

Module 1**FOREIGN TRADE MULTIPLIER****Unit Structure :**

- 1.0 Objectives
- 1.1 Introduction of Foreign Trade Multiplier
- 1.2 Income determination in a multiplier in a closed economy
- 1.3 Foreign Trade multiplier in an open economy
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1.0 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

1.1 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.

1.2 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,

$$K = f(\text{MPC})$$

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 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,

$$1 < K < \alpha$$

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 $\Delta C/\Delta Y = \frac{3}{4}$ hence $\Delta S/\Delta Y = \frac{1}{4}$.

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,

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

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

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.

K_f sets designated as Foreign Trade Multiplier.

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

K_f 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 K_f . Smaller the $s + m$ greater will the K_f . Conversely greater the $s + m$ smaller will be K_f .

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

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

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

The value of $MPS = 0.25$

The value of $MPM = 0.15$

Substituting the values we get,

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

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

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

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

$$\begin{aligned} \therefore Y_{E1} &= Y_E + \Delta Y \\ &= 1000 + 500 = 1500 \end{aligned}$$

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

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

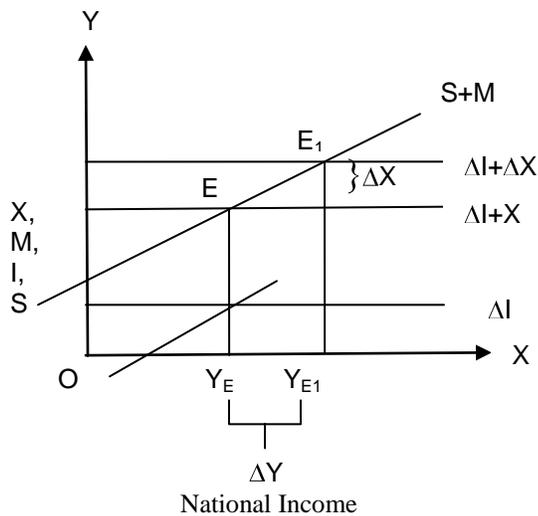


Figure 1.1

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.

1.4 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 ie 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?

1.5 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.

1.5.1 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.

1.6 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.

1.6.1 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.

1.6.2 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 concretionary 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.

1.7 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 in 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

1.8 INTRODUCTION OF POLICY MIX

To know the problem of policy mix we must know the efficacy of the monetary policy and the Fiscal Policy. The highest limitation of monetary policy in the context of the underdeveloped countries arises from the fact that the money market, the capital market and the financial institutions are highly unorganized in these underdeveloped countries which seriously limit the ability of the monetary authority to control the monetary variables. It is not in a position to expand and contract the money supply in the economy. It can't control the unorganized sector. The agricultural sector is the unorganized sector which depends to a large extent for its loan requirements on the indigenous banks and the money lenders. This sector still remains outside the orbit of the banking sector on which there is no control of the central bank of the country. The objectives of the monetary policy are not quite clear. These objectives contradict each other. For example economic growth and price stability objectives of monetary policy contradict each other. In the wake or economic development inflation is bound to take place. And if you stick to price stability then economic growth can't take place rapidly.

The technique of control adopted by the monetary authorities of the underdeveloped countries is less effective. The Bank Rate fails to restrict credit expansion since the interest rate structure is not sensitive to the bank rate. The underdeveloped nature of the money and capital markets restrict the ability of the open market operations to control credit. The variable reserve ratio policy has a greater chance of success as compared to the bank rate policy and the open market operations since the central bank can immobilise a part of the assets of the commercial banks and thus restrict their power to expand credit. However, in many developing countries commercial banks hold excess reserves. Even if the central bank raises the cash reserve ratio their capacity to create multiple credit doesn't get restricted. In some of the developing countries a substantial part of the banking sector is in the hands of the foreign bank branches in these countries. They rely on the resources from their head offices in the foreign countries. Because of the limited success of the quantitative credit control measures of the monetary policy the underdeveloped countries have switched over their emphasis to qualitative credit control measures. These measure have been frequently adopted to restrict hoarding of food grains sugar, oil etc. But they have not been successful in accomplishing much. It is because i) there is not check on the actual use of the credit. Loans taken for productive purposes are diverted to unproductive purposes. ii) Huge stocks of essential food grains are accumulated by the farmers 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.

1.9 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.

1.10 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.

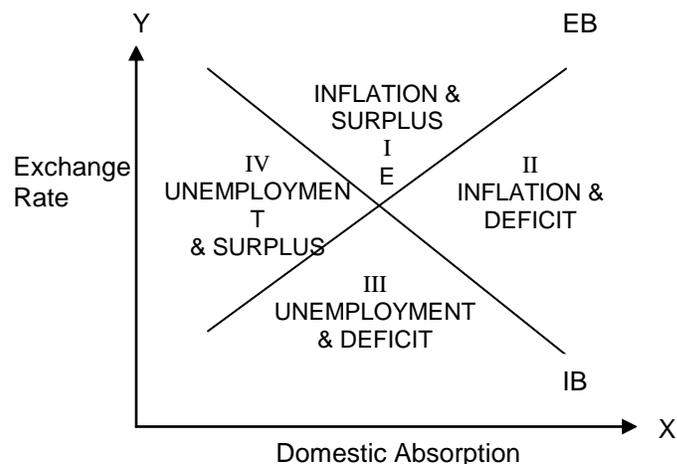


Figure 1.2

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.

1.11 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 ie 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 ie 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 ie internally inflation and externally deficit in the balance of payments then it is advisable that a country should follow concretionary 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.

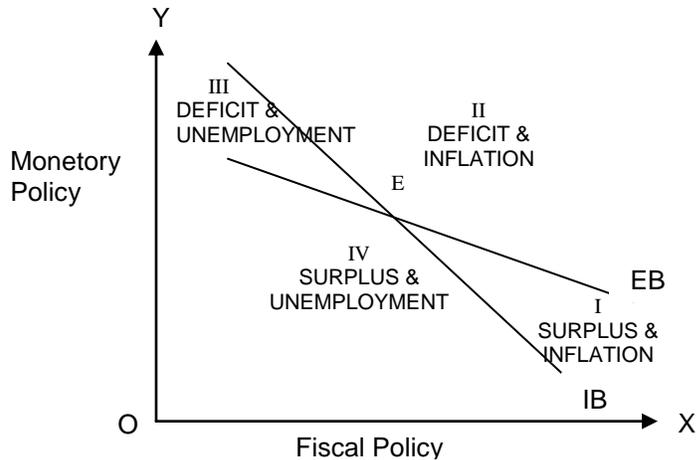


Figure 1.3

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 i.e. 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.

1.12 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

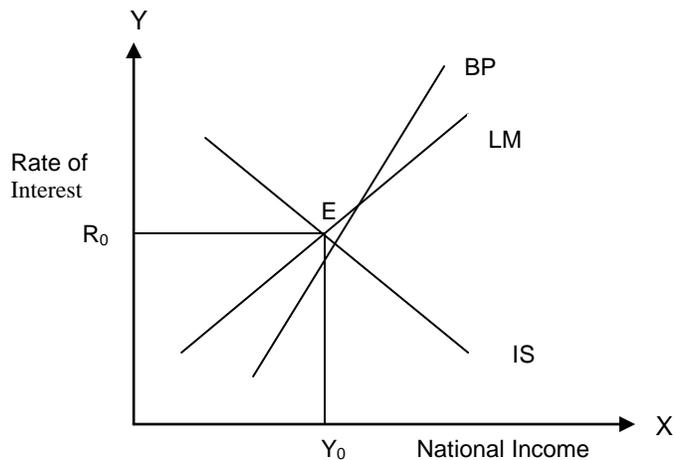
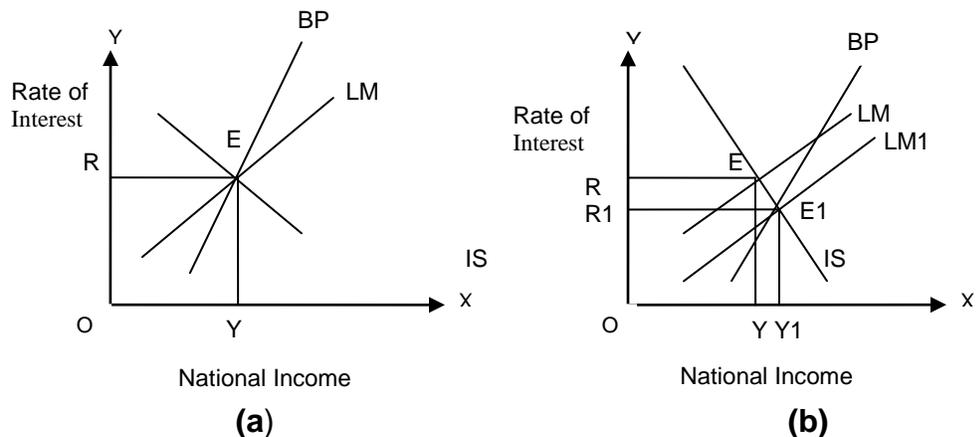


Figure 1.4

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



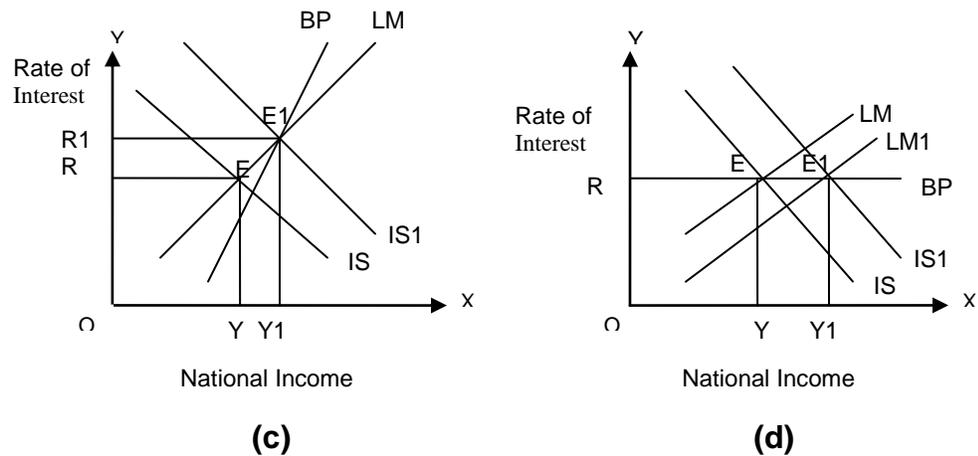


Figure 1.5

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. E₁ 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 E₁ 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

1.13 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.

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

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

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

9. If foreign repercussion is taken into account then,

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

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.

1.14 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 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 INTRODUCTON 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 ie 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.

2.5 CONCEPT OF TRADE BLOCK

A Trade block is a cluster of nations meant for regionalism. It is a free trade area which removes all the obstacles to trade (tariffs and non tariffs) among themselves. It is a custom union which not only removes obstacles to intra-regional trade but also follows a common trade policy towards rest of the world countries ie with the non member countries. In case of a regional trading block like common market there is not only a free movement of goods and services but also a free movement of factors of production regionally. In case of a perfect trading block like economic union there is a retention of all the feature of the previous types of regional trading blocks plus there is a harmonization of national economic policies viz. monetary and fiscal policies. The economic union may switch over to have its own common currency such that regional trading block can also be called as common currency block.

We are going to study the five main types of regional trading blocks which are as follows:-

- (i) E. U. i.e. ECONOMIC UNION
- (ii) NAFTA i.e. NORTH AMERICAN FREE TRADE AGREEMENT
- (iii) APEC i.e. ASIA-PACIFIC ECONOMIC CO-OPERATION
- (iv) ASEAN i.e. ASSOCIATION OF SOUTH EAST ASIAN NATIONS

- (v) SAARC i.e. SOUTH ASIAN ASSOCIATION FOR REGIONAL CO-OPERATION

2.6 ECONOMIC UNION (E.U.)

Economic Union (E.U.) is also known by several other names viz. E.E.C. which stands for European Economic Community.

E.C.M. which stands for European Common Market.

E.C. which stands for European Community.

The origin of Economic Union goes back to the signing of the treaty of Paris in April 1941 by Germany, Italy and Netherlands leading to the setting up of the European Coal and Steel Community (ECSC) Afterwards Europe made a comprehensive attempt in the realm of economic integration in forming the European Economic Community (EEC) on 1st January 1958 by signing the treaty of Rome on March 24, 1957 by six 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.



ECONOMIC 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.



4

URUGUAY ROUND OF GATT and WTO

Unit Structure:

- 4.0 Objectives
- 4.1 Background of the Uruguay Round
- 4.2 Concept of Uruguay Round
- 4.3 Groups and issues in Uruguay Round
- 4.4 Features of Uruguay Round
- 4.5 Dunkel Draft
- 4.6 Introduction and the concept of WTO
- 4.7 Structure of WTO
- 4.8 Objectives of WTO
- 4.9 Functions of WTO
- 4.10 Doha Declaration
- 4.11 WTO bodies
- 4.12 Challenges before WTO
- 4.13 Summary

4.14 Questions

4.0 OBJECTIVES

- i) To know the background of the Uruguay Round.
- ii) To know the Round prior to the Uruguay Round ie the seventh Round which was also known as the Tokyo Round.
- iii) To know the complexities of the Uruguay Round.
- iv) To know the package approach to the Uruguay Round.
- v) To know the Dunkel Draft.
- vi) To know the implications of the Uruguay Round.
- vii) To know the salient features of the Uruguay Round Agreement.
- viii) To know the terms viz GATS, TRIMs and TRIPs.
- ix) Evaluation of the Uruguay Round.
- x) To know the relationship between the Uruguay Round and the Developing countries.
- xi) To know the background of the establishment of W. T. O.
- xii) To know the objectives of W. T. O.
- xiii) To know the functions of W. T. O.
- xiv) To know about the Doha Declaration.
- xv) To know the role of India in W. T. O.

4.1 BACKGROUND OF THE URUGUAY ROUND:

Perhaps no other subject had evoked so much attention amongst the political leaders, media, economists, academicians and the general public during 1993, as the Dunkel Draft on the Uruguay Round of GATT negotiations and on the conclusion arrived at on December 15, 1993.

The GATT started with a round of negotiations, the first round ie the Geneva Round in 1947 in which 23 countries took part. It covered more than 50% of the world trade. The first round was successful in cutting the tariffs to a greater extent due to the initiation of United States. The negotiations up to fifth round were carried on bilaterally product by product request offer basis. A pair of negotiating countries exchanged two lists. One of the lists contained request that the other country should reduce tariffs on the exports of the country and the other list contained the set of offers to reduce tariffs on the export of the other country. These lists were also circulated to other negotiators who would then be able to take them into account in their own bargaining problem and could also join the original pair for solving their problem. In this way

the bilateral negotiations used to get transformed into multilateral negotiations. The subsequent four rounds viz second, third, fourth and the fifth didn't achieve comparable tariff reduction. The Sixth Round was the Kennedy Round (1964-67) which was held on 6th May 1964 at Geneva in Switzerland. It was agreed that the Kennedy Round would provide for acceptable conditions of access to international markets for agricultural commodities. In March 1965, the trade negotiations committee took up the procedure for negotiations on agriculture. By Sept 1965 nearly all developed countries tabled their offers. Similarly a plan for the participation of the developing countries was also adopted by the trade negotiations committee in March 1965. The overall results of the Kennedy Round were very substantial and of a very large magnitude as compare to the previous negotiations.

Tokyo Round (1973-79)

The economic scenario during the time of Tokyo Round was not encouraging. All over the world there was stagflation. It was Professor Samuelson who coined the term, "Stagflation." As per Professor Samuelson stagflation means inflation accompanied by unemployment. It is a situation wherein price level continuously rises with the simultaneous rise in the rate of unemployment and stagnation of growth stagflation involves inflationary rise in prices and wages simultaneously such that people are unable to find jobs and firms are unable to find customers for their products. Due to stagflation the non tariff barriers were increasing rapidly such that the trade relations between United States, European Community and Japan were strained. Due to which many problems which were on the agenda of Kennedy round could not be resolved viz. the problem of agriculture and non-tariff barriers. Due to a tug-of-war between United States and the European Community on the issue of cut in tariffs (U.S. was in favor of lenient cut while the E.C. was in favor of drastic cut in tariffs) Ultimately a "Swiss formula" was adopted to resolve the deadlock.

In the Tokyo Round once again the concessions were given to manufactured goods. Agricultural commodities were treated differently. Textiles and clothing, leather, footwear and travel goods received lower tariff cuts or no tariffs cut at all. Tropical products received some concessions. Many tropical products were granted duty free access. The tariff cuts granted to LDCs were lower than those enjoyed by the DCs (Industrial Countries)

The Tokyo Round was mainly concerned with rules for commercial policy. It set up several study groups. A group on non-tariff barriers was split up into five sub groups viz. i) technical barriers, ii) quantitative restrictions, iii) subsidies, iv) Government procurement and v) customs matters.

The other study groups covered sectoral approach tariffs, agriculture, Tropical products and safeguards ie emergency

protection. All these issues were negotiated multilaterally. In the Tokyo Round the small industrial nations and the Developing countries were more active than in the previous Rounds.

The quantitative restrictions being the most sensitive area despite considerable efforts very little came out of it. There was a production of new code as regards the discussion on Government procurement. The negotiations on liberalization were conducted on a request-offer basis. However the procurement was biased in favors of domestic suppliers.

However the Tokyo Round failed to resolve on trade liberalization through tariff reduction. Agricultural problems were not resolved and continued to be a source of friction. The Tokyo Round was also failure in resolving the safeguards issue. The Less Developed Countries remained dissatisfied as these countries failed to achieve greater concessions.

4.2 CONCEPT

The Uruguay Round of multilateral trade negotiations was the eighth and the final round of GATT which was launched at Punta del Este/Uruguay in Latin America, a developing country in September 1986 in which 117 countries participated because of which it gets referred to as "URUGUAY ROUND."

It was the most complex round of the GATT. It was because of the complexities of the issues involved and the conflicts of interest of the participating countries especially between the United States and the European Community that the Uruguay Round could not be concluded in Dec. 1990 as was originally scheduled. It was finally concluded on 15th December 1994. The final Act was signed by the representative of 125 nations on 15th December, 1994. It was to be implemented within ten years since 1995. Different time periods were given for effecting different agreements.

The jurisdiction of GATT was confined to boarder measures only such as tariffs and non tariffs barriers to goods trade only. The trade in service and domestic policies were regarded as outside the orbit of G. A. T. T. The first six Rounds of GATT concentrated almost exclusively on the reduction of tariffs. The seventh Round in the Tokyo Round moved on to Non-tariff barriers (NTBs). The Uruguay Round marks the water shed and sought to broaden the scope of Multilateral.

Trade Negotiations by including new area within its fold which are as under:-

- i) Trade in services
- ii) Trade Related aspects of Intellectual Property (TRIPs)
- iii) Trade Related Investment Measures (TRIMs)

Even within the goods sector, the negotiations cover the sensitive areas like agriculture and textiles which had remained untouched by GATT discipline for decades. The extension of the negotiating mandate to agriculture, textiles, investment, intellectual property rights. It means that the jurisdiction of GATT will not stop at national borders, but will impinge on the domestic policies of the member countries of G. A. T. T.

The Uruguay Round being the most complex, complicated and ambitious multilateral trade negotiations as compared to all the previous negotiations adopted a "Package Approach" on the multifarious issues. It contained a mandate for negotiations in 15 major areas of which 14 areas related to trade in goods and one related to trade in services.

4.3 GROUPS and ISSUES IN URUGUAY ROUND.

GROUPS

MAIN ISSUES

1: Group of Negotiations on Goods.

1) Tariffs	i) Reduction/elimination of existing tariffs ii) Tariff escalation iii) Formula approach vs. product by product approach.
2) Non-Tariff Measures	i) Elimination/Reduction of non tariff measures including quantitative restriction ii) How to establish "equivalence" for bilateral negotiations. iii) Whether to treat unjustified quantitative restrictions (QRs) as negotiable or whether to insist on rolling back these QRs.
3) Natural Resource Based Products	i) Tariff escalation ii) Use of quantitative restrictions. iii) Access to supplies. iv) Products coverage in the groups work.
4) Textiles and clothing	What procedures could be use to integrate trade in textiles and clothing into the working of the GATT, in effect, how to dismantle the MFA

5) Agriculture	<ul style="list-style-type: none"> i) Improved market access through reduction of import barriers. ii) Increased discipline over measures not conforming with the GATT, including direct and indirect subsidies, quotas, also reduction of subsidies which do not conform with the GATT.
6) Tropical Products	<ul style="list-style-type: none"> i) Increased liberalization of processed and semi-processed tropical products. ii) Tariffs and non tariff liberalization. iii) How much reciprocity should be required of developing countries. iv) Coverage by product.
7) GATT Articles	Articles on tariff binding, customs unions, balance of payments, State Trading, waivers etc are to be reviewed.
8) MTN Agreements and Arrangements	Improvement, classification on expansion of codes.
9) Safeguards	Selectivity, transparency, degressively, structural adjustment etc.
10) Subsidies and countervailing Measures	<ul style="list-style-type: none"> i) Review of the MTN Agreement on subsidies and countervailing measures. ii) Definition of subsidy iii) Discipline on export subsidies
11) Trade-Related Aspects of Intellectual property Rights (TRIPs) including Trade in counterfeit goods	<ul style="list-style-type: none"> i) Clarify GATT provisions. ii) Ensure measures and procedures to enforce IPR.
12) Trade Related Investment Measure (TRIMs)	To elaborate on further provisions.
13) Dispute Settlement	<ul style="list-style-type: none"> i) Effective enforcement of Panel's conclusions. ii) Improvement of efficiency and transparency.
14) Functioning of G A T T System	<ul style="list-style-type: none"> i) Enhanced surveillance in GATT to enable monitoring of trade policies and practices of contracting parties. ii) Improved functioning of GATT as decision making institution.

2. Group of Negotiations on Services

15) Services	i) Definition and statistical issues. ii) Broad concepts on principles and rules for trade in services. iii) Coverage of multilaterals discipline. iv) Foreign investment v) International labour mobility. vi) Right of establishment etc.
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Source: International Economics D. M. Mithani Himalaya Publishing House.

4.4 SPECIAL FEATURES OF URUGUAY ROUND AGREEMENT

1) AGRICULTURE

The liberalization of Agricultural trade was foremost exclusive feature of Uruguay Round Agreement. The root cause of international trade in agriculture was the massive domestic subsidies given by industrialized countries to their agricultural sector. This had led to an excessive production (as well as import restrictions to keep the foreign products away from entering into their markets). There was also an act of dumping in the international markets by the industrial countries. In order to minimize such dumped exports and to keep their markets open for the world countries, the starting point had to be the reduction of export subsidies and the market access opportunities for the world countries.

The Uruguay Round Agreement includes the following very important points on agricultural trade

- i) Tariffication
- ii) Tariff binding
- iii) Tariff cuts
- iv) Reduction in subsidies and domestic support

Tariffication means the replacement of the existing non-tariff restrictions like import quota, import licensing etc by tariffs such that the level of protection remains intact.

Tariff binding means commitment for reduction of tariffs on agricultural products. It was made binding for the industrial countries to reduce the tariffs on an average by 36% within six years from 1995. While it was made binding for the developing countries to reduce the tariffs as an average by 24% over a period of 10 years from 1995. No such commitment was there for the least developed or the poor countries.

There were three categories of subsidies.

- i) Prohibited Subsidies:- Subsidies given to boost up export by using domestic goods instead of imported goods were prohibited.

ii) Actionable Subsidies:- The subsidies that spread adverse effect on other member countries were listed as actionable subsidies.

iii) Non-actionable Subsidies:- Subsidies given for industrial research, development activity to disadvantaged region and for adjustment to new environment were referred to as non-actionable subsidies.

Restrictions were also imposed upon the use of countervailing measures where as food subsidy under the Public Distribution System (PDS) was exempted.

The Uruguay Round Agreement aimed at establishing a market oriented agricultural trading system in terms of improving transparency and market access.

2) TEXTILES and CLOTHING:-

The textiles and clothing sector remained beyond the pale of GATT discipline for over two decades. The major objective of the Uruguay Round was to integrate textiles and clothing into GATT. This sector accounted for 30% of our exports. In 1993-94 our exports in this sector were of the order of \$7.4 billion. The Multi Fibre Arrangement (MFA) of India existed with six countries namely USA, EEC, Canada, Finland, Norway and Austria. These countries accounted for nearly 2/3rd of the world trade in textiles and clothing. USA and EEC accounted for over 60% of our textiles and clothing exports. The Uruguay Round Agreement on textiles and clothing came into force from 1st January 1995 which was a matter of great advantage to us. Under the Uruguay Round Agreement on textiles and clothing it was envisaged that there should be a multilateral trade arrangement and not a bilateral trade arrangement and the bilateral trade arrangements would come to an end immediately from the date of coming into force the Uruguay Round Agreement on textiles and clothing.

The Uruguay Round Agreement followed two routs for the liberalization of trade in this sector

i) through abolition of quotas on specified products during the transition period of ten years. This abolition would be 16% of the total volume of imports, 17% after three yeas, 18% after four years and 49% on the final day of the transition period.

ii) Secondly through "growth factor" of 16%, 25% and 27% applied to the normal growth rates of the existing bilateral agreements at the above mentioned three stages.

India's gain in this sector of textiles and clothing of Uruguay Round Agreement was that of abolition of the arbitrary system of MFA and inclusion or integration of the textiles and clothing into GATT by a multilaterally agreed treaty. It must be noted that India, Pakistan and Indonesia were pushing for a faster liberalization of the sector of textiles and clothing while other exporters like Hong

Kong, Taiwan and South Korea were not so eager as these countries were enjoying big quotas under MFA. Faster liberalization was also not acceptable to countries such as Sri Lanka, Bangladesh and Jamaica.

3) SERVICES:-

(Liberalization of Trade in Services)

Prior to Uruguay Round there was no common set of rules and disciplines governing trade in services. It was Uruguay Round which brought trade in services into the negotiating net. The abbreviation GATS stands for the General Agreement on Trade in Services. It was said to be the landmark achievement of the Uruguay Round. Prior to the Uruguay Round services were subjected to various types of national restrictions due to their socio-economic and political implications. The countries used to take various protective measures such as visa requirements, investment regulations, restrictions on repatriation, marketing regulations, restrictions on employment of the foreigners, compulsion to use local facilities etc. The protective services included banking, insurance, transportation, television, radio, film means of communication and entertainment etc.

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

It means the GATS covered four modes of international delivery of services:-

- i) Cross-border supply (transporter data flows, transportation services)
- ii) Commercial Presence/Provision of services through representatives)
- iii) Consumption abroad (tourism)
- iv) Movement of Personnel (entry and temporary stay of foreign consultants)

The framework of GATS consisted of basic obligation of all member countries on international trade in services including financial services, telecommunications, transport, audio visual, tourism, professional services as well as movement of workers.

There were two most important obligations

i) Most Favored Nations Clause. (MFN) as per which member countries were prevented from making any discrimination among foreign suppliers of services.

ii) Transparency. It was another obligation according to which each member country was required to publish all its relevant rules and regulations pertaining to trade in services to which a member country is a signatory.

There were three main objectives:-

i) Creating a multilateral framework of rules and regulations for trade in services.

ii) transparency and progressive liberalization.

iii) economic growth of all member countries with special reference to the developing member countries.

4) TRIPs:-

The abbreviation TRIPs stands for "TRADE RELATED INTELLECTUAL PROPERTY RIGHTS". It was one of the most controversial issues of the Uruguay Round of GATT.

Before we know the salient features and the implications of TRIPs let us know the reasons for its insistence by the industrialized world led by USA to bring the subject of TRIPs under the orbit of GATT. Technology matters most so far as intellectual property is concerned. During those days technology was increasingly becoming a valuable commercial asset and was considered to be a dominant factor in determining international competitiveness. As the industrialized countries were losing ground in the field of traditional manufactures they wanted to shift it to knowledge based industries and "intellectual goods". Since these industrial countries were DCs they commanded a comfortable lead in the new technologies viz information, communication and biotechnologies. On the other hand the investment cost of research and development was also rising rapidly with the growing standard of health and environmental protection. The piracy of their intellectual property especially in the sectors like pharmaceuticals, chemicals, film, computer software etc. was causing them huge losses. The protection of technology meant a protection of their market power and prevention of competition. The lack of intellectual property protection distorted international trade and hence should be brought under the preview of GATT discipline. The inclusion of IPRs in the agenda of Uruguay Round negotiation would not only enable them to set uniform and higher standards for protection and enforcement but also empower them to take recourse to "cross retaliation".

The TRIPs agreement covered seven categories of intellectual property viz.

1) Copyrights and related rights

- 2) Trade mark
- 3) Geographical indications
- 4) Industrial designs
- 5) Patents
- 6) Layout designs of integrated circuits
- 7) Undisclosed information

1) The TRIPs agreement requires that if an identical new product is manufactured by another country then it will have to prove that it is not using the patented process of the country concerned.

2) The TRIPs agreement permits compulsory licenses given to the country concerned on individual merit basis but it prohibits the automatic and cross-the-board license of right. A compulsory license can be given under TRIPs agreement only after the compulsory license seeker has approached the patent owner to obtain compulsory license on reasonable commercial terms and conditions. A compulsory license cannot be given without the patent owner being heard by the Competent Authority and the compulsory license is subjected to judicial review.

3) The TRIPs agreement should not come in the way of safeguarding public interest in case a country making a judicious and selective use of compulsory licensing.

4) Technology can be broadly divided into two categories viz know how and patents. The value of know how lies in the secrecy while the value of patent lies in its disclosure.

5) Technology has now shifted from building a better mouse trap to building a better mouse.

6) Patents are given by inventions and not for discoveries.

7) Biotechnology is the technology of the future. It will have a pervasive role to play in agriculture, industry, food, machine environment and ecology. It is a knowledge based industry. Intellectual rather than financial capital will drive it.

5) TRIMs:-

The abbreviation TRIMs stands for "TRADE RELATED INVESTMENT MEASURES." The Trade Related Investment Measures (TRIMs) refer to certain conditions or restrictions imposed by the Government on foreign investment in the country. The agreement on TRIMs which applies to investment measures relate to trade in goods only. The agreement says that no country shall apply any TRIM that is inconsistent with the provisions of Article III (relating to national treatment) or Article XI relating to quantitative restrictions) of GATT. It also contains an illustrative list of a few TRIMs that are inconsistent with the obligations under Articles III and XI of G. A. T. T. They relate to the following:-

- i) Local content requirement (ie local input used for the manufacture of products,
- ii) Trade balancing requirement ie imports should not exceed exports.
- iii) Foreign exchange balancing requirement.
- iv) Domestic sales requirement ie some output should be sold locally in order to cater to local needs.

For the progressive liberalization of world trade and to facilitate investment across the international frontiers and also to facilitate economic development of the member countries with special reference to the developing countries the agreement on TRIMs made the following arrangement

- i) In order to meet the adjustment in the balance of payments the developing countries ere permitted to get rid off TRIMs temporarily.
- ii) Each member country was given the facility to eliminate the TRIMs within two years; the developing countries within five years and the least developed countries within seven years.

4.5 DUNKEL DRAFT:-

Perhaps no other subject had evoked so much attention amongst the political leaders, the media and the public during 1993-94 as the 'Dunkel Draft' or Dunkel Proposal on the Uruguay Round of GATT negotiations. A great deal was said and written on various aspects of Dunkel Draft. The document being the voluminous, complex and technical one, only a few had an opportunity to go through the original text. Mr. Ganesan, the secretary to the Government of India represented India as a chief negotiator at the Uruguay Round.

After having formed the two groups of negotiations on goods and services respectively covering in all fifteen items (14 items of goods + one item of services) a Trade Negotiations Committee (TNC) was formed to monitor the overall negotiations. The TNC was headed by two chairmen, one at the official level and the other at the ministerial level. Owing to the disagreements of some member countries especially USA and EEC on certain key issues for example agriculture, the Uruguay Round negotiations could not be completed within the scheduled time ie by December 1990. The trade negotiations therefore, resumed by the TNC in February 1991 by regrouping the original fifteen items into seven items viz.

- i) Market Access
- ii) Agriculture
- iii) Textiles and clothing
- iv) GATT Rules including TRIMs
- v) TRIPs

- vi) Trade in services
- vii) Institutional matters

Since January 1992 a four track approach was adopted for the Uruguay Round negotiations.

Track I- Pertained to negotiations on market access concessions.

Track II:- dealt with the initial commitment made in the area of services.

Track III:- involved the legal conformity and internal consistency of the agreements.

Track IV:- was kept for the possibility of adjustments in the final draft.

To expedite the resumed negotiations in 1991, Sir Arthur Dunkel The Director General of G A T T and the official chairman of TNC prepared a set of proposals taking into account the negotiations that had taken place among the member countries and the areas of differences that still persisted, and gave his perceptions of a package that could accommodate the interests of all the participating countries. These proposals were popularly called as “Dunkel Proposals” or “Dunkel Draft”. The Dunkel draft being the legal and technical document covered seven areas of negotiations viz I) Market Access II) Agriculture III) Textiles and clothing IV) GATT Rules V) TRIPs vi) Trade in Services and vii) Institutional matters.

The Dunkel Draft aimed at narrowing down the differences between the participating countries by liberalizing the trade but it become a highly controversial issue because it insisted that the whole package should be accepted without assuming for any concessions. However at the final stage of Uruguay Round negotiations the Dunkel Draft was altered and amended. In spite of that there remained a deep imbalance in the matter of concessions especially in the areas of agriculture, textiles and TRIPs.

The Final Act of GATT 1994 was signed at Marrakesh on April 15, 1994. The agreement on technical barriers to trade was highlighted. Under this agreement the importing countries were empowered to enforce technical regulations at the customs point. As per that goods were debarred which were not suiting to their technical requirements. All these technical regulations were meant for protecting human, animal and plant life and health, environment and also for the prevention of ambiguous practices. The FINAL Act defined the technical regulations as “document which lays down product characteristics or their related processes and production methods including the applicable administrative provisions with which compliance is mandatory”.

Check Your Progress:

1. Explain the background of Uruguay Round.
2. Discuss the special features of Uruguay Round.
3. What was the role of India in Uruguay negotiations?

4.6 INTRODUCTION OF WTO

The establishment of World Trade Organization is a landmark in the realm of the liberalization of the international trade. The origin of the W. T. O. can be traced back to the two world wars viz. First World War between 1914-1918 and Second World War between 1939-1945. The Bretton Wood's Conference held in 1944 had recommended for the establishment of three cornerstones of the world economy viz. International Monetary Fund (IMF), The International Bank for Reconstruction and Development (IBRD) ie World Bank and the International Trade Organization (I.T.O.) Accordingly the IMF and the World Bank were established in 1946. However, the proposal to establish ITO didn't materialize due to the objections raised by a few countries that its enforcement would interfere with the autonomy of domestic policy making of the member countries. Hence instead of ITO the GATT was formed. The General Agreement on Tariffs and Trade, the predecessor of W. T. O. was born in 1948 as a result of the international desire to liberalize trade. The GATT was both an agreement and an organization. It was an agreement signed by the contracting nations for setting out the rules for conducting international trade. It was also an organization which was created to facilitate discussions and administration relating to the agreement. GATT as an organization ceased to exist with the establishment of W.T.O. It is the WTO which replaced GATT. Still GATT as an agreement dealing with trade in goods continues to exist in the form of W.T.O. The old GATT 1947 now is called as GATT 1994. Therefore W.T.O. is called as GATT plus a lot more.

Since the inception of GATT as many as eight rounds were held at different places. The Uruguay Round was the latest and the eighth round which was held at Uruguay in Latin America. It lasted for seven years from September 1986 to December 1993. The GATT negotiations covered trade in manufactured goods while the Dunkel Draft expanded the scope of the negotiations by including trade in services. Agriculture, TRIPs and TRIMs. All these things put together form the basis of W. T. O.

The basic aim of GATT was to liberalize the international trade by removing tariffs and non-tariff barriers. Initially tariffs were only included for liberalization of trade. Later on non-tariff barriers were

also included for liberalization. The same is carried forward by W.T.O. This approach has got a theoretical support also. It derives its strength from the classical and neoclassical theories of international trade. The main spring behind the international trade as per them was free trade. Free trade promotes specialization, division of labor which leads to comparative advantage to the trading partners. It leads to savings of the cost of production and benefits not only for the producers but also for the consumers. It increases the total volume of trade. Under GATT international trade expanded through the multilateral trading system.

OF all the rounds of GATT the Uruguay Round was the most complex and controversial one. It took more than seven years for its completion as against the original contemplation of four years. The second very important thing that led to its complexity was the inclusion of new areas like Agriculture, Services, Textiles and clothing, TRIPs and TRIMs.

The success of the Uruguay Round depended upon the spirit with which it was practiced. The ratification of the NTBs was considered to be the success of the Uruguay Round. However the tariffication of NTBs got transformed into dirty tariffication due to high level of protection practiced by some of the member countries of GATT. The effect of Uruguay Round on all the participating countries was not the same. Most of the gains from Uruguay Round accrued to the Developed Countries especially the least developed and food grains importing countries suffered a lot. The developed countries were not sincere in implementing the proposal which would benefit the developing countries.

One of the most glaring achievements of the Uruguay Round is the making of the rules and regulations more transparent and thus making the trade – harassment and unilateral action more difficult. The results of the Uruguay Round will be implemented by the newly set up world Trade Organization (WTO) making the dispute settlement and arbitration easier.

CONCEPT OF W.T.O.

The World Trade Organization is defined as, “the legal and institutional foundation of the multilateral trading system.”

Establishment:- The establishment of the World Trade Organization was agreed at 1986-93. Uruguay Round of trade negotiations and its creation was approved by trade ministers of 81 countries which controlled over 90% of the world trade in goods and services. It's membership increased significantly. By 1998 its membership rose to 132. It was approved at Marrakech in Morocco in April 1994. The W. T. O. was launched on January 1, 1995. The G. A. T. T. and the W. T. O. co-existed for the transitional period of one year in 1994. On January 1, 1995 the W. T. O. completely replaced the G. A. T. T. India is a founder member of W. T. O. The

W. T. O. provides a single institutional framework encompassing GATT and all the results of the Uruguay Round. Following are the main results of the Uruguay Round:-

The Uruguay Round was most complex and controversial one. It took more than seven years to complete the negotiations. The tariffication of trade barriers was claimed to be a significant success of the Uruguay Round (UR). However, because of the way the 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 per cent.

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 per cent of World GDP.

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

According to some estimates the increase in real income will be roughly 1.6 per cent of GDP for the European Union, 0.2 per cent for the U.S. and 0.9 per cent for Japan. The gains would amount to about 2.5 per cent of the GDP for China, 0.5 per cent for India, 0.6 per cent for South Africa and 0.3 per cent for Brazil.

UR Agreement and Developing countries : As in the case of previous Rounds, the developing countries are dissatisfied with the outcome of the Uruguay Round. Some of the areas like TRIPs, TRIMs and services have been very sensitive as far as 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 payments purposes should do so in a way that causes minimum disruption to international trade and quantitative restrictions should be avoided as far as possible.

While the liberalization of agricultural trade and the increase in agricultural prices due to cut in producer subsidies 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.

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 multifibre arrangements (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.

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 service sector largely unaffected.

The effect of the UR is not the same on all countries. Latin American countries were 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.

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.

4.7 STRUCTURE OF WTO

Ministerial Conference (MC)

GENERAL COUNCIL (GC)

At the top of the structure of WTO there is Ministerial Conference (MC). It is a super governing body which takes ultimate decisions on all matters. It is constituted by representatives (Ministers) of all the member countries. Next to Ministerial council there is General Council (GS) which is composed of the representative of all the members. IT is the engine of WTO which acts on behalf of the Ministerial council. It also acts as a Dispute Settlement Body as well as the Trade Policy Review Body.

The Dispute Settlement Body has got three councils which are as follows:-

- i) Council for trade in goods
- ii) Council for trade in services
- iii) Council for Trade Related Aspects.

The Trade Policy Review Body (TPRB) has got three committees which are as under:

- i) A committee on Trade and Development
- ii) A committee on Balance of Payments Restrictions.
- iii) A committee on Budget Finance and Administration.

The Ministerial Council appoints the Director General who looks after the secretariate of WTO as an administrator. The Director General is appointed for a period of four years. The Director General is assisted by four Deputy Directors from different member countries. The Annual Budget Estimates and Financial Statement of WTO are presented by the Director General to the committee on Budget Finance and Administration for review and recommendations for the final approval by the General Council (G.C.)

4.8 OBJECTIVES OF W.T.O.

As per the preamble of WTO following are the only objectives of WTO:-

- i) To ensure the reduction of tariffs and the Non-tariff barriers to trade.
- ii) To eliminate discriminatory treatment in international trade relations.
- iii) To facilitate higher standard of living, full employment, growth in real income and effective demand and increase in production and trade in goods and services of the member countries.
- iv) To make positive effect, which ensures developing countries, especially the least developed to secure a level of share in the growth of international trade that reflects the needs of their economic development.
- v) To facilitate the optimum use of the world's resources for sustainable development.
- vi) To promote an integrated, more viable and double trading system incorporating all the resolutions of the Uruguay Round's multilateral trade negotiations.

Above all, to ensure that linkage trade policies, environmental policies with sustainable growth and development are taken care of by the member countries in evolving a New Economic Order.

4.9 FUNCTIONS OF WTO

The WTO performs the following Functions:-

- i) To lay down a substantive code of conduct aiming at reducing trade barriers including tariffs and eliminating discrimination in international trade relations.
- ii) To provide the institutional framework for the administration of the substantive code of conduct which encompasses a spectrum of norms governing the conduct of member countries in the sphere of international trade.
- iii) To provide an integrated structure of the administration to facilitate implementation, administration and fulfillment of the objectives of the WTO Agreement and other multilateral trade Agreements.
- iv) To ensure the implementation of the substantive code.
- v) To act as a forum for the negotiation of further trade liberalization.
- vi) To cooperate with IMF and IBRD and its associates for establishing a coherence in trade policy making.
- vii) To settle the trade related disputes.

4.10 THE DOHA DECLARATION

The fourth ministerial conference of WTO was held in Doha in November 2001 in which ministers from 142 member countries participated. India played a very important role at the Doha Conference. Firstly it strongly opposed the non trade issues like labour and didn't want it to be on the agenda. Secondly it wanted the implementation of the resolution relating to increased market access in agriculture, sufficient flexibility and clarity under TRIPs for public health policies. The developed countries wanted a new round of multilateral trade negotiation to be launched soon, covering covering the Singapore issues i.e. a list of seven items viz. investment, competition policy, trade facilitation transparency in Government procurement environment, agriculture and trade related aspects of intellectual property rights (TRIPs) which were opposed at the Singapore meeting in 1996. Developing countries like India on the other hand held that the implementation issue should be resolved before new Round. India had fought single handedly on behalf of the developing countries. India's low stand had a commendable effect on the Doha Conference. The chairman of the meeting announced that an explicit consensus would be required at the fifth ministerial conference in 2003, before negotiations could begin on the highly controversial Singapore issues. It is an indication that when a strong position taken by a single developing country can have such a profound positive effect the collective effort of all the developing member countries can create Oasis in the desert.

- viii) The Doha Conference adopted three major declarations:-
- ix) i) On the negotiating agenda for the new WTO round
- x) ii) On some 40 implementation countries of the developing countries and
- xi) iii) On patents and public health.
- xii) One remarkable achievement of the Doha Conference for developing countries is that of setting aside the patent laws if they face epidemics such as malaria, tuberculosis and AIDS. Each member country has been given the freedom to declare national emergency. In case of agriculture all the member countries decided that subsidies should be reduced and should be phased out.
- xiii) With the decision at Doha to admit China and Taiwan in W.T.O. its membership increased to 144.

4.11 WTO BODIES

There are three important WTO bodies which are called as the key units of W.T.O.

The three key units of WTO are as follows:-

- i) The Dispute Settlement Body (DSB)
- ii) The Appellate Body and (AB)
- iii) The Trade Policy Review Body (TPRB)

The Dispute Settlement Body meets usually meets twice a month to listen to the complaints from the member countries about the violation of WTO rules and agreements. It sets up panels of independent experts to look at the arguments of both the sides and to rule whether rules have been broken or not.

The Appellate Body hears appeals against panel findings. Its rulings are sent back to DSB which takes a consensus decision to adopt them.

The Trade Policy Review Body is a forum for the member countries to review, praise or criticize each other's policies. Major trading powers are reviewed every two years, others every four years. In six years the DSB had as many as 250 disputes for settlement. Many of these disputes have been resolved by the countries involved through bilateral negotiations under the pressure of the panel investigation. Developing countries regard the Dispute Settlement Body as a shield against more powerful countries. The very first ruling was given in 1995 for Venezuela in a case against United States over a gasoline tax. Ride Powers like the united states and the European Union have fought their disputes through

the DSB rather than by simply imposing unilateral sanctions or declaring trade wars.

4.12 CHALLENGES

Number of challenges lie ahead for the WTO. One is the enlargement of membership to include a number of major trading nations. For example China's vastly increased importance in international trade underlines the need for its full involvement in and acceptance of international trading arrangements if recourse to bilateral and managed trade solutions are to be avoided. Even among WTO member countries which have subscribed to multilateral rules and disciplines the temptation to manage trade has not been resisted. Quantitative restrictions especially voluntary export restraints import targets and price control measures offer through the anti-dumping and countervailing duties have proliferated in recent years. Much will depend on the how far the WTO new rules can counteract discriminatory and protectionist trade measures and on the efficacy and the speed of its new dispute settlement system.

Secondly the major challenge which lie ahead for WTO is to cope up with the risk that may arise from purely regional rather than multilateral trade liberalization. The Mercosuz Customs Union in South America (2002) and the Asia Pacific Economic Co-operation (APEC) free trade area are the two most visible examples of preferential regional trade arrangements.

A recent challenge to the WTO arises from attempts to link trade to environmental issues and workers rights. Trade policy is unlikely to provide an effective mechanism for addressing such concerns because the links involved are too indirect and the danger of unintended consequences too great (ie discrimination against low income countries) It is expected from WTO to handle this area very carefully because there new areas may used more domestic protection.

The multilateral trading system is at crossroads. The threads presently faced by WTO arise from a variety of fundamental changes in the world economy. These changes have produced fissiparous tendencies grouping at many of the basic principles embodied in WTO. The preamble of GATT drawn up in 1947 emphasizes the need for notification of trade policy measures, the use of tariffs rather than quotas, the obligation of consultation, but it doesn't provide an explicit general monitoring system to check the behavior of its members.

The WTO is expected to contribute to the reduction of transaction costs in the world trade and thereby further accelerate the ongoing process of economic globalization. Without double the economic globalization will have a significant effect on the political structure and processes both at the national and international

levels. It is assumed that the WTO will maximise efficiency in the allocation of factors of production at the global, level, which have been distorted by various protectionist barriers, and thereby raise income levels worldwide. It is also assumed that the multilateral system will also lead to an intensification of economic interdependence between member countries.

It is also assumed that the autonomy and the role of the state in international relations will decline as the multilateral trade order becomes institutionalized and economic globalization proceeds.

In fact, a report on the prospective long term effects of the WTO predicts that, the WTO system will bring absolute gains on a worldwide scale, it will also promote an increased gap in gains on a worldwide scale, it will also promote an increased gap in gains between the advanced capitalist countries and the developing countries. The WTO System needs to pay attention to the political implications of this gap. Any significant disparity in wealth between them and will accentuate unequal power relations between them.

Check Your Progress:

1. Discuss the establishment of WTO.
2. What are the objectives and functions of WTO?

4.13 SUMMARY

- i) The Uruguay Round is the eighth round of GATT.
- ii) It was signed by 117 countries of the world including India
- iii) It was the final round of GATT which was launched at Uruguay in Latin America in September 1986.
- iv) It was the most complex round of GATT.
- v) It broaden the scope of multilateral trade negotiations by including new areas in its fold viz. services, Trips, Trims.
- vi) There were two main groups of negotiations viz. I) Goods and ii) Services
- vii) The first group (Goods) incorporated 14 issues while the second group ie services incorporated only one issue ie services.

- viii) The Dunkel Draft was the most crucial event of the Uruguay Round which evolved much attention of the political leaders, media and the public.
- ix) The Dunkel Draft was prepared by Sir Arthur Dunkel who was the Director General of GATT and the official chairman of TNC
- x) India is more a gainer than a loser from the GATT.
- xi) The Uruguay Round is not a round to end all the rounds of GATT but it is the beginning of the new phase in the international economic relations.
 - xii) The establishment of WTO is a landmark in the realm of the liberalization of the international trade.
- xiii) The abbreviation WTO stands for "World Trade Organization."
- xiv) The establishment of WTO replacing the GATT was approved at the Marrakesh in Morocco in April 1994.
- xv) For a transit period of one year both the GATT and the WTO functioned simultaneously.
- xvi) On January 1, 1995 the WTO completely replaced the GATT.
- xvii) The WTO has created a strong dispute settlement mechanism which has a status of an international organization.
- xviii) The Ministerial Council appoints the Director General who look after the Secretariate of the WTO as an administrator.
- xix) The Doha Declaration represents the fourth Ministerial Conference which was held in Nov. 2001.
- xx) The multilateral trading system is at crossroads

4.14 QUESTIONS

- 1) Examine the contribution of Uruguay Round of GATT negotiations in reducing trade barriers between member countries of GATT. Point out the significance of trade in service.
- 2) Write short notes on
 - i) Tokyo Round
 - ii) Role of India.
- 3) Explain the following
 - i) TRIPs
 - ii) TRIMs
- 4) How W. T. O. was established?

- 5) Explain the objectives and functions of W. T. O.
- 6) Write shorts notes on
 - a) Structure of WTO
 - b) Challenges before WTO.



5

W. T. O. 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
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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 force of the understanding of Rules and Procedures governing Disputes.

In the overall structural design of the 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 share 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 instilling 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. Its 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 endowed 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 label 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, serving 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 consensus, 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

FOREIGN EXCHANGE MARKET

Unit Structure:

- 6.0 Objectives
- 6.1 Introduction of Foreign exchange
- 6.2 Need for foreign exchange
- 6.3 Instruments of International payments
- 6.4 Foreign Exchange Market
- 6.5 Functions of foreign exchange market
- 6.6 Transactions in the foreign exchange market
- 6.7 Introduction and concept of foreign exchange rate
- 6.8 Determination of foreign exchange rate
- 6.9 Exchange Rate Systems
- 6.10 Managed flexibility
- 6.11 Summary
- 6.12 Questions

6.0 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

6.1 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.

6.2 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.

6.3 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.

6.4 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.

6.4.1 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 transaction. 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.

6.5 FUNCTIONS OF FOREIGN EXCHANGE MARKET:

Following are the three very important functions of the foreign exchange market:-

- 1) Transfer Function
- 2) Credit Function
- 3) Hedging Function

1] TRANSFER FUNCTION:- The transfer function of a foreign exchange market is also called as money changing function of a foreign exchange market. It is the main function of the foreign exchange market. Through this function the foreign exchange market brings about a transfer of purchasing power between two countries. In order to do that it has to convert one country's currency into another country's currency. The international clearing function performed by the foreign exchange market plays a very important role in facilitating international trade and international capital movements.

2] CREDIT FUNCTION:- It is also one of the most important functions of the foreign exchange market. Just as domestic trade requires credit to finance trade transactions when the payment is postponed till future date. Likewise international trade also requires credit to finance international trade transactions when the payment is postponed till future date. When the goods are imported it takes time for the actual delivery of the goods because of shipment and transportation of goods. Therefore it entails credit and the credit is provided by the foreign exchange market. The foreign exchange market gives loans to the needy countries. Exporters may get pre-shipment and post shipment credit. Credit facilities are also available for importers. The Euro-dollar market has emerged as a major credit market.

3] HEDGING FUNCTION:- To hedge means to shoulder risk. It provides a mechanism for both the exporters and importers to guard themselves against the future fluctuations in the foreign exchange rate and the consequent lossless thereof. It is the function of the foreign exchange market to enter into forward contract to sell the foreign exchange at a predetermined rate. It assures the party concerned not to worry about the future changes in the foreign exchange rate.

6.6 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 ie 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. 1 then the forward rate of exchange at a premium will be Rs. 2 over and above Rs. 48 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 1%.

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 mean double deal. The spot currency is swapped against forward.

3) Arbitrage:- Arbitrage means the simultaneous buying and selling of foreign currencies with the intension of making profit. The profit accrues due to the difference between the different exchange rates providing 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 sale 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?

6.7 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.

6.8 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.

6.8.1 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.

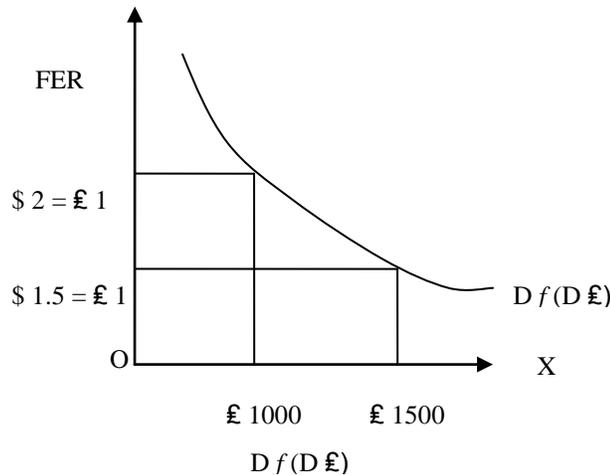


Figure 6.1

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 $\$ 2 = \text{£ } 1$ USA demands $\text{£ } 1000$ from England. As the foreign exchange rate falls to $\$ 1.5 = \text{£ } 1$ USA's demand for England's pound sterling rises to $\text{£ } 1500$.

6.8.2 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.

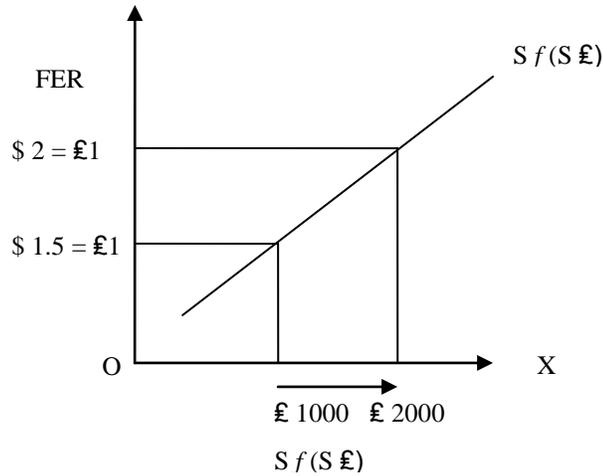


Figure 6.2

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.

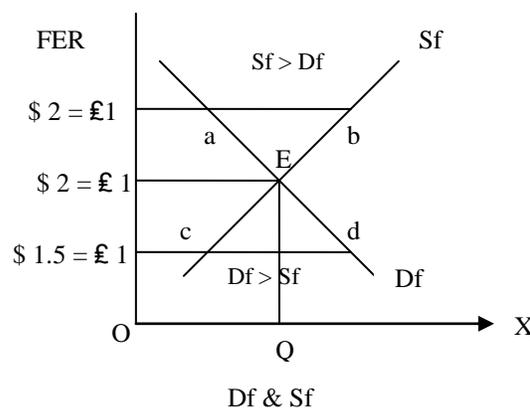


Figure 6.3

Along X axis demand for foreign exchange and supply of foreign exchange are marked while along Y axis foreign exchange rate is marked. Df 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.

6.9 EXCHANGE RATE SYSTEMS

Broadly there are two important exchange rate system viz.

- i) Fixed Exchange rate system and

ii) Flexible Exchange rate system.

6.9.1] 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.

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

$\therefore 1 \text{ £} = \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.

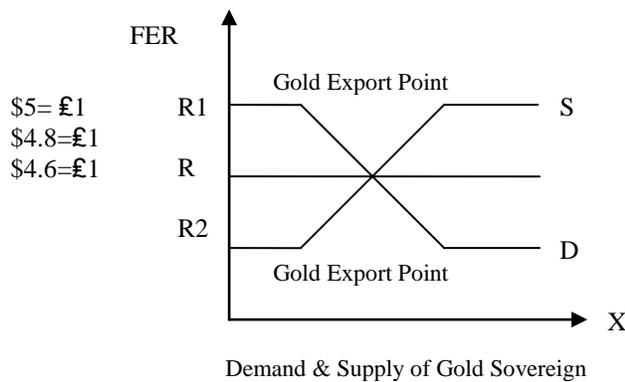


Figure 6.4

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 observe 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 exits 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 came 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.

6.9.2 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

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

R₀ = Original Base yeas foreign exchange Rate.

R₁ = New foreign exchange rate in the current year.

PA0 = Price indices in country A during base year. Let country A be USA.

PA1 = Price indices in USA during current year.

PB0 = Price indices in country B during base year. Let country B be India.

PB1 = Price indices in India during current year. Substituting values we get

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

∴ R₁ = \$ 1 = Rs. 25

CHANGES IN THE FOREIGN EXCHANGE RATE

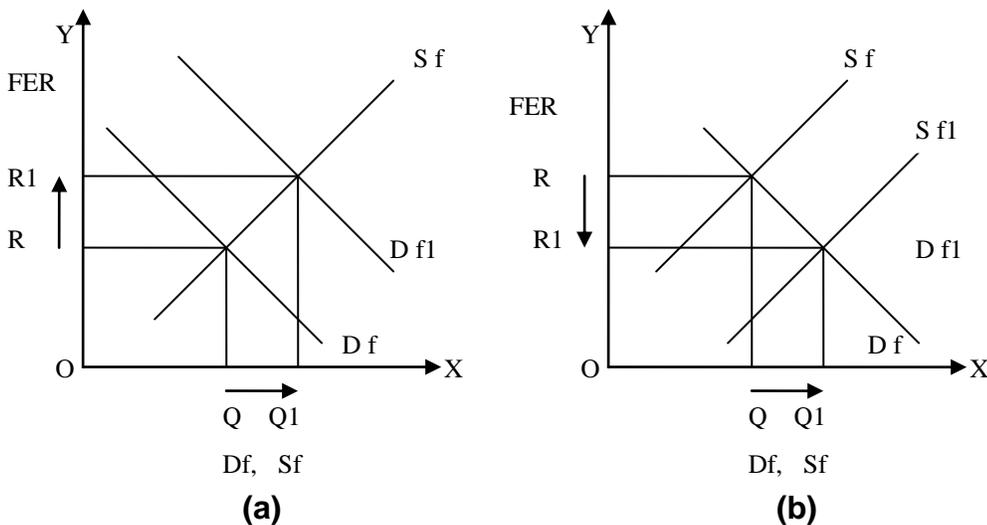


Figure 6.5

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.

6.10 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.

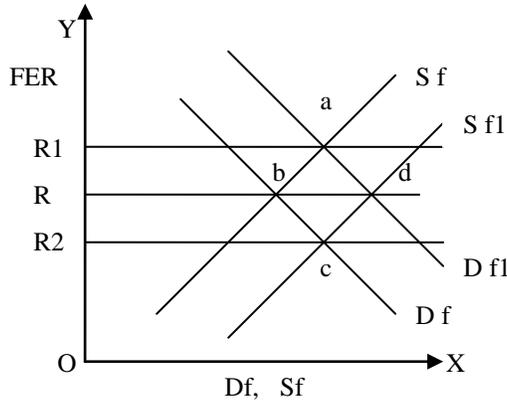


Figure 6.6

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?

6.11 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 (Df, Sf)

- 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.

6.12 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.



7

CURRENCY CONVERTIBILITY

Unit Structure:

- 7.0 Objectives
- 7.1 Introduction of the term Currency convertibility
- 7.2 Meaning of the term currency convertibility
- 7.3 Types of currency convertibility
- 7.4 Prerequisites of currency convertibility

- 7.5 Merits of currency convertibility
- 7.6 Convertibility of Indian Rupee
- 7.7 Introduction and concept of Foreign exchange reserves
- 7.8 Composition of International Reserves
- 7.9 The Reserve position in IMF
- 7.10 Special Drawing Rights (SDRs)
- 7.11 Exchange Risks
- 7.12 Global Linkage of Foreign Exchange(FX) Market
- 7.13 Summary
- 7.14 Questions

7.0 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

7.1 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.

7.2 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 exchanged 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.

7.3 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.

7.3.1 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.

7.3.2 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 i.e. the Current Account and the Capital Account the currency of the country is said to be full convertible currency.

7.4 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 i.e. a country should import only essential commodities.
- 4) Current Account position of balance of payment should be comfortable.
- 5) Laissez-faire and appropriate industrial and investment policies.
- 6) Development planning should be export oriented such that incentives should be given for the promotion of exports.

7.5 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.

7.6 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 developed in the wake of New Economic policy of India in two installments ie 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 become partially convertible since 1st March 1992. Our make 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 make 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 ie 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.

7.6.1 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 hold 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 submitted 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.

7.7 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.

7.7.1 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.

7.8 COMPOSITION OF INTERNATIONAL RESERVES

The table given below gives us an idea of the composition of International Reserves:-

7.8.1 Official Holdings of Reserve Assets (in billion of SDRs)

	1973	1980	March 1990	March 1997
Total Reserves Exchanging GOLD	117.7	321.8	590.7	1,133.0
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 Ounces)	1022.0	952.4	938.2	892.8
Value at London Market Price	95.0	440.2	265.6	224.1

(Source I.M.F. Annual Report)

7.8.2 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%

7.8.3 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.

7.9 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.

7.10 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. ie 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. It's 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 on 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.

7.10.1 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.

7.10.2 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 nation's 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 i.e. the Reserve Bank of India used to keep minimum 515 crores rupees worth in terms of gold and foreign exchange of which the gold amount was of the order of 115 crores 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 crores to Rs. 200 crores of which the gold reserve remains intact i.e. 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 upto 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 get 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.

abroad and its foreign exchange earnings will be poor. Such a currency will have a weak currency and its rate of exchange will be uncertain.

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.

7.11.2 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.

7.11.3 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.

7.12 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 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. State the Financial instruments used by the foreign exchange market to link it globally.

7.13 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 in 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.

7.14 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) Taraporewalla 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.



8

Module 5

INTERNATIONAL MONETARY FUND

Unit Structure:

- 8.0 Objectives
- 8.1 Introduction of International Monetary Fund (IMF)
- 8.2 Concept and Meaning of IMF
- 8.3 Objectives and Functions of the Fund
- 8.4 Sources of Finance
- 8.5 Borrowings
- 8.6 Achievements of IMF
- 8.7 Breakdown of the Bretton Wood System
- 8.8 Shortcomings of the IMF
- 8.9 Introduction of International liquidity
- 8.10 Concept of International liquidity
- 8.11 The problem of International liquidity
- 8.12 IMF and International liquidity
- 8.13 Summary
- 8.14 Questions

8.0 OBJECTIVES

- i) To know the background of the establishment of the I.M.F.
- ii) To know the nature of I.M.F
- iii) To know the objectives of I.M.F
- iv) To know the functions of I.M.F
- v) To know the Organization and structure of I.M.F.

- vi) To know is Quota system.
- vii) To know the achievements of I.M.F.
- viii) To know the short comings of I.M.F.
- ix) To know the relationship between I.M.F. and India.
- x) To know how to bring about reforms in I.M.F.
- xi) To know International Liquidity
- xii) To co- relate IMF with International Liquidity.
- xiii) To know the role of International monthly co-operation in the realm of International Liquidity.

8.1 INTRODUCTION OF IMF

The international monetary fund is a landmark in the history of international monetary Co-operation. It is an international Financial Institution.

From the early 19th century till the past First World War period most of the industrialised 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£=5\$**. 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. Money 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 normalacy
- ii) People wished to go back to pre-war conditions,
- ill) 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 uncertainly, 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 objections 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 forever. 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) 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.

8.2 CONCEPT AND MEANING OF IMF:

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 W.T.O. The Fund is a specialized agency within the United Nations 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 nations' 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.

8.3 OBJECTIVES and FUNCTIONS OF THE FUND:

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.

The following are the objectives as stated in Article 1 of the Fund Agreement.

- 1) To promote international monetary co-operation through a permanent institution which provides machinery for consultation and collaboration on international monetary problems.
- 2) 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.
- 3) To promote exchange stability to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.
- 4) 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.
- 5) 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.
- 6) In accordance with the above to shorten the duration and lessen the degree of disequilibrium in the balance of payments of the member countries.

8.3.1 FUNCTIONS OF IMF

- 1) The IMF functions as a short term credit institution.
- 2) It provides a machinery for the orderly adjustment of exchange rates.

- 3) It also functions as a central reservoir of currencies of all member countries needy country can borrow other nations currencies from IMF.
- 4) It is a lending institution of foreign exchange. However it grants loans for financing current Account Transactions only, (and not for financing capital Account Transactions.)
- 5) It provides a machinery for altering the par value of the currency of a member country and thus it provides our orderly adjustment of foreign exchange rates to improve the balance of payments position of the member countries.
- 6) It also provided a machinery for international consultations.
- 7) IMF contributes to the promotion and maintenance of high level of employment and real income and the development of productive resources of the member countries.

8.4 SOURCES OF FINANCE

IMF's financial resources consist of pool of currencies and gold contributed by member countries as per quota system laid down initially and revised several times thereafter. The contribution of each member country is decided through the quota allotted to them. Size of the quota is based on the GDP of the country.

During the time of the formation of the Fund each member country of the Fund was required to pay 25% of the quota in terms of gold or 10% of its net official holdings of gold and US dollars whichever was less. As per the amendment w.e.f. 1st April 1979 the gold contribution was substituted by SDRs. The remaining 75% of the quota is to be contributed in domestic currencies of the member countries which is to be deposited with the central banks of the respective member countries.

To provide adequate resources for IMF to meet the needs of the member countries for liquidity the IMF's quota is raised to 45% (i.e. 146 billion SDRs to 212 billion SDRs)

Check Your Progress:

1. Explain how IMF was established.
2. State the general objectives of IMF.
3. Explain various functions of IMF.

8.5 BORROWINGS

IMF is authorized to borrow funds to supplement the existing resources. IMF can borrow from Governments, Central Bank and Bank for International settlement. The Fund is also authorized to borrow funds from private sources. There are two schemes under which the IMF can borrow funds viz.

- i) GAB i.e. the General Arrangements to borrow and
- ii) NAB i.e. the New Arrangements to borrow.

The GAB started in 1962 under which Eleven industrial countries or their banks have agreed to lend funds to IMF. These countries are as follows :-

- 1) Belgium.
- 2) Canada.
- 3) The Deutsch Bunds Bank
- 4) The Swiss National Bank.
- 5) Italy.
- 6) Japan
- 7) Netherlands.
- 8) The Soveriges Risk bank
- 9) The Swiss National Bank
- 10) The United Kingdom.
- 11) The United States.

The availability of the amount of credit through GAB coming to 17 billion SDRS.

2) N.A.B :- Under N.A.B 25 participant countries and institutions are ready to lend funds to IMF up to 34 billion SDRS to Supplement its regular quota system. The funds so accumulated are to be used for exceptional situation. That threatens the stability of the system. The N.A.B started in 1995 but became effective from November 17,1998.

The N.A.B credit is for the benefit of all participant countries and also for non member countries. However, N.A.B cannot replace GAB.

Table 8.1

QUOTAS OF SELECTED MEMBER COUNTRIES :-
OF IMF as on Dec. 31. 1972 (SDRs of Dollars)

No	Country	Quota	Gold Subscription
1)	U.S.A	6,700 million	1,672 million

2)	U.K	2,800 million	700 million
3)	GERMANY	1,600 million	400 million
4)	FRANC	1, 500 million	375 million
5)	JAPAN	1,200 million	300 million
6)	CANADA	1,100 million	275 million
7)	ITALY	1,1 00 million	250 million
8)	INDIA	940 million	162 million

8.6 ACHIEVEMENTS OF IMF:

- 1) It has combined the merits of stability with flexibility in exchange management. It has avoided competitive exchange depreciations by making members to declare par values of their currencies in terms of gold or US Dollar. However, they are permitted to adjust exchange rates for correcting the fundamental disequilibrium in the balance of payments.
- 2) It served as an institution for consultation and guidance in international monetary matters.
- 3) It also served as a forum for discussion. It has also contributed to the growth of world trade.
- 4) The IMF also has achieved success in bringing about simplification of multiple exchange rate system.
- 5) It has ensured and made progress in the establishment of multilateral system of payments.
- 6) Though the Fund was primarily meant for providing short term loans for correcting fundamental disequilibrium in the balance of payments. Now it has changed its attitude and adopted a liberal policy of granting development loans too.
- 7) The Fund has become successful in maximizing employment accelerating the pace of economic development of the member countries.
- 8) The Fund shown soft corner for the developing countries in liberally ass/sting them in maintaining equilibrium in their balance of payments and their monetary stability.

8.7 BREAKDOWN OF THE BRETTONWOODS SYSTEM

The Bretton Woods system lasted till 1971. The stabilization process under this system required reserve assets like the gold standard. Under Bretton Wood system reserves are kept in terms of gold and dollar.

The Bretton Wood system collapsed in 1971 because of huge accumulation of dollar abroad. The U.S.A could neither command world confidence in her ability and willingness to exchange dollar for gold at the fixed exchange rate. USA couldn't afford to undertake the conversion of dollars into gold if all foreign dollar holding were presented for such exchange. The U.S.A witnessed a balance of payments deficit of over \$ 29 billion in 1971. The US official gold stock dropped to 10 billion in 1971. The depletion of US gold reserves and the huge accumulation of dollar and dollar convertible assets held by foreigners perpetuated the crisis of confidence. By 1971 the dollar assets held by the foreigners were of the order of \$ 68 billion. The International monetary system was confronted with two interrelated problems. On the one hand there was a tremendous desire to sell dollars and on the other hand the central banks were no longer willing to purchase them. The eventual outcome was the collapse of the par value system. The IMF's par value system officially ended on August 15,1971, when president Nixon withdrew US commitment to buy and sell gold at \$ 35 per ounce and thus abrogated the IMF agreement.

8.8 SHORTCOMINGS OF THE IMF

- 1) 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.
- 2) 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.
- 3) Some provisions of IMF were destructive rather than constructive. For example provision of devaluation. But devaluation succeeds under various safeguards i.e. internal price stability, foreign co-operation Marshall - Lerner condition etc.
- 4) The IMF has failed to prevent dollar crisis. No timely action and the measures were taken by the Fund .
- 5) The fund in totally failed to solve the problems of the underdeveloped countries.
- 6) It has failed to evolve a stable international monetary system.

Despite the various shortcomings, the fund has achieved a tremendous success in the field of international monetary cooperation.

Check Your Progress:

1. Explain the sources of finance and borrowings of IMF.
2. What are the achievements of IMF?
3. What are the shortcomings of IMF?

8.9 INTRODUCTION OF INTERNATIONAL LIQUIDITY

On account of U.S. Dollar crisis the world currently system was moving from the DCs i.e. The Developed Countries but also the LDC's i.e. the less developed countries. It led to a wide spread interest in the subject of International Monetary Cooperation not only among the academic world but also among the business community and general public.

In view of the said trouble there prevailed a general view that the international monetary system being inherently defective needed radical and fundamental reforms. At the same time we can't sidetrack the yomen's service rendered by IMF and IBRD in the sphere of International monetary Co-operation. IMF has given birth to SDRs i.e. the special Drawing rights. It is said "IMF has failed but it must succeed." The two factors shattered the whole scenario of the world economy viz.

- 1) The first worked was between 1914 to 1918 and the second world war between 1939 to 1945.
- 2) The inter war period marked by 1930's Great Depression . These events led to the scramble among the world countries to better their lot due to which they adopted. "The Tit for Tat" policy i.e. "Beggary thy neighbour" policy. Countries of the word switched over to competitive depreciation of their currencies and imposition of tariffs and non - tariffs barriers. This led to shrinking of world's volume of trade. Therefore the representatives of the 44 nations met in July 1944 at Bretton Woods for the establishment of the twins i.e. the International Monetary Fund and the International Bank for Reconstruction and Development i.e. the World Bank.

International Liquidity is not a new phenomenon. The world at large witnessed the problem of International liquidity during 1960's . The origin goes back to the First World War between 1914 to 1918. The International problem of liquidity happened to be the main reason for the breakdown of

the International Gold Standard. There were two types of countries viz. i) The debtor countries and ii) the creditor countries. The debtor countries suffered from the problem of deficit in the balance of payments and hence these countries had no gold reserves. On the other hand, the creditor countries though had surplus in the balance of payments but they were not in a position to lend funds to the debtor countries. The problem of International Liquidity has become a paramount problem.

8.10 CONCEPT OF INTERNATIONAL LIQUIDITY

When we speak of International liquidity we speak of financing of International trading transactions. We exclude from the term 'International Liquidity', the private foreign exchange holdings.

The term "International Liquidity" refers to the reserves to settle International trade transactions. Such reserves are required to import goods and services from the trading countries of the world. These reserves are kept in terms of gold which is the IMF currency, foreign exchange and SDRs. These reserves mark country's capacity to borrow from foreign exchange market.

International Liquidity refers to the stock of reserves available with a country which are acceptable for settling all International economic transactions in the International exchange market. Due to the development of International trade and capital transactions the problem of International liquidity has become serious. The role of IMF in providing liquidity has become crucial. The fund has provided to the members general drawing rights to meet their short term requirement. The SDRs i.e. the special drawing rights properly known as paper gold is a very novel idea in its application. The SDRs add to the International Liquidity.

International Liquidity is an important concept in the field of International trade and capital transactions. International liquidity is an extension of the term liquidity at the national level. International liquidity refers to stock of such items which are generally accepted in the International market for setting International economic transactions. International liquidity comprises of all reserves that are available to the monetary authorities of different countries for meeting their International economic transactions. In short that the term International liquidity refers to the stock of gold , SDRs and foreign exchange.

Just as an Individual has to be in a position to pay his debts and in order to pay his debts , he has to have his own income or has to borrow funds from others to settle the claim, in the same way every nation must be in a position to pay its imports of goods and services and hence it must have liquid resources at its disposal if not it will have to borrow from the developed countries of the world or from International financing agencies like IMF, IBRD, ADB etc.

8.10.1 MAIN COMPONENTS OF INTERNATIONAL LIQUIDITY

- 1) Gold reserves with the national monetary authorities i.e. the central banks of the world countries and with IMF
- 2) Dollar reserves
- 3) Pound Sterling Reserves
- 4) Stocks of other key currencies of the world.
- 5) The stock of General Drawing Rights (GDRs)
- 6) The stock of Special Drawings Rights(SDRs)

Of all the components of International liquidity gold, dollar, Pound Sterling. SDRs matter most.

Check Your Progress:

1. Define International Liquidity.
2. State the main components of International Liquidity.

8.11 THE PROBLEM OF INTERNATIONAL LIQUIDITY

The problem of International Liquidity crops up when there arises a gap between the demand for International liquidity and supply of International liquidity. Following are some of the dimension of the problem of International liquidity,

- i) The gap between the demand for and supply of International liquidity.
- ii) Different types of reserves
- iii) Problem of speculation.
- iv) Problem of adjustment.

8.11.1 DEMAND FOR INTERNATIONAL LIQUIDITY

Demand for liquidity comes due to the following factors,

- i) The main factor for the demand for International liquidity in the balance payments deficits.
- ii) Foreign Exchange Rate : When there is a appreciation in the foreign exchange rate or revaluation the foreign currencies became relatively cheaper while the domestic currency becomes relatively costlier hence the demand for foreign exchange rises.
- iii) Adjustment: When there is a sufficient gap between the demand for and supply of International liquidity the pace of adjustment becomes

wide as a result of which as a compensatory measure a country has to demand foreign exchange either from IMF, foreign exchange market or from the respective countries.

- iv) Debt servicing charges : When the foreign debt matures a country has to pay principal plus interest . It calls for a huge amount of foreign exchange to meet this huge requirement the demand for International liquidity rises.

8.11.2 SUPPLY OF INTERNATIONAL LIQUIDITY

Following are three main factors of the supply of International liquidity :-

- i) The main factor of the supply of International liquidity is the surplus balance of payments. In case of surplus balance of payments there is an excess of receipts overpayments.
- ii) **Borrowing facilities** : The needy countries when can't satisfy the demand for International liquidity out of the export earnings and also out of the stock of International reserves it has to resort to borrowing. It can borrow from IMF, IBRD, ADB Foreign exchange market or from the respective countries of the world.
- iii) **Problem of speculation** :- During the fixed exchange rate system the par values of the currencies which were on International gold standard used to be fixed on weight to weight basis i.e. on the basis of gold contained by the respective currencies. Hence there was no problem of speculation. The problem of speculation arises when Countries adopt flexible exchange rate system. Due to the speculation the foreign exchange value of the domestic currency violently fluctuates. In order to cater to the violent fluctuations in the foreign exchange value of the domestic currency a country has to keep good stock of International reserves.
- iv) **Problem of Adjustment** :- When the country faces the problem of deficit in the balance of payments a country is called upon to adjust the deficit in the balance of payments by switching over to devaluation. But there is every danger of non cooperation from the countries. Countries may switch over to retaliation i.e. the competitive devaluation.

8.12 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.

Check Your Progress:

1. Why problem of International Liquidity arises?
2. What are the types of International Liquidity?

8.13 SUMMARY

1. The IMF was organised in 1946 and it commenced its operation in March 1947.
2. The International Monetary Fund (IMF) is an organization of countries that seeks to promote international monetary co-operation. 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.

3. 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.
4. IMF's financial resources consist of pool of currencies and gold contributed by member countries as per quota system laid down initially and revised several times thereafter.
5. There are two schemes under which the IMF can borrow funds viz.
 - i) GAB i.e. the General Arrangements to borrow
 - ii) NAB i.e. the New Arrangements to borrow.
6. IMF has the merits of stability with flexibility in exchange management. It has simplified multiple exchange rate system. The Fund has become successful in maximizing employment accelerating the pace of economic development of the member countries.
7. Despite of many shortcomings, IMF has achieved success in International monetary co-operation.
8. The term" International Liquidity" refers to the reserves to settle International trade transactions. Such reserves are required to import goods and services from the trading countries of the world. These reserves are kept in terms of gold which is the IMF currency, foreign exchange and SDRs.
9. Of all the components of International liquidities gold, dollar, Pound Sterling. SDRs matter most.
10. The problem of International Liquidity arises when there arises a gap between the demand for International liquidity and supply of International liquidity.
11. The IMF provides two types of International Liquidity viz.
 - i) Conditional Liquidity and
 - ii) Unconditional Liquidity

8.14 QUESTIONS

- 1) What are the objectives and functions of IMF ?
To what extent has it succeeded in maintaining exchange stability ?
- 2) Why was the IMF set up ? What are the different types of funds given by it and how do they help the developing countries ?
- 3) Examine the role of International monetary Fund as regards provision of International liquidity.
- 4) a) Distinguish between International reserves and International liquidity

- b) How does IMF solve the problem of International liquidity.
- 5) What do you mean by International liquidity? How does the problem of International liquidity arise? Point out the main components of International liquidity.
- 6) Write short notes on the following:
- i) Dollar crises
 - ii) The problem of International Liquidity,
 - iii) Demand for and supply of liquidity.



9

FOREIGN CAPITAL AND ECONOMIC DEVELOPMENT

UNIT STRUCTURE

- 9.0 Objectives
- 9.1 Introduction of International capital movements
- 9.2 Classification of International capital movement
- 9.3 Determinants of International capital movement
- 9.4 Arguments in favour of International capital movement
- 9.5 Arguments against International capital movement
- 9.6 Introduction of Foreign capital
- 9.7 Importance of Foreign capital
- 9.8 Forms of Foreign capital
- 9.9 Role of Multinational Corporations (MNCs)
- 9.10 Drawbacks of MNCs
- 9.11 Public Foreign capital
- 9.12 Foreign Collaboration
- 9.13 Emerging economies and Capital flows
- 9.14 Summary
- 9.15 Questions

9.0 OBJECTIVES

- i) To familiarize the students with the concept of International Capital Movements
- ii) To know the different types of Capital movements
- iii) To know the need for capital movement from the Dc's to the LDC's
- iv) To know the advantages of Capital movements,
- v) To know the disadvantages of Capital movements,
- vi) To know the sources of foreign Capital movements,
- vii) To know the concept of FDI,

- ix) To know the concept of portfolio investment
- x) We have to examine the role of foreign capital in bringing about rapid economic development.
- xi) We would like to know the need of foreign capital especially in underdeveloped countries.
- xii) To know the different forms of foreign capital
- xiii) To know the benefits from foreign investment.
- xiv) To know the role of multinational corporations (MNCs)

9.1 INTRODUCTION OF INTERNATIONAL CAPITAL MOVEMENTS

The classical economist believed that the factors of production are immobile internationally. This was their assumptions for the simplification of their International trade theories. While the modern economist like Heckscher- Ohlin believed that factors of production move internationally. However, the fact remains that the factors of production move less freely than the movement of goods and services internationally.

International Capital movement plays very important role not only in the economic development of the developed countries but also in the economic development of the developing 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 developmental projects and helps to solve the disequilibrium in the balance of payments problem of the underdeveloped countries. There is a dire need of the inflow of foreign Capital into the underdeveloped countries as these countries suffer from vicious circles of poverty. Scarcity of Capital is due to low rate of saving and investment. Capital is not only scarce in the underdeveloped countries but also shy as it hesitates to get invested in adventure projects. The underdevelopment countries have got poor technology. The International Capital movement raises the level of increase and employment by financing the investment projects.

The International exchange transactions are not only concerned with the movement of goods and services but also the movement of International Capital. The International Capital movement has played a significant role in the economic development of all sorts of world countries.

During the good old days the International Capital movements were merely treated as balancing items to balance the balance of payments positions. For example when the creditor country has got a surplus in its current account of the balance of payments it is to invest or lend Capital to

the deficit country conversely the country having a deficit in its current account of the balance of payments will borrow or import Capital from the surplus country. Thus both the countries viz. the surplus and the deficit countries will bring about a balance in their balance of payments position.

However, modern Economists are of the view that International Capital movements are not merely balancing factors of balancing the balance of payments of the countries participating in the International trade. In the International money and Capital markets the countries take their individual decisions about the borrowing and lending of International funds irrespective of their balance of payments adjustments. Countries of the world may invest their surplus funds in order to make profitable gains out of it. Countries may also indulge in to flow of funds in order to help the countries in eradicating poverty, unemployment etc.

International Capital movements tend to equalize the rates of interest and profits between the countries of the world. Foreign aid which is a part and parcel of International Capital movements plays very important role in economic development of the underdeveloped countries.

CONCEPT

The term International Capital movement refers to borrowing and lending of funds between countries of the world.

The International Capital movements get recorded in the Capital account of the balance of payments of the countries of the world.

The International Capital movements are also called International Capital flows.

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 America. 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 utilized to the fullest extent possible then it can do a needful to the economic development of the underdeveloped countries. To attain the third and the most important stage of economic development i.e. the take off into self sustained economic growth it is essential to supplement the domestic Capital by foreign Capital.

9.2 CLASSIFICATION OF INTERNATIONAL CAPITAL MOVEMENT:

Following is the classification of the International Capital movement:

1. Short term and long term Capital movements,
2. Direct and indirect Capital investments,

3. Government, Institutional and private Capital,
4. Foreign Aid,

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. Direct and indirect Capital investments,

The foreign direct investment (FDI) refers to the investment by the reporting country in the foreign country by establishing the branches or subsidiary offices of its main branch in the foreign countries and thus retaining the ownership control and management of these subsidiary protection branch offices with it.

While the indirect investment refers to a portfolio investment. It refers to purchases of shares, debentures, securities of the companies in the foreign countries. In this case the investing firm doesn't retain the control and management of the company concerned. The investing firm gets only long term returns on the funds invested in shares, securities and debentures. This return may either be in the form of interest or dividend. Generally, those who don't possess enough surplus Capital to buy permanent assets in the foreign countries do indulge into portfolio investment.

3. 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.

4. 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:

5. 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.

9.3 DETERMINANTS OF INTERNATIONAL CAPITAL MOVEMENTS

Following are the determinants of 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 an official minimum rate of the central bank of the country to advance loans to the commercial banks. There is a link between the bank rate and the market rate. A market rate of interest is a rate of interest which the commercial banks charge for lending of funds to their customers. There is generally a two percent difference between the bank rate and the market rate. Since the international flow of funds depends upon the market rate of interest and the market rates of interest depends upon the bank rate. Logically it follows that the international flow of funds depends up on the bank rate.

3. M.E.C.: The abbreviation M.E.C. stands for marginal efficiency of Capital. There is a positive functional relationship between the M.E.C. and the international flow of capital. A country having a high M.E.C. will attract the flow of foreign capital and vice versa.

4. Speculations: Speculations refer to future occurrences of the events i.e. the future changes in the rate of interest. This has got relevance on the short term International Capital movements. When people expect the rate of interest to rise in future then they will invest at present abroad in short term securities i.e. there will be an outflow of capital. Conversely, when there is an expectation of fall in the rate of interest in future then there will a tendency on the part of the foreigners to invest their funds in that country at present in short term securities.

5. The degree of openness of the financial and other markets : The International Capital movements depend upon the degree of openness of the capital and other markets. It also depends upon their International integration. In recent years in the wake of globalization most of the countries have adopted the policy of structural reforms or adjustment, privatization, liberalization, deregulation, delicensing, decontrol etc. All these changes call for the inflow of foreign capital into the country.

6. Capital Account Convertibility : In the wakes of liberalization and globalization most of the world countries have switched over to convertibility of their currencies on capital account. It involves changes in national policies towards different types of international capital flows viz. short-term investment long term investment i.e. FDI and portfolio investment etc.

7. Tariff Policy: If a country follows high protective tariff policy by raising the tariff rates highest of the high so as to safeguard the domestic infant industries then it may prevent the inflow of foreign investment and vice versa.

8. Exchange Control Policy : If a country follows severe exchange control policy then it puts automatically restrictions on the flow of foreign capital.

9. Government Policy : If the Government of the country follows the policy of nationalization and the expansion of public sector then it is an indication of Government hostile attitude towards foreign capital i.e. international capital will not flow into the country. On the other hand if Government follows the policy of privatization, liberalization, structural adjustment, globalization, capital account convertibility then all these things will welcome international capital flow.

10. Stability: The overall stability of an economy represents a congenial atmosphere for the foreign capital to play its role in to the economy. Conversely the overall sociopolitical and economical instability prohibit the international capital movements.

9.4 ARGUMENTS IN FAVOUR OF INTERNATIONAL CAPITAL MOVEMENT:

Following are the arguments advanced in favour of international capital movements:

1. 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.

2. 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.

3. Exploitation of natural recourses : "India is a rich country inhabited by the poor". India is rich as regards availability of natural resources. But mere availability of natural resources is not enough. These resources must be fully exploited. Capital skilled personnel, technology etc. are the resources which bring about the maximum exploitation of the available resources. India is a capital hungry country. Capital is not only scares in India but it is also shy. It hesitates to come forward to get invested in venture projection. Therefore resources remain unutilized, underutilized and even misutilized. Therefore there is a need to supplement the domestic capital by importing foreign capital for the maximum exploitation of the available resources.

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. 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.

6. 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.

7. 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.

8. 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 additions to that due to the domestic and International demonstration effect the rate of saving 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 remain extremely low such that three countries are branded as underdeveloped countries. Influx of foreign capital happens to be the solution to generate capital formation and fill in the vacuum.

9.5 ARGUMENTS AGAINST INTERNATIONAL CAPITAL MOVEMENTS

Following are the arguments against international capital movement:

1. Cyclical fluctuations: The business cycles happen to be the sine-qui-non of the capitalistic economies. When the underdeveloped countries import capital from these industrially advanced countries. Thereby we import cyclical fluctuation from the advanced countries.

2. Hurting the Domestic Economy: The import of capital and superior technology competes with the domestic capital and the indigenous technology. Their capital and technology being superior hurts our indigenous capital and technology.

3. Discrimination between local population and the foreign: International capital movement makes discrimination between the local population and the foreigners. When Flls 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. 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.

5. Plunder of Wealth: 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.

6. Dangerous during emergency: During emergency it is very dangerous to rely solely on foreign capital. The foe 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.

7. Politically Dangerous : Greater dependence on foreign capital may prone to be fatal or dangerous to our national sovereignty.

Check Your Progress:

- 1.Explain the term International capital movement.
- 2.Distinguish between the following:
 - a) Short term and Long term capital movements
 - b) Direct and Indirect capital movements
- 3.Which factors determine the International capital movement
- 4.Check the arguments in favour and against international capital movement.

9.6 INTRODUCTION OF FOREIGN CAPITAL

The idea of import of foreign capital is not new to underdeveloped countries. Even the developed countries of the world had to depend upon foreign capital during their early stage of economic development. Even the country like England which witnessed the industrial revolution for the first time in the world during the middle of the 18th century had to borrow capital from Holland in the 17th and 18th centuries. The rapid growth of USA had been due to large supplies of capital from Europe in the 19th Century. US.S.R. also developed due to large supplies of foreign capital from Western Europe during the period 1890-1914 due to which USSR attained take off into self sustained economic growth before the commencement of first world i.e 1914.

The underdeveloped countries are characterized as capital hungry countries. Capital is not only scarce in these countries but it is also shy. It is shy in the sense that it hesitates to come forward to get invested in Venture Projects. The capital formation is low because of low saving and low investment because of which most of these countries including India have not yet attained take off into self sustained stage of economic development. These countries are over populated countries therefore whatever rate of savings and investment is achieved by these countries is not enough to take off. The Marginal propensity to consume being very high the marginal propensity to save is very low. These countries also suffer from demonstration effect which keeps the rate of savings at an extremely low rate. Effects to mobilise domestic savings through taxation and public borrowing are not sufficient to raise the rate of capital

formation. The import of foreign capital helps to reduce the shortage of domestic capital formation.

Besides low savings, low investment and low capital formation these countries also suffer from Technological backwardness. Technological backwardness is reflected in high average cost of production and low productivity of labour and capital. It is reflected in high capital output ratio i.e. more capital is required to produce a unit of output. The use of foreign capital overcomes not only capital deficiency but also technological backwardness. Foreign capital brings sufficient physical and financial capital along with technical know how, skilled personnel, organizational experience, market information, advanced techniques, innovation etc. The Technically skilled personnel imported from advanced countries train the unskilled labourers of these countries.

Underdeveloped countries lack in overhead capital which directly facilitates investment. The railways, roadways, canals and power projects provide the necessary infrastructure for economic development. Since all these require large capital investment and require long gestation period the underdeveloped countries are unable to undertake such projects without foreign capital.

Similarly the underdeveloped countries are not in a position to start basic and key industries by themselves. It is again through foreign capital that they can establish iron and steel, machine tools, heavy electrical, chemical plants etc. Moreover, the use of foreign capital in one industry may encourage local enterprise by reducing costs in other industries which may lead to chain expansion of other related industries. Thus the use of foreign capital leads to industrialize the economy.

Further private enterprise in underdeveloped countries is reluctant to undertake ventures like exploitation of untapped natural resources, exploitation of new areas. Foreign capital assumes all risks and losses at the primary and pioneering stage of the risky ventures. Thus it opens up inaccessible areas. Taps new resources and helps in augmenting the natural resources of the country. In this way it helps to remove regional imbalances. It also tends to increase employment opportunities in the economy especially in the urban areas. It also leads to migration of surplus labour from rural to urban sector of the economy. Thus it reduces the pressure of population on land and helps it reduce the disguised unemployment. This is supposed to be the social gain from the foreign capital.

All these things imply that foreign capital tends to raise the level of national productivity, income and employment which in turn lead to higher real wages for labour, lower prices for consumer and rise in the standard of living with the inflow of foreign capital local labour becomes skilled and the marginal productivity gets enhanced. Due to superior technology, superior know how, superior management, machines and

equipments the qualitative products available to the consumers at lower prices. Govt. revenue increases by taxing the royalties received by the foreign investors.

Due to the existence of disequilibrium between demand and supply and the existence of structural rigidities the inflation pressure develops. Foreign capital helps to minimise such Inflationary pressure due to the flow of essential consumer goods into the country.

Foreign capital also overcomes the balance of payments difficulties experienced by the underdeveloped countries during the process of economic development. To accelerate the rate of economic development it needs to import foreign capital. The gap between imports and exports leads to balance of payments disequilibrium, it is through foreign capital that the underdeveloped countries can meet its balance of payments requirements. It also facilitates the servicing of external debt.

Thus the import of foreign capital is indispensable for accelerating economic development . It helps to industrialise the country. It helps to build its economic overhead capital. It increases the employment opportunities, it taps the unused resources, it increases productivity and reduces prices such that the real income increases. It leads to increase the quality of goods which leads to increase in the standard of living of the people on the one hand and on the other hand it fetches more foreign exchange by exporting the qualitative commodities to the foreign countries. Thus foreign capital facilities the all round development of an economy.

9.7 IMPORTANCE OF FOREIGN CAPITAL

Following are the arguments advanced in favour of foreign capital.

1) Sustaining high level of investment :-In order to bring about the speedy rate of economic development it is essential to industrialise the economy within the short period of time. In order to increase the tempo of industrialization it is essential to raise the level of investment substantially. To increase the level of investment substantially it is essential to raise the level of savings at least by 15% to 20% of national income. However the actual level of savings in the underdeveloped countries is less than 10%. This leads to a gap between savings and investment. In order to fill in the gap between savings and investment it is essential to import foreign capital. The foreign capital helps to supplement the domestic savings.

2) The technological gap - As compared to advanced countries the underdeveloped countries have got a inferior technologies. The underdeveloped countries suffer from low level of economic development. These countries possess an inherent urge to develop their economics fastly to raise the standard of living. It needs the use of advanced technologies, the underdeveloped countries have to import advanced technology from

foreign developed countries. It raise the tempo of rapid economic development.

3) Exploitation of natural resources : The underdeveloped countries are rich as regards availability of natural resources. But they wait for their exploitation. Since these countries do not possess the technical skill and other facilities like capital know how etc. They can't exploit the natural resources to the fullest extent possible. Therefore the import of foreign capital does this task.

4) Scarcity of Risk taking Entrepreneurs : In the underdeveloped countries there is the scarcity of risk bearing entrepreneurs it acts as an obstacle in the way of Industrialization . Foreign capital undertakes this risk and thus provides the required impetus to the process of industrialization.

5) Lack of Infrastructure :- In the underdeveloped countries the domestic capital is incapable of building up of adequate economic infrastructure. Hence these countries have to take the aid of foreign capital for building up of economic infrastructure viz the transportation and communication, generation and distribution of electricity, development of irrigation facilities etc.

6) Adverse balance of Payments: The underdeveloped countries suffer from adverse balance of payments the payments exceed the receives due to excess of imports over exports. The export earning is not capable of covering all the import of machinery spare parts, technically skilled personable etc. the import of foreign capital remain on the only answer to solve the problem of balance of payments deficit.

9.8 FORMS OF FOREIGN CAPITAL

Foreign capital can enter into the country in the following forms :-

- 1) Private Foreign investment
- 2) Public Foreign capital
- 3) Foreign collaboration

1) Private foreign investment :-

The private foreign capital may be of two types viz

- a) Direct foreign Private investment
- b) Indirect foreign Private investment

a) Direct foreign private investment: It means the investing country exercises de facto or de jure control over the assets created in the capital importing country by means of directly investing in the capital assets of the country concerned.

The direct investment may take many forms viz. the formations of a subsidiary or a branch of a company of a capital exporting country, the

formation of a capital exporting or investing country has a majority holding. The formation of company in a capital importing country financed exclusively by the private company of a capital investing country; creation of fixed assets by a foreign investing company in a capital importing country.

b) Indirect foreign private investment: It is also known as portfolio investment. The portfolio investment means the holding of transferable securities (issued or guaranteed by the Government of the capital importing country's) shares or debentures by the citizens or the companies of the foreign countries such holdings do not amount to a right to control the company. The shareholders are entitled to dividend only .

Merits of Direct foreign investment:

- i) Higher wages to domestic labour
- ii) Lower prices to consumers.
- iii) Income accruing to Government in the form of taxes
- iv) Besides these direct benefits there are a few indirect benefits also accruing to a country importing foreign capital which can be called as external economies.

These are the benefits which are not in the form of capital formations and foreign exchange but in the form of managerial ability, technical personnel, technological knowledge, administrative organization and innovation in products and production techniques. The knowledge obtained through private technical assistance and demonstration effect have beneficial effects in other sectors of the economy. In addition to these there is also an advantage of training labour in new skills. Cost of domestic industries may be reduced and demand for their products may be created. There are both forward and backward linkage effects of private foreign investment.

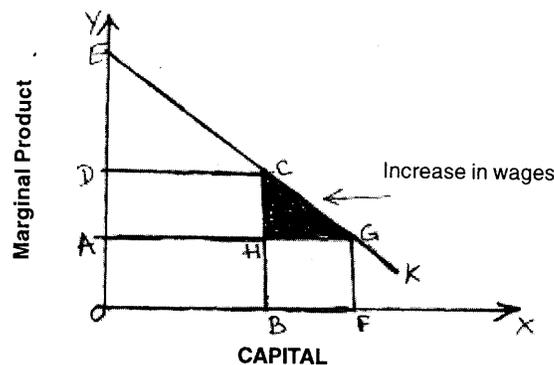


Figure 9.1.

The above diagram shows the benefits accruing to a foreign capital importing country from the import of foreign capital.

Along x axis capital is marked while along y axis marginal product is marked. Ex line shows marginal productivity which is down word sloping. OB is the level of domestic capital which is given. At this domestic capital OBCE is the level of total output. And)BCD is the level of profit. DC E is

the real wages accruing to the labourers. Under this situation when the private foreign capital enters into the country which is of the order of IF . As a result of which the total output increase to BFGC. The income in wages coming to labourers is of the order of HGC and the increase in profit to investors comes) BFGH . Thus the inflow of foreign capital makes it possible to migrate the labourers from rural to urban area and seek employment in the most advanced sector of an economy. On the one hand employment increases and on the other hand wages also increase. This increase in wages is certainly higher than what they would have received in the rural sector of an economy.

The Private foreign capital in India controlled by four agencies at the Government 'el viz.

1. The Ministry of Finance
2. The Ministry of Company Affairs.
3. *The Ministry of Industrial Development.*
4. The Reserve Bank of India

Two lists were prepared in 1978 viz. the list of industries where foreign investment d be permitted and the list of industries where no foreign investment would be permitted.

The industrial policy resolution of 1973 listed a number of industries where investment was open to MRTP and FERA companies.

For controlling the activities of the multinational companies in India the foreign Exchange Regulations Act (FERA) was passed in 1973 which came into force from January 1,1974. This Act made it obligatory for non-banking foreign companies and subsidiaries with foreign equity exceeding 40% to obtain permission of the Reserve Bank Of India to carry on their business in India. Permission was also necessary to start new undertakings to acquire any other company or to buy shares in existing companies. According to the guidelines given in 1973 and its amendments in 1976 all foreign companies were required to dilute their equity capital to the extent of 60% of their local equity holding i.e. these companies were to bring down their own equity to 40%. companies engaged in

a) Core industries b) predominately export oriented industries c) sophisticated technology or d) tea plantations were allowed to have foreign equity between 51 % and 74% ,100% export oriented foreign companies were even allowed 100% foreign equity participation. Foreign equity investment of more than 40% was to be treated as FERA company.

Thus there was a great scope for foreign private investment in India. There was no compulsion that each and every company should retain only 40% foreign equity. FERA (Section 29) gave adequate opportunity to foreign investors to retain their foreign equity at various levels, ranging between 40% to 74% depending upon the field in which they desired to

operate. Thus, there was a pragmatic and constructive approach under the guidelines of FERA giving opportunity to the foreign investor to contribute to the economic and industrial development in India.

Later on many provisions were relaxed and the foreign investors were allowed 50% equity in new industries. There was an automatic approval to foreign technology agreements in these industries. (New Industrial policy announcement on July 24,1991) the rupee is made fully convertible on current Account. Many of the FERA provisions have become redundant and inapplicable. It is always feared that foreign equity investment would lead to outflow of foreign exchange. However the facts are otherwise. The Reserve Bank of India in its foreign collaboration survey (1977-1978 and 1980-81) has revealed that " the aggregate annual average remittance in foreign exchanges comprising dividends, royalties, technical fees, interest on foreign loans and other remittances to foreign collaborations amounted to Rs. 70 crores. Dividend was the largest single item and formed 47%. On the average their aggregate remittances formed one percent of the total value of production of the private sector companies covered in the survey". Thus as a matter of fact, the equity investment helps in increasing production and profitability of a company and increases proportionately the revenue resources of the country in the form of excise duty, income tax on profits and dividends , sales tax etc.

9.9 THE ROLE OF MULTINATIONAL CORPORATIONS (MNCs)

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 individual 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 branches 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.

In modern times the growth of multinationals has contributed significantly to the development of global trade and the economies at large. As Peter Drucker has said," Multinational and expanding world trade are the two sides of the same coin".

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.

9.9.1 The MNCs usually include the following things :

- i) A large pool of management talent
- ii) A wide range of skills
- iii) A better understanding of consumer behaviour
- iv) Technology and competition
- v) New perceptions about international operations
- vi) Holding of large assets.
- vii) MNCs contribute to the following :-

- a) Efficiency
- b) Equity
- c) Creativity
- d) Participation
- e) Stability

9.9.2 Classification of MNCs:

The Multinational corporations can be classified on the basis of several criteria such as functions, control, investment, origin, turnover, product etc.

On the basic functional criterion, the MNCs are grouped into the following :

- i) Service MNCs
- ii) Manufacturing MNCs
- iii) Trading MNCs

i) Service MNCs : A service MNC is defined as a transnational company which derives more than 50% of its revenue from service. Service MNCs are found in areas such as banking, insurance, finance, transport, tourism etc.

ii) Manufacturing MNCs : A manufacturing MNC is one which derives at least 50% of its revenue from manufacturing activity. A large number of MNCs has entered into the manufacturing sector. Out of the top 200 MNCs, 118 are manufacturing MNCs. They produce a variety of goods for example, Cadbury chocolates, Colgate and Palmolive soap and detergents, Ponds cosmetics goods.

Olivetti - Teleprinting equipments, Dunlop, Good year, Ceat Tyres and tubes,

iii) Trading MNCs : A trading MNC is one which derives at least 50% of its revenue from trading activity. These are the oldest form of MNCs]

9.9.3 MNCs do the following :-

- 1) MNCs help host of developing countries by increasing investment, income and employment.
- 2) They contribute to the rapid economic development of the underdeveloped countries through transfer of technology, finance and management.
- 3) MNCs. promote professionalisation management in the companies in the underdeveloped countries.
- 4) MNCs. promote exports
- 5) MNCs. help to reduce dependence on imports
- 6) MNCs. equalize the cost of production in the global market through network of productive activity.
- 7) MNCs. make the market more competitive
- 8) MNCs. accelerate the process of economic development.
- 9) MNCs. create a positive fact on the business environment.
- 10) MNCs. are regarded as agents of modernization.
- 11) MNCs. are vehicles of peace in the world through developing cordial political relations among the world countries.
- 12) MNCs lead to exchange of cultural values.
- 13) MNCs develop positive attitude towards the establishment of social welfare institutions and improvement in health facilities.
- 14) MNCs lead to improving the balance of payments of the host country.
- 15) MNCs integrate national market with the international market.

9.10 DRAWBACKS OF MNCs

1) Profit maximization : The basic purpose of MNCs in 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 gamed 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) Insignificant Employment Potential: The MNCs generally invest their surplus funds in capital intensive technique of production industries which are labour saving and as such they do not employ more labour.

5) Misuse of economic status : 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) Spreading the influence of their own countries : The MNCs may spread the influence of their own culture in the host country culture.

7) High tempo of show and advertisement:- The MNCs may take undue advantage of their financially well-to-do-ness 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) Maximization of profit: The MNCs undertake large scale production and reap the fruits of economics of large scale which leads to intensity their profits. There by they exploit the domestic consumers.

9) 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.

10) Creation of Monopoly : The MNC's being the joint companies establish their monopolies and iron out competition in the host country.

11) Evasion of taxes : The MNC's may evade the taxes by manipulating their accounts.,

12) Economic Threat: the MNCs being financially very powerful may persuade the host country to increase its dependence on the MNC's. Such that the host country gets tide down to the MNC's.

9.11 PUBLIC FOREIGN CAPITAL

Public foreign investment is more important for accelerating economic development than the private foreign investment. The financial need of the underdeveloped countries is so great that private foreign investment can only partially solve the problem of financing. Much cannot be expected form private foreign capital. There is a growing awareness that "poverty" anywhere is dangerous to prosperity everywhere and prosperity anywhere must be shared everywhere.

The Inter Governmental loan is the most important component of public foreign capital. The develop countries consider it to be their moral duty to help the less fortunate brothers in the underdeveloped counties. They are generally motivated by the international policies to help the underdeveloped countries. Foreign aid flows to underdeveloped countries in the form of loans, assistance and outright grants from various foreign Governments and International organizations like IMF, .IBRD, ADB etc. During early years of India's five year plans USA had supplied food grains (wheat) under PL 480 programme, where the entire amount was to be paid in Indian Rupees to be credited to its account in Reserve Bank of India.

9.12 FOREIGN COLLABORATION

There are three ways of foreign collaborations viz.

- i) Between private foreign parties and Indian Parties.
- ii) Between private foreign parties and the Government of India and the Indian Government.
- iii) Between foreign Government and Indian Government.

Check Your Progress:

1. What do you understand by Foreign capital?
2. Explain why foreign capital is important.
3. What are the various forms of foreign capital
4. Write a note on: MNCs

9.13 EMERGING ECONOMIES AND CAPITAL FLOWS

The causes of capital inflows: Earlier capital inflows in emerging economies was attributed to domestic developments, such as sound policies and stronger economic performance, implying both the good use of such funds in the recipient country and the informed judgement of investors in the developed world. The single factor which encouraged the capital flows to emerging economies was the sustained decline in interest rates in the industrial world. For e.g., short term interest rates in the United States declined steadily in the early 1990s and by late 1992b were their lowest level since the early 1960s. Lower interest rates in developed countries attracted investors to the high yields offered by economies in Asia and Latin America. Given the high external debt burden of many of these countries, low world interest rates also appeared to improve their credit worthiness and to reduce their default risk. Those improvements were reflected in a market rise in secondary market prices of bank claims on most of the heavily indebted countries and pronounced gains in equity values. Thus, the tightening of monetary policy in the United States and the resulting rise in interest rates made investment in Asia and Latin America relatively less attractive, triggering market corrections in several emerging stock markets and a decline in the prices of emerging market debts.

Capital flows from rich to poor: More capital does not flow from rich countries to poor countries. Those countries who do not repay their debts may face the difficulty while borrowing from the rest of the world. The fact that these poor countries are in default on their debts, that so little

funds are channelized through equity, and that overall private lending rises more than proportionally with wealth, all strongly support the view that credit markets and political risk are the main reasons for low capital flows to developing countries.

The consequences of capital inflows: The experience of many emerging market economies is that attracting global investor's attention is a mixed blessing of macroeconomic imbalances and attendant financial crisis. As to the imbalances, a substantial portion of the capital inflows tends to be channelized into foreign exchange reserves. For instance, from 1990 to 1994, the share devoted to reserve accumulation averaged 59 percent in Asia and 35 percent in Latin America. In most countries the capital inflows were associated with widening current account deficits. This widening current account deficit usually involves both an increase in national investment and a fall in national saving. In almost all countries, capital inflows were accompanied by rapid growth in the money supply both in real and nominal terms and sharp increases in stock and real estate prices.

Then the consequence of this is the crisis, because the inflow of capital never proves durable. Unlike their more developed counterparts, emerging market economies routinely lose access to international capital markets. Furthermore, given the common reliance on short term debt financing, the public and private sectors in these countries often are asked to repay their existing debts on short notice. Even with the recent large scale rescue packages, official financing only ,makes up for part of this shortfall.

Bullish Long term outlook in the current economic crisis: In the long run emerging economies have great future because of the following reasons-

- Emerging market economies will prove resilient during this economic slowdown and may account for all of world economic growth in 2009 as developed markets slow to zero.
- Emerging economies are not nearly as dependent on consumer spending and almost not at all exposed to consumer credit.
- Emerging markets by and large suffer neither the demographic imbalance nor the entitlement imbalance that plague the developed nations.
- Corporate and personal balance sheets in emerging markets are stronger than those in the developed markets.
- In many emerging markets (Brazil, most of South East Asia, India) as well as several African nations, domestic or regional demand is now more important than exports for GDP growth.
- Among stronger economies, high foreign exchange reserves and lower foreign debt levels act as insurance against the global slowdown; reserves have grown six-fold to over \$4 trillion over the last ten years.
- Over the past ten years, emerging market companies have produced higher profits with lower leverages, while profits expanded annually by double digits during the past ten years.

Cash rich, Resource rich: Compared to the late 1990s Asia crisis, the present situation is much more stable for emerging markets. In this global slowdown and recessionary pressures, emerging markets will face this challenging period with cash in their bank accounts. Many emerging economies have a greater reserve of wealth with which to buffer financial market headwinds. This gives them the option of taking fiscal stimulus measure to offset the effects of a developed markets slowdown without having to go into debt.

The turning point: Emerging markets will be the catalyst for global economic recovery, not the West. Like China, many emerging markets that have been saving and having cash and political will to spend on development projects that require raw materials.

As such resource rich emerging markets are going to find themselves being the future home to foreign investment capital again.

9.14 SUMMARY

1. 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.
 2. 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
 3. Rate of interest, bank rate, speculation etc. determine International capital movements.
 4. Foreign capital facilities the all round development of an economy.
 5. Foreign capital can enter into the country in the following forms :-
 - a) Private Foreign investment
 - b) Public Foreign capital
 - c) Foreign collaboration
 6. The Term Multinational Corporation is used to identify an enterprise which controls assets, factories, mines, sales and other offices in two or more countries.
 7. On the basic functional criterion , the MNCs are grouped into the following :
 - i) Service MNCs
 - ii) Manufacturing MNCs
 - iii) Trading MNCs
 8. The single factor which encouraged the capital flows to emerging economies was the sustained decline in interest rates in the industrial world.
 9. Resource rich emerging markets are going to find themselves being the future home to foreign investment capital.
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9.15 QUESTIONS

- 1) What are the different forms of international capital movements? Explained how short term and long term capital movements affect countries economic development.
- 2) Bring out the economic implications of international capital with respect to developing countries. Up to what extent it is effective to solve the problem of balance of payments problem?
- 3) Write short note on:
 - i) Factors affecting international capital movements,
 - ii) Types of International Capital Movements
- 4) Examine the role of foreign capital in bringing about economic development of the underdeveloped countries.
- 5) Bring out the arguments for and against role of foreign aid.
- 6) Bring out the arguments for and against Multinational Corporations.
- 7) Write short notes on :
 - i) Types of foreign capital
 - ii) Multinational corporations.
 - iii) Foreign aid and economic development.
- 8) Explain the role of emerging markets in changing scenario.



10

Module 6 CURRENCY MARKET

Unit Structure

- 10.0 Objectives
- 10.1 Introduction, Meaning and Scope of Euro dollar market
- 10.2 Salient features of the Euro-Dollar market
- 10.3 Origin and Growth of Euro-Dollar market
- 10.4 Factors contributing to the growth of Euro-Dollar market
- 10.5 Operation and effects of Euro currency market
- 10.6 Problems created by Euro currency market
- 10.7 Segments of Euro currency market
- 10.8 Currency Areas
- 10.9 Currency areas and common currencies
- 10.10 International Financial Integration with respect to European Union
- 10.11 Summary
- 10.12 Questions

10.0 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

10.1 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 bonds 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 France, 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 thrones 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.

10.2 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.

10.3 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.

10.4 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 market to 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.

10.5 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.

10.6 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.

10.7 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.

10.7.1 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 fix 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 j 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.

10.7.2. 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 borrowers 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-coordinating 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.

10.7.3 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?

10.8 CURRENCY AREAS

Periodic Balance of Payments crises will remain an integral feature of the international economic system as long as fixed exchange rates and rigid wage and price levels prevent the international price system from fulfilling a natural role in the adjustment process.

A system of flexible exchange rates is usually presented as a device whereby depreciation can take the place of unemployment when the external balance is in deficit, and appreciation can replace inflation when it is in surplus. But then the question arises whether all existing national currencies should be flexible.

To define a currency area as a domain within which exchange rates are fixed is absolutely necessary because of the following reasons :

- Certain parts of the world are undergoing processes of economic integration and disintegration, new experiments are being made, and a conception of what constitutes an optimum currency area can clarify the meaning of these experiments;
 - Those countries that have experimented with flexible exchange rates are likely to face particular problems which the theory of optimum currency areas can elucidate if the national currency area does not coincide with the optimum currency area; and
 - The idea can be used to illustrate certain functions of currencies that have been inadequately treated in the economic literature and that are sometimes neglected in the consideration of problems of economic policy.
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10.9 CURRENCY AREA AND COMMON CURRENCIES

A single currency implies a single central bank and therefore a potentially elastic supply of interregional means of payments. But 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. There will be a major difference between 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).

10.10 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.

10.11 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.

10.12 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.



11

Module 7

EMERGING ISSUES IN GLOBAL TRADE AND FINANCE INTERNATIONAL DEBT PROBLEM

Unit Structure

- 11.0 Objectives
- 11.1 Introduction of International debt
- 11.2 Concept of International debt crisis
- 11.3 The World debt crisis
- 11.4 Indicators of International indebtedness
- 11.5 Causes of International debt crisis
- 11.6 Debt Relief measures
- 11.7 Introduction of World Bank(WB)
- 11.8 World Bank's Organization
- 11.9 Critical Analysis
- 11.10 Summary
- 11.11 Questions

11.0 OBJECTIVES

- i) To know the problem of international indebtedness or international debt crisis
- ii) To know the various purposes behind obtaining loans by the underdeveloped countries

- iii) To know the magnitude of the problem of international debt crisis,
- iv) To know the measures of international indebtedness
- v) To know the causes of international debt crisis
- vi) To know the remedial and preventive measures of international debt crisis
- vii) To know India's external debt problem
- viii) To know the background behind the establishment of the World Bank
- ix) To know the relationship between India and the World Bank
- x) To know the constituting institutions of the World Bank

11.1 INTRODUCTION OF INTERNATIONAL DEBT

Capital like labour is mobile between countries. However international Capital mobility doesn't mean the movement of machines or buildings. But capital mobility doesn't mean (he movement of machines or buildings . But capital mobility means mobility of financial claims between lenders and borrowers, between owners and the enterprises. The owners or the lenders lend their surplus capital to the borrowers or the borrowers borrow the capital from the lenders or the owners of the capital for variety of purposes for example the LDCs may borrow for the variety of purposes which are as follows:-

- i) Consumption :- Borrowing for consumption is undertaken to smother the path consumption overtime to better their standard of living.
- ii) Adjustment:- Borrowing for adjustment in undertaken to permit the gradual introduction of policy measures which may be required as a consequence of changes in economic conditions.
- iii) Borrowing for investment to finance to development projects
- iv) Borrowing for the repayment of the foreign debt.

Countries that borrow prudently do not experience difficulty in debt servicing i.e. payment of principal + interest. However it is observed that number of LDCs and the middle income group countries do not borrow foreign fund prudently. Imprudent borrowers however should not be able to obtain loans from prudent lenders.

Analysis of the Operation of Loan Markets suggest that prudent lending may be difficult to achieve. Lenders rarely have full information about the intention of the borrower and are also exposed to the risk. Most of the loans to LDCs however were either given to Government or were guaranteed by them and lenders are inclined to believe that the Governments would not repudiate those debts.

The lenders or the owners lend funds to the borrowers to be used now in exchange for IOUs or ownership share entitling them to interest and dividends later. International capital close are conveniently divided

into privately held v/s official claim, long term v/s short term and direct v/s portfolio claim which are as follows :

A) Private lending :

- 1) Long term (Bonds, stocks, use of patents or copy right)
 - a) Direct investment (ownership share and controlled by the investor)
 - b) Portfolio investment (Purchase of shares)
- 2) Short term portfolio investment (Bills of credit maturing in less than a year).

B) Official lending (ownership purchases mostly portfolio, mostly lending both for long term and short term).

The International lending has been changing. Until recently, the main lender was the United joint after 1973 by the newly rich oil exporter the main borrower, especially across 1970s were the developing countries or the third world countries. But in said 1980s the United States has become the world largest net borrower and the oil exporters as the group are borrowing almost as much as they lend. The main new lender is Japan, with lesser lending roles being played by Canada and some of the European countries. The type of lending has changed back to private loans to vote Government and private borrowers.

The International lending is also in a state of severe crisis. The wave of lending to the third world from 1874 to 1981 ended abruptly in a breakdown of confidence late in 1982. Lenders scrambled to stop lending and set repaid. Governments of 38 countries home failed to meet their agreed repayment schedules since 1975, most of them falling behind in 1983 and 1984. The largest banks in the world face major losses on their international loans.

11.2 CONCEPT OF INTERNATIONAL DEBT CRISIS

The international indebtedness or mounting or accumulated international debt gets referred to as international debt crisis.

The international debt crisis threatens the development of not only the developed countries but also the developed countries. When the borrowers do not honour their commitments to repay in full their debt the international debt goes on mounting leading to international debt crisis.

The international debt crisis, came to the forefront when the Mexican Government announced on August 12, 1982 that it could not meet the repayment of its international debt. It was followed by a similar act on the part of number of third world countries.

The international lending is also in a state of severe crisis. The wave of lending to the third world countries from 1974 to 1981 ended abruptly in a breakdown of confidence in 1982. Lenders scrambled to stop lending and waited for the repayment of the full debt i.e. principle plus interest. Governments of 38 countries have failed to meet their agreed repayment schedule since 1975. The largest banks in the world face major losses on their international loans. The world faced the problem of international debt crisis and hence the problem before the world was to solve the problem of international debt crisis.

If the world is stable and predictable, and if borrowers honour their commitments to repay their international debt in full i.e. principle along with interest then the international lending can be efficient from the point of view of the world, it will bring gains to those which outweigh the losses to others. In such a world the welfare effects of international lending will benefit both the countries i.e. the lending and the borrowing countries.

Along 'x' axis wealth of both countries viz. country A and country B is marked while along 'Y' axis rate of return (Rate of interest) per annum is marked.

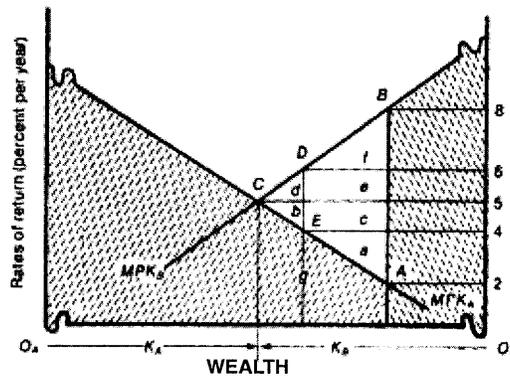


Figure 11.1

- OWA shows the wealth of country A.
- OWB shows the wealth of country B.
- MPCA shows the marginal productivity of capital of country 'A'
- MPCB shows the marginal productivity of capital of country 'B'

Point 'C' shows the determination of the rate of return (rate of interest) p.a. where MPCA MPCB intersect each other due to competition.

Country 'A' is having abundant wealth and relatively unattractive domestic investment opportunities while country 'B' is having a little wealth with abundant opportunities for profitable investment.

If all lending is domestic then country 'A's lenders must accept low rate of return p.a. which is the order of 2% p.a.

Country B has scarcity of funds which prohibits capital formation beyond point B. In country B domestically the borrowers borrow at a higher rate of interest i.e. at 8% rate of interest.

In a situation of this type if all barriers to international capital flow are withdrawn then the investors of county 'A' and borrower of country 'B' will have a strong incentive to get together. There will be a scramble on the part of A's lenders to lend funds to B's borrowers at the determined rate of 5% which is higher than the domestic lending rate of 2%. Conversely there will be a scramble on the part of B's borrower to borrow funds from A's lenders at 5% rate of interest which is lower instead of their domestic 8% rate of interest. With new international freedom country A's lending gains come to a+b+c and country B's borrowing gains come to d+e+f and total gain comes to ABC.

With each country viz. A and B there are gainer and looser from the new freedom. The lenders in country A gain by lending at 5% instead of 2% rate of interest. But it harms the borrowers in A because now they have to borrow at 5% rate of interest instead of 2% rate of interest.

In country B the borrowers gain because they now borrow funds at 5% rate of interest instead of 8% rate of interest. But the lender in country B prove to be looser as they have to lend funds at 5% rate of interest instead of 8% rate of interest. Thus the gains and losses are identical. The international freedom benefit the world as whole and the groups for whom the freedom means opportunity. While it harass the groups for whom the freedom means tough competition.

11.3 THE WORLD DEBT CRISIS

It is observed that there was no well behaved lending since mid 1970s. Good behavior of lending presumes that debtors do repay their loans on time. But it is sorry to *I* state that the debtors failed to repay their debt on time. In the early 1980s the governments of as many as 38 countries postponed the repayment of their debt (both principle and interest). Though the postponement of the repayment of debt marks relief for the debtor countries but it marks a loss for the creditor countries. By mid 1982 the lending of the mine major banks in the United State to these countries alone viz. Argentina, Brazil and Mexico exceeded their paid up capital.

The problem is also very serious for the debtor countries. They borrowed in 1970s at high nominal interest rates reflecting the widespread fear of dollar-price inflation to stop inflation. The Federal Reserve Bank of United States followed a tight monetary policy in 1982. Suddenly the high nominal interest rates turned into high real interest rates which hit the borrowers harder than they had been hit since the great slump of 1929-32. Even though the debtor countries could save extra resources by not repaying debt on time, they feared the damage to their future credit

worthiness so greatly that they would rather tighten their belts in order to keep repaying their creditors. Many debtor countries imposed unemployment and pay cuts to release resources for the repayment of foreign debts. Hence economic growth slowed down in number of debtor countries in 1980s.

In 1982 Mexico announced its decision to suspend the repayment of its debt which was followed by countries like Brazil and Argentina. The external debt increased from dollar 100 billion in 1970 to dollar 650 billion in 1980 to dollar 1350 in 1990 and to dollar 1744 billion by 1997. As per World Bank (IBRD) 57% of the debt was held by just 20 countries which was led by five countries viz. Brazil, Argentina, India and Egypt. The IBRD declared 15 countries as the severely indebted countries viz. Argentina, Bolivia, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Morocco, Nigeria Peru, Philippines, Uruguay, Venezuela and Yugoslavia.

11.4 INDICATORS OF INTERNATIONAL INDEBTEDNESS

Following are the economic indicators of international indebtedness

- 1) Ratio of external debt to its export earnings :- This ratio indicates the international indebtedness because the countries pay off their foreign debt out of their export earnings.
- 2) Ratio of foreign exchange reserves to external debt:- This ratio also plays very important role in indicating countries external indebtedness because the Central Banks of the countries make the repayment of their external debt out of their foreign exchange reserves.
- 3) Ratio of external debt to GDP :- This indicator gives the idea of countries total debt burden in relation to its GDP.
- 4) Total debt service as a percentage of exports of goods and services :- It gives an indication of the annual debt burden a debtor country is facing in relation to its export earnings.

11.5 CAUSES OF INTERNATIONAL DEBT CRISIS

Following are the causes of international debt crisis :-

- 1) **Oil Price hike** :- The manifold increase in crude oil prices in 1970 and the consequent increase in balance of payments deficit happened to be the root cause of external debt crisis. The Israel - Egypt was led to four-fold increase in crude oil prices. It produced harmful effect on the non oil producing developing countries in terms of increasing their current account deficits and the deterioration in their term of trade which compelled these countries to borrow more and more.

2) Pattern of Financing :- The changes in the pattern of financing of the payments deficit and the changes in the terms of loans contributed significantly to the external debt crisis. The huge deficit in the balance of payments led to shortfall of the IMF resources to meet the requirements of the developing countries financial need. There was also a decline in the flow of concessional finance from the World Bank. The commercial borrowing had an inherent problem of high rates of interest.

3) Increase in Interest Rate :- In 1980s there was fivefold increase in the rates of interest hence the developing countries had to pay five times more than what they were supposed to pay the rate of interest on the foreign borrowing the external debt crisis got deepen due to a fall in the maturity period.

4) Trade related factors :- The trade related factors also led to increase in the external debt problem. The growth of protectionism, particularly the non-tariff barriers adversely affected the developing countries export and they aggravated the repayments and debt problem. The determination of the terms of trade also added fuel to fire in term of huge losses.

5) Domestic economic management:- Most of the developing countries followed expansionary macro economic policy which led to increase in domestic demand and inflation. Several other factors like political instability, economic instability also affected the capital flow.

11.6 DEBT RELIEF MEASURES

The problem of international debt commenced in 1980 and became aggravated in 1982 such that it was designated as 'Debt Trap. Different strategies were tried to mitigate the international debt problem and to put the indebted countries back to normalacy.

There is a traditional approach for debt relief which is called as rescheduling of debt i.e. the postponement of debt. However the problems being so deep that mere rescheduling of the debt won't solve the problem. Hence the more realistic approach to solve the problem of international debt would be the right one.

A) BAKER PLAN :-

In 1985 at the IMF-World Bank annual meeting Mr. Jaines Baker announced a plan to solve the problem of international debt. The baker plan emphasized growth orientated structural economic reforms in debtor countries. As per the plan the IMF and World Bank should make new loans of \$ 20 billion over three years to the debtor countries. However the Baker plan was meant for the Western hemisphere countries hence the scheme was criticized as a vested interest scheme than the general scheme.

In 1989 the World Bank announced a new scheme known as Debt Reduction Facility Scheme of \$ 100 million to carry out structural

adjustment programmes in the debt affected countries . However the scope of the scheme was limited as it was confined to those countries which were eligible for IDA assistance and the maximum amount of grant per external debt affected country was \$ 10 million.

B) DEBT WRITE OFF :- The group of seven industrial countries in their meeting at Toronto in 1988 proposed for the debt write off. The nine industrial countries announced their plan to help the low income indebted African countries to write off the bilateral loan or converting loan into grants. In 1989 the us Treasury secretary Mr. Nicholas Brudey also supported the move to write off the external debt. France and Japan also came forward with the proposal to help the debtor countries to have growth oriented adjustment programmes. Proposals like debt buybacks , exchange of old debt for new collateralized bonds and exchange of old dates for new bonds at par value were also floated open.

C) TRINIDAD DEBT REDUCTION PROPOSALS :

A Meeting of the common wealth Finance Minister proposed a debt reduction programme having the following proposals :

- i) Instead of negotiating new terms as debts mature each year, the total debt of each country should be dealt with in one long term operation.
- ii) Two-third (2/3) of the debt of the poorest countries should be written off
- iii) The repayment period should be lengthened to 25 years.
- iv) Interest payments due in the first five years should be capitalized and the principal and interest then should be repaid in a phased manner.
- v) Debtors capacity of repayment of debt should be increased. In spite of several attempts to mitigate the debt problem, number of developing countries continue to accumulate the internet arrears . Hence what was needed was a concerted approach to achieve a substantial reduction of debt and debt service simultaneously. Negative transfer of resources from the poor to the rich should be ended, and the service of the debt should be related to the ability of an economy to pay and to grow the amount of debt service that a country can bear and is required to pay should be linked to the level of resources it needs to keep income per head rising at a rate of at least 2-3 per unit per annum. The necessary level of resources can be determined with reasonable accuracy through macro economic analysis for individual countries. The policies for achieving this target should then be negotiated, taking into account the various forms of debt and the circumstances of the debtor country concerned. The central point is that the reduction of debt and of debt service should be the subject of multilateral inter-governmental negotiation.

It was also emphasized that there was a need for an International debt conference with the participation of the debtor governments, the governments of the creditor countries and the International Financial Institutions to decide the framework for the solution to the problem of International debt.

Despite manifold problems of finding out solutions and translating them into practice remarkable achievement has been made in easing the debt burden.

Due to the aggregate debt relief measures taken by the developing countries debt burden got reduced substantially since 1986 which led to reduced borrowing, improved economic performance etc. The debt to GDP ratio for the developing countries fell from 39% in 1986 to 32% in 1991. It was also projected that it would further fall to 27% by 1993. However the improvement was only marginal. The aggregate debt service ratio declined from 22% in 1986 to 14% in 1991. It was projected to fall further by 1993. It was specifically in case of the fifteen heavily indebted countries. The debt service ratio of these countries had fallen from 45% in 1986 to 31% in 1991.

Check Your Progress:

1. What do you understand by the term international debt?
2. What are the indicators of international indebtedness?
3. Why the problem of international indebtedness arises?
4. Write a note on Debt relief measures.

11.7 INTRODUCTION OF WORLD BANK

The International Bank for Reconstruction and Development (IBRD) popularly known as the World Bank, one of the Britton Wood's twins was established in 1945. The International Monetary Fund (IMF) was set up for providing the short term, temporary assistance to member countries to correct the balance of payments difficulties. There was a need to provide long term assistance to member countries. Hence the IBRD was established to provide long term funds to undertake development activities on reasonable terms.

11.7.1 Concepts:

The abbreviation IBRD stands for International Bank for Reconstruction and Development. It is popularly known as World Bank. It

is an inter-governmental institution the capital stock of which is entirely owned by its member countries. The member countries of IMF are the member countries of IBRD. India is a founder member of the World Bank. In 2001 its membership was of the order of 184.

The IBRD whose capital is subscribed by its member's countries finances its lending operations primarily from its own borrowing from the international capital markets. A substantial contribution to the banks resources comes from its earning of interest on long term loans and the repayment of loans. The world Banks loans are repayable over twenty years with a grace period of five years. The interest rates on long term loan are calculated in accordance with the guidelines laid down i.e. is accordance with the cost of borrowings from the international capital markets.

The IBRD has an authorized capital of \$21 billion divided into 2,10,000 shares. Each share has got a par value of 1,00,000 of the present authorized capital 20.48 billion are subscribed by the issue of 2,08,848 shares. Of the subscribed capital only 10% is paid up capital i.e. 2.048 billion. Of the paid up capital 2% is subscribed in gold or US dollars and the remaining 98% has been paid in terms of currency of the members countries.

Loans are granted to member countries only when the Bank is fully satisfied about the economic position of the barrowing member country and also about the viability of the project for which the loan is opted for. The Bank insists that the loan amount should be utilized for the successful completion of the project only. The Bank has a power to supervise and control to ensure that the loan amount is utilized for the purpose for which loan is granted. The Bank makes medium and long term loans.

11.7.2 The World Bank gives loans in one of the following ways:

- i) By giving direct loans out of its own funds.
- ii) By giving loans out of funds raised in the capital market.
- iii) By guaranteeing either whole or a part of loans given by private investors.

The total amount of loan given by the World Bank or guaranteed by it should not exceed 100% of its total subscribed capitals. The interest rate charged by the World Bank on its loans is estimated according to the cost of the Bank's borrowing of funds from the international capital markets. In addition to the rate of interest the World Bank also charges a commission of 1 % for the purpose of creating a special reserve against losses and 1/2% for administrative expenses.

The World Bank also gives loans for specific development projects viz. agriculture, power, transport, industry etc. The underdeveloped countries are the beneficiaries of these types of loans. India is World Bank's largest individual borrower.

In addition to financial assistance the World Bank also provides suitable technical assistance for developing programmes to member countries.

The World Bank has also set up in Washington an Economic Development Institute with financial assistance from the Rockefeller and Ford Foundation to provide an opportunity to selected groups of senior officials from the under developed countries to participate manually in an international course of studies designed to give them broad prospective of the problems of economic development and to increase their efficiency.

11.8 WORLD BANK'S ORGANIZATION:

There is a three tier system of World Bank's Organization which is as under:-

- i) Board of Governors,
- ii) Executive Directors and
- iii) President.

The Board of Governor is a supreme body on a governing authority. It consists of one Governor who usually happens to be the Finance Minister of the member country and one alternate Governor who usually happens to be the Governor of the Central Bank of the member country appointed for the period of 5 years by each member country. All powers of the World Bank is vested in the Board of Governor. The Board of Governors delegates its powers to a Board of Executive Directors. The Board of Executive Directors carries out the day to day administration of the World Bank. The Board of Governor meets once in a year. It reserves the power to decide the important matters such as new admissions, changes in the Banks stock of capital, wage and means of distributing the net income etc.

The Board of Executive Directors works on full time basis at the Banks headquarter. There are 21 Executive Directors of which five are appointed by the five member countries having the largest share capital and the remaining Executive Directors are elected by the Governor representing the member countries. The headquarter of the World Bank is in Washington.

The World Bank President by tradition happens to be a citizen of the largest share holding country i.e. United States of America. He is elected by the Executive Directors for five years. He can also be re-elected. He becomes an ex-officio chairman of the World Bank. He is the chief of the operative staff of the World Bank. The Executive Directors decide the World Bank's policy and all loan and credit proposal.

11.8.1 Objectives: The objectives of the World Bank, as laid down in its Articles of Agreement are as under:

1. To assist in the reconstruction and development of the territories of the member countries, by facilitating the investment of capital for productive purposes, including the reconstruction of economics, which were destroyed or disrupted by war, the reconversion of productive facilities to peace time needs and the encouragement of the development of productive facilities and recourses in less developed countries.
2. To promote private foreign investment by means of guarantees or participation in loans and other investments made capital is not available on reasonable terms, to supplement private investment by providing on suitable conditions finance for productive purpose out of its own capital funds raised by it in the international capital market and other resources.
3. To promote the long range balanced growth of international trade and the maintenance of equilibrium in the balance of payments by encouraging international investment of the productive resources of member countries, thereby assisting in raising predictability the standard of living and conditions of labour in their territories.

11.8.2 Guiding Principles:

The World Bank is guided by the policies which have been formulated on the basis of Articles of Agreement which are as under:

1. The World Bank should properly assess the repayment prospects of the loans. For this purpose, it should consider the availability of natural resources and existing productive plant capacity to explain the resources and to operate the plant.
2. The World Bank should lend only for specific projects which are economically and technically sound and of a high priority nature. As matters of general policy, it concentrates on lending for projects which are designed to contribute directly to productive capacity, and normally doesn't finance projects which are primarily of social character such as education, housing etc. Most Bank loans have been made for basic utilities such as power and transport, which are prerequisites for economic development. Besides, the Bank places considerable emphasis upon the proper management of the projects.
3. The World Bank show lends to enable a country to meet the foreign exchange needs of any projects it morally expects the borrowing country to mobilize its domestic resources.
4. The World Bank should not expect the borrowing country to spend the loan in a particular country, in fact, it encourages the borrowers to produce machinery and goods for Bank financed projects in the cheapest possible market consistent with satisfactory performance.
5. The World Bank has to maintain continuing relation with borrowers with a view to check the progress of projects and keep in touch with financial and economic development in borrowing countries. This

also helps in the solution of any problem which right arises in the technical and administrative fields.

6. The World Bank indirectly attaches special importance to the promotion of private enterprise.

11.8.3 Functions:

The main function of the World Bank is set forth in Article of the Agreement which is as follows:

1. To assist in the reconstructions and development of the territories of its member by facilitating the investment of capital for productive purpose.
2. To promote private foreign investment by means of guarantee of participation in loans and other investments made by private investors and when the private capital is not available on reasonable terms to make loans for productive purpose out of its own resources or from funds borrowed by it.
3. To promote the long term balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the development of the productive resources of member.
4. To arrange Loan made or guaranteed by it in relation to international loan, through other channels *so* that more useful and urgent projects large and small alike, will be dealt with first. It appears that the world Bank was created to promote and not to replace private foreign investment. The world Bank considers its role to be a marginal one to supplement and assist private foreign investment in the member countries.

Its appears that the objectives and functions of the world Bank are complementary to each other. .

11.9 CRITICAL ANALYSIS

- 1) It is alleged that the World Bank charges a very high rate of interest on the loans (5 3/4 % rate interest including commission of 1% to create special reserve of the bank.)
- 2) The World Bank applies orthodox standards to judge the repaying capacity of the borrowing country.
- 3) The financial help rendered by the World Bank is just a drop of water in the ocean. It means that the Capital and other financial resources of the World Sa/pk are not adequate to meet the increasing requirements of the member countries.

- 4) **Discriminatory Treatment:** While dealing with the problems of the member countries the World Bank makes discrimination between the developed and the developing countries and gives an upper hand to the developed countries. The interest of the underdeveloped countries gets jeopardized.
- 5) The World Bank insists on the repaying capacity of the borrowing country before granting of loan to the member country which has got little relevance in modern times. As a matter of fact the repaying capacity follows the actual utilization of the loan.
- 6) The World Bank has extended loans to developing countries mostly for agriculture and other related occupations but not for heavy and basic industries.

The World Bank has been playing an important role in promoting economic development to the member countries since its existence. The bank has helped in the establishment of reasonable International loan conditions. It has also helped to develop a system of multilateral trade and investment by permitting the borrowing countries to spend the process of loan in any country they like. The bank has also promoted regular servicing and repayment of loan by the borrowing countries because ultimately all the member countries are jointly responsible for any financial bite during the operation.

The World Bank has encouraged the borrowing and lending of funds for the sound development projects only. Before extending loans the Bank looks into the feasibility of the project. The loan is granted only if the project is viable.

The World Bank has rendered valuable services to the developing countries of the world. It has extended loans to those less developed countries for the projects like agriculture, irrigation, power, transport, education, eradication of poverty etc. As a result of World Bank developmental assistance the developing countries have made a substantial economic progress. The Bank may not come up to the expectations of the developing countries. But in evaluating its role we should not ignore the limitations within which it has been Instrumental in accelerating the pace of economic growth in different member countries of the world viz. the developing and the developed member countries of the world.

Check Your Progress:

1. Why the World Bank was established?
 2. What are the objectives and functions of the World Bank?
 3. Critically analyse the functioning of the World Bank.
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11.11 QUESTIONS

- 1) Explain the nature and causes of the International debt problem.
- 2) Write short notes on
 - i) International debt trap
 - ii) Debt relief measures
 - iii) Alternatives to International debt.
- 3) Discuss world Banks organization and functions.
- 4) Write short notes on:-
 - a) Organization of World Bank
 - b) Functions of World Bank
- 5) Critically analyse the working of World Bank



12

WORLD BANK -II (CONSTITUENTS OF WORLD BANK)

Unit Structure

- 12.0 Objectives
- 12.1 Introduction and constituents of World Bank
- 12.2 International Finance Corporation (IFC)
- 12.3 International Development Association (IDA)
- 12.4 International Financial Hub: Singapore and New York
- 12.5 Summary
- 12.6 Questions

12.0 OBJECTIVES

- i) To know the constituents of World Bank.
- ii) To know the establishment of International Development Association (IDA)
- iii) To know the top IDA borrower.
- iv) To know the IDA subscriptions and contributions.
- v) To know the impact of IDA funding.
- vi) To know the establishment of International Finance Corporation. (IFC)
- vii) To know the funding activities of IFC.
- viii) To know the mission and objectives of IFC.
- ix) To know the relationship between IFC and India.

- x) To know the establishment of Multilateral Investment Guarantee Agency (MIGA)
- xi) To know the Principles of MIGA.
- xii) To know the impact of MIGA on Developing Countries.
- xiii) To know the achievements of MIGA.
- xiv) To know the establishment of International center for settlement or Investment Disputes (ICSID)

12.1 INTRODUCTION

As the time rolled on the priorities of the World Bank changed drastically.

It has become the largest funder of education. The funding of education began from 1963. It helps the developing countries in universalization of primary education and also raising the standard of education. It gives emphasis to female literacy.

The World Bank has also become the largest funder of the move towards the fight against HIV/AIDS. It has launched the multi country HIV/AIDS programme.

The World Bank has also become the largest funder of health programme. It provides loans for basic health and nutrition facilities to less developed countries which help them to reduce poverty and in turn promote their economic development.

It also provides comprehensive debt relief to the worlds poorest of the poor countries which are the most indebted countries in the World.

It has also become the largest funder for food, shelter, medicine, income generation, employment generation and cultural identity.

It has also become the leader to fight against the worldwide corruption. The World Bank insists that the projects financed by the Bank should be free from corruption.

It also helps the countries which are affected by the vicious circle of conflict viz. the rehabilitation of the street children. The rehabilitation of the war shattered economies and the peaceful development thereon etc.

It helps the underdeveloped countries in breaking the vicious circles of poverty originating from the sides of demand, supply and the backwardness of population. It has adopted a multi-dimensional support for poverty alleviation viz. raising the life expectancy, fight against illiteracy, universalization of primary education, reducing infant mortality etc.

The drastic changes in the priorities of the World Bank led to the establishment of its affiliates.

12.1.1 CONSTITUENTS

The constituents of the World Bank are as follows:

- 1) International finance corporation (IFC)
- 2) International Development Association (IDA)
- 3) International center for settlement of Investment Disputes (ICSID)
- 4) Multilateral Investment Guarantee Agency (MIGA)

These four are affiliated to the World Bank and thus the World Bank has become a club of fine viz.

- 1) International Bank for Reconstruction and Development (IBRD), 1945.
- 2) International Development Corporation (IDA 1956)
- 3) International Development Association (IDA 1960)
- 4) International Center for settlement of International Disputes (ICSID) 1966.
- 5) Multilateral Investment Guarantee Agency (MIGA) 1988.

12.2 INTERNATIONAL FINANCE CORPORATION (IFC)

It is one of the members of the World Bank Group. It is affiliated to the IBRD i.e. World Bank. It was established in 1956. One of the aims of International Finance Corporation is to improve the standard of living the peace of the member Countries. Through poverty alleviation by promoting Sustainable private sector in vestment in the developing Countries. Though the membership of World Bank is a prerequisite of the membership of IFC, the IFC is legally and financially a separate entity. It has its own operating staff. However it depends upon the World Bank for administrative and other services. The IFC is the largest source of loan and equity financing for the member countries especially in the private sector investment in the developing countries.

12.2.1 OBJECTIVES:

1) The main objective of IFC is to contribute to the poverty alleviation drive and improving the standard of living of the people of the member countries through the application of the basic tool i.e. the loan and equity financing of private enterprises mobilization of foreign capital along with its own resources and also the provision of advisory and technical assistance.

2) The second objective of IFC is to assist the economic development of the less developed countries by promoting growth in the private sector of their economic and helping them to mobilize domestic and foreign capital.

3) The third objective of IFC is to stimulate the flow of private capital into productive private sector, mixed sector and public sector enterprises. It acts as a catalytic agent in bringing about a close coordination between entrepreneurship, investment capital and production. The IFC realized that the provision of essential infrastructure is not enough to attract private investment flows in the economics where underdevelopment is more pronounced. Hence in addition to this, it was necessary to encourage the growth of productive private investment and savings in the developing countries.

12.2.2 Main features of Assistance of IFC

Following are the main features of assistance ordered by IFC-

- i) The IFC joins hands together with the capital exporting country as a partner as regards private investment.
- ii) It invests not more than half the total capital required by the enterprise.
- lii) The minimum investment of the IFC is fixed which is to the tune of \$ 1,00,000 while there is no fixity of the upper limit.
- iv) It advances loans to predominantly the industrial enterprises.
- v) The rate of interest is a matter of negotiation between the enterprise and the IFC. It also depends upon the risk and other investments of IFC.
- vi) It will not accept any Government guarantee for the repayment of investment except when it is legally required for.

The IFC makes the commitments to provide project sponsors with the necessary technical assistance which ensure that their ventures are potentially productive and financially sound. It also provides policy assistance to member Government in support of their efforts to develop the necessary investment climate which encourages productive as well as beneficial domestic and foreign investments. The IFC has a specialized department white deals with the activities towards the development of international capital market especially to cater to the needs and problems of the developing countries. From 1984 it has started to expand its operations in the new areas viz. assisting in the physical and financial restructuring of the existing firms; it helps to create a bond facility construction firms operating outside their own country; helps to establish a mortgage marketing institution; provides finance for a regionally oriented venture capital company.

12.2.3 India and IFC

The IFC has assisted number of projects in India. The New Economic Policy of India of July 1991 which has substantially enhanced the role of the private sector implies a greater role for the IFC to play in the industrial development of India. The IFC has identified five priority areas in India where it plans to start its activities which are as follows-

- i) Capital markets development.
- ii) Direct foreign investment.

- iii) Access to foreign markets.
- iv) Equity investments in new and expanding companies to finance capital investment.
- v) Infrastructure.

India is the first member country of IFC to get such a benefit of decentralization policy of IFC.

- 1) Firstly IFC will invest in a range of financial service companies and provide technical assistance to help the development of capital market in India.
- 2) Secondly IFC will bring together Indian and Foreign companies as a Catalyst.
- 3) Thirdly IFC will intensify its efforts to help Indian Companies, to gain access to funding in the international financial market through loan and underwriting of securities issues.
- 4) Fourthly the IFC is giving special emphasis to equity investment in companies that are internationally competitive.

12.3 INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA)

It is the second most important constituents of the World Bank. The abbreviation IDA stands for International Development Association. On 1st October 1958 the IBRD unanimously adopted a proposal to setup International Development Association. It is affiliated to World Bank.

The idea to set up such an Association to provide soft loans to the poorest of the poor countries of the world an easy terms was first mooted by Senator Monroney which received an approval of President Eisenhower. In August 1959, President Elsenhower gave public expression to his support to IDA. It was included as one of the three proposals for raising international liquidity. It was established in 1960 and commenced its operations from November 8,1960.

The International Development Association is nicknamed as 'Soft loan Window' at which the underdeveloped countries can borrow hard currencies without being worried to repay in the same currency. IDA imports development loans more generally than the World Bank to the developing economies. The IDA loans are more flexible than the World Bank loans. These loans are given for forty year period with the graced period of ten years on repayment of the principal. These loans are interest free loans. But it carries only a service charge of 0.75%. IDA lends to those countries which are eligible to receive such loans. The eligibility of the countries depends upon their per capital income. Those countries having low per capital income become eligible to borrow funds from IDA. These countries are unable to borrow funds from the World Bank due to low per capita income. At present there are 79 countries which are eligible to borrow funds from IDA. India is eligible to borrow funds from IDA due

to low per capita income at the same time it is eligible to borrow funds from the World Bank as well.

Since 1960, IDA has lent \$107 billion to 106 countries for different types of development projects viz. primary education, health, clean water, sanitation etc. It also provides funds to protect the environment, improve conditions for private business, building infrastructure, employment generation improving standard of living etc. Its funds move from haves to have-nots. Because the loans given to less developed countries are funded out of the repayment of loans from the developed countries.

To join IDA a country must be a member of the World Bank. The IDA has 163 members.

The developing countries can avail themselves of IDA loans on very liberal terms for projects which are not eligible for assistance from the World Bank either because loans for such projects do not carry the guarantee of the Government of the borrowing country or because such projects do not contribute directly or indirectly to the productive capacity of the borrowing country viz. water supply, urban development, housing, slum clearance, education, sanitation, health etc.

In approving IDA credit three criteria are observed which are as follows-

i) Poverty criterion : It means IDA loans are given to the poorest of the poor countries.

ii) Performance criterion - Satisfactory overall economic policies and past success in the project executions in the midst of so many difficulties.

iii) Project criterion - The purpose of IDA is to advance soft loans and not to finance soft projects.

The following table shows the top borrowing countries in the fiscal year 2001

	Countries	\$ million
1)	Etheopia	667
2)	Vietnam	629
3)	India	520
4)	Pakistan	374
5)	Uganda	358
6)	Kenya	350
7)	Bangladesh	280
8)	Senegal	255

Source : <http://www.worldbank.org>

(As incorporated by Johnson and Mascarenhas in their book 'Economics of Global Trade and Finance' published by Manan Prakashan.

Check Your Progress:

1. What are the main objectives of IFC?
2. Explain the functions of IDA.

12.4 INTERNATIONAL FINANCIAL HUB

12.4.1 Singapore: A well established and diversified financial sector

In just four decades, Singapore has established as a financial centre of international repute, serving not only its domestic economy, but also the wider Asia Pacific region and also the world. More than 700 local and foreign financial institutions are located in Singapore and offering a wide range of financial products and services. These include trade financing, foreign exchange, derivative products, capital market activities, loan syndication, underwriting, mergers and acquisitions, asset management, securities trading, financial advisory services, and specialised insurance services. The presence of these leading institutions has contributed to the vibrancy and sophistication of Singapore's financial industry. In 2004, the World Economic Forum Global Competitiveness Report ranked Singapore among the top 10 most sophisticated financial markets in the world.

Singapore has become one of the important International financial centre due to following reasons:

1. **Conducive business environment:** Singapore has been recognised as one of the best cities for business. In the Swiss-based international Institution for management Development's 2008 world Competitiveness Yearbook, Singapore has been ranked as the second-most competitive country in the world after the United states. Investors have also come to appreciate the high levels of transparency and reliability in business, economic and regulatory affairs in Singapore. A stable political structure with parliamentary democracy, a well established judicial system, and the presence of strong domestic institutions with good corporate governance

practices, have made the Singapore business environment even more attractive to global investors.

2. Excellent infrastructure: Singapore's unique location and sophisticated telecommunications network allow financial institutions here to transact business with any part of the world within the same working day. International travel out of Singapore is equally convenient with more than 84 international airlines operating scheduled services through Singapore to more than 180 cities in 57 countries worldwide.
3. Cost competitiveness: Singapore's corporate tax rate is one of the lowest in Asia-Pacific. Singapore also offers the advantage of having a comprehensive network of Double Tax Agreements with more than 60 countries. Singapore also continues to be cost competitive compared with other major cities.
4. Skilled workforce and attraction of talents: Singapore also have a skilled workforce to meet industry demand. In addition to grooming the local workforce meet the demand of the industry, Singapore also has an open door policy to international talent and expertise. Washington based risk consultancy agency, Business Environment Risk Intelligence (BERI), has rated Singapore's workforce as the world's best workers since 1980. And according to the IMD World Competitiveness Yearbook 2007, Singapore has the most skilful and motivated labour force in Asia-Pacific.
5. Strategic location in a region of opportunities: Singapore is strategically located in a region of opportunities. Located at the heart of Southeast Asia, Singapore is well placed to serve the fast growing markets of the Asia-Pacific region. Financial institutions in Singapore also trade around the clock with Asia-Pacific centres, as well as European and American centres, making Singapore a significant hub for 24-hour trading in foreign exchange and securities. International travel is equally convenient. Singapore has grown to be strategic link and important gateway for global investors.

Singapore seeks to ensure its relevance and connectivity to growth markets, not just in Asia but also beyond. As part of this initiative, Singapore has concluded Free Trade Agreements (FTAs) with major economies, including the United States, Japan, Korea, Australia, New Zealand, India and Jordan. There are ongoing FTA talks with other countries. These FTAs provide privileged access to the markets of partner countries. Beyond the immediate region, Singapore is also building

linkages with countries further a field including the Middle East, capitalising on the growing trade and investment interests between these two regions.

Banking – Asia’s hub: Singapore based banks, many of which service the wider Asia-Pacific region, have a good understanding of the Asian corporate landscape and associated risks. They are well placed to partner Arab corporations that seek to expand into Asia by providing structured financing, trade financing, syndication and risk hedging services. Similarly, the Middle Eastern banks present in Singapore find it convenient to use Singapore as a hub to cover the Asia region and Australia and New Zealand. They conduct activities including structuring of trade related finance and Islamic financing for Gulf oil export to countries in the Asia-Pacific region.

Wealth management – A high growth segment: Singapore’s sound macroeconomic fundamentals, political stability, transparent and reliable legal and judicial framework, and high standards of financial sector supervision and regulation provide a conducive environment for wealth management activities. Singapore has a deep pool of investment and requisite Asian expertise to be the trusted investment hub for Middle East investors to diversify their investments and also gain access to growth markets in the Far East. In 2003, assets managed by Singapore based financial institutions grew by 35% to S\$465.2 billion, and indicators suggest that 2004 saw strong growth.

Foreign exchange – Singapore is World’s 4th largest Forex centre: The foreign exchange market in Singapore showed strong growth in 2004. Daily trading activity reached US\$153 billion in 2004, a 51% growth over 2001. Singapore also continues to be recognised as a leading forex centre. In the Bank of International Settlement Triennial Survey of Forex, Singapore was ranked the fourth largest forex centre in the world and second largest in Asia after Tokyo.

Capital markets – Vibrant Debt and REIT market: The Singapore corporate debt market is expected to show continued growth. In 2003, total outstanding corporate debt securities rose 16% (over 2002) to reach S\$103 billion at year-end, as a diversified range of borrowers tapped the Singapore market. This growth continued into 2004.

The capital markets also saw strong interest in structures products such as Real Estate Investment trusts(REITs), as investors sought higher yields in a low interest rate environment.

The REITs market in Asia is generally nascent and has significant potential to develop. Singapore is the first country in Asia other than Japan to have launched REITs successfully. Since July 2002, the market for REITs in Singapore has grown substantially, with 5 listed REITs worth s\$9 billion on the Singapore Exchange, including the first cross border REIT in Asia.

12.4.2 International Financial Hub- New York

New York City and New York, has been the most populous city in the United States. It is the leading financial centre of the world and a premier headquarters location for leading global financial services companies. New York is distinctive for its high concentrations of advanced service sector firms in fields such as law, accountancy, banking and management consultancy.

The New York Stock Exchange, located on Wall Street, and the NASDAQ are the world's first and second largest stock exchanges, respectively, when measured by average daily trading volume and overall market capitalization. New York city has been the leading centre of finance in the world economy since the end of the World War I. As of August, 2008 the city's financial services industry employ 344,700 workers. Manhattan is home to six major stock, commodities and future exchanges: American Stock Exchange, International Securities Exchange, NASDAQ, New York Board of Trade, New York Mercantile Exchange, and New York Stock Exchange. This contributes to New York City being a major financial service exporter, both within the United States and globally.

Since the 1990's New York has been re-establishing its claim as the city of corporate headquarters. The number of headquarters and subsidiaries in Manhattan has more than doubled since 1990. For the very largest American corporations it is important to be in a global city. In 2005 there were 602 stand alone headquarter operations for major companies in the city. Many international corporations are headquartered in the city, including more Fortune 500 companies than any other city.

Since 2000, China has been New York's leading growth market for exports. The New York Metropolitan region is home to more than half of the 32 largest Chinese companies with offices in the United States. These companies represent a broad array of industries including shipping, steel, energy and manufacturing firms, and services. Many have chosen to open headquarters in New York in anticipation of eventual listing on the respective New York stock exchanges and entering U.S. capital markets. New York city currently boasts seven Chinese daily newspapers, two Chinese language television stations, and the largest Chinese neighbourhood in the United States. New York area airports provide 12 daily flights to Hong Kong and five to Beijing.

International shipping has always been a major part of the city's economy because of New York's natural harbour, but with the advent of containerization most cargo shipping has moved from the Brooklyn waterfront across the harbour to the Port Newark-Elizabeth Marine Terminal in New Jersey. Some cargo shipping remains for e.g., Brooklyn still handles the majority of cocoa bean imports to the United States.

High-tech industries like software development, gaming design, and Internet services are also growing: New York is the leading international internet gateway in the United States, with more 430 Gbit/s of international internet capacity terminates, because of its position at the terminus of the transatlantic fibre optic trunkline.

According to New York's Economic Development Corporation, telecom carriers, cable companies, Internet Service Providers and Publishers were a \$23 billion industry in 2003.

New York City is home town to some of the nation's and the world's most valuable real estate. 450 Park Avenue was sold on July 2, 2007 for \$510 million, about \$1,589 per square foot.

Check Your Progress:

1. Write notes on:
 - a) Singapore as a Financial Hub
 - b) New York as a Financial Centre

12.5 SUMMARY

1. There are various constituents like IFC, IDA etc. through which World Bank functions. It is mainly funding for education, health, debt relief, to fulfill basic necessities, income generation, employment generation etc.
2. IFC was established in 1956. One of the aims of International Finance Corporation is to improve the standard of living the peace of the member Countries.
3. The New Economic Policy of India of July 1991 which has substantially enhanced the role of the private sector implies a greater role for the IFC to play in the industrial development of India.
4. The International Development Association (IDA) is nicknamed as 'Soft loan Window' at which the underdeveloped countries can borrow hard currencies without being worried to repay in the same currency.
5. In just four decades, Singapore has established as a financial centre of international repute, serving not only its domestic economy, but also the wider Asia Pacific region and also the world.
6. New York City is the leading financial centre of the world and a premier headquarters location for leading global financial services

companies. New York is distinctive for its high concentrations of advanced service sector firms in fields such as law, accountancy, banking and management consultancy.

12.6 QUESTIONS

- 1) Explain the role of IDA and IFC in terms of providing long term finance to underdeveloped countries.
- 2) Write short notes on –
 - i) IDA
 - ii) IFC
- 3) Explain why Singapore has become one of the important Financial Hub in the world.
- 4) Write a note on New York as a leading Financial centre.



13

Module 8

EMERGING ISSUES IN GLOBAL TRADE

UNIT STRUCTURE

- 13.0 Objectives
- 13.1 Trade Policy
- 13.2 Introduction of Tariff
- 13.3 Classification of Tariffs
- 13.4 Effects of Tariffs
- 13.5 Optimum Tariffs Terms of Trade and Welfare
- 13.6 Summary
- 13.7 Questions

13.0 OBJECTIVES

1. To understand the meaning and types of Trade Policy
2. To study the concept of Tariff
3. To study the classification of tariff
4. To study various effects of tariff
5. To understand the concept of Optimum Tariff Terms of Trade and Welfare

13.1 TRADE POLICY

The trade policy or commercial 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. 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.

Trade 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.

13.2 INTRODUCTION OF TARIFF

Tariffs represent protective devices i.e. instruments of protection. After the outbreak of two world wars viz. the First World War between 1914 to 1918 and the Second World War between 1939 to 1945 and the Great Depression of 1930s in between the two World Wars led to the emergence of the problem of rehabilitation of the number of war-shattered economies of the world. Both the types of countries viz. the underdeveloped and the developed countries like UK, USA, Germany etc. started adopting the policy of protection. In order to protect the domestic industries the countries started resorting to trade barriers viz. tariffs and the non-tariff barriers as protective devices. Out of the categories of the protective devices tariffs and Quotas are the most commonly used devices or methods of trade barriers or protection. The main objectives of imposing trade barriers are as follows:

- i) To protect the domestic industries from foreign competition.
- ii) To guard against dumping.
- iii) To promote development and research.
- iv) To conserve the foreign exchange resources of the country.
- v) To make the Balance of Payment position more favourable.
- vi) To curb conspicuous consumption.
- vii) To raise the revenue for the Government.

13.2.2 Concept of Tariff

Tariffs in international trade refer to the duties or taxes which are imposed on internationally traded commodities when these goods cross the national borders.

Tariff is a very important instrument of trade protection.

Tariff can be defined in the narrow sense as the duties levied upon imports by the reporting country.

Tariff can also be defined in a broad sense as the custom duties which include import duties, export duties and transit duties.

Tariffs are generally regarded as less restrictive than other methods of protection like quantitative restrictions. Therefore WTO generally prefers tariffs to non-tariff barriers.

13.3 CLASSIFICATION OF TARIFFS

There are different ways of classifying tariffs which are as under:

13.3.1 On the basis of origin and destination of the goods crossing the national boundary. There is a three fold classification of Tariffs which is as under:

- a) Import Duties,
- b) Export Duties and
- c) Transit Duties.

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

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

c) Transit Duty : 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.

13.3.2 On the basis of the qualifications of tariff: There is also a three fold classifications of tariff which is as follows :

- i) Specific Duties,
- ii) Ad-valorem Duties,
- iii) Compound Duties,

i) Specific Duties : Specific Duties are levied as per physical unit of a commodity imported or exported viz. per meter, per Kilo, per ton, per litre etc.

ii) Ad-valorem Duties : Ad-valorem Duties are levied as per fixed percentage of the value of a commodity imported or exported. A higher percentage of ad-valorem duty may be levied on the commodities like gold, diamond etc. While a low percentage of ad-valorem duty may be levied on consumer durables like utensils, readymade garments etc.

iii) 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.

13.3.3 With respect to the application of tariff between different countries : There is also a three fold classification which is as follows: i) Single columns Tariff, ii) Double columns Tariff, iii) Triple columns Tariff.

i) 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. It is very simple and also very easy to administer.

ii) 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.

The Double columns Tariff may be divided into two categories viz.

- a) General and Conventional Tariff
- b) Maximum and Minimum Tariff

a) General and Conventional Tariff consist of two schedules of tariffs viz. the General and The conventional. The General schedule is fixed by law while the conventional schedule results from the commercial treaty between the countries.

b) Maximum and Minimum Tariff consists of two autonomously determined schedules of tariffs viz. the maximum and the minimum. The minimum schedules of tariff applies to those countries which have obtained concession as a result of treaty or through Most Favoured Nations clause (MFN) while the maximum schedule of tariff applies to all other countries.

iii) Triple columns Tariff: The Triple columns Tariff comprises of three autonomously determined tariff schedules viz. the general, the intermediate and the preferential. The general and intermediate rates of tariff are similar to the maximum and minimum rates of tariff. The preferential rate of tariff is generally applied in care of Trade between the mother country and its colonies.

13.3.4 With reference to the purpose of the imposition of tariff. There is also a three fold classification of tariff which is as under:

- i) Revenue Tariff,
- ii) Protective Tariff,
- iii) Countervailing and Anti-Dumping Duties.

i) **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. :

a) Obligatory functions like administrations of the country, maintenance of law and order, administrations of justice, preservation of peace. Protecting the life and property of the people of the country not only from the internal disorder but also from the foreign aggression.

b) Optional functions or development and welfare oriented functions like poverty alleviation, employment generations, reducing the gap between haves and have-nots, social justice, planning, economic development etc.

ii) **Protective Tariff:** When the primary intention behind imposition of tariff is to protect the domestic industries from foreign competition then the tariff gets refers to as protective tariff. In case of protective tariff the rates of tax tend to be very high so as to curtail imports and give due protection to domestic industries. It leads to import substitutions and export promotions.

iii) **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 Trade Policy.
2. What do you mean by the term Tariffs?
3. What are the different types of Tariffs?

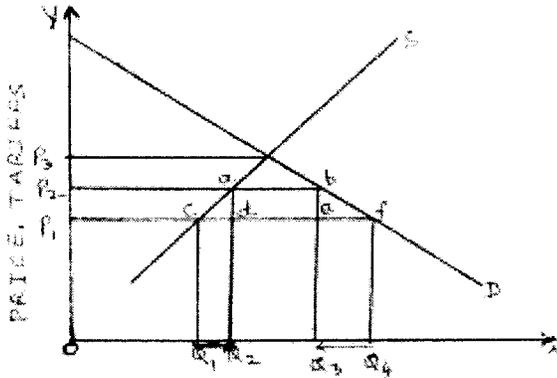
13.4 EFFECTS OF TARIFFS

Following are the effects of Tariffs:-

- 1) Price Effect

- 2) Protective Effect.
- 3) Revenue Effects.
- 4) Consumption Effects.
- 5) Terms of Trade Effects.
- 6) Balance of Payments effects.
- 7) Income and Employment Effects
- 8) Transfer Effects or Redistribution Effects.

Some of the effects can be shown with the helps of the diagram.



DEMAND, SUPPLY

OUTPUT, EMPLOYMENT, CONSUMPTION ETC.

Figure 13.1

1) PRICE EFFECTS:- While bringing about the price effect to tariff it is assumed that the price of a commodity in the exporting country remains the same. The Price of a commodity under consideration in the tariff imposing country rises by the amount of tariff. As in shown in the diagram originally before the imposition of tariff the price of a commodity in the tariff imposing country remains at OP Level. When the country imposes tariff to the tune of PP the Price of the commodity also shoots up by the same amount i.e. by PP and the price of the commodity now after imposition of tariff will be OP . The incidence of the imposition of Tariff falls on the tariff imposing country. There can be at all variations in price rise. If the price doesn't rise at all then the incidence of tariff will entirely fall on the exporting country. And if the price rises only by 50% then the incidence of tariff will be share by both the importing and exporting country by 50: 50 ratios.

The price effect depends up on two factors viz.

- 1) Elasticity of demand and
- 2) Elasticity of Supply.

2. Protective Effect : As per definition a tariff is a restriction or preventive or protective device or instrument. The imposition of tariff prohibits the entry of foreign goods into the country because of the erection of strong tariff wall. Due to the strong tariff Wall domestic industries get protected. It leads to import substitution i.e. the goods we used to import we start producing in the country itself. The production

leads to generation of employment. As is shown in the diagram imposition of PP tariff leads to a hike in the output or production from OQ to OQ'. It increases total receipts which are shown by a triangular

3. Revenue Effects : - It has already been pointed out that there two objectives of tariffs viz.

- 1) Protection and
- 2) Revenue

If the Protective objective is the primary objective of the imposition of tariffs then the revenue objective becomes the secondary objective. Conversely if the revenue objective happens to be the primary objective then the protective objective becomes the secondary objective. The idea behind the revenue objective is that the imposition of tariffs gives an additional revenue to the Government of the tariff imposing country with the help of which it can cater to its various functions. The functions of the Government are two fold viz.

- 1) The obligatory functions and
- 2) The optional functions.

The Obligatory function include the administration of the country, the maintenance of peace, law and order in the country, administration of justice, protecting the life and property of the people of the country not only from the internal disorder but also from the foreign aggression.

The optional functions include the developmental and welfare oriented functions like alleviation of poverty, generation of employment, social justice, homes to homeless, economic planning, economic development etc. If the tariff is imposed to the tune of PP then imports will be to the tune of QQ and therefore the full revenue effect will be to the tune of a rectangle abde. If there is no imposition tariff then there will be no revenue effect.

4. Consumption Effect: Tariff affects consumption negatively. As per Marshals Law of demands other things being equal more is demanded at a low price than at a higher price conversely less is demanded at a higher price than at a lower price. Before imposition of tariff at OP level the domestic demand was of the order of OQ'. When the country imposes tariffs to the tune of PP the price also rises from OP to OP' due to which the demand curtails OQ4 to OQ3. there is a loss of consumer surplus to the tune of a triangle bef.

5. Income and Employment Effect : The basic idea of this effect in that the imposition of tariff leads to increase in income and employment in the tariff imposing country. When a country imposes, tariff to the tune of P1 P2 it erects a tariff wall which gives protection to domestic industries. A country switches over to import substitution. It gives boost up to domestic production which is of the order of OQ1 to OQ2. In order to

undertake production employment generation takes place. The increase in production and the price hike thereof lead to generation of producers income i.e. producers surplus which is shown by a triangular area and as shown in the diagram.

6. Transfer Effect or Redistribution Effect: The imposition of tariff brings about redistribution effect or triangular effect. On the one hand when the importing country imposes tariff to the tune of $P_1 P_2$ it leads to price hike at the same extent due to which the tariff wall gets erected and the imports get curtailed. A country switches over to import substitution, which creates producer surplus, which is to the tune of a triangle area and as shown in the diagram. Simultaneously the imposition of tariff produces negative effect on consumption. As per the Law of demand of Marshall the imposition of tariff ($P_1 P_2$) leads to price hike ($P_1 P_2$) which reduces demand (consumption) from OQ_4 to OQ_3 . Thus the imposition of tariffs on the one hand leads to generation of producer's surplus (and) which gets checkmated by a loss of consumption surplus (bet) which gets designated as a transfer effect or a redistributive effect.

7. Terms of Trade Effect: The terms of trade especially the gross barter Terms of Trade represents a ratio between the quantities of commodity imported to quantities of commodity exported.

$$GBTT = Q_m / Q_x$$

GBTT the abbreviation stands for Gross Barter Terms of Trade

Q_m = stands for quantities of a commodity imported.

Q_x = stands for quantities of a commodity exported.

If $Q_M > Q_x$ then the gross barter terms of trade will be favourable to a country concerned.

Conversely if $Q_x > Q_m$ then the gross barter terms of trade will be unfavourable to a country.

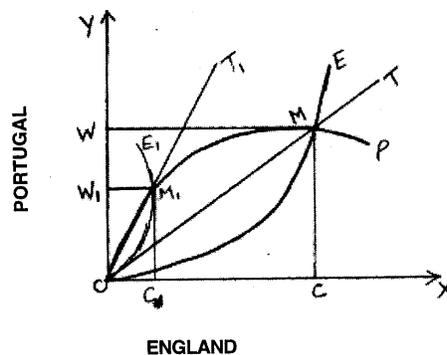


Figure 13.2

England and Portugal are the two countries taking part in the International trade. England specializes in the cloth production while Portugal specialized in the wine manufacture. OE is England's offer curve while OP is Portugal's offer curve. OT is Original equilibrium line and point M

is the original equilibrium point. OC is the units of cloth offered by England against OW units of wine offered by Portugal to England. Now England levies tariff on imports of wine from Portugal due to which the offer curves of England changes to OE1. It intersects OP Portugal's offer curve at the point M1 at which the ratio of quantities of a commodities imported to quantities of a commodity exported changes. Now by exporting only OC1 units of cloth it imports OW1 quantities of wine. Since $OW1 > OC1$ the terms of trade is favourable to England.

8. Balance of Payment Effect: If there are two countries viz. A and B taking part in the International trade and country A suffers from deficit in the balance of payments. In order to improve its balance of position it levies tariffs and erects a strong tariff wall which reduces its imports. It saves her foreign exchange. It switches over to import substitution and export promotion which accelerates its production of exportable goods which fetch her foreign exchange. As such its balance of payments position improves.

13.5 OPTIMUM TARIFF TERMS OF TRADE AND WELFARE

The idea of optimum tariff arises from the fact that the imposition of tariff unilaterally leads to gain accruing to the tariff imposing country but at the same time it leads to reductions in the volume of trade. The improvement in the terms of trade tends to offset the accompanying reduction in the volume of trade. The Optimum tariff is a golden mean between the maximum and the minimum rates of tariffs to two extreme ends. The welfare is shown with the help of trade indifference curves. Higher and higher is the trade indifference curve higher and higher will be the welfare.

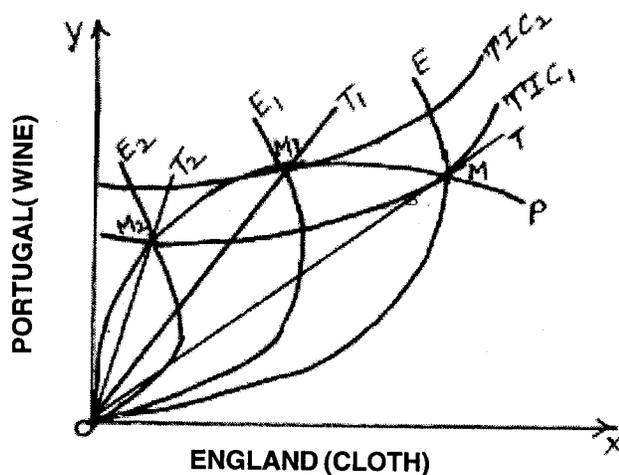


Figure 13.3

Along X axis England's offer of cloth is marked.

Along Y axis Portugal's offer of wine is marked.
 OE represents England original offer curve.
 OE represents England's changed offer curve No.2
 OE represents England's changed offer curve No 3
 OP represents Portugal's offer curve of wine to England.
 OT represents original equilibrium line.
 Point M represents original equilibrium point.
 OT represents changed equilibrium line.
 M point represents changed equilibrium point.
 OT represents changed equilibrium No.2
 M represents changed equilibrium Point No.2
 TIC represents Trade Indifference Curves No.1
 TIC represents Trade Indifference Curve No.2

The initial terms of trade gets determined at point M, TIC, is tangential to offer curve of England (OE) and offer curve of Portugal(OP). As England increase the tariff rate further the equilibrium point change to M which falls at the tangential point of TIC and changed offer curves of England OE and OP Portugal offer curve. At this equilibrium point England's terms of trade improves because England now offers less cloth as against Portugal's offer of wine remaining the same. As England further raises the rates of tariff England's offer curve once again changes to OE , and the equilibrium point falls along the lower Trade indifference curve i.e. along TIC .

M and M are the two equilibrium points which are the extreme points which fall along lower Trader Indifference Curve i.e. TIC hence represent lower welfare. The Golden mean between these two points, is point M which falls along higher trade indifference curve i.e. TIC hence represents higher level of welfare and the optimum level of tariff.

Check Your Progress:

- 1.What are the effects of Tariffs?
- 2.What do you understand by Optimum Tariff?

13.6 NON - TARIFF BARRIERS

13.6.1 INTRODUCTION:

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 direct controls like non-tariff barriers i.e. import quota and not the indirect controls like tariffs.

13.6.2 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.

13.7 IMPORT QUOTA

Import Quota is the old and traditional trade restrictive device. The Mercantilist followed the policy of one way trade i.e. only export but don't import. This policy of one way trade fetches gold and foreign exchange which makes the domestic country strong.

Import quota emphasizes a fixed amount of commodity to be imported from the trading countries during the stipulated period of time. It also means the fixed value of quantities of commodities to be imported from the trading countries.

Import Quota can be looked at from different angles (low types) viz.

- i) Quantitative angle: Quota mean direct quota when looked at from the quantitative angle.
- ii) Indirect quotas when looked at from the angle of exchange control.

13.7.1 Objectives:

- i) Import quotas check speculative imports.
- ii) It leads the economy towards self sufficiency and self reliance.
- iii) It correct the disequilibrium in the balance of payments, iv) It protects infant industries.

13.7.2 Types of Import Quotas :

1. Tariff Quota : Tariff Quota being the composite word comprises of two words viz Tariff and Quota. Hence tariff Quota combine the features of tariffs and quotas. Tariff is related to price and quota is related to fixed physical quantity of commodity to be imported.

2. Bilateral Quota : The word 'Bilateral' denotes from both the sides. Bilateral quota implies negotiation between both the trading countries regarding the fixing of quota of the commodity to be imported. An importing country levies bilateral quota in consultation with the exporting country.

This system has got certain merits which are as follows:

- a) Mutual settlement in deciding the quota of goods to be imported.
- b) Mutual consultation.
- c) No opposition from the exporting country. However, there is every fear of creation of monopolies.

3. Unilateral Quota: Unilateral Quota is to be fixed without negotiation with the foreign trading partner. The unilateral quota can be of two types viz.

- iv) Global Quota v) Allocated Quota

Under global quota a fixed amount of goods can be imported from any country of the globe. In this type of quota there is a fear of a scramble or race between the importing countries therefore there is no guarantee of protecting the domestic industries.

Under Allocated Quota a fixed amount of goods to be imported is rigidly fixed and the exporting country also gets fixed. Hence there is also a fear of creation of monopoly.

4. Mixing Quota : By the very title it appears that mixing quota combines the features of the domestic raw materials and the imported spare parts from the exporting country. The assembling takes place in the domestic country. Mixing Quota is advisable in order to boost up domestic production (through import substitution). It also saves scares and precious foreign exchange.

5. Import Licensing : Import licensing is nothing but import quota regulatory system. Under this system the prospective imports would be required to obtain import license from the Authority. The quota so fixed is distributed among the prospective imports. This system exerts a better control over imports.

However, the seeds of corruption and favouritism are sown in this system. There is every possibility of transfer or resale of import licenses to the third party at a premium.

13.7.3 Effects:

Following are the effects of quotas

- 1) Protective Effect
- 2) Revenue Effect
- 3) Terms of Trade Effect.
- 4) Balance of Payments Effect.
- 5) Price Effect.

Protective Effect: Import Quotas are protective. By limiting the size of the goods to be imported it protects the domestic industries. It leads to import substitution which stimulates production domestically. It therefore gets referred to as protective effect.

Revenue Effect: The revenue effect of quota is different from the revenue of tariff. In tariff as we have already seen that tariff is levied the price shoots up to the same extent. In case of import quota when quota is levied price rises but not up to the extent of quota. The revenue doesn't accrue to Government. It accrues to import license holders. Government earns revenue only by issuing import licenses.

Terms of Trade Effect : If there are two countries viz country A and country B. Country A exports wheat to country B and Country B imposes import quota. The terms of trade generally benefits the quota imposing country. However it depends upon the elasticity of the exporting country's offer curve. If the offer curve is more elastic then the terms of trade will be favourable to quota imposing country. Conversely if the offer curve is less elastic then the terms of trade will be unfavourable to quota **imposing** country.

Balance of Payments Effect : Due to imposition of import quota the MPM i.e. marginal propensity to import declines, leading to curtailment in imports. It gives protection to domestic industries. A country switches over to import substitution and export promotion. In this way balance of payments adjustment can be brought about.

Price Effect: The imposition of import quota raises the price of the commodities. This price rise is different from the price rise due to imposition of tariffs. The imposition of tariffs brings about the increase in price equal to the imposition of tariffs. But in case of import quota the price rise can take place up to any extent.

Difference between Tariffs and Import Quota.

Check Your Progress:

1. Define and explain the concept of non-tariff barriers.
2. What are the different types of import quotas?
3. What are the effects of import quotas?

13.8 Following are the difference between tariff and import quota:

1) **Rigidity** : Import quotas are more rigid than tariffs while tariffs are less rigid than import quota.

2) **Market forces** : In case of Import Quotas market forces can't work freely because import quota restricts the supply of goods while in case of tariffs there is no restriction so long as importer is ready to pay the tariff.

3) **Effect**: Import quotas produce direct effect while tariffs produce indirect effect through changes in price.

4) **Protective Device** : Import Quota act as absolute protective device. While tariffs act as a relative protective device in the sense that protection to domestic *industries* depends upon responsiveness of market forces.

5) **Price Changes**: Tariffs bring about changes in price up to the extent of price while in case of import quota there is no limit of changes in price i.e. import quota bring about changes in price up to any extent.

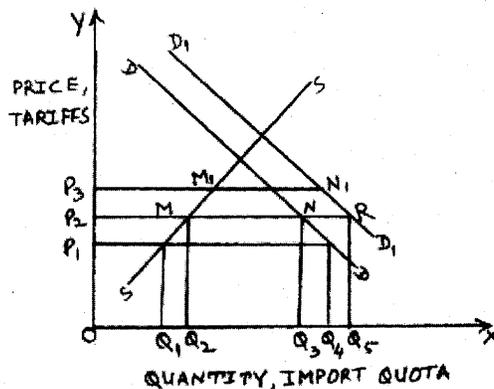


Figure 13.4

Along X axis quantity of a commodity (produced and imported) and import Quota are shown while along Y axis price and tariffs are marked. DD is the original demand curve and SS is the original supply curve. DID1 represents the shift in the demand curve. OP1 is the domestic price to start with at which OQ1 is the domestic production of a given commodity. At OP1 price domestic demand is OQ4. This marks the difference between domestic supply and demand. So as to meet the

difference between demand and supply ($D > S$) a country has to import $Q_1 - Q_4$ quantities of a commodity. Under these circumstances if a tariff is imposed to the tune of $P_1 - P_2$ it will enhance the price from OP_1 to OP_2 which will lead to enhance domestic production from OQ_1 to OQ_2 which will reduce the demand from OQ_4 to OQ_3 . Thus the difference between demand and supply will be reduced which in turn will lead to curtailment in the volume of imports from $Q_1 - Q_4$ to $Q_2 - Q_3$. Under these circumstances if the Government imposes import quota to the tune of MN then the price remains intact at OP_2 and the same amount gets imported ($Q_2 - Q_3$). Now let us allow market conditions to change. When the supply curve remains the same the demand curve shifts from DD to D_1D_1 price remains intact at OP_2 . But the volume of imports increases from $Q_2 - Q_3$ to $Q_2 - Q_5$. Under these circumstances if the import quota is imposed to the tune of M_1N_1 Price shoots up from OP_2 to OP_3 while the quantities of imports remain intact at the original levels. The distance between MN and M_1N_1 is the same. We can conclude from this that when tariffs are imposed the volume of imports gets changed but when Quota is imposed the volume of imports remains intact and the price shifts upward.

13.9 SUMMARY

1. The trade policy or commercial policy is meant, "All measures regarding all international economic transactions between the reporting country and the foreign countries."
Trade policies are of two types: Free Trade and Protection
2. Tariffs represent protective devices i.e. instruments of protection. Tariffs in international trade refer to the duties or taxes which are imposed on internationally traded commodities when these goods cross the national borders.
3. On the basis of origin and destination of the goods crossing the national boundary, Tariffs can be classified as under:
 - a) Import Duties,
 - b) Export Duties and
 - c) Transit Duties.
4. On the basis of the qualifications of tariff :
 - i) Specific Duties,
 - ii) Ad-valorem Duties,
 - iii) Compound Duties
5. With respect to the application of tariff between different countries :
 - i) Single columns Tariff,
 - ii) Double columns Tariff,
 - iii) Triple columns Tariff.
6. With reference to the purpose of the imposition of tariff:
 - i) Revenue Tariff,
 - ii) Protective Tariff,
 - iii) Countervailing and Anti-Dumping Duties.
7. Following are the effects of Tariffs:-
 - a) Price Effect
 - b) Protective Effect.

- c) Revenue Effects.
 - d) Consumption Effects.
 - e) Terms of Trade Effects.
 - f) Balance of Payments effects.
 - g) Income and Employment Effects
 - h) Transfer Effects or Redistribution Effects.
8. The Optimum tariff is a golden mean between the maximum and the minimum rates of tariffs to two extreme ends.
 9. To correct the deficit in the balance of payment the underdeveloped countries need to have direct controls like non-tariff barriers i.e. import quota and not the indirect controls like tariffs.
 10. 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.
 11. 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.

13.10 QUESTIONS

- 1) What do you mean by tariffs? Give a Classification of tariffs.
- 2) Write Short notes on:
 - i) Protective Tariffs,
 - ii) Revenue Tariffs.
- 3) Explain the various effects of tariffs?
- 4) Discuss optimum tariff.
- 5) What do you mean by non-tariff barriers? Examine the impact of NTBs on the exports of developing countries.
- 6) Why are NTBs regarded as more harmful than tariffs barriers to trade? Give a brief account of NTBs.
- 7) What do you mean by import Quota? Explain the different type of Quotas.
- 8) Explain the effects of Quotas.
- 9) Write short notes on :
 - i) Terms of trade effect of Quota,
 - ii) Difference between tariffs and Quotas.



14

FOREIGN EXCHANGE RESERVES

Unit Structure

- 14.0 Objectives
- 14.1 Introduction and concept of international cartels
- 14.2 Purpose of international cartels
- 14.3 Dumping
- 14.4 Introduction of Developing countries and UNCTAD
- 14.5 Developing countries and G.A.T.T.
- 14.6 United Nations Conference on Trade and Development (UNCTAD)
- 14.7 Functions of UNCTAD
- 14.8 UNCTAD – II
- 14.9 New International Economic Order (NIEO)
- 14.10 Declaration of NIEO by U.N. General Assembly
- 14.11 Program of action
- 14.12 Critical Appraisal
- 14.13 Problem and Prospects of Globalization in India and China
- 14.14 Summary
- 14.15 Questions

14.0 OBJECTIVES

- i) To study the meaning and concept of international cartels
- ii) To study the purpose, arguments in favour and against of international cartels
- iii) To study the concept of Dumping

- iv) To study the attempts made by UNCTAD for Developing countries
- v) To study the earlier attempts made by developing countries to achieve common goals
- vi) To study the formation and organizations of UNCTAD
- vii) To study the functions performed by UNCTAD
- viii) To study the functioning of the second meeting of UNCTAD
- ix) To study the formation of NIEO
- x) To study the declaration of NIEO by U.N. General Assembly
- xi) To study the program of action adopted by U.N. for NIEO
- xii) To study the critical appraisal of NIEO

14.1 INTERNATIONAL CARTELS

14.1.1 INTRODUCTION

Competition was the economic watchword of the 19th century. Both the economists and the political Scientists regarded competition as the spur to efficiency. Competition is a means and not an end in itself. The end of business activity is profit. Even though competition may be the invisible hand which safeguard the interest of the consumers, it jeopardizes profits.

Some producers and sellers may be able to escape from the most rigorous competition through the ownership of popular trade marks, the patents or natural monopoly. Competition doesn't seem to be the life blood of trade or the progress. Rather it proves to be ruinous hence it should be avoided as far as possible. Cooperation became the law of self preservation. Business agreements and combinations have thus evolved primarily for the purpose of limiting and even eliminating competition.

14.1.2 CONCEPT:

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.

Following are the principal activities of the international cartels:

- 1) Price Fixing

- 2) Limiting sales, output and exports.
- 3) Redistributing profits according to predetermined formula.
- 4) Allocating market territories.

Cartel doesn't interfere with the independence of the member countries. Complete autonomy is retained by the members in respect of production, finance, administration and labour policy.

Prior to World War I international cartels existed in industries dominated by a few large firms including shipping, armaments, steel rails, electric bulbs, aluminum calcium, carbide plate glass, enamel wares and bottles. Some of these cartels disintegrated during the war. But when peace was maintained they were soon rebuilt and many new ones were created affecting oil, steel, rayon, dyestuffs, diamonds and rubber.

14.1.3 Conditions conducive to International Cartels

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

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

14.2 PURPOSE OF INTERNATIONAL CARTEL

The main purpose of international cartel is to ensure their members higher profits than would be possible without agreement. They attain this objective by means of limiting competition i.e. by means of price control.

1. The most common device employed by international cartels to control price is the allocation of industrial fields and national markets. By the allocation of industrial fields one or more enterprises may be given the exclusive control over the supplies or certain designated commodities. The remaining members may be granted exclusive control of other articles
2. Even if the cartels give complete protection against foreign competition, the life *of the cartel is not usually permanent. The cartel agreement may be limited by the term of life.* Otherwise the cartel may collapse. The projective duties provide insurance against the collapse of the cartel.
3. The Cartel agreements are formulated on the basis of the commercial possibilities resulting from the protection afforded by

the existing tariffs. The removal or the substantial reduction of the existing tariffs may weaken or sometimes may lead to dissolution of international Cartels.

14.2.1 Arguments for Cartels:

1. Cartel agreements generally lower down the protection costs by abounding high cost firms and eliminating wasteful competition. This is one of the major arguments for cartels. However, cartelization doesn't produce such economically desirable results. High cost firms don't disappear under cartelization. On the contrary they become more secure because the aim of cartelization is to share the available business among all members. Cartels fix prices, which are mutually satisfactory to the members. This implies that the prices must be acceptable to the high cost members also.

2. Certain firms may not be able to compete with the foreigners even though they have built up their plants to the optimum size. In such a case, it will be advantageous to form cartels solely for foreign operations.

14.2.2 Arguments against Cartels:

The basic objection to the formation of international cartel is economic. In a freely competitive economic system the individual producers can increase his profit only through expanding his output, as he has no control over price. As against this a cartel restricts output and fixes high price in order to enlarge profits of its members. It impedes the entry of new firms. This obstructs the maximization of output. High prices curtail consumption. Therefore, expansion of the economy is not possible under cartelization.

International cartels also tend to restrict exports. This is the result of the allocation of market. It displaces one product with another or one market with another. How can there be overall expansion of exports?

International cartels usually fix higher price than the price under competition. These higher prices may have restrictive effects on the cartelized goods.

It is often charged that cartel members are more loyal to cartel than their respective countries covered by the agreement. Restrictions of these types are possible only when the commodities that come under agreement can be patented.

Alternatively, by the allocation of national markets a regional monopoly may be established for each of the participating firms. Frequently each firm undertakes not to sell even to those customers who are likely to export to the reserve territory. This method obviously restricts exports and the investment of capital

abroad. It also deprives consumers of imported commodities and consequently domestic prices shoot up.

2. Cartels may fail to eliminate all the competitors. A protective tariff gives protection against outsiders who do not cooperate with cartel. It also gives protection against those cartel members who undertake price cutting as a disciplinary device.

14.2.3 Status of International Cartels :

Cartels flourished in the pre 1939 Germany. The German Government gave its full support to various cartels dominated by German concern. German Govt. granted special legal status to the cartels and used them as instruments to maintain German exports. However, in Britain and USA there was an opposition to group monopoly. In order to see to it that the cartels flourish the Govt. must give at least its sanction.

14.3 DUMPING

According Prof. Viner dumping means price discrimination between different national markets.

It refers to sale of goods in foreign market at a price lower than the domestic market. It also means sale of goods in the foreign market at times even below the cost of production.

14.3.1 Kinds of Dumping:

Prof. Viner Classifies dumping into three main categories according to the duration of the dumping viz i) occasional ii) short run and iii) long run

i) Occasional Dumping : Occasional dumping means disposing occasional overstocks or remainders at the end of selling season which may be practically unsalable in the home market.

ii) Short run Dumping : Short run dumping exists from time to time for a short period of time. This is done for the following purposes a) in order to maintain connections in a market in which prices are for the time being unacceptable, b) To develop trade relations and to build up buyers good will, c) To eliminate competition.

iii) Long run Dumping : On the other hand means selling year in and year out at lower prices. This is also called as continuous dumping. Continuous dumping can take place under conditions of competition only when the Government or some other body grants a bounty on exports.

14.3.2 Conditions necessary for Dumping

If the dumping is to be carried on successfully it is absolutely essential that the dumped articles be prevented from being sold back into the domestic market i.e. there should be no see page of the commodity from the foreign market. Where it is sold at a cheaper price to the home market where the price is relatively high. It means that goods should be prevented from caring back to the exporting country. To prevent this difference between the prices at the two markets should be as far as possible minimum so that nobody will venture to sell back these goods.

The Second essential condition for the dumping to be successful is the existence of monopoly at home. If there is a perfect competition the average cost of production will be equal to the marginal cost of production. The marginal cost of production will be equal to the selling cost. Under these circumstances no seller would like to sell the commodity abroad without the export bounties. Under monopoly the average cost/marginal cost is lower than the selling cost. Consequently the monopolist can afford to sell the product abroad.

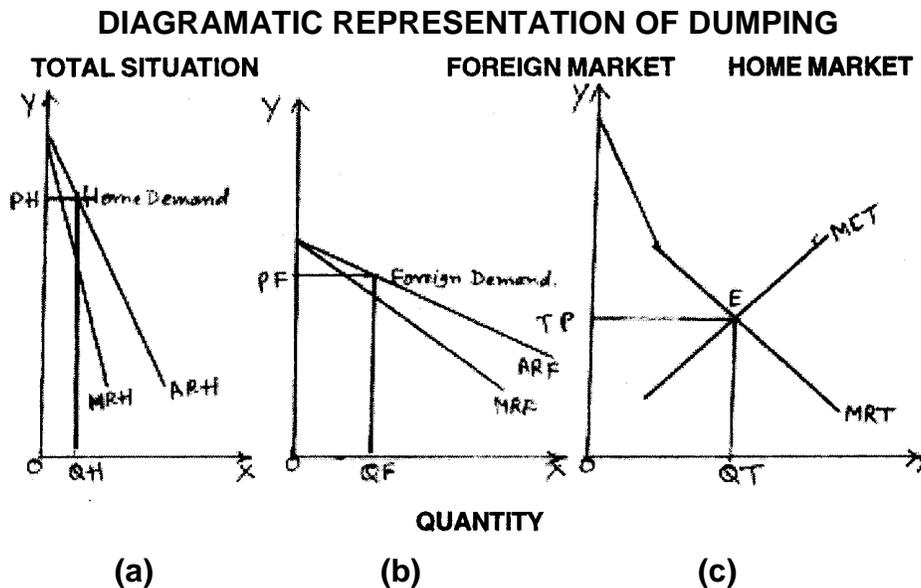


Figure 14.1

Diagram (a) represents Home Market. ARH+1 is the home demand curve, which is steeper, followed by a steeper Marginal Revenue Curve. OPH is the home price, which is higher than the foreign price. OQH is the home quantity of goods.

Diagram (b) represents foreign Market. ARF is the foreign demand curves, which in flatter followed by a flatter marginal revenue curve (MRF). OPF is the foreign price, which is lower than the home price (OPH). OQF is the foreign quantity of goods.

Diagram (c) represents the total situation. MRT represents the total Marginal Revenue Curve which is the combination of home Margin Revenue Curve (MRH) and Foreign Margin Revenue Curve (MRF). MCT represents the total Marginal Cost Curve. The intersection between MRT and MCT takes place at the point E and here OQT will be the total quantities of a commodity.

14.3.3 Effects of Dumping:

The Import of cheap commodities in the importing country benefits the consumers as they enjoy consumer's surplus. Sporadic dumping is dangerous and injurious to importing country in the sense that if dumping ceases then the producers in the importing country cannot adjust their production because now they will have to incur huge cost of production. The consumers will also stand to lose their consumer's surplus.

As regards exporting country dumping temporary provides a hand hit as the country has to sell the goods in the foreign market below the price prevailing in the domestic country and at times even below the cost of production but in the long run it benefits the whole country because the market gets captured and the foreigners go on importing the goods even at a higher price.

14.3.4 Measures against Dumping:

Under pressure from import competing firms the Governments of the importing countries after start levying anti-dumping tariffs. Such duties are sanctioned under International Antidumping code signed by the member countries of GATT in 1967, which averts dumping.

The importing countries even resort to competitive dumping or what is rightly called as Retaliatory dumping. They follow Tit For Tat Policy.

Check Your Progress:

1. What do you mean by the concept international cartels?
2. Examine the arguments in favour and against international cartels.
3. What are the various kinds of dumping?
4. State the essential conditions for dumping.
5. Explain the effects of dumping.

14.4 DEVELOPING COUNTRIES AND UNCTAD

14.4.1 INTRODUCTION:

The world gets divided into two viz. the Developed and the Developing countries. As per Prof. Higgins the world get divided into DCs and the LDCs on the basis of per capita income. All those countries having per capita income more them \$500 are designated as DCs while all those countries having per capita income below \$500 are referred to as underdeveloped countries. The underdeveloped countries are also called as 'South' as they are in the Southern Part of the World. These countries are also called as Third World Countries' The First World comprised of the DCs. The Second World Comprised of USSR and other Socialist and Communist Countries. The Third World Countries are the developing countries. The Third World Countries are also called as 'poor' or 'backward' countries. Since these underdeveloped countries are under the process of economic planning these countries get referred to as 'Developing Countries'. The developing countries are the capital hungry countries. Capital is not only scarce in these countries but it is also shy. Capital is shy in these countries because it hesitates to come forward to get invested in venture projects where risk and entrepreneurial Zeal get involved. These countries are late comers in the field of industrialization. However industrialization is a must for stepping up the rate of economic development.

The developing countries cannot switchover to the policy of free trade as these countries suffer from poor technology and low capital. These countries have special reasons to adopt the policy of protection.

1) The underdeveloped countries have got infant industries due to lack of industrialization. These industries can't stand on their own legs hence they need support. Hence in these countries the infant industry argument assumes greater importance than the developed countries. Since there is a inherent tendency on the part of these industries to remain all the while infant to claim protective benefits even after attaining adulthood therefore selective or discriminatory protection happens to be the remedy for the industrial growth of the developing countries.

2) The developing countries are the agricultural countries. Their economies cannot be developed at the desired speed unless protection is granted to number of prospective enterprises. As per A.C. Pigou the case for protection with a view to building up productive power is strong in any agricultural country which seems to possess natural advantages for manufacturers. In order to allow

backward agricultural countries to develop their industrial potentialities rapidly, foreign competition should be minimized through protection.

3) The underdeveloped countries are the primary producing countries. They are the exporters of primary products for which the demand of the foreign countries is elastic. Hence as per the reciprocal demand theory of terms of trade of U.S. Mill the terms of trade all the while remain unfavourable. When the developing countries productive resources go out of country their domestic industries starve. Hence in order to conserve the precious natural resources these countries should adopt the policy of protection.

4) The developing countries suffer from balance of payments deficits due to excess of import over exports. Hence by adopting the policy of protection import should be curtailed on the one hand through tariffs and non-tariff devices and on the side of exports the policy of import substitution and export promotion should be adopted to bring about balance of payments adjustment.

5) Besides protection tariffs also act as a revenue device. Government of the developing countries are welfare oriented governments. Besides obligatory functions these government cater to the developmental and welfare oriented function like undertaking economic planning, Poverty alleviation, provision of infrastructural facilities, economic development etc. So as to cater to all these functions the governments of these underdeveloped countries need revenue. Additional revenue can be obtain through imposition of tariffs.

6) The per Capita income of these countries is very low. As per the vicious circles of poverty per capita income being very low savings and investment happen to be very low. Therefore capital formation remains very low. Majority of these countries have not yet attained the third and the most important stage of economic growth i.e. take off into self, sustained economic growth. It is due to demonstration effect that the MPM i.e. the marginal propensity to import of these countries remains very high. Hence import restriction become inevitable which calls for the adoption of the policy of protection.

7) Most of the underdeveloped countries are undergoing planned economic development. Economic planning implies control, regulation of economic activity of the economy to achieve the desired macro economic goals. The policy of protection becomes inevitable to achieve the desired targets and goals of economic planning

14.5 DEVELOPING COUNTRIES AND G.A.T.T.

The developing countries couldn't get a fair deal from G.A.T.T. One of the objectives incorporated in the Articles of G.A.T.T. was MFN i.e. the Most Favoured Nations Clause. As per MFN all the member countries of GATT were treated equally without any discrimination between the developed and the developing countries. Though the economic status of DCs and LDCs were different they were treated on par which was unjustifiable i.e. though there was equality there was no equity. From the equity point of view the underdeveloped countries should have been given some concessions or reservations.

As a matter of fact the developed countries took the advantage of the various loopholes of the rules and regulations of GATT in terms of adopting number of non-tariff barriers to restrict their imports viz. MFA, VERs etc. which affected the developing countries exports.

14.5.1 EARLIER ATTEMPTS MADE BY THE DEVELOPING COUNTRIES TO ACHIEVE COMMON GOALS

With an urge to achieve common goals the developing countries made a firm beginning in 1955 by organizing the Asian African conference in Bandung, Indonesia. It was organized by Prime Ministers of India, Burma, Ceylon, Indonesia and Pakistan. The Representatives of 29 countries gathered there to discuss mainly political independence. However, the meeting gave importance to a number of principles for economic cooperation which were to form the basis for the demands of the developing countries. One of the proposals accepted in the meeting was stabilization of prices of the raw material and increasing processing of the raw materials in the developing countries.

The second attempt towards co-operation among the developing countries was made in 1961. With the initiative taken by world leaders, like Nehru, Nasser, N Kruman, Tito and Sukarno a conference of the third world countries was convened at Belgrade, Yugoslavia mainly to discuss the political status of the developing countries in the midst of cold war that was going on between the western block led by the United States and the Communist block led by USSR during 1960s. However the conference pave the way for the adoption by the U.N. a program for economic development of the Third World Countries. Following this 1960s was designated as the first development decade with a target of at least 5% p.a. growth rate in the developing countries. This marked a change in the character of U.N. from international security system to an organization giving importance to economic matters as well. The world Bank was supplemented by establishment of special agency called IDA i.e. the International Development Association in order to help the developing countries with development credit on easy terms.

14.6 UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT (UNCTAD)

As has already been pointed out that due to MFN and many other things the developing countries were greatly dissatisfied with the working of GATT. Though GATT had made a very significant contribution to the liberalization of international trade it failed to reduce the trade gap of developing countries. Hence UNCTAD was created.

The first United Nations Conference on Trade and Development (UNCTAD) was held in March 1964 in Geneva. It was an ad-hoc gathering of representatives of about 120 countries which were members of the United Nations. It marked a turning point in international economic relations. With the establishment of UNCTAD a new era commenced in the evolution of world trade and development. It represented the first major endeavour to examine all the problems of international economic relations with special reference to the needs of the developing countries.

14.6.1 ORGANIZATION:

The UNCTAD is established as a permanent organ of General Assembly of the United Nations. It has its own subsidiary bodies and also a full time secretariat to serve it. It has a permanent organ called Trade and Development Board as the main Executive Body. The Board functions between the plenary sessions of the conference. It meets twice a year. It is composed of 55 members elected by the conference from among its members on the basis of equitable geographical distribution.

The Trade and Development Board has four subsidiary organs to assist it in the performance of its functions viz.

- i) The committee on Commodities,
- ii) The committee on Manufactures,
- iii) The committee on shipping
- iv) The committee on Invisible Items and Financing related to Trade

Generally these committees meet annually. However, they may be called for special session in order to consider urgent matters.

14.7 FUNCTIONS OF UNCTAD

The main intention of the conference was to assist the developing countries in achieving accelerated economic development by helping them to control economic forces.

The main functions of UNCTAD are as follows-

- 1) To promote international trade all over the world between the developed and the developing countries with different socio-economic systems and thus to accelerate economic development.
- 2) To formulate principles and policies regarding international trade and related problems of economic development.
- 3) To make proposals for putting the said principles and policies into effect.
- 4) To review and facilitate the co-operation of activities of the other institutions within the U.N. System in the field of international trade.
- 5) To be available as a center for harmonious trade and related documents in development policies of Governments.

The third step in the direction of co-coordinating the Third World Countries was taken by the U.N. which led to the establishment of United Nations conference on Trade and Development which was held in Geneva. It was attended by 77 representatives from the developing countries. It was called as UNCTAD-1. It set the pattern of subsequent international conferences. The UNCTAD-1 mainly aimed at facilitating the sale of primary commodities in the markets of the industrialized countries. This naturally led to the acceleration of the developing countries as a whole. The UNCTAD-1 adopted a Final Act which was mostly in favour of the developing countries. There was a general opposition from the developed countries to the Final Act. The 77 representatives of the developing countries, called the Group of 77 insisted on the strategy for increased integration of the world economy at subsequent conferences. However, many developed countries voted against the proposal of UNCTAD-1. But the UNCTAD became a permanent institution with its headquarters at Geneva. It was decided to convene the UNCTAD conferences once in four years. Since 1964 various UNCTAD conferences were convened at various places which are as follows-

- 1) UNCTAD -I Geneva (Switzerland) 1964
- 2) UNCTAD-II New Delhi (India) 1968
- 3) UNCTAD - III Santiago (Chile) 1972
- 4) UNCTAD - IV Nairobi (Kenya) 1976
- 5) UNCTAD - V Manila (Philippines) 1979
- 6) UNCTAD - VI Belgrade (Yugoslavia) 1983
- 7) UNCTAD - VII Geneva (Switzerland) 1987
- 8) UNCTAD - VIII Cartagena (Colombia) 1992
- 9) UNCTAD - IX Midrand (South Africa) 1996

14.8 UNCTAD-II

The second meeting of UNCTAD was held in New Delhi (India) from February 1 to March 28 1968. This session had a very ambitious agenda to confront the problems of the developing countries and other major issues relating to World Trade and development. The broad objectives of the conference were as follows-

- 1) To reappraise the economic situation and its implications in implementing the recommendations of the UNCTAD-I
- 2) To achieve specific results by initiating appropriate negotiations which ensure real progress in international co-operations for development.
- 3) To explore and investigate matters requiring through study before fruitful agreements can be envisaged.

During UNCTAD-II several aspects of trade preferences and concessions were discussed.

The conference reaffirmed that for prosperity as a whole, a generalized, non-reciprocal and non-discriminatory system of preferences in favour of the LDCs should be implemented as soon as possible Which" would assist them in increasing their export earning and to contribute to accelerate the rate of economic growth. The export earnings of the LDCs should be augmented through liberalization policy adopted by the developed countries.

The final resolution of the conference stressed that a mutually acceptable system of generalized, non-reciprocal and non-discriminatory preferences beneficial to the developing countries should be immediately established. It is popularly known as the Generalized Scheme of Preferences the following were the objectives of the said schemes-

- i) To increase export earnings of the less developed countries.
- ii) To promote their industrialization.
- ii) To accelerate their rate of economic growth.

To meet all these the conference established a special organ of i.e. Trade and Development Board which was to pay special attention to this matter.

During the conference the developed nations reaffirmed their desire to transfer at least 1 % of their GNP resources to the developing countries through their all programs. The developed countries also agreed to provide concessional terms of official lending and to liberalize the terms of international lending and finance. The delegate of the socialist nations in the conference favoured the stimulations of export earnings by the developing countries rather than the concessions by the developed nations. As regards commodity agreements it was decided that the conference should be convened before June 1968 to evolve an

international agreement on cocoa. Similarly it was laid down that the Sugar Agreement should come into operation before January 1969. In case of other commodities the conference suggested that this matter be studied further.

The less developed countries urged at the conference that the advanced countries should remove all trade barriers in their markets to the entry of poor nations commodities in primary, processed or semi-processed forms. But no due attention was paid to this Plea.

The conference did not deal with the possibilities of agreed solution to the problem of prices, trade liberalization and increased access to the markets of advanced countries for the primary products exported by the less developed countries. The resolution of the conference merely asked the Trade and Development Board to follow the activities of the existing commodity groups with a view to promoting international co-operation in this matter.

The Conference urged that the socialist countries should expand and diversify their trade with the developing countries by according special preferences to the products of these countries. The permanent machinery of UNCTAD was entrusted with the responsibility of promoting trade relations between socialist and developing nations.

The conference also stressed the need for trade expansion and economic integration among the developing countries. The rich countries declared support to the integrated endeavors of the poor countries by rendering them financial and technological help. Similarly the poor countries consented for the mutual economic integration and trade expansion among them. The conference entrusted the work of dealing with certain unsettled issues in this regard to a subsidiary body on the Trade and Development Board. The New Delhi session of UNCTAD could not make any significant achievements and concluded with disillusionment. Most of the problems facing the conference remained unsolved, as there was no consensus on them.

Some European Countries have however, given some concessions and facilities under the G.S.P. especially to export of manufactured and semi-finished goods produced by the LDCs. Through the ECM countries rendered some facilities to developing countries under GSP, it didn't serve any good purpose under the import quota system adopted by them. As a result no fair and free trade possibilities remained open for the developing countries in the European Common Market.

The U.S. didn't do much in this regard. On the Country it imposed 10% surcharge on their imports from the developing

countries in order to save from the dollar crisis due to which the developing countries exports suffered a lot.

IN short UNCTAD-II though hopeful, had remained unsuccessful in achieving its goal.

Check Your Progress:

1. Why Third World countries require protection in their process of development?
2. Why UNCTAD was formed?
3. Explain the functioning of the second meeting of UNCTAD.

14.9 NEW INTERNATIONAL ECONOMIC ORDER (NIEO)

14.9.1 INTRODUCTION:

There was a strong feeling that the post second world war international Trading monetary, financial, institutional and other resource transfer system and the development pattern have been prejudicial to the interests of the developing countries in relation to the developed countries that led to the demand for New International ECONOMIC ORDER (NIEO).

The Bretton Woods was designed to solve mainly the problems of the developed countries to reconstruct and rehabilitate the war shattered economies. The economic interest needs, demands and special problems of the developing countries were largely ignored. In spite of subsequent changes, the existing order and the mechanism did not improve the economic conditions to the desired extent of most of the developing countries. The vast majorities of population of the developing countries live in utter poverty, chronic unemployment, under employment and disguised unemployment. The call for a new international economic order was due to dissatisfaction of the underdeveloped countries with the old international economic order.

Many of the underdeveloped countries didn't get independence when the Bretton woods systems was established in 1945. Most of the developing countries got independence after the establishment of IMF and IBRD.

The movement for the establishment of the NIEO is caused by the existing deficiencies in the current International Economic order and the gross failure of the GATT and the UNCTAD in the fulfillment of their objectives.

The present international economic order was found to be asymmetrical with units working. It was biased favouring the advanced countries. There was an overdependence of South on North. The developed countries tend to have major control over vital decision making in matters of international trade, terms of trade, international finance, aids and technology.

14.10 DECLARATION OF THE NEW INTERNATIONAL ECONOMIC ORDER BY THE U.N. GENERAL ASSEMBLY ON 1st May 1974.

The problems of the developing countries having been already examined in various UNCTAD conferences and other international meetings the U.N. took up the issue by convening a special session of the General Assembly to study for the first time the problems of the raw materials and development. The following declaration was made by the special session of the General Assembly on 1st May 1974.

"We the members of the United Nations, Having Convened a special session of the General Assembly to Study for the first time the problems of the raw material and development, devoted to the consideration of the most important economic problems facing the world community.

Bearing in mind the spirit purposes and principles of the charter of the United Nations to promote the economic advancement and social progress of all people.

Solemnly proclaim our united determinations to work urgently for the establishment of New International Economic Order based on equality. Sovereign equality, interdependence, common interest and co-operation among all states irrespective of their economic and social systems which shall correct inequalities and redress existing injustices, make it possible to eliminate the widening gap between the developed and the developing countries and ensure steadily accelerating economic and social development, peace and justice for present, future generation.

The abstracts of the declaration made by the U.N. General Assembly are given below:

- 1) Although independence from colonial and alien domination has been achieved by many countries in the 40's and 50's the

benefits of technological progress are not equitably shared by all member of the international communities. The developing countries which contribute 70% of the world's population account for only 30% of the world's income. The existing international economic order has created a great imbalance in the development of the developed and developing countries.

- 2) The developing world has become a powerful force, both economically and politically and is able to create a powerful impact on all fields of international activities. As such the developing countries need to participate in the decisions and policies that concern the international community.
- 3) With increasing interdependence in the world order, current events have proved the fact that the interests of the developing countries are to be safeguarded.
- 4) The developing countries and the developed countries can no longer be isolated. International Co-operation for development is to be shared by all the countries.
- 5) The NIEO is to be established on the following principles-
 - A) Sovereign equality and independence of all member countries.
 - B) Effective participation of all countries in solving the global economic problems with particular reference to the developing countries.
 - C) Highest degree of Co-operation amongst the member Countries to ensure economic prosperity for all.
 - D) Every country to have its own appropriate social and economic system without the risk of any discrimination from outside.
 - E) No economic or political coercion on a state from any other state with regard to the utilization of the natural resources by the former.
 - F) Restitution and full compensation to ail states which are under colonial or alien rule for loss or exploitation of natural resources while under alien rule.
 - G) Regulation of and supervision of Multinational Corporations.
 - H) Liberation of countries under Alien rule or domination so that they can give shape to there economies.
 - I) Preferential and nonreciprocal treatment for developing countries.
 - J) Improving the terms of trade between the developing and the developed countries.
 - K) International assistance to developing nations without and political or military implications.

- L) International monetary system to aim at helping the development process of developing countries.
 - M) Securing favourable conditions for transfer of financial resources to developing countries.
 - N) Enabling the developing countries to have access to the benefit of and transfer of modern science and technology of the developed countries.
 - O) Strengthening the mutual co-operations between the developing countries at the individual and collective levels.
 - P) Producers associations to help in the sustained growth of the world economy and accelerating the development of the developing countries.
- 6) The unanimous adoption of the international development strategy for the second United Nations Development Decade.
 - 7) The UN as an Universal Organization must have a greater role in the establishment of NIEO.
 - 8) The present declaration on the establishment of NIEO shall be one of the most important basis of economic relations between all people and all states.

14.11 PROGRAMME OF ACTION:

On the basis of the above principles the UN General Assembly adopted a program of action in order to implement them gradually and within a specified period. The introductory part of the UN General Assembly resolution made in this connections says "with a view of ensuring the application for the declaration of the establishment of the New International Economic order, it will be necessary to adopt and to bring about maximum economic co-operation and understanding among the state particularly between the developed and the developing countries, based on the principles of dignity and sovereign equality" (Resolution 3201 S-VI)

All the order resolutions made in this connection were with a focus on improving the lot of the developing countries with reference to their exports and terms of trade, food position, transport and insurance, their machinery system and developmental finances, their programs of industrialization, transfer of technology etc. various measures also have been suggested to promote international co-operation to enable the developing countries to achieve higher levels of development and welfare.

The resolution has suggested the following special measure by way of assistance to developing countries.

- 1) Special arrangements on particularly favourable terms of trade and conditions including possible subsidies for and assured supplies of essential commodity.

- 2) Deferred payments for all or part of imports of essential commodities.
- 3) Commodity assistance including food aid on a grant basis or deferred payments in local currencies bearing in mind that this should not adversely affect the exports of developing countries.
- 4) Long term supply of credit on easy terms.
- 5) Long terms financial assistance on concessionary terms.
- 6) Drawing from special IMF facilities on concessional terms.
- 7) Establishment of a link between the creation of special drawing rights and development assistance, taking into account the additional financial requirement of the most seriously affected countries.
- 8) Debt re-negotiations a view to concluding arrangements on debt cancellation moratorium or rescheduling
- 9) Provision of more favourable terms of capital goods and technical assistance to accelerate the industrialization of the affected countries.
- 10) Investment in industrial and development projects on favourable terms.
- 11) Subsidizing the additional transit and transport costs, especially of the land-locked countries.

A Common Fund was created for enabling the developing countries to enter into commodity agreements with developed countries. There was also a remarkable change in the relationship between UNCTAD and GATT which represents the interests of the industrial Countries

14.12 CRITICAL APPRAISAL:

1) Referring to the opinion of leading spokesman of UN, Anell and Nygren in their book entitled, "The developing countries and the world Economic Order State", the leading spokesman for the developing countries have made it clear that international conferences, should only make recommendations about interstate relations while each sovereign state will decide its own internal affairs".

Stressing the need for greater international economic co-operation, Home and Masson state "A more ambitious form of co-operation is policy co-ordination which can be of two types. First, Ad-hoc or episodic co-ordination characterised by discussion among the interested parties. Second institutionalized co-ordination or centralized decision making. The essence of all provisions of the NIEO is greater co-operation among countries". Aziz AN Mohammad emphasizes the linkages between the developed world and the developing world in terms of trade policies, global markets, exchange rates, fiscal policies and real interest rates. He points out

that the developing countries do contribute to the exports and growth of exports to the developed countries.

The bitter experiences of increased protectionist policies and consequent retaliatory measure, resorted to by countries during 1960's and 1970's should have made them understand the need for co-operation through policies of co-ordination at the world level.

2) The NIEO not only indicates the equitable distribution of income within each developing country, ensuring fulfillment of basic needs to all the people. This was stressed in the World Employment Conference of the ILO in 1976. The basic needs as stressed by the conference include food, clothing, traveling, housing, health, drinking water, education and power. It implies that even if resource transfer from the developed countries to the developing countries are effected through NIEO programmes. Governments of the developing countries will have to undertake income distribution programmes through appropriate fiscal and social measures. Otherwise international resources transfer will have no meaning.

3) Whatever be the claims of the developing countries, international agreements cannot be made in a manner which forces the donor countries to sacrifice their sovereignty and economic independence. But the demands of the developing countries will definitely affect the internal affairs of the industrialized countries and this may force the latter to put up resistance to the very principle of NIEO.

4) Transfer of technology from the developed countries raise two points of controversies.

i) The transfer of technology can never be costless.

ii) Whether the developing countries will be in a position to assimilate such advanced technologies of the industrialized countries.

5) With regard to commodity agreements involving higher prices for commodities of the developing countries, a question is raised as to what extent such price rise would benefit the farmers and labourers of these countries.

6) A controversy is raised in relation to the overall UN Resolutions of 1974. Are there Resolutions equally applicable to all the developing countries? All the developing countries are not alike. Some countries like Singapore, India have achieved higher rate of growth while some are poorest of the poor. As such when a benefit is extended by an industrialized country, the extent of the flow of benefits will not be equal to all the developing countries.

7) The Industrial Countries cannot maintain the consistency of assistance to the developing countries when they too face the serious internal problems.

Looking at some of the controversies we are tempted to think that the prospects of NIEO are somewhat shaky. However the situation is not completely hopeless. The world is witnessing a new awakening on the part of the industrially advanced countries on the need to take the developing countries along with them.

Check Your Progress:

1. What are the demands of the developing countries?
2. Critically examine the functioning of NIEO.

14.13 PROBLEMS AND PROSPECTS OF GLOBALIZATION IN INDIA AND CHINA

Most of the global economies have chose to turn their economic systems towards the market economy and global economy. These countries include Eastern European countries, Vietnam, Peru, Mexico, Brazil, India, Ethiopia, Morocco, Chile, Spain, Cuba etc. India had observed these development in the global economies and responded favourably to these changes in 1991.

When most of the world markets were open for the rest of the globe, the advanced countries dumped their goods in these countries. The initial expectations were made them to increase the production. Almost all the advanced countries did not view that the population of the third world has a desire to consume, but they do not have the ability to buy the foreign goods. This mistake led to the first setback to the process of globalization.

Multinational companies, consequent upon globalization virtually killed the small industry in developing countries particularly in India. Many small scale industrial units were closed and the industrial estates in the country turned into graveyards. Even the sick, large and medium scale industrial units were forced to close. A number of large scale companies reduced their manpower either through VRS or through retrenchment. Banks and a number of Public sector

Units have also taken measures for cutting down staff through VRS.

14.13.1 Impact on India and China:

The critics of the present scenario of globalization recall the East Asia crisis during 1997-99. The sudden devastation to the economies of ASEAN in 1997 setback its standing and its capability to play an international role. Thailand and Indonesia accepted IMF rescue packages with conditions.

East Asian's crisis indicates that the hasty process of globalization and the imposition of the conditions unsuitable for the country are the causes for the negative impact of globalization.

China would be a threat to many developing countries including India in the near future. A recent report of the Government of India indicates that China's competitiveness is not a myth built on cheap labour, but the result of far sighted planning. China managed to increase its per capita income by seven times and its GDP by four times during 1978 to 2000. China is the first in the world in the production of corn, cotton, meat, charcoal, chemical fibre, yarn, cloth, cement, steel, colour T.Vs and Digital control panels. It stands second in the power generation and the production of fertilizers.

Several transnational companies realised that not participating in China's economy is like not participating in the world economy. These companies include : GE, Cisco, Motorola, Intel, IBM, and Kodak. Around 200 transnational companies entered China to get benefit of:

- Cheap labour
- Freedom to hire and fire
- Low taxes
- Flexible labour laws
- Higher labour productivity
- Low priced power
- World class infrastructure
- Little fear from strikes
- Political systems committed to reforms

One of the factors responsible for the higher growth of foreign exchange reserves of China is the high rate of inflow of foreign direct investment.

India and China experienced similar problems at the time of the introduction of economic reforms. But China could implement the reforms at a faster rate than India because China implemented unpopular steps like compulsory retirement / retrenchment of employees. China provide safety net to workers much before privatisation of government undertakings. The domestic investors invested in infrastructure projects in China. China closed more than 1,000 branches of banks which were unprofitable.

14.13.2 Sequence of reforms in china:

The First Phase (1978-1993)

Economic reforms in China began with reforms in agricultural and rural development

- 1978 : Dismantled the Rural people's Communes and allotted land reforms on long-term contract, with right of inheritance.
Adopted 'Dual Track Pricing Mechanism', under which agents were permitted to sell part of the produce in the open market.
- 1979 : Special economic Zones (SEZs) set up in Shenzhen, Zhuhai, Shantou, and Xiamen to attract FDI.
Foreign players allowed to make own investment-production and marketing-decisions in these zones.
Flexible labour laws introduced in these zones.
- 1984 : Free Trade Zones opened in 14 port cities along the North and South-Eastern coast and Hainan island
- 1985 : State monopoly on purchase and marketing of grains, cotton etc. replaced by a system of contract purchase
Agriculture products allowed to be bought and sold freely
State subsidies on agricultural products totally withdrawn
- 1987 : Contract system introduced among all newly recruited workers in state owned enterprises
- 1988 : Made Hainan island a separate province and a declared the whole island a Special economic Zone
- 1991 : Direct subsidies to exporters stopped
- 1993 : Central Bank of China given greater powers; influence of local governments over monetary and credit policies reduced

The Second Phase

- 1994 : A single VAT of 17 per cent introduced in place of a host of indirect taxes. Share of national and local governments changed to 75:25
- 1995 : large scale privatisation of loss making SOEs. Lay-off begin

- 1996 : current account convertibility allowed and averaged customs duty reduced from 36 percent to 23.4 percent
- 1997 : Launched programme to convert large industrial enterprises into conglomerates while releasing others
Bureaucracy streamlined to reduce the number of officials by half
- 1998 : Grain distribution system reformed, new channels for capital circulation opened, housing commercialised and a medicare programme introduced
- 1999 : Recapitalisation of national banks started by creating four asset management companies
- 2000 : Two government bonds issued to finance the government's infrastructure activities

Private Individual Wholly Invested Enterprise Law brought into effect Individuals allowed to set up private companies and tap the capital market

Indian industries does not have much to show its efforts towards globalization except its success in software projects. But Chinese consumer durable industry like Haier, Galantz, TCL and Konka are exporting to Asia and Europe with these phenomenal developments. China poses a threat to India not only in the Indian market, but also in the foreign markets

14.13.3 Economic Reforms in India

The First decade (1991-2001)

1991 : New Industrial policy announced

Foreign investment up to 51% in select industries allowed

PSU reserve list cut from 17 to 8

FII's allowed to invest in market

PSUs brought under SICA

1992 : Steel industry decontrolled

Wealth tax abolished

Free pricing of IPOs allowed

100% private equity in core sectors like steel, telecom and power permitted

Five year EXIM policy announced

1993 : Companies Act amended

Rupee made convertible on trade account

Excise duty simplified by merging special and basic duty

1994 : Private telcos allowed to compete with state owned COS

Lending rates deregulated

Automatic approval announced for foreign investment upto 51%

Rupee made convertible on current account

Drug industry delicensed

1995 : Modified carry forward trading system allowed

Insurance regulatory body mooted

1996 : 74% foreign equity in 9 industries, and 51% in 16 more permitted

1997 : Coal sector privatised

Maximum income tax rate cut to 30% and corporate tax to 35%

Restrictions on import of 69 goods lifted

New takeover code approved

1998 : New prudential norms for NBFCs notified

FII investment in treasury bills cleared

FDI norms under automatic route simplified

Trading in derivatives by FILLs cleared

Norms on foreign equity participation in airline sector overhauled

100% FDI in cigarettes allowed

74% foreign equity cap announced for TV software firms

Up to 40% FDI in private banks allowed

ISP policy frees tariffs, allows private gateways

Insurance, patent reforms cleared

1999 : IT ministry launches a Rs. 100 cr VC fund for start ups

IRDA (Insurance regulatory and development) bill passed

Foreign Exchange Regulatory Act replaced by the Foreign Exchange Management Act

Department of Disinvestment created to oversee privatisation of public sector enterprises

Excise rate slab cut from 11 to 3-8%, 16% and 24%

2000 : VC cos. made exempt from income tax as well as dividend tax

Rs. 150 cr. R and D fund set up

Minimum daily requirement for maintaining cash reserve ratio balances slashed from 85 to 65%

Inter-bank gold trading by banks allowed

Scheduled commercial banks allowed to float insurance subsidiaries

Special economic zones to be created with 100% foreign equity

Quantitative Restrictions (QRs) on 714 tariff lines at the 8 digit level lifted

Single window clearance for import of capital goods at a flat rate of 5% announced

Indian industry has to meet the competition of Chinese industry. There are three options to India. They are:

- Collaboration with China by forming regional trade block on the lines of ASEAN.
- Collaborate with USA / Japan, acquire competencies and meet the competition.
- Collaborate with some of the industries of other countries.

Thus the current issue of international business of India is the threat from China. Indian industry should take this threat as an opportunity, learn from China and build up the strategic competencies. India will have a tough time, with China joining the WTO.

India has been making efforts to have close business and economic ties even with its enemy country, i.e. Pakistan, in order to improve the business in the region. India's efforts to arrange the Agra Summit is the proof for this, though the Summit did not yield the expected results.

Indian Government in line with its commitments to WTO lifted quantitative restrictions on the import of 715 products with effect from April 1, 2001. The effect of this measure is viewed as follows :

- Consumers will get foreign products at less price with high quality
- Consumers will have a wide range of choice
- Affects the Indian business adversely in the short run
- Indian business firms will enhance the quality, offer the products at less prices or on par with the imported products

However, QRs have not yet significantly affected the Indian business. In addition, there is no significant change in the volume, variety of products and direction of imports after April 1, 2001.

These recessionary trends even made the IT companies to take appropriate measures like even pricing the e-mail services.

Check Your Progress:

1. Explain the process of reforms in India.
2. Explain the process of reforms in China.

14.14 SUMMARY

- 1) The Third World Countries are the developing countries. The Third World Countries are also called as 'poor' or 'backward' countries. Since these underdeveloped countries are under the process of economic planning these countries get referred to as 'Developing Countries'.
- 2) The developing countries couldn't get a fair deal from G.A.T.T. As per MFN all the member countries of GATT were treated equally without any discrimination between the developed and the developing countries. From the equity point of view the underdeveloped countries should have been given some concessions or reservations.
- 3) With the establishment of UNCTAD a new era commenced in the evolution of world trade and development. It represented the first major endeavour to examine all the problems of international economic relations with special reference to the needs of the developing countries.
- 4) The second meeting of UNCTAD was held in New Delhi (India) from February 1 to March 28 1968. This session had a very ambitious agenda to confront the problems of the developing countries and other major issues relating to World Trade and development.
- 5) The movement for the establishment of the NIEO is caused by the existing deficiencies in the current International Economic order and the gross failure of the GATT and the UNCTAD in the fulfillment of their objectives.
- 6) The prospects of NIEO are somewhat shaky. However the situation is not completely hopeless. The world is witnessing a new awakening on the part of the industrially advanced countries on the need to take the developing countries along with them

14.15 QUESTIONS

- 1) Give an account of International commodity agreements,
- 2) Write short note on:
 - a) International Cartels,
 - b) Dumping.
- 3) Discuss the developing countries trade under GATT and UNCTAD.
- 4) Discuss the issue of 'underdeveloped countries and the policy of Protection.
- 5) What do you mean by UNCTAD? Discuss the functions of UNCTAD.

- 6) Write short note on :
 - i) UNCTAD-II
 - ii) Underdeveloped countries and UNCTAD.
- 7) Explain how the NIEO is biased against the developing countries.
- 8) Discuss the need for New International Economic Order
- 9) Write short notes on
 - i) NIEO
 - ii) Demands of the developing Countries.
- 10) Discuss the problems and prospects of globalization in India.
- 11) Discuss the problems and prospects of globalization in China.



Syllabus**M.Com. Part – I**

Economics of Global Trade and Finance
(With effect from 2009 – 2010 for IDE students)

Module 1: BOP Adjustments

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).

(12 Lectures)

Module 2: Economics of Integration

Types of integration (EU, NAFTA, APEC and ASEAN).

SAARC: Achievements and Future Prospects; Regionalism Vs Multilateralism.

(12 Lectures)

Module 3: WTO and Global Economy

Implications of WTO Agreements for Developing Countries – Contentious Issues – Disputes Redressal Mechanisms – Critical Appraisal of WTO.

(10 Lectures)

Module 4: Foreign Exchange Market :

Flexible Exchange Rate – Spot and Forward Exchange Rate, Interest Rate Arbitrage – Currency Convertibility – Significance of Foreign Exchange Reserves – Exchange Risks – Global Linkage of Foreign Exchange Market.

(10 lectures)

Module 5: International Monetary Fund and Capital Flows

Changing Role of IMF since 1990 with reference to International Liquidity and Critical Appraisal – International Capital Movements – International Flows of Portfolio Capital ; Role and Impact – Foreign Capital and Development – Emerging Economies and Capital Flows.

(10 lectures)

Module 6: Currency Markets

Nature and Characteristics – Euro Currency, Euro Equity and Euro Bond Markets – Currency Areas – Common currencies and European Monetary Union – International Financial Integration with respect to European Union.

(12 Lectures)

Module 7: Emerging Issues in Global Finance

Emerging Global Financial Architecture – Lessons from International Crisis – Problems of International Debt and Role of World Bank – International Financial Hub: New York and Singapore

(12 Lectures)

Module 8: Emerging Issues in Global Trade

Tariff and Non Tariff barriers – Neo Protectionism – Strategic Trade Policy and its Implications – Problems and Prospects of Globalisation in India and China

(12 Lectures)

READING LIST

Sr. No.	Title of the Book	Name of Author	Publisher	Year
1.	International Economics 1995	H.G.Mannur	Vikas	
2.	Managing the Global Economy	Michie and Smith	Oxford Univ. Press	1995
3.	International Economics	Dominic Salvatore	John Wiley	2001
4.	Handbook of International 2000 Economics	Jones R.W. and P.B. Kenen	Cambridge Univ. Press	
5.	Open Economy macro Economics	Dornbush R.	Tata Mcgraw Hill	1998
6.	Strategic Trade Policy and the New International Economics (International Economics : Theory and Practice)	Krugman PD	Addision Welsey	2000
7.	WTO and Developing Countries	Surendra Bhandari	Deep and Deep	1998
8.	Foreign Trade Theory and Practice	Velayudhan TK	Wheeler	1998
9.	International Finance	Avadharu	Himalaya	1998
10.	International Economics	J. Kindleberger	Irwin	1968
11.	International Economics	T. Ellsworth	McMillan	1969
12.	International Economics	Bo Sodersten	McMillan	1994
13.	International Business	Anant K. Sundaram	Prentice Hall	2000
14.	Environment of India	Stewart Black		
15.	International Business	Michael r Czinkota and Others	Dryden Press	1968

