International Business
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Lecture - 14
Commercial / Trade Policy, Objectives, Instruments, Business Cycle, Tariff Barriers, Subsidies

Welcome everyone to our course of International Business. So, today we will be starting on a new unit which is called Commercial Policy, before I start this lecture, I would give you an insight which is happened recently. The US has you know withdrew the zero duty exports for the Indian exporters, right. So, this has made a loss of 5.6 billion worth of revenue to the Indian exporters; on the contrary the Indian government has levied a retaliatory you know tariff on 29 US products.

So, what I am talking today and we are going discuss today is on a topic called commercial policy. Now what commercial policy is all about and how it affects the trade, international trade, we will be discussing in this lecture, ok.

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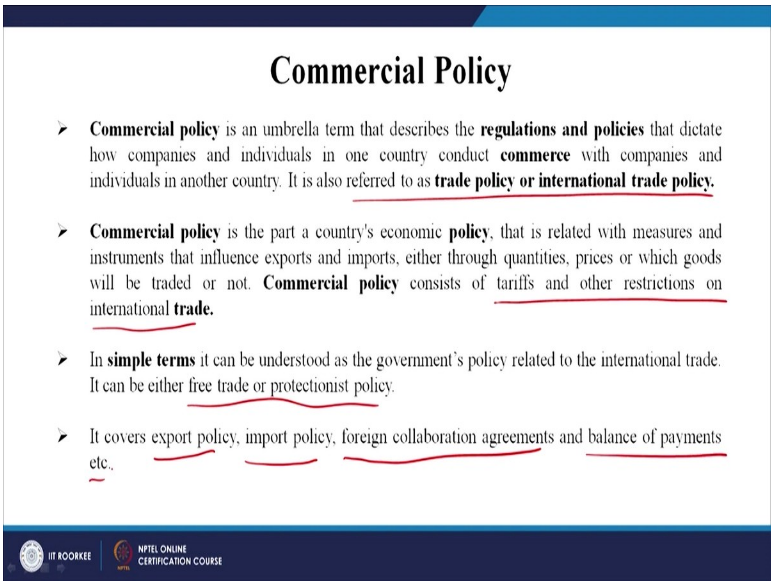

So, what is commercial policy? As you can see, commercial policy is an umbrella term that describes the regulations and policies that dictate how companies and individuals in one country conduct commerce or trade with companies and individuals in another country. It is also referred to as trade policy or international trade policy, ok.

So, commercial policy is part of a country's economic policy, that is related with measures and instruments that influence the export and import, either through quantities, prices or which goods will be traded and which one not. Commercial policy consists of tariffs and other restrictions on international trade; it could be tariff, it could be non tariff also, right. In simple terms we can understand it as the government's policy related to the international trade. It can be either free trade or protectionist policy.

So, the government can be you know might be trying to encourage more free trade or it could be trying to have some protection, make some protection for its domestic players, right. What is it cover? It covers the export policy, the import policy of the government, foreign collaboration agreements and the balance of payment etcetera. So, these are some of the things that the commercial policies encompass, right. So, what is the objective?.

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Now if you start thinking a bit; when we are talking about international trade and you know growth of international trade, so the objectives of commercial policies starts like this.

First is, the first and foremost point is to increase the quantity of trade with other nations, with foreign nations. So, the government; for example, India would like to do more of business with other countries like Belgium, Denmark, Japan, you know China and other countries, so that more the trade; we have seen in our earlier lectures that as trade grows, it is a benefit to every player involved in the trade, right.

Second is to preserve the essential raw material for encouraging the development of domestic industries. Sometimes it becomes important for the government to preserve the essential raw materials which are maybe you know exclusive to a country, and so that it helps in the development of domestic industries. So, policies are made, commercial, commerce policies are made according keeping those things in mind, right.

To protect the domestic market prevailing in the country; it is very important that, although we talk a free trade, sometimes some protection is required in order to save your domestic players as I said. Why? Because, the you know there is a difference in the income, in the among the people of the developed and the developing countries, right. So, because of this difference in revenue, in income and all; it becomes important for the government to take some action to protect their own domestic market.

To stimulate the export of particular goods and products with a view to increase their scale of production at home. So, some products are being exported; the government wants to export a few products, which actually helps in the growth or you know in the increase of the you know production of some other components which are used for the export item, right.

For example, let me say if you, one is producing a product called A; then to make this product A, may be few other components are required or few parts are required, let us say B and C.

So, when the export of A will increase, automatically this things which are made locally would, there would be a raise in demand B and C. So, automatically this tends to growth, give a raise to the domestic industries, right. So, it helps in the increasing the scale of production at home, that is what it is saying.

Fourth, to prevent the import of some goods for giving protection to infant industries or developing key industry or saving foreign exchange. Sometimes it becomes important to save the infant industries; infant industries means we are saying, the industries which are not very capital intensive or they are new to the market and they are young players.

So, if some protection is not given to them, then it is possible that their idea might get completely taken away by some large players and these infant industries might not be able to compete with them; they may you know they may circum to the pressure, they may die down, right. So, the government needs to give some protection right; in terms of price in, you know and you know some, some benefits, right.

Or developing the key industry; for example, defense could be a key industry where the government wants to you know grow rapidly, right. Or even save the foreign exchange; the government wants to save the foreign exchange, so it wants to you know control the import and export of the items.

Next is to assist or prevent the export or import of goods and services for achieving the desired rate of exchange. So, here the government deliberately wants to have a desired rate of exchange to control the rate of exchange. So, for that it wants to have a policy to make the, you know to control the flow of import and export, ok.

Next is to encourage the import of capital goods for speeding up the economic development of the country. So, some goods may be for example, India is a labour intensive country and more dependent on the capital from other developed countries. So, and there are some technology, some you know-how which India does not have. So, India would like to import those capital goods and bring it to our own market, so that it helps in speeding up the economic development.

For example, shipping; now shipping, defense these are some areas where India is yet to catch up with the developed countries; it is we are doing well there is no doubt about it, but then there is lot to achieve. So, in such conditions, it helps to encourage the import of capital goods right; German for example, engineering right; the precision instruments, right.

To restrict the import of the goods with a view to correct the unfavorable balance of payment. Now I hope what is balance of payments you must be slightly aware; balance of payments is nothing like a balance sheet of the country, right. So, how to correct the unfavorable balance of payment? For that reason, the government tries to restrict the import of goods with a view to correct it, ok.

Last, the last objective is to enter into trade agreements with other nations for stabilizing the foreign trade. So, the Indian government has been into several trade agreements with neighboring countries and other countries too, so that to it would improves the foreign trade, the business done with other countries and this would create a equilibrium, a state of equilibrium, right and growth.

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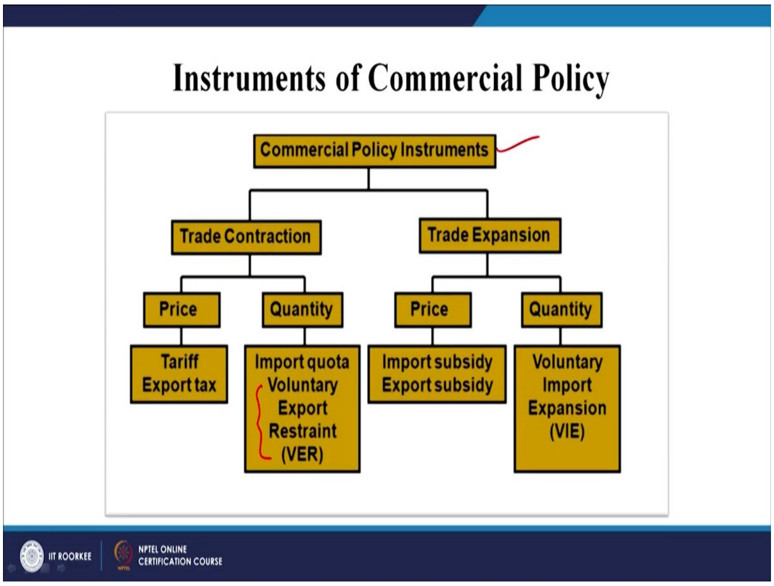

What are the instruments? What are the instruments involved in the commercial policies? As you can see, so there are two ways of understanding; first is from the trade contraction and the trade expansion mechanism, right. So, trade contraction means when the trade is contracting or there is a fall or there is a slowdown; there is a recession.

Trade expansion means, where there is a boom in the market, where there is a growth in the market, ok. So, in terms of price and quantity right both sides; during trade contraction and trade expansion, we follow certain you know policies, some measures.

For example, tariff export tax are some of the tariff related measures which is an instrument during trade contraction period. Import quota, Voluntary Export Restraint (VER); what is said as VER right, then are some of the instruments.

Similarly, in terms of during trade expansion, we use import subsidy, export subsidy as a measure; then voluntary import expansion as a measure. So, we will learn all of these things in detail now, right.

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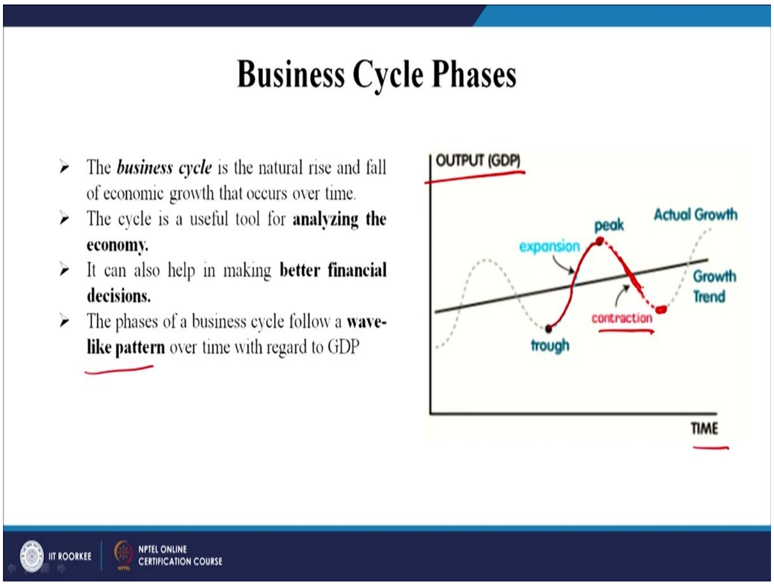

So, let us go one by one. First let us understand this contraction and expansion first. During any business cycle, there is a natural rise and fall of the economic growth. So, you must have heard about several recessions and several boom periods; for example, the world market has had seen a very serious you know depression in the thirties and then we found one during 2007-08, because of the financial market and the real estate market.

So, now, because of such kind of time periods, there is a growth, sudden growth in the market and sometimes there is a period of lull or a you know slowdown in the market. So, this period of growth is the period of expansion, right. So, what did we saying; this is the peak, this is the trough, trough means the lowest point.

So, this movement is called the expansion and this fall is called the contraction. So, what happens is, the business cycle is the natural rise and fall of economic growth right, that occurs overtime.

So, with time, there is nothing permanent; whatever kind of you know business is maybe; that is why the countries, there is always a criticism for the developed countries is that developed countries sometimes, this criticism goes for them is that, they use globalization as a measure to always escape from the period of contraction.

They want to exploit the resources of other countries, other markets, so that they can avoid this situation of contraction and they would be on a expansion mode all the time.

So, this is a criticism for globalization; some social scientist economist have a thought that, because of globalization, poor countries are becoming more poorer and rich countries are becoming richer. So, this an argument, right.

So, what it is says? The cycle is a useful tool for analyzing the economy. How you analyze the economy? It can help in making better financial decisions. So, during a period of expansion what could what should be your strategy, your decision how should you take a decision, during a period of contraction or lull or slowdown.

So, the phases of a business cycle follow a wave like pattern right; this is a wave like pattern, so this is what we talk. So, what are the two axis? The one is time versus the output GDP, right. So, how, what happens to the output during a particular time period, right?.

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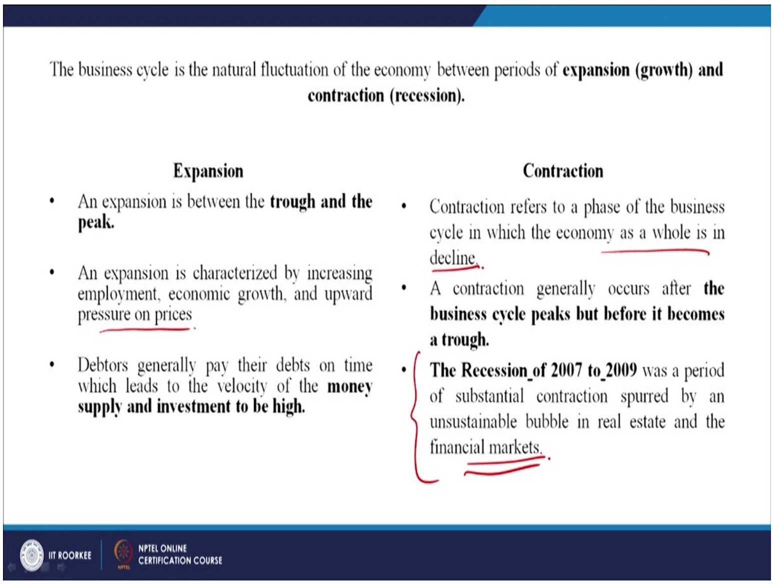

Now let us see this, the difference between expansion and contraction. So, business cycle is the natural fluctuation of the economy between periods of expansion and contraction, right. So, an expansion is between the trough and the peak, so we saw that. Contraction refers to the phase of the business in which the economy is in a decline, ok.

An expansion is characterized by increasing employment. So, when there is a growth, there is a time of growth; so employment also grows right, economic growth happens and there is upward pressure on prices, right.

On the other hand, when this in contraction or a recession period, the business generally occurs after the business cycle peaks; so that means it has reach the top position and then it starts falling, but before it becomes a trough. So, this is the period, we are talking about this difference, right.

So, this is the trough, this is the peak; so we are talking about this, this position, right. What happens during in the expansion stage you see? Debtors generally pay the debts on time which leads to the velocity to the money supply and investment to be high. So, there is a faster money supply, and naturally the investments also becomes faster, so it grows faster, right.

On the other hand this is the case of the recession of the 2007-09; when a period of substantial contraction spurred by an unsustainable bubble in real estate and the financial markets. So, it has been seen that when there is a contraction, many companies tend to reduce their production; because they feel there is a slow down and people would not buy, so the inventories would lie idle.

Some countries even spend a very little on their brand building or you know on advertisement and all. So, during this contraction we see, there is a fall in jobs; because obviously when the production is going to stop, so obviously job will come down and natural spending of people will fall.

So, if you remember in a last class when I was talking about multiplier effect or trade multiplier and employment multiplier; so we were talking about this the strategies that the government uses generally during this kind of a depression or a recession, right.

So, when there is a recession; it is advised or it is you know suggested that the government should inject some amount of money into the system, so that people who have become little scared and they are avoiding spending, they would tend to get more money. And, as they get more money, they would tend to spend; and as they spend again in the economy would become natural, become normal, ok.

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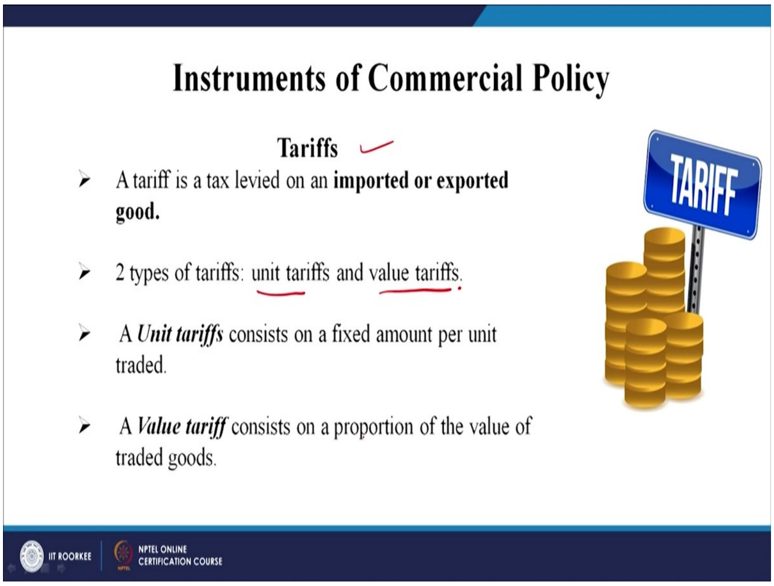

So, instruments of trade policy sorry, commercial policy or trade policy right are of two types; tariffs versus non-tariff, let us see what is tariff first. A tariff is a tax levied on an imported or exported good. So, tariffs are basically monetary, right. So, it is a tax levied on imported or exported goods. There are 2 types of tariffs- unit tariffs and value tariffs.

So, what is a unit tariff saying? It consists of a fixed amount per unit traded, it consists of a fixed amount per unit traded. So, number of units into a fixed amount, right. A value tariff consists of a proportion of the value of the traded goods, right. So, the proportion of the value; 10 percent or let us say 5 percent, when we say a percentage or a proportion of the value of the traded goods.

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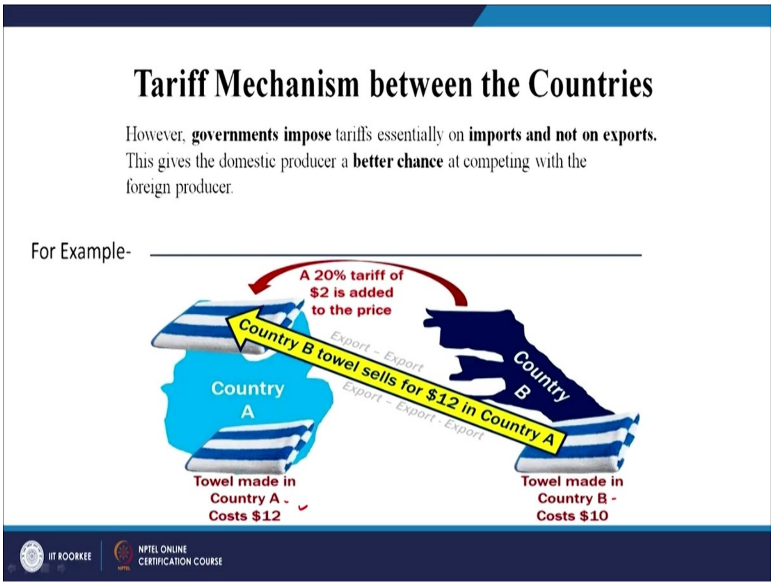

Let us see, tariff mechanism between two countries, generally governments impose tariffs especially on the imports; when you are importing something, the government would tend to impose tariffs.

Very rarely it has been connected with exports right; until and unless it is a very precious raw material that the government does not want it to go out or something, but that is the very rarity. So, generally when we import; the government tries to you impose tariffs, so that the cost of the goods goes up and it you the, it tries to discourage import, so that the local domestic players can make the production. So, how it is happening you see.

There are two countries A and B; producing a towel in the country A cost 12 dollars, producing in the B 10 dollars. Now automatically, that means it is a understandable that, if it is a10 dollars right; if you would have been reading, if you as we are read in the trade theories, so it there is a clear cut advantage of country B in terms of the production. So, but trade theory is not that simple. So, what happens here? So, country B towel sells for now 12 dollar in country A. Now, why? Because this is country 12 dollar; so what happens, why it is 12 dollar now?.

The country B, there is a 20 percent tariff of 2 dollar is added to the price. So, the government of the importing country puts in a tariff of 20 percent to make it again 12 dollar as it is in the country A, right. So, when now both that countries will have 12 dollars; so the price unfair advantage or the price advantage will not be there, right. But there is criticism for such kind of mechanisms also, right.

So, if there is an unfair advantage given to the; you know for example, like the there is subsidies given in the country B, because of which the cost of production has come down, then it is fine to give a, to impose a tariff, right. But if the real cost of producing without any subsidy or support is 10 dollars because of the factor endowments or the factors of production; so in that case, the imposing a tariff is not competitive in nature, right.

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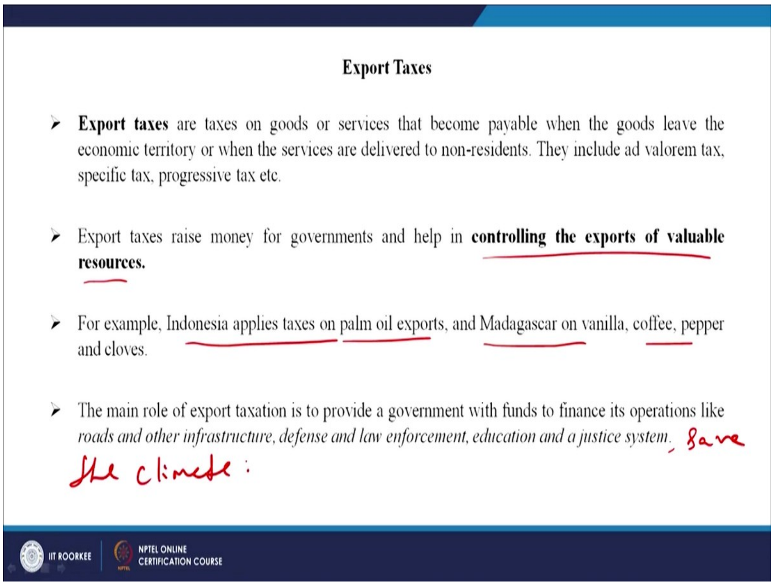

Next is export taxes, now export taxes are taxes on goods or services that become payable when the goods leave the economic territory or when the services are delivered to non-residents. They include ad valorem tax, specific tax, progressive tax etcetera right; some of the taxes, the government when a product is being exported, right. So, at that time, a tax it is a taxes on the goods are that become payable, when the goods are leaving the country, right.

Similarly export taxes raise money for government and help in controlling the exports of valuable resources; that is what the government is afraid that, valuable resources should not go out. So, it levies a tax. Example, Indonesia applies taxes on palm oil exports; palm oil is a natural ingredient which happens lot in Indonesia. So, to avoid palm oil exports;

because what happened, why this I was just going through the discovery just day before yesterday when I happen to see this example.

Indonesia, because of the palm oil exports and there is been heavy demand of palm oil; the there is a large production of palm oil and there is a plantation you know goes on.

So, what happens is; the natural forestry and all they are being cut down, depilated and in there palm trees are being planted, so that the export can be done. But as a result what has happen; the impact of cutting down of the trees and having larger units of production capacity plants for palm oil production has resulted in destroying the you know the climate in these countries, right.

So, the government tries to now stop it, so that there is a restriction on the export. So, if there is a restriction means what? There will be lesser of exports. So, if there is a lesser export, means lesser production; lesser production means not cutting too many trees, you know such kind of chain effect is there, and Madagascar on vanilla, coffee, pepper and cloves example.

The main role of export taxation is to provide a government with funds to finance its operations like road, infrastructure, defense etcetera, right. So, the government uses its money for its development, but also to save the climate; I can mention here, to save the climate also, because it affects the climate of that place because of ramped production, right.

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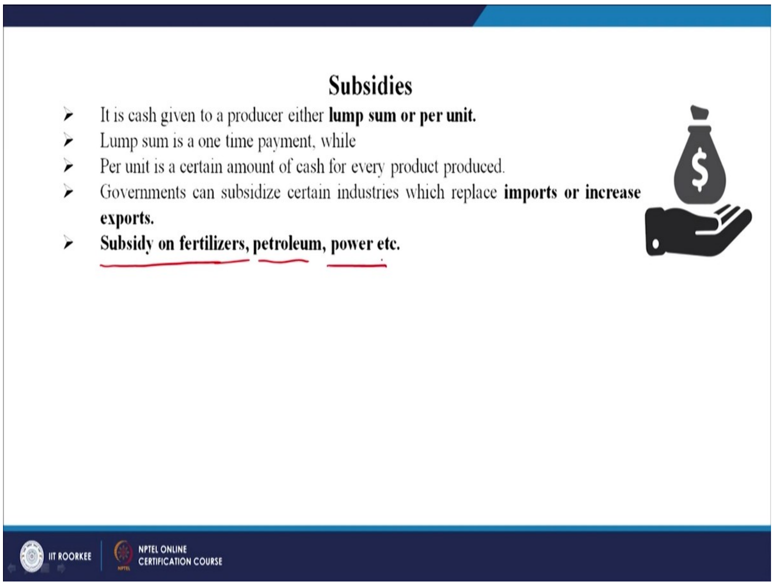

Then the next is subsidies. What is subsidy? It is a cash given to the producer either lump sum or per unit, right. Lump sum is at one time payment, while per unit is a certain amount of cash for every product produced. Governments can subsidize certain industries which replace imports or increase the exports.

So, the government tries to give subsidies to those, for examples agriculture. Now suppose the country is going to import agricultural items; it is better to avoid that and give some kind of subsidy to our own farmers and agriculturist, so that they can do it their own, and so that dependency is reduced, ok. Some of the subsides are; for example, in India are on fertilizers, petroleum products, power etcetera.

So, for example, you must have seen, the power given to farmers in Punjab and some other states is highly subsidized, may be it is free of cost also or it is very very less, right. So, the rest, the amount of cost; the cost does not go anywhere. So, who bears it? It is a government. So, this is a subsidy given by government, ok.

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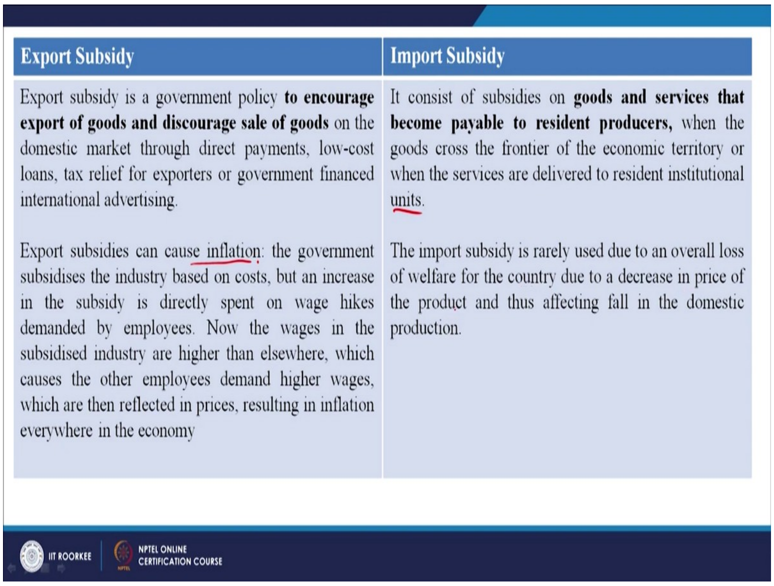

Export subsidy versus import subsidy. Export subsidy is a government policy to encourage export of goods and discourage sale of goods on the domestic market right, through direct payments, low cost loans, tax relief for exporters or government financed international advertising.

So, what it is saying? It is a government policy to encourage the export of goods. So, government gives you subsidies, so that you produce more and you can export it to other countries. On the other hand import subsidy says, it consists of subsidies on goods and services that become payable to resident producers; that means the local producers, when the goods cross the frontier of the economic territory.

So, when the services are delivered to resident institutional units, so this subsidy is given during import; when somebody imports an item right, the subsidy is given to the institutional units, right. Now what happens here let us see. What is the effect of this? Export subsidies can cause inflation; why? Let us see. When the government subsidises the industry based on cost. So, the government has subsidised, so that it could become more healthier and they can export better.

But in increase in the subsidy is directly spent on wage hikes demanded by the employees, right. So, when this money, extra money is there, it goes to the employees who demand their higher salary. Now the wages in the subsidised industry are higher than elsewhere.

So, this the salary in this sector has grown up, so that automatically makes a you know competitive environment, and people from the other sectors they also demand a higher salary right; so which causes the other employees demand higher wages right, which are then reflected in prices, resulting in inflation everywhere in the economy.

So, this is one important you know effect that export subsidies when given too much can lead to inflation, so the government needs to understand this. Second, on the import subsidy part if you see, what is the problem? It is rarely used due to an overall loss of welfare for the country due to an decrease in price of the product. So, when I imported and I have been given a subsidy; so the price of the product for the consumers has decreased.

Thus affecting a fall in the domestic production; so when thus, when the imported item has become cheaper, so the government has borne the subsidy, has borne the money. So, what happens is it is a cheaper product and the consumers will demand more of that product, so automatically the domestic production, the other substitute products in the domestic market they would find it very costly for them. And that would result in a fall in the domestic production.

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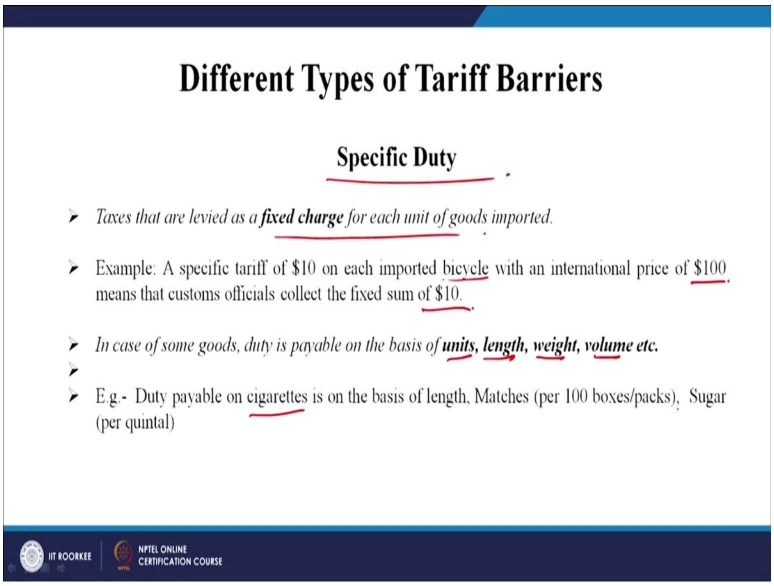

Now coming to different types of tariff barriers; so we said, one of them was specific duty. Now what is specific duty? Taxes that are levied as a fixed charge; for example, a specific tariff for example, for 10 of 10 dollar on each unit right, imported bicycle with a price of 100, means that the custom officials collect the fixed sum of 10 dollar per cycle, ok.

In case of some goods, duty is payable on the basis of units, length, weight, volume etcetera. Example, duty payable on cigarettes is on the basis of length and not units, right; matches per 100 boxes or packs, sugar per quintal, so these are the examples of specific duty, right.

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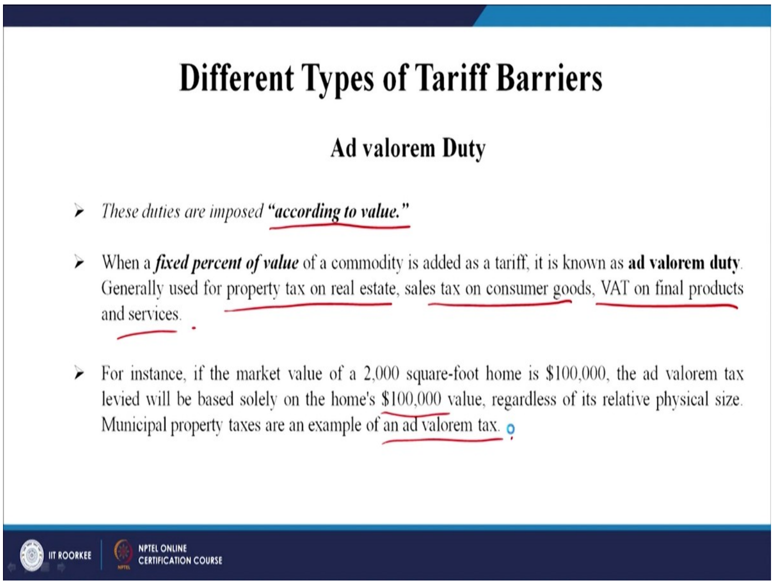

Now, what is ad valorem duty? So, another kind of a tariff barrier; these duties are imposed according to the value. So, the earlier one was on units, here on value; when a fixed percent of value of a commodity is added as a tariff, it is known as ad valorem duty.

Generally used for property tax on real estate, sales tax on consumer goods, value added tax on final products and services, right. Let us see this case. If the market value of a 2,000 square foot home is 100000. Let us say the market value of a 2000 square foot home is 100000; the ad valorem tax levied will be based solely on the homes 100000 value, regardless of its relative physical size.

So, suppose some expansion has been done in the house, it immaterial. So, on the market value, on only this the ad valorem taxes levied; it is less or more, it does not matter. So, the municipality property taxes are an example of ad valorem tax, ok.

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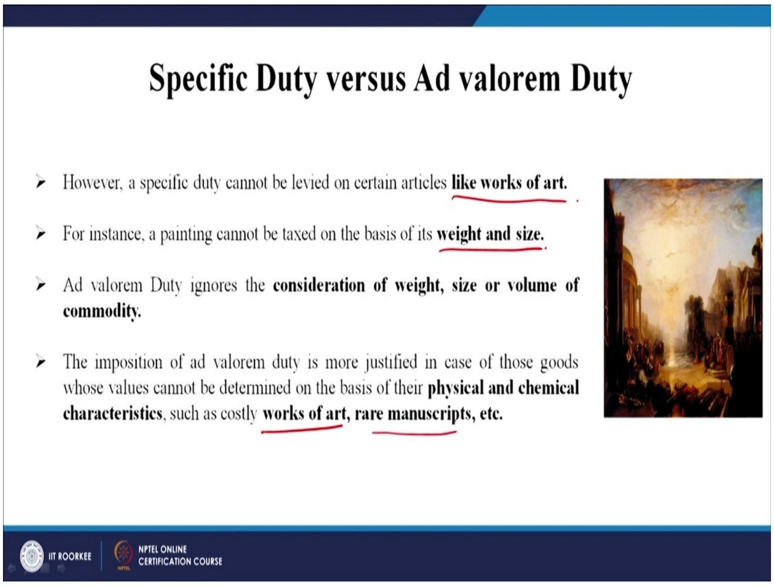

Let us see some of the more examples; however, a specific duty it says cannot be sometimes levied on articles like works of art. How do you levy taxes on a work of art?. For instance a painting cannot be tax on the basis of weight and size, right. If you start doing it, then an M F Husain’s painting might not cost you, should not cost you more than thousand rupees right, but then it sells in crores, ok.

So, ad valorem duty ignores the consideration of weight, size or volume of commodity, ok. The imposition of ad valorem duty is more justified in case of those goods whose values cannot be determined on the basis of their physical and chemical characteristics, such as work of art, rare manuscripts etc, right.

So, there are certain manuscripts which for a suppose a one paged letter of Mahatma Gandhi somewhere written during 1930s or 40s or letter of Einstein, where he had written his formulas will be so costly that, you cannot equate it through weight and size, ok.

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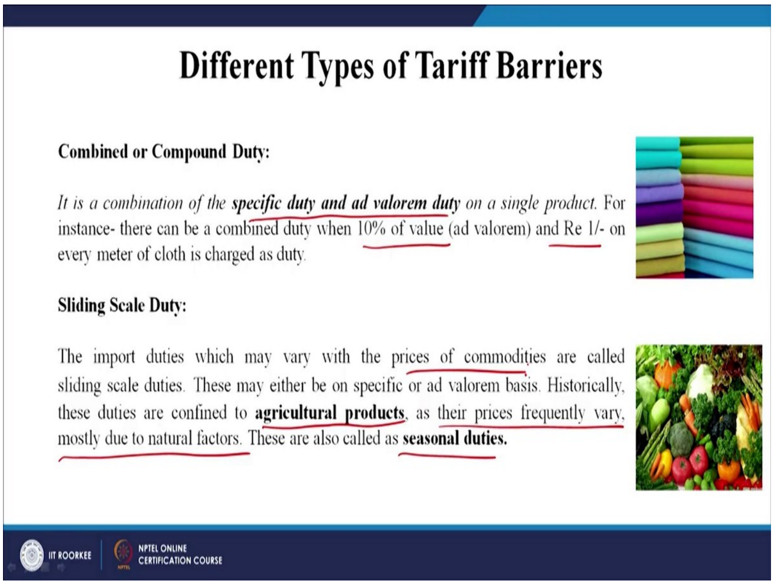

Some other types of tariff barriers, combined or compound duty; it is a combination of the specific and ad valorem duty on a single product it is a combination. For example there can be combined duty when 10 percent of value and rupees 1 on every meter of cloth is charged as duty. So, it is a combined; ad valorem + specific.

Sliding scale duty is something called as seasonal duties also. What it says? The import duties which may vary with the prices of commodities are called sliding scale. What it is saying? The import duties may vary with the prices of the commodities; these may either be on specific or ad valorem basis.

Historically these are confined to agricultural products; since as their products frequently vary mostly due to natural factors. So, these are also sometimes called as seasonal duties. It is basically on the prices of commodities, ok. So, this is the, we are talking about the tariff barriers.

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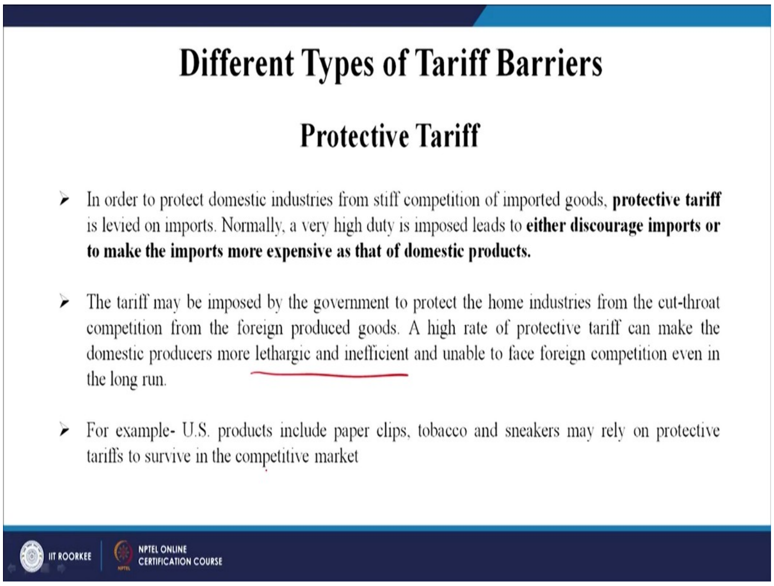

Now one more tariff barrier we will talk about is the protective tariff. In order to protect domestic industries from stiff competition of imported goods, protective tariff is levied on imports.

What it is saying? In order to protect domestic industries from stiff competition of imported goods, protective tariff is levied on imports. Normally, a very high duty is imposed which leads to either discourage the import; so one would not like to get the product or to make the imports more expensive so as that of domestic products.

The tariffs may be imposed by the government to protect the home industries from cut throat competition from the foreign based goods. A high rate of protective tariff can make the domestic producers more lethargic and inefficient and unable to face foreign competition. So, when protective, too much of protection is also dangerous and bad. So, it might create more lethargic and inefficient, you know develop lethargic and inefficient you know producers in the domestic market.

US products include paper clips, tobacco and sneakers may rely on protective tariffs to survive in the competitive market. So, it is an example that these products will survive in the competitive market only if they are given a protective tariff.

So, what I will do is, we will stop here today because of paucity of time and in the next lecture, in the next class we continue from the tariff barriers, from protective tariff again and then we will get into the other things of you know commercial policy, right. Thank you very much, have a nice day.

Thank you very much.