absorbed in exports to gain the same amount of imports (unless the decline in export price is due to increased productivity), inhibits the inflow of foreign investments and may cause a redirection in the allocation of resources away from exports. The course of development, of course, affects the terms of trade because "as development proceeds there are likely to be changes in consumption pattern, technology, factor supply, factor prices and competitive and monopolistic elements in market structure. All these will affect commodity prices and hence the terms of trade"[74].

The terms of trade have assumed considerable importance in the transfer of resources from developing countries to developed countries. The concept of **"Terms of trade"** was suggested by Alfred Marshall[75]. This was used as an analytical tool in comparative cost theory of international trade. Trade takes place between two countries because the trading partners hope to gain from it. J .S. Mill introduced the concept of barter terms of trade for determining the division of gains between two trading countries. It was explained as quantitative relations between two commodities trade between two countries.

Taussig made a distinction between the 'Net' and 'Gross' barter terms of trade[76].

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73. The possibility of a model in which trade of selected items may be linked with rate of growth in their respective sectors may not be ruled out.

74. G. M. Meier and R. E. Baldwin OP. Cit. P.234-235.

75. A. Marshall, Money credit and commerce, August M. Kelly, (1959), Publishers, New York.

76. F.W. Taussig, (1927), 'International trade' John Wiley and sons, New York, P.113-114.

The 'Net' barter terms of trade was defined as the ratio between import price and export price and the 'Gross' barter term of trade as the ratio of physical quantity of imports to the physical quantity of exports[77], the higher the ratio between quantities of imports and exports, the better the 'Gross' terms of trade. The concept of commodity terms of trade does not take account of productivity changes in export industries. Dorrance has improved upon the concept of the Net barter terms of trade by formulating the concept of the 'Income' terms of trade. 'Income' terms of trade are defined as the product resulting from dividing the total value index of exports by the price index of imports[78]. Prof. Viner had developed the concept of Factoral terms of trade (Single and Double factoral terms of trade).The 'Double Factoral' terms of trade which is considered as 'true' terms of trade[79], may be defined as the number of units of the productive services of the countries whose products are exchanged for the product of one unit of productive services of another countries[80]. The 'Double factoral' terms of trade take into account productivity changes both in the domestic export sector and the foreign sector producing the country's imports. A rise in the index of double factoral terms of trade of a country means that the productive efficiency of the factors producing exports has increased relatively to the factors producing imports in the other country[81].

These definitions compensate the theoretical and practical inadequacies of barter terms of trade. The classical economists had generally recognized the 'Double factoral' terms of trade and its superiority over the 'Net' barter terms of trade. They had generally identified it with the Net barter terms of trade in their theoretical analysis. Sidney. J. Wells rightly concludes – "It is generally assumed that an improvement has taken place in a country's terms of trade when its exports prices rise in relation to the price it pays for imports, a distinction should be made between a relative rises in export prices due to rising domestic costs". He further maintains that "a reduction in export prices due to an improvement in efficiency reflects itself in the index differently from a reduction resulting from declining foreign demand.

77. Ibid.P.113-115.
78. G.H. Dorance, 'The Income terns of trade' Review of Economic, vol.XVI, 1948-49.
79. D.H. Robertson, (1951), 'The terms of trade' International Social Science Bulletin, Paris, P.29.
80. Ibid.P.29-30.
81. Jhigan M.L. (2012), 'International economics' vrinda pub.,P. 135, www.vrindaindia.com

Commodity terms of trade between raw martial and manufactured products are of course not the same as the terms of trade between poor or rich countries. It is an incontrovertible fact that the economy's activities in the peripheral countries are almost entirely dominated by the cycles of industrial activity in the cyclical centre. The capacity of prices to influence the demand of industrial countries is strictly limited. It is their own level of income, their rates of industrial growth and their demands for imports, so that when this demand rise and prices rise together with them, a negative correlation between prices and demand, but positive correlation between demand and income.

It was commonly accepted that the terms of trade would inevitably turn in favour of primary products and against manufactures because the extractive industries were subject to diminishing returns. The second hypothesis suggests that productivity increases about equally in primary products and manufactures, but that with the growing real income it brings, Engel's law lead to smaller increase in demand for agricultural products than for manufactures and services, so that terms of trade will favour the latter. It is increasingly recognized that since developed countries occasionally exports primary products and underdeveloped countries may import food, it is customary to associate manufactures with economic development and primary products with underdevelopment. Prebisch and Singer observe secular deterioration in the terms of trade of the underdevelopment countries. A secular deterioration in the terms of trade of underdeveloped countries implies that there has been an international transfer of income from the poor to rich countries and that the gains from international trade have gone more to developed countries at the expense of the former. Thereby reducing the level of real income and hence the capacity for development.

Singer is of the opinion that the opening of the underdeveloped countries to foreign trade and investment has tended to inhibit their development since the purpose and effect of these investment have been to open up new sources of food for people and for machines of industrialized countries. In his own words "It is matter of historical fact that ever since the seventies the trend of prices has been heavily against sellers of food and raw material and in favour of the seller of manufactured article"[82]. This has

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82. H.W. Singer, (1950), 'The Distribution of gains between investment and borrowing countries' American economic review, Vol. KL, No. 2, (May, 1950).

impoverished the underdeveloped countries because the industrialized countries have gained in the form of higher wages and profits by exporting manufactured article to underdeveloped countries at higher prices, whereas the gains in food and raw material production in the underdeveloped countries has been dissipated in price reductions, thereby again benefiting the industrial countries. This is reflected in rapidly rising standards of living of the latter as against the former. Singer is of the opinion that a rise in income occurs as result of technical progress in manufacturing industries, while a fall in price in underdeveloped countries comes as a result from technical progress in the production of food and raw material.

Thus the underdeveloped countries have failed to benefit from higher prices for their primary products, because they use the profits for expanding their production rather than investing them in capital goods. Conversely when prices are low, they do not have the means to industrialize, though the desire is great. Here again, as **Singer** observes- "The underdeveloped countries are in danger of falling between two stools, failing to industrialize in a boom because things are as good as they are, and failing to industrialize in a slump because things are as bad as they are"[83].

Raul Prebisch, like singer, maintains that unrestricted play of market forces is the result of deterioration in the terms of trade in the peripheral process of growth. The unrestricted market forces brings about a disparity between income elasticity of demand and uneven form in which technical progress has spread into the world economy, bringing very great disparities in technological densities. And these disparities put the periphery in a weaker position vis-à-vis the centre, as regards the terms of trade. He maintains "Protection of the center gives additional force to the peripheral tendency towards deterioration in the terms of trade. If there is a free play of market forces at the center, some marginal primary activities might disappear because of competition from increased peripheral exports at lower prices. But if these marginal activities are protected at the center, the possibility of increasing exports in the periphery will be less and consequently a greater part of the surplus manpower will have to seek employment in industrial activities with a lower marginal productivity ratio, which would entail a further

83. Ibid.

decrease of the wage level in foreign currency, with a further deterioration in the terms of trade[84].

The secular deterioration theory of Prebisch and Singer has been criticized by many economists both for statistical and analytical argument. It has not been proved by modern researches of Kindleberg, Ellsworth, Morgen, Haberler, and Lipsey. It is not correct to identify that all underdeveloped countries export primary products and all developed countries export manufacturers because there are many underdeveloped countries that export manufacturers and developed countries like Australia and Denmark that export primary products.

Prebisch and Singer's there are based entirely on the 'inverse' of the annual index of the U.K.'s commodity terms of trade. The arguments that monopolistic elements in the industrial countries have kept the benefits of technical progress with themselves and have hurt the producers of primary products in underdeveloped countries has not been proved by any empirical evidence. The income statistics to indicate broad gain for both (industrial and non-industrial) areas over the past century than any movement in the terms of trade, Primary producing countries have supplies essential raw material for the industrialization process in exchange for consumer goods and capital goods supplied by industrial regions have also provided an important basis for further expansion with in non-industrial countries. This broad dynamic relation between imports and increased production possibilities in primary producing regions and the more general inter-relation between intensive and extensive development must always be remembered in assessing the history of world trade and economic development.

However, the fact remains that deterioration in terms of trade will adversely affect the development. The real gains from the exports of primary commodities are limited by the adverse movements of terms of trade. There are many factors affecting the prices of these commodities. Not only technical changes in the production of these goods but also the availability of cheap substitutes adversely affect the prices. Income affect is also very poor but in case of developmental goods there are hardly any substitutes and the demand

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84. Raul Prebisch, 'Commercial policy in the underdeveloped countries' reading in the theory of international trade and commercial policy. D. T. Lakadawala, J. N. Bhagawati and R. Bharadwaj (EDs.) 1975,University of Bombay, Bombay, P. 733-36.

is ever–increasing in view of growing requirements of developing countries. Thus, terms of trade are bound to play a dominant role in growth process and at time can become a crucial determinant of developmental effort.

2.2 Foreign Aid

This is any capital inflow or other assistance given to a country which would not generally have been provided by natural market forces. There are four main types of Aid.

First, For long-term loans which have to be repaid in foreign currency but are usually repayable over ten or twenty years. The advantage to the recipient is that the annual repayments are for less burdensome than those of short and medium-term loans.

Secondly, there are 'soft loans' which can be repaid in local currency. Some are paid in foreign currency but over long periods such as 99 years with very low interest rates while some which are repaid in local currency will then be lent back to the recipient for further development work. Sometimes straight grants are given.

The third type of aid is the sale of surplus products to a country in return for payment in that country's local currency like as PL480 program of the USA. This can be very valuable to an underdeveloped nation with very little foreign exchange as it will enable them to buy from abroad. They often need to import foodstuffs and other consumption goods as their own agricultural sectors cannot produce enough to maintain the urban workers involved in construction or other investment –oriented work.

The fourth type of aid although not strictly a capital inflow is technical assistance given to underdeveloped countries[85]. So, foreign aid is a most important factor of development in developing countries, like India.

It has been argued that the development process generally encounters two bottlenecks, viz., the 'saving investment gap' or the 'resource gap' and the 'foreign exchange earning expenditure gap' or the 'trade gap', external assistance helps in meeting both the gaps. The economic history of developed countries reveals that these countries had to rely to a great extent on external assistance. Foreign capital assumed greater significance after the second world–war when massive aid was given to Japan

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85. David W. Pearce (1981) "The dictionary of modern economics" Macmillan press.

under the Marshall plan to rebuild her war-shattered economy. It is now widely accepted that there could have been no development programming in less developed countries without the flow of foreign aid from advanced countries and assistance from international institutions, such as International Bank for Reconstruction and Development **(IBRD)** and International Development Association **(IDA)** which were founded in the post war years. Thus, foreign capital has made a significant impact on the programs and policies of developing countries. The purpose of an international program of aid in underdeveloped countries is to accelerate their economic development up to the point where a satisfactory rate of growth can be achieved on a self–sustaining basis[86].

2.3 Foreign Collaboration

Foreign collaboration plays a very important role in the economic development of a developing country like India. A partnership between host and foreign industrialists for the establishment of joint-venture undertakings in host countries may be called foreign collaboration. There are varieties of patterns for foreign collaboration. There may be equal partnerships in which the local investors, public or private, holds one–half of the shares and the foreign investor the other half. Then, there are equity associations in which one partner holds a majority (though often only 51 percent of the shares) and the other partner the minority. An existing enterprise may be transformed into a joint-venture with the foreign investor retaining a controlling interest, while the minority share are held by the local government or a government controlled development corporation, or a small group of local capitalists, or the public.

The agreement for setting up joint-venture with the foreign collaboration may be financial collaboration agreements or technical collaboration agreements or both agreements. No sharp distinction can be made between financial and technical collaboration agreements, as there is some collaboration which are both financial-cum-technical. From purely licensing arrangement to complete financial and technical agreements, there can be many types of collaboration agreements each differing from the other according to the nature of industry, technical as well as financial requirements,

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86. P. N. Rosenstein, (1961), 'International Aid for underdeveloped countries' review of economic and statistics, (May, 1961), P. 107.

resources of both the parties, conditions of governments approvals and the details agreed upon by the enterepreneurs[87].

2.3.1 Financial Collaboration Agreements

In such agreements, the foreign partner agrees to subscribe to the equity capital of the host coming. Such collaboration may arise- As an exchange for machinery and equipment or as a result of the investment to case in the host company; as payment to the foreign partner for drawings, specifications, engineering plant design and layout, installation of machinery or other initial services etc; as an advance part payment in return for a lower royalty rate. Foreign private investment may be of two types, Foreign Direct Investment (**FDI**) and Foreign Institutional Investment (**FII or Portfolio Investment**). When the foreign investor directly participates in the ownership, management and control of business and is a partner both in the losses and profits of concern, it is called foreign direct investment (FDI). Foreign Institutional Investment means loans at a fixed rate of interest usually without any share in the ownership, control and management of enterprises to which loans have been advanced.

Economists like – Rostow, Wicksell, Behrman, Lewis, Robinson, Islam and Daneil, emphasise the need of private foreign investment in promoting economic development of underdeveloped countries. They are all unanimous on the point that such investment not only add to the capital resources of the host nations but also facilitate the inflow of managerial and technical skills of advanced countries thereto. Private investment guided by the profit motive is likely to be more protective. Many countries of the world like Japan, Germany, and USSR (Russia) owe a good deal for their industrial development to the inflow of foreign capital. The contribution that might come from foreign private sources has been increasingly recognized in 1991. A number of developed countries like Japan, Germany, USA, etc. attach great importance to private lending.

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87. R. K. Hazari (Ed.), (1967), Foreign collaboration: reports and proceeding of the seminar held by the centre of advanced studies, development studies, department of economics university of Bombay, Bombay, P. 34-36.

2.3.2 Technical Collaboration Agreements

Foreign investors agree to supply the technical know–how by way of patents, processes of manufacture, surveys, charts, blue-prints, technical personnel to build the factory and maintain it for some time during which the personnel of host country are trained. In lieu of this technical aid, the foreign party gets royalty as some fixed percentage or a lump sum payment or some percentage of profit plus all the expense incurred by them. The various rights, services and technical assistance which may flow from the foreign collaborator, a licensor or technical advisor as he may be designated (if it is purely technical collaboration agreements) are trademarks, patents, specifications, designs, patterns and drawings, models, know–how, plant layout, installation of machinery and equipment, supervisory and managerial services, technique, special product design, training of personnel of the host country, facilities and services, in supply and or purchase of components machinery, equipment, raw materials, etc; sales promotion marketing and advertising information and services, research formula, methods, process, trade secrets and technique, new product information and developments, material lists, maintenance manuals and literature, trade information and news of currents developments in particular industrial field and quality control methods any systems.

Technical collaboration know–how covers a very wide range of items. It is not necessary that every license agreements would contain all these items. The extent to which they may be found in a contract will depends primarily upon the nature of the products, the extent to which they will be manufacture in a host country, the character and extent of the technology, and processes involved in the need of the host country with respect to new facilities and machinery and equipment the type of training required by the personnel the degree of complexity or confidential nature of the product, processes, technology etc, and the extent of control that is necessary and extent to which the particular industry involves and continuous development of new products, processes and design, etc.

Technical collaboration cases are considered on the basis of areas requiring technology not available indigenously. Payments for such collaboration can be made on lump sum basis or annual royalty payments basis or both. Normally agreements are valid for a period of 5 years from the date of production or 8 years from the date of signing the agreements[88].

2.4 Foreign Trade and National Income

The foreign sector is not isolate from the total economy and it can be integrated in to the analysis of the components that determine the levels of national income and employment of a country. The analysis of income determination in a closed economy, in which the foreign sector is excluded, begins with the familiar national income equation;

$$Y = C + I + G \qquad \text{(i)}$$

Where Y = national income

C = national consumption

I = total investment

G = government spending

By including the foreign sector into the model, we can write the national income equation for an open economy as follows:

$$Y + M = C + I + G + X \qquad \text{(ii)}$$

Where M = imports

X = exports

The left side of the equation shows the total supply [the sum of total domestic supply (Y) and imports (m)] and the right side of the equation shows the three ways in which the total supply of output can be used viz. consumption (C), investment (I), government purchases of goods and services (G), and exports (X), the above equation which is an identity expression can be rewritten a follows:

$$Y = [C + I + G + (X - M)]$$

The terms (X – M), the balance of trade, is often called as net exports or net foreign investment and it may be positive or negative or zero depending upon the relative magnitudes of imports and exports. The values of the sum of net exports (X – M) determine the contribution of foreign trade to national income or GNP.

The relative importance of the foreign sector in the total economy depends on the

88. Foreign collaboration policy, February 1991, Indian international center, (IIC), New Delhi.

'foreign trade ratio' like the ratio of foreign trade to GNP. In an open economy the expenditure of consumer investors and government, together with the expenditure of foreigners on the countries is exports, generates the country's production of goods and services. This can be symbolically expressed as:

$$C + I + G + X = \text{income generated} \qquad \text{(iii)}$$

This should not be equated with the GNP or X. This is income generated, which is disposed off in the form of purchase of imported goods and services (M). To the savings of households are also added the undistributed profit of firms or business savings, which are include in (S).

$$C + I + S + M = \text{income spent or disposed off} \qquad \text{(iv)}$$

Then we can write the identity equation as follows:

$$C + I + G + X = C + S + I + M \qquad \text{(v)}$$

$$I + G + X = S + I + M \qquad \text{(vi)}$$

S = total saving

T = government tax

If $G = T$, no net government surplus or deficit or a balanced budget, we have

$$I + X = S + M \qquad \text{(vii)}$$

Which is the simplified from of the foreign trade equation[89].

2.5 International & Regional Financial Institutions

The International financial Institutions (IMF, IBRD, IDA, ADB, & WTO etc) have played pivotal roles in stabilizing post-war international monetary system and organizing reconstruction and development plans for developed and developing countries. The International financial institutions are a new concept of mid twentieth century (after second WW). They were established to promote economic, financial and technical co-operation among its members in order to facilitate the expansion and balanced growth of world trade. These are pillars of world trade & globalization. They have provided debt, AID and advice to member countries with their economic development and policy-making.

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89. Rober, H. (1974), 'International Monetary Economics' Eagiwod, cheffs, Prentice Hall, P. 123-129.

The International negotiations or Regional Trade Agreements refer to a decision or process whereby two or more countries combine into a large economic region by removing discontinuities and discriminations existing along national frontiers, and by establishing certain elements of co-operation and co-ordinations between them, the member countries remove tariffs and other trade barriers among themselves, but each member retains its own tariff, trade restrictions and commercial policies with non-member countries. The RTAs is simply based on intra-area trade, the total numbers of Regional Trade Agreements worldwide were 490 in 2009. But in 1990, only 50 RTAs had been operating. The RTAs during 1991 to 2009 in worldwide has sharply increased. EFTA, LAFTA, SAFTA, ASEAN, APEC, NAFTA, BRICS, are examples of Regional Trade Agreements. At the present time, IFIs and RTAs are core part of International Economic relations.

Present chapter puts forth a systematic discussed of international economic relations, evolved over a long period of time relations. Various facts of international economic relation are discussed, the terms of trade is also presented. In addition, the analytical treatment of the foreign trade and national income is presented. Finally, the geographical treatment of the International Regional Institutions and International Financial Institutions are presented. In the next chapter [policy framework since independence] an overview of the Indian trade policy are discussed. Details of the treatment are as follows chapter.