

M.COM. - PART – I

ECONOMICS OF GLOBAL TRADE AND FINANCE

(with effect from academic year 2013-2014 for IDOL Students)

CONTENTS

Sr. No.	Title	Page No.
1.	Module 1 - Commercial Policy	01
2.	Module 2 - Economics of Integration – I	26
3.	Economic Integration – II	40
4.	Module 3 – Trends in World Trade, WTO and Developing Countries	50
5.	Dispute Redressal Mechanism	73
6.	Module 4 - Balance of Payment Adjustment	85
7.	Module 5 - Foreign Exchange Market	111
8.	Current Convertibility	135
9.	Current Market	161
10.	Module - 6 International Factor Movements	176
11.	Multinational Company (MNC's) & International Monetary Fund (IMF's)	194



Syllabus

M.Com. Part – I

Economics of Global Trade and Finance

(Revised Syllabus for IDOL Students from academic year 2013-14)

Preamble:

The syllabus of M. Com Part 1 is designed to acquaint the students with the various aspects of International Trade, Commercial Policy and Global Finance as well as recent trends and developments in international trade.

Section I

Module I: Commercial Policy:

Tariff and Non-tariff barriers, Miscellaneous Protection Techniques - Dumping, Subsidies, Cartels and Commodity Agreements.

Module II: Economics of Integration:

Types of integration (EU, NAFTA, APEC, ASEAN, and SAARC): Achievements and Future prospects, Regionalism Vs. Multilateralism.

Module III: Trends in World Trade WTO and Developing Countries:

Recent Trends in Global Trade - Contentious issues - Agriculture and Market Access, Trade and Environmental issues, Dispute Settlement Mechanism.

Section II

Module IV: Balance of Payments Adjustment:

Foreign Trade Multiplier and Global Repercussions - BOP and Policy Mix: Role of Monetary and Fiscal Policy in BOP -Trade-off between Internal and External Balance (Mundell and Flemming Model).

Module V: Foreign Exchange Market:

Flexible Exchange Rate, Currency convertibility, Significance of foreign exchange reserves, Exchange risks, Global linkage of foreign exchange markets, Open and Closed: Interest Parity Conditions - Euro Currency Markets , Euro Equity and Euro Bonds Markets - Nature and Characteristics.

Module VI: International Factor Movements:

Movement of labour between countries - Trends in Migration, International capital movements - Role and impact of foreign capital, Types and factors, Role of MNCs, Changing role of the IMF in the emerging international scenario.



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Module 1

COMMERCIAL POLICY

Unit Structure

- 1.0 Objectives
- 1.1 Introduction
- 1.2 Meaning and Definition of Tariff
- 1.3 Types of Tariffs
- 1.4 Effects of Tariffs
- 1.5 Concept of Non-Tariff Barriers
- 1.6 Types of Non-Tariff Barriers
- 1.7 Miscellaneous Protection Techniques
 - 1.7.1 Dumping
 - 1.7.2 Subsidies
 - 1.7.3 Cartels
 - 1.7.4 Commodity Agreements
- 1.8 Summary
- 1.9 Questions

1.0 OBJECTIVES

1. To understand the meaning and types of Commercial Policy
2. To study the meaning of Tariff
3. To study the types of tariff
4. To study various effects of tariff
5. To study the meaning of Non-Tariff barriers.

6. To know the types of Non-Tariff barriers.

7. To know the Miscellaneous Protection Techniques

1.1 INTRODUCTION

The commercial policy plays an important role in economic growth and development of the country. Many of the countries of the World sometimes use free trade policy as well as protectionist commercial policy. The countries participating in the international trade are geographically and politically independent countries. These

countries pursue their own trade policies independently from the point of view of their own economic development.

The commercial policy or trade policy is meant, ***“All measures regarding all international economic transactions between the reporting country and the foreign countries.”*** International trade involves the trade between two or more countries.

- ***Commercial policies are of two types:***

1. Free trade policy: A free trade policy is a type of trade policy which does not place any restriction on the movement of goods and services between countries. According to Adam Smith Free Trade is an international trade policy which draws no distinctions between the domestic goods and the foreign goods. It is a policy which doesn't give any special favour to domestic goods or doesn't impose extra duties on foreign goods.

2. Protection: means safeguarding the home country by erecting a strong tariff wall to fortify the domestic infant industries from the attack of the foreign sophisticated goods and simultaneously giving some concessions, bounties, subsidies, tax holidays etc, to domestic industries. It includes import substitution and export promotion as well.

1.2 MEANING AND DEFINITION OF TARIFF

Traditionally trade was regulated through bilateral treaties between two nations. For centuries under the belief in mercantilism most nations had high tariffs and many restrictions on international trade. Free and fair international trade is an ideal situation as free trade is beneficial to all participating countries. However, various types of barriers/restrictions are imposed by different countries on international marketing activities. Such imposed or artificial restrictions on import and exports are called Trade barriers which are unfair and harmful to the growth of free trade among the nations. The trade barriers can be broadly divided into two broad groups.

- Tariff Barriers.
- Non-Tariff barriers.

- ***Tariff Barriers:***

Tariff is an important method to prevent imports in any particular nation. In simplest terms, a tariff is a tax. A tax imposed on imported goods and services. Tariffs are used to restrict trade, as they increase the price of imported goods and services, making them more expensive to consumers. They are one of several tools available to shape trade policy. Tariffs are available in the form of export as well as import tariffs.

Governments may impose tariffs to raise revenue or to protect domestic industries from foreign competition, since consumers will generally purchase cheaper foreign produced goods. Tariffs can lead to less efficient domestic industries, and can lead to trade wars as exporting countries reciprocate with their own tariffs on imported goods.

❖ ***General Definitions of Tariff:***

- “A tariff is a tax imposed on the import or export of goods.”
- “A tariff refers to “Import duties” charged at the time goods are imported.”
- “Tariff barriers represent taxes on imports of commodities into a country and are among the oldest form of government intervention in the economic activity.”
- “Tariffs are a kind of specialized tax that affects goods imported to, or exported from, a country.”

❖ ***The main causes of imposing trade barriers are as follows:***

- For protecting the domestic industries from foreign competition.
- For protecting domestic employment.
- For promoting development and research.
- For the purpose of National Security
- For conserving the foreign exchange resources of the country.
- For guarding the domestic industries against dumping.
- For making the Balance of Payment position favourable.
- For raising the revenue for the Government.

1.3 TYPES OF TARIFFS

There are several types of tariffs and barriers that a government can employ . These types are explained as follows:

(A) *On the basis of origin and destination of the goods crossing the national boundary:-*

On the basis of origin and destination of the goods crossing the national boundary ,there is a threefold classification of Tariffs which is as under:

a) Import Duties: An import duty is a tax imposed on a commodity originating from abroad and imported by the duty levying country.

b) Export Duties: An export duty is a tax levied up on a commodity originating from the duty levying country imported by the foreign country.

c) Transit Duties: A transit duty is a tax imposed upon a commodity crossing the national frontiers originating from the foreign country and imported by other foreign country.

(B) On the basis of the qualifications of tariff :-

a) Specific Duties: A fixed fee levied on one unit of an imported good is referred to as a specific tariff. This tariff can vary according to the type of good imported. For example, a country could levy a Rs. 100 tariff on each pair of shoes imported, but levy a Rs. 1000 tariff on each computer imported.

b) Ad-valorem Duties: The phrase ad valorem is Latin for “According to the value”, and this type of tariff is levied on a good based on a percentage of that good’s value. An example of an ad valorem tariff would be a 15% tariff levied by India on U.S. automobiles. The 15% is a price increase on the value of the automobile, so a \$10,000 vehicle now costs \$11,500 to Indian consumers. This price increase protects domestic producers from being undercut, but also keeps prices artificially high for Indian car shoppers.

c) Compound Duties: When a commodity is subjected to both specific and ad-valorem duties then the tariff gets referred to as compound duty. These duties are charged depending upon the situation of minimum criterion. If the specific duty happens to be minimum then specific duty will be charged conversely if the ad-valorem duty happens to be minimum then the ad-valorem duty will be charged.

(C) On the basis of the application of tariff between different countries :-

a) Single columns Tariff: The single columns Tariff is also known as uni-linear tariff. When the uniform rate of duty is charged on all the commodities without making any discrimination between countries then the tariff gets referred to as Single Columns Tariff.

b) Double columns Tariff: When two rates of duties are charged on some or all the commodities then the tariff gets referred to as double column tariff. The double column tariff discriminates between countries.

(D) On the basis of the purpose of the imposition of tariff :-

a) Revenue Tariff: Many a times a tariff is imposed on the goods and services to earn revenue or income to the country then it is termed as “Revenue tariff”. When the main purpose of the Government in imposing tariff is to obtain revenue then the tariff gets referred to as revenue tariff. When raising of revenue happens to be the main or primary motive behind imposition of tariff the rate of tariff generally remains low otherwise imports will be curtailed and the Government will not be in a position to raise enough revenue. Revenue tariff tends to fall on mass consumption goods. Government would like to earn additional revenue in order to calls to various functions viz.:

- 1) Obligatory functions like administrations of the country, maintenance of law and order, administrations of justice, preservation of peace.
- 2) Optional functions or development and welfare oriented functions like poverty alleviation, employment generations, social justice, planning, economic development etc.

b) Protective Tariff: when the tariffs imposed in order to restrict imports into a country as far as protection to the domestic industries are concerned then it is called as “Protective tariffs” these kinds of tariffs are used by developing nations of the World.

c) Countervailing and Anti-Dumping Duties: Countervailing Duties may be imposed on certain items of imports when these items have been subsidized by foreign countries Governments. Anti-Dumping Duties are imposed in the foreign goods when there goods get dumped in the domestic market. Below the price prevailing the originating the market. Countervailing and Anti-Dumping Duties are generally the penalty duties.

❖ Check your Progress:

1. Define Commercial Policy.
2. Define Tariff.
3. Explain the different types of Tariffs?

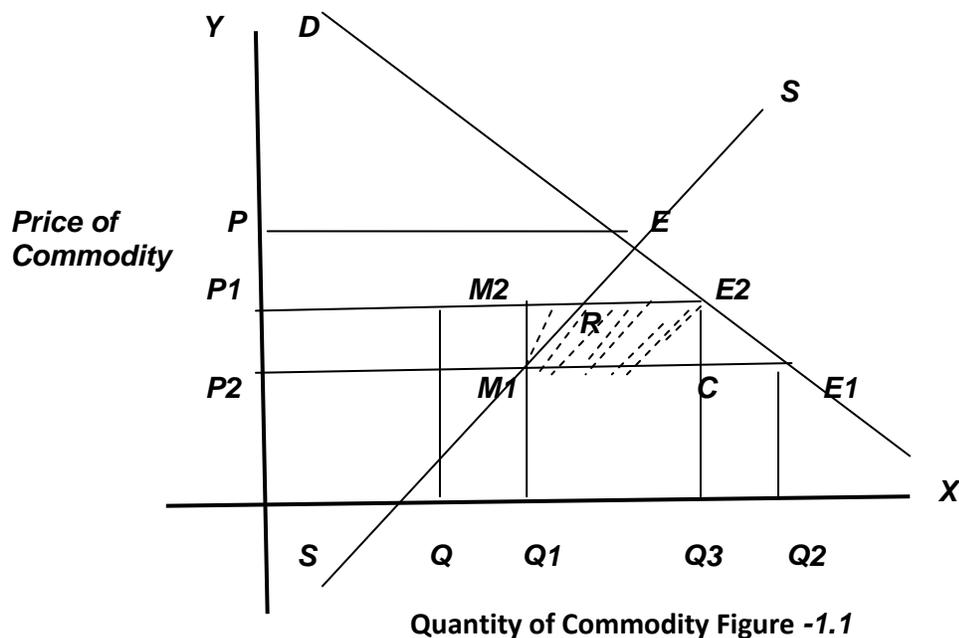
1.4 EFFECTS OF TARIFFS

As far as tariffs are concerned these are concerned with two important things i.e. revenue and protection to the domestic industries from the foreign goods. The role of tariffs is very important as far any particular nation of the World is concerned. Many of the developing nations take an advantage of tariffs in the forms of protection and revenue source as well.

Kindleberger has analyzed various effects of tariffs based on price, consumption, revenue, protection and so on. It has been briefly explained as follows:

- 1) Price effect
- 2) Revenue effect
- 3) Protection effect
- 4) Consumption effect
- 5) Redistribution effect
- 6) Terms of trade effect
- 7) Competition effect
- 8) Income and employment effect
- 9) The balance of payment effect (BOP)

All these effects of tariffs are discussed below with the help of following diagram



In the above diagram quantity of commodity is represented on 'X' axis and on the 'Y' axis price of commodity has been mentioned.

Where, DD is the Domestic Demand Curve, SS is the Domestic Supply Curve, OP is the Equilibrium Price without Trade, OP1 is the Price of the Import under the Trade, OP2 is the Price after Imposition of Tariff on Imports,

Various effects of tariffs mentioned above can be better understood with the help of above diagram and an explanation given below;

1) Price effect:

The price effect of tariff refers to an increase in the price of the commodity on which profit is levied. It is the tendency of the importer to impose the entire tariff on the consumers the price will increase as an amount of tariff is levied on the import of goods. If in the market the demand is inelastic in nature then full burden will be passed on the consumers and in the opposite situations if demand is perfectly elastic then the price effect will have fewer burdens as well. In the above diagram P1P2 is the price effect of tariff as the post tariff price is OP2.

2) Revenue effect:

Many of the times there have been tendencies of the nations to earn revenue by imposing tariffs. The revenue effect can be expressed by simple calculations of, the rate of tariff multiplied by the imports.

3) Protection effect:

A tariff has protective effect for the domestic industries. It tends to raise the domestic price of the imported commodity, reduce the domestic demand for that commodity and thereby stimulates its domestic production.

4) Consumption effect:

Imposition of tariff raises the price, and as a result, the demand for the commodity falls. Total outlay on consumption of the commodity is larger or smaller depending upon whether demand is inelastic or elastic.

5) Redistribution effect:

Redistribution Effect refers to the transfer of real income from the consumers to the producers as a result of tariff. The tariff-imposed price increase results in the loss of consumer's surplus. The redistribution effect takes place while an increase in the price due to tariffs. It implies redistribution of income and wealth from one class to

another class. As far as developing nations are concerned capital is limited available as compared to the labor so tariff is not expected due to the social justice.

6) Terms of trade effect:

When a country imposes a tariff duty, its willingness to receive imports is reduced. For a given quantity of exports, the country now demands a larger quantity of imports because a part of these imports are to be surrendered to the customs authorities in the form of tariff payment. Or, putting the same thing differently, the country is now willing to offer less of exports in exchange for a given quantity of imports.

Thus, the tariff reduces the country's offer of exports for imports.

7) Competition effect

Tariff protects the domestic industry from foreign competition. Under this protection an infant industry after a period of time, grows into an economically strong industry which can fully compete in the world market. But, the sluggish and lazy industry may not like to face the competition and remain inefficient even under the protection cover provided through tariffs.

8) Income and employment effect:

As a result of tariff, the expenditure on imported goods is reduced. This will increase the export surplus of the country and thereby the income from foreign trade. The money shifted from imports can now be spent on the domestically produced goods. If the country is at less than-full employment level, this will raise income and employment in the country.

9) The balance of payment effect (BOP): Tariff has favorable effect on the balance of payments position of the imposing country. It reduces imports and increases the export surplus of the country. Thus, through tariffs, a deficit in the balance of payment can be corrected.

Thus, tariff plays an important role as far as international trade and relations are concerned, it has positive and negative effects on the exporting as well as importing nations of the world. It is not only bringing revenue to the government but also to protect and save the domestic industries, but an appropriate use of tariffs is very important.

1.5 CONCEPT OF NON TARIFF BARRIERS

The issue of non-tariff barriers crops up because of the glaring defects of tariffs. As is already seen in the previous modules, "Tariffs" that at the imposition of tariff leads

to bringing about gains to the tariff imposing country but at the same time it reduces the volume of trade. At the highest of the high tariff the losses will be more than the gains. Moreover, Tariff produces indirect effect through raising of the price of the tariff imposed goods. Therefore tariffs should be within limits which should lead to minimization of losses and maximization of gains i.e. the "tariff should be optimum tariffs". Hence it paves the way for non-tariff barriers.

Tariffs are not very effective in under developed countries. Their problems are different from the problems faced by the developed countries. The problem before the developed countries is to maintain the already attained high rate of economic growth while the problem before the undeveloped countries is to accelerate the rate of economic growth. The underdeveloped countries face the problem of deficit in the balance of payment. To correct the deficit in the balance of payment the underdeveloped countries need to have indirect controls like non-tariff barriers i.e. import quota and not the direct controls like tariffs.

❖ **CONCEPT :**

The measures which are used other than tariffs to restrict imports get collectively referred to as non-tariff barriers. These are direct measures of import restrictions. The setting up of GATT and WTO led to progressive reduction in tariffs. However it paved the way for the adoption of non-tariff barriers methods by the developed countries for the reduction of imports.

The non-tariff barriers include a cafeteria of Trade barriers viz. Import Quota, Import licensing, voluntary export restraints, Dumping, International Cartels, Subsidies etc.

The non-tariff barriers can broadly be divided into two categories viz.

- i) Those non-tariff barriers which restrict imports directly,
- ii) Those which restrict imports by encouraging domestic production.

1.6 TYPES OF NON-TARIFF BARRIERS

There are various types of barriers available to the Non-Tariff Barriers to Trade. Following are the various Six Types of Non-Tariff Barriers to Trade

1. Specific Limitations on Trade: it includes the Quotas, Import Licensing requirements, Proportion restrictions of foreign to domestic goods (local content requirements), Minimum import price limits, Embargoes

2. Customs and Administrative Entry Procedures: It includes the Valuation systems, Anti-dumping practices, Tariff classifications, Documentation requirements, Fees and so on.

3. Standards: In this type the Standard disparities, Intergovernmental acceptances of testing methods and standards, Packaging, labeling, and marking etc. are included.

4. Government Participation in Trade: It has Government procurement policies, Export subsidies, Countervailing duties, Domestic assistance programs

5. Charges on imports: It includes Prior import deposit subsidies, Administrative fees, Special supplementary duties, Import credit discrimination, Variable levies, Border taxes etc.

6. Others: It has Voluntary export restraints, Orderly marketing agreements and so on.

Thus, the various types of barriers to the Non-Tariff barriers are explained as well. The Non-Tariff barriers can include wide variety of restrictions to trade. Here is some example of the “popular” Non-Tariff barriers.

A) Licenses

License is the most common instruments of direct regulation of imports (and sometimes export) are licenses and quotas. Almost all industrialized countries apply these Non-Tariff methods. The license system requires that a state (through specially authorized office) issues permits for foreign trade transactions of import and export commodities included in the lists of licensed merchandises. The main types of licenses are general license that permits unrestricted importation of goods included in the lists for a certain period of time.

B) Quotas

A quota is a limitation in value or in physical terms, imposed on import and export of certain goods for a certain period of time. It is also an important instrument to restrict trade as far as Non-Tariff barriers are concerned. Licensing of foreign trade is closely related to quantitative restrictions – quotas - on imports and exports of certain goods. This category includes global quotas in respect to specific countries, seasonal quotas, and so-called “voluntary” export restraints. Quantitative controls on foreign trade transactions carried out through one-time license.

Licenses and quotas limit the independence of enterprises with a regard to entering foreign markets, narrowing the range of countries, which may be entered into transaction for certain commodities, regulate the number and range of goods permitted for import and export. The licensing and quota systems are an important instrument of trade regulation of the vast majority of the world.

The consequence of this trade barrier is normally reflected in the consumers' loss because of higher prices and limited selection of goods as well as in the companies that employ the imported materials in the production process, increasing their costs.

C) Voluntary Export Restraints (VERs)

A Voluntary Export Restraints (VERs) is a restriction set by a government on the quantity of goods that can be exported out of a country during a specified period of time. Often the word voluntary is placed in quotas because these restraints are typically implemented upon the insistence of the importing countries.

D) Embargo:

Embargo is a specific type of quotas prohibiting the trade. As well as quotas, embargoes may be imposed on imports or exports of particular goods, regardless of destination, in respect of certain goods supplied to specific countries, or in respect of all goods shipped to certain countries. Although the embargo is usually introduced for political purposes, the consequences, in essence, could be economic.

E) Standards:

Standards take a special place among Non-Tariff barriers. Countries usually impose standards on classification, labeling and testing of products in order to be able to sell domestic products, but also to block sales of products of foreign manufacture. These standards are sometimes entered under the pretext of protecting the safety and health of local populations.

1.7 MISCELLANEOUS PROTECTION TECHNIQUES

In the international trade the role of trade barriers is very important. There have been various kinds of protection techniques used by the developed as well as the developing nations of the World. The protection techniques are available in the form of tariff and non-tariff barriers. Trade restrictions are also available due to the international cartels, dumping and the subsidies. In the recent past the international trading system has been threatened by the global 'New Protectionism' policy.

Some miscellaneous protection techniques can be better understood with the help of the following important types.

1.7.1 Dumping:-

In economics, "**Dumping**" is a kind of predatory pricing, especially in the context of international trade. It occurs when manufacturers export a product to another country at a price either below the price charged in its home market, or in quantities that cannot be explained through normal market competition. A standard technical definition of dumping is the act of charging a lower price for a good in a foreign market than one

charge for the same good in a domestic market. This is often referred to as selling at less than “fair value”. Under the World Trade Organization (WTO) Agreement, dumping is condemned (but is not prohibited) if it causes or threatens to cause material injury to a domestic industry in the importing country.

The practice of selling goods abroad below the price charged for the same goods in the domestic market or at a price below the cost of production, usually with the aim of driving competitors out of the market. Dumping is considered to be an unfair trade practice and, as such, is prohibited under many national trade laws.

Definition:

- According to the **Haberler**, “The sale of goods abroad at a price which is lower than the selling price of the same goods at the same time and in the same circumstances at home, taking account of differences in transport cost”
- “Selling the same good to a foreign country at a lower price, often below production cost, than that charged to the domestic buyers.”

Objectives of dumping:

Dumping in general is nothing but the kind of price discrimination in the international market. It has various objectives, explained as follows:

- 1) **To grow and expand industry or business:** As far as an expansion of any particular industry or business is concerned the monopolist always applies the technique of ‘Dumping’. An expansion results into the internal and external economies of scale and lead to the law of increasing returns to the scale, as a result the cost of production is to be reduces at the greater extent and by selling the commodities in the international market the producer or seller make the profit.
- 2) **To find a place in the international market:** It is an important objective of ‘Dumping’ that to find a suitable place in the international market. Because of an availability of perfect competition in the foreign market he lowers the price of the commodity as compared to the other producers which result into the more demand for his commodities and result into the appropriate place in the foreign market.
- 3) **To sell surplus commodities:** When there is availability of surplus production, the producer by applying the ‘Dumping’ method he may sell the commodities in the international market.
- 4) **To develop new trade relations with the other nations of the World:** Through ‘Dumping’ it is also an important objective to develop new trade relation with the other nations of the World.

Following are the various types of dumping:

1. Sporadic Dumping: Occasional sale of a commodity at below cost in order to unload an unforeseen and temporary surplus of the commodity such as cheese, milk, wheat etc. in the international market without reducing domestic prices.

2. Predatory Dumping: Temporary sale of a commodity at below its average cost or a lower price abroad in order to drive foreign producers out of business, after which prices are raised to take advantage of the monopoly power abroad.

3. Persistent Dumping: Continuous tendency of a domestic monopolist to maximize total profits by selling the commodity at a higher price in the domestic market than internationally (to meet the competition of foreign rivals).

◆ **Price Determination Under Dumping:**

The role of discriminatory monopoly is very important in under 'Dumping' as far as price determination is concerned. The price determination under 'Dumping' is being done on the basis of '*Domestic market*' as well as the '*Foreign market*'. In dumping a monopolist sell his product at a higher price in the domestic market and lower price in the foreign market.

Following are the conditions of the dumping:

- 1) All the monopolists are having their aim to maximize their profit. For this aim they produce that output at which his marginal revenue is equals to his marginal cost. The producer always sells his product differently in the domestic as well as the foreign market, where he usually adjust the quantity in each market that the marginal revenue in both the markets are equal. As far as the marginal cost of the commodity is concerned, the most profitable monopoly output will be determined at the point where the combined marginal revenue of both the markets equals the marginal cost.
- 2) The elasticity of demand must be different in both of the markets i.e. Domestic market and the foreign market.
- 3) The foreign market or international market should be perfectly competitive and the domestic market is monopolistic.
- 4) The buyer in the domestic market cannot buy the cheap commodity from the foreign market.

The above conditions are fulfilled in the following diagram of price determination under dumping:

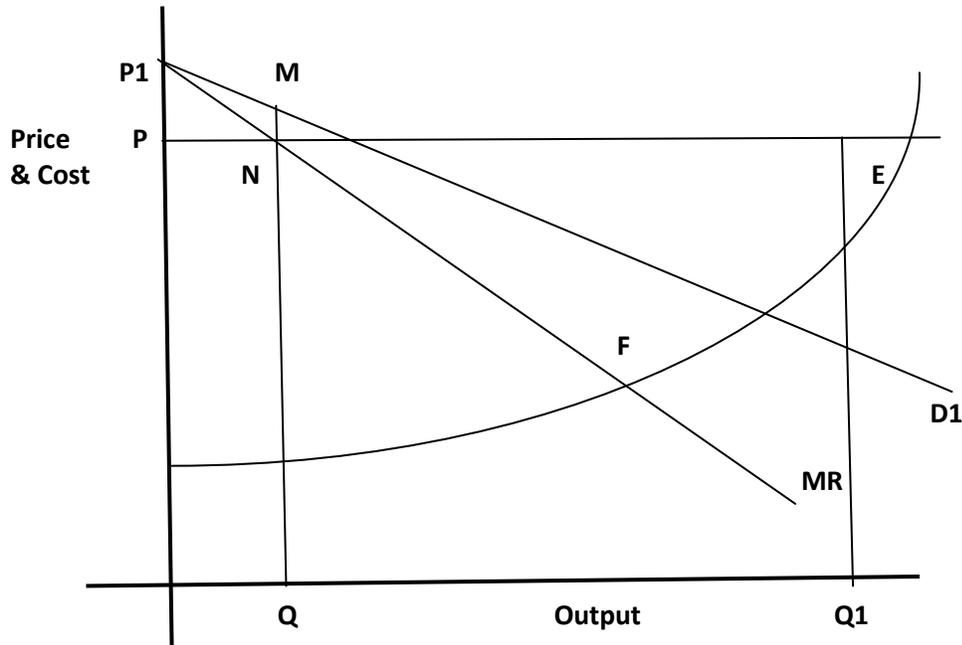


Figure -1.2

The above diagram indicates price-output determination under dumping. In the diagram D1 shows the demand curve in the home market with the less elastic demand for the product is the downwards sloping curve and the correspondent marginal revenue curve is MR. The foreign market demand curve faced by the monopolist is the horizontal line PD. The MR and PD curve leads to the formation of P1HED it shows the combined marginal revenue curve.

As far as determination of quantity of commodity produced by the monopolist, the Marginal cost curve MC has been drawn. An equilibrium point is 'E' where MC curve and combined marginal revenue curve (P1HED) equals.

So, OQ1 output will be produced for the sale in both the markets i.e. Domestic and international markets. Since 'Q1E' is the marginal cost equilibrium in the domestic market will be established at point 'H' where the marginal cost 'Q1E' equals the MR curve. In this situation 'OQ' quantity will be sold at the 'QM' price in the domestic market and rest of the quantity 'QQ1' to be sold in the foreign market at the price 'OP' or 'Q1E' price.

Thus, it is clear that the monopolist sells more in the foreign market with the more elastic demand and a low price and less in the domestic market with high price then his total profits are 'P1HEG'

- **Anti-Dumping Measures:**

Anti dumping, in common parlance, is understood as a measure of protection for domestic industry. However, anti dumping measures do not provide protection per se to the domestic industry. It only serves the purpose of providing remedy to the domestic industry against the injury caused by the unfair trade practice of dumping. In fact, anti dumping is a trade remedial measure to counteract the trade distortion caused by dumping and the consequential injury to the domestic industry. Only in this sense, it can be seen as a protective measure. It can never be regarded as a protectionist measure

Though dumping plays an important role in the international market but then also dumping is harmful in the different ways. Following measures can be adopted to prevent or stop dumping;

- 1) **Tariff duty:** It is an important measure to prevent dumping. An increasing the tariff rates by the country for the imported products the prices of the imported goods will increase and it may possible to save the country from the threat of dumping. At the same time it is very important that the rate of duty on import should be equal to the difference between the domestic price and the price of dumped commodity.
- 2) **Import quota:** It refers to a commodity of a specific volume or value is allowed to be imported in the country. It includes import duty with fixing quota at the same time provision of limited amount of foreign exchange to the importers. Import quota is also an important measure to prevent dumping.
- 3) **Import embargo:** It refers to imports of certain or all types of goods from the dumping nation are banned. Import embargo is a specific tool to prevent dumping in the hands of the government but it is rarely used as well.

1.7.2 Export Subsidies:-

Export subsidy is a government policy to encourage export of goods and discourage sale of goods on the domestic market through low-cost loans or tax relief for exporters, or government financed international advertising or R & D. An export subsidy reduces the price paid by foreign importers, which means domestic consumers pay more than foreign consumers. The WTO prohibits most subsidies directly linked to the volume of exports.

Export Subsidies are also generated when internal price supports as in a guaranteed minimum price for a commodity creates more production than can be consumed internally in the country. That is without undermining the guaranteed minimum price. These price supports are often coupled with import tariffs. Instead of

letting the commodity rot or destroying it the government exports it. Saudi Arabia is a net exporter of wheat, Japan often is a net exporter of rice.

Export subsidies can also be a perpetual inflation machine the government subsidizes the industry based on costs, but an increase in the subsidy is directly spent on wage hikes demanded by employees. Now the wages in the subsidized industry are higher than elsewhere, which causes the other employees demand higher wages, which are then reflected in prices, resulting in inflation everywhere in the economy. Export subsidies are payments made by the government to encourage the export of specified product. As with taxes, subsidies can be levied on a specific or ad valorem basis. The most common product groups where export subsidies are applied are agricultural and dairy products.

Most countries have income support programs for their nation's farmers. These are often motivated by national security or self-sufficiency considerations. Farmers' incomes are maintained by restricting domestic supply, raising domestic demand, or a combination of the two. One common method is the imposition of price floors on specified commodities. When there is excess supply at the floor price, however, the government must stand ready to purchase the excess. These purchases are often stored for future distribution when there is a shortfall of supply at the floor price. Sometimes the amount the government must purchase exceeds the available storage capacity. In this case, the government must either build more storage facilities, at some cost, or devise an alternative method to dispose of the surplus inventory. It is in these situations, or to avoid these situations, that export subsidies are sometimes used. By encouraging exports, the government will reduce the domestic supply and eliminate the need for the government to purchase the excess.

One of the main export subsidy programs in the US is called the Export Enhancement Program (EEP). Its stated purpose is to help US farmers compete with farm products from other subsidizing countries, especially the European Union, in targeted countries. The EEP's major objectives are to challenge unfair trade practices, to expand U.S. agricultural exports, and to encourage other countries exporting agricultural commodities to undertake serious negotiations on agricultural trade problems. As a result of Uruguay round commitments, the US has established annual export subsidy quantity ceilings by commodity and maximum budgetary expenditures. Commodities eligible under EEP initiatives are wheat, wheat flour, semolina, rice, frozen poultry, pork, barley, barley malt, table eggs, and vegetable oil.

In recent years the US government has made annual outlays of over \$1 Billion in its agricultural Export Enhancement Program (EEP) and its Dairy Export Incentive Program (DEIP). The EU has spent over \$4 billion annually to encourage exports of its agricultural and dairy products.

- **Export Subsidy Effects on Exporting Country :**

Exporting Country Consumers -

Consumers of the product in the exporting country experience a decrease in well-being as a result of the export subsidy. The increase in their domestic price lowers the amount of consumer surplus in the market.

Exporting Country Producers –

Producers in the exporting country experience an increase in well-being as a result of the subsidy. The increase in the price of their product in their own market raises producer surplus in the industry. The price increase also induces an increase in output, an increase in employment, and an increase in profit.

Exporting Country Government –

The government must pay the subsidy to exporters, These payments must come out of the general government budget. Who loses as result of the subsidy payment depends on how the revenue is collected. If there is no change in total spending when the subsidy payments are made, then a reallocation of funds implies that some other government program is cut back. If the subsidy is paid for by raising tax revenues, then the individuals responsible for the higher taxes lose out. If the government borrows money to finance the subsidy payments, then the budget cut back or the tax increase can be postponed until some future date.

Since all three components are negative, the export subsidy must result in a reduction in national welfare for the exporting country. However, it is important to note that a redistribution of income occurs, i.e. some groups gain while others lose. The likely reason governments implement export subsidies is because they will benefit domestic exporting firms. The concerns of consumers must be weighed less heavily in their calculation since the sum of their losses exceeds the sum of the producers' gains.

- **Export Subsidy Effects on Importing Country :**

Importing Country Consumers –

Consumers of the product in the importing country experience an increase in well-being as a result of the export subsidy. The decrease in the price of both imported goods and the domestic substitutes increases the amount of consumer surplus in the market.

Importing Country Producers –

Producers in the importing country suffer a decrease in well-being as a result of the export subsidy. The decrease in the price of their product on the domestic markets reduces producer surplus in the industry. The price decreases also induces a decrease in output of existing firms, a decrease in employment, and a decrease in profit and/ or payments to fixed costs.

Importing Country Government–

There is no effect on the importing country government revenue as a result of the exporter's subsidy.

This means that an export subsidy implemented by a “large” exporting country in a perfectly competitive market will raise national welfare in the importing country. This result has inspired some economists to argue that the proper response for an importing country when its trading partner implements an export subsidy is simply to send along a thank you note.

It is worth noting here the WTO allows countries to impose countervailing duties to retaliate against its trading partners when it can be shown that an exporting country government has used export subsidies. However, it is also important to note that everyone's welfare does not rise when there is an increase in national welfare. Instead there is a redistribution of income. Consumers of the product will benefit, but producers and payers of government taxes will lose.

A national welfare increase, then, means that the sum of the gains exceeds the sum of the losses across all individuals in the economy. Economists generally argue that, in this case, compensation from winners to losers can potentially alleviate the redistribution problem.

1.7.3 Cartels:-

An international cartel is formed by producers in the same line of production in two or more countries, agreeing to regulate production and sales for monopolistic ends. **Haberler** defines international cartels more precisely as “*A union of producers in a given branch of industry, of as many countries as possible, into an organisation to exercise a single planned control over production and price and possibly to divide markets between the different producing countries.*”

Concept of Cartel:

- Business Agreement whether formal or informal that serve to limit or suppress competition are referred to as cartel. Cartels originally developed to suppress competitions from abroad.
- Formal or informal agreements among business enterprises engaged in the same trade but located in different countries to limit competition to regulate markets and restrict trade are known as international cartels.

Thus international cartels are a sort of monopoly combines to eliminate competition in the foreign markets. Cartel members usually form an organised association through explicit agreements which would ensure them higher profits than would be possible otherwise.

Conditions conducive to International Cartels:

Numbers of conditions led to the cartelization, which are as follows:

- When the number of producing firms is small.
- When the firms belonging to given industry have already reached cartel agreements between different countries.
- When the process of manufacture or fabricated products can be patented, iv) When there is a natural scarcity of raw material and
- When there is Government cooperation or leadership in the organization of Cartel.

Indeed, the scope of cartels is wide enough covering metals and minerals, and manufactured goods like chemicals, dyestuffs, pharmaceutical products and electrical goods. The main inducing factor behind the formation of cartels is the fear of cut-throat competition and desire for monopoly control. Further, when productive capacity is found to exceed current demand, international cartels have been formed as an attempt to share a diminished market. Professor Krause points out the following important objects of cartels:

- 1) To achieve control over prices Cartels resort to price-fixing above .competition price and reap high monopoly profits.
- 2) To impair the quality of product. When cartels are formed, buyers will have no safeguards against low quality, since hardly an opportunity is made available to the buyers to choose between different varieties.

- 3) To make allocation of trade territories and thereby to acquire and maintain a monopolistic position by each cartel member in their respective allocated-markets.
- 4) To restrict supply, assigning quotas to each cartel member.
- 5) To deliberately retard technological change until the existing plants and productive facilities have been fully depreciated.

▪ **Merits of cartels:**

- 1) Due to business combines, large-scale output is made possible, so goods may be sold at cheaper rates through cartels.
- 2) Cartels tend to eliminate wasteful competition also.
- 3) Cartels can solve the problem of excess capacity.

▪ **Drawbacks of cartels:**

- 1) They tend to reduce international trade on account of restricted output and high price policy.
- 2) International cartels may also mean under-utilization of the world's resources and manpower, in view of lack of competition and the system of production quotas followed by the cartel members.

Since international cartels are not governed by impartial international machinery in favor of the consumer's interest in general, it is utmost desirable that cartels must be prevented by all means. For breaking up the cartels, it is necessary to adopt unilateral action through anti-trust measures by a country, coordinated with such international actions.

1.7.4. Commodity Agreements:-

An international commodity agreement is an undertaking by a group of countries to stabilize trade, supplies, and prices of a commodity for the benefit of participating countries. An agreement usually involves a consensus on quantities traded, prices, and stock management. A number of international commodity agreements serve solely as forums for information exchange, analysis, and policy discussion.

Agreements are international agreements designed to stabilize commodity prices in the interest of producers and consumers. They can include mechanisms to influence market prices by adjusting export quotas and production when market prices reach certain trigger price levels. They sometimes employ buffer stocks which release stocks

which release stocks of commodities onto the market when prices rise to a certain level and build them up when they fall.

◆ Theories of Commodity Agreements

Producing commodities such as coffee, cotton or tobacco for the international markets is a hazardous business. All are grown commercially in Zambia. Commodity markets are characterized by instability and uncertainty. This uncertainty may arise due to

- Fluctuations in the market prices due to market conditions changing
- Changes in prices due to changes in exchange rates.
- Changes in foreign government protectionist measures.

Often producers (and sometimes consumers) of commodities will co-operate together in an attempt to introduce more stability into the markets. These agreements attempt to stabilize prices. Indeed with most primary commodities they are used to prevent prices from falling below certain levels.

- **A production quota system** as the International Coffee Agreement operated by the International Coffee organization between 1962 to 1980
- **A buffer stock system**

◆ Production Quota System

A production quota system is an agreement by producers to limit the amount supplied to the market place. By forming a cartel and co-operating together, the producers attempt to influence the market supply and hence the price. The individual members of the cartel are then given a quota on the amount they are able to produce. If the intention is to prevent the price falling the cartel members will be instructed to reduce their quotas.

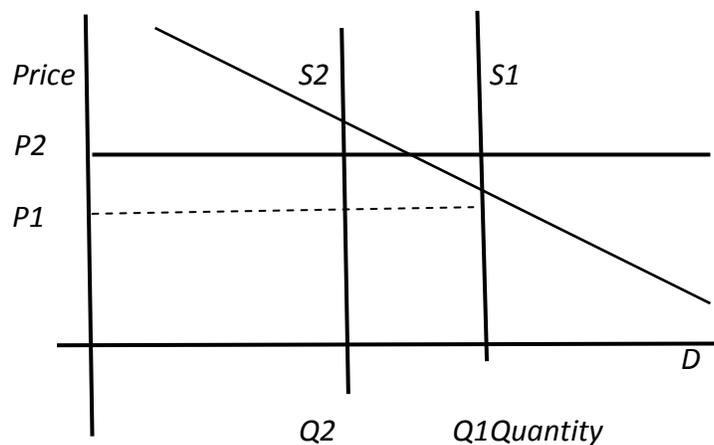


Figure 1.3

If the market price for the commodity was P_1 and the cartel wanted to raise the market price to a target price of P_2 then by reducing the quotas produced by each one of the members of the cartel the market supply curve can be shifted to the left and the market price raised.

◆ Buffer Stock System

This system is operated by a group of producers, known as the buffer stock authority, often with government support setting a target price or a target price band i.e. a price ceiling and price floor. If the market conditions are such that a surplus is produced, which would cause the price to fall below the target price; the buffer stock authority will agree to purchase the surplus at the intervention price. If market conditions have produced a shortage then the buffer stock authority will prevent the price from rising above the target price by selling off previously acquired stocks (assuming they exist).

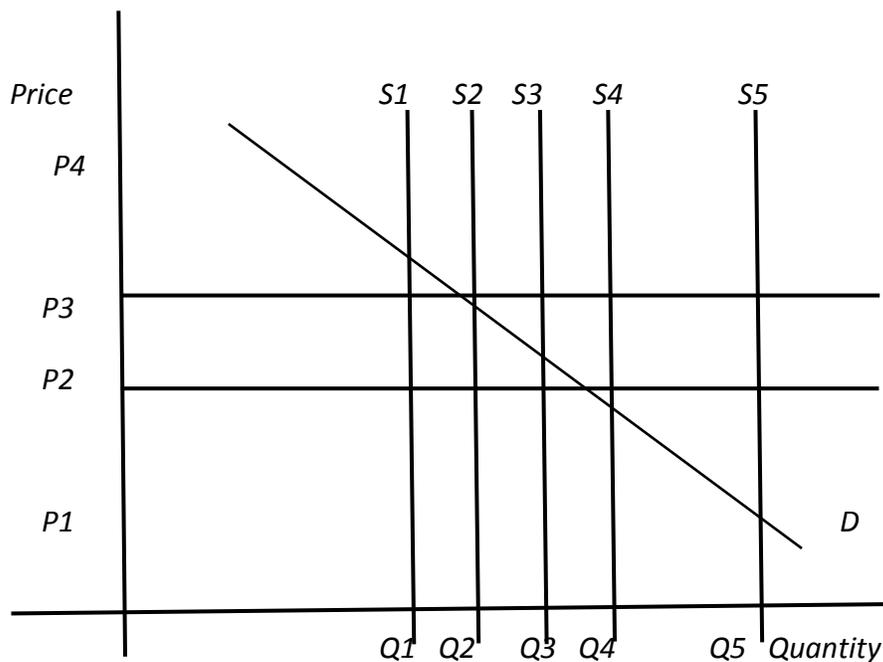


Figure 1.4

In the above diagram shifts in the supply curve between S_2 , S_3 and S_4 will only result in the price changing between the acceptable price band. If a supply shock causes the supply curve to shift to the right to S_5 then the buffer stock authority will

intervene and purchase the surplus Q4-Q5 thus preventing the market clearing by itself through a lowering of the equilibrium market price to P1.

If the supply curve shifted to the left then the buffer stock authority would release stocks equal to Q1-Q2 on to the market thus preventing the price rising to P4.

In the case where the surplus is bought there are number of options that can happen to the stock.

1. It can be stored
2. It can be destroyed
3. It can be sold to other countries
4. It can be given as overseas assistance.

Each option has a number of costs associated with each. Storage is expensive and involves an opportunity cost of the storage facilities. Destroying surpluses especially if the surplus is a food is morally questionable in a word devastated by poverty and hunger. Selling to other countries at low prices or dumping can undermine domestic producers in the countries where the goods are sold. Giving the food as aid could, it is argued, lead to a dependency culture.

1.8 SUMMARY

1. The commercial policy plays an important role in economic growth and development of the country.
2. The commercial policy means, "*All measures regarding all international economic transactions between the reporting country and the foreign countries.*"
3. Commercial policies are of two types:
 - a. Free trade policy:** A free trade policy is a type of trade policy which does not places any restriction on the movement of goods and services between countries.
 - b. Protection:** means safeguarding the home country by erecting a strong tariff wall to fortify the domestic infant industries from the attack of the foreign sophisticated goods.
4. The trade barriers can be broadly divided into two broad groups.
 - Tariff Barriers.
 - Non-Tariff barriers.

5. Tariff is an important method to prevent imports in any particular nation. In simplest terms, a tariff is a tax. A tax imposed on imported goods and services.
6. The measures which are used other than tariffs to restrict imports get collectively referred to as non-tariff barriers.
7. Dumping is the act of charging a lower price for a good in a foreign market than one charge for the same good in a domestic market.
8. Tariff duty, Import quota and Import embargo these are some measures which can be adopted to prevent or stop dumping.
9. Export subsidy is a government policy to encourage export of goods and discourage sale of goods on the domestic market through low-cost loans or tax relief for exporters.
10. An international cartel is formed by producers in the same line of production in two or more countries, agreeing to regulate production and sales for monopolistic ends.
11. International cartels are a sort of monopoly combines to eliminate competition in the foreign markets.
12. An international commodity agreement is an undertaking by a group of countries to stabilize trade, supplies, and prices of a commodity for the benefit of participating countries.
13. **A production quota** system is an agreement by producers to limit the amount supplied to the market place.

1.9 QUESTIONS

❖ **Write Short Note :**

1. Define Commercial Policy.
2. Define Tariff.
3. Define Non-Tariff barriers.
4. Types of Non Tariff Barriers
5. Dumping.
6. Cartels
7. Commodity Agreements

❖ ***Answer the following questions:***

1. What are the main effects of tariff?
2. Explain the different types of Tariffs?
3. Process of Price Determination under Dumping.
4. What is meant by Export Subsidies? Describe the effects of export subsidies.
5. What is a Commodity agreement? What are the theories of commodity agreements?



Module 2

ECONOMICS OF INTEGRATION – I

Unit Structure:

- 2.0 Objectives
- 2.1 Introduction of the term Economic Integration
- 2.2 Causes of popularity of Economic Integration
- 2.3 Types of Economic Integration
- 2.4 Introduction of Protection and Trade liberalism
- 2.5 Concept and examples of Regional Trade Block
- 2.6 European Union (EU)
- 2.7 North American Free Trade Agreement (NAFTA)
- 2.8 Summary
- 2.9 Questions

2.0 OBJECTIVES

- 1. To understand the term Economic Integration
- 2. To know the causes of popularity of Economic Integration
- 3. To understand the various types of Economic Integration
- 4. To know the concepts of Protection and Trade Liberalism
- 5. To understand the meaning and types of Regional Trade Blocks
- 6. To know about European Union
- 7. To know about North American Free Trade Agreement

2.1 INTRODUCTION

To know economic integration it is desirable to know economic liberalization. Economic liberalization is a process whereby structural reforms are initiated in the economy. Economic liberalization involves the following major changes:-

- i) changes in the outlook

- ii) Technological up gradation
- iii) Changes in trade, fiscal, monetary, price and industrial policies
- iv) Opening the economy for foreign investment
- v) Delicensing and enhancing export incentives.

Economic liberalization attempts to remove restrictions and make an economy global in its approach. Economic liberalization and globalization go hand in hand. Economic liberalization facilitates global integration of open economies.

After Second World War, countries of the world followed the policy of protection so as to rehabilitate the war shattered economies. But it led to adoption of a retaliatory policy on the part of other countries of the world. It is called as the policy of tit for tat which led to the lowering down of the volume of trade, lowering down of competitiveness, efficiency, income and employment. Hence all these things triggered off the wave for speedy liberalization by reducing tariff barriers. It paved the way for economic integration among the countries of the region and also among the countries of the world. When economic integration takes place among the regional economic integration. On the other hand when economic integration takes place among the countries of the world it gets referred to as multilateral economic integration. E.U, NAFTA, ASEAN, OPEC, SAARC are some of the glaring examples of regional economic examples while GATT which later on got merged into WTO are the glaring examples of multilateral economic integration. A very important point to be noted in connection with economic integration is that economic integration entails some extent of political integration too if not full political integration.

2.1.1 CONCEPT

The Term economic integration has been interpreted in different ways. Some authors even include social and political integration in economic integration.

As per some authors the mere existence of trade relations between two or more independent national economies signifies economic integration.

As per some authors economic integration is a type of an arrangement which leads to removal of artificial trade barriers for example tariffs between two or more independent economies.

Economic integration is a general term which covers several kinds of arrangements by means of which two or more independent economies agree to come closer economically. By economically integrating themselves in the form of a union they would like to discriminate against goods produced by countries of the rest of the world lying outside the economic union.

As per Timbergen “economic integration is the creation of most desirable structure of international economy removing artificial barriers to the optimum operation

and introducing deliberately all desirable elements of coordination or unification.” While defining the term economic integration he draws a distinction between two types of economic integration viz. positive and negative economic integration. Positive economic integration refers to bring about reforms in the existing institutional arrangement, checking out the neo policy to correct the market imperfections. On the other hand the negative economic integration refers to removal of artificial barriers like tariffs on the movement of goods among the member countries of the group.

Mr. Balasa defines economic integration as, “a process and as a state of affairs. As a process it encompasses measures designed to abolish discrimination between economic units belonging to different national states; viewed as a state of affairs, it can be represented by the absence of various forms of discrimination between national economies.”

While interpreting the term “economic integration he draws a distinction between economic integration and economic co-operation. The nature of the difference is both quantitative and qualitative. Co-operation entails action leading to lessen the severity of discrimination while economic integration is a process which leads to adoption of measures which can be used for the suppression of some form of discrimination. For example G.A.T.T. or W.T.O. are the examples of cooperation. It is an agreement between the member countries of the world about the trade policies to be pursued in order to intensify the volume of trade among the member countries of the world while removal of trade barriers the tariffs and other non-tariff barrier is an example of economic integration.

2.2 CAUSES OF THE POPULARITY OF ECONOMIC INTEGRATION:-

Now a days economic integration is becoming more popular because of the mutual benefits which spring up from economic integration. “United we stand divided we fall”. In economic integration the economic activities of the member countries are harmonized, co-ordinated and unitedly operated.

Following are the reasons of the popularity of economic integration:-

- i) Widening of market:- By regional grouping or integration the domestic market gets widened. There happens to be a move from domestic market to a regional market.
- ii) Economies of scale:- Due to regional integration or grouping production takes place at a very large scale due to specialization. Due to specialization economies of scale both internal and external spring up.
- iii) High degree of specialization:- The regional integration leads to widening of market, large scale production, economies of scale (internal and external) which paves the way for a very high degree of specialization. A micro-level specialization ie

specialization amongst the specialized items takes place which gets referred to as high degree specialization.

- iv) Optimum reallocation of resources:- Assuming full employment when the market widens due to economic integration in order to cope up with the increased demand the country concerned has to reallocate resources ie resources are withdrawn from high cost production and put in use to the low cost production.
- v) Increase in the volume of trade: Due to reallocation of factors of production the volume of production increases ie the volume of production doubles.
- vi) Changes in the cost price structure:- As per the modern theory of foreign trade due to economic integration each member country specializes in the reduction of a commodity in which it is best suited for which leads to production of a commodity at an extremely low cost of production which in turn leads to keeping the price of the product extremely low.
- vii) Mutual Benefits:- Due to regional economic integration mutual benefits accrue to all the member countries of the group due to specialization, changes in the cost price structure in the member countries.
- viii) Consumer's Surplus:- Before economic integration consumers of the home country use to get the goods at a very high domestic price. When regional economic integration takes place consumers get goods at a very low price due to import of goods at a very low price without tariff. Thus it leads to increase in the real income of the consumers which gets referred to as consumer's surplus.
- ix) Increase in efficiency:- Due to healthy competition among the member countries of the group efficiency in production increases.
- x) Increase in standard of living:- Due to economic integration a high degree of specialization takes place due to which qualititiveness increase. Not only quantity but also quality of product increase due to which life style changes.
- xi) Increase in economic development:- The increase in the volume of trade leads to increase in per capita income and the standard of living of the people. It is an indication of increase in the rate of economic growth of the member countries.
- xii) Overall increase in welfare:- All the above mentioned factors, pave the way for increasing the general welfare and well being of the people of the member countries.

2.3 TYPES OF ECONOMIC INTEGRATION:

There are as many as five major types of economic integration which are as follows:-

- i) A group of countries making preferential Trading Agreements.
- ii) F.T.A i.e. Free Trade Area.
- iii) C. U. i.e. Customs Union.
- iv) C. M. i.e. Common Market
- v) E. U. i.e. Economic Union

i) A group of countries making Preferential Trading agreements:- In this type of economic integration a group of countries come together and make tentative or temporary preferential trading agreements among themselves to give preferential treatment to each other's goods. This is a loose type of economic integration because this type of integration remains temporary. The member countries of this group reduce tariffs on imports of goods from each other while there is no change in the original tariff policy followed by each member country of the group trading with rest of the countries of the world which are not the members of the group. For example common-wealth Preferential System of 1932. Great Britain and the member countries of commonwealth established among themselves a system of trade which was referred to as commonwealth Preference System. As per this system the commonwealth countries reduced tariffs among themselves but allowed their high tariff rates to continue on the imports from rest of the world countries.

ii) F.T.A. i.e. Free Trade Area:- As per the title a group of countries forming a free trade area bring about a free trade between them by removing all the trading restrictions. They completely remove all tariffs on imports of goods from the member countries. However, each member country of the free trade area retains its autonomy in levying tariffs on the imports from non member countries of the world. The European Free Trade Area (EFTA) is a burning example of Free Trade Area.

iii) C. U. i.e. Customs Union:-

A customs Union is a free trade area plus a common policy of tariffs adopted by the member countries in dealing with the imports from the non member countries of the world. A burning example of customs union is E. C. ie the European Community. It was formed in 1958 by signing the treaty of Rome in 1957. By July 1, 1958 a customs union was established among the original six members of the European Economic Community viz Belgium, France, Federal Republic of Germany, Italy, Luxembourg and Netherlands.

iv) Common Market:-

A common market is a step higher than the customs union. A common market is a customs union plus free movement of factors of production viz labor and capital within the common market area or region. A common market retains the two common character features of a customs union viz i) free trade among member countries by removing tariffs internally and ii) the member countries follow the common tariff policy in dealing with non member countries of the world.

A glaring example of common market is European Economic Community which is also called as European Common Market which was established in Jan. 1958 by

signing the treaty of Rome in 1957. It had original six members viz Belgium, France, Federal Republic of Germany, Italy, Luxembourg and Netherlands.

The treaty of Rome required every member to.

- i) eliminate tariffs, quotas and other barriers on intra-community trade.
- ii) devise a common internal tariff on their imports from countries belonging to rest of the world.
- iii) allow free movement of factors of production within the EEC.
- iv) harmonies their taxation and monetary policies and social security policies and
- v) adopt a common policy on agriculture, transport and competition in industry.

The EEC was expanded in 1973 with the inclusion of United Kingdom, Denmark and Ireland. Greece joined the EEC in 1981. Spain and Portugal joined the EEC on 1st January 1986. Austria, Finland and Sweden joined the EEC afterwards and as such the membership of EEC became 15.

The common market is an advanced stage of customs union. It provides a free market for goods belonging to all the member countries. It facilitates the mobility of factors of production among the members of the community. It means factors of production viz labour, capital and enterprise can switch on to any member country to EEC which they can find most profitable due to which efficiency and productivity increase.

v) E. U i.e. Economic Union:-

The Economic Union is still an advanced stage of economic integration. The Economic Union is a common market plus harmonization of national economic policies viz monetary and fiscal policies.

An economic union can be defined as an economic integration which leads to monetary union. The member of the economic union chalk out common rules embodying things like taxation, economic legislation foreign trade, agriculture, transport balance of payments, fiscal and monetary policies, social and economic welfare etc.

The glaring example of economic union is E. U. ie European Union viz Benelux ie Belgium, Netherlands and Luxembourg.

- vi) **ECM or EEC i.e. European common market or European Economic Community-** An economic union is a case of absolute economic integration. It means it is a complete economic integration of group of countries.

Check Your Progress:

1. What do you understand by Economic Integration?

2. Give the reasons of popularity of Economic Integration.
3. What are the different types of Economic Integration?

2.4 INTRODUCTION OF PROTECTION AND TRADE LIBERALISM :

After two world wars countries of the world thought it wise to have collusion instead of collision. Countries of the world realized that Regional Co-operation had become the sine-qua-non of the development of the trade policy so as to trigger off the way for speedy rate of economic development. An important theoretical problem of commercial policy regarding the terms and conditions on which imports and exports of commodities and services are all allowed is that of free trade versus protection. The problem is whether the Government should allow imports and exports without restrictions of any kind i.e. free trade, or it should impose tariffs and other non-tariff restrictions on trade i.e. protection. In other words free trade refers to the trade that is free from all artificial barriers to trade like tariffs, quotas, exchange control etc. Protection on the other hand refers to the Government policy of according protection to the domestic industries from foreign competition.

The following are some of the demerits of the policy of protection:-

- i) Protection is against the interest of the consumers as the consumers get things i.e. goods and services at a higher price (as the cost of production being higher)
- ii) From the point of view of the consumers there is a lack of variety and the choice and the quality.
- iii) The producers and the sellers become less quality conscious.
- iv) It encourages domestic monopolies.
- v) It discourages innovation
- vi) It leads to corruption.
- vii) It reduces the volume of trade
- viii) It leads to uneconomic utilization of world resources.
- ix) Above all protection leads to retaliation i.e. the competitive retaliation. The neighboring countries start adopting the policy, "Tit for tat."

In the wake of globalization the cross boarder interdependence is progressively increasing which leads to progressive trade liberalization.

Following are the arguments for Trade liberation.

- i) It leads to most economic utilization of productive resources of the world because a country specializes in the commodity in which it is best suited for i.e. it can produce the commodity most cheaply and it exports the same. In turn it imports from other countries these goods which it can produce most dearly.
- ii) It leads to division of labors, specialization efficiency, economies of scale, savings of the cost of production etc.
- iii) It leads to intense competition. The inefficient producers are either compelled to improve or to quit.
- iv) It leads to breaking of the domestic monopolies.
- v) It benefits the consumers to enjoy consumers surplus i.e. getting the goods and services at the lowest prices. They enjoy the variety, quality and choice.
- vi) It widens the volume of trade.

The world is becoming narrower and narrower because of global market. The grand success of European Union i.e. the European Economic Community i.e. the European Common Market has given impetus towards a growing trend of formation of regional trading block and retaining the existing regional trading blocks. It is not only on the part of the developed countries but also on the part of the developing countries.

Economic integration of developing countries has been advocated by many economists as a means to accelerate their economic development and strengthen their trading and bargaining power vis-à-vis the developed economies. The United Nations Conference on Trade and Development (UNCTAD) felt "Regional economic groupings or any other form of economic co-operation should be promoted among developing countries as a means of expanding their intra-regional and extra-regional trade and encouraging their economic growth." "Trade expansion, economic co-operation and integration among developing countries is an important element of an international development strategy. It would make an important contribution towards their economic development.

The domestic market of number of developing countries is limited by the low per capita income. It is but natural that it comes in the way of achieving economies of scale (both internal and external) and industrial development. It is hoped that the increase in the size of the market due to regional economic integration will therefore, remove this obstacle. These developing countries should therefore prefer regional economic grouping.

Check Your Progress:

1. Differentiate between Protection and Trade Liberalism.

Western European countries known as “Inner Six” viz. France, Germany, Italy, Belgium, Netherlands and Luxemburg.

The immediate objective behind the establishment of EEC was to set up a custom union. A custom union is one which removes the tariff barriers within the regional trading block and follows a common tariff policy in trading with the non-member countries. Later on the custom union was transformed into a common market in which not only goods and services but also factors of production like labour, capital, enterprise are free to move within the regional trading block. Later on the EEC as a common Market got transformed into economic Union which led to harmonization of laws, social policy, economic, monetary, fiscal policies, international trade policies etc.

The following are the provisions of the treaty of Rome:-

Article 2

- i) The community shall have a common market
- ii) A harmonious development of economic activities within the region.
- iii) Balanced expansion of the region increase in stability, increase in the standard of living of the people of the region and the closer relationship between the countries belonging to the region.

Article 3

- i) Elimination of custom duties and qualitative restrictions on the import and export of goods
- ii) The establishment of common commercial policy towards other countries (non member countries)
- iii) The abolition of all obstacles to freedom of movement for persons, services and capital.
- iv) The adoption of common policy of Agriculture.
- v) The adoption of common policy of transportation.
- vi) To ensure that competition in the common market is not distorted.
- vii) To coordinate the economic policies of the members of the region and disequilibrium in the balance of payments should be corrected.
- viii) The laws of the member countries of the region should be adjusted as required for the proper functioning of the Common Market.
- ix) Improvement in employment opportunities and raising of the standard of living.
- x) The establishment of European Investment Bank to facilitate the economic expansion of the EEC through creation of fresh resources.
- xi) To promote economic and social development of the member countries of EEC

The membership of the EEC is open to all the European countries. It rose from the original Six to Nine in 1973 when Denmark, Ireland and United Kingdom joined the community. In 1981 the membership of EEC rose to ten when Greece joined the community. Portugal and Spain joined the community in 1986 and the membership of the EEC rose to twelve. In 1995 three more countries viz. Austria, Sweden and Finland joined the EEC and thus the total membership of the community rose to fifteen.

In 1992 a Treaty of Maastricht was signed which strengthen the process of integration by creating a common currency w. e. f. Jan. 1999. It led to making the price system and the exchange rate system more stabilized.

The Economic Union has built up an institutional system which is unique in the world. Following are some of the most important institutions:-

- i) The Council of European Union:- It is a main decision making body of The Economic Union. It is a cluster of ministers from each member country of the union.
- ii) European Parliament:- It is a cluster of elected members from each member country. It supervises the European Commission. It also shares the legislature and budgetary powers with the council of the E.U.
- iii) European Commission:- It is a conglomeration of the commissioners nominated by the member countries of the E.U. It is the main administrative body of E.U. which is responsible for day to day administration of E.U.
- iv) Court of Justice:- It is the highest legal authority of E. U. Each country nominates one judge to the court of Justice of E.U.
- v) European Central Bank:- It is a central monetary authority of E. U. It issues Euro notes and coins. It is a foreign exchange authority of E.U.
- vi) Court of Auditors:- It's main function as a court of Auditors is to cheque EU's revenue and expenditure.
- vii) Economic and Social Committee:- It is an authority on economic and social policy of E.U.
- viii) European Committee of Regions:- The portfolio of this committee is to maintain the rules, regulations and identities to the respective regions. It is composed of representatives from all the states of the region.
- ix) European Investment Bank:- It is the financial Institution of E.U.
- x) European Ombudsman:- It is an official appointed by E.U. to investigate people's complaints against public organizations.

The European Union is not against globalization. It's exports and investments are of very high order. The European Union contributes 1/4th of the total worlds exports which accounts for about 15% of its GDP. As much as 40% of the foreign direct investment (FDI) of the developed countries goes to the European Union.

2.7 NORTH AMERICAN FREE TRADE AGREEMENT (NAFTA):-

NAFTA stands for NORTH AMERICAN FREE TRADE AGREEMENT. NAFTA is an extension of CUSTA i.e. the Canada United states Trade Agreement. Though United States of America supported the move to form the regional trading groups like EEC but it was suspicious about its working. Therefore in 1965 the united states of America and Canada entered into bilateral trade agreement to eliminate tariffs on automobiles and auto-parts. In 1985 both the countries decided to integrate their economies generally by reducing trade barriers like tariffs gradually over a period of ten years. In 1989, USA and Canada formed a Free Trade Area and hence along with goods trade in services among them was also liberalized. It was also decided that other internal problems like subsidies, dumping and other trade policy should be settled peacefully and friendly. However they couldn't set up customs union as it was difficult to have a common tariff policy with rest of the world countries or with non member countries. Canada joined hands with America in forming Free Trade Union because it faced with the disadvantageous situation due to following of the policy of protection on the part of U.S.A. The United States of America also wanted to see that Mexico also should join the agreement and ultimately in December 1992, the three countries signed the agreement leading to the formation of the North American Free Trade Agreement (NAFTA). The operation of NAFTA commenced from January 1994.

As per the provision of NAFTA all tariffs and quotas on manufactured and agricultural goods are to be eliminated within 5 to 15 years. It is called as a transitional period. Restrictions on direct foreign investment (DFI) between the NAFTA members will be lifted. The Intellectual Property Rights (IPRs) are to be protected in the member countries i.e. in the NAFTA viz. U.S.A. Canada and Mexico. It is expected that Chile and other Latin American countries may join NAFTA in future. It was decided that trade in financial services will be liberalized by 2000.

Check Your Progress:

1. What do you mean by Regional trade blocks?
2. Explain the working of European Union.
3. What do you understand by NAFTA?

2.8 SUMMARY

- 1) To know economic integration we have to know economic liberalization.
- 2) Economic integration is a general term which covers several kinds of arrangements by means of which two or more independent economies agree to come closer economically.
- 3) As per Timbergen, economic integration is the creation of most desirable structure of international economy, removing artificial barriers to the optimum operation and introducing deliberately all desirable elements of cooperation or unification.
- 4) As per Balasa, economic integration is a process and it is a state of affairs.
- 5) There is a distinction between economic integration and economic co-operation.
- 6) Now a days economic integration is becoming more and more popular
- 7) “United we stand, Divided we fall”
- 8) There are as many as five major types of economic integration which are as follows:-
 - i) Preferential Trading Agreements.
 - ii) Free Trade Area.
 - iii) Customs Union.
 - iv) Common Market.
 - v) Economic Union.
- 9) An economic union represents a case of complete economic integration.
- 10) A trade block is a cluster of nations meant for regionalisms.
- 11) There are following types of regional trade blocks which are as follows:-
 - a) Economic Union (EU)
 - b) North American Free Trade Agreement (NAFTA)

2.9 QUESTIONS

- 1) What do you mean by economic integration? What are the different types of economic integration?
- 2) Explain the causes of the popularity of economic integration.
- 3) What types of economic integration would you suggest for developing countries.
- 4) Write short notes on the following:-
 - a) Free Trade Area.

- b) Customs Union.
 - c) Common Market.
 - d) Economic Union.
- 5) Explain in details the functioning of European Economic Community.
- 6) Write a note on NAFTA.



ECONOMICS OF INTEGRATION – II

Unit Structure:

- 3.0 Objectives
- 3.1 Asia-Pacific Economic Co-operation (APEC)
- 3.2 Association of South East Asian Nations (ASEAN)
- 3.3 South Asian Association for Regional Co-operation (SAARC)
- 3.4 Regionalism Vs. Multilateralism
- 3.5 Summary
- 3.6 Questions

3.0 OBJECTIVES

- 1. To know about Asia-Pacific Economic Co-operation
- 2. To know about Association of South East Asian Nations
- 3. To know about South Asian Association for Regional Co- operation
- 4. To understand the difference between Regionalism and Multilateralism

3.1 ASIA-PACIFIC ECONOMIC CO-OPERATION (APEC):-

APEC stands for ASIA-PACIFIC ECONOMIC CO-OPERATION. It is a forum comprising of 18 members. Following are the names of some of the members of the APEC forum:- Australia, Brunel, Canada, Chile, China, New Zealand, Papus New Guinea, Philippines, Singapore, Taiwan, Thailand, United States etc.

The Asia Pacific Economic Cooperation forum accounts for 45 percent of India's exports and 30% of its imports and 54% of its foreign direct investment (EDI) Countries like Russia, India and Vietnam have expressed their desire to become the members of APEC. At the Manila Conference the APEC members decided an action plan for a giant step forward in six areas towards free trade among members of APEC.

These six areas are as follows:-

- i) greater overall market access.
- ii) Enhancing market excess in services.

- iii) Provision for open investment.
- iv) Reducing the cost of business.
- v) Building up open and efficient infrastructure sector.
- vi) Strengthening economic and technical cooperation.

For strengthening the economic and technical cooperation among member countries the APEC declaration mentions guidelines.

The following are the goals of economic and technical cooperation among the members of APEC:-

- i) to attain sustainable growth.
- ii) To reduce economic disparities.
- iii) To improve wellbeing of the people.
- iv) To deepen the spirits of community in the Asia-Pacific region.

It was also decided that the economic and technical cooperation among APEC must be goal oriented. The APEC forum has also decided to increase the membership of the forum by liberalizing trade and investment and free information technology trade. They have also decided to develop the capital markets to promote capital flows, to mobilize domestic savings and to enhance the environment for private investment in infrastructure. The APEC declaration also mentions about the strengthening of economic infrastructure especially in telecommunication, transportation energy and also in the promotion of small business.

3.2 ASSOCIATION OF SOUTH EAST ASIAN NATIONS (ASEAN):-

ASEAN stands for Association of South East Asian Nations. The origin of ASEAN goes back to ASA. ASA stands for Association of Southeast Asia. It was proposed by Mr. Tunku Abdul Rahman, the Prime Minister of Malaya in 1959. The member countries of ASA fought among themselves due to political and territorial disputes as a result of which ASA couldn't last long. On 8th August 1967 a declaration was signed by Five south East Asian countries viz. Indonesia, Malaysia, Philippines, Singapore, Thailand as per which the Association of South East Asian Nations (ASEAN) was formed to accelerate the economic growth of the member countries with the spirit of equality and partnership. Brunei and Vietnam joined ASEAN in 1984 and 1995 respectively. Burma and Laos joined ASEAN in 1997. United States of America supported the establishment of ASEAN. The establishment of ASEAN shows a move towards globalization.

ASEAN nations area of land and the population are larger than European union comprising of 15 nations. The outstanding feature of the economic growth strategy of ASEAN is FDI i.e. Foreign Direct Investment. Foreign trade in the life blood of ASEAN.

The economic prosperity and the economic integration of ASEAN depend upon two important factors viz. controlling inflation and sustained high growth rate. As regards natural resources ASEAN is a treasure island. The aim of ASEAN is to become a Free Trade Area by reducing tariffs among the ASEAN. In spite of tremendous political, economic and cultural diversity the ASEAN countries are becoming integrated.

3.3 SOUTH ASIAN ASSOCIATION FOR REGIONAL CO-OPERATION (SAARC)

The abbreviation, "SAARC" stands for The South Asian Association for Regional cooperation. The move to have an economic regional block among south Asian countries started taking shape from 1980. The first summit of seven south Asian countries viz. India, Pakistan, Bangladesh, Nepal, Sri Lanka, Bhutan and Maldives took place at Dhaka in December 1985 and the SAARC came into existence. The idea behind the formation of 'SAARC' was to have fearless tensionless progress and prosperity in the South Asian Association for Regional cooperation regional group countries. The SAARC emerged out of the problems faced by South Asian countries. The SAARC has got over 1/5th of world's population. It has only 3.3% of world's total land area. It has a major share of total world's poor population. These countries can be branded as a low per capital income countries. India is the largest SAARC country having 2/3rd of SAARC population while Maldives is the smallest island having population of only 3 lakhs.

Following are some of the most pressing problems faced by SAARC countries:-

- i) The very first problem faced by the SAARC countries is the Boarder dispute problem, political problem and the religious problem.
- ii) The economies of all the seven member countries of SAARC are more or less similar. Dissimilar economies call for economic integration.
- iii) Neglect of intra-regional trade. Their exports are channelised towards hard currency area.
- iv) Most of the SAARC member countries are exporting almost the same types of products. For example India and Sri Lanka export tea.
- v) The economic strength of the member countries of SAARC is different so is the case with economic development. Hence benefits accrue more to the relative economically stronger countries than the relative economically poor countries was the feeling developed amongst the SAARC countries.
- vi) The main hurdle in the way of intra-regional trade is the scarcity of foreign exchange.
- vii) These countries also face number of inadequacies like transportation, communication etc.

The main objectives of SAARC:-

Following are the main objectives of SAARC as per Article 1 (One) of the charter of SAARC:-

- i) To promote the welfare of the people of South Asia and to improve their standard of life.
- ii) To accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realize their full potentials.
- iii) To promote and strengthen collective self reliance among the member countries of SAARC.
- iv) To contribute to mutual trust, understanding and appreciation of each others problems.
- v) To promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields.
- vi) To strengthen cooperation among themselves on matters of common interest.
- vii) To strengthen cooperation among other developing countries.
- viii) To co-operate with international and regional organizations with similar aims and purposes.

Principles:-

Following are the principles laid down as per Article II of the charter of the SAARC:-

- i) Co-operation within the framework of the Association shall be based on respect for the principles of sovereign equality, territorial integrity, political independence, non-interference in the internal affairs of other countries and mutual benefit.
- ii) Such co-operation shall not be a substitute for bilateral and multilateral co-operation but shall be complementary.
- iii) Such cooperation shall not be inconsistent with bilateral and multilateral obligations.

The SAARC countries started with cooperation in non-economic areas like sports, arts, culture etc. Later on they switched over to the following area: Agriculture, Rural development, Telecommunication, Science of technology, Health Transport, Post etc.

In 1991 6th SAARC Summit was held at Colombo in which the idea of Preferential Trading Arrangement popularly known as SAPTA was piloted. On 11th April, 1993 7th SAAR Summit was held at Dhaka.

The basic principles of are as follows:-

- i) Overall mutual advantages.
- ii) Step by step extension of preferential trade arrangements.
- iii) Inclusion of all types of products – raw, semi finished and finished.

iv) Special and favorable treatment to LDCs ie Less Developed Countries.

The SAARC Preferential Trading Arrangement (SAPTA) is to play a very important role in stepping up the intra-regional trade. All the SAARC countries have been implementing the proposal of reduction in tariffs and they have also undertaken economic policy reforms.

SAARC Preferential Trading Agreement (SAPTA):

SAPTA came into operation from December 7, 1995. It heralds a new chapter of economic co-operation among the original seven member countries of SAARC-India, Pakistan, Bangladesh, Sri Lanka, Nepal, Bhutan and Maldives, Afghanistan became its eighth member in early 2007. It also concretise the first step towards creation of a trade bloc in the South Asian Region.

Under the SAPTA mechanism, the SAARC countries have identified 226 items for exchange on tariff concessions ranging from 10 per cent to 100 per cent. India has agreed to extend tariff concessions on 106 items, while Bangladesh has agreed to offer tariff concession on 12 items, Maldives on 17, Nepal 14, Pakistan 35, Sri Lanka 31 and Bhutan 11. Out of 106 items offered by India for tariff concessions, 62 items would be for the least developed countries in the SAARC.

SAPTA to SAFTA: SAPTA has paved way for the setting up of the South Asia Free Trade Area(SAFTA), which came into force from July 1, 2006. The developing countries have been given a span of seven years, and the least developed countries have been provided a span of ten years for its full implementation.

The South Asian developed countries are well endowed with labour and natural resources. Growing openness among themselves would lead to higher production and expansion of labour-intensive exports, thus increasing employment, increased wages and thereby helping in reducing poverty .

Role of India:-

India plays a dominant role in SAARC because of its commanding position in SAARC. Demographically India is the most popular country among the SAARC countries. It possess the largest land area and economically also it commands relatively a better position. Though India itself suffers from several problems still there is a scope for India to play its dominant role in SAARC from both the sides ie from the side of rendering helping hand to member countries of SAARC to tide over their problems and from the side of demanding help from the member countries of SAARC in terms of piloting the scheme of joint ventures specially in the fields of Co-operation, Agriculture, industry, energy, transport, tourism, business, communication, widening of markets etc. The second SAARC summit was held in India at Bangalore in 1986.

Check Your Progress:

1. Explain aims and goals of APEC.
2. Explain ASEAN as a regional trade block.
3. What are the objectives and principles of SAARC?

3.4 REGIONALISM VS. MULTILATERALISM:

The proliferation of regional trading blocs during the second half of the last century and their real impact on the multilateral trading system is emerging as a key issue for discussion at both the intellectual and policy levels. The emergence of the European Union, the North American Free Trade agreement (NAFTA), the common market of the South American Southern Cone (MERCOSUR), the ASEAN Free Trade Area (AFTA), the Asia Pacific Economic Cooperation (APEC), the South Asian Free Trade Agreement (SAFTA), have led to fears of fragmentation of the world economy into trading blocs, in antithesis to the multilateral free trade system represented by the World Trade Organisation (WTO). Whether regionalism or the wave of new regionalism hindered multilateral trade, is the crucial question.

Over the last 50 years, when the world emerged from hardship of Second World War, the challenge was to establish economic stability and strengthen the basis for future growth and prosperity. The growth of trade, investments, technology and communication increasingly link a world of countries at different levels of development and has expanded the frontiers of the multilateral trading system. The establishment of the WTO in January 1995 was symbol of the emergence of a more global economic order.

The world economy witnessed a parallel trend of the multilateralism and regionalism. There has been a surge in Regional Trade Agreements (RTAs) notified to the former General Agreement on Tariffs and Trade (GATT) and subsequently to the WTO.

More than 60 per cent of the world trade is now covered by regional pacts, and almost all major trading nations are now members of at least one regional trade agreement. This lends credence to the theory that regionalism is emerging as a parallel force to multilateralism in the international economic system.

The multilateral trading system, as embodied in the GATT-47 and now the WTO, has completed more than 50 years of existence. The basic philosophy behind multilateralism is that open markets, non discrimination and global competition in

international trade are conducive to the national welfare of all countries. The key guiding principles of this system is 'nondiscrimination', which is embodied in 'Unconditional Most-Favoured Nation' (MFN) clause and 'National Treatment'.

With the successful conclusion of the Uruguay Round, resulting in the Marrakesh Agreement as a 'single undertaking', multilateralism was given a fresh lease of life. The present system, as has been carried over to the WTO, is more far-reaching than GATT-47's mandate. Subjects such as agriculture, intellectual property rights, investment measures and services were brought under the umbrella of multilateral regulations.

WTO Rules and RTA's : WTO rules require that each member accord Most Favoured Nation (MFN) status to other WTO members.

RTA's: Rationale and Benefits:

Most economists argue that multilateral agreements are the preferred instruments for liberalizing international trade. Such agreements ensure a non-discriminatory approach, which provides political and economic benefits for all. But the current political environment as demonstrated by the failure of the Cancun Ministerial, is not particularly favourable for multilateral trade negotiations. There are numerous important and unresolved issues in the WTO negotiations. 2004 is a critical year for the WTO, and agreement must be reached soon on the modalities for these negotiations or they are likely to drift on indefinitely.

It is against that background that more and more countries have turned their attention to RTA's. Countries are taking that route because such agreements are often a more practical and feasible way to liberalize trade. RTA's can bring faster results than the multilateral process. They may enable the parties to make commitments that are more meaningful and more trade liberalizing than a multilateral undertaking. RTA's can be valuable in dealing with tough issues, which often cause deadlocks on the multilateral front in such area as services and government procurement.

For e.g. the U.S. Free Trade Agreement with Australia calls for the elimination of tariffs on 99% of U.S. exports of manufactured goods immediately upon the agreement's entry into force. Manufactured goods account for 93% of all U.S. exports to Australia. All U.S. agricultural exports to Australia will also receive immediate duty free treatment. In the case of services, the U.S. and Australia agreed to the "negative list" approach to the services sector in contrast to the "positive list" method of the WTO> That is important because it means all service sectors are liberalized unless specifically listed as an exception. So there is broader coverage and some protection against backsliding by locking in the regulatory status quo.

The investment provisions in all recent U.S. FTA's go beyond the WTO by allowing parties the right to establish a presence in the other country, a commitment that does

not exist in any WTO agreement. Many RTA's go further by building on the treatment and protection principles of bilateral investment treaties.

RTAs : Their costs and consequences:

RTA's can have negative effects as well by diverting trade away from lower cost producers outside the bloc. They also can undermine the multilateral system because of their inherently discriminatory nature.

Each RTA establishes its own rules of origin, which can have adverse effects. Preferential rules of origin can stifle innovation, impede the creation of networks and joint manufacturing, and unduly restrict third country sourcing leading to trade diversion. This proliferation of divergent rules of origin increases the transaction costs for business and slows processing times at borders.

An OECD study found that countries belonging to RTAs might now have 20 or more different tariff rates for the same product.

The countries like Australia, Chile, and Singapore, which are medium sized trading partners, the other RTA participants have fairly insignificant volumes of trade with the U.S. All this points to the inherently political nature of some RTAs, which apparently were concluded primarily to cement diplomatic ties, forge new alliances, or achieve other geopolitical objectives. Trade deals of the magnitude are not likely to create much momentum for RTAs with more significant economic players, such as the EU or Japan, or do much to stimulate WTO negotiations.

Multilateralism and Regionalism: Costly approach for developing countries:

Countries across the globe are competing with one another to enter into bilateral and/or regional trade agreements. The benefit-cost analysis of expenditure incurred on such negotiations is regressive with the smaller countries losing a relatively bigger chunk out of the total pie of government expenditure for undertaking regional trade ventures. In fact, they can ill afford to undertake any meaningful work on the pros and cons of engaging in RTAs. Moreover, most of these countries also have to afford their embassies in Geneva for participating in the multilateral agreements. There is every possibility that these countries might not actually get any significant benefits, matching with the costs incurred, through their participation in the dual games of international trade policy.

On the other hand, the industrialized countries can afford the luxury of maintaining a galaxy of experts dealing with issues of respective national interests both at the regional as well as the multilateral trade policy platforms. Armed with results of plenty of homework done, these countries may be able to justify costs incurred on studies of regional pursuits since they may be able to demonstrate much larger potential gains to be reaped in this dual game.

With the weakening of the multilateral discipline, the developed countries may well continue to maintain domestic as well as export subsidies on their agricultural products but at the cost of interests of farmers in the developing world. Nevertheless such gains may only be short term in nature. In the long run, this would hurt the interests of their own economies through inefficient allocation of domestic productive resources. Further, in the absence of strong multilateral trade disciplines, their interests would be hurt due to relatively weak market access provided to them by the growing and large markets of the developing countries.

At the end we may say that, RTAs are a reality and will not go away. What is important then is to ensure that RTAs conform to WTO rules in so far as possible. That is why the negotiations to clarify and improve WTO existing rules and procedures with respect to RTAs are so critical. These negotiations deserve greater attention by WTO members so that the remarkable trend in trade liberalization begun after the end of World War II can continue unabated. That means that countries like U.S. and Poland, with its new EU partners, must demonstrate the political will to make these discussions succeed and therefore pave the way for renewed trade negotiations in 2004 and beyond multilaterally as well as regionally and bilaterally.

3.5 SUMMARY

1. Following are the examples of Regional Trade Agreements (RTAs)
 - c) Asia-Pacific Economic Co-operation (APEC)
 - d) Association of South-East Asian Nations (ASEAN)
 - e) South Asian Association for Regional Co-operation (SAARC)
2. Regionalism and multilateralism are not contradictory but rather they are complementary to each other.

3.6 QUESTIONS

1. Write notes on the following:
 - a) European Union
 - b) North American free Trade Agreement
2. What are the problems faced by SAARC countries?
3. What are the objectives of SAARC?
4. "Regionalism and Multilateralism are complementary to each other". Explain the above statement.



Module 3

TRENDS IN WORLD TRADE, WTO AND DEVELOPING COUNTRIES

Unit Structure

- 4.0 Objectives
- 4.1 Introduction of Trade Liberalization
- 4.2 World Trade Organization and Liberalization
- 4.3 Liberalisation of trade in manufacturing
- 4.4 Liberalization of agricultural trade
- 4.5 Liberalization of trade in services
- 4.6 Controversies in trade policy with environment
- 4.7 Controversies in trade policy with labour policy
- 4.8 Controversies in trade policy with TRIPs
- 4.9 Dispute Settlement Body
- 4.10 Summary
- 4.11 Questions

4.0 OBJECTIVES

- To study and understand the concept of trade liberalisation
- To study the role of World Trade Organisation (WTO) in trade liberalisation
- To study liberalisation of trade in manufacturing
- To study liberalisation of agricultural trade
- To study liberalisation of trade in services
- To study controversies in trade policy with environment
- To study controversies in trade policy with labour policy
- To study controversies in trade policy with TRIPs
- To study Dispute Settlement Body

4.1 INTRODUCTION OF TRADE LIBERALIZATION

The history of trade between nations has been a long and colorful one, punctuated by wars and dramatic changes in beliefs about trade. Because of the

economic impact that trade has always had on civilizations, governments often become involved in trade with the goal of producing a particular economic outcome for their countries. Trade liberalization refers to the removal of government incentives and restrictions from trade between nations. It is a subject of much scholarly and political debate, given the impact that trade has on the livelihood of so many people, especially in developed countries.

Economists in particular have debated the advantages and disadvantages of trade liberalization for centuries. Classical economists such as David Ricardo and Adam Smith were strongly in favor of free trade, believing that it led to the economic prosperity of civilizations. They pointed to examples of civilizations that had flourished as a result of increased trade liberalization, such as Egypt, Greece, and the Roman Empire, as well as the more modern example of the Netherlands.

Modern economists who favor trade liberalization cite evidence that it creates jobs, fosters economic growth, and improves the standard of living because of increased consumer choice in the marketplace.

Those who argue against rapid trade liberalization also cite statistical evidence that free trade can harm the ecology of the marketplace and have negative effects on poor countries. For example, the World Bank estimates that the number of people in the world living on less than \$2 U.S. Dollars (USD) per day has risen by almost 50% since 1980. This correlates precisely with the period of the most worldwide trade liberalization in recent history. The implication of many of the arguments against trade liberalization is that trade negotiations should focus first on fairness to developing countries, rather than further opening up the markets of the poorest countries to competition.

All developed countries have had to deal with the question of free trade versus its opposite, protectionism. In most of the world's developed nations, tariffs are in place on agricultural products, and in the developing world, there are high tariffs on many goods, especially manufactured goods. Trade barriers such as these are the subject of debates that will undoubtedly.

4.2 THE WORLD TRADE ORGANIZATION AND LIBERALIZATION

The WTO was founded with the purpose of liberalizing international trade. Its aim was to help member nations reach cordial solutions to their trade-related problems.

The World Trade Organization (**WTO**) was founded in 1995 by the members of the General Agreement on Tariffs and Trade (GATT). The WTO is the world's only international organization that supervises 95% of the world's global trade. It assists trade related issues of its member nations that produce, export and import goods and services in a smooth manner. Comprising 153 member nations, the agreements pertaining to the WTO have been signed and confirmed by respective member nations.

The International body has over 148 members as on October 13, 2004 accounting for 90% of the world trade and around 30 others are negotiating membership and are WTO observers.

4.2.1 The main principles of WTO are:

- To promote fair competition
- To encourage economic and development reforms
- To increase predictability through transparency
- To lower trade barriers for freer trade
- To ensure fair treatment to locals and foreigners

4.2.2 Objectives of the WTO

With manifold objectives like helping trade flow smoothly, freely, fairly and predictably it has become capable of organizing trade and commerce over the Globe through the mantra of liberalization, privatization and globalization. It is stepping forward with objectives like:

- 1) Rejecting all forms of protectionism.
- 2) Removing trade barriers and eliminating discriminatory treatment in international trade through successive multilateral trade negotiations.
- 3) Providing a fair, predictable and open rule-based trading system through overseeing the implementation of multilateral trade rules and enforcing legally binding obligations.
- 4) Providing a mechanism for settling trade disputes.
- 5) Integrates developing and least developed economies into the world trading system

4.3 LIBERALIZATION OF TRADE IN MANUFACTURING

Liberalization of trade in manufactures is sought to be achieved mostly by reduction of tariffs and phasing out of non-tariff barriers.

4.3.1 Tariff Barriers

The major liberalisation in respect of trade in manufactures, regarding tariffs, are:

1. Expansion of tariff bindings
2. Reduction in the tariff rates
3. Expansion of duty-free access

The UR Agreement envisages substantial tariff reductions in both industrial and developing countries.

The main liberalisations by industrial countries include the expansion of tariff bindings.(i.e., commitment not to exceed a particular level of tariff) to cover 99 per cent of imports, the expansion of duty-free access from 20 to 43 percent of imports, and the reduction of trade weighted average tariff by 40 per .cent, from 6.2 to 3.7 per cent.

However, the gains to developing countries from the tariff cuts by industrial countries is less impressive. The reduction in the average tariffs on their exports to industrial markets is 30 per cent and the labour intensive manufactures (textiles, clothing, leather goods) and certain processed primary products (fish products) which are regarded as sensitive have below average tariff cuts.

In industrial countries, tariffs will be eliminated in several sectors like steel, pharmaceuticals and wood and wood products.

Developing countries agreed to bind their tariffs on 61 per cent of their imports of industrial products, compared with 13 per cent before the UR Round. They also offered to reduce their trade-weighted average bound tariff on imports from industrial countries by 28 percent, from 15 to 11 per cent. The offers of tariff reduction on manufactures by developing countries are estimated to amount to over a third of the world total. The expansion of tariff binding by the developing countries, which rules out future increases in tariffs, is regarded as a significant achievement.

India has bound tariffs at 40 per cent (where they were above 40 per cent in 1993-94) on industrial raw materials, components and capital goods and at 25 per cent in other cases. After the UR Agreement comes into force, about 68 per cent of India's tariff lines will be bound (compared to five percent earlier). In comparison, many developing countries in Asia and Latin America have bound between 90 and 100 per cent of their tariff lines at levels comparable to, or lower than, India's bindings.

4.3.2 Non-tariff Barriers

In the area of NTBs, the Agreements to abolish voluntary export restraints (VERs) and to phase out the Multifibre Arrangements (MFA) are regarded as landmark achievements for developing countries.

The phasing out of the existing VERs within four years and the MFA within ten years would scale back the coverage of NTBs on developing countries' trade from 18 per cent of their 1992 exports. As trade in derestricted product lines would tend to grow faster than other trade, this coverage **could foil** to 4.2 per cent by 2005.

The U.R. Agreement seeks to phase out the MFA by 2005. According to some estimates the phasing out of MFA would contribute about 20 per cent of the total welfare gains from the UR. The largest gains will go to the MFA importers who will be able to import basic clothing and textiles from the more efficient suppliers in ASEAN, China, South Asia and other regions. By 2005, the total benefits to the European Community, the US and Canada are estimated at \$ 56 billion per year at 1992 prices. Income gains

of over \$ 13 billion are projected for highly competitive exporters such as China, Indonesia, Thailand and South Asian exporters, despite the loss of quota rents provided under the MFA. Some less competitive exporters will suffer from the loss of their preferential access to industrial country markets unless they are able to increase their efficiency, and some currently unrestricted importers will lose as the exports currently diverted toward them by restrictions elsewhere can flow freely to the other markets.

Check Your Progress:

1. What are the main principles of WTO?
2. State the objectives of WTO.
3. Explain the role of tariff in liberalization of trade in manufactures.
4. State how liberalization of trade in manufactures is achieved.

4.4 LIBERALIZATION OF AGRICULTURAL TRADE

As mentioned earlier, one of the salient features of the UR was the inclusion, for the first time, of agriculture in the MTN. The exclusion of agriculture from the previous rounds and its effective exemption from the GATT discipline made agriculture a highly protected sector in the developed countries. The depressing impact of this on world prices prevented efficient producers from realising the benefits of their comparative advantage. Developing country exports suffered a lot.

The important aspects of the UR Agreement on agriculture include.

1. Tariffication
2. Tariff binding
3. Tariff cuts
4. Reduction in subsidies and domestic support.

Tariffication and Tariff Cuts: Tariffication means the replacement of existing non-tariff restrictions on trade such as import quotas by such tariffs as would provide substantially the same level of protection.

From the first year of the Agreement's implementation, nearly all border protection is to be bound by tariffs, which (in principle) are to be no higher than the tariff equivalent of the protection levels prevailing in the base periods.

Industrial countries are then to reduce their tariff bindings by an average of 36 per cent within six years (from 1995) while all developing countries but the poorest are required to reduce tariffs by an average of 24 per cent over a period of ten years. Least developed countries are not required to make any commitment for reduction of tariffs on agricultural products.

On agricultural tariffs, developing countries have the flexibility of indicating maximum ceiling binding. India has indicated ceiling bindings of 100 per cent on primary products and 300 per cent on edible oils.

Subsidies and Domestic Support Policies: The UR Agreement deals with three categories of subsidies.

1. Prohibited subsidies: those contingent upon export performance or the use of domestic instead of imported goods.

2. Actionable subsidies: those that have demonstrably adverse effects on other member countries.

3. Non-actionable subsidies: including those provided (with stipulated limitations) to industrial research and procompetitive development activity to disadvantaged regions, or to existing facilities to adapt themselves to new environmental requirements.

The Agreement also puts restrictions on the use of countervailing measures against competitors' subsidies. To prevent undue hardships, developing countries and countries in transition from centrally planned to market economies are allowed extra time to bring the subsidies into conformity with the new rules.

While industrial economies are required to reduce, over six years, the volume of subsidised agricultural exports by at least 21 per cent and the value of subsidies at least by 36 per cent, the respective figures for developing countries are 14 per cent and 24 per cent. All countries are bound not to introduce new subsidies.

The UR agreement has brought the domestic support policies also under the multilateral trade discipline. However, domestic support measures that have almost a minimal impact on trade ("green box" policies) such as general government services in the areas of research, disease control, infrastructure and food security as also certain direct payments such as certain income support policies, structural adjustment assistance, payment under environmental programmes and regional assistance programmes are exempted. The non-exempted types of subsidies included in the aggregate measure of support (AMS) required to be reduced include assistance in the form of production-limiting subsidies and assistance given for growth of agriculture and rural development like procurement at support prices and subsidies on inputs and credit. However, even these subsidies are required to be reduced only if their total amount as a proportion of the value of agricultural production exceeds five percent in case of developed countries and 10 per cent in case of developing countries. If the non-exempted subsidies are above these limits, they are required to be reduced by 20 per

cent in case of developed countries and by 13.3 per cent in developing countries by 1999.

According to government of India, India's total AMS is negative (without taking into account exemptions available on input subsidies to low income and resource poor farmers) and there are no reduction commitments. Nor does India have any minimum market access commitments in agriculture, (the UR Agreement provides for the establishment of minimum access tariff quotas ,at reduced tariff rates, where the access is less than 3 per cent of the domestic consumption. The minimum access tariff quotas are to be expanded to five per cent over the implementation period).

Assistance for 'food security" such as the food subsidy under the public distribution system (PDS) will be exempted to the extent they confine to the poor.

Non-agricultural Export Subsidies: Countries whose per capita income is less than \$ 1000 is not bound to phase out export subsidies. (India's per capita income in 1994 was only \$ 310). However, even such countries will have to phase out export subsidies on products where the share in the world exports is 3.25 per cent or more in two consecutive years. This is applicable to India in respect of exports of diamonds.

4.5 LIBERALIZATION OF TRADE IN SERVICES

The General Agreement on Trade in Services (GATS) which extends multilateral rules and disciplines to services is regarded as a landmark achievement of the UR although it achieved only little in terms of immediate liberalisation.

Because of the special characteristics and the socio-economic and political implications of certain services, they have been generally subject to various types of national restrictions. Protective measures include visa requirements^ investment regulations, restrictions on repatriation, marketing regulations^ restrictions on employment of foreigners, compulsions to use local facilities etc. Heavily protected services in different countries include banking and insurance; transportation; television, radio, film and other forms of communication; and so on.

The GATS defines services as the supply of a service from the territory of one member (country) into the territory of any other member, in the territory of one member to the service consumer of any other member; by a service supplier of one member, through commercial presence in the territory of any other member; or by a service supplier of one member, through presence of natural persons of a member in the territory of any other member.

In short, the GATS covers four modes of international delivery of services.

1. Cross-border supply (transborder data flows, transportation services)

2. Commercial presence (provision of services abroad through FDI or representative offices).

3. Consumption abroad (tourism)

Movement of personnel (entry and temporary stay of foreign consultants)

Check Your Progress:

1. State the important aspects of the UR Agreement on agriculture.
2. State the categories of subsidies with which the UR Agreement deals.
3. State the four modes of international delivery of services.

4.6 CONTROVERSIES IN TRADE POLICY WITH ENVIRONMENT

4.6.1 Environmental Impacts of Trade

World trade expansion has raised the issue of the relationship between trade and the environment. Is trade good or bad for the environment? The answer is not obvious. The production of goods that are imported and exported, like other production, will often have environmental effects. But will these effects increase or decrease with expanded trade? Will they affect the exporting nation, the importing nation, or the world as a whole? And whose responsibility is it to respond to environmental problems associated with trade? Questions such as these have received increasing attention in recent years.

International attention was first focused on these issues in 1991, when the Mexican government challenged a United States law banning imports of tuna from Mexico. The U.S. Marine Mammal Protection Act prohibited tuna fishing methods that killed large numbers of dolphins, and banned tuna imports from countries that used such fishing methods. The Mexican government argued that this U.S. law was in violation of the rules of the General Agreement on Tariffs and Trade (GATT).

According to the free trade principles that provided the basis for GATT and for its successor, the World Trade Organization (WTO), countries cannot restrict imports except in very limited cases such as protection of the health and safety of their own citizens. A GATT dispute panel ruled that the U.S. could not use domestic legislation to protect dolphins outside its own territorial limits.

Although Mexico did not press for enforcement of this decision, the tuna/dolphin decision opened a major controversy over issues of trade and environment. In a similar case in 1999, the World Trade Organization ruled that the U.S. could not prohibit shrimp imports from countries using fishing methods that killed endangered sea turtles.

The implications of this and the earlier tuna/dolphin decision could affect many other international environmental issues, such as forest protection, ozone depletion, hazardous wastes, and global climate change. All these issues are linked to international trade.

To address these questions, we need to examine the theory and practice of international trade. Most economists believe that expanded trade is generally beneficial, promoting increased efficiency and greater wealth among trading nations. But what if expanded trade causes environmental damage?

At the national level, the standard economic policy response to environmental impacts is to implement policies that internalize externalities. At the international level, however, the picture is more confused. The burden of environmental externalities associated with trade may be borne by importers, exporters, or by others not directly involved in the production or consumption of traded goods. The authority to formulate and enforce environmental policies usually exists only at the national level. This can create significant problems when environmental impacts are transnational, since most international trade agreements do not include any provisions for environmental protection.

4.6.2 Environmental Agreements (MEAs)

It has long been recognized that some environmental problems require international solutions. The first international treaty dealing with trade and the environment was the Phylloxera agreement of 1878, which restricted trade in grapevines to prevent the spread of pests that damage vineyards. In 1906 an international convention was adopted banning the use of phosphorus in matches. Phosphorous was responsible for serious occupational disease among match workers, but it was the cheapest ingredient for matches. An international convention was required to prevent any exporting country from gaining competitive advantage by using phosphorus in match production.

Since then, numerous international treaties have been adopted to respond to specific environmental issues. These include conventions protecting fur seals, migratory birds, polar bears, whales, and endangered species. Transboundary and global environmental issues have been addressed in the Montreal Protocol on Substances that Deplete the Ozone Layer (1987), the Basel Convention on Hazardous Wastes (1989), the Antarctica Treaty (1991), and the Convention on Straddling and Highly Migratory Fish Stocks (1995). In 1997 the Kyoto Protocol on Climate Change established guidelines for reducing greenhouse gas emissions, including important trade-related

measures. These international treaties have addressed the environmental impacts of production methods in ways that individual nations cannot.

Serious questions remain, however, about the compatibility of MEAs with WTO rules. Which set of international agreements should take precedence in the case of a conflict? For example, the Kyoto Protocol encourages the subsidized transfer of energy efficient technology to developing nations – but this provision could be in violation of the WTO's prohibition of export subsidies. Whereas national laws such as the U.S. Marine Mammal Protection Act have been found incompatible with WTO rules, there has so far been no major test case involving conflict between an MEA and a trade agreement.

4.6.3 Strategies for Sustainable Trade

The emerging twenty-first century global economy will be characterized both by resource and environmental limits and by a much more important role for the presently developing nations. Expanded global trade will bring benefits in terms of increased efficiency, technology transfer, and the import and export of sustainably produced products. But we must also evaluate the effects of trade in terms of social and ecological impacts.

A World Bank review of trade and environment issues finds that many participants in the debate now agree that (a) more open trade improves growth and economic welfare, and (b) increased trade and growth without appropriate environmental policies in place may have unwanted effects on the environment. This implies that future trade agreements must take environmental sustainability more explicitly into account. Introducing sustainability into trade policy will require institutional changes at global, regional, and local levels.

4.6.4 “Greening” Global Environmental Organizations

At the global level, a major reform proposal would be to set up a World Environmental Organization (WEO) which would counterbalance the World Trade Organization (WTO) much as national environmental protection agencies balance departments of finance and commerce. This would create a global environmental advocacy organization, but might lead to conflict and deadlock with other transnational institutions. Another approach would be to "green" existing institutions, broadening the environmental and social provisions of GATT's Article XX, and altering the missions of the World Bank and International Monetary Fund to emphasize sustainable development objectives.

The idea of a World Environmental Organization may seem visionary, but there is a good argument for its establishment. According to Sir Leon Brittan, former Vice President of the European Commission: “Setting environmental standards within a territory may be fine, but what about damage that spills over national borders? In a rapidly globalizing world, more and more of these problems cannot be effectively solved at the national or bilateral level, or even at the level of regional trading blocs like the European Union. Global problems require global solutions.”

Local, Regional, and Private Sector Policies:

The trend towards globalization, which increasingly makes communities subject to the logic of the global marketplace, is in conflict with the goal of strengthening local and regional policies promoting sustainable development. Reserving powers of resource conservation and management to local and regional institutions is important to the sustainable management of resources. Also, it is often difficult to make a match between centralized World Bank or institutional financing, even if "greened", and the local institutions that are crucial to effective implementation of resource conservation and environmental standards. Most environmental policies are implemented at the national level, and it is important to maintain national authority to enforce environmental standards.

In regional groupings such as NAFTA, that involve no supranational rule-making body, trade agreements could give special status to national policies aimed at sustainable agriculture and resource management. NAFTA rules currently give precedence to international environmental treaties (the Basel Convention on hazardous wastes, the Montreal Protocol on ozone depleting substances, and CITES on endangered species). This principle could be expanded to all national environmental protection policies, and effective sanctions for environmental violations could be established.

In regional trade and customs unions such as the European Union where elected supranational policy-making bodies exist, these bodies must take responsibility for environmental and social issues to the extent that their legitimate democratic mandate allows. Transboundary issues are a logical area for supranational bodies to be responsible for environmental rule making. Where they are empowered to intervene in national policy-making, the process must be oriented towards "harmonizing up" rather than "harmonizing down" standards. This means that countries within the common market must retain the power to impose higher social and environmental standards where they see fit.

Certification and labelling requirements for sustainably produced products help consumers make informed purchasing decisions. Germany's "green dot" system has also set up certification systems for goods such as coffee and timber. To be effective in a globalized world, however, certification systems must be international. This requires support both at the national level and from corporations and international agencies.

In conclusion, achieving this goal will be a major challenge for trade negotiators at both regional and global levels for the foreseeable future.

4.7 CONTROVERSIES IN TRADE POLICY WITH LABOUR POLICY

4.7.1 Labour standards. In some extreme cases, such as the use of slave labour, restrictions on trade are usually considered permissible. But should countries be allowed to use trade restrictions to punish unfair labor practices? Some poorer countries have accused richer countries of imposing unreasonably high labor standards. Under

the pretext of trying to protect global workers, they say, the richer countries are just trying to protect their workers from fair competition.

At the 1996 Singapore Ministerial Conference, members defined the WTO's role on this issue, identifying the International Labour Organization (ILO) as the competent body to negotiate labour standards. There is no work on this subject in the WTO's Councils and Committees. However the secretariats of the two organizations work together on technical issues under the banner of "coherence" in global economic policy-making.

However, beyond that it is not easy for them to agree, and the question of international enforcement is a minefield.

The WTO agreements do not deal with labour standards as such.

On the one hand, some countries would like to change this. WTO rules and disciplines, they argue, would provide a powerful incentive for member nations to improve workplace conditions and "international coherence" (the phrase used to describe efforts to ensure policies move in the same direction).

On the other hand, many developing countries believe the issue has no place in the WTO framework. They argue that the campaign to bring labour issues into the WTO is actually a bid by industrial nations to undermine the comparative advantage of lower wage trading partners, and could undermine their ability to raise standards through economic development, particularly if it hampers their ability to trade. They also argue that proposed standards can be too high for them to meet at their level of development. These nations argue that efforts to bring labour standards into the arena of multilateral trade negotiations are little more than a smokescreen for protectionism.

At a more complex legal level is the question of the relationship between the International Labour Organization's standards and the WTO agreements — for example whether or how the ILO's standards can be applied in a way that is consistent with WTO rules.

In the WTO, the debate has been hard-fought, particularly in 1996 and 1999. It was at the 1996 Singapore conference that members agreed they were committed to recognized core labour standards, but these should not be used for protectionism. The economic advantage of low-wage countries should not be questioned, but the WTO and ILO secretariats would continue their existing collaboration, the declaration said. The concluding remarks of the chairman, Singapore's trade and industry minister, Mr Yeo Cheow Tong, added that the declaration does not put labour on the WTO's agenda. The countries concerned might continue their pressure for more work to be done in the WTO, but for the time being there are no committees or working parties dealing with the issue.

The issue was also raised at the Seattle Ministerial Conference in 1999, but with no agreement reached. The 2001 Doha Ministerial Conference reaffirmed the Singapore declaration on labour without any specific discussion.

This issue was also indirectly mentioned in the Appellate Body Report on the dispute initiated by India against the European Communities concerning the conditions for granting of tariff preferences to developing countries.

Check Your Progress:

1. What is Multilateral Environmental Agreement?
2. State the labour standards.

4.8 CONTROVERSIES IN TRADE POLICY WITH TRIPS

Trade-Related Aspects of Intellectual Property Rights (TRIPS) is arguably the most important and comprehensive international agreement on intellectual property rights. Member countries of the WTO are automatically bound by the agreement. The Agreement covers most forms of intellectual property including patents, copyright, trademarks, geographical indications, industrial designs, trade secrets, and exclusionary rights over new plant varieties.

4.8.1 Obligations under the TRIPS Agreement

The TRIPS agreement outlines several important trade related aspects of intellectual property. More specifically, it requires signatory countries to adhere to its criteria for intellectual property monopoly grants of limited duration, along with requiring adherence to the Paris Convention, Berne Convention and other WTO Conventions. The criteria are minimum standards for granting a monopoly over any type of IP, as well as duration limits, enforcement provisions and methods of IP dispute settlements.

When the TRIPS Agreement took effect on January 1, 1995, all developed countries were given twelve months from the date of signing the agreement to implement its provisions. Developing countries and transition economies (under certain conditions) were given five years, until 2000. Least developed countries (LDCs) were given 11 years, until 2006, to comply. Some countries have indicated that a longer period should obtain. For pharmaceutical patents in these LDCs, the term for compliance has been extended to 2016. There are currently 30 LDCs within the WTO organization bound by TRIPS and another 10 LDCs are waiting accession.

4.8.2 Controversial provisions in the TRIPS:

Some of the most important (and controversial) provisions in the TRIPS agreement concern patent protection. TRIPS signatories are obliged to make patents available for all inventions, whether products or processes, in all fields of technology without discrimination (Article 27.1). Interestingly, TRIPS does not define the term "invention". The agreement states three exceptions that countries may rely on to exclude otherwise patentable subject matter. These include:

1. inventions which are contrary to *ordre public* or morality, *i.e.* inventions which are dangerous to human, animal or plant life or health or seriously prejudicial to the environment. (Article 27.2)
2. diagnostic, therapeutic and surgical methods for the treatment of humans or animals (Article 27.3(a)).
3. plants and animals other than microorganisms and essentially biological processes for the production of plants or animals other than non-biological and microbiological processes. Any country excluding plant varieties from patent protection must provide an effective *sui generis* system of protection (Article 27.3 (b)).

The interpretation of this last clause has been extremely contentious. The term *sui generis* (Latin for 'of its own gender/genus') is not defined in the agreement, but it is generally believed that it enables member countries to fashion their own protection scheme for plants. Possible protection mechanisms include the Plant Breeder's Rights system offered by UPOV Convention, plant patents or a licensing regime. More than one form of plant protection can be implemented in a given member country.

4.8.3 Controversy surrounding Article 27.3

One of the controversies of **Article 27.3** focuses on the meaning of '*sui generis*' and exactly what is considered an 'effective' form of plant variety monopoly right. In part because of the difficulties with this provision, Article 27.3 was to be reviewed in 1999, four years after the entry into force of the agreement. The review has never been completed, and this Article remains a hot issue. To date, some 30 countries are calling for further discussion on Article 27.3, and some have proposed:

1. rewriting the Article to exclude patents for any organisms or genetic material (although ostensibly countries could achieve this by defining these subject matters as "discoveries" and not "inventions");
2. defining in detail what an effective plant variety development right system is;
3. extending exclusionary rights of some sort to traditional or indigenous knowledge; and
4. making explicit linkages with obligations for the conservation and use of biodiversity, including mandatory disclosure of the source of genetic materials

used in a patented invention, and creating obligations to record arrangements for access to genetic resources as evidence of prior informed consent.

It remains to be seen whether any of these proposals will be adopted.

4.8.4 Patentee Rights, Term of Protection and Enforcement Rights

The rights obtainable by patentees are clearly outlined in **Article 28**. The Article also provides that rights are conferred for products which are directly obtained by a patented process or method.

EXAMPLE: If a patent is issued for a novel method of manufacturing snow skis, the skis produced will also be protected by the patent.

The TRIPS agreement provides that inventions must be disclosed by publication (Article 29) and sets out a minimum term of 20 years for patent protection. The 20 year term is calculated from the filing date (Article 33). Although a patent term begins at filing, enforcement rights only ensue from the date of patent grant.

TRIPS also provides rules regarding domestic procedures and remedies for the enforcement of intellectual property rights. The rules are general principles applicable to all enforcement procedures, *i.e.* they contain provisions on civil and administrative procedures and appropriate remedies so that right holders, be they patentees, copyright owners or other intellectual property owners, can effectively enforce their rights.

4.8.5 Effects of TRIPS and the Resulting Controversies

One of the effects of the TRIPS agreement has been to tie trade and intellectual property together. Traditionally, developing countries have opposed the range of nontariff barriers, such as the protection of inventions, which they see as preventing them from trading competitively throughout the rest of the world. Controversy has arisen over perceptions of inconsistency between the TRIPS Agreement and other international agreements, such as the Convention on Biological Diversity. There have also been suggestions, for example, that patenting restricts the availability of the latest chemicals, pharmaceuticals and fertilizers, thereby necessitating the use of older, less-safe and more toxic products. There have been reports that intellectual property rights on plant varieties erode biological diversity, especially in agriculture. Some countries are also demanding that the existing intellectual property system should accommodate concepts traditionally outside of the scope of intellectual property, for example indigenous and traditional knowledge.

The examples above highlight some of the issues surrounding the TRIPS agreement which are the subject of much international debate.

Some nine years after TRIPS was first implemented, its provisions are still in a state of review and alteration. For individual country positions on TRIPS see Grain's TRIPS Review pages. Grain is an international non-governmental organisation which promotes the sustainable management and use of agricultural biodiversity based on people's control over genetic resources and local knowledge.

Article 27 Patentable Subject Matter

Members may also exclude from patentability:

(b) Plants and animals other than microorganisms, and essentially biological processes for the production of plants or animals other than non-biological and microbiological processes. However, Members shall provide for the protection of plant varieties either by patents or by an effective *sui generis* system or by any combination thereof. The provisions of this subparagraph shall be reviewed four years after the date of entry into force of the WTO Agreement.

Article 28 Rights Conferred

1. A patent shall confer on its owner the following exclusive rights:

(a) where the subject matter of a patent is a **product**, to **prevent** third parties not having the owner's consent from the acts of: **making, using, offering for sale, selling, or importing for these purposes that product**;

(b) where the subject matter of a patent is a **process**, to **prevent** third parties not having the owner's consent from the act of **using the process**, and from the acts of: **using, offering for sale, selling, or importing for these purposes at least the product obtained directly by that process**.

2. Patent owners shall also have the right to assign, or transfer by succession, the patent and to conclude licensing contracts.

4.9 DISPUTE SETTLEMENT BODY

Dispute settlement is the central pillar of the multilateral trading system, and the WTO's unique contribution to the stability of the global economy. Without a means of settling disputes, the rules-based system would be less effective because the rules could not be enforced. The WTO's procedure underscores the rule of law, and it makes the trading system more secure and predictable. The system is based on clearly-defined rules, with timetables for completing a case. First rulings are made by a panel and endorsed (or rejected) by the WTO's full membership. Appeals based on points of law are possible.

However, the point is not to pass judgement. The priority is to settle disputes, through consultations if possible. By July 2005, only about 130 of the nearly 332 cases had reached the full panel process. Most of the rest have either been notified as settled "out of court" or remain in a prolonged consultation phase — some since 1995

Disputes in the WTO are essentially about broken promises. WTO members have agreed that if they believe fellow-members are violating trade rules, they will use the multilateral system of settling disputes instead of taking action unilaterally. That means abiding by the agreed procedures, and respecting judgements.

A dispute arises when one country adopts a trade policy measure or takes some action that one or more fellow-WTO members considers to be breaking the WTO

agreements, or to be a failure to live up to obligations. A third group of countries can declare that they have an interest in the case and enjoy some rights.

A procedure for settling disputes existed under the old GATT, but it had no fixed timetables, rulings were easier to block, and many cases dragged on for a long time inconclusively. The Uruguay Round agreement introduced a more structured process with more clearly defined stages in the procedure. It introduced greater discipline for the length of time a case should take to be settled, with flexible deadlines set in various stages of the procedure. The agreement emphasizes that prompt settlement is essential if the WTO is to function effectively. It sets out in considerable detail the procedures and the timetable to be followed in resolving disputes. If a case runs its full course to a first ruling, it should not normally take more than about one year — 15 months if the case is appealed. The agreed time limits are flexible, and if the case is considered urgent (e.g. if perishable goods are involved), it is accelerated as much as possible.

The Uruguay Round agreement also made it impossible for the country losing a case to block the adoption of the ruling. Under the previous GATT procedure, rulings could only be adopted by consensus, meaning that a single objection could block the ruling. Now, rulings are automatically adopted unless there is a consensus to reject a ruling — any country wanting to block a ruling has to persuade all other WTO members (including its adversary in the case) to share its view.

Although much of the procedure does resemble a court or tribunal, the preferred solution is for the countries concerned to discuss their problems and settle the dispute by themselves. The first stage is therefore consultations between the governments concerned, and even when the case has progressed to other stages, consultation and mediation are still always possible.

4.9.1 How long to settle a dispute?

These approximate periods for each stage of a dispute settlement procedure are target figures — the agreement is flexible. In addition, the countries can settle their dispute themselves at any stage. Totals are also approximate.

60 days	Consultations, mediation, etc
45 days	Panel set up and panellists appointed
6 months	Final panel report to parties
3 weeks	Final panel report to WTO members
60 days	Dispute Settlement Body adopts report (if no appeal)
Total = 1 year	(without appeal)
60-90 days	Appeals report
30 days	Dispute Settlement Body adopts appeals report
Total = 1yr 3m	(with appeal)

4.9.2 Procedure to settle dispute:

Settling disputes is the responsibility of the Dispute Settlement Body (the General Council in another guise), which consists of all WTO members. The Dispute Settlement Body has the sole authority to establish “panels” of experts to consider the case, and to accept or reject the panels’ findings or the results of an appeal. It monitors the implementation of the rulings and recommendations, and has the power to authorize retaliation when a country does not comply with a ruling.

First stage: consultation (up to **60 days**). Before taking any other actions the countries in dispute have to talk to each other to see if they can settle their differences by themselves. If that fails, they can also ask the WTO director-general to mediate or try to help in any other way.

Second stage: the panel (up to **45 days** for a panel to be appointed, plus 6 months for the panel to conclude). If consultations fail, the complaining country can ask for a panel to be appointed. The country “in the dock” can block the creation of a panel once, but when the Dispute Settlement Body meets for a second time, the appointment can no longer be blocked (unless there is a consensus against appointing the panel).

Officially, the panel is helping the Dispute Settlement Body make rulings or recommendations. But because the panel’s report can only be rejected by consensus in the Dispute Settlement Body, its conclusions are difficult to overturn. The panel’s findings have to be based on the agreements cited.

The panel’s final report should normally be given to the parties to the dispute within six months. In cases of urgency, including those concerning perishable goods, the deadline is shortened to three months.

The agreement describes in some detail how the panels are to work. The main stages are:

Before the first hearing: each side in the dispute presents its case in writing to the panel.

First hearing: the case for the complaining country and defence: the complaining country (or countries), the responding country, and those that have announced they have an interest in the dispute, make their case at the panel’s first hearing.

Rebuttals: the countries involved submit written rebuttals and present oral arguments at the panel’s second meeting.

Experts: if one side raises scientific or other technical matters, the panel may consult experts or appoint an expert review group to prepare an advisory report.

First draft: the panel submits the descriptive (factual and argument) sections of its report to the two sides, giving them two weeks to comment. This report does not include findings and conclusions.

Interim report: The panel then submits an interim report, including its findings and conclusions, to the two sides, giving them one week to ask for a review.

Review: The period of review must not exceed two weeks. During that time, the panel may hold additional meetings with the two sides.

Final report: A final report is submitted to the two sides and three weeks later, it is circulated to all WTO members. If the panel decides that the disputed trade measure does break a WTO agreement or an obligation, it recommends that the measure be made to conform with WTO rules. The panel may suggest how this could be done.

The report becomes a ruling: The report becomes the Dispute Settlement Body's ruling or recommendation within 60 days unless a consensus rejects it. Both sides can appeal the report (and in some cases both sides do).

Check Your Progress:

- 1. What are the obligations under the TRIPs Agreement?
- 2. What are objectives of the Dispute Settlement Body of WTO?
- 3. State the approximate period for each stage to settle a dispute.

4.10 SUMMARY

- 1. Trade liberalization refers to the removal of government incentives and restrictions from trade between nations.
- 2. The World Trade Organization (**WTO**) was founded in 1995 by the members of the General Agreement on Tariffs and Trade (GATT). The WTO was founded with the purpose of liberalizing international trade. Its aim was to help member nations reach cordial solutions to their trade-related problems.

3. The major liberalisation in respect of trade in manufactures, regarding tariffs, are: Expansion of tariff bindings, Reduction in the tariff rates, Expansion of duty-free access.
4. In the areas of NTBs, the Agreements to abolish Voluntary Export Restraints (VERs) and phase out the multifibre Arrangements (MFA) are regarded as landmark achievements for developing countries.
5. The important aspects of the UR Agreement on agriculture include : tariffication, tariff binding, tariff cuts and reduction in subsidies and domestic support.
6. The GATS covers four modes of international delivery of services: cross border supply, commercial presence, consumption abroad, movement of personnel.
7. Trade-Related Aspects of Intellectual Property Rights (TRIPS) is the most important and comprehensive international agreement on intellectual property rights. The Agreement covers most forms of intellectual property including patents, copyright, trademarks, geographical indications, industrial designs, trade secrets, and exclusionary rights over new plant varieties.
8. Dispute settlement is the central pillar of the multilateral trading system and the WTO's unique contribution to the stability of the global economy. WTO members have agreed that if they believe a fellow-members are violating trade rules, they will use the multilateral system of settling disputes instead of taking action unilaterally. That means abiding by the agreed procedures, and respecting judgements.

4.11 QUESTIONS

1. Discuss the role of WTO in liberalisation of trade between v member countries.
2. Discuss the role of tariff and Non-tariff barriers in liberalisation of trade in manufactures.
3. Explain in detail the important aspects of the UR Agreement on agriculture.
4. Write a note on liberalisation of trade in Services.
5. Discuss the environmental impacts of trade.
6. Explain the strategies for Sustainable Trade.
7. Explain the role of WTO in labour standards.
8. Describe the controversial provisions in the TRIPs.
9. Write a note on Dispute Settlement Body of WTO.
10. Explain the procedure to settle a dispute.



DISPUTE REDRESSAL MECHANISM

Unit Structure:

- 5.0 Objectives
- 5.1 Introduction and provision for Dispute Settlement Mechanism in GATT and WTO
- 5.2 Dispute Settlement Procedure
- 5.3 Dispute Settlement Mechanism
- 5.4 Critical Appraisal of WTO
- 5.5 Summary
- 5.6 Questions

5.0 OBJECTIVES

- i) To know the dispute settlement mechanism of WTO.
- ii) To know the dispute settlement procedure of WTO.
- iii) To know the structural design of WTO dispute settlement system.
- iv) To know how the developing countries have been integrated in the WTO dispute settlement system.
- v) To describe the WTO dispute settlement system from the perspective of developing countries.
- vi) To know whether the developing countries could make use of the WTO dispute settlement system more effectively.
- vii) To study the critical appraisal of WTO

5.1 INTRODUCTION OF DISPUTE SETTLEMENT MECHANISM:

The main task of the GATT, 1947 settlement of dispute was the reduction of tariffs in the various rounds of tariff negotiations. The contracting parties were under the obligation to observe whatever commitments they had made under the GATT agreement. The Article X of GATT conceived an important obligation towards achieving the obligations by mandating that the contracting parties must publish laws & regulations in such a manner that the Governments and traders are acquired with them.

Articles XXII and XXIII have been described as conceiving formal mechanism of settlement of disputes. Article XXII concerns with the consultation and obtains that every contracting party shall accord sympathetic consideration to and shall afford adequate opportunity for consultation as may be made by another contracting party with respect to any matter affecting the operation of GATT. The contracting parties may at the request of a contracting party consult with any contracting party or parties in respect of any matter for which it has not been possible to find a satisfactory solution through consultation. Article XXIII not only provides last resort in any dispute but its range defines the scope of all the substantial provisions of the GATT. Article XXIII has been incorporated in various WTO agreements, as a standard for dispute settlement.

In 1964, Part IV was added to the GATT 1947 in terms of Articles XXXVI, XXXVII and XXVIII. It was an attempt to give legal recognition to the special status of the developing countries in GATT. It was the first step towards providing some dispute settlement mechanism for developing countries. In 1966, certain procedures were incorporated in Article XXIII of GATT for settlement of disputes in keeping in view the special needs of the developing countries by providing

- a) utilization of the good offices of the Director General when the bilateral negotiations fail.
- b) time frame to establish panel, submit its report and comply with its decision and
- c) the provision for suspension of concessions in case of non-compliance with the recommendation.

In 1979 after the Tokyo Round of Tariff Negotiations, understanding Regarding Negotiation, consultation, Dispute settlement and Surveillance set out the commitment of contracting parties to notify such measures to the maximum extent possible notwithstanding whether those measures are consistent with the rights and obligations of the contrasting parties under the GATT. From the point of view of the developing countries, the 1979 understanding didn't yield much to the developing countries except to conduct a regular and systematic review of the developments in the trading system with regard to matters affecting the interests of developing countries and recognized the need for appointing a panelist from developing countries when the dispute was between the developed and the developing member country.

With the establishment of WTO the dispute settlement mechanism in the realm of international trade has become not only rule oriented but also more innovative with the entry into fare of the understanding of Rules and Procedures governing Disputes.

In the overall structural design of he WTO dispute settlement system, it is important to understand that there is a need for positive efforts to ensure that the developing countries especially the least developed among them should seems a share in the growth of international trade. It is all the more important to know how the

developing countries have been integrated in the WTO dispute settlement system. Accordingly it is designed to describe the dispute settlement system from the perspective of developing countries. Secondly we would like to know whether the developing countries could make use of the WTO Dispute Settlement System more effectively. Finally we are interested in knowing whether the WTO will succeed in injuring confidence in the developing countries in the WTO's Dispute Settlement System.

5.1.1 CONCEPT:-

The dispute redressal mechanism of WTO is a device to listen to the complaints from the member countries about the violation of the WTO rules, regulations and agreements and setting up of a panel of independent experts to look into the arguments of both the sides and to rule whether the rules, regulations and agreements of WTO have been broken or not. There is also an Appellate body which hears appeals against panel findings. It's rulings are sent back to the Dispute settlement body (DSB) which takes a consensus decision to adopt them.

5.2 DISPUTE SETTLEMENT PROCEDURE

Following is the dispute settlement procedure as given by Harin Wardha in his book "WTO & Third World Trade challenges" published by commonwealth publishers.

The WTO essentially is geared for the development of a rule of law whose main purpose should be liberalization of trade and non discrimination of member states. The WTO and its robust dispute settlement mechanism and surveillance are binding on all member states. The richness and revolutionary character of WTO can be catalogued as under:-

- i) WTO is now established as a permanent international institutions headed by a Director-General of a stature equivalent to the Heads of IMF and IBRD and similarly endured with an independent * and a regular ministerial level conference to provide policy directions.
- ii) The patchwork of previous GATT obligations has been replaced with an integrated, single undertaking that applies to all the member countries of WTO. Obligations covering the full array of GATT disciplines have been substantially depend through a series of binding agreements and understandings.
- iii) GATT-like principles, rules and procedures have been extended to cover trade in services and the protection of intellectual property, while disciplines to govern trade in agriculture and trade in textiles and clothing have been strengthened an integrated.

- iv) The trade and trade related policies of WTO members are steadily converging, providing Trader and investors with increasing stability and confidence in their ability to do business on a global basis.
- v) Special and differential treatment for developing countries has been curtailed as a permanent feature of international trade obligations, instead there is a growing recognition by developed and developing countries need to be full and active members of WTO with no more than time limited departures and technical assistance programmers making the difference them and the developed member countries.
- vi) The protocol of provisional applications for 23 original members, and its echo is the protocol of subsequent members have disappeared. Instead each member has accepted the positive obligation to ensure the formality of its laws, regulations and administrative procedures with its obligations as provided in the annexed agreements.
- vii) Members have agreed to subject their trade laws, policies and practices to periodic public scrutiny and review.
- viii) It is now possible to foresee WTO members gradually developing a seamless code of conduct governing the full contestability of global markets.

5.3 DISPUTE SETTLEMENT MECHANISM:

The understanding on dispute settlement embeds a member critically important principles and procedures in the WTO besides formally accepting adherence to Articles XXII and XXIII of the GATT, 1947. The understanding on Rules and Procedures Governing the settlement of Disputes, 1994 (DSU) came into being only after the WTO Agreement came into force. The rules and procedures of DSU are applicable to the Agreements establishing the WTO; Agreement on Trade in Goods; Agreements on Trade in Services (GATS); Agreements on Trade Related Aspects of Intellectual Property Rights (TRIPs) and Dispute Settlement Understanding (DSU). DSU shall also apply to Agreement on Trade in Civil Aircraft; Agreement on Government Procurement; International Dairy Agreement; and Arrangement Regarding Bovine meat provided the signatories to each Agreement decide for accepting the terms of the DSU application.

The rules of DSU with special modification have been applicable to other Agreements such as Anti-dumping; Technical Barriers to Trade; Subsidies and Countervailing Measures; Customs Valuation; Sanitary and Phytosanitary Regulations; Textiles; General Agreement on Trade in Services (GATS) Financial services; Air Transport services; and Ministerial Decisions on services Disputes.

The main features of WTO Dispute settlement can broadly be characterized as:-

- i) the right of every member to have its complaint addressed by a panel experts;
- ii) the promise that panel will act expeditiously and independently on the basis of clear rules and procedures;

- iii) the commitment that the panel reports will be adopted by the WTO unless and objecting member can successfully organize a consensus to block adoption.
- iv) the right to have decisions and reasoning of panels subjected to review by a permanent appellate body;
- v) the obligations of members to implement adopted panel findings by taking action to remove the basis of complaint.
- vi) the confidence that panels will have the assistance of a qualified, capable, independent group of officials with legal training in analyzing the issues and reaching decisions.
- vii) the promise that decisions will accumulate into a body of precedent that will further strengthen the rule of law in international trade and trade related activities.

Dispute settlement procedure in Article 64 adopts the machinery provided by the WTO. Article XXII and XXIII of the GATT as elaborated and applied by Dispute settlement. Understanding shall apply to consultations and settlement of disputes. When benefits are nullified by a measure which does not conflict with any of the provisions of the TRIPs agreement or existence of any other situation for a period of five years Article XXIII cannot be invoked. Under Article 64(3) a consensual decision is possible to be taken in such situations.

5.3.1 THE DSU PROCESS

Dispute settlement mechanism ensures respect for negotiated rules. The new binding set of WTO rules on dispute settlement, the semi automatic character of the process and the threat of economic sanctions facing a member not fulfilling its obligations, have led some authors to lable the dispute settlement rules of the WTO as the “Jewel” of the WTO crown or the “Teeth” of the system. The panel of the Appellate Body are, expressly prohibited from adding rights and obligations when adjudicating on disputes, interpretation of WTO agreement is a necessary component of the dispute settlement process.

The rules of the dispute settlement mechanism are initiated by WTO, Members and the DSU is administered by the DSB, servings as the Parliament of Members for deliberations on disputes. A dispute settlement procedure is initiated with a request for consultation by a member, or group thereof, claiming that benefits under any of the covered WTO agreements are being nullified or impaired by the failure of another member, or group thereof, to carry out obligations under the agreement(s). If the complaining country pushes the process further, the DSU provides for a set of steps in the dispute settlement that occur almost automatically. Actions by the DSB are necessary for some of these steps to occur. However, the DSU is drafted so that the members of the DSB must approve or authorize any action requested by one member unless, by concensus, all members decide not to. All members present, including most importantly the Member which has interest in pursuing the process, must agree to stop

the process. Therefore, the process is in the hands of complaining party or parties. Even surveillance and compliance with the Panel and Appellate Body reports are in the hand of the members themselves.

The formal participation of non – members in the dispute settlement process is limited. The Appellate Body reiterated that only members can initiate dispute settlement procedures. However, panels are authorized to obtain information from any source, as is highlighted by Article 13 of the DSU.

- 1) Each Panel shall have the right to seek information and technical advice from any individual or body which it deems appropriate. However, before a panel seeks such information or advice from any individual or body within the jurisdiction of a member it shall inform the authorities of that member. A member should respond promptly and full to any request by a Panel for such information as the Panel considers necessary and appropriate. Confidential information which is provided shall not be revealed without formal authorization from the individual body or authorities of the member providing the information.
- 2) Panels may seek information from any relevant source and may consult experts to obtain their opinion on certain aspects of the matter. With respect to a factual issue concerning a scientific or other technical matter raised by a party to a dispute, a panel may request an advisory report in writing from an expert review group. The NGOs have got opportunities to influence and participate in the dispute settlement process. Various agreements such as Anti-dumping, the SEM, the safeguard and the TRIPs Agreements, provide for rights in favor of individuals and non-governmental bodies affected by measures adopted pursuant to these agreements. Such agreements oblige WTO members to have dispute settlement and other forms of mechanisms in place domestically to assess the legal value of the rights of such interested party or parties.

An important feature of the GATT has always been to ensure that contracting parties maintain an independent domestic system to review decisions by customs authorities regarding customs matters.

Under the WTO this obligation has evolved to take into account the rights of interested parties other than those of member governments.

The WTO is a forum for Governments. The non governmental interest groups do not participate directly in the negotiation process. However, non-governmental groups do exercise influence on WTO procedures and policies through their lobbying efforts and activities at the domestic level. Charnovitz and Esty have compiled a long list of international bodies that pursue consultations with non governmental entities at the international level. In order to permit the formal participation of non-members at the international level of the WTO, or permit them to attend any of the meetings, consensus on this matter would have to be reached.

Check Your Progress:

1. Explain the provision for Dispute Settlement Mechanism in GATT and WTO.
2. Discuss the working of the Dispute Settlement Mechanism.

5.4 CRITICAL APPRAISAL OF WTO :

The Uruguay Round was by far the most complex and controversial one. It took more than seven years to complete the negotiations. It is the inclusion of new areas like TRIPs, TRIMs, services and attempts to liberalise agricultural trade and elimination of NTBs like MFA that increased the complexity of the negotiations.

The success of the Uruguay Round (UR) agreement will depend upon the spirit with which it will be translated into practice. The tariffication of trade barriers was claimed to be a significant success of the UR. However, because of the way NTBs were converted into tariffs, the so called dirty tariffication, many of the tariff bindings exceeded the protection rate applying during the base period, some by as much as 200 percent.

Several estimates of the gains from the UR Agreement are available. They vary widely. According to some estimates the real world income will increase by between \$212 billion and \$274 billion in 2005. Further, such annual increases will follow. This amounts to around one percent of World GDP. According to a GATT study the gain will be as much as \$510 billion.

Most of the gains will accrue to the developed countries. Some developing countries in the in the category of least developed countries and net food importers are expected to lose because of the Uruguay Round package.

According to some estimates the increase in real income will be roughly 1.6 percent of GDP for the European Union, 0.2 percent for the U.S. and 0.9 for Japan. As a single country, the largest gain in absolute terms will accrue to the US. It will be between \$27 and \$42 billion for Japan, between \$61 and \$98 billion for the EU and between \$36 and \$78 billion for the developing countries. The gains would amount to about 2.5 percent of the GDP of China, 0.5 percent for India, 0.6 percent for South Africa and 0.3 percent for Brazil.

UR Agreement and Developing countries: As in the case of the previous rounds, the developing countries, in general, are dissatisfied with the outcome of the Uruguay

Round. The Wall Street Journal has reported that while the US and the EC are getting the best pieces of the world trade pie, the developing countries are getting the crumbs.

Some of the areas like TRIPs, TRIMs and services have been very sensitive as far as the developing countries are concerned as the Uruguay Round Agreements in them mean that the developing countries will have to lower the protection against competition from the unequal developed economies. However, as in the previous Rounds, the UR also gives special considerations to developing countries, particularly to the least developed countries and to those with balance of payments problems. The Agreement, however, lays down that member countries imposing trade restrictions for balance of payment purposes should do so in a way that causes minimum disruption to international trade and quantitative restrictions should be avoided as far as possible.

Indeed, it would be the developed countries who would suffer most by liberalization of the agricultural sector. But to argue that the developed countries should completely liberalise agriculture without any reciprocity on part of the developing countries is clearly illogical. As a matter of fact, the U proposals in respect of agriculture, as in several other cases, give special consideration to the developing countries. Developed countries will, however, be hit hard.

While the liberalization of agricultural trade and the increase in agricultural prices due to cut in producer subsidy in the developed countries would benefit agricultural exporters, the increase in food prices due to cut in subsidies may adversely affect the food importers. More than 100 of the developing nations are reported to be net food importers. However, the increase in food prices should be expected to make food production in these countries more competitive leading to an increase in production. It has been alleged that the subsidization of production and export of farm production in the developed countries would have the effect of discouraging their production in the developing countries where farmers have not been able to compete with the imported stuff bearing artificially low price because of the subsidies.

One of the major areas of disappointment for many developing countries is trade in textiles. Textiles is one of their most important export items but developed countries have been following a very restrictive import policy. The developing countries wanted a fast phasing out of the Multi-fibre Arrangement (MFA) under which the textile imports have been restricted. However, the MFA will be phased out, in stages, over a 10 year period and a major part of the liberalization will take place only towards the end of the transitional period. A little consolation for the developing countries is that the US demand for extending the phase out period to 15 years was not accepted.

International trade in textiles is estimated to be worth \$240 billion a year. Estimates are that after the phasing out of MFA, world exports of textiles may go up by \$25 billion a year. With a 2.2 percent share in the world textile trade, India's share in the additional exports could be \$0.55 billion. But the real gain will depend on the country's ability to

compete with countries like China, Hong Kong, Taiwan, South Korea, etc. which are considered leaders in the textile trade.

Developing countries were very apprehensive about the proposal to liberalise trade in services. However, fortunately for them, the differences of opinion between the US and EC on this issue left the services sector largely unaffected.

The effect of the UR is not the same on all countries. The extent of the favourable or unfavourable impact may also vary. It is, therefore, quite natural that conflicts of interest have occurred both among developed and developing countries. Latin American countries were perhaps not very interested in liberalizing the trade in textiles because they calculated that if they could gain a direct entry to the NAFTA through some regional arrangement, it would provide them an edge over competitors like India and Pakistan.

Some studies also show that sub-Saharan Africa, Indonesia and some Caribbean islands will be poorer as a result of the UR Agreement. However if liberalization leads to higher productivity, they would also gain.

One of the achievements of the UR is the making of the rules and regulations more transparent, thus making trade harassment and unilateral actions more difficult. The results of the UR will be implemented by the newly set up World Trading Organisation making dispute settlement and arbitration easier.

UR Agreement and India: The UR Round Agreements have come in for scathing criticisms in India. Many politicians and others have argued that India should withdraw from the GATT. Most of the criticisms are either baseless or due to lack of knowledge of the international trading environment, and misinformation, or just meant to oppose the government by the opposing parties.

It is true that the Round mostly benefits the developed countries. That does not mean that developing countries like India are losing – only that their gain is limited as compared to that of the developed countries.

Accepting the demand of some of the critics, that India should withdraw from the WTO will be a great blunder that the nation can commit. By being a part of WTO India enjoys the most favoured nation (MFN) status with all the other members of the WTO. Opting out the system would mean an infinitely laborious task of entering into bilateral negotiations with each and every one of the trading partners.

One major controversy of GATT is the agricultural subsidies. However, GATT decision would not adversely affect India's agricultural subsidies and its agricultural exports. Other developing countries would also largely benefit because of the lowering of the agricultural protection by the developed countries, in spite of the fact that the wish of the

developing countries that the major Western nations would totally drop subsidies for their producers, substantially lower tariffs, and open markets did not materialize.

According to Government of India, the market Access Agreements signed by India with the USA and EU will result in additional export earnings of around Rs. 1,100 crores in the initial years and the additional access achieved will get magnified in the second and third phase of integration of the textiles trade with the multinational trade system and will provide larger earnings during these periods.

Assuming that India's market share in world export improves to one percent, and that it is able to take advantage of the opportunities that are created, the trade gains may consequently be placed at \$2.7 billion exports per year.

However, India's gain will be much less than these of several other developing countries like China and the newly industrialized economies because: i) India's share in the world trade is very low; ii) the foreign trade-GDP ratio of India is low. The gain will also depend on the rate of growth of India's exports.

5.5 SUMMARY

1. Dispute settlement is the sine-qua-non of the multilateral trading system of W. T. O.
2. It paves the way for bringing about stability to multilateral trading system.
3. Trade dispute arises when member countries of WTP break their promises and the rules and regulations of W. T. O.
4. Therefore the problem of settling the dispute arises.
5. The GATT had some procedure for settling the trade disputes but it had no fixed time table.
6. A more systematic process of settling the trade disputes was introduced at the Uruguay Round Agreement.
7. As per the provisions of W. T. O. the dispute settlement is the responsibility of the Dispute Settlement Body.
8. The Dispute Settlement Body of WTO is the General Council.
9. The General Council of W. T O has the sole authority to set panel of experts to go through the trade dispute cases.
10. It has also an authority to accept or to reject the findings of the panel.
11. The dispute settlement case should not normally take more than one year.
12. If the case is very urgent then the case should be settled within three months (in case of perishable goods)
13. There is a provision of appeal. In case of appeal the case takes maximum 15 months to settle.

14. The WTO has a permanent Appellate Body comprising of seven members which is appointed by the Dispute Settlement Body ie the General Council of WTO. The members have got four years term.
15. The Appellate Body can uphold, modify or reverse the findings of the panels.
16. The Dispute Settlement Body has to accept or reject the decision taken by the Appellate Body within 30 days.
17. The very first stage of dispute settlement is consultation among both the parties.
18. The second stage in the setting up of Panel when consultation fails.
19. The Panel may hold meetings of the two sides.
20. After three weeks the final report is submitted to the two parties and also to the members of the WTO.
21. The Report becomes the Ruling.
22. Both the sides can appeal.
23. The Dispute Settlement Mechanism entails very high cost which is not permissible to the underdeveloped countries.
24. The Uruguay Round took more than seven years to complete the negotiations. It includes the new areas like TRIPs, TRIMs, services and attempts to liberalise agricultural trade and elimination of NTBs like MFA.
25. The gains and the loss to the member countries from WTO may vary widely but most of the developed countries gain a lot from WTO.

5.6 QUESTIONS

1. Examine the Dispute Settlement Mechanism of W. T. O.
2. Explain the procedure of Dispute Settlement Mechanism.
3. Explain the impact of WTO on member countries.



Module 4**BALANCE OF PAYMENTS ADJUSTMENT****Unit Structure :**

6.0 Objectives

6.1 Introduction of Foreign Trade Multiplier

6.2 Income determination in a multiplier in a closed economy

6.3 Foreign Trade multiplier in an open economy

6.4 Foreign Repercussion

6.5 Introduction of the concepts External and Internal balance and Role of Monetary and Fiscal Policy

6.6 Expenditure Changing policies

6.7 Expenditure Switching policy

6.8 Introduction of Policy Mix

6.9 A case for Monetary and Fiscal Policy Mix

6.10 Meade's Model

6.11 Mundell's Model

6.12 Mundell-Flemming Model

6.13 Summary

6.14 Questions

6.0 OBJECTIVES

1. To understand the concept of Foreign Trade Multiplier
2. To know the income generation process through multiplier in a closed economy.
3. To know the income generation process through the foreign trade multiplier in an open economy.
4. To study the rate of foreign repercussions on the income generation process through the foreign trade multiplier in an open economy.

5. To understand the concept of External and International balance and Role of Monetary and Fiscal Policy
6. To study Expenditure Changing Policy
7. To study the Expenditure Switching Policy
8. To understand the concept of Policy Mix
9. To study Monetary and Fiscal Policy Mix
10. To study Meade's Model
11. To study Mundell's Model
12. To study Mundell and Flemming Model

6.1 INTRODUCTION OF FOREIGN TRADE MULTIPLIER:

The original idea of multiplier was given by R. F. Kahn, this multiplier was Employment Multiplier. The Employment Multiplier studies the effect of changes in employment on changes in income as per which the changes in income happens to be greater than the initial change in employment. It works through employment multiplier.

Algebraically,

$$\Delta Y = k_e \cdot \Delta E$$

ΔY stands for change in income. k_e stands for Employment Multiplier ΔE stands for initial change in Employment.

Lord J. M. Keynes borrowed the idea of his Investment Multiplier from R. F. Kahn's Employment Multiplier. The Post-Keynesian economists extended the Keynes's multiplier meant for closed economy to foreign trade multiplier meant for an open economy.

The Concept of foreign trade multiplier was given by Mr. Leighton.

6.2 INCOME DETERMINATION IN A MULTIPLIER IN A CLOSED ECONOMY :

In a closed economy the total national income is equal to the sum total of private spending ie $C + I$ and the Government Spending i.e. G . When national income is looked at from the angle of total expenditure, it represents the expenditure side of the total national income of the country.

Algebraically,

$$Y = C + I + G$$

Y stands for total national income. C Stands for total Consumption expenditure. I stands for total investment expenditure. G stands for Governmental expenditure.

Since Government doesn't strictly follow the rules of economics its role gets omitted. Hence in a closed economy the total national income will be equal to the sum of consumption and investment expenditure.

Algebraically,

$$Y = C + I$$

$$C = f(Y)$$

Since consumption is an indigenous variable it depends upon total national income. As income rises consumption rises too but it rises at a diminishing rate

$$I \neq f(Y)$$

Since Investment is an exogenous variable it is not a function of total national income.

$$Y = C + S$$

$$Y = C + I$$

C, C from both the equations get cancelled hence savings will be equal to investment and conversely investment will be equal to savings.

Algebraically,

$$S = I$$

$$I = S$$

If we allow time period to exert its influence on savings and investment then it will bring about changes in savings and investment. The change in savings will be equal to change in investment and vice versa.

Algebraically

$$\Delta S = \Delta I$$

$$\therefore \Delta I = \Delta S$$

Keynes Multiplier depends upon the marginal propensity to consume (MPC)

Algebraically,

$$K = f(MPC)$$

K stands for Multiplier.

f stands for functional relationship.

MPC stands for marginal propensity to consume. The Marginal propensity to consume is equal to change in consumption upon change in income i.e.

Algebraically,

$$MPC = \frac{\Delta C}{\Delta Y}$$

There are two limiting cases to marginal propensity to consume viz.

- i) MPC is always positive ie it is always greater than zero.
- ii) MPC will never be equal to 1

Hence MPC will get sandwiched between zero and one to two extremes.

Mathematically,

$$0 < \frac{\Delta C}{\Delta Y} < 1$$

$$\left[K = f\left(\frac{\Delta C}{\Delta Y}\right) \right]$$

Since Multiplier is a function of MPC the multiplier also has two limiting cases.

- i) The Multiplier will always be greater than one.
- ii) The multiplier will never be equal to infinity.

Mathematically,

$$1 < K < \infty$$

If K is equal to 1 then there will be no meaning to multiplier because the original value will not change for example $10 \times 1 = 10$. It means multiplier is meaningful only when it is greater than one. For example $10 \times 2 = 20$.

K is a ratio between increase in income to increase in investment.

Algebraically

$$K = \frac{\Delta Y}{\Delta I}$$

K stands for Multiplier.

ΔY stands for change in National Income

ΔI stands for change in Investment.

Since we are interested in the income propagation through Multiplier with the initial change in investment given let us take out ΔY from the equation

$$\Delta Y = K \cdot \Delta I$$

It means the ultimate increase in income will be K times change in investment i.e. $\Delta I \times K$.

$$K = f\left(\frac{\Delta C}{\Delta Y}\right)$$

$$1 = \frac{\Delta C}{\Delta Y} + \frac{\Delta S}{\Delta Y}$$

i.e. 1 is equal to MPC + MPS.

MPC stands for Marginal Propensity to Consume. MPS stands for Marginal Propensity to save.

Formulae for calculation of Multiplier

$$K = \frac{1}{1 - \frac{\Delta C}{\Delta Y}}$$

$$\therefore K = \frac{1}{\frac{\Delta S}{\Delta Y}}$$

$$\Delta Y = K \cdot \Delta I$$

K is the reciprocal of MPS.

Let us assume that the value of ΔI is 1,000 crores rupees and the value of MPC is $\frac{\Delta C}{\Delta Y} = \frac{3}{4}$ hence $\frac{\Delta S}{\Delta Y} = \frac{1}{4}$.

Substituting the values in the formulae we get,

$$K = \frac{1}{1 - \frac{3}{4}}$$

$$\therefore K = \frac{1}{\frac{1}{4}}$$

$$\therefore K = 4$$

$$\Delta Y = K \cdot \Delta I$$

Substituting the values we get,

$$\Delta Y = 4 \times \text{Rs. } 1000 \text{ crores}$$

$$\therefore \Delta Y = \text{Rs. } 4000 \text{ crores.}$$

6.3 FOREIGN TRADE MULTIPLIER IN AN OPEN ECONOMY :

Keynes concept of closed Economy-Multiplier was extended to open economy by Mr. Leighton to be termed as Foreign Trade Multiplier. It is also called as Export Multiplier.

The Foreign Trade multiplier brings about the effect of change in exports on change in income. In the open economy exports are exogenous ie they do not depend upon national income of an economy. It gets determined exogenously in the external factors like taste and preferences of the residents of the foreign country and the national income of the foreign countries. While imports get determined by national income of an economy (Imports are indigenous)

Algebraically

$$M = f(Y)$$

M stands for imports.

f stands for functional relationship.

Y stands for total National Income.

There is a direct and positive relationship between imports and National Income. As total national income rises imports rise too and vice versa.

$$X \neq f(Y)$$

X stands for exports.

\neq It signifies not.

f stands for functional relationship.

Y stands for Total National Income.

In an open economy an equilibrium level of national income gets established when savings are equal to investment and imports are equal to exports.

Algebraically,

$$S = I$$

$$M = X$$

S stands for savings.

I stands for Investment.

M stands for Imports.

X stands for Exports.

The equilibrium condition of national income in an open economy will be as follows:-

$$Y = C + I + X - M$$

In a closed economy equilibrium of income takes place when savings are equal to investment.

Algebraically

$$S = I$$

While in an open economy the equilibrium of national income takes place when investment plus exports are equal to savings plus imports.

Algebraically

$$I + X = S + M$$

I + X stand for Investment and exports which are injections. When they are injected into the economy they bring increment to national income.

S + M stand for Savings and Imports. They are leakages. They leak out the national income. Thus when

- i) $I + X > S + M$ Expansion takes place
- ii) $I + X < S + M$ Contraction takes place

When we introduce the change then the equation will be as follows:-

$$\Delta S + \Delta M = \Delta I + \Delta X$$

ΔS stands for change in savings.

ΔM stands for change in imports.

ΔI stands for change in Investment.

ΔX stands for change in Exports.

The marginal propensity to saving ie $\Delta S / \Delta Y$ determines change in savings which is designated as S while the marginal propensity to import determines the change in imports.

$\frac{\Delta M}{\Delta Y}$ which is designated as m hence the equation will be as follows:-

$$(S + M) \Delta Y = \Delta I + \Delta X$$

$$\therefore \Delta Y = \frac{1}{s + m} [\Delta I + \Delta X]$$

The foreign trade multiplier is a function of marginal propensity to save plus marginal propensity to import.

Kf sets designated as Foreign Trade Multiplier.

$$Kf = f(S + M)$$

Kf stands for Foreign Trade Multiplier.

f stands for functional relationship.

S stands for marginal Propensity to save.

M stands for marginal Propensity to import.

There is an inverse relationship between $s + m$ and Kf. Smaller the $s + m$ greater will be the Kf. Conversely greater the $s + m$ smaller will be Kf.

Hence the formula of income propagation through foreign trade multiplier will be as follows:-

$$\Delta Y = \frac{1}{s+m} \Delta X$$

$$Kf = \frac{1}{MPS + MPM}$$

The value of MPS = 0.25

The value of MPM = 0.15

Substituting the values we get,

$$Kf = \frac{1}{0.25 + 0.15} = \frac{1}{0.40} = 2.5$$

$$\Delta Y = Kf \cdot \Delta X$$

If exports increase by 200 ie from 300 to 500; $\Delta I = 0$

$$\therefore \Delta Y = 2.5 \times 200 = 500$$

$$\therefore Y_{E1} = YE + \Delta Y$$

$$= 1000 + 500 = 1500$$

$$\Delta S = s \Delta Y = 0.25 \times 500 = 125$$

$$\Delta M = m \Delta Y + 0.15 \times 500 = 75$$

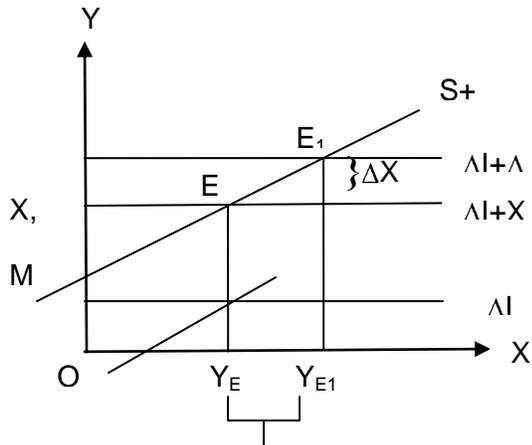


Figure 6.1

At the point of changed equilibrium level of national income

$$\Delta I + \Delta X = \Delta S + \Delta M$$

$$\therefore 0 + 200 = 125 + 75$$

$$\therefore 200 = 200$$

$K = 4$ in the closed economy while $K_f = 2.5$ in the open economy.

$K_f < K$ because of two leakages i.e. savings and imports.

Check Your Progress:

1. Distinguish between foreign trade multiplier in a closed economy and in an open economy.

.....

6.4 FOREIGN REPERCUSSION

There are two countries taking part in the foreign trade. One is the reporting country and the other trading partner is the foreign country. When exports of the reporting country rise the implied meaning is that the imports of the foreign country rise. As the exports of the reporting country rise it leads to increase in export earnings. As the imports of the foreign country rise it will lead to fall in the income of the foreign country. As its income falls its imports will also fall which will have its repercussion on the exporting country i.e. on the reporting country. It is called as foreign repercussion. It will reduce the size of the foreign trade multiplier of the exporting country.

Formula of Computation of the value of foreign trade multiplier,

$$K_f = \frac{1}{MPS_1 + MPM_1 + MPS_2 + MPM_2}$$

The subscripts 1 and 2 represent the Reporting Country and the foreign country respectively.

$$MPS_1 = 0.25; MPM_1 = 0.15; MPS_2 = 0.06; MPM_2 = 0.04$$

Substituting the values we get,

$$K_f = \frac{1}{0.25 + 0.15 + 0.06 + 0.04}$$

$$\therefore K_f = \frac{1}{0.40 + 0.10}$$

$$\therefore K_f = \frac{1}{0.50}$$

$$\therefore K_f = \frac{1}{\frac{1}{2}}$$

$$\therefore K_f = 2$$

$$\Delta Y = K_f \cdot \Delta X$$

$$= 2 \times 200 = 400$$

$$YE_1 = YE + \Delta Y$$

$$= 1000 + 400 = 1400$$

Thus if we take into account foreign repercussion the value of foreign multiplier will get reduced and hence the new equilibrium level of national income will also get reduced from 1500 to 1400.\

Check Your Progress:

1. What do you mean by foreign repercussions?

6.5 INTRODUCTION OF EXTERNAL AND INTERNAL BALANCE

Under the pegged exchange rate system of IMF the member countries of IMF faced the twin problem of maintaining the external balance and internal balance. The External balance dealing with maintaining the balance of payments equilibrium while the internal balance deals with maintaining full employment and price stability. When a country is to attain two targets simultaneously it is required to use two policy instruments simultaneously. Thus to attain the internal and external balance the use of monetary and fiscal policy simultaneously is called for.

6.5.1 CONCEPTS

External Balance and Internal Balance:-

External balance refers to achieving equilibrium in the balance of payments.

Internal balance refers to achieving full employment with price stability.

Generally a country assigns a priority to maintain internal balance by maintaining full employment level of employment and price stability. But when a country witnesses persistently fundamental or structural deficit in the balance of payments the concerned country has to switch over its priority from maintaining internal balance to maintaining external balance.

The cyclical or seasonal type of disequilibrium in the balance of payments is a transitory phenomenon which can be reversed or corrected automatically while it is not the case with regard to structural or fundamental disequilibrium in the balance of payments especially when it persists for a long time. Then it gets transformed into a chronic phenomenon. Hence it is the fundamental disequilibrium in the balance of payments that needs adjustment.

When a country has several objectives to be achieved the country is bound to use several policy instruments. Hence the problem of Assignment comes into being. The problem of pairing targets and instruments gets referred to as the problem of Assignment. The Assignment problem is a problem of assignment of policy instruments to achieve the targets.

6.6 EXPENDITURE CHANGING POLICIES

The expenditure changing policies are referred to as the expenditure adjustment policies. The expenditure change or adjustment can be brought about either by reducing or increasing the expenditure. The expenditure changing policies bring about changes in income. Thus the expenditure changing policies can also be called as income changing policies. The deficit in the balance of payments arise due to increase of imports and decrease of exports or both. To curtail imports you must curtail your expenditure. Hence expenditure reducing policy pertains to correcting the deficit in the

balance of payments. On the other hand expenditure increasing policy pertains to correct the surplus in the balance of payments. By following the expenditure increasing policy you can increase your imports thereby it reduces your surplus balance of payments. Out of deficit and surplus balance of payments it is the deficit in the balance of payments which becomes a more serious problem to deal with. Hence the expenditure changing policy goes with the name of expenditure reducing policy. The monetary and fiscal policies are used to bring about reduction in expenditure to cure deficit in the balance of payments.

6.6.1 MONETARY POLICY

The monetary policy is the policy of the monetary authority of the country. The monetary authority of the country is the Central Bank of the country. In case of India, the Reserve Bank of India is the Central Bank of India. The monetary policy deals with the monetary management ie controlling the supply of money and credit of the economy through the use of monetary instruments. The central bank of the country has got so many instruments at its disposal to control the quantum of money and credit of which two are very important viz i) Bank Rate and ii) Open Market Operations.

Bank Rate is an official minimum rate of the Central Bank of the country at which it advances short term loans to commercial banks. The Bank Rate policy means raising or lowering down of the bank rate depending upon the situation.

Open market operations mean buying or selling of the Government securities in the open market.

The Bank Rate and open market operations go hand in hand.

The Central Bank of the country follows two types of monetary policy Viz.

- i) Contradictory monetary Policy and
- ii) Expansionary monetary Policy

The contradictory monetary Policy is also called as tight monetary Policy. When a country suffers from deficit in the balance of payments it follows tight monetary policy. It raises the bank rate. When the bank rate is raised by the Central Bank the commercial bank finds it very difficult to get short term advances from the central bank because loan from central bank becomes costlier. There is generally a 2% difference between the bank rate and market rate. The market rate is a rate which is charged by the commercial banks to their customers for advancing loans. When there is a hike in the market rate of interest getting loans from commercial banks becomes costlier for the bank's customers which curtails money supply.

Simultaneously the central bank of the country sells Government securities in the open market. Those who buy the securities issue cheques to the Central Bank on

their accounts with the commercial bank. The central bank thus withdraws cash from the commercial bank which controls their habit of creation of multiple credit.

Thus the central bank of the country by following tight monetary policy reduces money supply which leads to reduction in expenditure which in turn reduces imports and thus ultimately brings about improvement in the balance of payments. (The increase in the rate of interest will lower down investment) In case of surplus balance of payments the central bank follows easy monetary policy in which the rate of interest gets lowered down which leads to increase in investment and income which increases imports. In case of tight monetary policy due to hike in rate of interest the inflow of foreign capital takes place which also renders a helping hand to correct the deficit in the balance of payments. Conversely when the central bank follows easy money policy the rate of interest falls which leads to flight of capital from the concerned country to foreign countries which renders a helping hand to correct surplus balance of payments.

Monetary policy also helps to maintain internal balance. When the central bank follows easy money policy the rate of interest is lowered down. It accelerates investment which leads to generation of income and employment through multiplier. It leads to rise in price level. Thus easy money policy of the central bank maintains internal balance through maintenance of full employment and price stability. The vice versa situation takes place when the central bank follows tight money policy.

6.6.2 Fiscal Policy:- The fiscal policy is also used as an instrument of maintaining both internal and external balance. The term fiscal is derived from the Greek word 'fisc' which means basket. The Government's basket is its treasury. Thus fiscal policy is the policy of the Government with regard its treasury. It is also called as 'Budgetary Policy' of the Government which deals with revenue and expenditure of the Government ie the public bodies. According to Arthur Smithies fiscal policy is a policy under which the Government. uses its revenue and expenditure in such a way as to produce desirable effects avoiding undesirable effects on the national economy as regards production, income, employment and balance of payments. Fiscal Policy uses two very import fiscal tools to bring about defined changes i.e. to maintain internal and external balance viz taxation and expenditure like monetary policy fiscal policy is also of two types viz.

- i) Contractionary fiscal Policy and
- ii) Expansionary fiscal Policy.

To reduce deficit in the balance of payments the Government follows contractionary fiscal policy. On the one hand Government reduces public expenditure and on the other hand Government raises tax rates of both the direct taxes and indirect taxes. The reduction in Government. expenditure will reduce income and employment through multiplier in the reverse gear which will also reduce price level. It will control inflation and will maintain internal balance. It is also called as an anti-inflationary fiscal

policy. It will also maintain external balance by improving balance of payment situation of a country. By reducing income it will reduce imports because import is a function of income. $M = f(Y)$ There is a positive and direct relationship between income and imports. When income decreases it brings about a corresponding decrease in imports. By decreasing prices of goods and services, our country becomes a good country for the foreigners to buy the things from and hence exports accelerate leading to increase in export earning which leads to improvement in balance of payments.

An expansionary fiscal policy is followed when the country would like to reduce surplus in the balance of payments. The Government expenditure increases and the tax rates of both direct and indirect taxes are reduced. It leads to increase in income and employment through multiplier effect. It leads to increase in consumption, price level also rises. A country becomes a very good country for the foreigners to sell their goods into the reporting country. Thus imports accelerate while exports contract and as such the surplus in the balance of payments get reduced. Thus a country maintains external balance. It also maintains internal balance of maintaining employment income and price level to equilibrium position.

However monetary policy is preferred for maintaining external balance while fiscal policy is preferred for maintaining internal balance. Since expenditure reducing policy brings about a positive effect on balance of payments while expenditure increasing policy brings about a negative effect on balance of payments the expenditure changing policy gets colored by its bright side ie the expenditure reducing policy.

6.7 THE EXPENDITURE SWITCHING POLICY:-

At the outset let us make it very clear that the expenditure switching policy means expenditure increasing policy. The second very important point about expenditure switching policy is that the expenditure switching policy works through changes in relative prices. The mechanism through which changes or adjustment in the relative prices can be brought about in the changes in exchange rate. The changes in the exchange rate bring about depreciation or appreciation. Depreciation or devaluation means lowering down of the external value of the domestic currency in terms of foreign currencies. The meaning and results of both depreciation and devaluations are same ie decrease in the price level of the goods in the domestic country which cheapens our goods for the foreigners because of which our exports accelerate. Simultaneously it curtails our imports because of relative costliness of the foreign goods. Thus depreciation or devaluation improves balance of payments by reducing deficit. However Devaluation works effectively when Marshall-Lerner condition is satisfied i.e. the elasticity of Exports plus the elasticity of imports must be greater than one. The vice versa will be the situation in case of appreciation. When there is an appreciation in the foreign exchange rate it raises the Price level domestically and the country becomes a good country to sell the foreign goods into our economy. Relatively the foreign goods

become cheaper. Thus it contains our exports and accelerates our imports. It reduces the surplus in the balance of payments.

The depreciation is automatic which work under fixed exchange rate. The devaluation is voluntarily resorted to by the Government. It works under flexible exchange rate system.

The direct controls can also be used as an instrument of expenditure switching policy. By banning the imports of foreign goods the consumers will be directed to spend more in buying domestic goods only.

The direct controls can be of two types:-

- i) Commercial Controls and
- ii) Financial Controls.

i) Commercial Controls:- Tariffs, import quotas are some of the examples of commercial controls. Tariffs mean import and export duties. When import duties are raised it restricts our imports. When export duties are reduced it accelerates our exports. The import quotas also reduce our imports. Thus commercial controls correct disequilibrium in the balance of payments.

ii) Financial Controls:- Financial Controls includes the use of devices like exchange control and multiple exchange rates. When exchange controls are in force the export earners are forced to surrender 40% of their foreign exchange earning to the foreign exchange authority of the country i.e. the central bank of the country against the domestic currency at an official minimum rate. Then they are free to sell the remaining 60% of foreign exchange in the foreign exchange market at the free market rate. The country also follows multiple exchange rate system i.e. changing different rate of exchange against different commodities.

The policy of direct control is meant for short term and not for long term it may spread harmful effects on the national economy.

Check Your Progress:

1. Explain the following terms:
 - a) Expenditure switching policy
 - b) Expenditure changing policies
2. Differentiate between Internal and external balance.
3. Write notes on:
 - a) Monetary policy
 - b) Fiscal policy

themselves. These stocks never come to the market place. (Either they keep it for self consumption or sell out in the villages.)

Fiscal Policy is a policy of the Government as regards Taxation, Public expenditure and Public borrowing. Taxation, Public expenditure and Public borrowing are the three instruments of Fiscal Policy. Fiscal Policy is a part of general economic policy. Fiscal Policy uses its instruments in such a way as to produce desirable effects and to avoid undesirable effects. The objectives of fiscal policy are directed towards achieving economic stability in developed countries and economic development in developing countries.

The success of fiscal policy largely depends on a fairly accurate forecasting of the course of trade cyclical activity which is a very difficult task. Even if we are able to know the future course of trade cycle it is very difficult to know the impact of combination of various instruments of fiscal policy on the different variables of the economic activity. Increase in public investment may cause a decrease in private investment because of rise in prices of factors due to keen competition from the Government. Fiscal Policy for achieving full employment may be made ineffective by rising wages. Fiscal measures may be effective only in curbing unemployment resulting from a deficiency in demand. A fiscal policy for curbing unemployment may create balance of payments difficulties because additional income may be spent on importing goods from foreign countries. Increase in Governmental spending on public works during deflation and the decrease in the same during inflation may clash with other social and economic objectives. A vigorous fiscal policy to combat depression may cause a vast increase in public debt which may make the debt management extremely difficult.

As regards taxation which is the main instrument of raising the resources for undertaking the developmental projects the underdeveloped countries face number of problems which are as under:-

- i) These countries try to raise the rates of the existing taxes and impose new taxes. But there is a large non-monetized sector in the developing countries. Therefore it is very difficult to assess the income originating in this sector.
- ii) The majority of the population in the developing countries is illiterate such that they can't file the income tax returns.
- iii) Through direct taxes the Government reduces the disposable income of the people and thus restricts their capacities to buy the goods. Through indirect taxes Government raise the prices of the goods. This also restricts consumption. There is a large scale tax evasion as regards direct taxes.
- iv) The key to successful income tax is voluntary compliance on the part of tax payers. This condition is not satisfied in the developing countries.

As regards public expenditure which is the second most important instrument of fiscal policy it is ever growing due to the growth of the Governmental functions. However there is a built in inflationary tendency in public expenditure. Secondly the marginal social benefits go on diminishing as the public expenditure goes on increasing. Thus in the underdeveloped countries there are large number of free riders which jeopardise the Governmental revenue.

Public borrowing is the third most important instrument of fiscal policy. Public borrowing includes both the internal and external loans. These loans help the development process by financing the developmental projects and build up the repaying capacity of the public authorities. However the continued dependence on the public borrowing especially external loans reduces the economic independence of these countries besides introducing uncertainty in the whole developmental process. The biggest disadvantage of foreign loans is that continued dependence on them or a number of years increases the burden of repaying and servicing foreign debts as these are to be paid in foreign exchange.

6.9 A CASE FOR MONETARY AND FISCAL POLICY MIX

So as to iron out the limitations of both the monetary policy and fiscal policy, there is a need to have a judicious blend of monetary and fiscal policy. It will step up the effectiveness of both the policies viz the monetary policy and the fiscal policy.

During 1930's great depressions the importance of fiscal policy was first recognized in the right perspective. Since then it has been given increasing importance not only in the developing countries but also in the developed countries. The role of deficit financing was duly recognized to raise the resources for economic development. Therefore though originally it was proposed to supplement the monetary policy it has tended to supplant it. The neglect of the monetary policy, the reckless monetary expansion and the consequent soaring trend of prices led to the loss of confidence in domestic currencies. This points to the necessity of evolving a judicious blend of monetary and fiscal policies. The tight fiscal policy combined with fairly easy credit policy will place ample resources at the disposal of the Government to finance public expenditure projects and it will induce the private investment which will add more quickly the output without borrowing.

6.10 MEADE'S MODEL

Meade has given his model of simultaneous achievement of internal and external balance with the help of the simultaneous application of expenditure adjustment and expenditure switching policies. He was of the opinion that if both the policies are used

singly then it may lead to a conflict between the internal balance and the external balance.

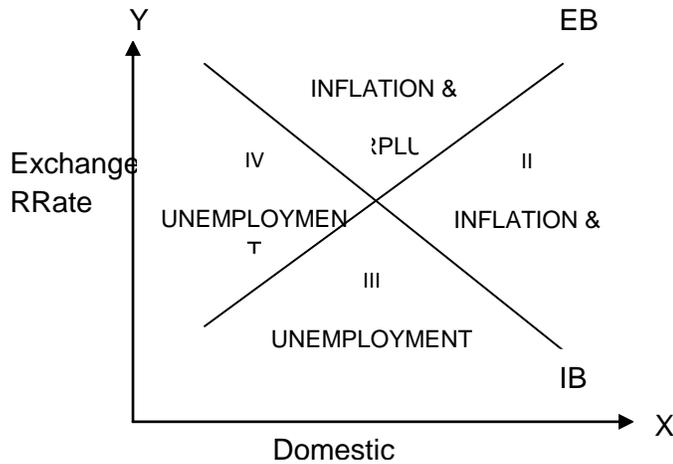


Figure 6.2

In the above diagram, Domestic Absorption i.e., expenditure is marked along X axis while Exchange rate is marked along Y axis. IB curve is a internal balance curve which slopes downward (negative slope) from left to right. It shows that as exchange rate depreciates domestic absorption must rise so as to achieve internal balance. EB curve indicates external balance. It is positively sloped indicating that as exchange rate appreciates domestic absorption must rise and vice versa so as to maintain external balance. The intersection between IB curve and EB curve takes place at the point E which determines the internal balance and external balance simultaneously. In the diagram following four zones are shown:-

- 1) Zone I shows inflation and surplus in the balance of payments.
- 2) Zone II shows Inflation and Deficit in the balance of payments.
- 3) Zone III shows unemployment and deficit in the balance of payments.
- 4) Zone IV shows unemployment and surplus in the balance of payments.

The above diagram shows how the two policy instruments should be combined to achieve simultaneously internal and external balance.

Solution:- In case of Zone I a country has to follow appreciation in the exchange rate so as to combat surplus in the balance of payments at the same time it has to follow contractionary fiscal policy to reduce domestic expenditure to combat inflation. In case of Zone II a country has to follow devaluation i.e. reduction in the foreign exchange rate

so as to combat deficit in the balance of payments. At the same time a country has to follow contractionary fiscal policy to reduce domestic expenditure to combat inflation.

In case of Zone III a country has to follow devaluation and an expansionary fiscal policy. In case of Zone IV a country has to follow revaluation and an expansionary fiscal policy.

6.11 MUNDELL'S MODEL

It was given by Robert A. Mundell. He was of the opinion that in order to achieve internal balance and external balance simultaneously there is a need to apply monetary and fiscal policy simultaneously. Internal balance refers to domestic balance i.e. full employment with price stability. External balance refers to equilibrium in the balance of payments. He highlighted the fixed exchange rate system so as to achieve equilibrium in the balance of payments because in a freely fluctuating exchange rate system external balance is automatically achieved. When external balance is achieved it doesn't mean that internal balance is in equilibrium. In order to bring about internal balance it is necessary to reduce inflation and unemployment to zero. (There is a trade off between inflation and unemployment) In order to bring about external balance there is a need to bring about equality between imports and exports i.e. debits and credits.

Expansionary monetary policy i.e. the cheap money policy can be resorted to by reducing the rate of interest. It will lead to increase in the level of income and employment. It will also increase imports as imports are the function of level of income.

$$M = f(Y)$$

Contractionary monetary policy i.e. the dear money policy can be resorted to by enhancing the rate of interest which will lead to reduce investment, income and employment. It will also lead to reduce imports i.e. it will reduce inflation and deficit in the balance of payments. Expenditure increasing policy consists of expansionary monetary and fiscal policy i.e. reduction in the rate of interest and increase in public expenditure.

Expenditure reducing policy consists of contractionary monetary and fiscal policy i.e. increasing the rate of interest and reducing public expenditure.

Both these policies referred to as expenditure adjustment or changing policy.

If a country faces the problem of internal and external imbalance i.e. internally inflation and externally deficit in the balance of payments then it is advisable that a country should follow contractionary monetary and fiscal policies.

Combining Monetary and Fiscal Policy

Under the pegged exchange rate system the Governments of the countries are unwilling to use exchange rate changes as a policy instrument to bring about external balance because the I. M. F. procedure requires that a currency be devalued only when a country suffers from fundamental disequilibrium the balance of payments. Hence the countries are left with the option to use only two policy instruments viz. the monetary policy and the fiscal policy to bring about external balance and internal balance. Of these two Robert Mundell has recommended the assignment of monetary policy for external balance and fiscal policy for internal balance.

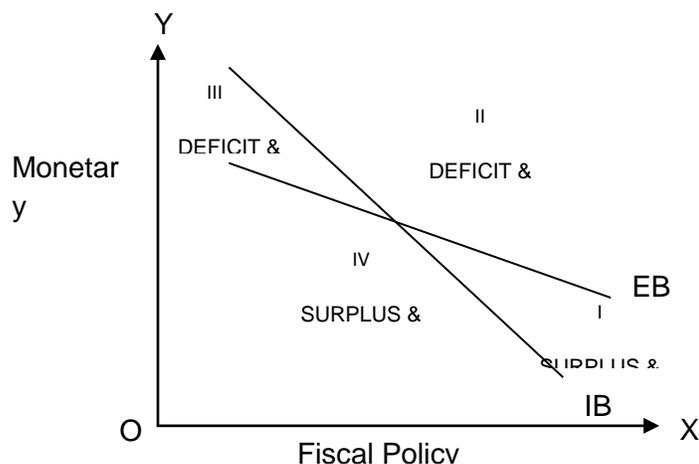


Figure 6.3

Fiscal Policy is marked along X axis while monetary policy is marked along Y axis. IB curve is an internal balance curve. EB curve is an external balance curve. Both the curves are negatively sloped. It is assumed that monetary policy is more powerful in bringing about external balance hence EB schedule is flatter than IB schedule. Point E shows the intersecting point at which both internal and external balance are simultaneously achieved. In this diagram four zones are shown which are as follows:-

- 1) Zone I which shows balance of payments surplus and inflation
- 2) Zone II which shows deficit in the balance of payments and inflation
- 3) Zone III which shows deficit in the balance of payments and unemployment
- 4) Zone IV which shows surplus in the balance of payments and unemployment.

Solution:- In case of Zone I expansionary monetary policy to combat surplus in the balance of payments and contractionary fiscal policy to combat inflation will be adopted.

In case of Zone II a contractionary monetary policy and contractionary fiscal policy will be adopted.

In case of Zone III a contractionary monetary policy and expansionary fiscal policy will be adopted.

In case of Zone IV a expansionary monetary policy and expansionary fiscal policy will be adopted.

However the fact remains that in number of countries of the world the monetary policy and the fiscal policy are under the control of separate authorities ie the monetary policy remains under the control of the Central Bank of the country while the fiscal policy remains under the control of the Government.

6.12 MUNDELL – FLEMING MODEL

Mundell and Fleming have given jointly their model in terms of IS, LM and BP schedules. They have extended the IS, LM model to incorporate External Balance by way of incorporating B. P. Schedule.

IS schedule represents Investment and savings schedule

LM schedule represents Demand for and Supply of money schedule

BP schedule represents Balance of payments schedule

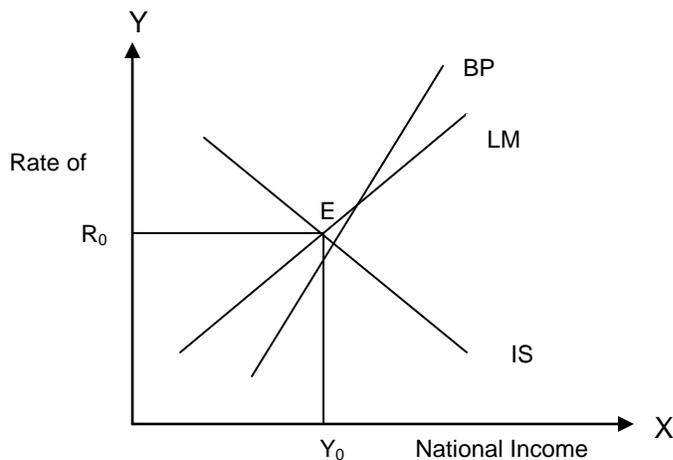
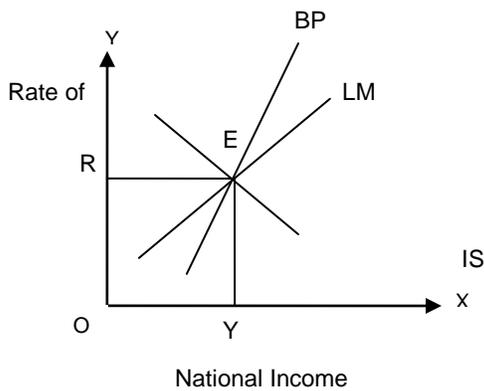


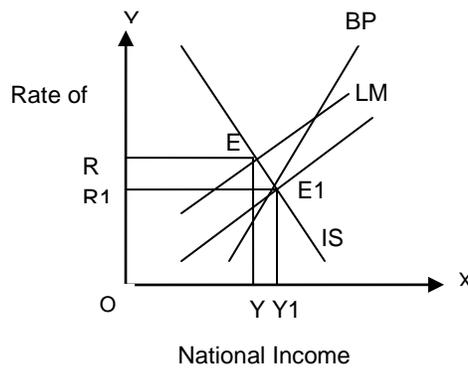
Figure 6.4

The intersection between IS and LM schedules determine internal balance which is shown by the Point E at which rate of interest is of the order of OR_0 and national income is OY_0 since point E lies above and to the left of BP schedule it shows that the economy is running a balance of payments surplus.

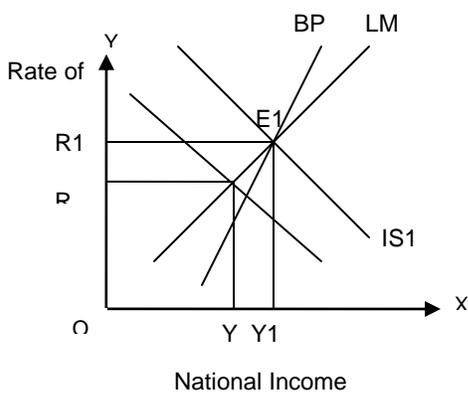
Under these circumstances if the economy would like to achieve both internal and external balance then it has three options



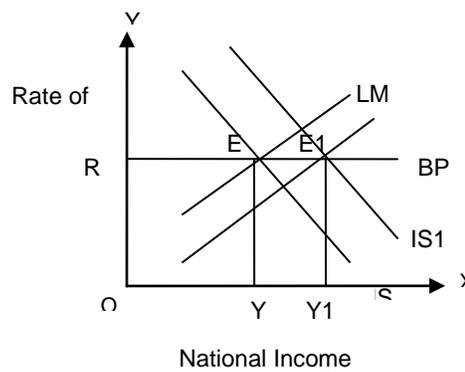
(a)



(b)



(c)



(d)

Figure 6.5

Diagram (a) shows appreciation in the foreign exchange rate such that BP curve shifts upward and passes through equilibrium point E and intersects IS and LM curves. As such the internal balance and the external balance are achieved.

Diagram (b) shows the central bank pursuing the expansionary monetary policy by lowering down the rate of interest such that LM schedule shifts to the right and passes through IS and BP schedules thus at the point of intersection i.e. E_1 once again internal balance and external balance are achieved.

Diagram (c) shows the Government switches over to the expansionary fiscal policy such that the IS curve shifts to the right upward and passes through the intersecting point E_1 as such once again internal and external balance are attained.

Diagram (d) shows the role of monetary and fiscal policy when there is a perfect capital mobility i.e. BP curve is a horizontal straight line going parallel to X axis. Initial

equilibrium is at E at which IS and LM schedules intersect each other with BP schedule given. When the central bank follows expansionary monetary policy which shifts the LM schedule to the right leading to LM schedule. When the Government follows expansionary fiscal policy the IS schedule. With the BP schedule given IS₁ and LM₁ schedules intersect at the point E₁ leading to establishing internal and external balance at a higher level with the national income increasing from OY to OY₁.

Check Your Progress:

1. Explain how the problem of policy mix arises.
2. Write notes on the following models of policy mix:
 - a) Meade’s model
 - b) Mundell’s model
 - c) Mundell-Fleming model

6.13 SUMMARY

The original idea of multiplier was given by R. F. Kahn.

1. Lord J. M. Keynes multiplier was investment multiplier which was meant for closed economy.
2. Keynes multiplier is extended to open economy which gets referred to as foreign trade multiplier.
3. The term foreign trade multiplier was given by Mr. Leighton.
4. Closed economy multiplier gets designated as K which is a function of MPC.
5. Foreign Trade Multiplier is a function of MPS + MPM.

6.
$$\Delta Y = \frac{1}{s + m} (\Delta I + \Delta X)$$

7.
$$Kf = \frac{1}{MPS + MPM}$$

8.
$$\Delta Y = Kf \cdot \Delta X$$

9. If foreign repercussion is taken into account then,

$$Kf = \frac{1}{MPS_1 + MPM_1 + MPS_2 + MPM_2}$$

10. $K_f < K$
11. The foreign repercussion will reduce the size of foreign trade multiplier which will also reduce the size of new equilibrium level of national income.
12. There are two types of balances viz.
 - a) Internal Balance and
 - b) External Balance
13. Internal balance refers to maintaining full employment and price stability.
14. External balance refers to achieving equilibrium in the balance of payments.
15. Generally country assigns priority to maintain internal balance.
16. The problem of pairing targets and instruments gets referred to as the problem of Assignment.
17. There are two types of policies to bring about internal balance and external balance viz.
 - a) Expenditure changing policies and
 - b) Expenditure switching policies.
18. The expenditure changing policies are also termed as expenditure adjustment policies.
19. The expenditure adjustment policies are of two types viz.
 - a) The Monetary Policy and
 - b) The Fiscal Policy.
20. The expenditure switching policies work through changes in price level.
21. The expenditure switching policies include devaluation and revaluation.
22. Internal balance refers to achieving full employment with price stability.
23. External balance refers to the equilibrium in the balance of payments.
24. Expenditure changing policies refer to the expenditure adjustment policies.
25. Monetary Policy and Fiscal policies are used to bring about expenditure adjustment.
26. Expenditure switching policy refers to expenditure increasing policy.
27. Expenditure switching policy operates through changes in exchange rates and direct controls.
28. Monetary policy is a policy of the Central Bank of the country.
29. Fiscal Policy is the policy of the Government of the country.
30. Simultaneous achievement of the objectives requires simultaneous adoption of the policies.

31. Meade's model recommends the simultaneous achievement of internal and external balance with the help of simultaneous application of expenditure adjustment and expenditure switching policies.
32. Internal balance is brought about by full employment with price stability.
33. External balance is brought about by equalizing imports with exports.
34. Mundell's model brings about the simultaneous internal and external balance by using monetary and fiscal policies simultaneously.
35. Mundell-Fleming model brings about internal and external balance through the equality between IS, LM and BP schedules.

6.14 EXPECTED QUESTIONS

- 1) Explain the process of income propagation through foreign trade multiplier.
- 2) Explain foreign trade multiplier and bring out its global implications.
- 3) Write short notes on the following:-
 - a) Closed economy multiplier.
 - b) Open economy multiplier.
 - c) Foreign repercussions.
- 4) Explain the role of expenditure changing policies in bringing about internal and external balance.
- 5) Discuss the role of monetary policy in bringing about internal and external balance.
- 6) Discuss the role of fiscal policy in bringing about internal and external balance.
- 7) Write short notes on the following:-
 - a) Expenditure Switching Policy.
 - b) Expenditure changing policies
 - c) Monetary policy
 - d) Fiscal Policy
- 8) Discuss Meade's model of expenditure adjustment and expenditure switching policies to bring about internal and external balance simultaneously.
- 9) Critically evaluate Mundell's model of a mix of monetary and fiscal policy to attain internal and external balance simultaneously.
- 10) Discuss Mundell-Fleming model.
- 11) Write short notes on the following:-
 - i) Monetary Policy
 - ii) Fiscal Policy
 - iii) Expenditure Switching Policy
 - iv) Mundell's model.



Module 5

FOREIGN EXCHANGE MARKET

Unit Structure:

- 7.0 Objectives
- 7.1 Introduction of Foreign exchange
- 7.2 Need for foreign exchange
- 7.3 Instruments of International payments
- 7.4 Foreign Exchange Market
- 7.5 Functions of foreign exchange market
- 7.6 Transactions in the foreign exchange market
- 7.7 Introduction and concept of foreign exchange rate
- 7.8 Determination of foreign exchange rate
- 7.9 Exchange Rate Systems
- 7.10 Managed flexibility
- 7.11 Summary
- 7.12 Questions

7.0 OBJECTIVES

1. To understand the concept of foreign exchange
2. To study the need for foreign exchange
3. To study the various instruments of foreign exchange
4. To understand the meaning of foreign exchange market
5. To study the functions of foreign exchange market
6. To study the transactions in the foreign exchange market
7. To study the concept of foreign exchange rate
8. To determine foreign exchange rate
9. To study various exchange rate systems (Fixed and Flexible)
10. To study the concept of managed flexibility

7.1 INTRODUCTION OF FOREIGN EXCHANGE

International trade is a trade which takes place between two or more countries of the world. It involves exports and imports of goods and services which in turn involves receipts and payments unlike the primitive economy the exchange of goods and services is no longer carried out directly on barter basis. Nowadays every country of the

world is a politically sovereign country having independent currency of its own which is a legal tender in its territory. This currency doesn't act as legal tender money outside its boundary. The same thing happens in case of other countries of the globe. Thus different countries of the globe have got different currencies which circulate as legal tender money in the respective country viz Rupee in India, Pound Sterling in England, U S Dollar in USA, Franc in France, Roubles in Russia etc. Therefore whenever a country buys or sells goods and services from or to another country the residents of the two countries have to exchange their currencies. Thus the problem of foreign exchange arises. The importing country, while making payment to exporting country has to convert its currency in to the exporting country's currency or in to the internationally acceptable currencies like US Dollar or Pound Sterling. This type of conversion or transfer is facilitated by the foreign exchange market.

7.2 NEED FOR FOREIGN EXCHANGE

The need for foreign exchange can be explained with the help of a hypothetical example. If India exports tea to Japan and Japan exports electronic goods to India, Yen being the currency of Japan, Japan will pay Yen to India and India will pay Rupees to Japan. But Yen can't be accepted by India as Yen can't be used for making payments to the raw materials and the wage earners. So will be the case of Japan. In Japan Indian rupee can't be used as means of payment. Hence the problem of foreign exchange will crop up. Japan will have to convert Yen into Indian rupees and make payment for imports in Indian rupees. Similarly India will have to convert Indian rupees into Yen and make payment for imports to Japan in Yen. Thus there is a need for foreign exchange to facilitate the international trade transactions. The payments and receipts for international trade transactions can be effected in internationally accepted foreign exchange like US Dollar, Pound Sterling or Gold.

Foreign exchange gets highlighted due to the growing importance of foreign trade in the national income not only of the DE's but also of the LDC's. Secondly most of the world countries have abandoned exchange control due to which there is a wide spread of capital flows. Thirdly there is a widespread move to make foreign exchange market a part and parcel of money market. Fourthly the move of globalization of the economies has also rendered a helping hand to boost up the importance of foreign exchange.

Concept of Foreign exchange

The term foreign exchange can be defined as the mechanism through which payments are effected between two or more countries of the globe having different

currencies. The term foreign exchange is a very broad term which includes in its fold not only foreign money but also near money instruments denominated in foreign currency.

In India as per Foreign Exchange Regulation Act 1973 section 2(b) foreign exchange means foreign currency which includes the following:-

- i) all deposits, credits and balances payable in any foreign currency and any drafts, traveler's cheques, letters of credit and bills of exchange, expressed or drawn in Indian currency but payable in foreign currency.
- ii) any instrument payable, at the option of drawer or holder thereof or any other party thereto, either in Indian currency or in foreign currency or partly in one and partly in the other.

From the above explanation foreign exchange refers to foreign money which includes paper currency notes, cheques, bills of exchange, bank balances and deposits in foreign currencies.

As per H. E. Evitt "foreign exchange is that section of economic science which deals with the means and methods by which rights to wealth in one country's currency are converted into rights to wealth in terms of another country's currency." It involves the investigation of the method by which the currency of one country is exchanged for that of another, the causes which render such exchange necessary, the forms which such exchange may take, and the ratios or equivalent values at which such exchanges are effected.

7.3 INSTRUMENTS OF INTERNATIONAL PAYMENTS

Following are the instruments of international payments:-

- i) Foreign Bill of Exchange
- ii) Bank Draft
- iii) Mail Transfer
- iv) Letter of Credit.

i) Foreign Bill of Exchange:-

A foreign bill of exchange can be defined as a negotiable credit instrument. It is an unconditional order in writing drawn by a drawer addressed to the drawee to pay a sum of money on demand to the payee or to the undersigned at a specified future date for the volume of goods received. It arises out of genuine trade transaction.

There are generally three parties to foreign bill of exchange viz.

a) The drawer of the foreign bill of exchange:- The drawer of the foreign bill of exchange is an exporter. Having exported the goods he draws the foreign bill of exchange and sends the written order to the drawer by signing at the right hand side bottom of the foreign bill of exchange.

b) The Drawee:- The drawee is an importer. It is he who receives the written order of the drawer. After receiving the order he acknowledges his responsibility of making payment to the payee.

c) Payee:- A Payee is a person who receives the payment. When the drawer orders the drawee to pay to MR. XYZ then Mr. XYZ becomes the payee. And if he orders the drawee to pay to the undersigned then the undersigned drawer becomes the payee.

The working of the bill of exchange is very simple. The mechanism of the foreign bill of exchange makes it necessary that every payment in one direction is matched with equal payments in another direction.

Merchant A in Delhi imports machinery from person B in England and Person C in England imports tea from Person D in Delhi. In such a situation person B in England will draw the foreign bill of exchange on person A in Delhi who accepts the bill and acknowledges his responsibility of payment of the bill. However Mr. B in England sells his right to Mr. C in England who has imported tea from merchant D in Delhi. Mr. C in his term sends that bill to Mr. D in Delhi. He will collect the money through his bank from Mr. A in Delhi.

ii) Bank Draft:-

A Bank draft can be defined as an order of a bank on its branch or on another bank to pay a sum of money to the bearer of a bank draft on demand. In the international trade transactions a debtor who imports goods from the creditor or an exporter approaches his bank, deposits adequate money with commission and obtains a bank draft. He sends that bank draft to the creditor by registered post. On receipt of the bank draft the creditor presents it across the counter of the said branch of the bank and gets it encased.

iii) Mail Transfer:-

Just as funds are transferred from one bank account to another bank account of the same bank at two different places through post office by mailing the post card in the international trade transactions are effected through air mail other things remaining the same.

iv) Telegraphic Transfer:-

It is a telegraphic order of a bank to its branch or to the correspondent bank to pay a sum of money to a person concerned. When a debtor would like to remit money quietly then he makes such type of an arrangement. He deposits the money in his bank asking the bank to remit the sum of money through telegraphic transfer to a person concerned through its branch or through a correspondent bank. It is a quicker mode of payment.

v) Letter of Credit:-

A Letter of Credit is an authorization. It authorizes a person to draw a cheque up to a specified amount of money on a bank or on a branch of a bank during a specified time period. It facilitates travelling very easily. When a traveler would like to travel he has to carry a lot of money along with him. There is every danger of getting robbed while on tour. In order to get rid off a situation of this type he would like to avail of the facility of traveler's cheque. He approaches his bank, deposits a sum of money along with commission asking the bank to issue travellers cheque to him. While doing so he has to specify the direction of his travel. The bank informs all the branches of the bank in that direction. Thus on presentation of the travelers cheque he can get it encased at any of the branches of the bank of situated in that direction.

7.4 FOREIGN EXCHANGE MARKET:

A foreign exchange market facilitates the monetary transactions of foreign trade. It is a part and parcel of international money market. A foreign exchange market can't be designated by any geographical area or location. A foreign exchange market can be defined as a mechanism through which foreign currency can be bought and sold. It comprises of the buyers and sellers of foreign exchange and the intermediaries through which the buyers and sellers of foreign exchange are brought to-gether. They deal with each other through telecommunication network viz. telephones, mobiles, telexes, and electronic systems. With the advent of advanced technology like Reuters Money 2000 – 2 it is possible to access the trader in any corner of the world within a few seconds. The deal can be done through electronic devices which allow bid and offer rates to be matched through central computers.

7.4.1 Participants in the Foreign Exchange Markets:-

The main participants or players in the foreign exchange markets are as follows:-

1) Customers:- The customers who participate in the foreign exchange markets mainly comprise of the importers and exporters. They participate in the foreign exchange market by availing of the bank services. The importer has to make payments to the exporting country in the exporting country's currency hence he utilizes the services of bank to convert its local currency into exporting country's currency. The exporter also would like to avail of the services of bank to convert the receipt of foreign currency into local or domestic currency.

2) Commercial Banks:- Commercial banks facilitate the conversion of one country's currency into another country's currency. The commercial banks are supposed to be the most active players in the foreign exchange market. These banks have a wide network of branches or the correspondent banks all over the world because of which they can transact the foreign exchange business smoothly, fastly and efficiently. The importers and exporters belong to different countries. These banks act as intermediaries between the importers and exporters. They buy foreign exchange from the exporter and sell it to the importers.

Commercial banks being the active players in the foreign exchange market achieve the following objectives:-

i) Profitability:- Foreign exchange business is a profitable activity. The commercial banks buy the foreign exchange from the exporting country at a lower rate and sell the same to the needy importing country at a higher rate. The difference between these two rates leads to accruing of profit to the commercial banks.

ii) Risk bearing:- The foreign exchange business entails risk which arises out of fluctuations in the foreign exchange rate. This risk is shouldered by the foreign exchange banks by entering into a contract with the party concerned. It gets referred to as forward dealing.

iii) Better service:- Commercial banks render better service to the customers by offering competitive foreign exchange rates.

In India in order to indulge into foreign exchange business the commercial banks have to obtain license from the Reserve Bank of India under section 6 of Foreign Exchange Regulation Act (FERA), 1973.

3)Central Banks:- The central banks are the main players in the foreign exchange market. It is one of the functions of the central banks of the world countries to maintain the external value of the domestic currency. There are two main types of foreign exchange rate systems viz

- a) fixed exchange rate system and
- b) floating or fluctuating exchange rate system.

Under fixed exchange rate system the central bank has to maintain the parity under floating exchange rate system the central bank as a monetary and foreign exchange authority of the country has to intervene in to the foreign exchange market to buy and sel the foreign exchange depending upon the situation. When the demand for foreign exchange is more then it releases its foreign exchange reserves and sells foreign exchange. Conversely when the supply of foreign exchange happens to be more it buys foreign exchange from the market. Thus it tries to maintain the external value of the domestic currency.

4) Bill Brokers:- Bill brokers are the intermediaries who act as liaison between the buyers and sellers of foreign exchange. Their function is to bring both the parties together to settle the foreign exchange traction. For performing this function they get their commission known as brokerage.

5) Discount Houses:- The discount houses are the specialized houses specializing in the business of discounting the foreign bill of exchange. The discount houses discount the foreign bill of exchange put forwarded by an exporter and finances him before the maturity of the foreign bill of exchange at a discount. They retain the foreign bill of exchange till maturity and recover the full value of the foreign bill of exchange. The London discount houses are the glaring example of specialized discount houses in the London International money market.

6) Acceptable Houses:- The Acceptance Houses are the financially well to do firms which have earned name and fame in the foreign exchange world. When an importer who is a drawer receives the foreign bill of exchange from the drawer of the foreign exchange will be acknowledges the responsibility of involving payment of the said foreign exchange bill. He being an armature he would like to put the weight of the acceptance house once that foreign bill of exchange. The acceptance house lends its name and acknowledges the responsibility to make the payment of the foreign exchange bill to the payee on behalf of the drawee. The New York Acceptance Houses are the world f* acceptance houses which is the special feature of the New York International Money Market.

Check Your Progress:

1. Define the term Foreign Exchange.
2. State and explain in brief the instruments which are used for international payments.
3. Only Exporters and Importers are the main participants in the Foreign exchange Market- Examine.

7.6 TRANSACTIONS IN THE FOREIGN EXCHANGE MARKET:

The following are the main transactions in the foreign exchange market:-

1) Spot and Forward Exchanges:- The spot rate of exchange is the day to day rate of exchange which is charged on the delivery of goods on spot. In actual practice the settlement takes place within two days in most of the foreign exchange markets. The rate of exchange effective for the spot transactions is known as the spot market.

The forward rate of exchange refers to the rate of exchange charged on delivery of goods at some future date. The forward rate of exchange is determined at the time of buying and selling but the actual rate of exchange may fluctuate to and fro which may put the party concerned into a great financial loss. This risk of exchange rate fluctuation is shouldered by the foreign exchange market. The foreign exchange market quotes the forward foreign exchange rate a priori in two ways i.e. either at a premium or at a discount. The premium is always quoted at a percentage deviation from the spot rate of exchange which is over and above the spot rate of exchange. The forward rate of exchange is quoted at a discount which is also expressed as percentage deviation of exchange rate from the spot rate of exchange which is below the spot rate of exchange. For example if the spot rate of exchange between US Dollar and Indian rupee is 1 \$ = Rs. 50. When it is quoted at a premium of Rs. 2 then the forward rate of exchange at a premium will be Rs. 52 over and above Rs. 50 per U S dollar which will be of the order of 1\$ = Rs. 52. Conversely when the forward rate of exchange is quoted at a discount of Rs. 2 then the forward rate of exchange at a discount will be quoted as 1\$ = Rs. 48. In this way the percentage deviation either at a premium or at a discount comes to 4%.

2) Swap Operations:- The swap operations are undertaken by the commercial banks in the foreign exchange market. The term swap means simultaneous sale of spot currency or the purchase of the spot currency for the forward sale of the same currency. The simultaneous sale or purchase of spot currency for forward delivery, are technically known as swaps. The swap means double deal. The spot currency is swapped against forward.

3) Arbitrage:- Arbitrage means the simultaneous buying and selling of foreign currencies with the intention of making profit. The profit accrues due to the difference between the different exchange rates prevailing in two different markets at the same time. For example in London the foreign exchange rate between pound sterling and US dollar is 1£ = \$4 while in New York at the same time it is 1£ = \$4.5 then it is desirable to buy the dollar at the rate of 1£ = \$4 from London and sell the same at New York at the rate of 1£ = \$4.5. This way the simultaneous buying and selling of dollar against pound

sterling at London and New York respectively will lead to earning of profit to the tune of .5 US dollar.

The arbitrage leads to iron out the differences in the rates of exchange of at different places. It seems to be a move towards creating a single world market for foreign exchange.

Check Your Progress:

1. What are the functions of the foreign exchange market?
2. Distinguish between Spot and Forward exchange market.
3. What do you understand by Arbitrage?

7.7 INTRODUCTION AND CONCEPT OF FOREIGN EXCHANGE RATE

Domestic trade involves no question of foreign exchange and hence no question of foreign exchange rate because trade remains within the geographical/political boundary of a country and the trade is facilitated through the medium of national currency only. Unlike the domestic trade the international trade involves the participation of two or more than two countries and hence two or more than two currencies come to the forefront. Therefore there arises the problem of foreign exchange rate.

CONCEPT:-

The foreign exchange rate is defined as the rate at which the currencies of two countries get exchanged against each other. It is the price of one country's currency in terms of another country's currency. For example in U. S. A. Dollar is the domestic currency while in India Rupee is the domestic currency. When international trade takes place between these two countries it leads to payments and receipts. So as to facilitate payments and receipts between these two countries we have to correct one country's currency in terms of another country's currency which is effected through the medium of foreign exchange rate. If 1 \$ = Rs. 45. This foreign exchange rate gets established then it expresses the price of one U.S. dollar in terms of Indian Rupees. i.e. one U.S. Dollar is equal to 45 Indian Rupees.

7.8 DETERMINATION OF FOREIGN EXCHANGE RATE:

As per the balance of payments theory there are twin market fares which determine the foreign exchange rate in the foreign exchange market.

Algebraically.

$$F. E. R. = f (D_f, S_f)$$

F. E. R. stands for Foreign Exchange Rate.

f stands for functional relationship.

D_f stands for Demand for foreign exchange

S_f stands for Supply of foreign exchange.

7.8.1 Demand for foreign exchange:-

Foreign exchange is demanded by the residents of the country for the following reasons:-

1) Imports of goods:- It is one of the major reasons for the demand for foreign exchange. Raw materials and semi-finished goods are imported by the residents of the reporting country so as to undertake production of finished goods. It also imports consumer durables, so as to facilitate the consumption of sophisticated, qualitative goods. Capital goods like machinery, spare parts etc. are imported so as to industrialize the economy. All these types of imports require the demand for foreign exchange.

2) Import of services:- Services belong to the tertiary sector. Residents of the country demand two types of services viz. a) the services rendered by the individual professionals like traders, lawyers, doctors, musicians, dancers, etc. b) The other types services are also demanded which get referred to as institutional services viz. banking, educational services, insurance, transportation, communication, tourism etc. For importing of services of these types foreign exchange gets demanded.

3) Unilateral Payments:- In order to make unilateral payments i.e. one sided payments viz. donations, gifts etc one has to demand foreign exchange.

4) Miscellaneous:- The miscellaneous items constitute repayment of foreign debt, purchase of assets in foreign countries, direct foreign investment etc. All these miscellaneous items also require the demand for foreign exchange.

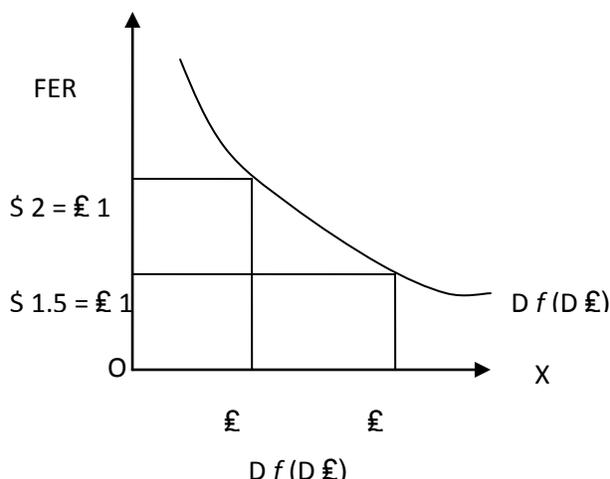


Figure 7.1

The demand for foreign exchange curve is a downward sloping curve which slopes downward from left to right indicating an inverse relationship between the rate of exchange and the demand for foreign exchange. There are two countries viz. USA and England. In the diagram USA's demand for England's pound sterling is shown. When the foreign exchange rate is \$2 = £1 USA demands £ 1000 from England. As the foreign exchange rate falls to \$1.5 = £ 1 USA's demand for England's pound sterling rises to £1500.

7.8.2 Supply of foreign exchange:-

The supply of foreign exchange comes out of receipts due to excess of exports over imports. The following are the main sources of supply of foreign exchange:-

1) Exports of goods:- It is the main source of receipt and hence the supply of foreign exchange. It depends upon the size and the price of exports. If the size of exports is large price of the exports remaining the same the receipts will be more. The size of the exports remaining the same if the price of exports rises then the receipts will be more. It also depends upon the elasticity of exports.

2) Export of services:- Export services include both the types of services viz. the individual professional services and the institutional services. The export of all these types of services earn foreign exchange.

3) Unilateral or one sided receipts:- These include donation, gifts, grants etc. This is a sort of an earning of foreign exchange due to which the supply of foreign exchange increases.

4) Miscellaneous:- The miscellaneous items which are the source of earning of foreign exchange include direct foreign investment, portfolio investment, repayment of debt etc which form the source of supply of foreign exchange.

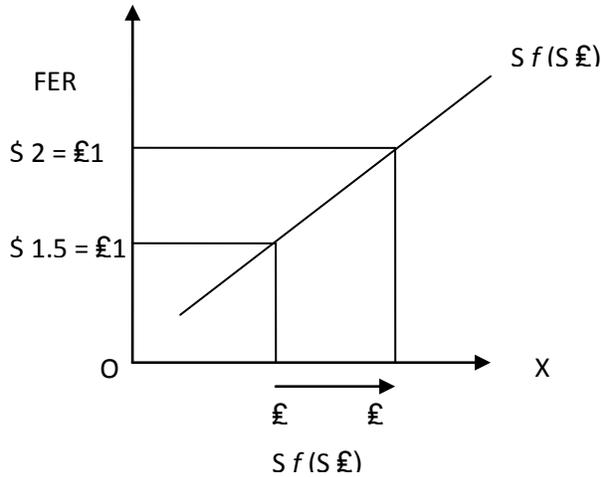


Figure 7.2

The supply of foreign exchange curve is an upward sloping curve which slopes upward from left to right. It indicates a positive and direct relationship between rate of exchange and the supply of foreign exchange. When the rate of exchange was \$1.5 = £ 1 England used to supply £ 1000. When the rate of exchange shoots up from \$1.5 = £ 1 to \$2 = £ 1 her supply of foreign exchange shoots up from £1000 to £2000.

The intersection between the demand for foreign exchange curve and the supply of foreign exchange curve determine the equilibrium foreign exchange rate.

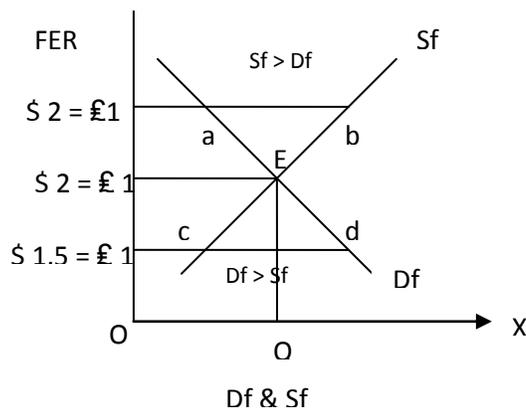


Figure 7.3

Along X axis demand for foreign exchange and supply of foreign exchange are marked while along Y axis foreign exchange rate is marked. D_f is a demand for foreign exchange curve which slopes downward from left to right indicating an inverse relationship between the foreign exchange rate and the demand for foreign exchange i.e. at a higher rate of exchange less foreign exchange will be demanded conversely at a lower foreign exchange rate more foreign exchange will be demanded. S_f is the supply of foreign exchange curve which slopes upward from left to right establishing a positive and direct relationship between the foreign exchange rate and the supply of foreign exchange. Higher is the foreign exchange rate more foreign exchange will be supplied conversely lower is the foreign exchange rate less foreign exchange will be supplied. Both the demand for foreign exchange curve and the supply of foreign exchange curve intersect at the point 'E' where foreign exchange rate gets determined. If we take a perpendicular line from point E along Y axis we get point 'R' hence OR will be the equilibrium foreign exchange rate. Supposing if the foreign exchange rate shoots up from OR to OR^1 then supply of foreign exchange exceeds the demand for foreign exchange due to which the foreign exchange rate will fall from OR^1 to OR. Supposing if the foreign exchange rate slows down from OR to OR_2 then the demand for foreign exchange will exceed the supply of foreign exchange by cd amount. Hence there will an upward tendency of foreign the exchange rate i.e. the foreign exchange rate will shoot up from OR_2 to OR. In this way once again the equilibrium foreign exchange rate will be maintained.

The merit of the balance of payments theory of foreign exchange rate is that it has brought the phenomenon of foreign exchange rate under the preview of general equilibrium theory.

The defect of the balance of payments theory of foreign exchange rate lies in the fact that it assumes perfect competition. Nowhere in the world perfect competition exists. It is the imperfect competition or monopolistic competition which exists everywhere. Secondly it is also assumed that foreign exchange rate is a function of balance of payments. But there are other forces which influence the foreign exchange rate.

Check Your Progress:

1. Define Foreign exchange rate.
2. Explain how demand for and supply of foreign exchange determine the foreign exchange rate.

7.9 EXCHANGE RATE SYSTEMS

Broadly there are two important exchange rate system viz.

- i) Fixed Exchange rate system and
- ii) Flexible Exchange rate system.

7.9.1] FIXED EXCHANGE RATE SYSTEM:-

The fixed exchange rate system is also known as stable exchange rate system or pegged exchange rate system. Under this system of exchange rate countries agree to keep their currencies at a fixed or pegged exchange rate.

Under gold standard the values of the currencies were fixed in terms of gold and the exchange rate fluctuated within very narrow limits. It was called as a very rigid version of the fixed foreign exchange rate. It prevailed till the First World War period. The gold standard had its different versions viz.

- a) Gold specie standard
- b) Gold Bullion standard
- c) Gold Exchange standard

In the gold specie standard the currency in circulation consists of gold coins with fixed gold content. In the gold bullion standard the currency in circulation consists of paper currency notes which are convertible into gold and the paper currency notes are fully backed by gold. In the gold exchange standard the domestic currency of the country concerned is linked with the paper currency of another country which is fully convertible into gold.

For the determination of foreign exchange rate under fixed foreign exchange rate system one has to refer to the mint parity theory of foreign exchange rate.

The fundamental assumption of the mint parity theory of foreign exchange rate is that the currencies of the two trading or participating countries must be on the same mono-metallic standard i.e. either on the gold standard or on the silver standard. The foreign exchange rate between the two currencies of the two countries will be determined on the basis of metallic content of the two currencies. In case of gold standard when both the participating countries are on gold standard then the foreign exchange rate will be determined on the basis of the gold content of the two currencies. The value of each gold currency depends upon the gold contained by the respective currencies.

For example, before First World War both England and U.S.A. were on gold standard. The England's currency was called as Gold Sovereign Pound Sterling which contained 113.0016 grains of gold while USA's currency was Gold Dollar which contained 23.2200 grains of gold. Hence the mint parity was a ratio between the gold value of the Gold Sovereign and the Gold dollar.

$$\frac{113.0016}{23.2200} = 4.8665$$

∴ 1 £ = \$4.8665

Under mint parity the foreign exchange rate was fixed which was allowed to fluctuate within very narrow limits called the gold export point and gold import points. The gold export point and gold import points were also called as specie export and import points respectively. The gold or specie points were determined on the basis of transport, handling, loading, unloading, shipment of gold insurance etc.

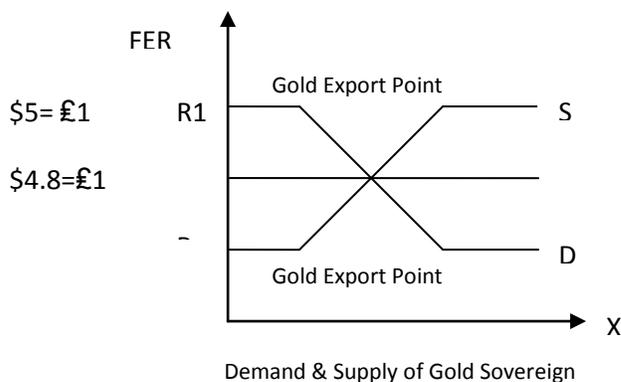


Figure 7.4

The gold export point and gold import point give an idea of maximum fluctuations to and fro in the foreign exchange rate.

Along X axis demand for and supply of Gold Sovereign are shown while along Y axis foreign exchange rate between Gold Dollar and gold Sovereign is shown. D shows the demand for Gold Sovereign and S curve shows the Supply of Gold Sovereign. R point shows the mint parity i.e. fixed exchange rate between Gold Dollar and Gold sovereign which comes to \$4.8 = £ 1. R1 shows Gold export point which is higher than

the mint parity which is of the order of \$5 = £ 1. R2 shows the gold import point which is lower than the mint parity which is of the order of \$4.6 = £1. These are the to and fro fluctuations in the fixed exchange rate which remain within the very narrow limit.

The gold standard operates successfully under certain strict rules which are as under:-

- 1) There must be free import and export of gold between the participating countries.
- 2) Governments of the participating countries must observed the golden rule of the gold standard i.e. expand the volume of currency when the gold comes into the country and contract the volume of currency when the gold waxes exit from the country.
- 3) The monetary authorities of the gold standard countries should maintain their gold parities by buying and selling gold in unlimited quantities.
- 4) There should be a high degree of flexibility in the price system of the participating countries.
- 5) The monetary authorities of the participating countries must be willing to stick to the rules of the game of gold standard even at the cost of sacrificing the conflicting aims of the domestic monetary policy.

World War I brought to an end the gold standard because the participating countries couldn't observe the rules of the game of gold standard.

The bitter experience of war forced the world countries to create a free, stable and multilateral monetary system which could help in restoration of international trade. In 1944 an international monetary conference was held at Bretton Woods according to which the International Monetary Fund was established in 1946. This led to an establishment of an exchange rate system which come to be known as Bretton Woods system. This system was followed by member countries from 1946 to 1971.

The main objectives of the system were as follows:-

- i) to establish an international monetary system with stable exchange rates.
- ii) To eliminate existing exchange controls.
- iii) To bring about free convertibility of all currencies.

The Bretton Woods system required the member countries to fix the parities of their currencies in terms of gold or U.S. Dollar.

The objective of the stable exchange rate system was achieved as the countries were asked to keep the fluctuations of their currencies within $\pm 1\%$ of their declared parity. It was also agreed that without the approval of the Fund no change in parity should be undertaken. USA agreed to fix the parity of US Dollar in terms of gold at \$35 per ounce of gold and undertook to convert dollar balances held by other countries at the fixed rate.

Under this system as the central banks were obliged to intervene in the foreign exchange market to keep the exchange rate within $\pm 1\%$ of the declared parity. It required to maintain foreign exchange reserves by the central banks. If the reserves of foreign exchange with the central banks are not sufficient then the central banks were allowed to switch over to special Drawing Rights and other I. M. F. facilities.

The Bretton Woods system of exchange rate collapsed because of persistent deficit in the U.S. balance of payments. It led to flood of U.S. dollar in the international market. The gold reserves of USA were not sufficient to cover the massive supply of dollar in the international market. This led to a loss of confidence in U.S. dollar and US capacity to convert US dollars into gold at fixed rate ie \$35 per ounce of gold. On 15th August 1971 USA announced its inability to convert U.S. dollars into gold at fixed parity which virtually brought to an end the Bretton Woods System of fixed exchange rate.

Case for fixed exchange rate:-

- 1) Fixed exchange rate ensures stability, certainty and confidence which promote international trade. The trading partners know a priori how much they are going to receive or how much they are going to pay. In case of flexible exchange rate the picture doesn't become clear.
- 2) It paves the way for long term investment which facilitates the growth of capital market.
- 3) There is no danger of speculation ie in future there will be no ups and downs in the foreign exchange rate.
- 4) It leads to bring about internal economic stabilization.
- 5) Fixed exchange rate system suits to the underdeveloped countries. These countries heavily depend upon foreign loans and foreign capital. The stable exchange rate promotes international lending. In this system both the lender and the borrower know how much they are going to receive and pay respectively. The economic development of the underdeveloped countries gets retarded due to speculation about the appreciation or depreciation of the currency.
- 6) In case of small countries like Belgium and Denmark foreign trade plays very important role in their national income. Hence stable exchange rate is the only right policy to better the lot of these countries.

7) Fixed foreign exchange rate is also very much essential for the up to date growth of international money and capital markets.

However the system of fixed exchange rate lacks adjustability.

7.9.2 FLEXIBLE EXCHANGE RATE SYSTEM

Flexible exchange rate system exists when countries of the world switch over to inconvertible paper currency standard. Under this form of foreign exchange rate system the foreign exchange rate is determined freely by the twin market forces of demand for and supply of foreign exchange in the foreign exchange market. The foreign exchange rate goes on fluctuating as per the fluctuations in the demand for and supply of foreign exchange under this system the foreign exchange rates are allowed to fluctuate freely.

When the fixed exchange rate system was relegated to the background it was replaced by the flexible exchange rate system. So as to understand it desirable to understand the purchasing power parity theory of foreign exchange rate. The limitations of the mint parity theory led to the introduction of the purchasing power parity theory. After the breakdown of the gold standard the countries of the world switched over to the adoption of the inconvertible paper currency standard.

The concept of purchasing power parity was originally enunciated by John Wheatley but later on it was modified and renovated by the Swedish economist, Gustav Cassel.

There are two versions to the Purchasing Power Parity Theory viz.

- i) Absolute Version and
- ii) Relative Version

A per absolute version of the Purchasing Power Parity Theory the foreign exchange rate depends upon the domestic purchasing power of the currencies of the two countries. The ratio between the domestic purchasing power of the two currencies of the two countries determine the equilibrium foreign exchange rate which gets referred to as parity. The domestic purchasing power of the currency depends upon the prices of goods and services prevailing in the respective countries.

$$FER = \frac{DPPI}{DPPUSA}$$

FER = Foreign exchange rate.

DPPI = Domestic Purchasing Power of Rupee in India.

DPP USA = Domestic Purchasing Power and Dollar in United States of America.

Substituting figures we get

$$FER = \frac{Rs.45}{\$1}$$

∴ P.P.P. or F.E.R. = \$1 = Rs. 45.

It shows what 1 US dollar can buy in USA Rs. 45 can buy in India.

ii) Relative Version.

The relative version of purchasing power parity points out the to and fro changes in the purchasing power of the respective currencies i.e. In the equilibrium foreign exchange rate. It is caused due to changes in the purchasing power of both the currencies in their respective countries. This is brought about by changes in the price indices in both the countries.

Formula

$$R_1 = R_0 \times \frac{PAO}{PAI} \times \frac{PBI}{PBO}$$

R_0 = Original Base year foreign exchange Rate.

R_1 = New foreign exchange rate in the current year.

PA_0 = Price indices in country A during base year. Let country A be USA.

PA_1 = Price indices in USA during current year.

PB_0 = Price indices in country B during base year. Let country B be India.

PB_1 = Price indices in India during current year. Substituting values we get

$$R_1 = \$1 = Rs.50 \times \frac{100}{400} \times \frac{200}{100}$$

∴ $R_1 = \$ 1 = Rs. 25$

CHANGES IN THE FOREIGN EXCHANGE RATE

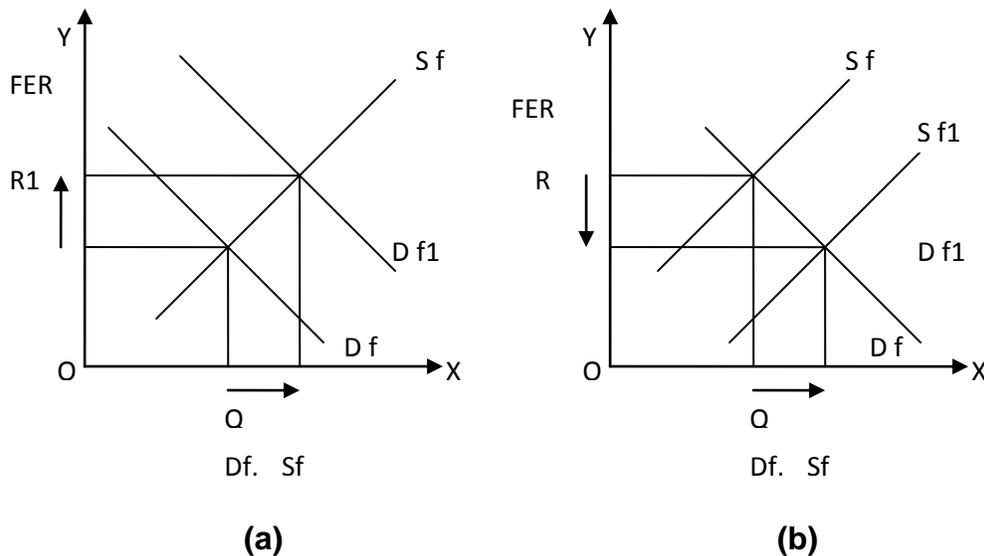


Figure 7.5

Arguments for Flexible Exchange Rate:-

- 1) This system depends upon the operation of twin market forces of demand for foreign exchange and supply of foreign exchange in the foreign exchange market. Hence it represents the general theory of value.
- 2) In the flexible exchange rate system the Governments of the countries concerned are free to pursue their own fiscal and monetary policies.
- 3) It serves as an instrument of adjustment in the balance of payments.
- 4) It helps to solve the problem of disequilibrium in the balance of payments.
- 5) It relieves the country's dependency on foreign exchange reserves.
- 6) Flexible Foreign Exchange Rate System paves the way for the effective functioning of foreign exchange market as regards its lodging function.

However it leads to uncertainty, speculation, inflation and discouragement to foreign investment.

7.10 MANAGED FLEXIBILITY

Managed flexibility means the system of controlled flexibility to foreign exchange rate. The system of managed flexibility is a golden mean, a via media between the two extreme situations of foreign exchange rate systems viz.

- i) the fixed exchange rate system and
- ii) the flexible exchange rate system.

As a matter of fact the system of managed flexibility emerged out of the drawbacks of both the foreign exchange rate systems.

In the managed flexibility the Govt. is called upon to play a very important role of intervening in the foreign exchange market. The central bank of the country being the monetary and foreign exchange authority of the country intervenes into the foreign exchange market.

As per the managed flexibility the foreign exchange rate is allowed to fluctuate but within limit. Hence it is also called as controlled flexibility.

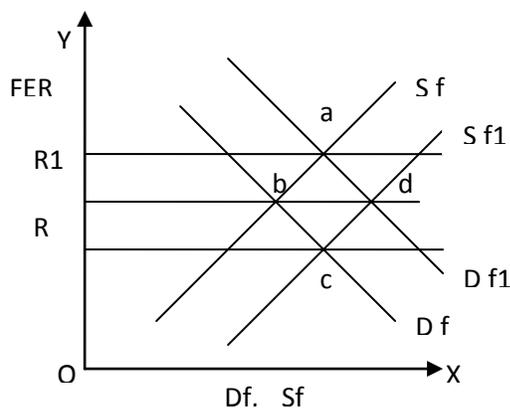


Figure 7.6

OR is the equilibrium foreign exchange rate. When the foreign exchange rate fluctuates around the equilibrium foreign exchange rate then the central bank intervenes into the foreign exchange market. When the demand for foreign exchange rises the central bank releases its foreign exchange reserve and sells the foreign exchange in to the market to tide over the increased demand for foreign exchange. Conversely when the supply of foreign exchange rises it buys the foreign exchange from the market. Thus the central bank keeps the fluctuations in the foreign exchange rate within limit.

The managed flexibility can be of three types.

- i) Adjustable Peg System
- ii) Crawling Peg System
- iii) Managed floating.

The adjustable Peg System believes in the fixed rate of exchange up to a certain point-beyond which it doesn't stick to it and hence switches over to adjustable Peg System. So long as a country possessed adequate foreign exchange reserves it sticks

to fixed exchange rate. Afterwards a country may resort to devaluation of the currency by lowering down the foreign exchange value of the domestic currency. In short it recommends a little flexibility in the midst of stability of exchange rate. Thus this system possesses the dual characteristics of stability and flexibility.

In the Crawling Peg System on and after adjustment is made in the fixed exchange rate system due to changes in the market conditions of demand and supply. But it recommends only mild devaluation and not extreme devaluation.

A system of managed floating believes in Governmental intervention for a quick and reasonable adjustment in the foreign exchange rate.

Check Your Progress:

1. Distinguish between Fixed exchange rate and Flexible exchange rate system.
2. What is managed flexibility?

7.11 SUMMARY:

- 1) The term foreign exchange can be defined as the mechanism through which payments are effected between two countries having different currencies.
- 2) The following are the instruments of international payments:-
 - i) Foreign Bill of Exchange
 - ii) Bank Draft
 - iii) Mail Transfer
 - iv) Telegraphic Transfer
 - v) Letter of Credit.
- 3) A foreign exchange market can be defined as a mechanism through which foreign currency can be bought and sold.
- 4) The following are the main participants in the foreign exchange market:-
 - i) Customers
 - ii) Commercial banks
 - iii) Central banks
 - iv) Bill brokers
 - v) Discount houses
 - vi) Acceptance houses.
- 5) Functions of the foreign exchange market:-

- i) Transfer function
 - ii) Credit function
 - iii) Hedging function
- 6) Transactions in the foreign exchange market
- i) Spot and forward exchanges
 - ii) Swap Operations
 - iii) Arbitrage
- i) The foreign exchange rate is defined as the rate at which the currencies of two countries get exchanged against each other.
 - ii) It is the price of one country's currency in terms of another country's currency.
 - iii) $F. E. R. = f(D_f, S_f)$
 - iv) The foreign exchange rate is determined at a point at which the demand for foreign exchange curve intersects the supply of foreign exchange curve.
 - v) There are two main types of exchange rate systems viz.
 - a) Fixed Exchange Rate System which is also called as Pegged Exchange Rate System.
 - b) Flexible Exchange Rate System.
 - vi) Managed flexibility means controlled flexibility of foreign exchange Rate.
-

7.12 QUESTIONS

- 1) What do you mean by foreign exchange market? What are its functions?
- 2) Write short notes on
 - a) Hedging function
 - b) Swap operations
 - c) Foreign bill of exchange
- 1) Define the term: Foreign Exchange Rate? How foreign exchange Rate is determined?
- 2) Explain the Purchasing Power Parity theory of foreign exchange rate.
- 3) Write short notes on the following:-
 - a) Mint Parity
 - b) Purchasing Power Parity
 - c) Managed Flexibility.
- 4) Advance arguments for and against Fixed exchange rate System.
- 5) Advance arguments for and against Flexible exchange rate system.



CURRENCY CONVERTIBILITY

Unit Structure:

- 8.0 Objectives
- 8.1 Introduction of the term Currency convertibility
- 8.2 Meaning of the term currency convertibility
- 8.3 Types of currency convertibility
- 8.4 Prerequisites of currency convertibility
- 8.5 Merits of currency convertibility
- 8.6 Convertibility of Indian Rupee
- 8.7 Introduction and concept of Foreign exchange reserves
- 8.8 Composition of International Reserves
- 8.9 The Reserve position in IMF
- 8.10 Special Drawing Rights (SDRs)
- 8.11 Exchange Risks
- 8.12 Global Linkage of Foreign Exchange(FX) Market
- 8.13 Summary
- 8.14 Questions

8.0 OBJECTIVES

- i) To know the meaning of the term 'Currency Convertibility.'
- ii) To know the advantages of currency convertibility.
- iii) To know the different types of currency convertibility.
- iv) To know the meaning of the term, 'Foreign exchange reserves.'
- v) To know the relationship between currency convertibility and the foreign exchange reserves.
- vi) To know the case of the convertibility of Indian rupee.

- vii) To analyze the report of the Taraporwala Committee on Capital Account Convertibility.
- viii) To know the meaning of the term foreign exchange reserve.
- ix) To know the constituents of foreign exchange reserves.
- x) To know the demand and supply sides of the foreign exchange reserves.
- xi) To know the scheme of Special Drawing Rights.
- xii) To understand the concept of Exchange risk
- xiii) To study the global linkage of foreign exchange market

8.1 INTRODUCTION

Currency convertibility is essential if multilateral trade is to be developed.

During the period 1925 – 31 which was a period of revival of gold standard Bank of England's paper currency notes were convertible into gold in the restricted sense.

When the currency convertibility is used in the sense of foreign exchange a currency is said to be convertible when it can be readily exchanged for other currencies. It may be fully convertible when it can be exchanged under all circumstances.

Under the Washington Loan Agreement of December 1946 pound sterling had to be made freely convertible by July 1947. But it couldn't be made fully convertible currency by July 1947. The European countries had a great demand for American goods such that whatever sterling they acquired had to be immediately converted into U.S. dollar. Great Britain had to pay for all its imports in U.S. dollars. It was a drain on Great Britain foreign exchange reserves. It was so heavy that after about five weeks convertibility of pound sterling had to be suspended. At the time of Washington Loan Agreement American Government had greatly underestimated the effect of world wars on Great Britain economy and one estimated America's Power of recovers which led to America's generous scheme of assistance which was known as Marshall Plan.

Great Britain's failure to maintain the convertibility of pound sterling in 1947 made the British monetary authority not to take risk afterwards. Hence convertibility was restored after 1947. It was limited only to sterling area countries. Later on gradually the convertibility was extended to two more areas viz I) The area of American Account and ii) The area of Transferable Account.

The former group of countries comprised of United States of America, Canada etc. The area of Transferable Account comprised of rest of the world. The countries were admitted to it by individual agreement. By 1955 it included almost the whole of the world outside the sterling area and the area of American Account. By 1959 the pound sterling became freely convertible between members of different areas.

The convertibility of Indian rupee has been a subject of great interest which excited discussions in recent years specially due to the submission of the Taraporewalla Committee on Capital Account convertibility. But first of all we have to describe the Liberalized Exchange Rate Management System (LERMS) and then we will have to examine the prospects and feasibility of full convertibility of rupee.

Under the LERMS exports of goods and services who are in receipt of bulk of foreign exchange will have to their foreign exchange at the market rate in the foreign exchange market except 40% of their foreign exchange earnings which will have to be surrendered to the monetary authority of India ie the Reserve Bank of India at an official rate. (ie the balance 60% of their foreign exchange earnings will have to be sold in the free market at the marked rate)

The RBI will sell foreign exchange at the official rate to authorized dealers only for

- i) Imports of specified goods covering Governmental needs
- ii) Imports under Exim scraps unutilized as on February 29, 1992.
- iii) Imports of life saving drugs and equipments under licenses.

For import under advance licenses and special impress licenses and imports for replenishment of raw materials for gem and jewelers exports foreign exchange will be available at official rate for 40% of the value. The remaining requirements will be met through purchases in the free market.

8.2 CONCEPT

There are two types of currencies, viz

- i) Convertible currency and
- ii) Controlled currency

A convertible currency is one which can be converted into foreign currencies and can be used freely for payment against import of goods and services.

This is unlike the controlled currency which cannot be converted into foreign currencies without prior authorization because of exchange controls which are imposed in that country.

Free convertibility of the currency means that the currency can be exchanged for any other convertible currency, without any restriction, at the market determined exchange rate.

The convertibility of the Indian rupee means that the Indian rupee can be freely converted into foreign currencies like US dollar, pound sterling, yen, Roubles, Deutsche

mark etc. at the market rate of exchange which is determined through the twin market forces of demand for and supply of foreign exchange.

The currency convertibility concept originated in Bretton Woods Agreement which led to the establishment of International Monetary Fund and the World Bank.

The following are the basic features of currency convertibility:-

- a) freedom of trade and payments for current account transactions.
- b) application of fixed exchange rate ie par value in respect of payments for current account transactions.
- c) national endeavor to maintain adequate reserves supplemented by multilateral reserves under the IMF Quota System to meet any temporary difference between demand for and supply of foreign exchange in the foreign exchange market.

Note: Capital account transactions were explicitly excluded from the purview of the Bretton Woods scheme of currency convertibility.

It is to be noted that convertibility of the currency was not introduced straight way under the Bretton Woods Agreement. A transition period of five years was allowed, but in actual practice it took over fifteen years for currency convertibility to come into effect which was in early 1960's. In the mean time a number of countries adopted different trade and payments liberalization devices as per balance of payments adjustment requirements. These measures were intended to tackle the imbalance between the demand for and supply of foreign exchange. Major European currencies become fully convertible only when their balance of payments position improved leading to macro economic stability. The improved external sector was regarded as a pre condition of currency convertibility.

As per I. M. F. Article VIII a currency is convertible if it is convertible for current Account transactions alone ie to acquire the status of convertible currency capital Account Convertibility (CAC) is not essential.

8.3 TYPES OF CURRENCY CONVERTIBILITY

Currency convertibility can be of two types, viz

- i) Partial convertibility of the currency and
- ii) Full convertibility of the currency.

In order to know the difference between the partial convertibility of the currency and the full convertibility of the currency one must know the constitution of the Balance of Payments.

As per the constitution of the Balance of Payments of a country comprises of two main Accounts. Viz

- a) Current Account and
- b) Capital Account

The dichotomy between the Current Account and the Capital Account is based upon the classification of international economic transactions into two parts. I) real transactions and ii) financial transactions. Real transactions are the transactions in the real sense of the term ie the transactions of goods and services ie import and export of goods and services. The real transactions are also called as income heating transactions. Financial Transactions are those transactions which involve the transfer of money or claims on money or little to investment. Financial transactions are often referred to as capital transactions. These transactions do not directly involve the transfer of output or income. These transactions signify only transfer of claims between the countries concerned. Hence the real transactions enter into Current Account while financial transactions enter into Capital Account.

8.3.1 Current Account:-

The Current Account mainly consists of two sub parts viz

- i) Trade Account or Merchandise Account or Visible Account.
- ii) Invisible Account or Tertiary Account or Service Account.

A merchandise account or trade account or goods account consists of import and export of goods only. Goods are visible. Hence it is also called as visible account.

The invisible account or tertiary account or service account consists of services. Services are of two types viz.

- a) Individual Professional Services like teachers, doctors, dancers, musicians etc.
- b) Institutional services like banking, insurance, transportation, communication, travel, tourism, education, health etc.

Besides these two Current Account also includes unilateral items ie receipts and payments like gifts, donations, charities, grants etc. In unilateral receipts you only receive you do not make payments. In unilateral payments you only make payments but you do not receive anything in return.

It should be noted that current account never includes financial transactions.

8.3.2 Capital Account:-

Capital Account consists of financial transactions. It consists of all items which may be employed in financing both imports and exports. The Capital Account items can be divided into the following transactions:-

- i) Short term capital movements.
- ii) Long term capital movements.

iii) Repayment of Loans.

The short run capital movements include buying and selling of short term Government and corporate securities the maturity period of which comes to one year.

The Long run capital movements consist of purchase and sale of shares and debentures (long term bonds) which get referred to as portfolio investment.

The repayment of loans consist of loans taken from Developed Countries and from international financial institutions like IMF, IBRD, ADB etc.

Specie Account is a part and parcel of capital account which comprises of Gold and SDR.

When a currency of a country is convertible into foreign currencies only on Current Account transactions of balance of payments it is said to be partial convertible currency. But when the currency of a country is convertible in both the Accounts ie the Current Account and the Capital Account the currency of the country is said to full convertible currency.

8.4 PRE-REQUISITES

For making the convertible system a grand success following are some of the most essential conditions:-

- 1) Domestic stability of an economy.
- 2) Adequate stock of foreign exchange reserves.
- 3) When foreign exchange reserves are not adequate then the imports should be restricted it a country should import only essential commodities.
- 4) Current Account position of balance of payment should be comfortable.
- 5) Lounducine and appropriate industrial and investment policies.
- 6) Development planning should be export oriented such that incentives should be given for the promotion of exports.

8.5 MERITS OF CONVERTIBILITY

- 1) It encourages exports by increasing profitability of exports.
- 2) It leads to import substitution and export promotion.
- 3) It gives incentive to Non-Resident Indians to remit funds.
- 4) Before convertibility Hawala market remains very active to the remittance of funds now after convertibility remittance of funds gets done through proper channel.
- 5) It assigns real value to the currency.

8.6 CONVERTIBILITY OF INDIAN RUPEE

In 1971 the Bretton Woods System collapsed. Therefore the Indian rupee was pegged to pound sterling for four years. Afterwards it was linked to a basket of fourteen major currencies of the world. Later on it was linked up to a basket of only five major currencies of the world. In 1981 rupee was appreciated which led to a fall in the profitability of exports due to which Reserve Bank of India switched over to managed floating system of exchange rate pegging rupee to dollar and pound sterling alternatively depending upon the situation.

In July 1991 Indian rupee was devalued in the wake of New Economic policy of India in two installments i.e. first on 1st July and second on 3rd July 1991 by about 18% to 20%.

As a part of economic policy reforms, the Finance Minister in his budget speech 1992 – 93 announced partial convertibility of the rupee on current account accordingly Indian Rupee became partially convertible since 1st March 1992. Our move of rupee convertibility was a part of world wide move towards currency convertibility. According to IMF as many as 70 countries of the world accepted current account convertibility of their currencies by 1990. Other ten countries joined the move towards convertibility of currency on current account.

As per Liberalised Exchange Rate Management System (LERMS) which was introduced in India in March 1992 60% of the foreign exchange earnings out of Current Account export earnings (both visible and invisible) to be converted as per free market rate and the remaining 40% foreign exchange earnings were to be surrendered to the monetary authority of the country i.e. Reserve Bank of India as per official minimum rate. In short India followed a dual exchange rate system.

The major reason for introducing partial convertibility of Indian rupee was to make foreign exchange available at a low price for essential imports so that the price of the essential goods should not be pushed up by the high market prices which was in turn due to high market foreign exchange rate.

It was very risky to introduce full convertibility of the Indian rupee when the current account showed heavy deficit.

While introducing partial convertibility, the Government announced its intention to introduce full convertibility on current Account in three to five years. However full convertibility of rupee on trade account was announced in the Budget for the year 1993-94.

8.6.1 CAPITAL ACCOUNT CONVERTIBILITY (CAC) of the Indian RUPEE

The Capital Account Convertibility (CAC) refers to the freedom to convert local financial assets into foreign financial assets and vice versa at the market determined rate of exchange. It is associated with changes of ownership in domestic/foreign financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world.

The currency convertibility on capital account is usually introduced only after the lapse of certain period of time after the introduction of partial currency convertibility on Current Account. The Capital Account convertibility can help to increase the inflow of foreign capital as it enables the foreign investors to repatriate their investments whenever they want. On the other hand it may also lead to flight of capital from the country if domestic conditions are unfavorable. Hence Capital Account convertibility is usually introduced only after experimenting with the current account currency convertibility for a reasonable period of time. The country has to see to it that the stabilization programmes have been successfully carried out and a congenial, favorable atmosphere is ensured.

The introduction of Capital Account convertibility (even for certain types of capital assets) helps to attract resources from abroad. It enables the residents to Gold internationally diversified portfolio investments. However, Capital Account convertibility can't be introduced until certain conditions are satisfied. If there is no macroeconomic stability and the competitiveness then the Capital Account convertibility entails the risk of capital flight and greater fluctuations in foreign exchange rate, foreign exchange reserves and interest rate. Hence till the economy is well developed the country has to maintain various types of controls. Under free capital convertibility the residents of the country can sell their property and can take their property abroad. Hence even if Capital Account convertibility is introduced several restrictions have to be attacked.

In pursuance of the commitment made by the Finance Minister Mr. P. Chidambaram in his Budget speech for 1997-98 the Reserve Bank of India appointed a committee on Capital Account convertibility (CAC) under the chairmanship of Mr. S. S. Taraporewalla on February 28, 1997 with the following terms:-

- i) To review the international experience in relation to CAC and to indicate the pre-conditions for introduction of CAC in India.
- ii) To recommend the measures that should be taken to achieve full CAC.
- iii) To specify the sequence and time framework in which CAC is to be adopted.
- iv) To suggest domestic policy measures and changes in institutional framework for the success of CAC.
- v) To make some other recommendations as the committee may feel relevant in their connections.

The Taraporewalla Committee on CAC studied the Indian situation and subedited its Report on May 30, 1997.

The committee has given the working definition of CAC as per which CAC refers to the freedom to convert local financial assets into foreign financial assets and vice versa at the market determined rates of exchange. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on or by the rest of the world. It doesn't preclude the imposition of monetary and fiscal measures relating to foreign exchange transactions which are of prudential nature.

The committee pointed out that CAC leads to availability of larger capital stock to supplement the domestic resources thereby it will lead to improve access to international financial markets. THE CAC allows residents to hold an internationally diversified portfolio investment which reduces the vulnerabilities of income streams and wealth. This leads to lower funding costs for borrowers and higher prospects for yields to savers. The qualities of financial assets improves due to greater liquidity and widening and deepening of markets. It strengthens the conduct of monetary policy by the pursuit of realistic and appropriate exchange rate policy. The CAC enhances the effectiveness of fiscal policy by bring about optimal combination of taxes following the international level of taxes, by reducing crowding out effect in the access to funds. In fact, the prudent fiscal policy can play a major role in canalizing capital flows into productive investment.

The committee also recommended some preconditions for CAC which include

- i) Fiscal consolidation
- ii) Mandated inflation Rate
- iii) Strengthening of Financial System
- iv) Adequacy of foreign exchange reserves
- v) Good foreign exchange rate policy and a sound Balance of Payment Position.

For preparing the financial system for CAC the committee also recommended removing market segmentation, uniform treatment of resident and non resident liabilities for purposes of reserve requirements improving risk management system, introduction of more stringent capital adequacy standards, effective supervisory system and greater autonomy for banks and Financial Institutions.

The committee was also of the view that the time didn't get mature to switch over to CAC directly and therefore should switch over to a phased programmed of three years.

- i) First phase 1997 – 98
- ii) Second phase 1998 – 99

iii) Third phase 1999 – 2000

Check Your Progress:

1. Define currency convertibility.
2. Distinguish between Partial convertibility and Full convertibility of the currency.
3. Write notes on Prerequisites and Merits of currency convertibility.
4. Explain briefly on convertibility of Indian Rupee.

8.7 INTRODUCTION AND CONCEPT OF FOREIGN EXCHANGE RESERVES:

Just as an individual has to be in a position to pay his debts. in order to pay the debts a person must have his own income. In the same way every nation has to pay for the imports of goods and services. To settle the international obligation a nation must have adequate foreign exchange reserves. In order to accumulate foreign exchange reserves a nation must earn foreign exchange by exporting goods and services. The reserves are generally hold in the form of gold, Dollar, Pound Sterling and other strong or reserve carries of the world plus other international financial assets, S.D. Rs. etc.

There is a linkage between the growth of international trade and the growth of foreign exchange reserves. With the growth of international trade foreign exchange reserve also grows. When the demand for foreign exchange reserve matches with the supply of foreign exchange reserves then there will be no problem of foreign exchange reserve. The problem of foreign exchange reserve crops up when the demand for foreign exchange reserves exceeds the supply of foreign exchange reserves.

8.7.1 CONCEPT:-

The term foreign exchange reserves is associated with the system of international payments of a country. It is a part and parcel of International liquidity.

There is a difference between the term international liquidity and the term foreign exchange reserves. The term international liquidity is a broad term which encompasses foreign exchange reserves while foreign exchange reserves is a very narrow term in the realm of meeting the balance of payments deficit and settling other international obligation. It is a part and parcel of international liquidity. International Liquidity refers to generally accepted means of international payments available to a country for the

settlement of international transactions. This International Liquidity comprises of two elements viz.

- i) Owned reserves and
- ii) Borrowing facilities

Of these two elements the foreign exchange reserves constitute the first one i.e. owned reserves. Hence it forms as only one fragment of International Liquidity.

International reserves of a country comprise of

- i) official holdings of gold
- ii) foreign exchanges like U.S. Dollar Pound Sterling and other strong or reserve currencies of the world countries.
- iii) Special Drawing Rights (SDRs)
- iv) Reserve Position in IMF.

Note:- The international reserves do not include private holdings of gold, private holdings of foreign exchange and private holdings of international financing assets.

8.8 COMPOSITION OF INTERNATIONAL RESERVES

The table given below gives us an idea of the composition of International Reserves:-

8.8.1 Official Holdings of Reserve Assets (in billion of SDRs)

	1973	1980	March 1990	March 1997
Total Reserves	117.7	321.8	590.7	1,133.0
Exchanging GOLD				
Fun Related Assets	15.0	28.6	46.6	54.98
Reserve Position in the Fund	6.2	16.8	25.2	36.2
SDRs	8.8	11.8	20.4	18.7
Foreign Exchange Gold	102.7	293.10	545.1	1078.2
Quantity (million)	1022.0	952.4	938.2	892.8

Ounces)				
Value at London Market Price	95.0	440.2	265.6	224.1

(Source I.M.F. Annual Report)

8.8.2 Gold Reserves:- In the International Monetary Fund gold was originally assigned the role of primary medium of International Reserve. It was also working as an International Unit of Account in terms of which each members currency was defined. In 1980 gold accounted for about 58% of total international reserves. By 1997 it declined to 16%

8.8.3 Key Currency Reserves:- As time rolled on and the Breton Woods System evolved, the composition of stock of international Reserves changed such that the reserve assets other than gold started assuming more importance. The US Dollar and the British Pound Sterling played very important role as key currencies. The I.M.F. System adopted the gold exchange standard in which the U.S. Dollar was convertible into gold and other currencies of the member countries were convertible into U.S. Dollar. Therefore U.S. dollar was regarded as goods as gold since it was convertible into gold at fixed rate. The countries acquired dollar reserves by enjoying balance of payments surplus in terms of dollars. When rest of the world acquired dollars the United States of America was suffering from deficit in the balance of payments. The deficit was financed in two ways, viz. I) through export of gold ii) through acquisition of dollar claims by the rest of the world countries. When the balance of payments position of USA deteriorated the rest of the world countries acquired huge international reserves. As long as the rest of the world countries accepted dollar in lieu of gold it didn't pose any reserve problem before USA. This all depended upon the confidence of people upon dollar being convertible to gold. But as the volume of dollar holding of the foreigners increased the ability of the USA to maintain convertibility of dollar into gold became doubtful. This led to an uneasiness about the future of dollar after mid 1960's. Expectations that the dollar would soon be devalued reached a climax in early 1971. There was a massive outflow of short term capital from USA. During first three quarters of 1971 the US balance of payments jumped up to an annual rate of \$23 billion as measured by Net Liquidity basis or \$31 billion as measured by the 'Official Reserve Transaction'. The United States of America faced the problem of how to get rid off this situation. One of the solutions before USA was to devalue dollar in terms of gold. However, devaluation would not change exchange rates as long as other currencies remained tied down to dollar. Effective devaluation of dollar in terms of other currencies required the cooperation of other countries. However, in August 1971 the dollar crisis reached a stage that demand immediate action. On August 15, 1971 President Nixon announced the suspension of convertibility of dollar into gold accompanied by certain

other measures viz. 10% surtax on imports. Thus the international value of the dollar began to float, depreciating against major currencies of the world countries which obviously led to the collapse of the Bretton Wood System.

8.9 THE RESERVE POSITION OF IMF

The reserve position of I.M.F. can be had from each member country's contribution to I.M.F. in terms of fixed quota. Each member country's quota is fixed on the following grounds:-

- i) 2% of national income
- ii) 5% of gold and dollar reserves
- iii) 10% of average annual imports
- iv) 10% of maximum variation in annual exports
- v) the sum of i), ii), iii) and iv) increased by the percentage ratios of average annual exports of national income.

The quotas of all member countries taken together determine the major financial resources of the fund. Each member country is required to subscribe its quota partly in gold and partly in its own currency. A member country must contribute gold equal to 25% of its quota or 10% of its gold stock and US Dollar holdings, whichever is less. The portion of subscription paid in nations currency is deposited in nations central bank on behalf of I.M.F.

Thus IMF gets a pool of foreign currencies.

Quotas of selected member countries of IMF:-

As on Dec. 31, 1972 in million U.S./ Dollars or in SDRs

Country	Quota	Gold subscription
1) USA	6,700	1,672
2) UK	2,800	700
3) Germany	1,600	400
4) France	1,500	375
5) Japan	1,200	300
6) Canada	1,100	275
7) Italy	1,000	250
8) India	940	162

1 SDR = 0.888671 gram of fine gold

Source: IMF International Financial Statistics Feb. 1973.

The quotas are reviewed every five years and adjusted from time to time by the fund.

The above table shows that India is the eighth largest quota holder today.

Gold Reserve Tranche:-

Twenty five percentage of member country quota held by IMF. It can be drawn by each member country as a matter of right. It is regarded as member countries owned reserves and its drawing cannot be derived by the IMF.

Reserve Tranche:-

Each member country of IMF has a reserve tranching position in IMF to the extent that its quota exceeds the IMF's holdings of its currency in the General Resources Account, excluding holdings arising out of purchases under all policies on the use of the IMF's general resources. A member may purchase up to the full amount of its reserve tranche at anytime, subject only to the requirement of balance of payment need. A reserve tranche purchase doesn't constitute a use of IMF credit and is not subject to changes or obligation to repurchase.

8.10 SPECIAL DRAWING RIGHTS (SDRs)

It was strongly felt that there should be an extra source of international reserves other than gold and dollar to cater to the growing need of international liquidity to finance the balance of payments deficits and other international financial obligations. Periodically quota subscriptions of the member countries were revived. Special devices were invented to provide extra reserves to countries in crisis. The most important of these devices were G.A.B. i.e. General Arrangements to borrow which was instituted in 1962. It was evident from this that the Fund had insufficient resources from quota to meet the potential demand for the currencies of the major countries. Another device was the bilateral "swap" agreements to make reciprocal credit available. None of these devices solved the problem. IMF credit was a temporary solution to the problem and the swap arrangement was an arrangement to get rid off the crisis. Hence the problem of international reserves required a new and innovative approach to be termed as special Drawing Rights.

After several years of growing concerns over the liquidity problem, an agreement was reached at the IMF annual meeting in Rio-de-Javeiro in 1967 to issue special Drawing Rights (SDRs) in 1969 the agreement was approved and the first allocation of SDRs was made in 1970. The SDRs are allocated to members of IMF in proportion to their quota in the I.M.F.

The Special Drawing Rights is an international reserve asset created by IMF by taking into account the global need to supplement the existing reserves and thus to alleviate the problem of international liquidity. It was intended that the SDRs should become the principal reserve asset in the international monetary system IMF has two Accounts viz.

- i) General Account and
- ii) Special Drawing Account

It is through special Drawing Account that the operations of SDRs are conducted.

The SDR is a created deposit of the IMF. It confers on the holder the right to obtain its defined equivalent in foreign exchange from other member countries of IMF. It is only a book entry in the special Drawing Account of the IMF. The allocation of SDRs takes the form of credit entry in the SDRs Account of the Fund. Its allocation to members does not involve any payment by the members to the Fund. There is no need to furnish any adequate collateral security when the SDRs are issued to any member country its account gets credited and it can be freely used by the creditor country to meet its balance of payment deficits. A member country can use SDRs unconditionally ie a participant country is not upon to adopt any specific economic policy or to seek the prior approval of IMF. A participating country is not required to supply its own currency in exchange. A participant member country having a need to use SDRs towards balance of payments deficit can approach a designated member of the Fund for the Supply of the required foreign exchange. The Fund designates members to provide the foreign exchange in exchange for SDRs on the basis of strength of their balance of payments and reserve position.

The SDRs are also used for a variety of voluntary transactions through agreements among themselves viz.

- i) To obtain currency in transactions through agreement with other members, without any requirement for balance of payment deficit.
- ii) For swap arrangements.
- iii) In forward operations
- iv) To make loans of SDRs.
- v) To settle financial obligations.
- vi) As security for the performance of financial obligations in either of the two ways (a) Members may pledge SDRs which is recorded in a special register kept in the IMF. B) SDRs may be used by members as security against performance of obligation (After the obligation is over the SDRs are returned to the transferor)
- vii) For donations, grants etc.

The SDR is known as paper gold as it is substituted for gold as the most important international monetary asset. Hence it is a new form of international monetary asset. The main objective of I.M.F. behind the issue of S D R s is to provide adequate reserves to member participating countries to facilitate the expansion and the growth of international trade. The allocation of SDRs supplements the existing international reserves. It also reduces the dependency of the member participating countries on U.S. dollar as the international means of payments.

The value of SDR is determined on the basis of a basket of five currencies viz. the U. S. Dollar, the Deutsch Mark, the French Franc, the Japanese Yen and the British Pound Sterling. It's value con 31st August 1998 was of the order of 1 SDR = \$1.342221. It is revised every five years.

The IMF has allocated a total of 21.4 billion SDRs in six allocations since the first allocation of SDRs in 1970. The SDRs are allocated to the participating member countries of I.M.F. in proportion to their quotas at the time of allocation.

The SDR is also used as a unit of account of the IMF.

8.10.1 ADEQUACY OF RESERVES:-

An adequate stock of reserves is one that is consistent with the smooth functioning of the international monetary system, an expansion of world trade and the absence of persistent inflation or deflation. An adequate level of level of resources may be larger or smaller than the desired holdings of reserves under a particular set of asset prices and economic condition. For example, an effective demand for reserves that reflect a depressed level of international trade and high interest costs could be considerably smaller than the amount of reserves that would be held under more favorable conditions.

As appraisal of adequacy of international reserves must take into account factors affecting the demand for reserves and the factors affecting the supply of reserves.

8.10.2 OBJECTIVES OF HOLDING FOREIGN EXCHANGE RESERVES:-

Following are the objectives of holding foreign exchange reserves:-

1) Maintenance of Confidence:- so as to maintain the confidence of people on the nations currency a monetary authority has to keep certain minimum amount of foreign exchange reserves. For example India switched over to minimum reserve system of note issue in 1956 according to which the central bank of the country ie the Reserve Bank of India used to keep minimum 515 cores rupees worth in terms of gold and foreign exchange of which the gold amount was of the order of 115 cores rupees and the remaining amount of Rs. 400/- was kept in terms foreign exchange, one rupee notes and coins and Govt. of India securities. In 1957 the minimum reserve was lowered down from Rs. 515 cores to Rs. 200 cores of which the gold reserve remains intact ie. Rs.

115 crores and the remaining intact i.e. Rs. 115 crores and the remaining Rs. 85 crores are kept as reserve in terms of foreign exchange, one rupee notes and coins and the Govt. of India securities. If the minimum reserve is kept RBI is empowered to notes up to unlimited extent.

2) To facilitate the intervention of the Central Bank:- As most of the countries of the world have switched over to managed floating exchange rate system the central bank of the country has to minimise the erratic fluctuations in the foreign exchange rate. It has therefore, to intervene in the foreign exchange market. So as to enable it to do so it must keep sufficient amount of foreign exchange reserves. When the demand for foreign exchange increases it releases the foreign exchange reserves and tides over the emergency and vice versa.

3) To curb the speculative tendency:- The speculators create instability in the country to avoid the speculation the Central Bank used the foreign exchange reserves.

4) Spreading confidence in the Foreign Exchange Market:- The very fact that the monetary authority of the country i.e. the Central Bank of the country possesses a comfortable surplus of foreign exchange reserve spreads confidence in the foreign exchange market of the country and as such brings stability.

The foreign exchange reserves held by the country depends upon the system of foreign exchange rate followed by a country. If a country follows fixed exchange rate system the country will have to hold more foreign exchange reserves to maintain the desired foreign exchange rate. If a country follows flexible foreign exchange rate system then the country need not possess more foreign exchange reserves. The foreign exchange rate automatically gets adjusted as per the twin market forces of demand for and supply of foreign exchange. When a country follows managed floating exchange rate system it has to intervene into the foreign exchange market to iron out undue for erratic fluctuations in the foreign exchange rate as such it is required to keep more foreign exchange reserves.

The demand to hold foreign exchange reserve also depends upon the size of the country from the point of view of population and GDP. The larger the size of population and GDP the more will be demand for holding the foreign exchange reserves.

Check Your Progress:

1. Explain the term foreign exchange reserves.
2. Explain composition of International reserves
3. Write a note on the Reserve position in IMF.
4. Explain the importance of SDRs.

A strong country like U.S.A. or Japan will have good export performance resulting in trade surplus and good inflow of foreign funds for investment because of its high productivity, low cost of production, latest technology and good investment climate, leading to high rates of growth of output, employment and income. So economy, its strength and its rate of growth and its competitive strength along with a host of other factors will influence the currency rates. The exchange risk is thus dependent upon an array of economic and extra economic factors which will lead to an unpredictable rate of exchange.

8.11.2 Exchange risk defined: Exchange risk simply means that the rate at which a currency is exchanged for another currency may be uncertain volatile and the amount that an exporter receives in domestic currency or an importer has to pay in terms of domestic currency will be unpredictable and uncertain. Similarly, if funds are transmitted from one country to another, the amounts to be set or to be received will not be certain, if exchange rates are not fixed. But in the present global economy, free market forces operate to determine the exchange rates depending upon the supply and demand for the currency. This will lead to fluctuating rates, which may result in profits or losses to the holders of foreign currency.

The fluctuating rates result in uncertainty and risk, which will have to be managed by the genuine traders and investors in foreign countries and dealers in foreign exchange and banks. Under free market forces operating, no individual dealer in foreign exchange can influence its price,, but the supply and demand pressures for any currency in total lead to its appreciation or depreciation. The totality of receipts either for exports or inward remittances or inflows of funds will decide the demand pressures emanate from those who have to make payments outside for imports, outward remittances or outflow of funds etc. Such demand and supply pressures influence the exchange rates on a daily and hourly basis and from time to time and lead to uncertainty, in exchange rates.

8.11.3 Types of Risk in Foreign exchange: There are different types of exchange risks in the foreign exchange market.

1. Credit risk of customer: Credit rating by international banks and international credit rating agencies will help reducing this risk.
2. Country risk: This is different slightly from currency risk and arises out of the policies of economic and political nature and their external payments position and their export earnings to service the foreign creditors, convertibility or otherwise of their currencies, etc.
3. Currency risk; This risk arises out of the volatility or otherwise of the currency and its strength or weakness in terms of other currencies and interest rates and relative degrees of inflation in the respective countries which influence the

exchange rates. It also depends on the hot money flows and speculative short term flows as between countries which will destabilise the exchange rates.

4. Market risk: Risks of commodities, their quality and change of government policies of taxation etc., are borne by the exporters. It will thus be seen that some risks cannot be avoided or passed on by the exporters and in fact many more risks are to be borne by the importers than by the exporters.

8.12 Global linkage of Foreign Exchange (FX) Market

The foreign exchange market is where currency trading takes place. Foreign exchange transactions typically involve one party purchasing a quantity of one currency in exchange for paying a quantity of another. Presently, the FX market is one of the largest and most liquid financial markets in the world, and includes trading between large banks, central banks, currency speculators, corporations, governments, and other financial institutions.

The purpose of FX market is to facilitate trade and investment. The need for a foreign exchange market arises because of the presence of multifarious international currencies such as US dollars, Euros, Japanese Yen, Pound sterling, etc., and the need for trading in such currencies.

A) **The market size and liquidity:** the foreign exchange market is unique because of

- Its trading volumes
- The extreme liquidity of the market
- Its geographical dispersion
- Its long trading hours: 24 hours a day except on weekends (from 22:00 UTC on Sunday until 22:00 UTC Friday)
- The variety of factors that affect exchange rates
- The low margins of profit compared with other markets of fixed income (but profits can be high due to very large trading volumes)
- The use of leverage

Foreign exchange trading increased by 38% between April 2005 and April 2006 and has more than doubled since 2001. This is largely due to the growing importance of foreign exchange as an asset class and an increase in fund management assets particularly of hedge funds and pension funds.

B) **Market participants:** The foreign exchange market is divided into levels of access. At the top is the inter-bank market. It accounts for 53% of all transactions. After that there are usually smaller investment banks, followed by large multi-national corporations, large hedge funds, and even some of the retail FX metal market makers. Central banks also participate in the foreign exchange market to align currencies to their economic needs.

- i) **Banks:** The interbank market caters for both the majority of commercial turnover and large amounts of speculative trading every day. A large bank may trade billions of dollars daily. Some of this trading is undertaken on behalf of customers, but much is conducted by proprietary desks, trading for the bank's own account.
- ii) **Commercial companies:** commercial companies often trade fairly small amounts compared to those of banks or speculators, and their trades often have little short term impact on market rates.
- iii) **Central banks:** National central banks play an important role in the foreign exchange markets. They try to control the money supply, inflation, and/or interest rates and often have official or unofficial target rates for their currencies. They can use their substantial foreign exchange reserves to stabilize the market.
- iv) **Hedge funds as speculators:** About 70% to 90% of the foreign exchange transactions are speculative. In other words, the person or institution that bought or sold the currency has no plan to actually take delivery of the currency in the end, rather, they were solely speculating on the movement of that particular currency.
- v) **Investment management firms:** Investment management firms (who typically manage large accounts on behalf of customers such as pension funds and endowments) use the foreign exchange market to facilitate transactions in foreign securities.
- vi) **Retail foreign exchange brokers:** There are two types of retail brokers offering the opportunity for speculative trading: retail foreign exchange brokers and market makers.
- vii) **Non bank Foreign Exchange Companies:** offer currency exchange and international payments to private individuals and companies. These are also known as foreign exchange brokers. It is estimated that in the UK, 14% of currency transfers/payments are made via Foreign Exchange Companies. These companies usually offer better exchange rates or cheaper payments than the customer's bank.

viii) Money transfer/remittance companies: perform high-volume low-value transfers generally by economic migrants back to their home country.

C) **Trading characteristics:** There is no unified or centrally cleared market for the majority of FX trades, and there is very little cross-border regulation. Due to the over-the-counter (OTC) nature of currency markets, there are rather a number of interconnected marketplaces, where different currencies instruments are traded. There is no single exchange rate but rather a number of different rates, depending on what bank or market maker is trading, and where it is.

The main trading centre is London, but New York, Tokyo, Hong Kong and Singapore are all important centers as well. Banks throughout the world participate. Currency trading happens continuously throughout the day; as the Asian trading sessions ends, the European session begins, followed by North American session and then back to the Asian session, excluding weekends.

D) **Determinants of exchange rates:** Economic factors: These include: a) economic policy, disseminated by government agencies and central banks, b) economic conditions, generally revealed through economic reports, and other economic indicators.

i) Political conditions: Internal, regional and international political conditions and events can have a profound effect on currency markets. All exchange rates are susceptible to political instability and anticipations about the new ruling party, political upheaval and instability can have a negative impact on a nation's economy.

ii) Market psychology

E) **Algorithmic trading in foreign exchange:** Electronic trading is growing in the FX market, and algorithmic trading is becoming much more common. According to financial consultancy, Celent estimates, by 2008 up to 25% of all trades by volume will be executed using algorithm, up from 18% in 2005. An algorithmic trader needs to be mindful of potential fraud by the broker. Part of the weekly algorithm should include a check to see if the amount of transaction errors when the trader is losing money occurs in the same proportion as when the trader would have money.

F) **Financial instruments:** Spot: A spot transaction is a two-day delivery transaction, as opposed to the futures contracts, which are usually three months. This trade represents a "direct exchange" between two currencies, has the shortest time frame, involves cash rather than a contract; and interest is not included in the agreed-upon transaction.

- i) Forward: One way to deal with the foreign exchange risk is to engage in a forward transaction. In this transaction, money does not actually change hands until some agreed upon future date. A buyer and seller agree on an exchange rate for any date, regardless of what the market rates are then. The duration of the trade can be a one day, a few days, months or years. Usually the date is decided by both parties.
- ii) Future: Foreign currency futures are exchange traded forward transactions with standard contract sizes and maturity dates. Futures are standardized and are usually traded on an exchange created for this purpose. The average contract length is roughly 3 months. Future contracts are usually inclusive of any interest amounts.
- iii) Swap: The most common type of forward transaction is the currency swap. In a swap, two parties exchange currencies for a certain length of time and agree to reverse the transaction at a later date. These are not standardized contracts and are not traded through an exchange.
- iv) Option: A foreign exchange option is a derivative where the owner has the right but not the obligation to exchange money denominated in one currency into another currency at a pre-agreed exchange rate on a specified rate on a specified date. The FX options market is the deepest, largest and most liquid market for options of any kind in the world.
- v) Exchange- Traded fund: Exchange –traded funds are open ended investment companies that can be traded at any time throughout the course of the day.
- vi) Speculation: Speculators have a stabilizing influence on the market and perform the important function of providing a market for hedgers and transferring risk from those people who don't wish to bear it, to those who do. Large hedge funds and other well capitalized "position traders" are the main professional speculators.

Check Your Progress:

1. Define Exchange risk.
2. What are the types of exchange risks?
3. Sate the Financial instruments used by the foreign exchange market to link it globally.

8.13 SUMMARY

- i) A convertible currency is one which can be converted into foreign currencies and can be used freely for payment against import of goods and services.
- ii) Controlled currency cannot be converted into foreign currencies without prior authorization because of exchange controls which are imposed in that country.
- iii) Free convertibility of the currency means that the currency can be exchanged for any other convertible currency without any restriction at the market determined exchange rate.
- iv) The convertibility is of two main types
 - a) Partial convertibility:- When a currency of a country is convertible into foreign currencies on current account only it is called as Partial convertible currency.
 - b) Full convertibility:- When the currency of a country is convertible into foreign currencies on both the accounts viz the current account and the capital account it is called as full convertibility.
- v) Indian rupee became partially convertible since March 1st, 1992.
- vi) The Taraporewalla Committee on CAC of Indian rupee submitted its report on May 30, 1997.
- vii) The CAC leads to availability of large capital stock to supplement the domestic resources.
- viii) The CAC leads to access to international financial markets.
- ix) The term foreign exchange reserves is associated with the system of international payments of a country.
- x) It is a part and parcel of international liquidity.
- xi) The term international liquidity is very broad which encompasses foreign exchange reserves.
- xii) There are various objectives of holding foreign exchange reserves.
 - a) Maintenance of confidence
 - b) To facilitate the intervention of central bank into the foreign exchange market.
 - c) To curtail the speculative tendency.
 - d) Spreading confidence in the foreign exchange market
- xiii) Exchange risk is due to fluctuations in the rate of exchange in conversion of one currency into another and likely changes in interest rates which might affect the forward rates. It will basically depend on the economic strength of the country and

its foreign exchange reserves, as the volatility of the exchange rate depends on them.

- xiv) The FX market is one of the largest and most liquid financial markets in the world. The need for a foreign exchange market arises because of the presence of multifarious international currencies such as US dollars, Euros, Japanese Yen, Pound sterling, etc., and the need for trading in such currencies.

8.14 QUESTIONS

- 1) What do you mean by convertibility? What are the different types of convertibility? Point of pre-requisites and merits of convertibility.
- 2) Write short notes on any two of the following:-
 - a) Partial Convertibility
 - b) Full Convertibility
 - c) Taraporewala Committee
- 3) What do you mean by foreign exchange reserve? What is the difference between the foreign exchange reserve and international liquidity? Bring about the various objectives of foreign exchange reserves.
- 4) Write short notes on
 - i) Key currency reserves.
 - ii) S D Rs
- 5) What are the reasons of the risk in the foreign exchange market?
- 6) Explain how foreign exchange market is globally linked.



CURRENCY MARKET

Unit Structure:

- 9.0 Objectives
- 9.1 Introduction, Meaning and Scope of Euro dollar market
- 9.2 Salient features of the Euro-Dollar market
- 9.3 Origin and Growth of Euro-Dollar market
- 9.4 Factors contributing to the growth of Euro-Dollar market
- 9.5 Operation and effects of Euro currency market
- 9.6 Problems created by Euro currency market
- 9.7 Segments of Euro currency market
- 9.8 Currency Areas
- 9.9 Currency areas and common currencies
- 9.10 International Financial Integration with respect to European Union
- 9.11 Summary
- 9.12 Questions

9.0 OBJECTIVES

- i) To know the origin of Euro-Dollar Market.
- ii) To know the narrow and broad meaning of the term Euro-Dollar Market
- iii) To know the benefits of the Euro-Dollar Market
- iv) To know the effect of Euro-Dollar Market
- v) To know the short coming of the Euro-Dollar Market.
- vi) To understand the concept of Currency areas
- vii) To study the relation between common areas and common currencies
- viii) To study the role of European Union in International Financial Integration

9.1 INTRODUCTION

The growth of Euro-Dollar Market is one of the significant developments in the international monetary scenario after Second World War. It has caused a profound influence upon the money and capital markets of the world such that the Euro-Dollar Market has become a permanent integral part of the international monetary system.

MEANING and SCOPE:

In a narrow sense, Euro-Dollars are financial assets and liabilities denominated in US Dollars but traded in Europe. The US Dollar still dominates the European money market especially London money market. But the scope of the Euro-Dollar Market is increased by leaps and bounds i.e. the Euro dollar transactions are also held in money markets beyond Europe and in currencies other than US dollar. Thus in a wider sense Euro-Dollar Market refers to transactions in a currency deposited outside the country of its issue. Any currency internationally demanded and supplied and in which the foreign bank is willing to accept liabilities and assets is eligible to become a Euro currency. As such dollar deposits with British Commercial Banks is called as Euro Dollar. Similarly pound sterling deposits with French commercial bank is called as Euro-sterling. Mark deposits in Italian banks get called as Euro-mark and so on. The market in which this sort of borrowing and lending of currencies take place is called as Euro currency market.

Initially only dollar was used in this market. Subsequently, other leading currencies such as British pound sterling, the German mark, The Japanese Yen and the French and the Swiss Franc began to be used in this way. So the term, "Euro-Currency Market" is in popular use. The practice of keeping bank deposits denominated in a currency other than that of a nation in which the deposit is held has also spread to non-European countries. International European monetary centre such as Tokyo, Hongkong, Singapore and Kuwait. Even though outside Europe and even if denominated in yen, then deposits are after referred to as Euro-Currency because the market has been concentrated in Europe.

The Euro-Dollar Market consist of the Asian -dollar market, The Rio dollar Market, the Euro-Yen market, Euro-sterling, Euros-Swiss Francs, Euro-French Francs, Euro-Deutsche marks etc.

In short in these markets commercial banks accepts interest bearing deposits denominated in a currency other than the currency of the country in which they operate and they re-lend these funds either in the same currency or in the currency of the third country.

In its annual report 1966, the Bank for International Settlement (BIS) described the Euro-Dollar phenomenon as "the acquisition of dollars by banks located outside the United State mostly through the taking of deposits, but also to some extent by swapping other currencies into dollars and the re-lending of these dollars after re-depositing with the other banks to non bank borrowers any where in the world."

The currencies involved in the Euro-Dollar market are not in any way different from the currencies deposited with the banks in the respective home country. But the Euro dollar is out side the orbit of monetary policy while the currency deposited with the banks in the respective home country is covered by the national monetary policy.

9.2 SALIENT FEATURES OF THE EURO-DOLLAR MARKET:

Following are the characteristics features of the Euro-Dollar market.

1. International Market: The Euro-Dollar market is an International market. The Euro currency market emerged as the most important channel of mobilizing funds on an International scale.

2. Under no national control: By its very nature, the Euro-Dollar market is outside the direct control of any national monetary policy. The dollar deposits in London are outside the control of United States because they are in London . They are also outside the control of the British because they are in dollar. The growth of the Euro-Dollar market is due to the fact that it is outside the control of any national authority.

3. Short tern money market: It is a short term money market. The deposits in this market rage from one day up to one year. Euro dollar deposits are predominantly a short term investment.

The Euro dollar market is a credit market. It is a market in dollar bank loans. The Euro dollar loans are employed for long term loans.

4. It is a whole sales market: The Euro-dollar market is a wholesale market in the sense that the Euro dollar is a currency which is dealt only in large units. The size of an individual transactions is usually above \$ 1 million.

5. A highly competitive and sensitive market: It is a highly competitive and sensitive market. It's growth and expansion tells us that it is highly competitive market. It is reflected in the responsiveness of the supply of and demand for funds to changes in the interest rates and vice-versa.

9.3 ORIGIN AND GROWTH

The origin of the Euro-dollar market can be traced back to 1920's when the United States dollars were converted into local currencies for lending purposes. However, the growth of the Euro-dollar market began to gain momentum only in late 1950's. Since 1967 the growth of the Euro-dollar market has been very rapid. The flow of petro-dollar s has given it an added momentum in 1970's.

As per BIS estimates its size grew from \$ 2 billion in 1960 to 256.8 billion in 1969. \$ 75.3 billion in 1970, \$ 97.8 billion in 1971 and 131.9 billion in 1972. By 1984 the size of the market reached \$ 2,325 billion.

9.4 FACTORS CONTRIBUTING TO GROTH OF THE EURO-DOLLAR MARKET:

1. Balance of payment deficit of USA :- The large and persistent deficit in the balance of payments of USA increased the flow of US dollars in these countries having surplus balance of payments in relation to USA. The USA has a deficit in the balance of payments since 1950 extent in 1957 and since 1956 the balance of payments deficits have assumed alarming proportion. Hence it was one of the most important factors responsible for the rapid growth of the Euro-dollar market.

2. Banking Regulation in USA: The Federal Reserve system of USA issued regulation "Q" in USA which fixed the minimum rate of interest payable by the member banks in USA. It also prohibited the payment of interest on deposit for less than 30 days. These things significantly contributed to the growth of Euro-dollar market. The Euro-dollar rates of interest were comparatively higher than the US interest rates which attracted the Collar deposits from USA to European countries. The selective controls in the United [States such as interest rate equalization and the voluntary restrictions on lending and investing abroad by United States corporations and banks also led to widening of the f Euro-Dollar market.

3. Innovative Banking : The advent of innovative banking, sphere headed by the American banks in Europe and the willingness of the banks in Europe in the Euro-Dollar ketto operate on a narrow spread, also encouraged the growth of Euro-Dollar market.

4. Supply and Demand : The supply and demand for funds in the Euro-currency market comes from the participants in the Euro-currency business viz. the Governments, International organizations, central banks, commercial banks, corporation's especially multinational corporations, traders and individuals etc. Governments have emerged as significant borrowers in the Euro-currency market. The frequent hike in price and the consequent increase in the current account deficits of number of countries compel them to increase their borrowings. The central banks of various countries constitute the important supplying. The bank of the central banks funds are channeled through BIS. The enormous oil revenue of OPEC countries has become an important source of flow of funds to the Euro-Dollar market. Multinational corporations and trader, too place their surplus funds in the market to obtain short term gains. The commercial banks in need of additional funds for lending purposes may borrow from the Euro market and relent it. At the end of the financial year, they some times resort to borrowing for "window dressing" purposes.

5. Supply of Petrodollars: The flow of Petro-dollars facilitated by the tremendous increase in OPEC oil revenue following the frequent hikes in oil prices since 1973 has been a significant factor in the growth of Euro-Dollar market. The Euro-Dollar market grew especially rapidly after 1973 with the huge dollar deposits from OPEC arising from the manifold increase in the price of petroleum.

6. The Suez crises : The Suez crisis occurred in 1957. During the crisis the restrictions were placed upon the sterling credit facilities for financing trade provided a stimulus for the growth of Euro-Dollar market. The British banks which could not meet the demand for credit from traders found out a good alternative to meet the demand for credit in terms of Euro-Dollar.

7. Relaxation of Exchange controls and Resumptions of currency convertibility: The relaxation of exchange control, the stability in the exchange market, and the resumption of currency convertibility in Western Europe in 1958 provided a fresh impetus to the growth of Euro-Dollar market. Due to resumption of currency convertibility and the comparative higher rate of interest attracted the flow of US dollars from USA to Europe. The US dollars could be converted into domestic currency to finance domestic economic activity.

8. Political Factor: The cold war between the United States and the communist countries also contributed to the growth of Euro-Dollar market. In the event of hostilities the communist countries feared, that there would be blocking of their dollar deposits and hence the communist countries deposited their dollar holdings with the East European banks. This move led to the growth of the Euro-Dollar market.

9.5 OPERATION AND EFFECTS OF EURO-CURRENCY MARKET

Euro-currencies are money substitutes or near money rather than money itself as they are in the form of demand deposits. Euro banks do not create money, but they are essentially financial intermediaries. They bring together lenders and borrowers. They function more like domestic saving and loan associations rather than commercial banks in the United States.

In the east, the United States and oil exporting countries have been the main lenders of Euro-Dollar funds while developing countries, the Soviet Union and eastern European countries have been the major borrowers. The Euro-currency market performed in recycling hundreds of billion of petro-dollars from oil exporting countries to oil importing countries during 1970's. This has paved the way for the huge International debt problems of developing countries, particularly those of Latin America.

9.6 PROBLEMS CREATED BY EURO-CURRENCY MARKET

Following are the problems created by the Euro-currency market.

1. It reduces the effectiveness of domestic stabilization efforts of national Governments. For example, large firms cannot borrow domestically because of credit restrictions instead they borrow from the Euro-currency market. Thus it is frustrating the Government effort to restrict credit to fight domestic inflationary pressure.
2. It creates another problem i.e. the frequent and large flows of short term Euro-Currency funds from one International monetary centre to another which produce great instability in foreign exchange rates and domestic interest rates.
3. Euro-currency markets are largely uncontrolled as a result of which the world wide recession may lead to insolvency of the banks i.e. the International bank panic which affected capitalist nations during the 19th century and the starting of the 20th century.

9.7 SEGMENTS OF EURO-CURRENCY MARKET

The Euro-currency market can broadly be divided into three segments which are as follows:

- i) Euro credit markets where International group of banks get engaged in lending funds for medium and long term.
- ii) Euro-bond market where banks raise funds on behalf of International borrowers by issuing bonds.
- iii) Euro-currency (deposits) market where banks accept deposits mostly for short term.

9.7.1 EURO CREDITS:

Most of the lending in Euro currency market takes the form of Euro credit. Euro credits are medium and long term loans. Euro-credits belong to wholesales sector of the International Capital market and normally involve large amounts.

Euro-credits are provided mostly without any collateral security from the borrower. Here emphasis is laid on credit rating i.e. credits worthiness of the borrower rather than on only tangible security.

Euro-credits are normally provided in either of the two forms:-

- a) Revolving credit and
- b) Term Credit,

A) Revolving Credit is similar to a cash credit facility. It is a stand by facility to meet temporary but recurring financial requirements of the borrower. Interest is charged on the actual amount utilized, a commitment fee may be charged on unutilized portion.

B) Term Credit is similar to medium term loans provided by banks. At the beginning both the lenders and borrowers agree on the schedule of changing the facility. The repayment schedule is fixed taking into account the expected revenue flow from the investment. Many loan agreements provide for pre-payment of the full amount without any penalty at 30 days or 60 days notice. This provision helps the borrowing companies to repay the loan and avail of better conditions that may prevail in the market at a later date.

The period of Euro-credit extends up to 15 years. But most of the credits are for 5 to 8 years. Interest is fixed at a certain percentage, generally the inter banks rate for Eurocurrency deposits. For dollar loans the reference rate is LIBOR i.e. London Inter Bank Offered Rate. Generally, interest for dollar loan is fixed at a percentage over LIBOR i.e. 1 % over LIBOR. Technically the credit is rolled over or renewed every six months. The variations are allowed from the method of rolling over the interest every six months at a fixed percentage over LIBOR.

Many of the loans raised are in dollars. The borrower is given the option to roll over the loan in different currencies according to his requirements. The multi currency option helps the borrower in avoiding exchange risk and also doesn't involve the lending bank in any risk. Since it is not possible for single bank to meet all the demand for loan the banks form the syndicate to provide funds to the borrower.

9.7.2. EURO-BONDS:

The Euro-bonds are International bonds. They are the main source of borrowing in the Euro-markets. Euro-bonds are those bonds which are sold for International borrowers in several Euro markets simultaneously by the International group of banks. They are issued on behalf of multinational corporations, International agencies and Governments Initially the borrower were belonging to the developed countries. Later on developing countries entered into the Euro-market on a very large scale. Euro-bonds are unsecured securities When they are issued by Governments, corporations and local bodies they are guaranteed by the Government of the country concerned.

Selling of Euro bonds is done through syndicates. The lead manager bank is responsible for advising on the size of the issue, terms and timing and for co-ordinating the issue. Lead managers take the help of co-managing banks. Most of the Euro-bond is bearer securities. Most of the Euro-bonds are denominated in US dollars issued in denominations of \$ 10,000. The average maturity of Euro-bond is 5 to 6 years. The maximum maturity is 15 years.

There are four types of Euro-bonds which are as follows:

- 1 Straight or Fixed rate bonds,
- 2 Convertible bonds
- 3 Currency option bonds,
- 4 Floating rate notes.

Straight or Fixed rate bonds are fixed interest bearing securities, the interest normally payable at yearly intervals. Maturities range from 3 to 25 years.

Convertible bonds are also fixed interest bearing securities. The investor has the options to convert them into equity share of the borrowing company. The conversion will be done at a stipulated price for the shares and during a stipulated period.

The currency options bonds are similar to straight bonds. The difference between these two bonds is that it is issued in one currency with the option to take payment of interest and principal in second currency. Normally option bonds are issued in sterling and provide option for payment in dollar or Deutsche mark.

The floating rate notes (FRNS) were issued in 1970 and now they occupy a prime position in the Euro-bond market. The FRNS are similar to straight bonds in respect of maturity and denomination. The difference is that it is payable in varying in accordance with the market conditions unlike the fixed rate payable on a straight bond.

9.7.3 EURO-CURRENCY DEPOSITS:

Euro-currency is the funds to collect in large quantities by the banks on behalf of International borrowers. The Euro currency deposits represent the funds accepted by the banks themselves. The Euro-currency market consists of all deposits of currencies placed with banks outside their home currency. The deposits are accepted in Euro-currency.

The Euro-currency time deposits are the most important investment in the Euro-Dollar market. The deposits may be placed at call or for fixed period on time deposits. Call deposits may be made for overnight, two days or seven day notice for US dollars. Canadian dollar, Sterling and Japanese Yen and a minimum notice of two days for other currencies. Time deposits are accepted for a period of 1, 3, 6 and 12 months for all currencies. There is a close link in the functioning of the Euro-currency deposit market and foreign exchange market. Deposits in US dollar and Pound Sterling can be placed for periods up to five years. In general, the minimum size of deposit in Euro-currency market is \$ 50,000 or its equivalent.

The interest rates in Euro-currency market are determined by the factors which affect the demand and supply conditions of the currency concerned viz.

- i) Volume of world trade transacted in the currency,
- ii) Domestic interest rates,
- iii) Domestic monetary policy and reserve requirements,
- iv) Domestic Government regulations,
- v) Relative strength of the currency in the foreign exchange market,

In practice domestic interest rates act as a floor to Euro-currency rates because the funds flow into Euro-currency market seeking higher interest. Although the Euro-currency market operates in number of centers around the world, interest rates for a particular currency are consistent. Any temporary variations at different market are quickly eliminated by the International arbitrage.

The following are some of the additional observation of the Euro- dollar market:-

- 1) A Euro-Bank is not subject to foreign exchange risk. Its dollar assets are equal to its dollar liabilities. This does not mean that Euro-Bank can not speculate.
- 2) The Euro-dollar market is a highly organized capital market that facilitates the financing of international trade and investment. The competition in the Euro currency markets is quite keen, with banks carrying on arbitrage operation between the dollar and other markets. Interest parity is usually maintained.
- 3) The Euro- dollar market has not been subject to any overall official regulation even though spotty requirements have marred from time to time rather free character of the market. Thus Euro-dollar market can potentially create dollars in the same way commercial banks create credit. Because of Several leakages the money multiplication is rather low.

The Euro-dollar banks behave more like the savings and loan association rather than the commercial banks of the United States.

Check Your Progress:

1. State and explain the features of Euro -Dollar market.
2. Write notes on the following:
 - a) Euro Credits
 - b) Euro Bonds
 - c) Euro currency deposits
3. Which factors led to the growth of Euro-Currency market?

adjustment within a currency area that has a single currency and a currency area involving more than one currency.

To illustrate this difference, let us consider a simple model of two regions or countries, initially in full employment and balance of payments equilibrium. This equilibrium is disturbed by a shift of demand from the goods of Region B to the goods of Region A. Let us assume that money wages and prices cannot be reduced in the short run without causing unemployment, and that monetary authorities act to prevent inflation.

The shift of demand from B to A causes unemployment in B and inflationary pressure in A. If A tightens credit restrictions to prevent prices from rising then B has to adjust itself otherwise output and employment in B would decrease. Such a problem is faced by the countries with different currencies.

The policy of surplus countries in restraining prices therefore imparts a recessive tendency to the world economy on fixed exchange rates or to a currency area with many separate currencies. Let us take an example where the entities are regions within a closed economy with a common currency and suppose now that the national government pursues a full employment policy. The shift of demand from B to A causes unemployment in region B and inflationary pressure in region A and a surplus in A's balance of payments. To correct the unemployment in B the monetary authorities increase the money supply. The monetary expansion leads to inflationary pressure in region A.

In a currency area comprising different countries with national currencies, unemployment in deficit country is corrected only by inflation in surplus country. Unemployment could be avoided in the world economy if central banks agreed that the burden of international adjustment should fall on surplus countries, which would then inflate until unemployment in deficit countries is eliminated or a world central bank could be established with power to create an international means of payment. But a currency area of either type cannot prevent both employment and inflation amongst its members.

Introduction of European Monetary Union :

Evolution of European Single Currency: The Bretton Woods system fixed every member country's exchange rate against the U.S. dollar and as a result also fixed the exchange rate between every pair of non-dollar currencies. While allowing their currencies to float against the dollar after 1973, EU countries have tried progressively to narrow the extent to which they let their currency fluctuate against each other. These efforts resulted in the birth of the Euro.

On January 1, 1999, 11 member countries of the European Union (EU) adopted a common currency, the Euro. They have since then joined by four more EU members. The birth of Euro resulted in fixed exchange rates between all EMU member countries. In deciding to form a monetary union, however, EMU countries sacrificed even more sovereignty over their monetary policies than a fixed exchange rate regime normally requires. They agreed to give up national currencies entirely and to hand over control of their monetary policies to a shared European System of Central Banks(ESCB).

9.10 INTERNATIONAL FINANCIAL INTEGRATION WITH RESPECT TO EUROPEAN UNION

In this section we will discuss the international role of Euro. The Euro has become the second most widely used currency as a result of the overall weight of the Euro area economy in the world. It is the second only to the US dollar among the world's official reserve currencies. According to the latest available data, the Euro accounted for around 13% of the world's official foreign reserve holdings, compared with a US dollar share of around 66% or the pound sterling and yen, which amount to about 5% each. The Euro contributes towards more stability in the international financial system by providing price stability, fiscal stability and financial stability.

The use of the euro as an international currency is and should remain the outcome of economic and financial developments and policies inside and outside the euro area. The international role of the euro is determined by the decisions of market participants in the context of increasing market integration and liberalisation. Given growing globalisation, policy makers could not directly affect the internationalisation of the euro as a significant extent even if they wanted to. This consideration is consistent with the objective of European authorities to promote an efficient and fully integrated financial market for euro-denominated assets and liabilities. Reaching this domestic objective may have the indirect effect of making euro more attractive to international borrowers and investors. In the same vein, a credible monetary policy focused on internal price stability is also a factor enabling a currency to develop an reduction and management of public debt, the enlargement of the EU, are also likely to have some indirect bearing on the use of the euro by non-residents.

From a monetary policy point of view, the possible negative impact of the internationalisation of the euro on monetary policy should not be overemphasised. The European Central Bank's (ECB's) monetary policy strategy, Instruments and procedures are capable of internalising and accommodating the implications of the international role of the euro.

As an anchor currency, the euro has largely inherited the role played by some of its legacy currencies (e.g. the Deutsch Mark, and the French franc). Overall, the euro plays a role as a peg in 55 countries outside the euro area. Arrangements adopted range from very close links to the euro (e.g. formal entitlement to use the euro as legal tender, as foreseen by the Maastricht Treaty in certain special cases, purely unilateral euroisation and currency boards, to looser forms of anchoring. Countries which anchor only to the euro are all located in the so called euro time zone (i.e. the geographical area that includes Europe, the Mediterranean area, the Middle East and Africa). This confirms the fact that close trade and financial links with the euro area remain the main factor behind the choice of the euro as a reference for exchange rate policy.

As an intervention currency, the use of the Euro is mainly related to its functions as an anchor currency. However, countries with currencies not pegged to the euro may also use it for intervention purposes.

With regard to other functions, the euro's international use has remained limited. The US dollar remains the main vehicle currency in the foreign exchange market (i.e. a currency that can be used as a means by which to exchange two other currencies) and the dominant pricing and quotation currency. The euro accounts for a fifth of the global foreign exchange market turnover. The predominance of the dollar is attributable mainly to the combined and reinforcing effects of network externalities and economies of scale in the use of leading international currency. At the regional level, however, the euro inherited a role from its legacy currencies, especially in Eastern Europe. As a reserve currency, the euro's share of total world foreign reserves is comparable to that reached by the euro legacy currencies prior to the introduction of the euro.

Future developments with regard to the private international use of the euro are likely to be heavily influenced by two main factors – size and risk. With regard to the size factor, a broad, deep and liquid euro area capital market may lead to greater use of the euro through lower transaction costs. This may, in turn, facilitate the development of the euro as a vehicle currency for trade and commodity pricing. In addition, if international investors and issuers consider the euro to be a stable currency, they will hold euro assets to minimise risk in their internationally diversified portfolios. Only if investors outside the euro area are confident that their purchasing power will be preserved over time will they engage in euro-denominated financial activities.

Check Your Progress:

- 1. What do you understand by the term Currency Areas?
- 2. Explain the role of European Union in International Financial Integration.

9.11 SUMMARY

1. The Euro-Dollar Market has become a permanent integral part of the international monetary system after Second World War.
2. In a narrow sense, Euro-Dollars are financial assets and liabilities denominated in US Dollars but traded in Europe.
3. The Euro-Dollar Market consist of the Asian -dollar market, The Rio dollar Market, the Euro-Yen market, Euro-sterling, Euros-Swiss France, Euro-French Francs, Euro-Deutsche marks etc.
4. Euro-currencies are money substitutes or near money rather than money itself as they are in the form of demand deposits. Euro banks do not create money, but they are essentially financial intermediaries. They bring together lenders and borrowers.
5. The Euro-currency market can broadly be divided into three segments:
 - i)Euro credit markets where International group of banks get engaged in lending funds for medium and long term.
 - ii)Euro-bond market where banks raise funds on behalf of International borrowers by issuing bonds.
 - iii)Euro-currency (deposits) market where banks accept deposits mostly for short term.
6. To define a currency area as a domain within which exchange rates are fixed is absolutely necessary.
7. In a currency area comprising more than one currency, the supply of international means of payment is conditional upon the cooperation of many central banks.
8. On January 1, 1999, 11 member countries of the European Union (EU) adopted a common currency, the Euro. The birth of Euro resulted in fixed exchange rates between all EMU member countries.
9. The Euro has become the second most widely used currency as a result of the overall weight of the Euro area economy in the world. It is the second only to the US dollar among the world's official reserve currencies.

9.12 QUESTIONS

- 1) Explain the factors that led to the origin and growth of Euro dollar market.
- 2) Write short notes on :-
 - i) Salient features of Euro- dollar market.
 - ii) Problems caused by the Euro- dollar market.
- 3) Describe the various segments of Euro-Currency market.
- 4) Explain the role European Monetary Union in Common Currencies.
- 5) Explain the importance of European Union in International Financial Integration.

MODULE 6

INTERNATIONAL FACTOR MOVEMENTS

Unit Structure

- 10.0 Objectives
- 10.1 Introduction
- 10.2 Movement of labor between countries
- 10.3 Trends in Migration
- 10.4 International capital movements
- 10.5 Types of foreign capital
- 10.6 Determinants of international capital movement
- 10.7 Role of foreign capital
- 10.8 Arguments In Favour Of International Capital Movement
- 10.9 Arguments against International Capital Movements
- 10.10 Summary
- 10.11 Questions

10.0 OBJECTIVES

1. To study the Movement of labor between countries.
2. To understand Trends in Migration.
3. To make the students aware about the International capital movements.
4. To know the different types of International Capital movements
5. To study the role of foreign capital.
6. To know the determinants of international capital movement.

10.1 INTRODUCTION

International factor movements include labour migration, the transfer of capital via international borrowing and lending, and the subtle international linkages involved in the formation of the multinational corporations.

The principles of international factor movements do not differ in their essential from those underlying international trade in goods. Both international borrowings and lending and international labour migration can be thought of as analogous in their causes and effects to the movement of goods. Although there is a fundamental economic similarity between trade and factor movements, however there are major differences in the political context.

A labour-abundant country may under some circumstances import capital intensive goods; under other circumstances it may acquire capital by borrowing abroad. A capital-abundant country may import labour-intensive goods or being employing migrant workers. A country that is too small to support firms of efficient size may import goods where large firms have an advantage or allow those goods to be produced locally by subsidiaries of foreign firms. In each case the alternative strategies may be similar in their purely economic consequences but radically different in their political acceptability. International factor movement trends to raise even more political difficulties than international trade, Thus factor movements are subject to more restrictions than trade in goods. Until the 1980s several European countries, like France, maintained controls on capital movements even though they had virtually free trade in goods with their neighbours.

The classical economist believed that the factor of production is immobile internationally. This was their assumptions for the simplification of their international trade theories. While the modern economist like Heckscher-Ohlin believed that the factor of production move internationally. However the fact remains that factors of production move less freely than the movement of goods and services internationally.

10.2 MOVEMENT OF LABOR BETWEEN COUNTRIES

Labour mobility or worker mobility (Migration) is the movement of people from one geographical location to another, involving permanent or temporary settlement. Migration is the socio-economic ease with which an individual or group of individuals who are currently receiving remuneration in the form of wages can take advantage of various economic opportunities.

Migration can be of two types I) internal migration or II) international migration.

- When people migrate within the same country or region is called Internal migration.

For example, moving from Maharashtra to Karnataka.

- When people migrate from one country to another then it is called International migration. For example, moving from India to the USA.

People migrate for many different reasons. These reasons can be classified as follows,

1. Economic migration - moving to find work or follow a particular career path. When people are interested in a particular job and if it is available, in that case people are motivated to move to that area.
2. Political migration - Individuals prefer to stay in peace. When there is constant fear of war people move to escape political harassment or war.
3. Social migration - People also move due to social factors like the urge to have a better quality of life or to be closer to family or friends.
4. Environmental causes of migration include natural disasters such as flooding, earthquakes, famines, highly polluted area which adversely affects the health of the individuals.

◆ **Push and Pull Factors of Migration:**

- Push factors: Due to lack of services, lack of safety, high crime, crop failure, drought, flooding, poverty, war people leave an area it is known as Push factors.
- Pull factors: Due to higher employment, more wealth, better services, good climate, safer, less crime, political stability, more fertile land, people attracted towards a particular country is known as Pull factor.

Migration usually happens as a result of a combination of these push and pull factors.

◆ **Main Causes of Migration:**

1) Poor living conditions:

Roughly two thirds of the world's population today lives in economically poor countries.

The growing gap between rich and poor is the most significant driving force for global migration.

Many leave their homes due to lack of arable land, food, water, work or other fundamental requirements. In 1960 the income of the richest fifth of the world's population was on average 30 times higher than the poorest fifth. By the year 1990 it was already 60 times higher.

2) The high rate of population growth:

The high rate of population growth and the poor perspectives for economic development in some regions leads to migration. In some countries, debts absorb a major part of the economic power. Falling raw material prices as well as the customs barriers and import

restrictions imposed by the industrialized countries prevent the development of viable export industries. Unstable economic policy, a lack of legal stability and widespread corruption discourage investors and concerns from locating their long-term industrial projects in such countries.

3) Violence and the abuse of power force people to flee:

People who are affected by conflicts and violence conflicts mostly flee in large numbers to safe regions in their native land or in a neighbouring country. In order to prevent unrest, hunger, disease and other problems, they are frequently accommodated in refugee camps.

4) Tourism, television and the Internet:

These factors also enhance the attractiveness of migration. They make the poorest aware of the wealth of the rich. The poor people are attracted by the wealth of the rich nations which motivates people to move.

5) Better living standard:

Migration to advanced countries provides better employment opportunities to the people which motivate the people to migrate. Higher income leads to not only improvement in the standard of living of the migrant, but even there is improvement in the standard of living of the family members due to the remittance of the migrants.

6) Education:

When the educational standards in a country are high, people with higher income are induced to move the host countries so that they can provide better educational facilities for their children.

10.3 TRENDS IN MIGRATION

The nationality composition of the immigrant population in several countries have changed due to the introduction of systematic regulation of immigration to suit the manpower requirement of the host countries along with the differences in the supply response of various emigrant countries.

Regulation and changes in the nationality composition: Countries like United States, Canada and Australia which had previously favoured immigrants from Europe and discriminated immigrants particularly from Asia introduced changes in their immigration legislation which shifted the emphasis away from the national origin of the immigrants to the skills which the potential immigrant possess. These changes occurred partly as a response to various pressures against racial or national origin discrimination, and partly because of the need for well defined industrial and professional skills and the disappearance of traditional European sources of skilled workers. The changes in the immigration policy of the developed countries which opened up large avenues of

emigration from the developing countries have resulted in a brain drain from these countries.

Similarly, there has remarkable change in the nationality of the population in the Middle East countries as well. The non- Arab countries in the Middle East came from countries like Pakistan, India, Bangladesh, Philippines and Korea, counter to the general tendency to attract workers from immediately neighbouring and culturally more similar countries.

Factors Affecting Changes in Composition:

The change nationality composition of the migrant workers was due to the inability of the Arab labour exporters to meet the growing demand of labour which increased the scope for participation by non- Arabs in the labour markets of the oil rich countries . The increase in the immigrants of the Asian workers was encouraged by their willingness to accept job and living conditions and wages that Arabs resisted. The Gulf countries had an apprehension that Arab migrants may bring unwelcome political ideologies and cleavage that characterize other countries in the region. Contrary to this Asian workers are seen as outsiders and as apolitical. They are expected not to interact with the local population, are less likely to stay permanently and they can be expelled with less political repercussion.

Composition of Migratory Population in Developed Countries:

Until the early1960s, about 80 of the immigrants in United States, Canada, and Australia came from the other industrial counties and the remaining coming from the developing economies. But by 1980s, the trend reversed with 80 percent of the immigrants in US came from the developing economies which accounted for nearly a quarter of the increase in population of which half of it came from Asia. Similarly there has been a rising share of immigrants from the developing countries to Canada, Australia and Europe. The aspiration for migration from the developing countries to developed countries will be stronger as the population rate of the developing countries has been falling while that of the developing economies has been on the rise.

The number of people migrating to some of the OEDC was on rise in the year 2003, 2004 and 2005 from 29,94,700 people to 47,68,300 people but from the year 2008 there had been a decline in immigrants to these countries mainly because of the Euro crisis, earth quakes and tsunami in Japan and slow economic recovery of US. The immigrants to the gulf countries also reduced due to the Arab Spring which is spreading in gulf countries which has reduced the employment opportunities of the immigrants. Moreover, the change in the policy of the gulf countries to employ first the local people has reduced the employment opportunities to the migrants in these countries.

In the recent years, movement of people from one country to another has restricted due to the fear of terrorism. In the long run as the developing countries develop and quality of life improves, the rate of migration will tend to decrease.

- **Effects of Migration:**

The effects of labour mobility (migration) can be studied in the following two categories:

- Positive Effects of Migration:

1. Wage Effect:

Labourers usually migrate from low wage countries to higher wage nations. Such movement of labour leads to changes in wages in both countries unless it is prevented or guarded by law. The effect of migration can be explained with the following diagram:

International Labour Mobility Graph

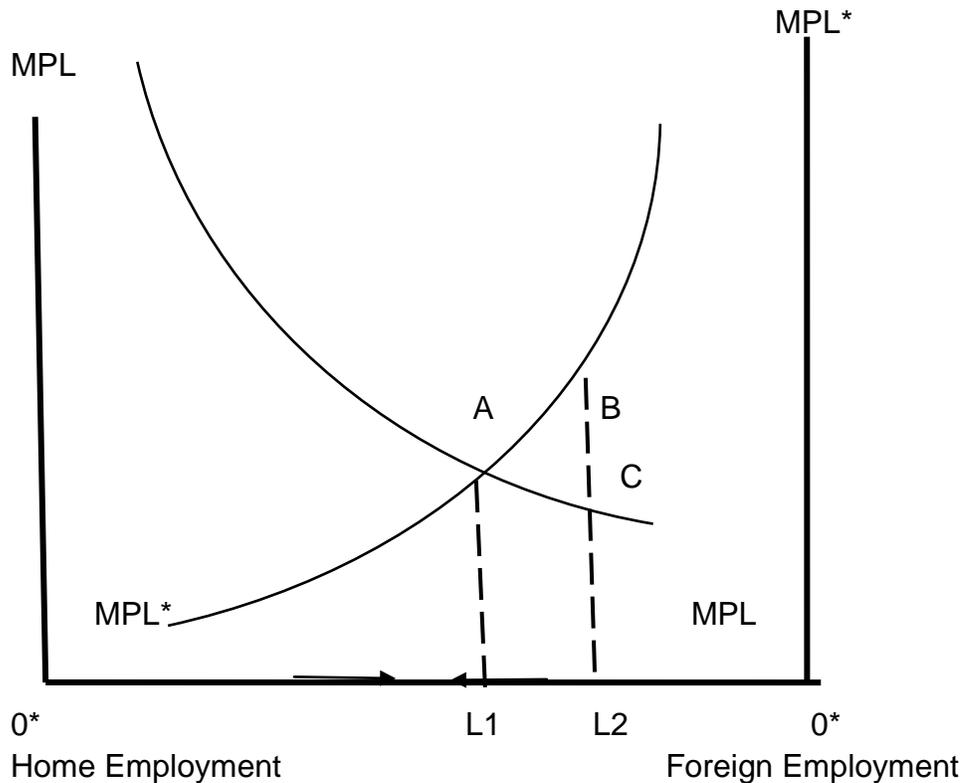


Figure 10.1

In the above Diagram employment of home and foreign country is measured on OX axis and Marginal Product of Labour (MPL) is measured on OY axis. Each country is represented by a MPL curve. MPL represent the marginal product of labour of home

country and MPL^* represents marginal product of labour of the foreign country. The Digram gives the explanation of two countries that is home and foreign.

The home's labor force of home country is at point C and labor force of foreign country is at point B. In the absence of labor mobility, these points would stay the same. However, when you allow labor to move between countries, assuming the costs of movement are zero, the real wage converges on point A, where the home country workers gain and to foreign where they will earn a higher wage. No doubt such a movement leads to gain in home country workers, where as there will be loss in wages of workers in the foreign country. The overall effect is equalization of real wages which is a positive effect. However the net positive effect depends on the number of labourers involved in the increase and decrease of real wages.

2. Effect on Skilled and Unskilled labour:

Countries where there are shortages of skilled and unskilled labour will benefit when there is movement of labour from other country to that country. Labour can be productively employed who can contribute to economic development in a positive manner.

3. Effect on Unemployment:

Emigration enables some countries to relieve their excess manpower and unemployment. The emigrant labour force forms a significant portion of the total labour force of several countries. In some of the European countries, emigrations helped to reduce employment demand which otherwise could not have absorbed domestically.

4. Remittance:

Emigrant remits a part of their income back to the native country for their families. It helps the home country to reduce their balance of payment problem and increase investment at home, import capital goods and promote development of the home country. Remittance from developed and developing economies with higher levels of per capita income, have become an increasingly important source of external development finance. Remittance rose steadily in the 1990s, reaching more than \$60 billion in 2001.

Negative Effects of Migration:

1. Brain Drain:

Flight of human capital, more commonly referred to as brain drain. It is the large-scale emigration of a large group of individuals with technical skills or knowledge. The reasons usually include two aspects which respectively come from countries and individuals.

- In terms of countries, the reasons may be social environment (in source countries: lack of opportunities, political instability, economic depression, health risks, etc.; in host countries: rich opportunities, political stability and freedom, developed economy, better living conditions, etc.).
- In terms of individual reasons, there are family influences (overseas relatives), and personal preference: preference for exploring, ambition for an improved career, etc.

Brain drain is often associated with de-skilling of emigrants in their country of destination, while the country of emigration experiences the draining of skilled individuals.

2. **Illegal immigrants:**

It is a serious problem in many countries India, USA, and Canada. It may take place due to political, economic, social and religious factors. Changes in the ethnic composition of the population can have socio-political repercussions. It can create social tensions.

3. **Problem of social integration:**

Immigrants belong to different countries, religion, race, colour, culture. Social assimilation with the people of host countries becomes difficult in the initial stages due to colour, religion and cultural difference. At times ethnic and religious differences create a problem for the host country as it happens in UK and India.

4. **Fiscal imbalance:**

When immigrants constitute in large numbers, the host country requires spending huge amount of capital to provide the required economic and social infrastructure. As some immigrants settle down permanently, the government has to spend greater amount on social security benefits. Expenditure on all these counts may create fiscal imbalance in the form of increase budgetary deficit.

10.4 INTERNATIONAL CAPITAL MOVEMENTS

International capital movement plays very important role not only in the economic development of the developed countries but also in underdeveloped countries. The international capital movement provides a solution to the problem of trade cyclical activity and thus provides a stable pattern of economic development. It finances the development projects and helps to solve the disequilibrium in the balance of payments to the underdeveloped countries. Due to the problem of vicious circles of poverty these developing countries required the inflow of foreign capital. The international capital movement raises the level of employment by financing the investment projects.

International capital movement or capital Flows refers to the outflow and inflow of capital from one country to another country. They do not relate to movement of goods or payment for exports and imports between countries. Refer to the borrowing and lending between countries and they are recorded in the capital account of balance of payments. They play an important role in the economic development of several countries. They provide an outlet for savings for the lending countries which help to flatten business cycles and lead to a more stable pattern of economic growth. They also help to ease balance of payments of the developing economies.

Foreign capital played an important role in the early stage of industrialization of most of the advanced countries of the world especially the European countries and USA. Even today foreign capital is playing its very important role in the economic development of the underdeveloped countries. If foreign capital is properly directed and utilised to the fullest extent possible then it can do a needful to the economic development of the 'underdeveloped countries.' To attain the stage of economic development it is essential to supplement the domestic capital by foreign capital.

- Concept of International Capital Movement:

The term International Capital Movement refers to the borrowing and lending of funds between countries of the world. The International Capital Movements recorded in the capital account of the balance of payments of the countries of the world. The International Capital Movements are also known as International Capital Flow.

10.5 TYPES OF FOREIGN CAPITAL

Following is the classification of the International Capital movement:

1. Short term and long term Capital Investments:

The International Capital movements can broadly be divided into two viz.

A) The short term Capital investment and

B) The long term Capital investment.

The short term Capital investments are for a period up to one year. The short term Capital investments use the following investments viz. demand deposits, foreign bill of exchange, overdrafts, cash credits etc, the motive behind the short term flow of International Capital is to take the advantage of International difference in the rates of interest.

The long term International Capital flow takes place for a more than one year period of time. There is a two fold classification of the long terms International Capital flow viz.

- i) FDI i.e. foreign Direct Investment and
- ii) Portfolio investment

The foreign direct investment is of the nature of the establishment of the subsidiary offices or branches of the main office or the foreign collaboration establishments. All these are the income generating assets. The cardinal point about FDI is that the controlled and the management vest with the investing firm.

The portfolio investment refers to long term investment in stocks, shares and securities. The portfolio investment doesn't give control and management to an investing firm. It gives only returns. The long term International Capital movements also include the grants and loans given by the developed countries and the International financing institutions like IMF, IBRD, ADB etc. to the less developed countries.

2. Loans from foreign countries and International institutions: Loans from foreign countries means loans from the developed countries to the underdeveloped countries also get loans from the International financial agencies like IMF, IBRD, ADB etc.

3. Foreign collaboration: Foreign collaboration means two countries participate together to undertake some venture. There are three types of foreign collaboration or joint ventures:

- a) Collaboration between private parties belonging to the two or more countries
- b) Joint participation of the two or more Government of the two or more countries
- c) Joint participation of the Government and the private foreign firms:

4. Foreign Aid or Foreign grants : Generally, the DC's i.e. the developed countries and the International financing agencies like IMF, IBRD, and ADB etc. help the less developed countries on humanitarian grounds in terms of giving foreign aid or foreign grants to the less developed countries of the globe for eradication of poverty, illiteracy, unemployment etc. For example during early year of India's five year plans USA had given foreign aid to India under PL 480 programmed the entire amount was to be paid in terms of Indian rupees to be credited in the accounts of USA with the Reserve Bank of India. History tells us that USA had also given an massive foreign aid to the war shattered countries for their reconstruction after the Second World War period.

10.6 DETERMINANTS OF INTERNATIONAL CAPITAL MOVEMENT

The following factors affecting international capital movements:

1. Rate of Interest: As per Ohlin the differences in there rates of interest between countries serve the most important stimulus to international capital movements in terms of import and export of capital. International Capital flow is a function of rate of interest.

Algebraically,

$$ICF = f(r)$$

IFC = stands for international capital flow,

f = stands for functional relationship,

r = stands for rate of interest

There is an inverse relationship between the rate of interest and the flow of international capital. When the rate of interest is high in the domestic country the foreign capital flows into the domestic country. Conversely when the rate of interest is low in the domestic country the international capital flows out of the domestic country into the foreign countries where the rate of interest is high. This represents the case of portfolio investment which fetches earning of .returns on buying of shares, securities, stocks of the foreign companies.

2. Bank Rate: Bank rate is the rate at which first class bills of the commercial banks are discounted by the central bank. A stable bank rate of the central bank of the country also influences capital movements because market interest rates depend on it. If bank rate is low, there will be out flow of capital and if the bank rate is high, there will be inflow of capital.

3. Speculation: Speculation related to expecting variations in foreign exchange rates or interest rates affect short capital movements. When speculators feel that the domestic interest rates will increase in future, they will invest in short- term foreign securities to earn profit. This will lead out flow of capital. On the other hand if possibility of fall of in domestic interest rates in future, the foreign speculator investing securities at a low price at present. This will lead to inflow of capital in the country.

4. Foreign Capital Policy: The government policy relating to foreign capital affects capital movements provision of different facilities relating to transferring profits, dividend, interest etc to foreign investors will attract foreign capital.

5. Profit Motives: A foreign investor always has the profit motives in his mind at the time of making capital investment in the other country. Where the possibility of earning profit is more, capital flows into that country.

6. Economic Condition: The economic condition of a country, especially size of the market, availability of infrastructure facilities like the means of transportation and communication, power and other resources, efficient labor, etc encourage the inflow of capital there.

7. Stability: Political stability, security of life and property, friendly relation with other countries, etc. are also important factors which will encourage the inflow of capital in the country. Country which faces political instability will find difficulty in capital inflow.

8. Tax Policy: The taxation policy of a country also affects the inflow or outflow of capital. To encourage the inflow of capital, soft taxation policy should be followed, give tax relief to new industries and foreign collaborations. If the tax rates imposed are high in an economy, it will not encourage inflow of capital.

9. MEC: Marginal Efficiency of Capital (MEC) is the expected rate of return over all capital invested by the entrepreneur. MEC is directly related with the inflow of capital. Investors usually compare MEC in different countries and like to invest in a country where MEC is high comparatively and are discouraged to invest in countries where MEC is relatively low.

10.7 ROLE OF FOREIGN CAPITAL

In traditional economics, capital movements were treated merely as international balancing items in a country's balance of trade. It was held that, a creditor country having a surplus in its current account in order to balance out its total payments account will invest or lend capital to deficit or debtor countries. Apparently, debtor countries with deficit in current account will borrow from the surplus countries in order to even out their balance of payments. Consequent upon foreign capital movements, thus, a credit in current account of a surplus country, there will be a corresponding lender position or its capital account, while to a deficit country there will be a corresponding borrower position on its capital account.

Where a country has a surplus in its current account, there will be an outflow of capital funds to deficit countries, hence, its holdings of short-term capital and its foreign and banking reserves will be depleted, while a deficit country will find an improvement in these holdings on account of the inflow of capital. Again, if a country has invested its capital abroad, it receives income in the form of interest, dividends, etc., which can be profitably used to finance its current deficits, which thus, help in balancing its balance of payments account.

Benefits of Capital Inflow:

As long as foreign investment increases productivity and this increase is not wholly pocketed by the investors, there will be some direct benefits in the following forms:

1. Government: The increase in production and foreign trade resulting from foreign capital might increase the fiscal revenues of government. It will generate more funds which will be available to the government for undertaking productive expenditure which can promote welfare to the economy.

2. Consumers: If the foreign investment is cost reducing, consumers gain since they get the product at a low price. If the investment is product improving or product innovating, consumers benefit from better quality of products or new products and it will enable to satisfy the diverse wants of the consumers.

3. Domestic Labour: Domestic labour may get higher real wages because of the increase in productivity. Higher wages will enable workers to have a better standard of living. It might also lead to expansion of employment opportunities as witnessed in China.

4. External Economies: Foreign capital may bring number of indirect gains through the realization of external economies. For e.g. if foreign investment are used for the development of infrastructure it will stimulate domestic investment in other sectors.

5. Balance of Payments and Foreign Exchange Reserves: The changes in the composition of the capital inflows and the substantial increase in the amount of some inflows like FDI have remarkably changed the balance of payments and foreign exchange reserves position of several countries. For e.g. the debt creating inflows as a percentage of total flows in the BOP of India averages as much as 97 percent during 1985-90, but it reduced to less than 20 percent by the end of mid 1990s. Eventually, India began to experience a surplus on the BOP and a very remarkable improvement in the reserve position.

6. Economic Growth: In a developing economy where the amount of domestic saving is less, will have to rely on foreign movement of capital to accelerate growth. China is in opposition to maintain high rate growth for a long time due to high saving rate and huge inflow of FDI.

Indeed, capital movement, especially direct investment and foreign aid, plays an important role in the economic development of backward countries. External assistance is an important source of capital formation and finance resource for planning of project in a capital-deficit poor country.

10.8 ARGUMENTS IN FAVOUR OF INTERNATIONAL CAPITAL MOVEMENT

Following are the arguments advanced in favour of international capital movements:

1. To Finance Plan Projects: Economic planning envisages investment in gigantic projects to industrialize our economy. On our own we can't meet the needs of financing

of these giant projects. Hence we have to rely on foreign capital to finance these giant projects.

2. Meeting Foreign Exchange Needs: Most of the developing countries are foreign trade oriented. They must indulge into foreign trade without which they cannot survive. To industrialize the country they must import capital goods, technical know-how, technology, foreign collaboration etc. To finance the import needs our export earnings fall short. Hence these countries have to supplement by importing capital i.e. foreign exchange to finance their import needs.

3. Balance of payments adjustment: The underdeveloped countries are branded as the primary products exporting countries for which the foreign demand is elastic. To industrialize the country the underdeveloped countries heavily depend upon the imports of Capital goods, machinery, spare parts, technically skilled personnel, foreign collaboration, technology etc for which their demand is inelastic. Hence the underdeveloped countries all the while suffer from balance of payments deficits. We are unable to finance balance of payments deficit out of our domestic sources. Hence to compensate that we have to import Capital from foreign countries. Hence the International Capital movement takes place.

4. Infrastructural development: It is said "though capital formation is necessary it is not sufficient. For its economic development and the exploitation of the resources especially the Capital there should the assistance of the infrastructural facilities without which Capital will remain unused. Besides transportation, communication, irrigation, power, education, health, finance is also our infrastructural facility. Without finance we can't exploit the Capital. We are unable to exploit the infrastructure with the domestic Capital only. Hence, there is a need to supplement the domestic Capital by importing foreign capital. Even the domestic Capital can be activated with the help of foreign Capital.

5. Employment Generation : The underdeveloped countries are over populated countries due to population explosion. For example, India is our underdeveloped country which is over populated. India is the most populous country in the world next to China. In India the rate of growth of population comes to 2.4% p.a. India adds one full Australia every year. In India there is a surplus labour. Hence, there is a prevalence of involuntary unemployment. Besides this there prevails white collar and blue collar unemployment. There prevails seasonal unemployment. On the top of it there prevails a peculiar type of unemployment which gets referred to as 'disguised unemployment'. The International Capital movement i.e. the inflow of foreign capital paves the way for employment generation.

6. Technology and Skill Improvement: The underdeveloped countries are branded as labour intensive technique countries because of labour surplus and scarcity of capital. These countries can't afford to adopt sophisticated technique and technology. These countries do not possess the skilled personnel to handle the automatic devices. The import of foreign capital makes it possible to adopt capital intensive techniques and technology. The foreign collaboration and the sophisticated technology train our labours to transfer them into technical skilled personnel.

7. Capital Formation : Capital formation is the kingpin of economic development i.e. the economic development depends to a great extent on capital formation such that economic development can be made the function of capital formation.

$ED = f(C.F.)$. The preconditions for capital formation are the rate of savings and the rate of investment. The rate of savings is very poor in the under developed countries because of high marginal propensity to consume. In addition to that due to the domestic and International demonstration effect the rate of saving is extremely low. There are no risk taking entrepreneurs. They do not like to take risk in investing funds in venture projects. As such capital formation remains extremely low due to which the tempo of economic development also remains extremely low such that these countries are branded as underdeveloped countries. Influx of foreign capital happens to be the solution to generate capital formation and fill in the vacuum.

10.9 ARGUMENTS AGAINST INTERNATIONAL CAPITAL MOVEMENTS

Following are the arguments against international capital movement:

1. Economic Drain: The foreigners are not so simple to invest their capital in to our country for the sake of solving our economic problems. They are also fired with their own interests. They accumulate huge profits by running the enterprises out of portfolio investment. They plunder the wealth from our country to their home country.
2. Increasing Dependence: International Capital inflow into the economy leads to greater and greater dependence on foreign capital at the cost of our economic independence i.e. we have to forfeit our economic independence for the sake of foreign dependence.
3. Discrimination between local population and the foreign: International capital movement makes discrimination between the local population and the foreigners. When FIs make direct investment in running and managing the enterprise, they make this sort of discrimination while employing the labourers on these projects. Generally the foreigners are offered the very highly cadre posts while the domestic people are offered very low cadre posts.
4. Cyclical fluctuations: The business cycles are the part of the capitalistic economies. When the underdeveloped countries import capital from these industrially advanced countries. Thereby we import cyclical fluctuation from the advanced countries.
5. Dangerous during emergency: During emergency it is very dangerous to rely solely on foreign capital. The foreign countries may secretly enter into negotiations with the foreign capital investing countries to destroy the reporting country. Thus during emergency a domestic country must be more vigilant about the inflow of foreign capital.
6. Politically Dangerous: Greater dependence on foreign capital may prove to be fatal or dangerous to our national sovereignty.

❖ Check Your Progress:

1. Explain the term International capital movement.
2. Which factors determine the International capital movement?
3. Check the arguments in favour and against international capital movement.

10.10 SUMMARY

1. International factor movements include:
 - Labour migration.
 - Transfer of capital via international borrowing and lending.
 - The subtle international linkages involved in the formation of the multinational corporations.
2. Labour mobility or worker mobility (Migration) is the movement of people from one geographical location to another, involving permanent or temporary settlement.
- 3 Migration can be of two types:
 - internal migration or
 - international migration.
- 4 Due to lack of services, lack of safety, high crime, crop failure, drought, flooding, poverty, war people leave an area it is known as Push factors.
- 5 Due to higher employment, more wealth, better services, good climate, safer, less crime, political stability, more fertile land, people attracted towards a particular country is known as Pull factor.
- 6 The main causes of migration are Poor living conditions, The high rate of population growth, Violence, Tourism, television and the Internet, Better living standard, Education etc.
- 7 International Capital movement refers to borrowing and lending of funds between countries of the world. It is recorded in the Capital account of the balance of payments of the countries of the world. It is also called International Capital flows.
- 8 Following is the classification of the International Capital movement:
 - Short term and long term Capital movements

- Direct and indirect Capital investments
- Government, Institutional and private Capital
- Foreign Aid

9 Rate of interest, bank rate, speculation etc. determine International capital movements.

10. Foreign capital facilitates the all round development of an economy.

10.11 QUESTIONS

1. Define the concept of 'Labour Mobility'.
2. What are the main reasons behind Migration?
3. Write note on Trends in Migration.
4. Explain the factors affecting international capital movements
5. Discuss the types of International Capital Movements
6. What are the different types of international capital movements?
7. Explain the Positive and Negative effects of Migration.
8. Discuss the factors affecting international capital movements.
9. Examine the role of foreign capital.
10. Bring out the arguments for and against role of foreign capital.



MULTINATIONAL COMPANY (MNC's) & INTERNATIONAL MONETARY FUND (IMF)

Unit Structure

- 11.0 Objectives
- 11.1 Introduction
- 11.2 Meaning and Characteristics of Multinational Companies (MNCs)
- 11.3 Merits of Multinational Companies (MNCs)
- 11.4 Demerits of Multinational Companies (MNCs)
- 11.5 International Monetary Fund (IMF)
- 11.6 Concept and Meaning of IMF
- 11.7 Objectives and Functions of International Monetary Fund (IMF)
- 11.8 Credit Facilities of International Monetary Fund (IMF)
- 11.9 IMF and International Liquidity
- 11.10 Criticisms of International Monetary Fund
- 11.11 Achievements of International Monetary Fund
- 11.12 Changing Role of the International Monetary Fund
- 11.13 Suggested Reforms in the International Monetary Fund
- 11.14 Summary
- 11.15 Questions

11.0 OBJECTIVES

1. To know the Concept and meaning of Multinational Company (MNCs)
2. To understand the Features of Multinational Companies (MNCs)
3. To know the Merits and Demerits of Multinational Companies (MNCs)
4. To know the background of the establishment of the I.M.F.
5. To know the objectives and functions of I.M.F
6. To know the Credit Facilities of IMF
7. To know the Achievements of IMF
8. To know the Changing Role of IMF
9. To understand the Reforms of the IMF

11.1 INTRODUCTION

The Term Multinational Corporation is used to identify an enterprise which controls assets, factories, mines, sales and other offices in two or more countries. The MNCs are oligopolistic in nature and gigantic in size. The total value of their individuals assets and turnover runs into billion dollars. There are over 800 such giants in the world to-day. More than 86% of the MNCs have their parent companies in USA, UK, France and W. Germany. These parent companies take decisions and control the operation of their branches or subsidiaries in other countries. A few MNCs have originated in Japan, Switzerland, Netherlands and Italy. These multinational corporations have spread their braches throughout the world and have dominated the socio-economic and political scenario in number of countries. These MNCs have become a problem for number of developing countries which are unable to free themselves from the clutches of these MNCs.

Developing countries today are widely opening the doors for the entry of the multinational corporations by encouraging foreign collaborations as well as foreign investment. The foreign investment acts as a vital input for rapid economic development of the developing countries. The rise of MNCs has been the most remarkable phenomenon of the post- war era. The MNCs are the product of industrial revolution, advancement in science and technology and speedy rate of growth of transportation and telecommunication system all over the world during the post world war period.

11.2 MEANING AND CHARACTERISTICS OF MULTINATIONAL COMPANIES (MNCS)

Multinational company is the company which is registered in one country but conduct its business operations in multiple countries. It evolved during the 19th century. First multinational company was formed in 1860 in U.S.A. At present these companies are operating worldwide.

Multinational company are not only found in USA, but also in many other countries like China, England, France, Germany, Japan, South Korea etc. These companies are doing well in India also. Multinational companies are also known as Trans-National Corporations or the International Corporations or the Global Giants. Hindustan Lever Limited, Hero Honda, Reliance Infosys, etc. are some examples of multinational companies operating in India.

◆ Definitions of MNCs:

1) According to **UNO**, multinational companies means, *“Those enterprises which own or control production or service facilities outside the country in which they are based.”*

2) According to **International Labour Organisation** “*The essential nature of the multinational enterprises lies in the fact that its managerial headquarters are located in one country, while the enterprise carries out operations in number of other countries*’.

3) According to **N.H. Jacob**, “*A multinational corporation owns & manages its business in two or more countries.*”

◆ **Characteristics of Multinational Companies (MNCs)**

The distinctive features of multinational companies are as follows.

1. Large Size:

A multinational company is generally big in size. Some of the multinational companies own and control assets worth billions of dollars. Their annual sales turnover is more than the gross national product of many small countries.

2. Huge Capital:

These companies can easily raise huge capital by way of issuing shares to general public, within & outside the country. They exercise great degree of economic dominance. A large part of the capital assets of the parent country are owned by the citizen's of the home country.

3. Worldwide operations:

A multinational corporation carries on business in more than one country. Multinational corporations such as Coco cola has branches in as many as seventy countries around the world.

4. International management:

The management of multinational companies are international in character. It operates on the basis of best possible alternative available any where in the world. Its local subsidiaries are managed generally by the nationals of the host country. For example the management of Hindustan Lever lies with Indians. The parent company Unilever is in The United States of America.

5. Mobility of resources:

The operation of multinational company involves the mobility of capital, technology, entrepreneurship and other factors of production across the territories.

6. Integrated activities:

A multinational company is usually a complete organisation comprising manufacturing, marketing, research and development and other facilities.

7. Several forms:

A multinational company may operate in host countries in several ways i.e., branches, subsidiaries, franchise, joint ventures. Turn key projects.

8. Centralized Control:

These multinational companies have their branches worldwide. They control all its branches through head office which is situated in home country of those companies.

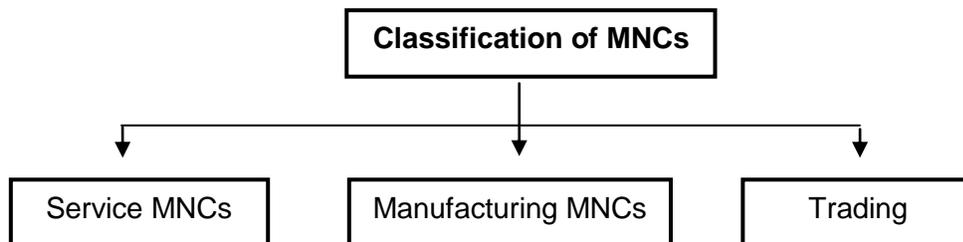
9. Employment:

It provides with employment opportunities to a large number of unemployed individuals in the respective countries of their operation. In 2006, foreign affiliates of MNCs employed over 73 million people, compared to 25 million in 1990.

◆ Classification of MNCs:

MNCs can be classified on the basis of several criteria, such as function, control, investment, origin, turnover, products, etc.

On the basis of functional criterion, the MNCs are broadly grouped into:



1. Service MNCs:

A service MNCs is defined as a transnational company which derives more than 50 per cent of its revenues from services. Service MNCs are found in areas such as banking, insurance, finance, transport, tourism, etc.

2. Manufacturing MNCs:

A Manufacturing MNCs is one which derives at least 50 per cent of its revenue from manufacturing activity. A large number of MNCs has entered into the manufacturing sector. Out of the top 200 MNCs, 118 firms are manufacturing MNCs. They produce a variety of goods. For example, Parry and Cadbury Fry produce Chocolates, Colgate and Palmolive produce soaps and detergents, Ponds - cosmetic goods, Olivetti - Teleprinting equipments, Dunlop, Good Year, Ceat-tyres and tubes.

3. Trading MNCs:

A trading MNC is the one which derives at least 50 per cent of its revenue from trading activity. These are the oldest form of multinationals. Trading MNCs control about 60 per cent of the world's export trade. Tatas, Liptons, Brooke Bond, Hindujas etc. are the trading MNCs.

11.3 MERITS OF MULTINATIONAL COMPANIES (MNCs)

- 1) **Economic Development:** The Developing countries need both foreign capital and technology to make use of available resources for economic and industrial growth. MNCs can provide the required financial, technical and other resources to needy countries in exchange for economic gains.
- 2) **Technology Gap:** MNCs are the instruments of transfer of technology to the host country. Technology is necessary to bring down cost of production and produce quality goods on a large scale. The services of MNCs can be of great help to bridge the technological gap between developed and developing countries.
- 3) **Industrial Growth:** MNCs are dynamic and offer growth opportunities for domestic industries. MNCs assist local producers to enter the global markets through their well established international network of production and marketing. And there by ensure industrial growth.
- 4) **Marketing Opportunities:** MNCs have access to many markets in different countries. They have the necessary skills and expertise to market products at international level. For example, an Indian Company can enter into Joint Venture with a foreign company to sell its product in the international market
- 5) **Work Culture:** MNCs introduces a work culture of excellence, professionalism and fairness in deals. The sole objective of Multinational is profit maximisation. To achieve this, they use various strategies like product innovation, technology up gradation, professional management etc.
- 6) **Export Promotion:** MNCs assist developing countries in earnings foreign exchange. This can be done by promoting and developing export oriented and import substitute industries.
- 7) **Tax Revenues:** For the host country, there is a likelihood that the MNC will have to be subject to the tax regime in that country. As a result, many MNCs pay large sums in taxes to the host government. In less developed countries the problem might be that there is a large amount of corruption and bad governance and as a result MNCs might

not contribute the tax revenue they could and even if they do it might not find its way through to the government itself.

8) Improvements in Infrastructure: In addition to the investment in a country in production or distribution facilities, a company might also invest in additional infrastructure facilities like road, rail, port and communications facilities. This can provide benefits for the whole country.

9) Raising Standards: Multinational corporations bring about competition in the foreign markets they venture in. Multinationals produce goods and services that adhere to the best possible standards. Since consumers are willing to spend their money on only the best products, local businesses are forced to improve on the quality of their products. This competition to produce good quality ends up benefiting consumers who get good value for their money

10) Job Creation: Multinational corporations play a big role in creating employment in the foreign countries they venture in. Because of their massive operations, they employ many local people in those countries to work there. They also employ some to work in their headquarters, thereby giving foreign nationals a chance to gain international career exposure. In 2006, foreign affiliate of MNCs employed over 73 million people, compared to 25 million in 1990. Greater part of increase of employment in foreign affiliates in recent times has taken place in developing countries.

11.4 DEMERITS OF MULTINATIONAL COMPANIES (MNC'S)

1) Profit maximization: The basic purpose of MNCs is the maximization of profit through exploitation of host country's resources. MNCs hardly bother about the economic development of the host country.

2) Plunder of wealth: MNCs plunder wealth to their home countries in the form of transferring the huge amount of foreign exchange gained through royalties, fees, dividends etc. to their home countries.

3) Useless transfer of technology: The technology transfer which takes place is of the nature of capital intensive and import oriented which doesn't suit to the underdeveloped countries. Generally it is observed that the MNCs do not transfer their advanced technology to the underdeveloped countries.

4) Effect on Employment: Employment might not be as extensive as hoped, many jobs might go to skilled workers from other countries rather than to domestic workers. Moreover, the amount of new jobs are created depends on the type of investment. Investment into capital intensive production facilities might not bring as many jobs to an area as hoped.

5) Misuse of weak Government: The size and power of multinationals can be used to exploit weak or corrupt governments to get better deals for the MNC. The MNCs may use their economic power to turn the political table in their own favour. They may even see to it that the choicest party Govt. should get elected by hook or crook.

6) Undermining Local Cultures and Traditions: The MNCs have been criticized for their business strategies and practices in the host countries. They may undermine local cultures and traditions, change the consumption habits of the people for their benefit against the long term interest of the local community, promote conspicuous consumption, and dump harmful products in the developing countries.

7) High tempo of show and advertisement:- The MNCs may take undue advantage of their financial strength in terms of lavishly spreading the huge amount in unnecessary showrooms and advertisement as a result of which the prices of goods zoom like anything in the host country.

8) Repatriation of profits: Profits might go back to the headquarters of the MNC rather than staying in the host country. Hence, the benefits might not be as great. These funds will not be beneficial for the domestic country which is allowing MNCs to establish their base in the home country.

9) Destruction of Local Industries: Multinationals usually have more money in terms of capitalization than local businesses. This means that they are able to finance operations for a long time even without making a profit in the knowledge that, once they have developed brand loyalty, they will start making sustainable profits thereafter. This means that they can deliberately set very low prices so as to take the market share of the companies they have found in that market. This may therefore lead to the local companies to close down as they cannot afford to charge these low prices.

10) BOP Problem: The MNCs transfer the technology which is import oriented due to which the host countries imports increase . On the contrary due to high prices prevailing in the host country its exports curtail. Thus the B.O.P. problem gets aggravated.

11) Monopoly: The MNC's being the joint companies establish their monopolies and iron out competition in the host country.

12) Evasion of taxes: The MNC's may evade the taxes by manipulating their accounts.

In the era of Liberalization we are not suppose to look towards MNCs as a agents of exploitation but they also act as agents of development by helping the host countries to increase domestic investment and employment generation, boost exports, transfer of technology and accelerate economic growth.

What is needed is to have a proper code of conduct for MNCs and an effective competition policy and law in the host countries.

11.5 INTERNATIONAL MONETARY FUND (IMF)

From the early 19th century till the past First World War period most of the industrialized countries of the world followed gold standard. Under gold standard each country following gold standard expressed its currency in terms of gold. In 1900 for example the dollar was equal to 1/20th ounce of gold and the Pound sterling was equal to 5/20th ounce of gold. Hence **1£=S5**. Secondly the countries also agreed to convert its paper currency in the gold on demand. Thirdly there was no restriction on the shipment of gold from one country to another. The gold standard provided for an automatic corrector of balance of payments disequilibrium. If the country imported goods more than its exports then gold flowed out.

Conversely when a country exported goods more than its imports gold flowed in. Many supply in the country also depended on the receipt and payment of gold. In case receipt of gold money supply expanded in the country conversely in case of payment of gold money supply contracted in the country. The increase in money supply led to increase in prices. While the contraction in money supply led to fall in the price level. Until the outbreak of First World War (1914) the gold standard worked remarkably well and the stability in the exchange rate was maintained. Gold standard countries were very eager to abide by the golden rule of gold standard to expand money and credit. When it coming in and to contract the volume of money and credit when gold is going out. The gold standard was, shattered in the first week of first world war (1914-1918). The conversion of paper currency notes in the gold was prohibited and the import and export of gold was stopped. After the First World War the international gold standard was restored line due to the following reasons:-

- i) There was a natural wish to return to normalcy
- ii) People wished to go back to pre-war conditions
- iii) Post war inflation

However, after a decade the international gold standard once again was abandoned by majority of the world countries due to 1930's great depression. Great Britain suspended international gold standard in 1931 followed by majority of the countries of the world including U.S.A.

The breakdown of the international gold standard created a vacuum in the field of international trade. All the countries of the world realised the need for international economic co-operation. The breakdown of international gold standard created a chaos

in the field of foreign exchange rates. In order to take the advantage of increase in exports each country deliberately switched over to competitive devaluation. Each country tried to prosper at the cost of the other. They followed, "beggar thy neighbour policy." Competitive devaluation, exchange controls, import quota, tariffs, export regulations and bilateral pacts were the order of the day. Thus the volume of international trade declined to a considerable extent. Due to uncertainty, international investment suffered a lot.

It was realised that mutual agreements between world countries having international economic relation would solve the problem of international monetary disorder. International monetary Co-operation became the need of the hour. It was impossible to revive the international gold standard, a new system had to be devised which would provide sufficient flexibility through international assistance without disturbing the internal economies. Different nations put forward different plans to solve the problem of international trade and monetary disorder, in 1943 the United States Treasury published a proposal for the establishment of an International stabilization Fund of the United and Associated Nations. Great Britain also proposed the establishment of an International clearing union. The American proposal was known as "white plan" while the British proposal was known as, "Keynes plan". The author of "white plan" was Mr. White while the author of "Keynes plan" was Lord J.M. Keynes. In 1944 a joint plan in the shape of "Joint statement by Experts on the Establishment of International Monetary Fund of the United and Associated Nation" emerged which became the basis for the United Nations monetary and Financial conference. Which was held at Bretton woods, New Hampshire from July 1 to July 22, 1944. The purpose of the Bretton woods conference was to devise means for assuring a system of international trade and payments consistent with the dual objectives of high world productivity and trade and domestic income and employment with economic stability. At the meeting it was decided that an 'International Monetary Fund (IMF)' be organised for the smooth settlement of international payments.

The IMF was organised in 1946 and it commenced its operation in March 1947. The International monetary system introduced at Bretton woods rested on two pillars viz. the maintenance of stable exchange rates and a multilateral credit mechanism institutionalized in the IMF and supervised by it. The International Monetary System that existed from 1947 to 1971 is generally known as the par value system or pegged exchange rate system. Under this system each member country of IMF is required to define the value of its currency in terms of gold or U.S. dollar and to maintain (to peg) the market value of its currency within \pm of the defined par value. The value of US dollar was set at 1/35 of an ounce of gold and the United States promised that all US dollars in the hands of central banks would be redeemed in gold, up on demand at the fixed price of \$ 35 per ounce of gold. Every country defined its currency in terms of gold or

dollar. The dollar was not merely as good as gold, but it was better than gold because dollar reserves earned interest while gold did not. The exchange rate between two currencies would not remain constant for-ever. It would change under following conditions :-

- i) A member shall not propose to change except to correct the fundamental disequilibrium in the balance of payments and it shall act only after consultation with IMF.
- ii) The fund will not object to change not exceeding 10% of the initial par value.
- iii) It a change in proposed exceeding 10% but not exceeding 20% of the initial par value. The IMF may agree or object but must declare its attitude within 72 hours.
- iv) If the proposed change is longer than 20% the Fund may concur or object without limit of time.
- v) The Fund must agree "if it is satisfied that the change is necessary to correct fundamental disequilibrium in the balance of payments.

11.6 CONCEPT AND MEANING OF IMF

The international monetary fund is a landmark in the history of international monetary Co-operation. It is an international Financial Institution. The abbreviation IMF stands for International Monetary Fund. The International Monetary Fund (IMF) is an organization of countries that seeks to promote international monetary co-operation. It facilitates the expansion of international trade. Thus, it contributes towards increased employment and improved economic conditions in all member countries. Membership of IMF is open to-every country of the world that controls its foreign relations and is able and prepared to fulfill the obligations of membership. Membership of IMF is a pre - requisite for membership in the IBRD i.e. the World Bank. There is a close relationship between the IMF and the IBRD. The Fund is a specialized agency within the United Nation system, it cooperates with the UN on matters of mutual interest.

The IMF can be designated as a central bank of central Banks of the world countries because it collects the resources and maintains the reservoir of nation's currencies just like that of the central bank of a country which collects cash reserves of the commercial banks of the country. However, there is a difference in the functioning of the central bank of the respective countries and IMF. The central banks of the world countries can control the volume of money and credit through the monetary policy while IMF can't control the volume of money and credit of any member country.

11.7 OBJECTIVES AND FUNCTIONS OF INTERNATIONAL MONETARY FUND (IMF)

The fundamental objective of the IMF was the avoidance of competitive devaluation and exchange control. Basically there are three general objectives of IMF viz.

- i) The elimination or reduction of existing exchange controls.
- ii) The establishment of maintenance of currency convertibility with stable exchange rates.
- iii) The establishment of multilateral trade and payments.

Objectives As per the **Article 1 of the IMF Agreement** are as follows:

- To promote international monetary co-operation through a permanent institution which provides machinery for consultation and collaboration on international monetary problems.
- To facilitate the expansion of balanced growth of international trade and to contribute thereby to the promotion and maintenance of high level of employment and real income and to the development of the productive resources of all member countries as the primary objective of economic policy.
- To promote exchange stability to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.
- To assist in the establishment of a multilateral system of payments in respect of current transactions between member countries and in the elimination foreign exchange restrictions which hamper the growth of world trade.
- To lend confidence to members by making the Fund resources available to them under adequate safeguards, thus providing them with opportunity to correct mal adjustments in the balance of payments without resorting to measures destructive to national and international prosperity.
- In accordance with the above to shorten the duration and lessen the degree of disequilibrium in the balance of payments of the member countries.

◆ **Functions Of IMF:**

To fulfill the above objectives, the IMF performs the following functions:

1. The IMF operates in such a way as to fulfil its objectives as laid down in the Bretton Woods Articles of Agreements. It is the IMF's duty to see that these provisions are

observed by member countries. Some of the provisions of the original Articles such as relating to exchange rates have become obsolete due to international monetary events. Accordingly IMF has amended its Articles of Agreement to make appropriate adjustment.

2. The fund gives short-term loans to its members, so that they may correct their temporary balance of payments disequilibrium.
3. The fund is regarded as 'the guardian of good conduct' in the sphere of balance of payments. It aims at reducing tariff and other trade restrictions by the member countries. Article VII of the Charter provides that no member shall, without the approval of the fund, impose restrictions on the making of payments or engage in discriminatory currency arrangement or multiple currency practices. It is the functions of the IMF to have surveillance of the policies being adopted by the member countries.
4. The fund also renders technical advice to its members on monetary and fiscal policies.
5. It conducts research studies and publishes them in IMF staff papers, Finance and Development, etc.
6. It provides technical experts to member countries having balance of payment difficulties and other problems.
7. It also conducts short training courses on fiscal, monetary and balance of payments for personnel from member nations through its Central Banking Services Development, the Fiscal Affairs Department, the Bureau of Statistics and the IMF institute.

Thus the Fund performs Financial, Supervisory and Controlling functions.

11.8 CREDIT FACILITIES OF INTERNATIONAL MONETARY FUND (IMF)

In order to help the member countries to correct disequilibrium in their balance of payments, the IMF operates various borrowing facilities.

1. Basic Credit Facility:

The IMF provides financial assistance to its member nations to overcome their temporary difficulties relating to balance of payments. A member nation can purchase

from the Fund other currencies of SDRs (Special Drawing Rights). in exchange for its own currency, to finance payment deficits.

The loan is repaid when the member repurchases its own currency with other currencies or SDRs. A member can unconditionally borrow from the Fund in a year equal to 25% of its quota. This unconditional borrowing right is called the reserve tranche. In addition, four tranches (each equal to 25% of the quota) are available to a country.

Thus, a member country has the basic credit facility of 5 tranches (i.e., 125% of its quota) from the Fund. In other words, the borrowings from the IMF should not increase the currency of a member country with the Fund more than 200% of its quota.

2. Buffer Stock Facility:

The buffer stock financing facility was started in 1969. The purpose of this scheme was to help the primary producing countries to finance contributions to buffer stock arrangements for the stabilisation of primary product prices.

3. Extended Fund Facility:

In September 1974, the IMF started extended fund facility to assist the member countries with severe balance of payments problem for long periods.

Under this arrangement, the IMF provides additional borrowing facility up to 140% of the member's quota, over and above the basic credit facility.

The extended facility is limited for a period up to 3 years and the rate of interest is low, i.e., from 4% to 6.5%.

4. Special Oil Facility:

In 1974, the IMF established a temporary credit facility called Special Facility to extend credit to countries with payments difficulties caused by oil price hikes. The facility was terminated in 1976.

5. Structural Adjustment Facility:

The IMF established in March 1986 Structural Adjustment Facility (SAF) to provide additional balance of payments assistance on concessional terms to the poorer member countries.

In December 1987, the Enhanced Structural Adjustment Facility (ESAF) was set up to augment the availability of concessional resources to low income countries. The purpose of SAF and ESAF is to help the poor countries to undertake strong macroeconomic and

structural programmes to improve their balance of payments positions and promote economic growth.

6. Trust Fund:

The IMF has sold gold in public auctions at prices much above the price prevailing in the market. Part of the profits so earned has been used to establish a Trust Fund in 1976 for making conditional loans to the less-developed countries with payments problems.

7. Compensatory Financing Facility:

In 1963, IMF established compensatory financing facility to provide additional financial assistance to the member countries, particularly primary producing countries facing shortfall in export earnings.

In 1981, the coverage of the compensatory financing facility was extended to payment problem caused by the fluctuations in the cost of cereal inputs.

11.9 IMF AND INTERNATIONAL LIQUIDITY

Major function of IMF is to provide International liquidity in accordance with the purpose of the Fund specified in Articles of Agreement.

The IMF provides two types of International Liquidity viz.

- i) Conditional Liquidity and
- ii) Unconditional Liquidity

The conditional liquidity is provided by IMF under its various lending facilities. Most of the funds credit extended under these arrangements require an adjustment programme for the members which is intended to promote a sustainable external position. When the member countries obtain Fund's finance under agreed condition, its access to International capital market is enhanced. This gets referred to as a catalytic role of the fund which has become more important in recent times when private lending institutions have been less willing to engage in international lending.

The unconditional liquidity is supplied by the Fund through the allocation or SDRs and also in the form of reserve positions in the Funds which are the claims corresponding to the resources that countries have made available to the Fund. The member countries holding SDRs and reserve positions in the Fund can use them finance balance of payments deficits without having to enter into policy commitments with the Fund

The fund makes its resources available to members under agreed conditions in support of efforts on their parts to overcome balance of payments problems in an orderly manner without undue disruption of the flows to International trade. Several facilities are available for extending credit to members for varying periods up to ten years subjected to different degrees of conditionality the credit arrangements that envisage policy actions to be taken by the member, the use of the Fund's resources is normally made conditional upon the policy action in accordance with the programme agreed between the member country and the Fund.

The limits placed under present policies on members use of Fund's credit facilities are defined in terms of members quota with the fund, for e.g. to meet a short fall in export earning a member may draw from the Fund up to 100% of its quota on the other hand in order to meet the structural balance of payments problem a member may borrow under certain conditions Funds reserves up to 150% of the quota in any year, up to 450% over three years.

11.10 CRITICISMS OF INTERNATIONAL MONETARY FUND (IMF)

The IMF has been severely criticized in recent years for mishandling global financial crises in East Asia and Latin America, aggravating poverty in developing countries, encouraging bad policies by governments and financial investors and favouring the developed countries. We discuss below some points of criticism.

- The IMF is not familiar with local economic conditions, cultures, and environments in the countries they are requiring policy reform. The Fund has very little knowledge about the impact of public spending on programs like public health and education, especially in African countries.
- The IMF proposed to give short term loans to correct the fundamental disequilibrium in the balance payments. But the post second world war and the 1930s great depression scenario required long Term loans and aid for reconstruction of the economies.
- In order to reduce the budget deficits the IMF sometimes advocates austerity measures, cutting public spending and increasing taxes even when the economy is weak, in order to bring budgets closer to a balance.
- The IMF has failed to prevent dollar crisis. No timely action and the measures were taken by the Fund .
- As per the agreement the member countries were required to fix the par value of their currencies in terms of gold or US dollar but the members had to fix the par values when there was already over valuation.

- A research undertaken by overseas development Institution (ODI) in 1980 pointed to find main criticisms of the IMF which support the analysis that it is a pillar of global apartheid. Firstly, developed countries were seen to have a more dominant role and control over less developed countries (LDCs) primarily due to the Western bias towards a capitalist form of the world economy with professional staff being Western trained and believing in the efficacy of market-oriented policies.
- Secondly, the Fund worked on the incorrect assumption that all payments disequilibria were caused domestically. The Group of 24 (G-24), on behalf of LDC members, and the United Nations Conference on Trade and Development (UNCTAD) complained that the Fund did not distinguish sufficiently between disequilibria with predominantly external as opposed to internal causes. This criticism was voiced in the aftermath of the 1973 oil crisis. Then LDCs found themselves with payments deficits due to adverse changes in their terms of trade, with the Fund prescribing stabilization programmes similar to those suggested for deficits caused by government over-spending. Faced with long-term, externally generated disequilibria, the Group of 24 argued that LDCs should be allowed more time to adjust their economies and that the policies needed to achieve such adjustment are different from demand-management programmes devised primarily with internally generated disequilibria in mind.
- The third criticism was that the effects of Fund policies were anti-developmental. The deflationary effects of IMF programmes quickly led to losses of output and employment in economies where incomes were low and unemployment was high. Moreover, it was sometimes claimed that the burden of the deflationary effects was borne disproportionately by the poor.
- Fourthly is the accusation that harsh policy conditions were self-defeating where a vicious circle developed when members refused loans due to harsh conditionality, making their economy worse and eventually taking loans as a drastic medicine.
- Lastly is the point that the Fund's policies lack a clear economic rationale. Its policy foundations were theoretical and unclear due to differing opinions and departmental rivalries whilst dealing with countries with widely varying economic circumstances.

Despite the various shortcomings, the fund has achieved a tremendous success in the field of international monetary cooperation.

11.11 ACHIEVEMENTS OF INTERNATIONAL MONETARY FUND (IMF)

Undoubtedly the IMF has made a remarkable success in achieving most of its principal objectives:

1. The primary goal of the IMF was **to promote stability in exchange rates**. The measure of exchange stability that the world has witnessed in the IMF era is remarkably superior to what was seen during the inter-war period or gold standard regime. Under IMF arrangements, stable exchange rates do not imply rigid exchange rates. IMF's object is to combine the merits of stability with flexibility in exchange management.
2. The IMF also served as an expert institution for **consultation and guidance in international monetary matters**. It serves as an excellent forum for discussions, practically on a day-to-day basis, of the economic, fiscal and financial policies of member nations, with particular reference to their balance of payments impact.
3. The Fund has contributed in certain ways to the **expansion of world trade** by providing credit facilities to member countries. It assists the deficit countries in meeting their temporary disequilibrium in the balance of payments. It also "works for facilitating multi-lateral payments and trade, promoting thereby, international trade as a whole.
4. In recent years the Fund has achieved some success in bringing about a **simplification of the multiple exchange system** at least in countries that have sought financial assistance from the Fund.
5. The Fund has been instrumental in ensuring steady **progress in the establishment of a multilateral system of payments** in respect of current transactions.
6. IMF has changed its attitude by accepting a **more liberal credit policy**. Today, the Fund grants development loans, too. Hence, the quantum of borrowings from the Fund has shown a marked increase in recent years.
7. In a nutshell, the Fund has thus, been able to secure all the advantages of managed paper standard by **maximizing employment** and **accelerating the pace of economic development** and of the gold standard by maintaining comparative economic stability, while carefully avoiding the disadvantages of either.
8. Moreover, the Fund has been particularly interested-in the newly developing countries of the world and has been liberally assisting them to **maintain a healthy balance of payments and monetary stability** at home.
9. The Fund has been already **providing technical assistance** to its members in this respect.

10. To solve the current international liquidity problem, the IMF has ***succeeded in establishing the SDR scheme.***

In recent years, however, underdeveloped countries have started looking to the Fund to assist them in their economic development programme also. Furthermore, most of the new member countries who have acquired independence recently are facing difficult problems in organizing their monetary, fiscal and exchange systems. These countries, thus, require Fund's growing assistance in constructing a solid monetary and exchange base for their economic growth.

11.12 CHANGING ROLE OF THE INTERNATIONAL MONETARY FUND (IMF)

Since the onset of the global economic crisis in 2007, The IMF introduced several changes in its lending reforms, policy of lending aid to poor countries, governance reforms, conditionality's of getting funds etc. which are as follows:

✿ **Governance Reform:**

On December 15, 2010, the Board of Governors approved far-reaching governance reforms under the **14th General Review of Quotas**. The package includes a doubling of quotas, which will result in more than a 6 percentage point shift in quota share to dynamic emerging market and developing countries while protecting the voting shares of the poorest member countries. The reform will also lead to a more representative, fully-elected Executive Board. Changes in Conditionality of Fund: The conditionality of IMF are no longer set in quantitative targets such as reducing fiscal expenditure, or contracting the supply of credit to bring aggregate demand in balance with the aggregate supply. The conditionality's are now set in qualitative targets such as structural reforms, passing of new legislations such as bankruptcy codes, reform of tax administration and removing rigidities that hold back growth.

✿ **Credit line for strong performers:**

The Flexible Credit Line (FCL), introduced in April 2009 and further enhanced in August 2010, is a lending tool for countries with very strong fundamentals that provides large and upfront access to IMF resources, as a form of insurance for crisis prevention. There are no policy conditions to be met once a country has been approved for the credit line. Colombia, Mexico, and Poland have been provided combined access of over \$100 billion under the FCL (no drawings have been made under these arrangements). FCL use has lead to lower borrowing costs and increased room for policy scheme. Structural performance criteria have been discontinued for all IMF loans, including for

programs with low-income countries. Structural reforms will continue to be part of IMF-supported programs, but have become more focused on areas critical to a country's recovery.

✿ **Social Safety Net Programs:**

The IMF is promoting measures to increase spending on, and improve the targeting of, social safety net programs that can mitigate the impact of the crisis on the most vulnerable in society.

✿ **Reforms in the Lending Framework of the IMF:**

To provide better support to countries during the global economic crisis, the IMF beefed up its lending capacity and approved a major overhaul of how it lends money by offering higher amounts and tailoring loan terms to countries' varying strengths and circumstances.

✿ **Policies for Low Income Countries:**

In response to the global financial crisis, the IMF undertook policy reforms toward low-income countries. As a result, IMF programs are now more flexible and modified to the individual needs of low-income countries, with streamlined conditionality, higher concessions and more emphasis on safeguarding social spending.

✿ **Availability of Resources:**

Resources available to low-income countries through the Poverty Reduction and Growth Trust over the period 2009–2014 were boosted to \$17 billion, consistent with the call by G-20 leaders in April 2009 of doubling the IMF's concessional lending capacity and providing \$6 billion additional concessional financing over the next two to three years. The IMF's concessional lending to low-income countries amounted to \$3.8 billion in 2009, an increase of about four times the historical levels. In 2010 and 2011, concessional lending reached \$1.8 billion and \$1.9 billion respectively.

✿ **Establishment of a Post-Catastrophe Debt Relief (PCDR) Trust:**

This allows the IMF to join international debt relief efforts for very poor countries that are hit by the most catastrophic of natural disasters. PCDR-financed debt relief amounted to \$268 million in 2010.

✿ **Efforts against Global Crisis:**

As a key part of efforts to overcome the global financial crisis, the Group of Twenty industrialized and emerging market economies (G-20) agreed in April 2009 to increase borrowed resources available to the IMF (complementing its quota resources) by up to

\$500 billion (which tripled the total pre-crisis lending resources of about \$250 billion) to support growth in emerging market and developing countries. In April 2010, the Executive Board adopted a proposal on an expanded and more flexible New Arrangements to Borrow (NAB), by which the NAB was expanded to about SDR 367.5 billion (about \$560 billion), with the addition of 13 new participating countries and institutions, including a number of emerging market countries that made significant contributions to this large expansion. On November 15, 2011, the National Bank of Poland joined the NAB as a new participant, bringing the total to about SDR 370 billion (about \$570 billion) and the number of new participants to 14 (once all new participants have joined). In addition to increasing the Fund's own lending capacity, in 2009, the membership agreed to make a general allocation of SDRs equivalent to \$250 billion, resulting in a near ten-fold increase in SDRs. This represents a significant increase in own reserves for many countries, including low-income countries.

✿ **Sharpening of IMF Analysis and Policy Advice:**

To try and prevent future crises, the IMF is working closely with governments and other international institutions. Risk analysis has been enhanced, including by taking a cross-country perspective, and early warning exercises are being carried out jointly with the Financial Stability Board. Analyses on linkages between the real economy, the financial sector, and external stability are being strengthened. Work has also been done on mapping and understanding the implication of rising financial and trade interconnectedness for surveillance and for lending to strengthen the global financial safety net.

11.13 SUGGESTED REFORMS IN THE INTERNATIONAL MONETARY FUND (IMF)

The IMF is the pillar of the edifice of the international monetary system. The world is changing very fast with dynamism to embrace the 21st century. Over 50 years old institution like the IMF need reformation to meet the emerging challenges and tackle the new problems in the modern global finance system.

Time has ripped to undertake certain reformatory measures immediately in the interest of the new economic order of the world economy and its progress, besides wiping out the tarnished image of the IMF in its working as a financial institution.

Power relationship within the IMF structure of the monetary system need a change. The SDRs scheme is a substitution for gold. SDRs should be made more significant in the international monetary system. SDRs should play the role of the main denominator in determining parties of different currencies and the exchange rate instead of the US dollar. Nowadays, there is de facto dollar standard in the global monetary system.

Instead of dollar, the SDRs should become the principal reserve asset, then only one can hope for the minimization of the American dominance into the global monetary system.

The IMF should become more strong, fair and neutral. This requires restructuring of its power relationships. With adoption of the SDR standard and its equitable distribution with due consideration for the liquidity need of developing countries, the power relationships can hopefully be rationalized.

The problem of currency speculation also deserves an immediate attention of the IMF. Ways should be formed to alleviate currency trading under speculation motive; When speculation leads to currency crises, it endangers the world trade, growth and welfare of the global economy. The IMF should intervene and cooperate with the Central Bank of a country whose currency tends to be a target of speculative attack.

Even if a country's currency appears to be weak, speculation is not to be justified as a method for de facto devaluation or to teach a lesson and forcing it to correct its BOP situation. Heavy speculation, on the contrary, will ruin the country's economy and worsen its BOP further.

Further, if currency speculation is checked immediately with IMF intervention when it is targeted on a country, it would be less costlier (in terms of assistance) than to assist the country to recover after the damage as often currency crisis forced by heavy speculation attack generates economic crisis as is evidenced by the recent Malaysian experience.

The IMF should also realize that in reality today liberalized market-oriented global economy is based on floating rate system and not on the fixed exchange rate ideology. As such, its policies and strategy of assistance to stabilize the exchange rate and economies of the countries should be revised appropriately as per the emerging need; The bureaucratic approach of the IMF must change with positive thinking and pragmatic consideration.

Further, IMF should be decentralized its working. There should be a few more regional centers in major parts of the world such as South Asia, East Asia, Africa, Europe, Middle East, etc., and deal with the problems locally. These regional centers may be established with the assistance and local personnel - experts from the countries in each region.

11.14 SUMMARY

1. The Term Multinational Corporation is used to identify an enterprise which controls assets, factories, mines, sales and other offices in two or more countries.

2. *“Those enterprises which own or control production or service facilities outside the country in which they are based.”*
3. On the basic functional criterion , the MNCs are grouped into the following :
 - Service MNCs
 - Manufacturing MNCs
 - Trading MNCs
4. There are some merits and demerits of MNCs.
5. Great Britain suspended international gold standard in 1931 followed by majority of the countries of the world including U.S.A.
6. The breakdown of the international gold standard created a vacuum in the field of international trade.
7. In this situation all the countries of the world realised the need for international economic co-operation.
8. The meeting held at Bretton Woods, it was decided that an 'International Monetary Fund (IMF)' be organised for the smooth settlement of international payments.
9. The IMF was organised in 1946 and it commenced its operation in March 1947.
10. The international monetary fund is a landmark in the history of international monetary Co-operation. It is an international Financial Institution.
11. The IMF can be designated as a central bank of central Banks of the world countries.
12. Basically there are three general objectives of IMF viz.
 - The elimination or reduction of existing exchange controls.
 - The establishment of maintenance of currency convertibility with stable exchange rates.
 - The establishment of multilateral trade and payments.
13. Undoubtedly the IMF has made a remarkable success in achieving most of its principal objectives.
14. In order to help the member countries to correct disequilibrium in their balance of payments, the IMF operates various borrowing facilities.
15. Major function of IMF is to provide International liquidity in accordance with the purpose of the Fund specified in Articles of Agreement.
16. The IMF provides two types of International Liquidity viz.
17. Conditional Liquidity and

18. Unconditional Liquidity

19. Since the onset of the global economic crisis in 2007, The IMF introduced several changes in its lending reforms, policy of lending aid to poor countries, governance reforms, conditionality's of getting funds.

11.15 QUESTIONS

1. Explain the characteristics of MNCs.
2. What are the merits and demerits of MNCs?
3. Discuss the Changing role of IMF.
4. Discuss the Functions of International Monetary Fund (IMF)
5. How far the IMF has been successful in achieving its objectives?
6. Focus on Suggested Reforms in the International Monetary Fund (IMF)

❖ **Write Short Notes:**

1. Define the term MNCs
2. Classification of MNCs
3. Objectives of IMF
4. Criticisms of IMF

