



MADURAI KAMARAJ UNIVERSITY
(The University with Potential for Excellence)



B. A. (ECONOMICS)

Second Year

INTERNATIONAL ECONOMICS



DISTANCE EDUCATION
(Recognized by D.E.C) .

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Second Year

Dear Student,

We welcome you to the **Second Year B.A.(Economics)** Degree course through our Directorate of Distance Education. International Economics is one of the three papers under Part - III on which you will be writing the University Examination at the end of your Second Year Degree course.

This subject is introduced to you in 10 Units. All the 10 Units are presented in such a way that you will be able to learn the subject yourself without any external guidance. You must read the study materials provided to you consistently so that it becomes easy for you to write the examination well and get through the examination with Distinction. Though we have taken our best efforts to present the subject matter in a lucid manner, you may find it difficult to understand certain concepts in some units or even the whole unit. In order to help you to overcome such difficulties, we organise contact seminar programmes for you. The Annual Schedule of the contact seminar programme is sent to you individually and also it is made available in our website www.mkudde.org. You are free to attend the contact seminar at any centre. As you are receiving the study materials immediately after you pay your second year Tuition fees in full, you should start studying them before you attend the contact seminar. Then only you will be able to get full benefit from the contact seminar.

Expecting you to meet in the contact seminar, we wish you Best of Luck in all your endeavours.

Dr.B.Subbulakshmi
Professor & Head,
Dept. of Economics,
Directorate of Distance Education,
Madurai Kamaraj University.

UNIVERSITY SYLLABUS
B.A.(Economics) - II YEAR
INTERNATIONAL ECONOMICS

UNIT 1 : TRADE THEORIES : Importance of International Trade - Inter -regional and International Trade - Theories of Absolute & Comparative Advantage - Heckscher - Ohlin Theory.

UNIT 2 : GAINS FROM TRADE : Measurement and Distribution of Gains - Trade as an Engine of Growth.

UNIT 3 : TERMS OF TRADE : Concept of Terms of Trade and their Importance in the Theory of Trade-Types of Terms of Trade - Factors Influencing Terms of Trade.

UNIT 4 : TRADE POLICY : Free Trade versus Protection - Types of Tariffs and Quotas.

UNIT 5 : BALANCE OF TRADE & BALANCE OF PAYMENTS : Concepts and Components of Balance of Trade and Balance of Payments. Equilibrium and Disequilibrium in Balance of Payments - Kinds of Disequilibrium - Various measures to correct deficit in Balance of Payments.

UNIT 6 : FOREIGN EXCHANGE : Foreign Exchange Market - Functions and Transactions - Purchasing Power Parity Theory.

UNIT 7 : EXCHANGE CONTROL : Meaning, Need and Methods of Exchange Control - Direct and Indirect.

UNIT 8 : INTERNATIONAL FINANCIAL INSTITUTIONS : IMF and World Bank - Functions, Objectives and Working of IMF and IBRD - IMF and India - IBRD and India.

UNIT 9: TRADE AGREEMENTS : GATT - WTO Impact on India.

UNIT 10 : FOREIGN TRADE IN INDIA : Trends and Composition of India's Foreign Trade - Export Promotion and Import Substitution Measures- Recent Trends in India's Trade Policy - Role of MNCs in India.

BOOKS FOR STUDY

1. International Economics - Jhingan, M.L - Konark Publishers Pvt. Ltd.
2. International Economics - Francis Cherunilam - Tata McGraw Hill Publishing Company Ltd.
3. International Economics - Sharma R. - Lakshmi Narain Agarwal Publishers.
4. International Economics- Desai and Bhalerao - Himalaya Publishing House.

REFERENCES

1. Money, Banking & International Trade - Shobam Lal Nagin - Chand & Co.
2. Money, Banking & International Trade - Sethi, T.T. - S. Chand & Co.
3. International Economics - Dwivedi, D.N. - Tamil Nadu Book House Publishers.

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INTRODUCTION TO THE SUBJECT

‘INTERNATIONAL ECONOMICS’

At the start of the 21st century, international aspects of Economics remain as important and controversial as ever. Students assimilate international economics most readily when it is presented as a method of analysis vitally linked to events in the world economy, rather than as a body of abstract theorems about abstract modes. The goal has therefore been to stress concepts and their application rather than theoretical formalism. The main stress is to show how the development of international economic theory has traditionally been shaped by the need to understand the changing world economy and analyse actual problems in international economic policy. This volume presents the whole syllabus for this subject in ten units.

Unit 1 explains the difference between internal and international trade and the basic theories which describe the circumstances under which two countries come to trade with each other.

One country will not trade with other countries if it is not able to get any gain from the trade. Therefore, it goes without saying that international trade is beneficial to each and every country involved in it. How to measure such gains for a country from international trade? The answer to this question is elaborated in Unit 2.

When trade takes place, one country exchanges its goods and services with other countries. How do such transactions take place? At what rate one country exchanges its commodities with another country is called terms of trade. There are various methods by which this terms of trade is measured. All these methods are explained in Unit 3.

Though countries involved in Foreign trade gain mutually, some countries may be interested in protecting their industries, particularly, indigenous industries and therefore, they put some barriers to trade. These barriers to trade may take different forms. They are all explained in Unit 4.

When a country buys goods and services from another country they are called imports. On the other hand, when it sells its own goods and services, they are called

exports. A country has to pay for its imports and gets payments for its exports. Whether the payments made and payments received are equal or unequal to one another is analysed with the help of the concept known as “Balance of Payments”. This concept is explained in Unit 5.

All countries of the world do not have the same monetary unit. India has Rupee, USA has Dollar, UK has Pound Sterling, Japan has Yen and so on. For the imports and exports the payment has to be made in money units only. Therefore, it becomes necessary to fix the rate at which one country’s money is to be exchanged with another country’s money. There are various theories to explain the determination of such exchange rate. These theories are explained in Unit 6.

Foreign Currency received through exports is called foreign exchange. The entire foreign exchange earned by all the exporters of a country has to be deposited with the central bank of the country and the central bank reimburses the exporters by making payments to them in Domestic Countries. To make payments for the imports the importers get foreign exchange from the central bank at official rates. The private traders are not allowed to buy or sell foreign exchange according to their own will and pleasure. There are various methods to control the foreign exchange and they are explained in Unit 7.

To help the countries which suffer from foreign exchange problems and other financial problems, there are some international financial institutions like IMF and IBRD. Role and functions of these international financial institutions are explained in Unit 8.

Many world countries favour extensive tariff negotiations for trade concessions. To take decisions on all matters related to such negotiations and agreements there is an organisation called World Trade Organisation (WTO). Role and functions of WTO and its impact on developing countries, particularly, India are explained in Unit 9.

The Last unit, Unit-10, explains the composition and the pattern of foreign trade of India.

UNIT - 1

INTERNATIONAL TRADE THEORIES

Space for Hints

INTRODUCTION

It is a well known fact that a country cannot exist independently. It has to depend on other countries, for, it has to export goods which it produces excessively and it has to import goods which it requires for its own use. Thus international trade plays a vital role in the economic development of a country. There are many theories propounded by many economists. In this first unit on International Economics, we explain the nature of trade, the need for foreign trade, differences between internal and international trade, advantages and disadvantages of international trade and the theories like Classical Theory of Comparative Costs and the Modern Theory that explains the circumstances under which trade between two countries take place.

UNIT OBJECTIVES: After studying this unit, you would be able to

- Understand the need for and features of international trade.
- Identify the differences between internal and international trade.
- Know about the advantages and disadvantages of international trade.
- Understand the Classical Theory of Comparative Costs.
- Learn the Modern Theory of International Trade.

UNIT STRUCTURE

1. Nature of International Trade
 - 1.1 International Trade - Meaning
 - 1.2 Need for Foreign Trade
 - 1.3 Special Features of International Trade
 - 1.4 Conclusion
2. Differences between Internal Trade and International Trade
3. Advantages and Disadvantages of International Trade
 - 3.1 Advantages
 - 3.2 Disadvantages

4. The Classical Theory of International Trade

4.1 Assumptions

4.2 Three Kinds of Cost Differences

4.3 An Illustration

4.4 Theory

4.5 Criticisms

5. The Modern Theory of International Trade

5.1 Does Not Invalidate the Classical Theory

5.2 Basic Conditions for Trade

5.3 Assumptions

5.4 Statement of the Theory

5.5 Why Called Factor-Proportions Theory?

5.6 Definition of Relative Abundance of Factors

5.6.1 Relative Abundance Defined in Terms of Factor Prices

5.6.2 Relative Abundance Defined in Physical Terms

5.7 Numerical Illustration of The Theorem Using The Definition In Terms of Factor Prices

5.8 Implication of the Definition of Relative Abundance in Physical Terms

5.9 Evaluation of Heckscher-Ohlin Theory

5.10 Criticisms

6. Keywords

7. Answers to CYP Questions

8. Model Questions for Guidance

1. NATURE OF INTERNATIONAL TRADE

Space for Hints

1.1 INTERNATIONAL TRADE - MEANING

The term 'trade' means exchange of commodities among people. Trade may be (1) internal and (2) external in character. Internal trade deals with the transactions taking place within the geographical boundaries of a country or region. It is also called intra-regional or home trade. External or international trade refers to the trade among different countries or trade across political frontiers. International trade refers to the exchange of commodities and services between one country or region and another. It is also called inter-regional or foreign trade.

1.2 NEED FOR FOREIGN TRADE

Countries vary greatly in efficiency in producing different goods. These differences arise largely out of the following considerations:

(i) Different Climatic and Geographical Conditions

The climate and geographical conditions of one country are entirely different from those of another. For instance, Brazil is climatically better suited to coffee cultivation. Cuba specializes in sugarcane production. While the Middle Eastern countries engage in extracting oil from the earth. No country in the world can economically produce all goods that are required by all her people. This necessitates specialization in the production of particular commodities in which a country possesses natural advantages. This geographic and climatic differences justify worldwide specialization.

(ii) Different Human Capacities

Human capabilities also vary over the world. Some people are physically strong enough to perform hard manual labour. Some others are better suited in trade skills. Some other people have exceptional entrepreneurial and organizational ability. These in-built basic differences among men may be due to long standing racial characteristics or due to political, social and economic environment in which individuals have

Check Your Progress

1. What do you understand by trade?
2. What do you understand by International Trade?
3. Where is the need for specialisation in production?

grown up and live. They constitute the major reason for international specialization and trade.

(iii) Difference in the Accumulation of Capital Goods

The accumulated supply of capital goods varies greatly from country to country. In some countries, centuries of accumulation have produced large supplies of fixed and mobile capital like rail-roads, buildings and machinery, etc. Examples are the United States of America and England. These countries specialise in industrial products. In some other countries like Greece and Nigeria capital is scarce. They specialise in farming and simple industrial production which requires little elaborate equipment.

(iv) Disproportions in the availability of Resources

The proportions among different types of resources vary widely from country to country. Australia has vast plains (lands) but relatively few people and capital goods. Therefore, she specializes in agricultural products that require a high proportion of natural resources (like land and water). In England, land is scarce relative to human beings and capital. Therefore, she is best fitted for manufacture and industry even though her soil may be as good as Australia's for wheat growing. Thus, differences in resource endowment in different countries lead to specialisation and pave the way for international trade.

(v) Difference in Political and Social Conditions

In addition to these economic considerations, great differences exist in political and social climate in different countries. In countries of stable Government, vast industrial organisations are likely to grow up. In backward, illiterate, badly governed areas conditions are almost unfavourable to mass industrial productions. Thus, the differences in political and social conditions lead to differences in the industrial organisations in different countries and pave the way for international trade.

It is now clear that foreign trade will be advantageous, if each country devotes itself to the production of a commodity for which it is having suitable conditions.

1.3 SPECIAL FEATURES OF INTERNATIONAL TRADE

Prof. Kindleberger has pointed out the important features of international trade as follows:

(i) Immobility of Factors of Production

Immigration laws, citizenship requirement restrict the international mobility of labour. International capital flows are either prohibited or severely limited by different Governments. The economic significance of such mobility of labour within a country tends to maintain equality in wage rates. But the immobility of labour between countries is the major cause for the wage inequalities. For instance, the wages of textile mill workers at Madurai and Coimbatore may be equal but not at Madurai and Newyork. Hence, the principles which determine the course and nature of the internal trade and the international trade are bound to be different.

(ii) Separate Markets

Due to state interference, the national markets are frequently separate. For instance, the British drive on the right and the French drive on the left. These traffic regulations are decreed by governments for national traffic safety. Since it is safer to sit close to the side of the car which passes the stream of traffic coming in the opposite direction, the British people use right-hand drive cars and the French people use left hand drive cars. Hence, the markets for automobiles are effectively separated. Moreover, markets are also separated by language, custom, usage, habit, taste and a number of other points of difference. Standards differ. Some goods are designed in inches, feet, pounds and some in metric measurements.

(iii) Different Currencies

Perhaps the important nature of foreign trade is the use of different currencies. A rupee is accepted at Madras and Calcutta. But the Indian rupee must be converted into Bangladesh 'taka' before it can be used to buy some commodities at Dacca, some hundred miles away from Calcutta. This involves the problem of exchange rates and foreign exchange. Different countries follow different foreign exchange policies. Thus, one has to study the factors that determine the value of each country's monetary unit and also the fact of various practices and exchange resorted to.

(iv) Different National Policies

Government policies relating to money and banking, government department, management, expenditure, taxation, trade and industry are, more or less uniform within a country, but differ widely between countries. Tariff policy action with respect to quotas, subsidies and other controls of trade are also adopted by governments to interfere with the course of trade between countries. Thus, State interference is an another important character of the foreign trade.

(v) Different Political Units

International trade occurs between politically different units, while internal trade takes place within the same political unit. Friedrich List says, 'Domestic trade is among us; international trade is between us and them'. Hence, each country's government tries to see its own interest in international trade policy at the cost of other country. Thus, the task of international economics is to discover a common ground for an economic relationship which will satisfy the various countries.

(vi) Widening the Economic and Political Unit

International economic relations create certain specific problem of a peculiar nature like international monetary co-operation, evolution of international organisation like European Common Market, etc. While the

political and economic nationalism is growing in Africa, Asia, Latin America and the Middle East the old solutions in terms of national interest have lost much of their validity in Europe and North America. With the disintegration of the economic ties of the British Common Wealth, Britain feels the need to enter a wider economic entity. Most of the countries in Europe including France, Italy and Germany feel that their national boundaries are much limited. The United States, Canada and Western Europe co-operate in the economic partnership of the Organization for Economic Co-operation and Development (OECD) and lowered tariffs in the Kennedy Round of 1967. The international companies and corporations formerly used to produce entirely in one country. Now they are increasingly extending their horizons to the world as a whole and helping the economic construction on a massive scale in Europe, Japan and the under developed countries. The civil servants of international bodies and economically linked business executives may frame new common elements in a new international community. To quote Kindleberger "In a world of rising nationalism, rising internationalism or both, international economics is an important tool of understanding and negotiation."

1.4 CONCLUSION

The fundamental basis of international trade lies in the fact that all countries cannot produce all things equally well or cheaply due to the unequal distribution of natural resources among countries. Different kinds of production techniques which were most advantageous to each of these countries are adopted. The exchange of these specialized goods have given birth to international trade. Just as geographical specialization helps various regions in a country to concentrate on the production of a particular commodity, so also it helps the various countries to specialise in the production of particular products.

However, the differences between internal and international trade are a matter of degree and not of kind. It is considered that the study of

international trade is merely an application of General Economics. If that is so, the questions that arise are : Why international trade is treated as a separate branch of economics? Why the laws of domestic trade are not applicable to international trade and transactions and what is the need for a separate theory of international trade?

2. DIFFERENCES BETWEEN INTERNAL TRADE AND INTERNATIONAL TRADE

International trade differs fundamentally from internal trade. Hence, we need a separate explanation or theory of international trade. And, there is a separate branch of Economics called International Economics. The following are the differences between international trade and internal trade (also known as inter-regional trade).

(i) Mobility of Labour

Labour may move relatively more easily within the same country. But as between countries labour is not so mobile. Language difficulty, differences in social set up, immigration laws and transport costs are responsible for this.

(ii) Mobility of Capital

Capital is also much more mobile within a country than between different countries.

(iii) Tariff Barrier

No restriction is placed on the trade between persons in the same country. But in the case of international trade, there are a number of restrictions. Every country controls its foreign trade by import duties, import quotas and other methods.

(iv) Conditions of Production

Firms engaged in the production of goods in the same country are subject to the same regulations. They are subject to the same regulations

with regard to taxation, factory organisation, industrial combination, etc. But as between countries, there are wide differences in this regard.

(v) Different National Groups

Internal trade is trade among the same group of people. Within the same country the socio-economic conditions are more or less the same. But, international trade takes place between different national groups. There are differences in the socio-economic conditions of the different countries.

(vi) Politically Different Units

Internal trade takes place within the same political unit. International trade takes place between politically different units.

(vii) Different Currency Systems

Within the same country one common money is in use. But, there is difference in the money in use as between two different countries. For instance, we use rupee, whereas the USA uses dollar. So, in the case of international trade, there is an additional problem. It is the problem of the rate at which one currency is to exchange for another currency. That is, international trade gives rise to foreign exchange operations.

(viii) Specific Problems

International economic relations have certain specific problems of a peculiar nature, e.g. international liquidity problems, problems of international monetary co-operation, evolution of international organisations like European Common Market, etc. Such problems can never arise nor they are required to be solved by regional economics. They are to be studied separately and solved by "International economics".

In view of the above mentioned differences between international trade and internal trade, there is a separate theory of international trade.

3. ADVANTAGES AND DISADVANTAGES OF INTERNATIONAL TRADE

3.1 ADVANTAGES

International trade has both advantages and disadvantages. The important advantages of international trade are as follows:

(i) No country can produce everything that it requires. Foreign trade helps a country to obtain goods which it cannot produce. For instance, England cannot produce jute or tea. It gets these things from India, Ceylon and Pakistan through international trade.

(ii) A country can get commodities which it could produce only with great difficulty or at a high cost. For Instance, India can produce dyes. But the cost of production would be considerably higher. Thus, India could get dyes from Germany at the lowest possible price.

(iii) It gives rise to division of labour among countries. Each country specialises in producing those commodities for which it has greatest comparative advantages. As a result of this, the efficiency of all the countries increases. This benefits everybody. Thus, international trade enables a country to secure all the benefits of division of labour.

(iv) There is an increase in the world's productive powers. This results in a fall in the cost of production. This is an advantage to people, for they are able to get things cheap.

(v) It enables the country to exploit natural resources fully as possible. This is due to wider market made possible by international trade.

(vi) Competition in international trade makes countries to adopt the latest methods of production. The quality of product is maintained at the best possible level.

(vii) There are other non-economic benefits from trade. It has a cultural and moral value. For, it promotes close contact between peoples of different countries. It promotes peace and goodwill among nations. It also

facilitates interchange of ideas. Thus, foreign trade promotes the growth of international co-operation.

Space for Hints

3.2 DISADVANTAGES

International trade is not an unmixed blessing. There are also certain disadvantages of international trade.

(i) It involves dependence on other countries. This may become dangerous especially in times of war. During periods of war, the country may find it difficult to import goods from foreign countries.

(ii) Sometimes, it may lead to over exploitation and rapid depletion of natural resources of a country. For instance, in the days of British rule in our country, many of the important minerals like manganese, mica, etc. were exported in large quantities. If these minerals had been conserved, independent India would have made the best use of them for industrial development.

(iii) It makes possible the import of cheap products. This may be poor in quality and even harmful to consumers.

(iv) It may give rise to dumping of foreign goods at very low prices. This may result in the decay of local industries. For instance, the dumping of cheap machine made British goods in India was responsible for the decay of our world famous handicrafts in the 19th century.

(v) It may result in one sided development of a country. Due to international trade, too much emphasis may be placed on industrial development. This may result in the neglect of agriculture as in England or due to international trade agriculture may be given too much attention. This may result in the neglect of industry as in India.

(vi) Countries having trade relations with one another are dependent on one another. As a result, inflation in one country may spread to other countries or depression in one country may spread to other countries.

Check Your Progress

4. In your view point, what is the major advantage and disadvantage of international trade?

However, advantages of international trade are greater than the disadvantages. Moreover, the disadvantages can be minimised by adopting suitable measures. Hence, countries have trade relations with one another.

4. THE CLASSICAL THEORY OF INTERNATIONAL TRADE (OR) THE THEORY OF COMPARATIVE COSTS

The Classical Theory of International Trade is the Theory of Comparative Costs. This Theory of International Trade explains the circumstances under which trade between two countries may arise. The theory was originally developed by Ricardo, a classical economist. Hence it is known as the Classical Theory of International Trade.

4.1 ASSUMPTIONS -

The Classical Theory of Comparative Costs has been built upon the following assumptions:

1. There are only two trading countries, say A and B.
2. Each country can produce only two commodities, say X and Y.
3. The cost of production of the commodities can be measured and expressed in terms of labour.
4. Both commodities are produced under conditions of constant cost, i.e., whatever be the volume of output, average cost remains the same.
5. Transport costs are completely ignored. In other words, cost of production consists of only production cost.
6. Each trading country has a fixed quantity of resources.
7. Factors of production are perfectly immobile as between different countries.

4.2 THREE KINDS OF COST DIFFERENCES

The exponents of the theory distinguish among three type of cost differences. They are as follows:

- 1) Equal differences in costs,
- 2) Absolute differences in costs, and
- 3) Comparative differences in costs.

4.2.1 EQUAL DIFFERENCES IN COSTS

Space for Hints

Equal differences in costs means that countries A and B have equal advantages in the production of both X-commodity and Y-commodity.

Suppose country A, by devoting one unit of labour can produce either 2 units of X-commodity or 2 units of Y-commodity and country B, by devoting one unit of labour can produce either 1 unit of X or 1 unit of Y. This can be presented in the form of a table as shown below:

TABLE 1.1
EQUAL DIFFERENCES IN COSTS

Country	Output per unit labour	
	X-commodity units	Y-commodity units
A	2	2
B	1	1

If country A produces both X and Y, 1 unit of X will exchange for 1 unit of Y or one unit of Y will exchange for 1 unit of X inside the country.

If country B produces both X and Y, 1 unit of X will exchange for 1 unit of X inside the country. Thus, the rate at which X can exchange for Y is the same in both A and B countries. So they do not stand to gain anything in specialising and having trade relations with one another. Thus, when there are equal differences in costs, there is no scope at all for trade between any two countries.

4.2.2 ABSOLUTE DIFFERENCES IN COSTS

Absolute differences in costs means the following:

Country A has absolute advantage in the production of one of the two commodities, say, X-commodity compared with B country. And country B has absolute advantage in the production of the other commodity viz., Y-commodity compared with A country.

Suppose, country A, by devoting one unit of labour can produce 2 units of X commodity or 1 unit of Y commodity. But country B, by

Check Your Progress

5. What do you understand by absolute cost differences?

devoting one unit of labour can produce 1 unit of X or 2 units of Y. This can be presented in the table as shown below:

TABLE 1.2
ABSOLUTE DIFFERENCES IN COSTS

Country	Output per unit labour	
	X-commodity units	Y-commodity units
A	2	1
B	1	2

If country A produces both X and Y, one unit of X will exchange for $\frac{1}{2}$ unit of Y or one unit of Y will exchange for 2 units of X inside the country.

If country B produces both X and Y, one unit of X will exchange for 2 units of Y or one unit of Y will exchange $\frac{1}{2}$ unit of X.

It is obvious that the country A has absolute advantage in the production of X-commodity. And country B has absolute advantage in the production of Y commodity. In this case, both the countries stand to gain if A specialises in the production of X and B in the production of Y.

If country A produces only X and gets its requirements of Y from country B, it can get 2 units of Y for 1 unit of X. This means gain to country A. For, if A were to produce both X and Y, 1 unit of X would have exchanged for only $\frac{1}{2}$ unit of Y as we saw above. Thus, country A can gain by producing that commodity in which it has absolute advantage viz., X-commodity.

This type of specialisation is gainful to country B also. If country B produces only Y and gets its requirements of X from country A, it can get 2 units of X for 1 unit of Y. This is a gain to country B. For, if B were to produce both X and Y, 1 unit of Y would have exchanged for only $\frac{1}{2}$ unit of X as we saw above. Thus, country B can gain by producing that commodity in which it has absolute advantage viz., Y-commodity.

4.2.3 COMPARATIVE DIFFERENCES IN COSTS

If the two countries have equal advantage in the production of both X-commodity and Y-commodity, we call it equal differences in cost. In which case, there is no possibility of trade between these countries. If country A has absolute advantage in the production of one commodity, say X commodity and country B has absolute advantage in the production of the other commodity, viz., Y-commodity, we call it absolute differences in cost. In this case, there is certainly a scope for international trade. Instead, a country, say, A-country may have absolute advantage in the production of both X-commodity and Y-commodity. Even then there is scope for international trade. This is what the theory of Comparative costs seeks to explain.

4.3 AN ILLUSTRATION

An illustration will make the theory clear. Suppose, there is a skilled lawyer. He is also a skilled typist. He is a better typist than any stenographer that he could employ. Suppose, the lawyer can earn easily Rs.500 an hour devoting his time for the preparation of cases and pleading them in the court. Suppose, stenographers are available for monthly salary of Rs.2000/-. There is no doubt that the lawyer has absolute advantage in both pleading cases and typing compared to the stenographer. But he has greater comparative advantage in pleading cases. So he stands to gain by devoting his time in full to pleading cases and employing a stenographer to do the work of typing.

4.4 THEORY

The same principle applies to countries with regard to the production of commodities by them. Suppose, country A, by devoting one unit of labour can produce either 3 units of A commodity or 2 units of Y commodity. But country B, by devoting one unit of labour can produce either one unit of A-commodity or one unit of Y-commodity. This can be presented in the form of a table below:

Space for Hints

Check Your Progress

6. What do you understand by comparative differences in costs?

TABLE 1.3
COMPARATIVE DIFFERENCES IN COSTS

Country	Output per Unit Labour	
	X-commodity units	Y-commodity units
A	3	2
B	1	1

It is obvious that country A has absolute advantage in the production of both X-commodity and Y-commodity compared with country B. But country A has greater comparative advantage in the production of X-commodity. For, in the case of Y-commodity, it can produce only two times the quantity produced by B, but in the case of X-commodity, it can produce three times the quantity produced by B. So, country A has to produce only X and country B only Y.

If country A produces X and Y, 1 unit of X will exchange for $\frac{2}{3}$ unit of Y (or in country A, 1 unit of Y will exchange for $1\frac{1}{2}$ units of X inside the country). Again if country B produces both X and Y, 1 unit of X will exchange for 1 unit of Y (or in country B, 1 unit of Y will exchange for 1 unit of X).

If country A produces only X and gets its requirements of Y from country B, it can get 1 unit of Y in exchange for 1 unit of X. This means gain to country A. For, if A were to produce both X and Y, 1 unit of X would have exchanged for $\frac{2}{3}$ unit of Y only as we saw above. Thus, country A has gained by producing that commodity in which it has greater comparative advantage.

This type of specialisation is gainful to country B also. If country B produces only Y and gets its requirements of X from country A, it can get $1\frac{1}{2}$ units of X for 1 unit of Y. This is gain to country B. For, if B were to produce both X and Y, 1 unit of Y would have exchanged for 1 unit of X only as we saw above.

Thus, if each country specialises in the production of that commodity in which it has greater comparative advantage, it will be gainful to both countries.

4.5 CRITICISMS

The Theory of Comparative Costs as explained above has been criticised by modern economists.

(i) In the first place, the theory is unrealistic, because it is based on the Labour Theory of Value which has been discarded by economists. Since total costs include other cost elements as well, a theory running exclusively in terms of labour cost cannot claim to be scientific. We must take into account other cost items as well.

(ii) Even if for the sake of simplification, the Labour Theory of Value is accepted, the theory is vitiated by the fact that labour is not homogeneous. As Cairnes has observed, there are non-competing groups among labourers. For instance, we cannot compare the efficiency of one unit of British unskilled labour with that of one unit of American skilled labour.

(iii) The Classical Doctrine of Comparative Costs has also been criticised on the ground that it does not take into consideration the effect of demand on the nature and volume of trade. That is, the theory does not take into account reciprocal demand. Mill has pointed out that the actual terms of trade depend on the nature of reciprocal demand i.e., the relative intensity of demand as between the two countries.

(iv) The classical doctrine is based on the unrealistic assumption of NIL transport cost. But once transport costs are taken into account, some complications may arise. The theory may have to be modified to make allowance for such complications.

(v) The classical economists have assumed the operation of only one law of production viz., the Law of Constant Cost. But this is an unrealistic assumption. The Law of Constant Returns simply suggests a particular

stage in the growth of an industry and as such it cannot be held as an universal law. Modern writers have modified this theory and explained it in terms of the operation of the Law of Increasing and Diminishing Returns.

(vi) The theory assumes that each trading country has a fixed quantity of resources. It does not take into account, the effects of growth and economic development. The theory confines its attention to a static economy. Actually, we are living in a dynamic economy where changes are constantly taking place. Moreover, international trade influences the employment of resources and may cause changes in the ratios of comparative costs.

(vii) The theory assumes that factors of production are perfectly immobile as between different countries. This assumption is not absolutely correct. Because, movements of capital and labour take place from one country to another, though not to a very great extent. The classical theory cannot, therefore be considered to be adequate.

Hence, modern economists have refined this theory by dropping the unrealistic assumptions that underlie the formulation of this theory. Foremost among them are Haberler and Bertil Ohlin. This theory as refined and improved by these economists is the generally acceptable theory of international trade at present.

5. THE MODERN THEORY OF INTERNATIONAL TRADE (OR) HECKSCHER - OHLIN THEORY OF INTERNATIONAL TRADE (OR) THE FACTOR - PROPORTIONS THEORY OF TRADE

The Modern Theory of International trade is associated with the names of Eli Heckscher and Bertil Ohlin. Bertil Ohlin has explained it in his famous book 'Inter-regional and International Trade' published in 1933. In fact, it was Eli Heckscher, who first propounded that trade results from differences in factor endowments in different countries and Bertil Ohlin carried it forward to build the Modern Theory of International Trade.

Check Your Progress

7. Who developed the Modern Theory of International Trade?

8. What is the name of Modern Theory of International Trade?

5.1 DOES NOT INVALIDATE THE CLASSICAL THEORY

Heckscher - Ohlin Theory accepts the comparative advantage as the immediate cause of trade. The new theory succeeds where the classical theory fails to give explanation for the difference in comparative costs among countries. Thus, the Heckscher-Ohlin Theory does not invalidate the Classical Theory, but rather powerfully supplements it.

5.2 BASIC CONDITIONS FOR TRADE

Heckscher and Ohlin state two conditions as the basis for trade.

(i) Countries differ in their factor endowments.

(ii) Different commodities are produced with different combinations of factors.

It is a commonly observable fact that some countries like Australia and Argentina are exceptionally well endowed with land. Others, like United States, Great Britain and Germany possess relatively large accumulations of capital. In still others like India and Egypt, labour is available in greater quantities. Thus, the factor supplies in different countries differ markedly. Differences in factor supplies lead to differences in factor prices.

If a country is capital abundant, it means that capital is cheaply available in that country. Abundant labour means wages will be lower in that country. Thus, a factor in abundant supply implies that its price is relatively lower in that country.

The proportion in which factors are combined in the production of different commodities also differs to a marked extent. For instance, production of some commodities like, automobiles, requires relatively more capital and less labour compared to some other commodities like wheat.

Hence, countries having cheap capital can get a comparative advantage in producing and exporting goods which require more capital for their production. Countries having cheap labour will enjoy a comparative

advantage in producing and exporting goods which require more labour for their production.

This means that indirectly factors in abundant supply are exported (in the form of goods produced by them) and factors in scant supply are imported by a country.

5.3 ASSUMPTIONS

Heckscher-Ohlin Theory is based on certain implicit and explicit assumptions. We have given below only the most important assumptions.

1. There are only two countries, two commodities and two factors.
2. There is perfect competition in both commodity and factor markets.
3. There are no transport costs.
4. Production functions are different for different commodities.
5. Production functions are identical between countries
6. Each production function is subject to constant returns to scale.
7. Countries differ in their factor endowments.
8. Qualitatively each factor is homogeneous in both the countries.
9. Factors move freely within a country.
10. Factors are immobile between countries.
11. There is full employment of resources in both the countries.

5.4 STATEMENT OF THE THEORY

Given the above assumption the Factor Proportions Theory concludes that a country will export goods using relatively large amounts of its relatively abundant factor. That is, capital abundant countries export capital intensive goods and labour abundant countries export labour intensive goods.

5.5 WHY CALLED FACTOR-PROPORTIONS THEORY?

Since Ohlin lays emphasis on differences in the proportion in which factors are combined for the production of different goods and on difference in the proportion in which different countries are endowed with factors,

Heckscher-Ohlin Theory is known as Factor Proportions Theory of International Trade.

So far, we have used the terms 'capital abundant' and 'labour abundant' rather in a loose manner. Before we can go further we have to define these terms in a more precise manner.

5.6 DEFINITION OF RELATIVE ABUNDANCE OF FACTORS

The relative abundance of a factor can be defined in two ways namely, (1) in terms of factor prices and (2) in terms of physical factor endowments.

5.6.1 RELATIVE ABUNDANCE DEFINED IN TERMS OF FACTOR PRICES

Let us suppose the two countries are US and India. Suppose in US, the price per unit of capital is \$2 and of labour is \$ 1. In India, suppose, the price of capital is Rs.40 and of labour is Rs.10. The ratio between the price of capital and labour in US is 2 : 1 and in India the ratio is 40 : 10 or 4 : 1. That is, in US, capital is two times as costly as labour whereas in India, capital is four times as costly as labour. That is, capital is cheaper in US than in India. In this case, we say that US is capital abundant country and India is labour abundant country.

Thus, a country is capital abundant, if the ratio between the price of capital and of labour is smaller in that country than in another country. The other country is said to be labour abundant. In other words, a country is capital abundant if capital is cheaper in that country compared to another country. The reverse will be true, if the country is labour-abundant.

5.6.2 RELATIVE ABUNDANCE DEFINED IN PHYSICAL TERMS

Let us take the example of the same countries, namely, US and India. Suppose, in US, 50,000 units of capital and 15,000 units of labour are available. In India, suppose, 30,000 units of capital and 15,000 units of labour are available. Now, the ratio between the total volume of capital and labour available in US is 50,000 : 15,000 or 10 : 3, in India, it is 30,000 :

15,000 or 2:1. That is, capital per unit of labour available in US is 5 whereas in India it is 2. In this case, we say, US is capital abundant and India is labour-abundant.

Hence, according to this definition, a country is capital abundant, if the ratio between the over all physical volume of capital and labour is greater compared to another country. If the reverse is the case, the country is said to be labour-abundant.

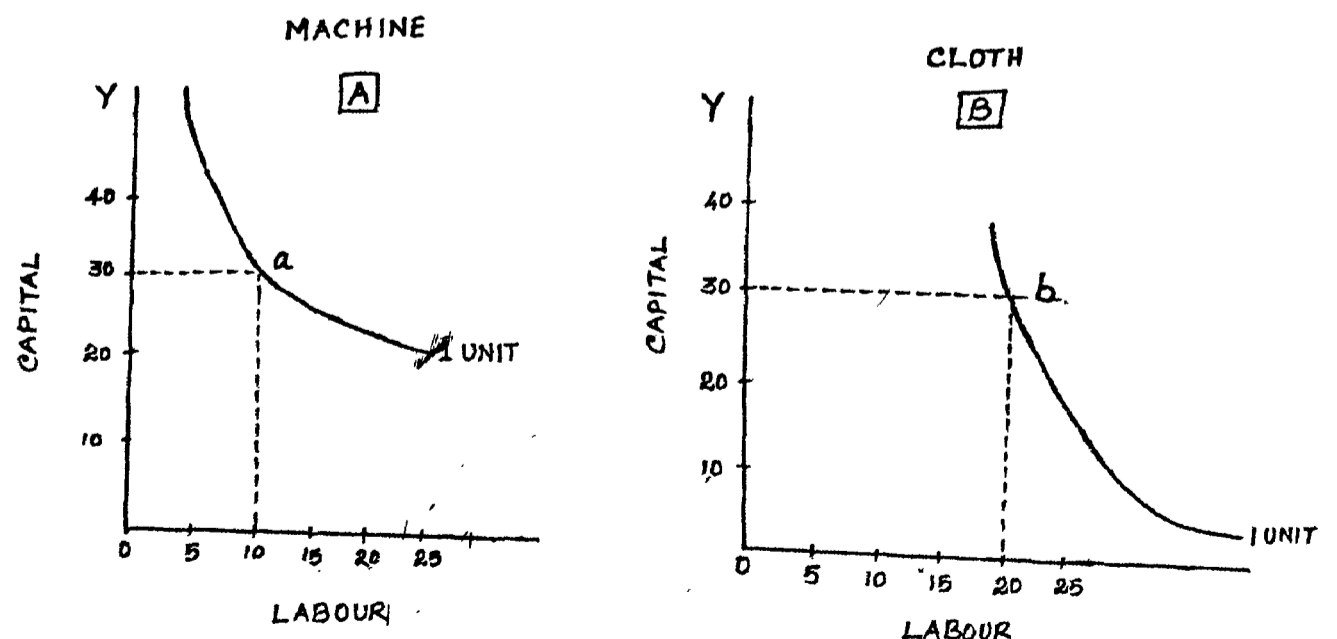
The above two definitions are not identically equal to one another. If we use the first definition, the Heckscher-Ohlin proposition follows immediately. But, if we use the second definition, it does not necessarily follow.

5.7 NUMERICAL ILLUSTRATION OF THE THEOREM USING THE DEFINITION IN TERMS OF FACTOR PRICES

Let us assume the two countries US and India. US is capital abundant, i.e. capital is cheaper in US. India is labour abundant, i.e. labour is cheaper in India.

Let us assume the same two commodities produced to be machines and cloth. Machine is capital intensive good compared to cloth. This is reflected by the shape of their isoquants given below.

Fig - 1.1
Relative Abundance in Terms of Factor Prices



Above we have given, an isoquant representing an output of 1 unit of machine in A diagram and another isoquant representing 1 unit of cloth in B diagram. On the isoquant for machine, consider a point **a**. It represents a factor combination, 30 units of capital and 10 units of labour. On the isoquant for cloth also consider a point **b**. It represents a factor combination, 30 units of capital and 20 units of labour. That is, with the same amount of capital machine production combines a lesser amount of labour (10 units) than cloth production (which combines 20 units of labour). Hence, machine is capital intensive and cloth is labour intensive.

The above isoquants give us various possible combinations of the two factors producing one unit of machine and one unit of cloth. Which combination is the best one in the production of each commodity? This question can be answered only with the help of the relative prices of the two factors which are represented by the isocost line.

The tangential point between an isocost line and the isoproduct curve gives the best or the most efficient combination of the two factors producing the given level of output. US is a capital abundant country and India is labour abundant, (i.e). capital is cheaper in US whereas labour is cheaper in India. Suppose, in US, the price of capital is \$ 20 and of labour is \$ 2; in India, the price of capital is Rs. 200 and of labour is Rs. 5 [capital labour price ratio in US 20 : 2 (=10:1) whereas in India it is 200 : (= 40:1). Thus capital is cheaper in US than in India]

Suppose, the optimum combinations of the two factors producing one unit of machine and one unit of cloth in both the countries are as follows:

TABLE - 1.4
OPTIMUM COMBINATION BEFORE TRADE TAKES PLACE

Factors	US		INDIA	
	Machine	Cloth	Machine	Cloth
Capital	8	2	8	1
Labour	20	30	80	40

Using the factor prices given earlier, we get the cost of producing one unit of machine and one unit of cloth in both the countries as shown in the table below.

TABLE - 1.5
COST OF PRODUCTION FOR TRADE TO TAKE PLACE

Factor Cost	US		INDIA	
	Machine	Cloth	Machine	Cloth
Capital Cost	\$ 20 × 8 =\$ 160	\$ 20 × 2 =\$ 40	Rs.200×8 = Rs.1600	Rs.200×1 = Rs.200
Labour	\$ 2 × 20 =\$ 40	\$ 2 × 30 =\$ 60	Rs. 5×80 = Rs.400	Rs.5×40 =Rs.200
Total Cost	\$200	\$100	Rs.2000	Rs.400

From the above table, we get the ratio between the cost of production and hence the prices of the two commodities, machine and cloth to be 200:100 (=2: 1) in US and 2000 : 400 (= 5 : 1) in India. That is, in US, one unit of machine is two times as costly as one unit of cloth whereas in India, the same one unit of machine is 5 times as costly as one unit of cloth. It follows that machine is relatively cheaper in US than in India and cloth is relatively cheaper in India than in US *. Hence, it is comparatively advantageous for US to specialize in the production of machine and export the same to India. On the other hand, for India, it is comparatively advantageous to specialize in the production of cloth and export it to US. This is in accordance with the Heckscher-Ohlin Theorem that the country abundant in capital will export capital intensive good and the country abundant in labour will export labour intensive good.

If the relative factor endowments were identical (i.e., the factor price ratios are the same in the two countries) the isocost lines will be the same in both the countries. This will give rise to the same optimum factor combination for each good in both the countries (because, we have assumed

identical production function implying identical isoquants for both countries). Hence, there will be no comparative cost differences and therefore, no comparative price differences. So, there is no theoretical basis for trade. Trade can take place only if there is a difference in relative factor endowment.

5.8 IMPLICATION OF THE DEFINITION OF RELATIVE ABUNDANCE IN PHYSICAL TERMS

Suppose we assume the same two countries US and India. According to the second definition, US is capital abundant if the proportion of capital to labour in US is greater than that in India. Hence, using all the available resources in the production of machine (capital intensive good) alone, US can produce more units of machine compared to India. On the other hand, if all the resources are put in the production of cloth (labour intensive good) alone US can produce only a lesser amount compared to India.

It does not follow from this, however, that US will export machines and India will export cloth. It might be the case that the demand conditions more than offset the bias from the production side. That is, in US, the demand for machines is so great that the derived demand for capital is also great enough to make capital get a higher relative price in US than in India. In that case, India will export machines and US, cloth. In other words, the country abundant in capital exports labour intensive good, and country abundant in labour exports capital intensive good. This result is just the reverse of the Heckscher - Ohlin proposition.

However, Ohlin conveniently assumes identical consumption pattern in both the countries. In that case, his proposition follows even if we use the definition of relative abundance in physical terms.

5.9 EVALUATION OF HECKSCHER-OHLIN THEORY

The Heckscher-Ohlin Theory can be well evaluated if we compare it with the Classical Theory of Comparative Costs. In the following respects, Heckscher-Ohlin Theory is different from the Ricardian Theory.

(i) According to the Classical Theory, the principle of comparative costs is a special feature of international trade. Ohlin does not subscribe this view. In his view, the principle of comparative costs is applicable to all trade whether internal or external.

(ii) The Classical Theory assumes immobility of factors among different countries. But, Ohlin says that the immobility of factors is also prevalent within the different regions of the same country. Again, the classical economists assume free mobility of factors within the different regions of the same country. Ohlin has proved that factors can also move between countries.

(iii) According to Ohlin, there is not much difference between internal and international trade. Hence, he explains International Trade Theory in terms of the General Theory of Value as explained by Marshall. Thus, the Modern Theory rescues the traditional analysis from the grip of the Labour Theory of Value.

(iv) Unlike the Classical Theory, it takes into account space factor. According to Ohlin, space is very important in economic life for two reasons.

(a) Some factors are confined to certain localities. Hence, they move only with difficulty.

(b) Free movement of commodities is prevented by the transport costs and other impediments.

(v) The Classical Theory assumes only one factor of production viz., labour and explains differences in labour productivity as the cause of trade. But Ohlin's Theory assumes two factors, capital and labour and it explains the differences in factor supplies as the main cause of trade between countries.

(vi) The Classical Theory is mainly interested in demonstrating the gains from international trade whereas the modern theory concentrates on explaining the basis of trade.

(vii) According to Lancaster, Heckscher-Ohlin Theory provides a satisfactory answer to the question regarding the future of trade. In the classical analysis, differences in the cost ratios between countries are due to differences in the knowledge of skill and efficiency of labour. It implies that there will be no trade in the future if the two countries have mastered each other's techniques and knowledge and labour becomes equally efficient in both.

But Ohlin's theory asserts that trade will never cease even if knowledge travels freely between countries and the best techniques of production are always known to both countries. Because, Modern Theory states that the relative differences in factor endowments and relative differences in factor requirements in the production of different commodities are the causes of differences in the relative prices of commodities.

5.10 CRITICISMS

(i) It is often held that the factor proportions theory is unrealistic because of its over simplified assumptions. The reason for the use of over simplified assumptions is to derive the minimum difference between countries which is suffice to explain the existence of trades. This minimum difference is a difference in the relative endowment of factors between countries.

(ii) Ohlin assumes the relative factor prices would reflect exactly relative factor endowments. This implies that in determining factor prices, supply plays a significant role than demand. But if demand forces are more significant, then capital abundant country will export labour-intensive good as the price of capital will be high due to high demand for capital. This relative difference in demand conditions also forms a basis for trade. In this sense, differing factor endowments becomes just one of the many possible explanations.

(iii) Some critics say that differences in relative factor endowments are only one of the many possible explanations for the commodity price differences underlying international trade.

(iv) It has been criticised that Ohlin's theory is static in nature. It only gives some characteristics of an economy at a given point of time.

(v) Ohlin assumes homogeneous production function for each commodity in the two countries. But production functions are different for the same commodity in the two countries. For example, cloth may be produced with handlooms which require more labour and less capital or it may be produced with powerlooms which require lesser number of workers. In such a situation, international trade may not follow the Ohlin's pattern.

(vi) The Modern Theory of International Trade assumes that there is the operation of Constant Returns to Scale. But this is not true. The production of commodities, may subject to the operation of the law of Increasing Returns to Scale or Diminishing Returns to Scale.

(vii) Ohlin assumes the existence of homogenous factors in the two countries. But, in reality the factors are not qualitatively homogeneous between the countries.

(viii) Ohlin does not consider transport costs in trade between two countries. If transport costs are included, they lead to price differentials for the same commodity in the two countries, which affect their trade relations.

(ix) The Heckscher-Ohlin Theory is based on the unrealistic assumptions of perfect competition and full employment because there is neither perfect competition nor full employment in any country.

(x) Wijnholds has criticised Ohlin for his view that commodity prices are determined by factor prices, which in turn, determine costs. He holds that the prices of commodities are determined by their utility to the consumers and that the prices of raw materials and labour are ultimately

dependent on the prices of the final commodities. He maintains that the right approach is to start with commodity prices rather than factor prices.

Despite the above criticisms, the Heckscher - Ohlin Theory of International Trade is definitely an improvement over the Classical Theory as it attempts explain the basis of international trade in the general equilibrium setting. According to Lancaster, the Heckscher-Ohlin Theory "Occupies the very centre of International Trade Theory for reasons unconnected with its realism and, indeed strengthened by the very properties which have been subject to so much criticism".

6. KEYWORDS

- Trade : Exchange of goods and services between two persons.
- Internal Trade : Exchange of goods and services within the geographical boundary.
- International Trade : Exchange of goods and services between two or more countries.

7. ANSWERS TO CYP QUESTIONS

1. Refer 1.1
2. Refer 1.1
3. Refer 1.2 (i)
4. Refer 3.1 & 3.2
5. Refer 4.2.2
6. Refer 4.2.3
7. Refer 5
8. Refer 5

8. MODEL QUESTIONS FOR GUIDANCE

10 Marks Questions (One page answer)

1. State the special features of international trade.
2. What are the differences between internal trade and international trade?
3. Mention the advantages and disadvantages of international trade.

20 Marks Questions (Three page answer)

1. Explain Adam Smith's Theory of Absolute cost Advantage.
2. State and illustrate the Doctrine of Comparative costs as enunciated by David Ricardo.
3. Analyse the core of Hecksher-Ohlin theory of International Trade. Illustrate your answer
4. What are the assumptions of H-O theory? Critically examine these assumptions?

UNIT - 2

GAINS FROM INTERNATIONAL TRADE

Space for Hints

INTRODUCTION

It goes without saying that international trade is beneficial to the countries which involve in trade. A country will not trade with another country, if it does not gain from trade. When one country trades with other nations, it gains not only through its exports of goods and services it produces in excess, but also it obtains what it requires which it cannot produce. In addition, it increases production and it also fetches new technology with which it can increase the consumption resulting from exchange of goods and specialisation in production through international trade.

This unit gives an account of the nature of gains, factor endowment and technological conditions, potential gain and actual gain, criteria of measuring gains from international trade, factors determining size of gain and international trade and economic development.

UNIT OBJECTIVES : After studying this unit, you would be able to

- Understand the nature of gains,
- Learn the factor endowment and technological conditions,
- Differentiate potential gain from actual gain,
- Know the criteria of measuring gains from international trade,
- Identify the factors determining the size of gain, and
- Understand the international trade as an engine of growth of the economy.

UNIT STRUCTURE

1. International Trade - Participating Nations Gain Mutually

1.1 The Nature of Gains

1.2 Factor Endowments and Technological Conditions

1.3 Potential Gain and Actual Gain

1.4 Criteria of Measuring Gains from International Trade

1.5 Factors Determining Size of Gain

2. International Trade and Economic Development

2.1 Impact of Foreign Trade on Economic Development - Classical View

2.2 Direct Benefits from Foreign Trade

2.3 Indirect Benefits from Foreign Trade

2.4 Trade as an Engine of Growth - Different View Points

2.5 Trade as an Engine of Growth - Criticisms

2.6 Conclusion

3. Answers to CYP Questions

4. Model Questions for Guidance

1. INTERNATIONAL TRADE - PARTICIPATING NATIONS GAIN MUTUALLY

Countries are not obliged to trade but they do trade because international trade is beneficial to the countries. Malthus held that the gain from trade consisted of "the increased value which results from exchanging what is wanted less for what is wanted more", and that "international trade, by giving us commodities much better suited to our wants and tastes than those which had been sent away, has decidedly increased the exchangeable value of our possessions, our means of enjoyment and our wealth". That is, the nations gain, since they export, what they have in excess and import what they are badly in need of.

1.1 THE NATURE OF GAINS

As Ohlin states, the disadvantage of disproportionate geographical distribution of productive resources are compensated to certain extent by international trade. That is, the loss attributed to the immobility of factors is overcome by the product movements between the trading countries. This forms the basis for modern theory of international trade. The geographical distribution of productive resources are not proportionate. That is, certain places are endowed with certain resources. This disadvantage is compensated by international trade because the products made out of these resources can be exported. In other words, the resources are exported

indirectly through the products. Thus, under international trade, each country gets more of each variety of goods, more varieties and qualities of goods to consume.

Another important aspect of international trade is specialisation. Each country specialises in the production of those commodities for which it is best suited. Because of international specialisation and geographical division of labour, the world resources are utilised in the best possible way. This causes enlargement of world's total output. All the output can be sold out in the wide world market provided by international trade.

Thus, international trade leads to an increase in the world's prosperity and welfare of each trading nation. The living standards of trading countries in turn improve. Hence, the world at large becomes a happy world.

1.2 FACTOR ENDOWMENTS AND TECHNOLOGICAL CONDITIONS

The total gain reaped by the participating nations increases as the size of foreign trade increases and vice versa. However, kinds and quality of factors available to a country and its technological advancement affect the size of trade. A big capital abundant and technically as well as economically advanced country will have a large size of foreign trade than a small, labour-abundant technically and economically backward country. Moreover, a country exporting manufactures will have a larger share of the gain against a country exporting primary products.

1.3 POTENTIAL GAIN AND ACTUAL GAIN

Trade between two countries takes place as far as there is a difference in the cost ratios of the commodities in country A and country B. If the cost ratios are equal, there will not be any gain to any country and so there will not be any trade. Based on these, the potential gain is defined as the difference in domestic cost ratios of producing two goods. That is,

Check Your Progress

1. What do you mean by Potential Gain?
2. What do you understand by Actual Gain?

$$G' = \left[\frac{C_x}{C_y} \right]_A - \left[\frac{C_x}{C_y} \right]_B$$

where

G' stands for the potential gain.

C_x for the money cost per unit of X.

C_y for the money cost per unit of Y.

and the subscripts A and B refer to the respective countries.

But, when the trade actually takes place, the price ratios of the commodities in country A and country B are compared. So, the actual gain is measured by the difference in price ratios of the two commodities X and Y in the two countries A and B. That is

$$G = \left[\frac{P_x}{P_y} \right]_A - \left[\frac{P_x}{P_y} \right]_B$$

Where,

G stands for the actual gain

P_x for the price of x - commodity

P_y for the price of y - commodity

and the subscripts A and B refer to the respective countries.

Suppose, perfect competition exists in the factor market as well as in the commodity market. And also, the trade is free without any tariff imposition. If both the conditions are fulfilled

$$(P_x/P_y) = (C_x/C_y)$$

for both the countries.

$$\therefore G = G'$$

Under this condition, the gain is maximised. In reality, there is no perfect competition in the factor market or commodity market and free trade is not possible on account of tariff imposition. The difference in price ratio will be less than the difference in cost ratio.

i.e., $G < G^1$

∴ In reality, actual gain always tends to be less than potential gain.

1.4 CRITERIA OF MEASURING GAINS FROM INTERNATIONAL TRADE

Gains accrue to all the countries participating in international trade. Following are the criteria employed by the classical economists for measuring the gain from trade accruing to an individual country.

1. Reduction in the cost of production.
2. Increase in the productivity of the factors.
3. Enhancement of the Real Income.
4. The Nature of Net Terms of Trade.

As a country specialises in the production of a particular commodity, the cost of production will decrease. This reduction in the cost of production can be employed as a measure

$$G = C_a - C_b = -ve \text{ value}$$

where G represents the gain

C_b represents the cost of production per unit before trade and C_a represents the cost of production per unit after trade.

As a result of specialisation, general productivity increases. So the difference in productivity is used as a measure.

$$G = MPP_a - MPP_b = + \text{ value}$$

where MPP_a represents the general productivity after trade and MPP_b represents the general productivity before trade.

Due to international trade, the real income of the nation increases. Therefore,

$$G = Y_a - Y_b = + \text{ value}$$

Where

Y_a represents the real income after trade and Y_b represents the real income before trade.

Net terms of trade is the important criterion used for measuring the gains.

Net terms of trade is defined as the ratio of export price index to import price index. i.e., $\frac{P_x}{P_m}$

where P_x is the export price index and P_m is the import price index

If $\frac{P_x}{P_m} > 1$ (is greater than 1) for country A, then country A will get a larger share of the gain.

If $\frac{P_x}{P_m} < 1$ (less than 1), it gets a smaller share of gain.

Similarly, relative elasticity of demand for the commodities can also be used for measuring the gains.

However, in modern analysis, Ohlin opines that the world is a dynamic world and the trade causes many radical changes. Therefore, he feels that it is not worthwhile discussing the question of the total gain from trade or its division between the trading countries.

1.5 FACTORS DETERMINING SIZE OF GAIN

Following are the important factors determining the size of gain and the share of each participating nation:

(i) Nature of Terms of Trade

The rate at which one country's goods exchange against those of another is known as the terms of trade. Let us illustrate the influence of the terms of trade with an example.

Let us take the example of comparative cost differences between two countries, and suppose that the following table represents the output possibilities for given factor inputs.

TABLE 2.1
OUTPUT POSSIBILITIES OF COUNTRIES A AND B

Space for Hints

Country	Output from available resources of the country	
	X-commodity units	Y-commodity units
A	3	2
B	1	1

The terms of trade will lie between

3 units of X = 2 units of Y and

1 unit of X = 1 unit of Y.

Country A alone will gain if the terms of trade is 1 unit of X = 1 unit of Y. Country B alone will gain if the terms of trade is 3 units of X = 2 units of Y. Since the terms of trade will lie between these two, both the countries share the gain.

Country A will get a larger share of the gains, when the terms of trade are closer to the domestic exchange ratio of country B and lesser share if the terms of trade are closer to the domestic exchange ratio of country A.

(ii) Difference in Cost Ratios

Gain by trade is possible only when the cost ratios are different in country A and country B. If the difference between the cost ratios are larger, the total gain will be greater. Let us illustrate this point with an example.

TABLE 2.2
**INITIAL COST CONDITIONS OF
THE COUNTRIES**

Commodity	Production cost per unit	
	India (Rs.)	U.S.A.(\$)
Wheat	10	1
Tea	5	1
Cost Ratio	10:5=2:1	1:1

India will specialise in the production of tea and U.S.A. in the production of wheat.

Whenever a commodity is produced more and more, the law of diminishing cost and the law of constant cost operate only upto a certain point. After that, only the law of increasing cost operates. So, as a country increases her output, the cost will rise and as she reduces her output, the cost will fall.

As India produces more and more of tea, the cost will rise and as India produces less and less of wheat, the cost will fall. Just the reverse thing will happen in U.S.A. Let the final position be

TABLE 2.3
FINAL COST CONDITIONS AND COST RATIOS OF
THE COUNTRIES

Commodity	Production cost per unit	
	India (Rs.)	U.S.A.(\$)
Wheat	9	1.35
Tea	6	0.90
Cost Ratio	9:6=1.5 : 1	1.35:0.9=1.5 : 1

The cost ratio is the same in both the countries and at this level the trade between the countries will stop. In other words, there will not be any gain to any of the countries when the cost ratio is the same.

So, if the difference between the cost ratios are larger, the total gain will be greater and vice versa.

(iii) Production Efficiency of the Country

The gain from international trade also depends upon the relative productive efficiency of the country.

Suppose, the productive efficiency of producing tea in India increases. Consequently, its cost and price will fall. So U.S.A. can get more amount of tea for the same amount of wheat. That is, it is advantageous to U.S.A.

Since tea is cheaper, the demand for tea in U.S.A. will increase. It leads to an expansion in the volume of trade. So the total gain from trade increases.

Thus, if the productive efficiency of one country increases, it will be advantageous to the other country. Moreover, the total gain from trade increases.

(iv) Relative Elasticity of Demand

The gain from international trade also depends upon the relative elasticity of demand for the commodities in different countries and the relative elasticity of supply of different commodities in different countries.

Let us say that India specialises in the production of tea. In that case, the real income of India increases since India is more suitable for the production of tea and thereby its resources are utilised in the best possible way. Similarly U.S.A. specialises in the production of wheat and her real income increases.

Further, due to international trade, wheat is cheaper in India and tea is cheaper in U.S.A. Since the price of wheat is lower in India and the price of tea is lower in U.S.A, the respective demand increases. The increase in demand depends upon the elasticity of demand. More elastic the demand for the commodities in both the countries, the greater would be the volume of trade, output and real income and larger the total gain.

2. INTERNATIONAL TRADE AND ECONOMIC DEVELOPMENT

Right from the mercantilists to present day economists, foreign trade has been regarded as vital for economic development. Entire mercantilistic doctrine hinges on foreign trade. Classical and neo-classical economists attached so much importance to foreign trade in the process of economic development that they regarded it as the engine of growth. Quite contrary view holds that it has led to international inequality whereby the rich countries becoming richer at the expense of the poor. It is therefore

contended that even if underdeveloped countries are required to sacrifice the gain from international specialisation, they can attain a higher rate of development by following policies of import substitution and deliberate industrialisation, and therefore expand output for domestic consumption.

2.1 IMPACT OF FOREIGN TRADE ON ECONOMIC DEVELOPMENT - CLASSICAL VIEW

Foreign trade is vital for underdeveloped economies. It ensures high rate of economic development. It provides an urge to develop the knowledge and experience that makes development possible, and means of accomplish it. The nineteenth century engine of growth foreign trade, does not now-a-days operate sufficiently powerfully to allow primary producing countries to make full use of their domestic markets. Trade can be analysed exclusively in terms of international specialisation, but is also the means by which growth is transmitted from the centres of economic expansion through a steadily rising demand for imports of primary commodities. This rising demand not only provides an expanding source of employment in the primary producing countries but also attracts capital and labour to them and accelerates the process of growth transmissions. Foreign trade has made tremendous contribution to the development of less-developed countries. In good many of the underdeveloped countries economic development aims to unite the subsistence and the market sector of the economy. That is, it provides fresh opportunities of development.

Principle of Comparative Costs leads to international specialisation and division of labour. This specialisation is beneficial because (1) production of different commodities require various resources in different proportions. (2) different regions of the world are differently endowed with various kinds of economic resources, and (3) international mobility of factors as land, labour and capital is limited.

Adam Smith mentioned of gains from foreign trade and its impact on the process of economic development. He wrote, "Between whatever places foreign trade is carried on all of them desire two distinct benefits from it. It

carries out that surplus for which there is no demand among them, and brings back in return from it something else for which there is a demand. It gives value to the superfluities, by exchanging with something else, which may satisfy a part of their wants and increase their enjoyments. By opening more extensive market for whatever part of the produce of their labour may exceed the home consumption, it encourages them to improve its productive power, and to augment its annual produce to the utmost and thereby to increase real revenue and wealth of society". It reveals the following facts:

First, foreign trade widens the scope of market creating outflow of surplus over domestic consumption of the isolated economy. Should the isolated economy having sufficient surplus be allowed to enter into trade it shall have costless means of acquiring imports and expanding aggregate domestic activities.

Second, by widening the extent of the market, it improves the division of labour raising general level of productivity within the country. It is often referred to as Productivity Theory of International Trade.

2.2 DIRECT BENEFITS FROM FOREIGN TRADE

When a country specialises in the production of few goods due to foreign trade and division of labour, it exports those commodities which it produces cheaper in exchange for what others can produce at a lower cost. Thus, both the countries get benefit from trade. As a result, level of national income and the rate of growth of the economy rises. A high rate of economic growth is therefore ensured in the economy. This higher level of output breaks the vicious cycle of poverty and promotes the economic development.

Under developed countries are characterised by low size of market that fail to absorb sufficient volume of output. It leads to low inducement to invest. Small market is further accentuated by low per-capita income and purchasing power. Foreign trade tends to widen the market and raises the level of saving through more efficient allocation of resources. Most of the

Check Your Progress

3. What is meant by direct benefit?

underdeveloped economies specialise in the production of one or two staple commodities that are exported to widen the market. The expansion of market leads to a number of internal and external economies and hence, to the reduction in the cost of production. It further helps to transform the subsistence sector into monetised sector by providing markets for farm produce and raise the income and the standards of living of the peasantry.

Caincross writes, Economic growth can be transmitted from one country to another both directly and indirectly. Trade does much more than provision of market and encourages growth or reallocation of the resources necessary in order to supply goods. It also transmits experience and ideas, changes attitudes and institutions and blows up obstacles for further development.

2.3 INDIRECT BENEFITS FROM FOREIGN TRADE

In addition to above direct benefits, there are indirect benefits even. These include provision of capital through international investment, access to the means of development in the form of raw materials, semi-finished goods and machinery, access to knowledge, skill, managerial ability and so on; and the galvanizing influence of competition. Indirect benefits are greater in less developed than in more highly industrial countries. Specialisation of these benefits leads to more gains. The larger the indirect gains the less reliable is the growth of exports as a measure of economic development. Some of the indirect benefits are the following:

- (i) Foreign trade facilitates the exchange of domestic goods having low growth potential for foreign goods having high growth potential. The staple commodities of underdeveloped countries are exchanged for machinery, raw-materials and semi - finished goods and materials; these are able to accelerate the pace of development by importing from developed countries and establishing social and economic overheads and directly productive activities. Thus, larger exports enlarge the volume of imports of equivalent that can be financed through endangering the balance of

Check Your Progress

4 What is meant by indirect benefit?

payments and the greater degree of freedom makes it easier to plan domestic investment for development.

(ii) Foreign trade possesses an educative effect as well. Underdeveloped countries lack in critical skills. These impede development. The scarcity of capital does not impede the process to that extent. Foreign trade overcomes this. Foreign trade helps in accelerating the development of poor countries by facilitating the selective borrowing of ideas, skills and know how from the developed countries and adopting them in accord with their factor endowment.

(iii) Foreign trade provides the basis for the importation of foreign capital in underdeveloped economies. Should there be no foreign trade, foreign capital would not flow from the rich to poor countries. The volume of foreign capital depends among other factors on the volume of trade, greater will be the ease with which a country can pay back interest and principal. It is much easier to get foreign capital for export increasing industries than for import substitution and public utility industries. But from the point of view of importing country, the use of foreign capital for import substitution, public utilities and manufacturing industries is more beneficial for accelerating development than merely for export promotion. Foreign capital not only explores new employment avenues, increases level of income and output but also smoothens the balance of payments and inflationary pressures.

(iv) Mill thought trade resulted in a "more efficient employment of the productive forces of the world", and this may further be regarded as the "direct economical advantage of foreign trade. But, Mill emphasised, "there are, besides, indirect effect which must be counted as benefits of a higher order", one of the most significant indirect dynamic benefits is, "the process of production."

2.4 TRADE AS AN ENGINE OF GROWTH- DIFFERENT VIEW POINTS

In the 19th century, there was concentration of modern industrial production in Great Britain. Increase in industrial production accompanied

with increase in population, in resources - poor Britain, led to increasing import of raw materials and food from the regions or recent settlements such as United States, Canada, Australia, New Zealand, Argentina, Uruguay and South Africa. For instance, in Britain during 1815 - 1913, Britain's population tripled, GNP increased ten times and the volume of imports increased by 20 times. This growth effects have spread to other nations, particularly, the regions of recent settlement through the accelerator, multiplier process. Thus, the export sector was the leading sector which brought growth and development in these countries.

The regions of recent settlement were able to export food and raw materials because of several favourable factors.

(1) These countries were richly endowed with natural resources such as fertile arable land, forest and mineral deposits.

(2) Workers with different skills moved from over - populated Europe to these mostly empty lands.

(3) There were huge inflow of capital into these new nations. The huge inflow of capital and workers made possible the development of infrastructure such as railroads, canals and improvement in sea transportation enabled these countries to supply food and raw materials more cheaply.

Thus, international trade functioned as an engine of growth of these nations during 19th century.

There are however, some economists who strongly believe that the international trade and the functioning of the present international monetary system have hindered rather than facilitated development through secularly declining terms of trade and widely fluctuating export earnings for developing nations. These economists criticised that standard international trade theory based on comparative advantages is completely irrelevant for developing nations and the development process. They advocate

industrialisation through import substitution, that is, domestic production of manufactured goods previously imported.

Some economists like Habarler and Caincross strongly argue that foreign trade can contribute substantially to the development of the developing countries. Gunnar Myrdal, Prebisch, Singer and others maintain the accrual of the gains from trade is biased in favour of the industrial countries. They view traditional trade theory as involving adjustment to existing conditions. While development necessarily require changing existing conditions. In short, traditional trade theory may maximize welfare at one point of time but not over time.

2.5 TRADE AS AN ENGINE OF GROWTH - CRITICISMS

(i) In spite of the contribution that it has made to world economic development, foreign trade is not a popular engine of growth. The foregoing analysis - based on comparative cost doctrine has been criticised by Raul Prebisch, H.W.Singer and Gunnar Myrdal. They argue that historically foreign trade has retarded the development of underdeveloped economies. Myrdal writes, "A quite normal result of unhampered trade between two countries of which one is industrial and the other underdeveloped is the invitation of a cumulative process towards the impoverishment and stagnation of the latter". One, the adverse effect of international capital movements; two, the operation of the international demonstration effect adversely and three, a secular deterioration in the commodity terms of trade.

(ii) Caincross has emphasised three reasons. These are:

"First of all it carries with it the dependence of external forces. This means that the pace of development cannot be set by domestic policy but is set by forces that are not within the control of the indigenous authorities nor indeed of any authority indigenous or foreign. Further the export rises, the higher this dependence mounts. More resources become tied to export requirements and less are left to meet the needs of the domestic market, so that there is less room for manoeuvre in organising an economic structure

adopted to those needs. In the underdeveloped countries, dependence on external forces is particularly resented, since it is associated with colonialism and loss of status and with the sense of inequality that always accompanies the dependence of the poor on the rich. Whether these attitudes are justifiable in terms of history or not, and whether they are harmful or otherwise to the countries where they prevail, their very existence itself limits the scope for foreign trade and the use that can be made in the future patterns of development that were important in the past.

The second source of objection is that foreign demand impinges only on a limited sector of the economy. Whatever the variety of their agriculture, they depend upon a single product for at least half their export earnings.

(iii) It is a further source of disquiet that the export-sector in such economies is rarely the vehicle of innovation in other sectors. The export markets of these countries are consequently sluggish. On the other hand, they have a growing population to employ and may be losing an opportunity of developing other assets through sheer stagnation of demand. In such circumstances, it is urged they have no option but to adopt a new pattern of advance and make deliberate efforts to develop their home market. The transmission of growth from foreign markets through foreign trade has ceased to be sufficiently powerful engine of development.

2.6 CONCLUSION

In the actual, prevailing trade practices, the assumption of the Neo-Classical Theory have been questioned and they are said to be unrealistic. "Trade is an engine of growth" is denied by economists in the developing countries. The imposition of tariff and non-tariff barriers by the industrial countries restrict imports from developing countries. Therefore, trade-based strategy of growth does not take place in many developing countries, except in a few countries like Taiwan, Singapore and South Korea.

3. ANSWERS TO CYP QUESTIONS

1. Refer 1.3
2. Refer 1.3
3. Refer 2.2
4. Refer 2.3

4. MODEL QUESTIONS FOR GUIDANCE

10 Marks Questions (One page answer)

1. State the meanings of Potential and Actual Gains.
2. Mention the nature of gains obtained from international trade.

20 Marks Questions (Three page answer)

1. How do you measure the gains from international trade?
2. “Trade as an engine of economic growth” - Discuss.

UNIT - 3

TERMS OF TRADE

Space for Hints

INTRODUCTION

When trade takes place, two or more countries exchange their goods and services among themselves. A student of Economics may be interested in knowing how or on what basis these transactions or exchange of goods and services take place between them. On what terms one country is ready to part with its goods to the commodities it is to receive from another country. This is explained in this Unit. In addition, there are some factors which influence the terms of trade between countries and they are also explained in this Unit.

UNIT OBJECTIVES : After studying this unit you will be able

- To understand how one country exchanges its goods with other countries,
- To know the base on which the values of the goods are measured when they exchange goods among themselves,
- To understand the formulae used to measure the exchange of goods among themselves.
- To identify the factors influencing the terms of trade.

UNIT STRUCTURE

1. Terms of Trade - Meaning and Various Concepts
 - 1.1 First Set of Definitions
 - 1.2 Second Set of Definitions
 - 1.3 Third Set of Definitions
2. Net Barter Terms of Trade
 - 2.1 Export Price Index
 - 2.2 Import Price Index
 - 2.3 Computation of Net Barter Terms of Trade
 - 2.4 Comparison for Two Years

2.5 Uses

2.6 Limitation

3. Gross Barter Terms of Trade (T_g)

3.1 Formula

3.2 Comparison between Two Years

4. Income Terms of Trade (T_y)

5. Single Factoral Terms of Trade (T_f)

6. Double Factoral Terms of Trade (T_{ff})

7. Real Cost Terms of Trade (T_r)

8. Utility Terms of Trade (T_u)

9. Factors Influencing Terms of Trade

10. Answers To CYP Questions

11. Model Questions for Guidance

1. TERMS OF TRADE - MEANING AND VARIOUS CONCEPTS

Whenever trade takes place between two countries, there will be exchange of commodities. The rate at which this kind of exchange takes place between countries is called terms of trade. How to account for the different commodities measured in terms of different units? How to calculate the terms of trade under such circumstances? To answer these questions we have to define different concepts of terms of trade.

1.1 FIRST SET OF DEFINITIONS

We can define the concepts in terms of the ratio of exchange between commodities. They are:

- i. Net barter or commodity terms of trade.
- ii. Gross barter terms of trade and
- iii. Income terms of trade

1.2 SECOND SET OF DEFINITIONS

Different nations are endowed with different types of productive resources. These productive resources cannot be exported or imported. So the commodities that are produced by making use of these productive

resources are interchanged. Indirectly it is the interchange of productive resources. So, we can define the terms of trade concept considering trade as the interchange of productive resources between countries. There are two versions in this regard. They are:

- iv. Single factorial terms of trade and
- v. Double factorial terms of trade.

1.3 THIRD SET OF DEFINITIONS

International trade takes place because benefits accrue to both the countries. These benefits are to be measured in terms of Utility and the loss in terms of Real cost. The concepts based on these terms are:

- vi. Real cost terms of trade and
- vii. Utility terms of trade.

2. NET BARTER TERMS OF TRADE

Here, we are going to consider the relation between two world prices-export price and import price. Since there are a number of commodities, we cannot take any single price as export price or import price. So we adopt a method of finding a special average called index numbers.

2.1 EXPORT PRICE INDEX

The export price index represents the average price level of all the exports with reference to base year for which the export price level is taken to be 100. For example,

Year	2000	2001	2002
Export Price Index	100	150	120

Let us represent the export price by P_x . Then we have to specify the year. For that we use the suffix '0' to represent the base year and '1' to represent the current year i.e., P_{x0} represents the export price index for the base year and P_{x1} , represents the export price index for current year.

Check Your Progress

1. What is meant by Net Barter Terms of Trade?

2.2 IMPORT PRICE INDEX

Space for Hints

Similarly the import price index represents the average price level of all imports with reference to a base year for which the import price level is taken to be 100 : For example,

Year	2000	2001	2002
Export Price Index	100	120	150

Suppose, we represent the import price index by P_m . We use the suffix '0' to represent the base year and '1' to represent the current Year. P_{m0} represents the import price index for the base year and P_{m1} represents the import price index for the current year.

2.3 COMPUTATION OF NET BARTER TERMS OF TRADE

Net barter terms of trade is defined as the ratio between the export price index and import price index. Viner calls this the commodity terms trade. Symbolically,

$$T_n = (P_x / P_m)$$

Where T_n represents Net barter terms of trade.

2.4 COMPARISON FOR TWO YEARS

Suppose, we have to compare the net barter terms of trade of a country for two years, i.e., current year and base year. In that case, we have to consider the ratio.

$$(P_{x1} / P_{m1}) : (P_{x0} / P_{m0})$$

When we consider the years 2001 and 2000 the ratio will be

$$(150/120) : (100/100) \quad \text{i.e., } 1.25 : 1 \quad \text{i.e., } 125 : 100$$

In 2001 the terms of trade shows an improvement of 25%, i.e., if the export prices rise relative to import prices, the terms of trade move favourably to that country.

When we consider the years 2002 and 2000

$$(120/150) : (100/100) = 0.8 : 1 \text{ (i.e.) } 80 : 100$$

In 2002, the terms of trade fall by 20%, i.e., if the import price rises relative to export prices, the terms trade are unfavourable to that country.

2.5 USES

Net barter terms of trade (T_n) is the widely used concept in the short run. Further, it expresses the purchasing power of exports. That is, we can get an idea about the amount of commodity that can be imported for a given amount of exports. It is obvious that when a country's terms of trade are favourable, the country can get more imports for a given amount of exports and vice versa.

2.6 LIMITATION

The draw back of this concept is that it does not reveal anything about the behaviour of the balance of payments. T_n is relevant only when nothing enters into the trade between countries except sales and purchases of merchandise.

3. GROSS BARTER TERMS OF TRADE (T_g)

This concept is defined by Professor Taussig. This is considered to be an improvement over net terms of trade. Instead of comparing the price indices, here quantity indices are compared.

3.1 FORMULA

$$T_g = (Q_m / Q_x) \text{ where } T_g \text{ stands for gross barter terms of trade}$$

Q_m for quantity index of imports and

Q_x for quantity index of exports.

3.2 COMPARISON BETWEEN TWO YEARS

We can compare the change between the current year (1) and the base year (0) by considering

$$(Q_{m1} / Q_{x1}) : (Q_{m0} / Q_{x0})$$

Suppose, the following table is given.

Check Your Progress

2. What do you understand by Gross Barter Terms of Trade?

Index	Year		
	2000	2001	2002
Import quantity index	100	150	120
Export quantity index	100	120	150

Therefore when we compare 2001 and 2000

$$T_g = (150/120) : (100/100) \quad 125 : 100 = 1.25 : 1$$

The terms of trade rise by 25% and are favourable to the home country.

If we compare 2002 and 2000, the ratio will be

$$(120/150) : (100/100) \quad 0.8 : 1 \quad \text{i.e., } 80 : 100$$

Here the terms of trade have fallen by 20% and are now unfavourable to the country.

If the balance of trade is in equilibrium, T_n and T_g are equal. If the balance of trade is not balanced T_g and T_n differ. T_g gives more importance to changes in the balance of payments than the price movements. If the balance of payments includes unilateral payments, so that there is an excess in money value of either exports or imports, then the relevant concept is T_g . Many economists prefer T_n because T_n gives more importance to price movements than T_g .

4. INCOME TERMS OF TRADE (T_y)

This was introduced by G.S.Torrance. This is defined as

$$T_y = (P_x \cdot Q_x) / P_m$$

Where, T_y stands for income terms of trade and other notations are as usual. This can also be written as $T_y = T_n \cdot Q_x$ since $T_n = (P_x / P_m)$

A rise in T_y indicates that the country can obtain a larger volume of imports from the sale of its exports. If India's T_y increases from 100 to 125, then India can import 25% more for the same amount of export.

T_y shows the nation's "capacity to import" - with export earnings, since $[(P_x \cdot Q_x) / P_m]$ determines Q_y . It is more useful to developing countries.

T_y should not be interpreted as a measure of the gain from trade or an indicator of welfare. It should be used simply as a measure of export -based capacity to import. This is different from total capacity to import, which includes capital inflow and other invisible exchange receipts with exports.

5. SINGLE FACTORAL TERMS OF TRADE (T_f)

This concept and all the other three concepts following were introduced by Professor Viner. This concept is based on the fact that whenever two commodities are exchanged, indirectly the factors used for the production of those commodities are exchanged.

This is introduced as an improvement over T_n . The index of the amount of export that can be produced by a unit factor, i.e., Export productivity index (F_x) is taken into account.

$$T_f = T_n \cdot F_x = [(P_x / P_m) \cdot (F_x)] [\because T_n = (P_x / P_m)] \text{ where}$$

T_f - single factorial terms of trade

T_n - net terms of trade and

F_x - export productivity index

A rise in T_f implies that the service of one unit of factor employed in producing exports can exchange with more units of imports. So a rise in T_f is considered to be favourable. This index suffers from the shortcoming that it does not take into consideration the potential domestic cost of production of imports.

6. DOUBLE FACTORAL TERMS OF TRADE (T_{ff})

The defect in T_f is rectified by correcting T_{ff} for changes in productivity in producing imports as well as exports. Thus, double factorial terms of trade (T_{ff}) is expressed as

$$T_{ff} = [T_n \cdot (F_x / F_m)] = [(P_x \cdot F_x) / (P_m \cdot F_m)] \quad [T_n = (P_x / P_m)]$$

Where F_m is the import productivity index. A rise in F_m shows that the services of one unit of home factor for the production of exports now

Check Your Progress

3. What do you mean by Single Factoral Terms of Trade?

4. What is the meaning of Double Factoral Terms of Trade?

exchanges for the services of more units of the foreign factors used for the production of imports. T_{ff} will diverge from T_f when there is a change in the factor cost of producing imports.

Kindle Berger, however, regards T_f as a much relevant concept than T_{ff} because a country is interested in knowing whether it receives more goods per unit of its "exported factor input" - not whether these imports contain more or less foreign inputs than before. In practice, both the concepts (T_f and T_{ff}) could not be used because of the difficulties involved in calculating the movements in productivity.

7. REAL COST TERMS OF TRADE (T_r)

Here we produced more directly to the level of welfare analysis. We want to express the total sacrifice of utility involved in the surrender of exports. Real cost terms of trade (T_r) is obtained by multiplying T_f with the index of the amount of disutility (irksomeness) per unit of productive resources used in producing exports (R_x). $T_r = T_f \cdot R_x$ gives the real cost terms of trade. If T_r rises as result of change in the methods of producing exports or a change in the factor proportions used in exports, this would indicate that the amount of imports obtained per unit of real cost is greater.

Here, the disutility of sending the exports is taken into account but the utility of getting the imports is neglected. This is the drawback of this concept.

8. UTILITY TERMS OF TRADE (T_u)

The defect in T_r is rectified in utility terms of trade (T_u). We define utility terms of trade as the total amount of gain from trade as the excess of the total utility accruing from imports over the total sacrifice of utility involved in the surrender of exports. So the utility terms of trade (T_u) is defined as, $T_u = T_r \cdot U_1$ where U is the index of the utility of imports relative to exports. Professor Robertson calls this index as the "true terms of trade".

Check Your Progress

6. What do you understand by Utility Terms of Trade?

In practice due to the difficulties involved in measuring the utility and disutility, T_r and T_u cannot be employed, the other three T_n , T_g and T_y are considered to be relevant concepts of the terms of trade for poor countries. Among the three, the net barter terms of trade or commodity terms of trade [$T_n = (P_x / P_m)$] is considered to be the most relevant concept and is commonly employed in practice.

9. FACTORS INFLUENCING TERMS OF TRADE

Let us have a discussion on the factors that affect the terms of trade.

(i) Economic Development

Economic growth may be defined simply as an increase in a country's gross national product overtime. With economic development, per capita income also rises. Rising income probably causes an increase in demand for the imports. A slower rise of development might allow a country's commodity terms of trade to improve, whereas a higher rate would cause a deterioration.

(ii) Tariffs

A tariff imposed by a country alters the terms of trade. But, a tariff can improve terms of trade only when the offer curve of opposite country is not perfectly elastic and it does not retaliate by imposing a tariff on its imports from the country concerned. In the case of retaliation, the final effect of tariff depends on the relative size of the tariff of both the countries. But due to tariffs, the prices of the commodities increase and the volume of trade decreases. Consequently it is a loss for both the countries.

(iii) Devaluation

Devaluation implies the lowering of the exchange rate of the country's currency. When a country devalues, the foreign price of its exports typically falls. By contrast the domestic price of imports normally rises. Many people conclude therefore, that devaluation worsens the terms of trade because it reduces export prices and increases the import prices.

This seemingly straight forward interpretation is not necessarily correct. The correct procedure is to compare export and import prices in the same currency; either domestic or foreign and then determine the effect of devaluation.

(iv) Demand Shifts

At a given terms of trade, the demand for and supply of imports and also the demand for and supply of exports of two countries will be in inequilibrium. Thus, other things being equal, if there is an increase in the demand for a country's export, the prices of exports relative to imports will rise. That means, there is an improvement in the terms of trade of this country. Similarly, when there is a rise in the demand for a country's imports, the prices of imports will rise relative to exports and the terms of trade will deteriorate.

10. ANSWERS TO CYP QUESTIONS

1. Refer 2
2. Refer 3
3. Refer 5
4. Refer 6
5. Refer 8

11. MODEL QUESTIONS FOR GUIDANCE

10 Marks Questions (One page answer)

1. Distinguish between Gross Barter Terms of Trade and Net Barter Terms of Trade.
2. Explain Single Factoral Terms of Trade.

20 Marks Questions (Three page answer)

1. Explain different concepts of terms of trade.
2. Discuss the factors influencing the terms of trade.

UNIT - 4

FREE TRADE VERSUS PROTECTION AND PROTECTIVE MEASURES

Space for Hints

INTRODUCTION

It is given to understand that some noted economists like Adam Smith, David Ricardo, J.S.Mill and Bastable regarded the entire world as one universe and they advocated free trade. That is, the trade between two or more countries should have no barrier or control. International trade should be of control free in nature. Any country can make trade with any other country that it wishes to.

On the contrary, there are some economists like Fredrich List, who are of the opinion that the economies should have some control over the international trade. It is because every economy or country should protect its indogenous industries from world competition by developed economies. Hence, they argue in favour of protection.

In this unit the students learn the arguments in favour of Free Trade and against Free Trade. If at all, the countries go in for protection, how they protect their economies are given vividly.

UNIT OBJECTIVES : After studying this unit, you will be able

- To understand the concept of free trade, protection and different methods adopted to protect them.
- To learn the arguments in favour of and against free trade and protection.
- To know the different methods adopted to protect trade like tariffs, quotas, dumping and the like.

UNIT STRUCTURE

1. Free Trade Versus Protection

1.1 Concept of Free Trade

1.2 Arguments for Free Trade

1.3 Free Trade and Under Developed Countries

- 1.4 Arguments Against Free Trade Policy
 - 1.5 Arguments In Favour of Protection
 - 1.6 Arguments Against Protection
 - 1.7 Protection At Present - Universal
 - 1.8 India's Trade Policy
2. Types of Tariffs and Quotas
 - 2.1 Advalorem Duty
 - 2.2 Specific Duty
 - 2.3 Compound Duty
 - 2.4 A Comparison of Advalorem Duty and Specific Duty
 - 2.5 Single Column Tariff
 - 2.6 Double Column Tariff
 - 2.7 Conventional Tariff
 - 2.8 Quotas
 - 2.9 Import Quotas
 - 2.10 Bilateral Quotas
 - 2.11 Mixing Quotas or Indirect Quotas
 - 2.12 Licensing of Imports
3. Answers To CYP Questions
 4. Model Questions for Guidance

1. FREE TRADE VERSUS PROTECTION

1.1 CONCEPT OF FREE TRADE

Free trade is the external trade system of liberalism and it opposes every interference by the State with the free play of economic forces. Classical economists like Adam Smith and Ricardo strongly advocated the policy of free trade against Mercantilism which was dominating England and the continental countries in the 16th and 17th centuries. According to Adam Smith, the concept of free trade policy refers to a "system of commercial policy which draws no distinction between domestic and foreign commodities and thus which neither imposes additional burden on the latter nor grants a special favour to the former". The advantages of free

Check Your Progress

1. What is meant by Free Trade?

trade were highlighted by the followers of Adam Smith like David Ricardo, J.S. Mill and Bastable. Among all, Ricardo was the ardent supporter of free trade. Free trade was accepted as the best commercial policy for about a century. Of course, sporadic attacks on the policy of free trade were made during the 19th century. In fact, Fredrich List severely attacked Smith's concept of free trade. But List was no match for Smith and so no serious harm was done to free trade policy. However, the Great Depression of 1930's struck a severe blow to free trade. Economists seriously questioned the validity of the assumptions underlying the Classical Theory of Free Trade. Keynes argued for protection and state intervention in the economic activity to lift the economy from depression. In spite of these developments, free trade policy was never completely abandoned and it had a great vitality to sustain any attack. The world witnessed rigorous controls on trade and commerce during 1930's, 40's and 50's. However, attempts were being made since 1940's to restore free trade by forming free trade areas. During last one decade the world has been moving closer towards free trade.

1.2 ARGUMENTS FOR FREE TRADE

The advocates of free trade have advanced the following arguments:

(i) Free Trade and Output Maximization

Free trade is defended on the ground of maximization of social outputs. The 'invisible hand' makes it possible to exploit advantages of division of labour and specialisation thereby enabling the countries to produce the maximum of social output. Under free trade, price mechanism works as a guide to investment. This ensures that each country specialises in the production of commodities for which the country is relatively best suited to produce. The country imports those commodities which it can buy more cheaply from abroad rather than produce them itself at higher costs.

Let us say, for example, Britain is relatively more efficient in car production than butter production, whereas Denmark is relatively suitable to butter production than car production. Hence, before trade, the domestic

prices would reflect relative internal production costs. Then, in Britain the cars will be relatively cheaper and butter costlier. If trade is opened up, Britain can gain by concentrating more of its resources on car production. It also gains by importing a part of its butter requirements from Denmark. Denmark can gain by concentrating on butter production and importing cars from Britain. The shift of resources in Britain from butter into car production and the diversion of productive factors in Denmark from car to butter production will result in an increased total output of both cars and butter.

Free trade equates commodity prices between different regions. Moreover, the prices of different goods and services are equated to their marginal costs. This ensures optimum production. Since the factors of production earn the same remuneration in every industry, free trade assures optimum allocation of resources. Thus, if maximization of social output is the desired goal, the free trade policy is justified.

(ii) Free Trade and the Optimization of Consumption

The classical school was concerned with free trade as a means of obtaining maximum output. But it also secures the optimization of consumption in the absence of market distortions. In our example, Britain is well endowed with the factors necessary for producing cars relatively cheaper and Denmark for producing butter relatively cheaper. In the absence of trade, the British people will have a relative abundance of cars and a relative scarcity of butter. The Danish people will have a relative abundance of butter and a relative scarcity of cars. Hence, the British people would be prepared to give up more cars to get an additional unit of butter than would Danish consumers. This means that the marginal utility of butter is higher in terms of cars to British consumers. So the price of cars as compared with the price of butter will be lower in Britain than in Denmark.

Now let us say the trade is opened between the two countries. Danish consumers take advantage of the relative cheapness of British cars. The British consumers buy the relatively cheaper Danish butter. This trade enables them to obtain butter on more favourable terms and so the British gain. Danish consumers also gain from this trade since they are able to obtain cars on more favourable terms. Thus, the flow of cars from Britain to Denmark and the export of butter from Denmark to Britain enable consumers in both the countries to optimize their consumption. It is very important to note that this improvement in consumption occurs irrespective of any change in production either in Britain or in Denmark. No movement of factors from one industry to another industry occurs. Yet free trade enables residents in both countries to obtain greater satisfaction from the spending of a given income.

(iii) Free Trade Lowers the Prices of Imported Goods

The most attractive argument for free trade is that free import lowers the prices of imported commodities. This argument for free trade is more strong, since everyone is a consumer and, as such, he desires lower prices.

But this explains only one side of the problem. So an objection always against free trade policy is that it considers only the consumer's interest and ignores totally the question of employment and the interests of producers. However, the advocates of free trade answer the objection by pointing out that in addition to the fall in prices, there will be movement of factors of production to the other parts of the economy, where they can earn more. Consequently, the factor rewards, the wages, interest, rent and profit will be higher under free trade than otherwise. Thus, producers will also gain under free trade.

(iv) Free Trade Prevents Monopolies

Free imports and exports prevent or at least make difficult for the establishment of injurious monopolies which are anti-social in nature. Under free trade, each country can specialise in a few branches of

production. This will help to establish the optimum size on production unit and to reduce the costs of production. Restriction on the trade will lead to a loss of these advantages of international division of labour. Moreover, such restrictions on the freedom of trade will raise the prices of goods which are being produced by monopolists. Above all, free trade has an educative effect. Foreign competition induces the home producer to adopt quickly any improvement in the methods of production and to become more efficient in the field of production.

However, Haberler says that free trade does not provide a complete safeguard against the formation of monopolies. Even under free trade, international monopolies and local monopolies may emerge.

1.3 FREE TRADE AND UNDER DEVELOPED COUNTRIES

Prof. Haberler says that free trade helps underdeveloped countries to accelerate their rate of economic development in the following way:

(i) Free trade enables underdeveloped countries to import capital machinery and essential raw materials required for implementing their development projects.

(ii) Free trade enables these countries to import the necessary technical knowhow, managerial talents, entrepreneurship, etc., from the developed countries at competitive terms.

(iii) Free trade encourages international capital movement which assists economic development of underdeveloped countries.

(iv) Free trade promotes free competition and prevents and the establishment of injurious and inefficient monopolies.

But these arguments are not totally acceptable to the underdeveloped countries, which may consider free trade is a colonial pattern of trade which permitted their exploitation by the developed countries in the past. So, almost all countries have been raising their voice at various international forum for thorough going changes in the existing pattern of trade which

safeguards the interests of developed countries at the cost of underdeveloped countries.

1.4 ARGUMENTS AGAINST FREE TRADE POLICY

Economic history also indicates that foreign trade has developed with the protectionist policy for the last two centuries. Despite the clamour of the classical economists about the advantages of free trade, many countries abandoned it for the following reasons.

(i) Under free trade, the underdeveloped countries suffer very much in competition with the advanced countries.

(ii) Trade restrictions become necessary to prevent the import of injurious and harmful products.

(iii) Many governments experienced difficulties during the times of war in implementing free trade policy due to economic interdependence. So, in order to maintain political independence, it was thought desirable to seek economic independence with abandonment of free trade.

(iv) Free trade led to cutthroat competition in the world market. So that exporters resorted to dumping. No government can allow dumping beyond limit and restrictions become inevitable.

(v) Backward countries have to protect their infant industries from foreign competition and hence they cannot adopt the policy of free trade.

1.5 ARGUMENTS IN FAVOUR OF PROTECTION

Protection on the other hand, is the deliberate regulation of foreign trade. The objective is to safeguard and foster home industries and the promotion of national strength.

It may take the following forms: (a) levy of import duty (b) levy of export duty (c) export subsidies (d) import quotas, and (e) reciprocal trade agreements.

The Mercantilists in the 16th and 17th centuries supported protection. List in Germany advocated protection in the 19th century. Alexander Hamilton in the U.S.A supported the policy of protection.

The chief arguments in favour of the policy of protection are as follows:

(i) Infant Industries Argument

This argument was put forth by List. Industries in the initial stages must be protected from the competition of the foreign countries. Then only they can develop and prosper. It is based on the following principle “Nurse the baby, protect the child and free the adult”.

(ii) The National Defence Argument

Defence industries must be given protection as a measure of national safety and security. Even ‘Adam Smith who advocated the policy of free trade, was in favour of giving protection to the defence industries. For, he was of the opinion that defence is better than opulence.

(iii) The Key Industry Argument

Rapid economic development of any country depends on the setting up of some key industries. They include iron, steel, aeroplane manufacture and ship building. To enable these industries to develop they must be given protection.

(iv) The Home Market Argument

This argument is associated with Henry Clay, an American economist. In his view, by protection, new industries can be built up; workers engaged in the new industry can provide a new market which is gainful to all domestic industries.

(v) The Balance of Trade Argument

This argument was put forth by the mercantilists of the 16th century. In their view, a suitable tariff policy can enable a country to create surplus of exports over imports.

(vi) Balanced Growth Argument

It is also known as the "Diversification of Industry Argument". Development of one or two industries will make a nation dependent on other countries. This is not desirable. This drawback can be rectified by establishing a wide variety of industries (i.e. by the diversification of industry). This will promote balanced growth of agriculture and industry. Only a policy of protection can secure this.

(vii) The National Self-sufficiency Argument

A country must try to be self-sufficient in goods like food stuffs and raw materials for industries. Self-sufficiency can be attained only through a policy of protection.

(viii) The Anti-Dumping Argument

Free trade will enable foreign country to flood the home markets with goods at very low price. This is called dumping. As a result of this practice, the home industries may be adversely affected. Protection prevents dumping.

(ix) Employment Argument

A policy of protection will help industrial development in the country. This will provide employment to a number of people in the country.

(x) The Wages Argument

As a result of protection, wages may increase. The reasoning is as follows : Protected industries do not have foreign competition. So they can earn more. This may enable them to give higher wages to labourers.

1.6 ARGUMENTS AGAINST PROTECTION

Protection is however, subject to the following limitations :

(i) Protection neglects the interest of the consumers. For they may have to pay high prices for protected articles.

(ii) Protection promotes monopolies. In the absence of foreign competition, the firms in a particular industry may combine and they may fix monopoly prices. In America, the policy of protection has created monopolies. So it is said "Tariff is the mother of Trusts".

(iii) Protection may promote corruption. This happened in America at one time.

(iv) Protected industries have no incentive to improve. They fail to adopt the latest methods of production.

(v) It does not promote international division of labour.

(vi) Protection may create ill feeling between countries; if one country shuts out the goods of another country the latter may retaliate. This is not good for world peace.

1.7 PROTECTION AT PRESENT - UNIVERSAL

With all these limitations, protection has found with all the countries of the world. It has been the policy followed by countries one and all since the period of the World War I. At present there is no country in the world following a policy of free trade. All the countries follow the policy of protection in one form or other.

1.8 INDIA'S TRADE POLICY

For a developing country like India, a sound commercial policy is protection and not free trade. Hence, India followed a policy of protection. The object is to industrialise our country within a short period. Import duties were levied. Export subsidies were granted. Import quotas were fixed. These are some of the forms of protection adopted in our country. But in the year 1991, Trade liberalisation measures were adopted. India has bidden adieu to the protectionist trade policy of the yester years. The trade policy reforms revolved round globalisation of the Indian economy, improving the competitiveness of its industries and setting right the adverse balance of payments situation.

2. TYPES OF TARIFFS AND QUOTAS

The most widely used instrument of protection is tariff. Tariff is a tax levied upon a commodity when it crosses a national boundary. The tariffs imposed by a country may generally be of three types. (i) Import duties (ii) Export duties and (iii) Transit duties. Import duties are those levied upon the importation of goods into a country from abroad. These are the most commonly used type of tariff. Export duties are levied on goods leaving a country. Only a few countries, primarily exporters of agricultural commodities and raw materials use export taxes. Transit duties are those imposed on goods crossing a country on the way to a destination elsewhere. Transit duties are also not very popular.

The import tariffs may be classified into the following three types:

2.1 ADVALOREM DUTY

It is levied as a fixed percentage of the total value of the commodity as it enters the country. When imported cars are taxed at 5% of value, it is a case of advalorem duty.

2.2 SPECIFIC DUTY

A specific duty is a fixed sum of money per physical unit of the imported commodity. A tax of Rs.10,000 per imported automobile is an example of specific duty.

2.3 COMPOUND DUTY

It is a combination of both the advalorem and specific duties. Suppose, an imported car is taxed at Rs.50 per unit plus 2 percent of its value. In this case, the tax imposed is called compound duty.

2.4. A COMPARISON OF ADVALOREM DUTY AND SPECIFIC DUTY

When the price of the commodity is low, specific duty yields a greater revenue per unit whereas an advalorem duty yields only a smaller revenue per unit of the commodity. The reverse will be true when the price of the commodity is high. An advalorem duty distinguishes among fine

Check Your Progress

3. What do you understand by Tariff, Quotas?

4. What are the three types of tariff?

gradations of commodity as they are reflected in its price. Hence, it is better to use advalorem duty for goods with a wide range of variations and specific duty for standardized products. A person importing a Cadillac car pays more than his counterpart importing a Chevrolet car if the tax imposed is one of advalorem duty. If, specific duty is imposed, both the persons would pay the same amount resulting in a higher percentage of tax on the cheaper import. Hence, an advalorem duty is more equitable compared to a specific duty.

However, specific duty is easy to apply and administer because it is a fixed sum of money per unit of the commodity. It is difficult to calculate the advalorem tax amount as it involves the evaluation of the price of the commodity. At times of rising prices, the specific duty becomes a diminishing percentage of price and hence protection is reduced. At times of falling prices, specific duty becomes a rising percentage of price and hence protection is increased. But an advalorem duty provides the same percentage of protection irrespective of the rising or falling prices.

For the same commodity, a country may employ different tariff rates depending upon its source of supply. On this basis, tariffs can again be classified into three types as follows:

2.5 SINGLE COLUMN TARIFF

Whatever be the country of origin of the goods, if only one tariff duty is established by law for each and every commodity, it is called single column tariff.

2.6 DOUBLE COLUMN TARIFF

Depending upon the source of supply, if two or more duties are established for the same commodity, it is called double or multiple column tariff.

2.7 CONVENTIONAL TARIFF

A basic duty may be established by law for each commodity with a provision that this duty may be reduced by international agreement. Such a duty is called conventional tariff. When the reduction is widely generalised, the resultant is a single column tariff, in the sense that the reduced rate is practically the only effective one.

Depending upon the purpose for which the duty is levied, tariffs may still be classified into two broad categories as follows:

- (i) Revenue tariff and (ii) Protective tariff

Revenue Tariff

A tariff imposed with the sole intention of raising revenue to government is called the revenue tariff. A duty is purely for revenue if it does not cause resources to move into the import competing industries*. Many under developed countries use this type of tariff.

Protective Tariff

In the present day world, most of the industrial nations impose tariff mainly for the purpose of reducing the volume of imports and thus providing protection to the domestic industries from foreign competition. Such a type of tariff which gives protection to the domestic industries is called protective tariff.

A tariff is purely protective, if it keeps out all imports (i.e., it gives only protection and no revenue). A purely protective tariff is also known as prohibitive tariff.

2.8 QUOTAS

The quantitative restriction or import quotas originated during the First World War. After some relaxation in the years immediately after the truce of the war, they were stiffened in the early 1920's due to the following reasons under diverse conditions:

* *Import competing industries are those which produce domestic substitute for the imported goods.*

A number of countries had built up additional industrial capacity during the war and quantitative controls offered a fairly easy way of continuing to utilise this capacity. In case of some other countries, the motive was to tackle the serious balance of payments disequilibrium. Trade controls appeared more effective in easing the balance of payments problem than a tariff because tariff is very often uncertain in its impact on the balance of trade. Post 1918 Germany was in an especially difficult situation since the German Government was forbidden to raise the tariff. At the same time, trade controls were adopted even by certain strong currency countries, notably Switzerland, as defence against the dumping of exports by countries with relatively weak balance of payments.

Trade controls were immensely strengthened during the early 1930's. The controls were introduced even by the countries which had so refrained from adopting them. For instance, countries dependent upon food exports were particularly affected by the impact of the fall in the commodity prices in and after 1929. They could not wait for the slow operations of the tariff or protect their rapidly dwindling reserves. Quantitative controls became more popular during the Second World War and continued in the early post-war years.

2.9 IMPORT QUOTAS

Import quotas place a limit on the import of a particular group of products in a given period of time. Import quotas restrict imports by quantity. The system of quotas may be divided into the following five categories:

1. Tariff or custom quotas
2. Unilateral quotas
3. Bilateral quotas
4. Mixing quotas and
5. Licensing of imports

2.9.1 TARIFF OR CUSTOM QUOTAS

A tariff quota has the combination of both tariff and an import quota. In this system, a specified quantity of imports is permitted by the government either duty free or at a low rate of duty. Any additional imports beyond the specified quantity are allowed only at an enhanced rate of duty.

(a) Merits of Tariff Quota System

Generally under this system, the rich people can import additional quantities of a commodity at higher rate of tariff. A high rate of duty on the imported goods discourages imports. So the scarce precious foreign exchange is saved to be spent on the import of goods essentially needed for the economic development of the country.

(b) Drawbacks of Tariff Quota System

This system of quota has proved unsatisfactory in most cases.

(i) The tariff quota system discriminates against the poor who cannot pay higher rate of duty.

(ii) When the imports exceed the quantity fixed under the low rate of tariff, the entire gains from the low rate are enjoyed by the countries exporting the quota.

(iii) The rush of the imported goods in the importing country may upset the domestic price level in importing country.

2.9.2 UNILATERAL QUOTA SYSTEM

Under this system, the total quantity or the total value of the commodities to be imported, is fixed without any prior negotiation with the foreign governments. Such a fixed quota may be of two types: (1) global quota and (2) an allocated quota.

(A) Global Quota System

Under the global quota, the full amount of the quota quantity can be imported either from any one or more countries during the specified period of time.

(a) Merits of the global quota system

The merit of the global quota system lies in the fact that it keeps the door of the importing country open for all exporting countries. So the exporting countries compete among themselves to capture the market of the importing country. Consequently, the importing country can take full advantage of this competition among the exporting countries. The advantage will be in the form of low price and other favourable terms offered to it by the rival exporting countries.

(b) Demerits of the global quota system

This system of quota suffers from the following drawbacks:

(i) This method tends to favour the very large importing firms. Such firms can order a huge quantity on short notice due to their well established trade connections and good credit. So this type of quota is detrimental to the interests of small importers.

(ii) When there are number of customs offices, it is very difficult to know from day to day as to how much total quantity of the commodity has been imported from all the customs houses taken together. Hence, the total imports very often exceed the quota quantity before the customs authorities become aware of it.

(iii) The importers rush to import the whole permitted quota quantity in the beginning of the period. If the imports are spread over the whole period, considerable storage costs can be avoided. Storage costs are particularly high in the case of perishable goods.

(iv) A sudden increase in demand in the beginning of the quota period is inevitable. This raises the price of the commodity and thus deteriorates the terms of trade of the importing country which applies for a global quota. Importers are in a hurry to import before the quota is exhausted. Hence, they do not find sufficient time to search out the cheapest sources of supply and to make the best possible deals.

(v) Global quota discriminates against the distant sources of supply. This is because the goods from nearby countries can enter into the importing country before the goods from the distant countries which have to travel a long distance.

(vi) Several importers are compelled to cancel their contracts at considerable loss. This is because, after entering into contracts they discover that the whole quota is exhausted and the country is closed for additional imports.

(vii) As soon as the quota is announced, the importing country's market is flooded by heavy imports and the prices fall very rapidly. Or, the stockists may tend to raise the prices of imports through stockpiling. Thus, the unilateral quota system encourages speculative stock-piling among the stockists and leads to wide fluctuations in the price of imports. So, it does not provide regular protection to the domestic industry.

On account of these drawbacks, the unilateral global quota has found much disfavour at present and the allocated quota system is more popular.

(B) Allocated Quota System

This is simply a method of distributing the total quota of imports among the different exporting countries. However, this system has also got its own shortcomings.

Demerits of Allocated Quota System :

(i) It imposes an undesirable rigidity on the sources of supply and it does not take into account the cost conditions abroad.

(ii) On account of the certainty of a share of quota, this system encourages monopoly practices by those countries, which export the allocated quota quantity.

(iii) There is enough scope for partiality in the matter of allocation of the quota quantity among the exporting countries.

Methods of Allocation of Quotas

(i) Through Auction

One way of allocating the quotas is to sell the licence to the highest bidders in an open auction. The auction may be open to all importers, exporters, wholesalers, consumers, etc., on equal terms. This system will eliminate bribery, favouritism and corruption. Consequently demoralisation of business community is also likely to be eliminated.

It will eradicate inefficiency since, it is the most efficient people who will obtain licenses by out bidding their less efficient competitors. This system will avoid the charges of discrimination between different importers and between different exporters.

Shortcomings of Allocation of Quotas Through Auction

(i) The number of importers is very small in most of the under developed countries. They may combine and defeat the purpose of auction. Thus, they earn huge profits at the cost of consumers and government revenue.

(ii) Once the licences have been auctioned, the importers are free to charge any price because there is no price control afterwards. They will take full advantage or suffer full loss of all charges that occur after the auction is over. This will not only destabilise prices but also expose the importers to greater risks.

(iii) This method is not suitable to the import of those commodities in the case of which it is highly desirable (for example food stuffs, medicines, machinery, essential raw materials, etc.). This method is more suitable mainly to the importation of luxury goods which a developing economy cannot afford due to shortage of foreign exchange even for goods essential for the development programmes.

(ii) Through Quota Regulation

The country which is imposing quota regulation often allocates the total quantity to be imported between different exporting countries. But the

problem of discrimination arises in this method. The following are the various ways to avoid such discrimination :

(i) To equally divide the total quota among all exporting countries.

This method will discriminate against the big exporting countries and will be in favour of small exporting countries. Moreover, sometimes small exporting countries are not in a position to supply the full quota allotted to them. Hence, a part of the quota may go unutilised and thus, the volume of imports may fall below the level desired by the importing country.

(ii) To distribute the licences among the importers and to leave them free to import from the most profitable exporter.

This system involves the danger that the government may exert concealed pressure on the importers to import from particular countries. The government may exert pressure by refusing to issue licences in future to these importers who did not obey the informal direction by the government in the previous quota period.

(iii) To allocate quotas on the basis of the share of each exporting country in the total imports of the country in some previous representative period.

'Representative period' formula ensures against deliberate discrimination in the allotment of quotas to a large extent. Of course the selection of representative periods offers some scope for discrimination as there is no objective and precise criterion for determining the representative period. A country can deliberately discriminate against some countries by selecting a period as representative in which the imports from those countries were particularly low.

2.10 BILATERAL QUOTAS

Under the bilateral quota system, the quotas are fixed after negotiations between the importing and exporting countries.

(a) Advantages

(i) The quota quantities are determined by mutual negotiation between the importing and exporting countries. So the scope of practising discrimination is minimised.

(ii) As the import of goods is spread evenly over the entire period, fluctuations in the price are minimised.

(iii) It provokes no retaliatory action on the part of certain exporting countries, as they also have an equal chance of participation in fixing the quota quantity. As the producers of both the countries are taken into confidence in determining the quota quantity, the bilateral quota system works more smoothly than the unilateral quota system.

(b) Disadvantages of Bilateral Quota

(i) The bilateral quota system encourages formation of international cartels.

(ii) This system opens the way for large scale competition.

(iii) Under this system, the importers stand to lose, as it has a tendency to raise the price level in the exporting country.

(iv) Some economists criticised this system as an open invitation of monopoly in the exporting country.

2.11 MIXING QUOTAS OR INDIRECT QUOTAS

Mixing quotas are also referred to as 'Indirect quotas' in the sense that quota regulations are applied to domestic producers instead of being applied to importers. The quota fixing authority of the country will prescribe a fixed proportion of the domestic raw material in combination with the imported raw material to produce a finished good.

(a) Advantages

(i) It provides protection to the domestic producers of raw materials.

(ii) It saves the valuable foreign exchange.

(b) Disadvantages

(i) Sometimes the domestic raw materials will be of low quality. The compulsory utilisation of such low quality raw materials may cause deterioration in the quality of the product.

(ii) The forced use of domestic raw materials is not in accordance with the principle of comparative cost advantage. This deviation from the theory of comparative cost is an invitation to productive inefficiency. This will result in the relatively higher cost of production.

2.12 LICENSING OF IMPORTS

Under this system, the importers are required to obtain an import licence from licence-issuing authority for a specific quantity of import quota before importing the goods. The merits of the licensing system are as follows:

(a) Merits of Import Licensing

(i) Import licences are generally distributed among the established importers in the country.

(ii) While issuing licences the import licence-issuing authority keeps a vigilant watch on the existing position of the country's total foreign exchange reserves. Since the import licences are issued with reference to the position of a country's foreign exchange reserve, the possibility of foreign exchange crisis is eliminated.

(iii) This system discourages speculation in foreign exchange and minimises fluctuation in prices.

(b) Demerits of Import Licensing

The system of import licensing has the following drawbacks:

(i) The authorities of the import licensing administration are entrusted with wide discretionary powers. So this leads to corruption favouritism and nepotism. In the hands of corrupt government officials it

leads to import licences scandals whereby import licences are issued in the names of bogus importers.

(ii) This system prevents the entry of new importers. The entry is very essential for importing the efficiency of importing trade. Consequently, the import trade in the country tends to be monopolised by a handful of big established importers who obtain licences in their names and they sell these licences to others at high profits.

3. ANSWERS TO CYP QUESTIONS

1. Refer 1.1
2. Refer 1.5
3. Refer 2
4. Refer 2

4. MODEL QUESTIONS FOR GUIDANCE

10 Marks Questions (One page answer)

1. Define Free Trade. What are the advantages of Free Trade?
2. What are the disadvantages of Free Trade?
3. Mention the major arguments in favour of protection.
4. State the main forms of protection.
5. What are the arguments against protection?
6. Explain various types of tariffs.
7. State various systems of quotas.

20 Marks Questions (Three pages answer)

1. Mention the chief arguments for free trade and do you advocate such a trade in a developing country?
2. Examine the arguments for a protective tariff in a country like India?
3. Explain different types of tariff.
4. Discuss the various types of quotas.

UNIT 5

BALANCE OF TRADE AND BALANCE OF PAYMENTS

Space for Hints

INTRODUCTION

As everyone knows, a country cannot live independently. It has to trade with other countries. That is, it imports what it requires and exports what it has in excess. These exports and imports accounts with other nations have to be properly maintained. This is otherwise called a systematic record of a country's economic transactions with other nations. In Economics this systematic record is called Balance of Payments. A student of Economics should know how these transaction accounts are prepared and what it tells us, and similar other things.

In this Unit, we describe what Balance of Payments is, the structure of Balance of Payments, Balance of Trade, the different accounts and components, the disequilibrium in the Balance of Payments, the causes of disequilibrium in the Balance of Payments and the different methods of correcting the balance of payments.

UNIT OBJECTIVES : After studying this Unit, you will be able

- To understand the various concepts and components of Balance of Payments, Balance of Trade and different accounts followed in it,
- To know about the concept like equilibrium and disequilibrium in the balance of payments and different kinds of balance of payments, and
- To understand the reasons for disequilibrium in the balance of payments and different methods of correcting balance of payments.

UNIT STRUCTURE

1. Balance of Trade and Balance of Payments

1.1 Concepts and Components

1.2 Balance of Payments

1.3 Kinds of Balance of Payments Concept

2. Equilibrium in the Balance of Payments
3. Disequilibrium in the Balance of Payments
 - 3.1 Kinds of Disequilibrium in the Balance of Payments
 - 3.2 Causes of Disequilibrium in the Balance of Payments
 - 3.3 Methods to correct Disequilibrium in the Balance of Payments
4. Answers to CYP Questions
5. Model Questions for Guidance

1. BALANCE OF TRADE AND BALANCE OF PAYMENTS

1.1 CONCEPTS AND COMPONENTS

Countries trade with one another, their export paying for their imports. Trade which refers to the exports and imports of goods is known as ‘visible trade’ since they consist solely of merchandise or goods, i.e., of things which can be seen in ships, trains, trucks or aeroplane across national frontiers and into customs house where they may be measured.

If the value of exports of a country exceeds the value of its imports, the country is said to have an ‘export surplus’ or a favourable balance of trade. If the value of its imports exceeds the value of its exports, the country is said to have an ‘import surplus’ or an adverse balance of trade. Exports and imports of a country may equal, in which case the trade is said to be balanced. In practice, exports and imports of a country will rarely be equal. Balance of trade, in other words, will not balance. During any year a country may experience a favourable or an adverse balance of trade.

It is important to note that the balance of trade includes the transactions of import and export of goods only. But in actual transactions there are many “invisible items” which are also exported and imported. Hence, balance of trade cannot be regarded as an indicator of the external economic performance of a country, since it gives only a partial picture of the total economic transactions in international trade. It is the balance of payment which provides complete record of international economic

Check Your Progress

1. What do you understand by Balance of Payments and Balance of Trade?

2. What is the main difference between Balance of Payments and Balance of Trade?

transactions. For, it includes apart from balance of trade account, the 'invisible' account comprising services, gifts and charities plus capital account.

Variation in balance of trade figures are likely to be misleading as they are due to (a) random fluctuations and (b) seasonal fluctuations. Random fluctuations are due to the imports or exports of large single items and abnormal changes in the general level of stocks of the incidence of dock and transport charges. Seasonal fluctuations tend to have a clearly unfavourable influence due to the adverse effect on exports. However, balance of trade is the major component of the balance of payments.

1.2 BALANCE OF PAYMENTS

Balance of payments is a record of all monetary transaction between residents of a particular country and the residents of all other countries over a given period of time, say a year. It may also be defined as a "systematic and complete record of a country's monetary payments to foreigners and its receipts from foreigners". It is more comprehensive in scope than balance of trade. By 'residents' we mean individuals, business firms, government agencies or other institutions and organizations legally domicile in the country. Hence, a branch of a foreign firm established in India would be treated as any other Indian enterprise for balance of payments purpose. But international organizations or agencies of foreign firms not legally established in India are not considered as residents.

Items included in the balance of payments accounts :

1. Expenditure of foreign travellers and transportation service rendered by companies to foreigners for freight or passenger transport.
2. Insurance and reinsurance premiums paid by foreign residents.
3. Interest, dividends, rents and profits paid by foreigners to the residents of a country.
4. Fees paid to contractors and engineers of the country by foreigners.

5. Firm rentals, copyright and trade mark royalties paid to the residents of a country by foreigners.
6. Gifts of cash, merchandise or services made by foreign residents.
7. Purchases of property belonging to the residents of a country by foreign residents.
8. Sales of a country's resident- owned or issued securities of a country by foreign residents.
9. Direct investments which carry a managerial interest in business firms, branches and subsidiaries located in a country by foreign residents.
10. Increase in foreign owned holding of drafts, bills, cheques, currency accounts receivable and other short term claims payable by the residents of a country.
11. Decrease in a country's resident owned, claims, deposit and balance in banks and other financial institutions located abroad.
12. Decrease in a country's holdings of drafts, bills, cheques account receivable currency and others short-term claims payable by foreign residents.
13. Repayments by foreign governments, firms and residents of a country, agency, loans and sales of a country's gold or reduction in the monetary gold stock.

The balance of payments is a useful statement in the study of international economic transactions, since it presents in a few words and figures, the broad outlines of the economic relations of a nation with the rest of the world or with selected areas and countries. Transactions entered on the balance of payments constitute the transfer of assets and liabilities, the creation or the reduction of claims or the receipts and payment of funds.

1.3 KINDS OF BALANCE OF PAYMENTS CONCEPT

The concept which is indiscriminately called the balance of payments is of three kinds. They are

- i) The market balance
- ii) The programme balance and
- iii) The accounting balance.

The Market Balance

The market balance is a model of a given situation in the foreign exchange market. It is characterised by the effective demand and supply of foreign exchange at the current exchange rate and its alternative, hypothetical rates. It is an ex ante concept comparing autonomous spending and receipts.

The demand for foreign exchange represents the sum of the demands of importers, donors abroad and investors all of whom usually purchase foreign currencies in order to complete their intended external transactions. Similarly, the supply of foreign exchange represents the sum of foreign donations and foreign demands for the country's exports, securities, etc., Like any other price, the price of foreign exchange or the rate of exchange is the result of interaction of the demand and supply schedules.

The market balance describes the current balance of autonomous international transactions but it is less comprehensive than the accounting balance of payments in projecting the character and dimensions of the country's participation in the world economy. However, the market balance provides a much more useful tool of analysis to measure the extent of balance or imbalance of the country's autonomous intended transactions. The market balance gives an accurate index of current international payments equilibrium or disequilibrium. The balance of payments will be in equilibrium when the demand for foreign exchange is just equal to the supply at the given exchange rate. The balance of payments will be in

Check Your Progress

3. What do you mean by market balance?

disequilibrium when demand and supply are not equal. Then the implication is that autonomous payments and receipts must be out of line. The problem of payments adjustment is to reconcile any such difference between autonomous demand and supply of foreign exchange at a given exchange rate.

The Programme Balance

The programme balance of payments of a country is a “systematic statement of sources and use of foreign funds expected or planned over a future period of one or more years”. It is based upon a calculation of domestic consumption and investments and upon a programme of meaning an excess of requirements over resources by recourse to foreign finance expected or sought. It is essentially a forecast of the country’s foreign exchange needs and desires, i.e., it is a kind of accounting balance of the future. Deficits and surpluses are defined in terms of the gaps between these needs and desires on the one hand, and the amounts of foreign exchange to become available from all regular sources like exports, foreign investments, etc.,

All countries do not compute programme balance of payments. But it is most useful to countries regularly dependent on foreign financial assistance to sustain certain levels of internal consumption and capital formation. It indicates the amount of financing which will be needed and for how long. Nowadays almost all developing countries compute programme balance. The ex-anti character of the programme balance is self evident. It provides the financial authorities with a useful tool for analysing the suitability of current policies and plans affecting the country’s international economic position. The entire programme is built around the potentialities of finding the foreign finance for the deficit.

The Accounting Balance

“The accounting balance of payments of a country is a systematic record of all economic transactions between the residents of a country and

foreign residents". For any specific period of time, the statistical record shows the character and dimensions of the country's international economic relationship with the rest of the world. It shows the countries trading position, changes in its official net position as foreign lender or borrower and changes in its reserve holdings. For these reasons it can be more useful to the financial authorities than market balance and the performance balance. What we are actually going to study under balance of payments is more confined to the accounting balance of payments.

The balance of payments accounting is constructed according to the principles of double-entry book-keeping. Any transactions that gives rise to the foreign monetary claim on the home country is a 'debit' or 'minus' entry. Any transaction giving rise to monetary claim by residents of the home country on foreign countries is a 'credit' or 'plus' entry. As with any double entry accounting statement each credit entry must be accompanied by an equal and opposite debit entry. For example, all international transactions that result in payments to India increase India's stock of or claims on foreign currencies and may be recorded as a credit or plus entries in India's balance of payments. Similarly, all payments by India (receipts to foreigners) deplete India's stock of or claims on foreign currencies and may be recorded as debit or minus entries in the balance of payment's account.

2.EQUILIBRIUM IN THE BALANCE OF PAYMENTS

A nation's balance of payments is in equilibrium when the autonomous supply of foreign exchange and the autonomous demand for foreign exchange are equal. This is an equilibrium situation where there is a monetary authority committed to maintain the exchange rate stability. The balance of payments statement is drawn up in terms of debits and credits based on a system of double entry book-keeping. If all the entries are made correctly, total debits must equal to total credits. This is because two aspects of each transaction recorded are equal in amount but appear on the opposite sides of the balance of payments account. In this accounting sense balance of payment for a country must always balance.

In the case of pure bilateral trade, all partial balances with different countries should balance. But in case of multilateral trade only the balance of payments must balance. Hence, it is not necessary that the regional sub-totals in the credit account should equal the corresponding sub-totals in the debit account.

The debit or payment side of the balance of payments account of a country represents the total of all the uses made out of the total foreign exchange acquired by the country during a given period. The credit or receipt side represents the sources from which this foreign exchanges was acquired by this country in the same period. The two sides as such necessarily balance. In short, the balance of payments may be considered as a balance scale with every addition on one side necessitating an additional on the other to keep it in equilibrium. It should also be noted that the two accounts, current and capital in the balance of payments should necessarily balance.

If, in the actual balance of payments account, the credit and debits do not balance, the balance is usually achieved by adding an item called errors and omissions. In fact, the net total of errors and omissions is a balancing item that compensate for any excess of recorded credits over recorded debits or vice versa. This total can be large, when balance of payments data are collected from diverse sources.

3. DISEQUILIBRIUM IN THE BALANCE OF PAYMENTS

A balance of payments comprises 'autonomous' and 'induced' transactions. Autonomous transactions are trade transactions pertaining to exports and imports of goods and services that are undertaken for their own sake under profits or utility motive. An imbalance in the value of autonomous transaction has to be counter-balanced by a corresponding change in foreign exchange reserve or short-term capital movement, which is referred to as 'induced' or 'accommodating', transaction. Induced transaction is not undertaken for its own sake but it emerges on account of

imbalance in the balance of trade. Thus, in the process of equalising balance of payments account, induced transactions are undertaken and recorded in the capital account.

These induced transactions, often involve short-term capital movements like lending or borrowing, inflow or outflow of gold, addition or subtraction in foreign exchange reserves of the country, etc. Since induced transaction being of a compensating nature, any imbalance in them is not very significant. But the real problem of disequilibrium lies in the imbalance of autonomous transactions of a country. Thus, the phenomenon of disequilibrium (a deficit or a surplus) in the balance of payments is viewed from the balance of transactions on current account as such. A disequilibrium - a surplus or a deficit - in this sense shows a strengthening or weakening of a country's external capital position.

3.1 KINDS OF DISEQUILIBRIUM IN THE BALANCE OF PAYMENTS

Disequilibrium in the balance of payments can arise owing to a number of causes leading to many kinds of disequilibrium. However, there are three kinds of disequilibrium. They are (i) cyclical disequilibrium (ii) secular disequilibrium and (iii) structural disequilibrium.

CYCLICAL DISEQUILIBRIUM

An important characteristics of the cyclical disequilibrium is that the balance of payments remains in equilibrium over the complete cycle. It arises from the occurrence of business cycles. Business cycle can cause cyclical disequilibrium in the balance of payments under any of the following conditions, which differ between countries.

(a) The intensity of booms and depressions

Other things remaining the same, if the business cycle is more intense in country A than in country B, Country A will suffer from a deficit during boom and enjoy a surplus during depression. Reserve will happen in country B. During the boom, income will rise more in A than in B

Check Your Progress

4. What is meant by cyclical disequilibrium?

Consequently rise in the imports of A will be larger than in those of B. During the depression, decline in income in A will be larger than in B. Consequently, the decline in imports of A will be larger than that in the imports of B.

(b) Timings of the various phases of cycles

Cyclical disequilibrium in the balance of payments will occur if the various phases of a cycle occur at different times in different countries. Other things remaining equal, if the various phases of cycles in country B as compared with country A by one year, the rise and decline in imports of B during the boom and depression respectively will occur with a time-lag of one year as compared with the occurrence of the rise and fall in imports of A. Thus, A will suffer from a deficit during boom and enjoy a surplus during depression. Reverse will happen in country B.

(c) Income elasticities of demand for imports

Cyclical disequilibrium may arise from difference in the income elasticities of demand for imports. Other things remaining equal, if the income elasticity of demand for imports is higher in country A than in country B, A will suffer from a deficit during the boom and enjoy a surplus during the recession. Due to comparatively higher elasticity of demand for imports, the rise and fall in imports during the boom and depression respectively will be larger in A than in B.

(d) Price elasticities of demand for imports

Cyclical disequilibrium may arise from differences in the price elasticities of demand for imports in different countries. Normally, prices rise during boom and fall during the depression. Other things remaining the same, if the price elasticity of demand for imports is higher in country A than in B, A will enjoy a surplus during the boom and suffer a deficit during the recession. With comparatively higher price elasticity of demand for imports, fall and rise in imports in A will be larger during boom and depressions respectively than in B.

SECULAR DISEQUILIBRIUM

It arises from long-run and slow-moving changes in an economy as it moves from one stage of growth to another. It may be due to a large number of factors, viz., capital formation, population, etc. For example, in its early stage, a developing economy requires investment of a magnitude far larger than that of domestic savings, imports tend to exceed exports. If sufficient foreign capital is not forthcoming, it may suffer from a secular deficit in its balance of payments.

On the other hand, in a mature economy, savings may be far larger than those which can be invested profitably within the domestic economy. Imports tend to fall short of exports. In the absence of an outflow of capital, such an economy may enjoy a secular surplus in its balance of payments. To take another case, other things remaining equal, if the rate of growth of population is higher in country A than that in country B, country A will suffer from a secular deficit in its balance of payments than B. Other things remaining the same, an increase in population increases the need for imports and the capacity to export.

STRUCTURAL DISEQUILIBRIUM

It arises from structural changes in the demand and supply conditions of exports and imports. Structural disequilibrium may arise from a change in foreign demand for exports. If the foreign demand for Indian tea declines due to say, a changed in tastes abroad, the resources employed in tea production will have to be shifted to the production of other commodities for which demand exists abroad. If India finds it difficult to adjust the required shift in resources, demand for imports remaining the same, it will suffer from a structural disequilibrium in its balance of payments. A similar situation can arise from a change in fashions, change in technology, invention of cheaper synthetic substitutes, etc.

Structural disequilibrium may arise due to a change in supply. A crop failure may decrease the capacity to export and increases the need for

Check Your Progress

5. What do you understand by secular disequilibrium?
6. What is structural disequilibrium?

imports and thus cause a structural deficit in the balance of payments. A similar situation can arise from a dislocation of production because of strikes or other political disturbances.

Structural disequilibrium may also arise from a decline in service income from abroad. Service income from abroad may decline due to bankruptcy, confiscation or nationalisation of direct investments abroad, etc.

3.2 CAUSES OF DISEQUILIBRIUM IN THE BALANCE OF PAYMENTS

Balance of payments refer to the value of both visible and invisible exports and imports. If the value of visible and invisible exports is greater than the value of visible and invisible imports there is said to be favourable balance of payments. Instead, if the value of visible and invisible exports is smaller than the value of visible and invisible imports, there is said to be disequilibrium in balance of payments.

A disequilibrium in the balance of payments may be produced by any of the following causes:

- i. Owing to the fall in the demand for the goods of a country, the exports of that country may decline.
- ii. Owing to an increase in the cost of production of a country's goods, the exports of that country may decline.
- iii. Unfavourable balance of payments may also be caused by excessive imports in countries like India, that are wedded to planned development, imports of raw materials and machines become absolutely essential.
- iv. Huge population growth in poor countries also has adversely affected their balance of payments position. Increase in the population, increases the need of these countries for imports, and decreases the capacity to export.

- v. Unfavourable balance of payments may also be due to international borrowing and investment. For instance, India has been borrowing heavily from other countries of the world to implement development programmes within the country. This is one of the reasons, for the persistence of disequilibrium in the balance of payments of India.
- vi. The policy of import restriction pursued by advanced countries is another factor causing disequilibrium in the balance of payments of poor countries.
- vii. Another cause of the disequilibrium in the balance of payments of a country is the appreciation in the value of the domestic currency in terms of other currencies. This will encourage imports into the country and discourage exports from the country.

3.3 METHODS TO CORRECT DISEQUILIBRIUM IN THE BALANCE OF PAYMENTS

When a country has an adverse balance of payments, it is in a debtor's position with all the disadvantages it entails. So, it may have to take steps to correct disequilibrium in the balance of payments. The following are the methods generally adopted to correct unfavourable balance of payments.

- i. **Expansion of Exports:** Exports from the country can be stepped up by adopting several methods. Exports subsidies may be given. Export duties may be abolished. Liberal credit facilities to exporters may be given.
- ii. **Restriction of Imports:** Imports may be cut down by adopting various methods. Heavy import duties may be levied. Import quotas may be fixed. A policy of import substitution may be adopted.
- iii. **State Trading:** To boost up exports and to check import, government itself may enter the field of foreign trade.
- iv. **Deflation:** If the government causes a decline in money supply in the country, the prices will tend to decline. This we call deflation. If prices decline in the country, the foreigners will be induced to buy

goods in that country. Again, the foreigners will be discouraged from selling goods to that country. This means increase in exports and decrease in imports.

- v. **Exchange Control:** The policy adopted by a country to maintain the external value of its currency at a level different from the one that would prevail in a free foreign exchange market is known as exchange control. Under the system of exchange control, the government will centralise all trading in foreign exchange with one central authority, normally, the central bank of the country. Again, the government prevents exchange of national currency against foreign currencies without its permission.
- vi. **Depreciation:** Under this method, the country allows the value of its currency to decline in the foreign exchange market. This will result in a decline in imports and an increase in exports.
- vii. **Devaluation:** There is only minor difference between devaluation and depreciation. Depreciation consists in allowing the value of the currency to fall in the free market. The forces of demand for and supply of the currency in the foreign exchange market bring about depreciation. But devaluation is intentional. Devaluation consists in the government itself lowering the value of its currency in terms of other currencies. However, they produce identical results. As a result of devaluation, imports will tend to decline and exports will tend to increase.

Thus, ultimately a country can pay back money due from it to other countries only by stepping up its exports. Hence, as J.S.Mill has put it “Exports pay for imports”.

4. ANSWERS TO CYP QUESTIONS

1. Refer 1.1
2. Refer 1.1
3. Refer 1.3

4. Refer 3.1
5. Refer 3.1
6. Refer 3.1

5. MODEL QUESTIONS FOR GUIDANCE

10 Marks Questions (One page answer)

1. Differentiate Balance of Payments from Balance of Trade.
2. Explain various types of disequilibrium in the Balance of Payments.
3. Describe various kinds of Balance of Payments concepts.
4. Explain various items included in the Balance of Payments accounts.

20 Marks Questions (Three page answer)

1. Distinguish between Balance of Payments and Balance of Trade.
How does equilibrium arise in a country's balance of payments?
2. What are the causes and cure for Balance of Payments disequilibrium?
3. What is meant by Balance of Payments? Suggest steps to correct an adverse balance of payments.
4. Explain how exports pay for imports in international trade.

UNIT - 6

FOREIGN EXCHANGE MARKET

Space for Hints

INTRODUCTION

The existence of International Trade or trade between countries gives rise to the problems of making payments to foreign countries and selling or buying of currencies between countries on the basis of credits and debits. International Trade in its turn gives rise to the problems of foreign exchange; i.e., fixing the rate of exchange of foreign currencies, controlling foreign exchange, etc.

In this unit we describe the meaning and functions of foreign exchange market, participants in foreign exchange market, organisation of the market, transactions in foreign exchange market and exchange rate determination in the case of inconvertible paper currencies.

UNIT OBJECTIVES : After studying this unit, you will be able

- To understand the concepts related to foreign exchange and foreign exchange market.
- To learn the various functions of foreign exchange market, the participants of the market and transactions in foreign exchange market and
- To understand exchange rate determination through various theories like Purchasing Power Parity theory, etc.

UNIT STRUCTURE

1. Foreign Exchange Market - Functions and Transactions

1.1 Meaning of Foreign Exchange

1.2 Foreign Exchange Market

1.3 Participants in Foreign Exchange Market

1.4 Organisation of the Market

1.5 International Transactions and Foreign Exchange

1.6 Functions of Foreign Exchange Market

1.7 Transaction in Foreign Exchange Market

2. Purchasing Power Parity Theory (Or) Exchange Rate Determination in the case of Inconvertible Paper Currencies

2.1 Exchange Rate Determination under Gold Standard

2.2 Inconvertible Currencies

2.3 Purchasing Power Parities

2.4 Changes in Internal Prices Cause Changes in Exchange Rate

2.5 Formula to calculate change in Exchange Rates

2.6 Criticisms

3. Answers to CYP Questions

4. Model Questions for Guidance

1. FOREIGN EXCHANGE MARKET - FUNCTIONS AND TRANSACTIONS

1.1 MEANING OF FOREIGN EXCHANGE

Dr. Paul Einzig states, "Foreign exchange is the System or process of converting one national currency into another and of transferring money from one country to another". The term foreign exchange is used to refer to foreign currencies.

1.2 FOREIGN EXCHANGE MARKET

Foreign exchange market is the market in which individuals, firms and banks buy and sell foreign currencies or foreign exchange. The foreign exchange market for any currency, for example, the U.S. dollar is composed of all the locations such as London, Paris, Frankfurt, Singapore, Hong Kong, Tokyo where dollars are bought and sold for other currencies. These different monetary centres are connected by a telephone network and video screens and are in constant contact with one another and thus forming a single international foreign exchange market.

The interbank foreign exchange market is the largest financial market on earth with a daily volume in excess of \$ 100 billion. It is an informal arrangement of the larger commercial banks and a number of foreign exchange brokers for buying and selling foreign currencies. The

Check Your Progress

1. What do you understand by foreign exchange and foreign exchange market?

banks and brokers are linked together by telephone, telex and satellite communications network called the Society for Worldwide International Financial Telecommunications (SWIFT). The computer based communications system, based in Brussels, links banks and brokers in just about every financial center.

1.3 PARTICIPANTS IN FOREIGN EXCHANGE MARKET

The participants in foreign exchange market are

(i) Traditional Users: They are exporters, importers, tourists and investors who exchange domestic currencies for foreign currencies to pay for their international transactions. Also traders and speculators (individual, investment managers and corporate treasurers) who trade currencies seeking short term profits by betting on the direction of changes in their relative price.

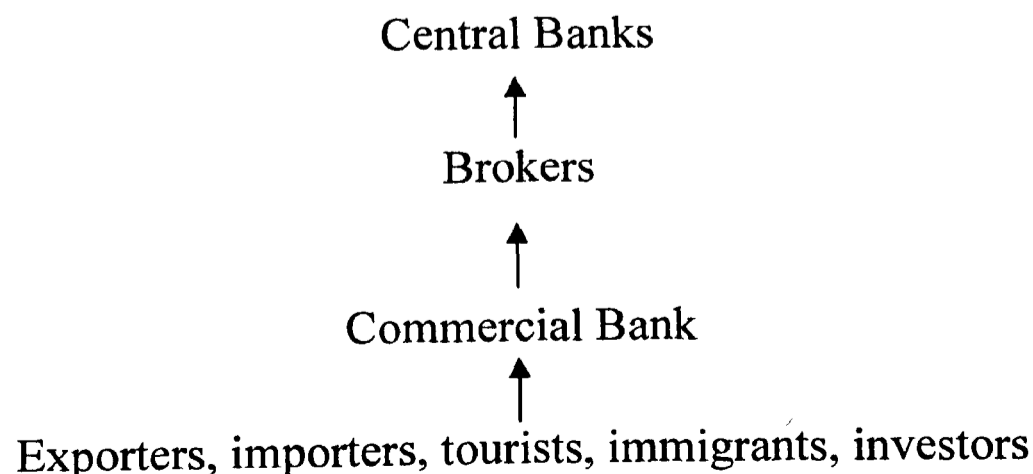
(ii) Commercial banks buy from and sell currencies to traditional users, traders and speculators.

(iii) Brokers who arrange currency deals among commercial banks. It is called as inter-bank or wholesale market.

(iv) Central banks will intervene in foreign exchange markets to affect the value of their currency in relation to other currencies. Thus, for levels of transactors or participants can be identified in foreign exchange markets.

1.4 ORGANISATION OF THE MARKET

The organisation of the foreign exchange market is given in the following exhibit.



Check Your Progress

2. Who are the participants in the foreign exchange market?

The participants in the foreign exchange market are represented by four layers. At the bottom, the exporters, importers and tourists generate either a supply or demand for foreign exchange. These ultimate users and suppliers of foreign exchange do not deal directly with one another. They are using the services of commercial banks which are represented by the next layer. Each commercial bank acts as a clearing house by purchasing foreign exchange from some of their customers while setting it to others. Sometimes, some commercial bank's total purchases of foreign exchange exceed their sales; or otherwise their purchases fall short of their sales.

To clear out their net balance, commercial banks do not transact directly with one another. They use the services of the foreign exchange brokers who form the next layer in the pyramid. The brokers keep in constant touch with commercial banks. The brokers also act as link between commercial and central banks. Competition among brokers is very severe. Central banks are represented by the top layer. The foreign exchange activities of central banks depend crucially on the existing exchange rate system.

1.5 INTERNATIONAL TRANSACTIONS AND FOREIGN EXCHANGE

What is the foreign exchange market? In brief, it is the market in which national currencies are bought and sold against one another. Why is the foreign exchange needed? In general, the flow of goods and services between countries requires the conversion of the currency of the importing country into the currency of the exporting country. This flow of goods and services among nations generates a large part of the supply and demand for currencies in the foreign exchange market. Along with it, foreign exchanges are also demanded by tourists travelling abroad. Tourists at the foreign airport rush to the exchange counter to convert their own currency into the foreign currency. Also many people in India who receive remittances from their relatives who emigrated to "Gulf" countries; enter into foreign exchange market to exchange the foreign currencies for their domestic

currency. Finally, people may demand foreign currencies because they want to buy assets from foreigners.

There are so many national currencies as there are so many sovereign states. The multitude of national currencies makes the international economic transactions more complex. Every international economic transaction by an exporter, importer, tourist or emigrant requires a foreign exchange transaction that is the conversion of one currency into another. Thus, the primary function of foreign exchange market is to perform this conversion of or the transfer of purchasing power from one currency into another. In general, foreign exchange includes in addition to foreign currencies, bank deposits and other short-term financial instruments denominated in foreign currencies. In practice, most foreign exchange transactions involve purchases and sales of bank deposits denominated in foreign currencies.

1.6 FUNCTIONS OF FOREIGN EXCHANGE MARKET

The foreign exchange market performs three important functions.

- (i) It transfers purchasing power from one currency to another and from one country to another.
- (ii) It provides credit for foreign trade.
- (iii) It furnishes for hedging foreign exchange risk.

(i) TRANSFER OF PURCHASING POWER

It is the primary function of the foreign exchange market. This international clearing function plays an important role in facilitating international trade and capital movements. Usually, transfer of purchasing power from one nation and currency to another is accomplished by a telegraphic transfer, which is a cheque that is wired rather than mailed. With it, a domestic bank instructs its correspondent bank in a foreign monetary center to pay a specified amount of the local currency to a person, firm or account. The foreign exchange market solves the conversion problem by performing an important clearing function.

Space for Hints

Check Your Progress

3. What is the main function performed by the foreign exchange market?

Traders (banks) and speculators buy or sell currencies in the expectation that they can earn quick profits by anticipating changes in relative currency values. The volume of such transactions has increased sharply in recent years due to the vast improvements in the communication; and the existence of a 24 hours foreign exchange market around the world.

With direct dialing telephone service anywhere in the world, foreign exchange markets have become truly global in the sense that currency transactions now only require a simple telephone call and take place twenty-four hours per day. For example, as banks end their regular business day in San Francisco; they open in Singapore and Tokyo. Thus, foreign exchange transactions take place throughout the country throughout the 24 hours of a day.

(ii) PROVISION OF CREDIT

Another function of 'foreign exchange market is the credit function. It plays a very important role in the growth of foreign trade; for international trade depends to a great extent on credit facilities. Credit is usually needed when goods are in transit and also to allow the buyer take time to resale the goods and make the payment. In general, exports allow 90 days for the importers to pay. The exporter usually discounts the importers obligations to pay at the foreign department of his commercial bank. As a result, the exporter receives payment right away; and the bank will eventually collect the payment from the importer when due.

(iii) PROVISION OF HEDGING FACILITIES

The other important function of the foreign exchange market is to provide hedging facilities. Hedging refers to covering of exporters to guard themselves against losses arising from fluctuations in exchange rates. Without hedging there would be smaller international capital flows, less trade and specialisation in production and smaller benefits from trade.

1.7 TRANSACTION IN FOREIGN EXCHANGE MARKET

A commercial bank which deals in foreign exchange maintains a foreign exchange department. The function of this department is primarily to convert foreign currency into home currency and vice versa for customers who have received remittances from abroad. A foreign exchange transaction is like any other transaction like a purchase or sale deal.

The following are the important types of transactions conducted in the foreign exchange market:

(i) SPOT EXCHANGE

The term spot exchange refers to the class of foreign exchange transaction which requires the immediate delivery on exchange of currencies on the spot. In practice, the settlement takes place within two days. The most common type of foreign exchange transaction involves the payment and receipt for the foreign exchange within two business days after the day the transaction is agreed upon. The two-day period gives adequate time for the parties to send instructions to debit and credit the appropriate bank accounts at home and abroad. This type of transaction is called spot transaction and the exchange rate at which the transaction takes place is called the spot rate and the market for spot transactions is called the spot market.

(ii) FORWARD EXCHANGE

Besides spot transactions there are also forward transactions. These involve an agreement to buy or sell a specified amount of a foreign currency at a specified future date at a rate agreed upon to-day (the forward rate). The typical forward contract is for one month, three months or six months; with three months, the most common. Forward contracts for longer periods are not so common because of the uncertainties involved. However, forward contracts can be negotiated for one or more periods when they become due. In brief, a forward transactions is merely an agreement (called the forward contract) between two parties (either a bank and a customer or two banks)

that calls for delivery at some prescribed time in the future of a specified amount of foreign currency by one of the parties against payment in domestic currency by the other party at a price (called the forward rate) agreed upon now when the contract is signed.

The foreign exchange regulations of various countries generally regulate the forward exchange transactions with a view of curbing speculation in the foreign exchange market. In India, for example, commercial banks are permitted to offer forward covered only with respect to genuine export and import transactions.

Forward exchange rate is determined by the demand for and supply of forward exchange. When the demand for forward exchange exceeds its supply, the forward rate will be quoted at a premium. When the supply of forward exchange exceeds the demand for it, the rate will be quoted at discount. When the supply is equivalent to the demand for forward exchange, the forward rate will tend to be at par.

iii) SWAP OPERATION

"Swaps" are operations comprising a simultaneous sale or purchase of spot currency accompanied by a purchase or sale, respective of the forward of the same currency. They are also known as "double deals". An investor who purchases a spot currency forward to secure himself against an adverse change in the rate of exchange at the time of repatriation of his funds. The rate of reconversion of the foreign funds into home currency is thus secured, and he can calculate his profit on the basis of the interest on his investment and the margin on the forward sale.

Banks undertake swaps as cover for their normal forward transactions with customers. A bank selling a currency forward to a customer, covers it with a spot purchase in the market. But this involves acquisition of funds at the foreign centre, which will be unused till the maturity of the forward sale market. Therefore to use its funds, the bank carries out a swap, that is a simultaneous purchase of forward and sale of

spot. Similarly, cover of a forward purchase by a spot sale ties up the banker's fund at the home centre. This is undone by a swap comprising a simultaneous purchase of spot and a sale of forward currency.

The scope for swaps is restricted in India by the exchange control regulations. Banks, have some freedom in this regard only for dealings in sterling.

(iv) ARBITRAGE

Arbitrage is the simultaneous buying and selling of foreign currencies with the intention of making profits from the difference between the exchange rates prevailing at the same time in different markets. Thus, it refers to the purchase of a currency in the monetary centre when it is cheaper for immediate resale in the monetary centre when it is more expensive in order to make a profit.

Arbitrage in foreign currencies is possible because of the ease and speed of modern means of communications between monetary centres throughout the world. Thus, an operator in London might buy pound sterling and sell them a few minutes later in New York.

(v) FOREIGN EXCHANGE FUTURES

An individual firm or bank can also purchase or sell foreign exchange futures and options. Unlike forward exchange contracts, which are bought and sold by banks, and trade in the inter-bank market, currency futures are bought and sold on the floor of a futures exchange. Trading in foreign exchange futures was initiated in 1972 by the International Monetary Market (IMM) of the Chicago Mercantile Exchange. A foreign exchange futures is a forward contract for standardised currency amounts and selected calendar dates traded on an organised exchange market. The currencies traded on the IMM are the Japanese Yen, the German Mark, the Canadian Dollar, the British Pound, the Swiss Franc and the Australian Dollar.

Only four dates per year are available, the third Wednesday in March, June, September and December. The IMM imposes a daily limit on exchange rate fluctuation. Buyers and sellers pay a brokerage commission and are required to post a security deposit or margin. A market similar to the IMM is the London-International Financial Future Exchange (LIFFE) which started operation in September, 1982.

Large firms and financial institutions with a fairly continuous stream of payments and receipts in the traded foreign currencies can find future contracts useful and cheaper. In recent years IMM has compared with the forward market. A daily volume of over \$ 4 billion in currency future is not very common; but in the forward market, the trading volume can exceed 20 times this amount. Despite the large difference in the sizes of the two markets, there is a mutual interdependence between them; each one is able to affect the other. The two markets are also connected by arbitrage when prices are different.

(vi) FOREIGN EXCHANGE OPTION

From 1982, individuals, firms and banks are also allowed to buy and sell foreign exchange options (in Australian dollars, British pounds, Canadian dollars, German mark, French Franc, Japanese yen and Swiss Franc) on the Philadelphia Stock Exchange; from 1984, in German mark on the Chicago Mercantile Exchange. A foreign exchange option is a contract giving the purchaser the right but not the obligation to buy (a call option) or to sell (a put option). A standard amount of a traded currency on a stated date (The European option) or at any time before a stated date (the American option) and at a stated price (the Strike or exercise price). Foreign Exchange options are in standard sizes that are half those of futures IMM contracts. The buyer of the option has the choice to purchase or forgo the purchase if it turns out to be unprofitable. The seller of the option, however, must fulfil the contract if the buyer so desires. The buyer pays the seller a premium (the option price) ranging from 1 to 5 per cent of the contract's value for their privilege when he enters the contract.

2. PURCHASING POWER PARITY THEORY (OR) EXCHANGE RATE DETERMINATION IN THE CASE OF INCONVERTIBLE PAPER CURRENCIES

2.1 EXCHANGE RATE DETERMINATION UNDER GOLD STANDARD

Exchange rate denotes the price of one currency in terms of another currency. When countries were on full gold standard, full bodied gold coins were in circulation; or the currency was convertible into gold. So exchange rate determination was not difficult. For instance, if gold contained in \$ 4 and that in £1 were equal the exchange rate between sterling and dollar would be about $£1 = \$ 4$.

2.2 INCONVERTIBLE CURRENCIES

At present, no country is on gold standard. Hence, there is no currency that is convertible into gold at present. So the currencies are called inconvertible paper currencies. The Purchasing Power Parity (PPP) Theory explains exchange rate determination between two inconvertible currencies. This theory is associated with the name of Gustav Cassel, a Swedish economist.

2.3 PURCHASING POWER PARITIES

By purchasing power of money, we mean the quantity of goods and services a monetary unit can command. Suppose, one rupee can buy $1/8$ unit of wheat in India. Again, suppose one U.S. dollar can buy unit of wheat in the U.S.A.

2.4 CHANGES IN INTERNAL PRICES CAUSE CHANGES IN EXCHANGE RATE

Suppose, one rupee commands only $1/10$ unit of wheat in India and there is no change in the purchasing power of the U.S. dollar. In which case, the purchasing power of Rs.10 and one U.S. dollar will be same. Hence, the rate of exchange between the U.S. dollar and the Indian rupee will become $\$ 1 = \text{Rs.}10$.

Check Your Progress

4. What do you mean by purchasing power parity?

Again, suppose one rupee commands 1/5 unit of wheat in India and there is no change in the purchasing power of the U.S. dollar. In which case, the purchasing power of Rs. 5 and one U.S. dollar will be the same. Hence, the rate of exchange between the U.S. dollar and the, Indian rupee will tend to be \$ 1 =Rs.5.

Thus, according to the PPP Theory, movements in the INTERNAL price level tend to cause movement in the exchange rate. However, it is to be noted that Prof. Cassel rules out the possibility of changes in exchange rate bringing about changes in the internal price level.

2.5 FORMULA TO CALCULATE CHANGE IN EXCHANGE RATES

According to the PPP Theory, the exchange rate can be measured by using the following formula.

$$\text{Foreign Exchange Rate} = \frac{\text{Domestic price of a Foreign Currency in the Base year} \times \text{Domestic Price Index}}{\text{Foreign Price Index}}$$

Let us suppose, the base year is 1950 and in the base year, the exchange rate was Rs.4=\$1. Suppose, in 1970 the domestic price index to be 400 and the foreign price index rose to 200; in which case, the exchange rate will be as follows :

$$\text{Foreign Exchange Rate} = [(Rs.4 \times 400) / 200] = Rs.8$$

That is Rs.8

2.6 CRITICISMS

1) To calculate the purchasing power of a currency, we have to take into account goods and services which the monetary unit can command. There are two types of goods, viz., (1) internationally traded goods and (2) goods having only a domestic market. If we take into account the internationally traded goods this theory amounts to a truism. For, assuming perfect competition and absence of control over trade, internationally traded goods must have the same price level. Instead, if we take into account goods having only a domestic market, the theory is not correct. For goods having only a domestic market cannot determine the exchange rate.

2) We have to calculate the purchasing power of a currency only by taking into account index numbers of prices of different goods. But there are some problems. We have got wholesale price index and cost of living index. We have to decide the particular index that we have to choose. Again, goods that enter into domestic trade may also find a place in the index number prepared. Thus, the index numbers of price, of two countries may not be comparable.

3) Capital moves from or into a country. Again, a country may borrow or lend money to other countries. The capital movements and loan transactions among countries may bring about changes in the exchange rate. For instance, if capital moves out of India, the demand for Indian rupees in the foreign exchange market will decline but supply of Indian rupee will increase. Hence, the exchange value of the Indian rupee may tend to decline. Thus, even without any change in the internal price level, the exchange rate may tend to change. But this theory ignores all these factors.

4) According to this theory, changes in exchange rate cannot bring about changes in the internal price levels. This is an erroneous view. Suppose the exchange rate of pound sterling falls from 1=Rs. 20 to 1=Rs.15. This means that now £1 can buy only imports worth Rs.15. This means a rise in the prices of goods imported into Britain. A rise in import prices may lead to a rise in costs of production in industries dependent on imports. This in its turn, will lead to a rise in prices of goods manufactured by these industries. Thus, changes in exchange rate are capable to bring about changes in internal price.

5) This theory is subject to modifications by tariff policy. Even though there is no change in the purchasing power of the currency, imposition of tariff may influence the exchange rate. For instance, the U.S.A. has been able to keep the exchange rate of the dollar at a higher level as result of the imposition of tariff.

6) Keynes has pointed out two defects in this theory. In his view (a) this theory fails to take into consideration the elasticities of reciprocal demand and (b) it fails to consider the influence of capital movements.

In view of the defects noted above, the PPP Theory is not considered a satisfactory theory. No doubt purchasing power of a currency is an important factor in determining its exchange rate. But it is not the only factor that determines the exchange rate of a currency. Hence, we subscribe to the view point of Keynes noted below. " The Purchasing Power Parity Theory is not an accurate forecaster of the course of the foreign exchanges".

3. ANSWERS TO CYP QUESTIONS

1. Refer 1.1 and 1.2
2. Refer 1.3
3. Refer 1.6 (i)
4. Refer 2.3

4. MODEL QUESTIONS FOR GUIDANCE

10 Marks Questions (One page answer)

1. Define foreign exchange. Mention the various participants who participate in the foreign exchange market.
2. Give a brief note on organisation of the market.
3. Explain various functions performed by foreign exchange market.
4. What are the important types of transactions conducted in the foreign exchange market?

20 Marks Questions (Three page answer)

1. Explain and evaluate the Purchasing Power Parity Theory of foreign exchanges.
2. Examine the Purchasing Power Parity Theory. Why are there deviations of actual rate from parities?

UNIT - 7

EXCHANGE CONTROL

Space for Hints

INTRODUCTION

Exchange control is a process by which the government centralises all foreign exchange operations within its purview through the central bank of the country and administers regulations pertaining to it, so that the foreign exchange resources will be utilised carefully on the basis of priorities. The entire foreign exchange earned by the country's exporters has to be deposited with the central bank of the country. The central bank reimburses the exporters by making payments to them in domestic currency. The importers of the country are allocated foreign exchange at official rates to enable them to make payments for the goods imported from abroad. Under exchange control, the private traders are not free to buy or sell foreign exchange in the desired quantities.

In this unit you are going to study the objectives of exchange control, methods of exchange control which consist of direct and indirect methods and a simple comparison of these methods.

UNIT OBJECTIVES : After studying this unit, you will be able

- To understand the concept of exchange control and the objectives of exchange control,
- To learn the direct and indirect methods of exchange control and
- To compare the direct and indirect methods of exchange control.

UNIT STRUCTURE

1. Exchange Control

1.1 Meaning

1.2 Objectives of Exchange Control

1.3 Methods of Exchange Control

1.3.1 Direct Methods of Exchange Control

1.3.2 Indirect Method of Exchange Control

1.4 Comparison of Direct Methods with Indirect Methods

1.5 Conclusion

2. Answers to CYP Questions

3. Model Questions for Guidance

1. EXCHANGE CONTROL

1.1 MEANING

When countries were on gold standard, there was a free foreign exchange market. Demand for and supply of a currency in the foreign exchange standard, countries of the world have been restricting free transaction in foreign exchange. The government has been intervening in the foreign exchange market to influence the exchange rate of its currency. This is known as exchange control. Thus, exchange control means government intervention in the matter of foreign exchange and the exchange rates. Exchange control has also been defined as “means of dealing with balance of payments difficulties which disregards market forces and substitutes for them the arbitrary decisions of government officials. Imports and other international payments are no longer determined by international price comparisons but by considerations of national need. Ingo Walter opines that the most drastic means of balance of payments adjustment available to a nation and perhaps the most undesirable, from an economic stand point is exchange control.

The government of a country may adopt various measures to control the transactions of foreign exchange market. The extent of control depends on the objectives of exchange control and the extent, to which the exchange control is treated as a part of the Government’s overall economic policy. From a balance of payment’s standpoint, the sole purpose of exchange controls is to ration out the available supply of international reserves according to some predetermined set of priorities.

In the post World War I- Period measures of exchange control were first adopted by the fascist Government of Italy and Germany. However, in

Check Your Progress

1. What do you mean by exchange control?

the later years, particularly during and after the Great Depression of early thirties, Governments of several other countries also followed suit and introduced policies to control and regulate their foreign exchange markets. In the present context, the exchange control has become an important part of national economic policies of not only planned or socialist countries but also of the policies adopted by the western countries.

1.2 OBJECTIVES OF EXCHANGE CONTROL

Government intervention in the foreign exchange market or exchange control is practised for satisfying a number of objectives. Broadly stated, the following are the main objectives of exchange control.

a. CONSERVATION OF FOREIGN EXCHANGE RESERVES

Exchange control may be introduced by the monetary authority to conserve the gold bullion, exchange currencies, i.e., foreign exchange resources of the country. It may be necessary to ensure the availability of sufficient amounts of foreign exchange needs to buy essential foreign goods.

b. RESTRICTING THE FLIGHT OF CAPITAL

Sometime, irregular, but large scale outward movement of capital may pose a big threat to the economic stability and also to the balance of payment equilibrium of a country as it happened in the case of some ASIAN members like South Korea during 1996-98. Under such conditions exchange control may provide an effective means to check the flight of capital from the country and may thus prevent further deterioration in the country's balance of payments. Even the International Monetary Fund permits exchange control to combat the flight of capital, especially, the speculative flight of capital.

c. CORRECTING THE ADVERSE BALANCE OF PAYMENTS

The major purpose of exchange control with its central element of restricting imports is the balance of payments. By overvaluing or devaluing

the exchange rate, the government attempts to affect the terms of trade and thus tries to directly affect the country's exports and imports.

d. STABILITY OF FOREIGN EXCHANGE RATES

Wide and frequent oscillations in the foreign exchange rates generally acts as a deterrant in the international movement of goods and capital. Every government has to ensure that the foreign exchange rate of the nation's currency is not subjected to political, economic and other pressures either international or external. As a consequence, it has to maintain exchange rate at an arbitrarily chosen level. This level may exceed or else may fall short of the rate which would have been determined by the forces of demand and supply in the foreign exchange market.

e. PROTECTING THE INTEREST OF HOME PRODUCERS

Exchange control may be used for giving protection to domestic producers by restricting the competition from foreign traders import controls.

f. GENERATING PUBLIC REVENUE

By multiple exchange rates system, the Government can yield revenue income through difference of average buying and selling rates, less costs of administration.

g. MAINTAINING OVER-VALUE OF HOME CURRENCY

Exchange control has often been resorted to maintain the exchange rate of the domestic currency at a level higher than that dictated by the free play of force of demand for and supply of foreign exchange. For this purpose, the available foreign exchange resources are rationed for use of specific and important purposes only. Thus, the government seeks to adjust total demand with total supply of foreign currencies.

h. FOR COMMERCIAL BARGAINING

The allocation of foreign exchange for imports offers substantial scope for discrimination between different countries. The country from

which a commodity would be imported depends upon the particular currency supplied by the exchange control agency. Further, the quantity imported depends on the amount of the currency supplied. Through discrimination, the exchange control can be used to exchange concessions on reciprocal basis between different countries.

i. TO OBTAIN PAYMENT FROM DEBTOR COUNTRIES

Creditor countries have used exchange control to influence the debtor in allocating its receipts of the creditor country's currency between that used for importing goods and services and that for servicing frozen debts.

j. REDEMPTION OF EXTERNAL DEBT

The Government may use the exchange control device to obtain foreign exchange needed for repaying or servicing of its foreign loans.

k. EFFECTIVE ECONOMIC PLANNING

Domestic plans may be disturbed by unexpected fluctuations in prices or in quantities of exports and imports. Such fluctuations are beyond the control of any national government. For successful economic planning, foreign trade has to be coordinated with planned programmes and the outflow of capital should be restricted in order to make it available to domestic industries. Exchange control is an effective instrument for insulating the internal economy from, or mitigating the repercussions of unanticipated external events of temporary nature.

1.3 METHODS OF EXCHANGE CONTROL

The various methods of exchange control may be classified into direct and indirect types. Direct methods include those devices which are adopted by governments to have an effective control over the exchange rate while indirect methods are designed to regulate international movements of goods.

1.3.1 DIRECT METHODS OF EXCHANGE CONTROL

Direct exchange control induces measures like (a) Intervention (b) Exchange Restriction. (c) Exchange Clearing Agreements, (d) Payment Agreements (e) Gold Policy.

(a) INTERVENTION

The Government or its agency- the Central Bank can intervene in the free market by resorting to buying and selling the home currency against foreign currency in the foreign exchange market to support or depress the exchange rate of its currency. Any one wanting foreign exchange should purchase it only from the central authority. Similarly anyone wanting to sell foreign exchange should sell it only to the central authority.

i) PEGGING OPERATION

Government intervention takes the form of “pegging up” or “pegging down” of the home currency to a chosen rate of exchange. Since under valuation or over valuation is not the equilibrium rate, it has to be pegged. Thus, pegging means keeping a fixed exchange value of a currency.

Pegging operations take the form of buying and selling of the local currency by the central bank in exchange for the foreign currency in the foreign exchange market in order to maintain an exchange rate, whether it is over-valued or under-valued. ”Pegging up” means maintaining the external value of the currency at a level higher than the free market value. In short, pegging up aims at over valuation or appreciation in the external value of the currency at a level lower than the free market value. In short, pegging down aims at undervaluation of depreciation in the external value of the currency.

In the case of pegging up, the central bank shall have to keep itself ready to buy unlimited amount of local currency in exchange for foreign currencies at a fixed rate, since, over-valuation tends to increase the demand for foreign currencies by creating import surplus. In the case of pegging

Check Your Progress

2. What is meant by pegging operation?

down, the central bank or central agency shall have to keep itself ready to sell any amount of local currency, because undervaluation tends to increase the demand for local currency by creating export surplus. Similarly, pegging up involves holding of sufficient amount of foreign currency while pegging down involves holding of sufficient amount of local currency by the Central Bank. Pegging up is more difficult to maintain as it requires huge amounts of foreign currencies which is difficult to obtain. Hence,, pegging up can be adopted only as a temporary measure.

It should be noted that intervention by a government in the foreign exchange market has the effect of neutralising the forces of demand and supply of foreign exchange. However, it is generally assumed that government intervention or pegging up and pegging down operations should be used as temporary expedients to remove fluctuations in the exchange rate.

(b) EXCHANGE RESTRICTIONS

Exchange restrictions refer to the policy or measures adopted by a government which restrict or compulsorily reduce the flow of home currency in the foreign exchange market. Exchange restrictions may be of three types: (i) The government may centralise all trading in foreign exchange with itself of a central authority usually the central bank; (ii) the government may prevent the exchange of local currency against foreign currencies without its permission; (iii) the government may order all foreign exchange transactions to be made through its agency.

The most important forms of exchange restrictions are (1) blocked accounts, (2) multiple exchange rates.

i) BLOCKED ACCOUNTS

Under the condition of severe financial crisis, a debtor country may adopt the scheme of blocking the accounts of its creditors. In 1931, Germany had adopted this system. Blocked accounts refer to bank deposits,

Check Your Progress

3. What is the meaning of blocked accounts?

securities and assets held by foreigners in a country which denies them conversion of these into their home currency. So Blocked accounts cannot be converted into the creditor country's currency. Under the blocked accounts scheme all those who have to make payments to the foreign creditors will not send them to the foreign creditors, directly but they will send their payments to the central bank of the country will keep the amount in the name of the foreign creditor. This amount will not be available to the foreigners in their own currency, but can be used by them for purchases in the controlling country.

Blocked accounts system has three drawbacks. They are: (i) it reduces international trade to a minimum; (ii) it leads to black marketing in foreign exchange; and (iii) it also affects the size of international liquidity adversely.

ii) MULTIPLE EXCHANGE RATES

In the early thirties, Germany had initiated the device of multiple rates as a weapon to improve her balance of payments position. This system was later followed by Argentina, Brazil and many other countries. Under the system, different exchange rates are set for different classes and categories of exports and imports. Generally a low rate, i.e., low prices of foreign money in terms of domestic currency, is confined to imports of necessary items having inelastic demand, while a high penalty rate is fixed for the import of luxury items. In short, the multiple exchange rate system implies official price discriminatory policy in foreign exchange transaction.

By simply fixing a high rate for a commodity, the Government can check its imports. Similarly, its imports can be encouraged by fixing a low exchange rate. Likewise, the export of a commodity can be encouraged by setting a high rate of exchange. Thus, the device of multiple exchange rates can be effectively used by the government without resorting to quantitative restrictions and licensing. The system of multiple exchange rates in essence, is a form of discriminatory partial devaluation because instead of devaluing

Check Your Progress

4. What do you understand by Multiple Exchange Rates?

the currency for the whole of foreign trade, the currency is devalued for imports, exports of goods with an elasticity greater than unity and appreciating the currency for the whole of foreign goods with inelasticity less than unity. It is thus more effective in bringing about the desired effect on the level of trade and thereby improve the balance of payments.

Thus, the main merit of the system of multiple exchange rate is that it allows more effective control of the balance of payments. Secondly, it also contains disguised subsidies and tariffs which may encourage or discourage trade in certain goods and affect the level of foreign trade. Another merit of the system is that it enables the government to yield revenue by buying foreign exchange at low price in domestic money from exporters and then selling it at higher prices to importers.

However, the system has the following drawbacks: (a) Instead of correcting the balance of payments, it adversely affects the growth of international trade and the maximisation of world output and welfare. (b) It puts too much arbitrary powers into the hands of the government to influence foreign trade. (c) It creates undue complexities in calculation, due to different exchange rates, for different imports and exports which may be changed from time to time resulting in uncertainty in foreign trade. (d) The system has a formidable administrative problem to effective control. Utmost vigilance has to be maintained against the undervaluation of export invoices and overvaluation of import invoices and care should be taken to see the exporters do not sell their proceeds of foreign exchange in the black market and importers do make specific and proper use of the allotted foreign exchange.

c. EXCHANGE CLEARING AGREEMENTS

European countries adopted this method of exchange control in 1930s. Under this system, two trading countries agree to establish an account in their respective central banks, through which all payments for exports and imports are cleared. This method is known as bilateral clearing or clearing agreements.

Under this system, if country A imports goods from country B, payments by importers are required to be made in the clearing account with its central bank in its own currency. Similarly, exporter of country A are paid in their own currency out of the clearing account. The same principle applies to the other trading partner. But it is not essential that exports and imports may be equal in both the countries and the clearing accounts may balance. So to balance them, the banks supply their own currency, at a fixed rate of exchange against the other country upto a certain limit. Beyond this limit, any surplus or deficits is settled in terms of gold or a convertible currency acceptable to both the countries.

But there are certain drawbacks in this system. They are (a) There is a possibility of exploitation of an economically weaker country by a stronger country (b) The exchange clearing agreement involved bilateral transactions in foreign trade, which cause a diversion of normal trade pattern and endanger the promotion of world trade. (c) This device also reduces the volume of international trade. Moreover, it attempts to do away with the foreign exchange market. (d) The scheme requires that all payments have to be centralised.

d. EXCHANGE PAYMENTS AGREEMENTS

A less rigid variety of bilateral agreement is an Exchange Payments Agreement. It is usually made for the repayment of the debt by one country to another. Under this system of exchange control, a certain percentage of payments for imports by the creditor country is passed on to its clearing account for the repayment of its debt. The creditor country does not impose any restriction on the imports from the debtor country. But the debtor country can restrict its imports from the creditor country, so that it can repay its debt through larger exports.

However, payments agreements suffer from two defects: (a) The agreement accounts could only be debited or credited for licensed

payments. (b) The balances in the accounts could only be used for payment from one partner to another.

e. GOLD POLICY

Through a suitable gold policy, the country can bring the desired exchange control. For this, the country may resort to the manipulation of the buying and selling prices of gold which affect the exchange rate of the country's currency. For example in 1936, the U. K., France and U. S. A., signed Tripartite Agreement in this regard for fixing a suitable purchase and sale price of gold.

1.3.2 INDIRECT METHOD OF EXCHANGE CONTROL

Apart from the direct methods, there are few indirect methods also for regulating the rates of exchange. They are:

i. CHANGES IN INTEREST RATES

Change in interest rate tends to influence indirectly the foreign exchange rate. A rise in the interest rate of a country attracts liquid capital and banking funds of foreigners. It will also prevent capital flight as the nationals of the country will tend to keep their funds in their own country. All this tends to increase the demand for local currency and consequently the exchange rate moves in its favour. It goes without saying that a lowering of the rate of interest will have the opposite effect.

ii. TARIFF DUTIES AND IMPORT QUOTAS

The most important indirect method is the use of tariffs and import quotas and other such quantitative restrictions on the volume of foreign trade. Import duty reduces and with it rises the value of home currency relative to foreign currency. Similarly, export duty restricts exports, and as a result the value of home currency falls relative to foreign currencies. In short, when import duties and quotas are imposed the rate of exchange tends to go up in favour of the controlling country.

iii. EXPORT BOUNTIES

Export bounties or subsidies increase exports. As such the external value of the currency of the subsidy giving country rises.

It should be noted that import duties and export countries are treated as indirect instruments of exchange control only if they are imposed with the object of conserving the foreign exchange. Otherwise the fundamental aim of import duty is merely to check imports and that export bounty is to encourage exports.

Thus, interest rates, import duty or export subsidy, each has its limitation. For example, import duty cannot go so far as to completely restrict imports. There is also the fear of retaliation in regard to tariff policy. Similarly, the volume of subsidy depends upon the support of public funds. Similarly, manipulation of exchange rates through interest rate may not be always effective. Moreover, rates of interest cannot be raised to any limit.

1.4 COMPARISON OF DIRECT METHODS WITH INDIRECT METHODS

It is to be noted that the indirect methods can only influence the exchange rate; they cannot control them, whereas the direct methods have the effect of controlling the exchange rate. Hence, as between the direct methods and indirect methods, the direct methods will be more effective.

1.5 CONCLUSION

Exchange control protects a relatively backward nation from violent oscillations occurring in the world economy. It particularly helps those countries which have very inadequate reserves of gold and foreign currencies. Moreover, exchange control enables such countries to import foreign made products on a priority basis and helps them improve their balance of payments position. For all these reasons, exchange control has become an integral part of national economic policy in several countries of the world.

Check Your Progress

5. What is meant by Export Bounties?

However, these merits of exchange control are based on the assumption that these devices are practised by a nation without inducing reaction or retaliation among other nations. If several countries resort to the policy of exchange control, many of its benefits will disappear. Simultaneous adoption of exchange control measures may have some bad effects. They are (a) Development of Economic Nationalism (b) Destruction of International Trade (c) Encouragement to bilateral agreement (d) Extensive powers to government authorities.

Despite these limitations, exchange control continues to remain an important part of national economic policies. Revocation of exchange control devices by a single country will prove to be a suicidal decision unless other countries also follow suit. The International Monetary Fund is endeavouring to minimise the scope of member nation's exchange control devices.

2. ANSWERS TO CYP QUESTIONS

1. Refer 1.1
2. Refer 1.3.1.a.(i)
3. Refer 1.3.1.b.(i)
4. Refer 1.3.1.b.(ii)
5. Refer 1.3.2.(iii)

3. MODEL QUESTIONS FOR GUIDANCE

10 Marks Questions (One page answer)

1. What is meant by Exchange Control? Why is this essential?
2. Give a brief account of pegging operation?
3. What are the major forms of exchange restriction?
4. Give short note on
 - a. Multiple Exchange Rates, b. Exchange Clearing Agreements,
 - c. Exchange Payments Agreements, d. Gold Policy,
 - e. Tariff Duties, f. Export Bounties.

20 Marks Questions (Three page answer)

1. Describe the main objectives and techniques of Exchange Control.
2. Discuss the different methods of Exchange Control.

UNIT - 8

INTERNATIONAL FINANCIAL INSTITUTIONS

Space for Hints

INTRODUCTION

During the inter-war period (1918-1939), there was international monetary confusion and chaos. The abandonment of Gold Standard in 1914 brought about the displacement of fixed exchange rate system. The adoption of flexible or floating exchange rates led to a great deal of uncertainty. There was complete lack of coordination and co-operation in the international field. Every country attempted to maximise its exports and minimise its imports by resorting to competitive currency devaluation. There was acute commercial rivalry among nations. Economic war was going on, sustaining political relationship, which ultimately culminated in the second world war(1939-45). During the second world war, several countries felt the need for economic and monetary cooperation among countries. Hence the creation of the two international financial institutions namely, International Monetary Fund and the World Bank.

In this unit you are going to study about these international financial institutions which helped the nations in the development of their economies.

UNIT OBJECTIVES : After studying this unit, you will be able

- To understand IMF and its functions in the development of the economy of the member countries,
- To study how the World Bank helps to develop the member countries.

UNIT STRUCTURE

1 . International Monetary Fund

1.1 Introduction

1.2 IMF Activities

1.3 Organisation

1.4 Resources

- 1.5 The Quota System
- 1.6 Gold Holdings
- 1.7 Borrowing Arrangements
- 1.8 IMF Concessional Lending and Debt Relief
- 1.9 IMF Income and Expenses
- 1.10 Funds Assistance
- 1.11 Repurchase Provision
- 1.12 The IMF's Lending Capacity
- 1.13 IMF's Lending Operations
- 1.14 The Process of IMF Lending
- 1.15 The Changing Nature of IMF Lending
- 1.16 Concessional and Non-Concessional Lending
- 1.17 Special Drawing Rights (SDRs)
- 1.18 Operation
- 1.19 Uses Of SDRs
- 1.20 Exchange Rate
- 1.21 Criticisms Against the IMF
- 1.22 IMF and India

2. The World Bank

- 2.1 Objectives
- 2.2 The World Bank Group
- 2.3 Membership of The World Bank
- 2.4 Resources of the Bank
- 2.5 Organisation of the World Bank
- 2.6 Lending Operations
- 2.7 Types of Lending
- 2.8 Lending Instruments
- 2.9 Investment Lending
- 2.10 Adjustment Lending
- 2.11 Grants

- 2.12 Other Activities of the Bank - Analytic and Advisory Services
- 2.13 Building Capacity
- 2.14 Preventing Corruption
- 2.15 Operations Evaluation
- 2.16 Settlement of Investment Disputes
- 2.17 Global Goods
- 2.18 The Variety of Work On The Ground
- 2.19 India and The World Bank
- 2.20 The World Bank Group in India
- 2.21 Critical Appraisal of the working of World Bank
- 2.22 Suggestions
- 3. Answers to CYP Questions
- 4. Model Questions for Guidance

1 . INTERNATIONAL MONETARY FUND (IMF)

1.1 INTRODUCTION

After the breakdown of the gold standard, the world has lost the most efficient automatic monetary standard on which countries had relied for restoring equilibrium in their balance of payments. However no alternative arrangement comparable to the gold standard emerged. Instead, each country dealt with its balance of payments deficit in its own way which resulted in the shrinkage of total world trade. Countries increasingly resorted to clearing agreements, blocked accounts, multiple exchange rates and many other restrictions on international trade and payments. These restrictions on multilateral trade and payments increased in severity during the second world war period. The enlightened public and world statesmen realised that these restrictive trade and payments practices would continue after the war unless concerted efforts were made to create some effective international machinery whereby exchange stability could be guaranteed. The war time discussions between the United States and British governments culminated in the Bretton woods conference of 1944 which

Check Your Progress

1. When was IMF established?

created two international institutions viz., i) The International Monetary Fund also known as the "IMF" or the "Fund" and ii) The International Bank for Reconstruction and Development. The International Monetary Fund was to have jurisdiction over currencies, exchange rates and the balance of payments policies of member countries. The World Bank (IBRD) was to raise and lend capital for development purposes. Thus, the IMF was established in 1945 to promote economic and financial co-operation among its members in order to facilitate the expansion and balanced growth of world trade. In April 2006 the IMF has 185 members. The objectives of IMF or the Fund are :

1. To promote international monetary cooperation.
2. To facilitate the expansion and balanced growth of international trade.
3. To promote exchange rate stability.
4. To avoid competitive exchange depreciation.
5. To eliminate foreign exchange restriction which hamper the growth of world trade.
6. To facilitate member countries to correct, maladjustments in their balance of payments by making the funds resources available to them.
7. To shorten the duration and reduce the degree of disequilibrium in the international balance of payments of members; and
8. To assist in the establishment of multilateral system of payments.

1.2 IMF ACTIVITIES

The IMF is responsible for ensuring the stability of the international monetary and financial system - The system of international payments and exchange rates among national currencies that enables trade to take place between countries. The Fund seeks to promote economic stability and prevent crisis; to resolve crises when they do occur; and to promote growth

Check Your Progress

2. How many members are there in IMF at present?

and alleviate poverty. It employs three main functions - surveillance, technical assistance and lending to meet these objectives.

The IMF works to promote global growth and economic stability and thereby prevent economic crisis. The IMF encourages the member countries to adopt sound economic policies.

Surveillance is the regular dialogue and policy advice that the IMF offers to each of its members. Generally, once a year, the Fund conducts in-depth appraisals of each member country's economic situation. The IMF discusses with the country's authorities the policies that are most conducive to stable exchange rates and a growing and prosperous economy.

The Fund conducts resource studies and publishes them. The IMF also combines information from individual consultations to form assessments of global and regional developments and prospects. Its views are published twice in the World Economic Outlook and the Global Financial Stability Report.

The IMF offers technical assistance and training, mostly free of charge, to help member countries strengthen their capacity to design and implement effective policies. It offers technical assistance in several areas including fiscal policy, monetary and exchange rate policies, banking and financial system, supervision and regulation and statistics.

The IMF gives financial assistance to correct balance of payments problems.

The Fund aims at reducing tariffs and other trade restrictions imposed by the member countries. Without the approval of the Fund, no member can impose restrictions on the making of payments or engage in discriminatory currency arrangements or multiple currency practices.

The IMF is also actively working to reduce poverty in countries around the globe, independently and in collaboration with the World Bank and other organisations.

1.3 ORGANISATION

At the apex of the Fund's organisational structure is its Board of Governors, which consists of one Governor from each of the IMF's member countries. All Governors meet once each year at the IMF-World Bank Annual Meetings. 24 of the Governors sit on the International Monetary and Finance Committee (IMFC) and meet twice each year. The day-to-day work of the IMF is conducted by its 24 – member Executive Board. This Board's work is guided by the IMFC and supported by the IMF's professional staff. The Managing Director is the Chairman of the Executive Board and head of the IMF staff. He is assisted by three Deputy Managing Directors.

1.4 RESOURCES

The resources of the IMF come from subscription by members, sale of gold and borrowings.

1.5 THE QUOTA SYSTEM

Each member of the IMF is assigned a quota, based on its relative size in the world economy, which determines its contribution to the IMF's financial resources. At the time of the formation of the IMF, each member was required to pay 25 per cent of its quota in gold or 10 per cent of its net official holdings of gold and Us dollars whichever was less. After amendment of its Article of Agreements, 25 per cent of a member's quota payable in gold was substituted by Special Drawing Rights (SDRs) or widely accepted foreign currencies such as the U.S.dollar, the euro, the yen or the pound sterling. The remaining 75 per cent was to be paid in the country's own currency. Quotas are used to determine the voting power of the members, their contribution to the funds resources, their access to these resources, their share in allocation of SDRs.

Quotas are reviewed at least every five years. The Quota review that was concluded in 1998 led to a 45 per cent increase in IMF quotas to SDR 213 billion (about \$ 316 billion). The review concluded in January 2003 resulted in no change in quotas.

1.6 GOLD HOLDINGS

The IMF's gold holdings, valued at current market prices, are worth about \$ 43 billion, making the Fund one of the largest official holders of gold in the world. However, the IMF's Articles of Agreement strictly limit its use. Under some circumstances, the IMF may sell gold or may accept gold as payment by member countries; but the IMF is prohibited from buying gold or engaging in other gold transactions.

1.7 BORROWING ARRANGEMENTS

The Fund is authorised to borrow under the General Arrangements to Borrow (GAB) from its eleven industrialised members to supplement its ordinary resources. The GAB remained in force from October 1962 to December 1998. The New Arrangements to Borrow (NAB) was established in 1998. Under the NAB, 26 countries have agreed to lend SDR 34 billion (about \$ 51 billion).

1.8 IMF CONCESSIONAL LENDING AND DEBT RELIEF:

The IMF provides two primary types of financial assistance to low-income countries: low-interest loans under the Poverty Reduction and Growth Facility (PRGF), and debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative. These resources come from member contributions and the IMF itself, rather than from the quota subscriptions. They are administered under the PRGF and PRGF-HIPC Trusts, for which the IMF acts as Trustee.

The PRGF Trust was established to provide, lending in support of PRGF arrangements and to subsidize the market rate of interest down to the concessional interest rate of 0.5 percent per annum. Loan resources in excess of \$21 billion have been provided by 17 contributors to the Trust, while a larger number of IMF member countries have made subsidy contributions.

The PRGF-HIPC Trust was established to provide debt relief under the HIPC Initiative and to subsidize PRGF lending during the period 2002-05. The resources available to the Trust consists of grants and deposits from 93 member countries and contributions from the IMF itself. The bulk of the IMF's contribution comes from the investment income on the net proceeds from off-market gold transactions in gold made during 1999-2000.

In addition to the above, there is a separate administered account financed by a group of member countries for interest subsidies in IMF emergency assistance to countries in post-conflict situations.

1.9 IMF INCOME AND EXPENSES

The IMF's annual expenses are financed largely by the difference between annual interest receipts and annual interest payments. In fiscal year 2003, interest and charges received from borrowing countries and other income totaled \$3.7 billion, while interest payments on the portion of members quota subscriptions used in IMF operations and other operating expenses amounted to \$1.8 billion. Administrative expenditures (including staff salaries and pensions, travel, and supplies) totaled \$0.9 billion. The remainder was added to the IMF's General Resources Account-the funds available for lending to member countries.

1.10 FUNDS ASSISTANCE

Each member has the right to purchase from the Fund, in exchange for its own currency, the currency of another member up to a maximum of 25 per cent of its quota per annum. However, it has been stipulated that the currency of a member country with the Fund must not exceed 200 per cent of its quota. We know that the original contribution of a member country to the Fund in its currency is not less than 75 per cent of its quota. This means that a country can purchase the currency of other countries only upto 125 per cent of its quota.

1.11 REPURCHASE PROVISION

There is provision for a member country to buy its own currency with the IMF in excess of its quota using gold, Special Drawing Rights or convertible currencies.

1.12 THE IMF's LENDING CAPACITY

The IMF can only use the currencies of financially strong economies to finance lending. The IMF's Executive Board selects these currencies every three months. Most are issued by industrial countries but the list also has included currencies of developing countries such as Botswana, China and India. The IMF's holdings of these currencies, together with its own SDR holdings, make up its usable resources.

The amount, the IMF has readily available for new (non-concessional) lending is indicated by its one-year forward commitment capacity. This is determined by its usable resources, plus projected loan repayments over the subsequent twelve months, less the resources that have already committed under existing arrangements, less a precautionary balance. As of December 31, 2003, the Fund's one – year forward commitment capacity was \$81 billion.

1.13 IMF's LENDING OPERATIONS

The Fund has a variety of facilities for lending to member countries. The principal way in which the IMF makes its resources available to members is by selling to them currencies of other members or SDRS in exchange for their own currencies. Such transactions change the composition, but not the overall size of the Fund's resources. A member to whom the Fund sells currencies or SDRS is said to make drawings from the Fund.

A main function of the IMF is to provide loans to countries experiencing balance of payments problems so that they can restore conditions for sustainable economic growth. The financial assistance

provided by the IMF enables countries to rebuild their international reserves, stabilize their currencies and continue paying for imports without having to impose trade restrictions or capital controls. Unlike development banks, the IMF does not lend for specific projects.

1.14 THE PROCESS OF IMF LENDING

IMF loans are usually provided under an "arrangement", which stipulates the conditions the country must meet in order to gain access to the loan. All arrangements must be approved by the Executive Board. Arrangements are based on economic programmes formulated by countries in consultation with the IMF and presented to the Executive Board in a "letter of intent." Loans are then released in phased installments as the program is carried out.

1.15 THE CHANGING NATURE OF IMF LENDING

The volume of loans provided by the IMF has fluctuated significantly over time. The oil shock of the 1970s and the debt crisis of the 1980s were both followed by sharp increases in IMF lending. In the 1990s, the transition process in Central and Eastern Europe and the crises in emerging market economies led to another surge in the demand for IMF resources.

1.16 CONCESSIONAL AND NON-CONCESSIONAL LENDING

Over the years, the IMF has developed a number of loan instruments, or "facilities," that are tailored to address the specific circumstances of its diverse membership. Low-income countries may borrow at a concessional interest rate through the poverty Reduction and Growth Facility (PRGF). Non-concessional loans are provided through other facilities like Stand-By Arrangements (SBA), the Extended Fund Facility (EFF), the Supplemental Reserve Facility (SRF) and the Compensatory Financing Facility (CFF).

Except for the PRGF, all facilities are subject to the IMF's market-related interest rate, known as the "rate of charge" and some carry a premium and surcharge also. The rate of charge is based on the SDR interest rate, which is revised weekly to take account of changes in short-term interest rates in the major international money markets. The IMF discourages excessive use of its resources by imposing a surcharge on large loans, and countries are expected to repay loans early if their external position allows them to do so.

The credit facilities are the following :

1. Buffer Stock Financing Facility (BSFF)

It was created in 1969 for financing primary products buffer stock by member countries. Now, a member can have outstanding purchases. Under the facility up to 45 per cent of quota. Repayments are made in 3¼ to 5 years.

2. Extended Fund Facility (EFF)

It was established in 1974 to provide term assistance to those members whose economy suffers from serious balance of payments difficulties resulting from structural imbalances in production, trade, cost and prices and to those countries which are unable to pursue active development policies because of their weak balance of payments positions. Arrangements under the EFF are thus longer (3 years). Repayment is expected within 4 ½ - 7 years unless an extension is approved. Surcharges apply to high levels of access.

3. Supplementary Financing Facility (SFF)

It was established in 1979 to provide assistance to members to facing balance of payments difficulties that are large in relation to their economies and their Fund quotas. The facility has been extended to low income developing member countries of the Fund. To reduce the cost of borrowing under SFF to such countries, the IMF established Subsidy Account in 1980 through which it makes subsidy payments to borrower countries.

4. Structural Adjustment Facility (SAF)

It was created in 1986 to provide concessional assistance to the eligible low income member countries to solve balance of payments problems and to carry out structural adjustment programmes.

5. Enhanced Structural Adjustment Facility (ESAF)

It was established in 1987 in order to provide additional finance to low income member countries under taking structural adjustment programmes and experiencing balance of payments problems. The objectives, eligibility, the period of repayment, interest rate and basic programme of this facility are same as that of the SAF. But in ESAF access to the Fund's resources are larger.

6. Poverty Reduction And Growth Facility (PRGF)

The IMF for many years provided assistance to low-income countries through the Enhanced Structural Adjustment Facility (ESAF). In 1999, however, a decision was made to strengthen the focus on poverty and the ESAF was replaced by the PRGF. Loans under the PRGF are based on a Poverty Reduction Strategy Paper (PRSP), which is prepared by the country in cooperation with civil society and other development partners, in particular the World Bank. The interest rate levied on PRGF loans is only 0.5 percent, and loans are to be repaid over a period of 5½ - 10 years.

7. Stand-By Arrangements (SBA)

The SBA is designed to address short-term balance of payments problems and is the most widely used facility of the IMF. The length of a SBA is typically 12-18 months. Repayment is expected within 2 ¼ - 4 years unless an extension is approved. Surcharge apply to high levels of access.

8. Supplemental Reserve Facility (SRF)

The SRF was introduced in 1997 to meet a need for very short-term financing on a large scale. The sudden loss of market confidence experienced by emerging market economies in the 1990s led to massive

outflow of capital, which required loans on a much larger scale than anything the IMF had previously been asked to provide. Countries are expected to repay loans within 2-2½ years, but may request an extension by up to six months. All SRF loans carry a substantial surcharge of 3-5 percentage points.

9. Compensatory Financing Facility (CFF)

The CFF was established in the 1960s to assist countries experiencing either a sudden shortfall in export earnings or an increase in the cost of cereal imports caused by fluctuating world commodity prices. The financial terms are the same as those applying to the SBA, except that GFF loans carry no surcharge.

10. Emergency Assistance

The IMF provides emergency assistance to countries that have experienced a natural disaster or are emerging from conflict. Emergency loans are subject to the basic rate of charge and must be repaid within 3¼ - 5 years. They do not carry an expectation of early prepayment.

1.17 SPECIAL DRAWING RIGHTS (SDRS)

To solve the problem of international liquidity, the scheme of Special Drawing Rights was instituted in 1969. SDRs are not paper notes or currency. They are artificially created international units of account in which the official accounts of the IMF are kept. They are allocated to the IMF members in proportion to their Fund quotas and are used to settle balance of payments deficits between them. The SDRs scheme is also known the Paper Gold Scheme. Through the Scheme, the member countries can get additional financial facilities.

1.18 OPERATION

The activities of the Fund are conducted under two separate accounts. The general transaction of the Fund, including the sale of foreign currencies to member countries are conducted through the General Account.

Check Your Progress

3. What do you mean by Special Drawing Rights?

4. When was SDRs instituted?

In other words, General Account deals with the general drawing rights of the member countries. But with the establishment of SDRs, a new account was opened known as Special Drawing Account. All operations and transactions involving special drawing rights are conducted through the Special Drawing Account.

1.19 USES OF SDRs

1. A member country is free to use its holdings of SDRs to meet the deficit in her balance of payments. A participant in the SDR scheme which has balance of payment difficulty is entitled to transfer its SDRs to another participating country which has been designated by the Fund and get the currency of that country or the currency of any other member country.

2. SDRs are used in all transactions with the General Account of the Fund. Participants pay charges in SDRs to the General Account for the use of Fund's resources and also to repurchase their own currency from it.

3. SDRs can be used in donations or grants. They can be used as security for the performance of financial obligations. SDRs can be used in loans. Thus, SDRs may be used in many forms of transactions and operations between the participants.

1.20 EXCHANGE RATE

The primary objective of the Fund is to promote the exchange rate stability to maintain coordinated and orderly arrangements among members. Initially par value of each member country was expressed in terms of gold or U.S. dollars. The member country can change the value of its currency ± 10 per cent of the par value without the permission of IMF. Beyond that, it has to get the permission of IMF. But, at present, IMF has limited control over the exchange rate adjustment policies of the member countries. It is required to lay down principles for the guidance of the exchange, rate adjustment policies of the member countries. It is expected to have international surveillance of exchange rate adjustment policies. A

team of four or five economists from the Fund headquarters visit the member countries national capitals to gather unpublished statistics, hear the first hand motivation for recent policy changes and authorities interpretation of recent trends. IMF personnel discuss the policy objectives with the competent authorities in the finance ministry, central bank and other agencies responsible for economic matters. This would result in policy oriented report. These reports are discussed in the Executive Board; and the comments and advises are conveyed to the concerned member country.

1.21 CRITICISMS AGAINST THE IMF

1. IMF Articles of Agreement stress on meeting economic requirements without any interference in the domestic affairs of the member countries. But, the IMF exercises surveillance over the exchange rates, monetary, fiscal and related policies of the borrowing countries which makes a mockery of its policy of non-interfering in the internal economic affairs.

2. An important criticism of the Fund is that the quotas of the various member countries have not been fixed on any scientific basis. Quotas were originally fixed keeping in mind the economic and political interests of U.S.A. and U.K. and the Fund has been continuously dominated by these two countries since origin.

3. The Fund has been criticised for its discriminatory policies against the developing countries and in favour of the developed countries. It is, therefore, characterised as "Rich Countries Club". Although the majority of the members are the developing countries of Asia, Africa and Latin America, yet it is dominated by the rich countries.

4. One of the objectives of the Fund is to eliminate foreign exchange restrictions which hamper the growth in world trade. But the Fund has not been successful in achieving the objective. Member countries are having variety of exchange controls and multiple exchange practices.

5. The Fund has not been able to bring about complete stability in foreign exchange rates. The exchange rates of different countries have been changing despite the existence of the Fund.

6. IMF is not able to solve completely the problem of international liquidity. The Fund found it difficult to meet the foreign exchange requirements of the members because of its limited resources. Introduction of SDR also has not also solved the problem of international liquidity.

1.22 IMF AND INDIA

India is one of the founder members of the IMF. It signed the Fund agreement on 27 Dec. 1945. Till 1970, India's quota in the Fund was the fifth and it had the power to appoint a permanent Executive Director. With the increase in the IMF's quota in 1970, the quotas of Japan, Canada and Italy increased more than that of India. Then India ceased to hold a permanent position as an Executive Director of the Fund.

India has made use of the different financial and other assistance of the IMF several times. India borrowed between 1947 to 1955 \$ 100 million to tide over its balance of payments difficulties. Between 1957 to 1975 India borrowed a total sum of \$ 1764 million. In 1979, India entered into agreement with IMF for a loan of \$ 5.6 billion. But, actual drawing by the end of 1983-84 was only \$ 3.9 billion and the programme was terminated in view of the improvement in foreign exchange reserve position.

In 1990, the debt service ratio increase sharply from 9.3 per cent in 1980 to 28.8 per cent. There was a huge trade deficit. Gulf war also affected the Indian reserve position. There was rise in oil prices. There was massive withdrawal of Non Residential Indian deposits. India could not borrow from other foreign sources due to a fall in India's credit rating. All these aggravates India's balance of payments problem.

At this juncture, India had no other alternative than to borrow from IMF. Borrowing from IMF involved the acceptance of the Fund's

conditionalities. Conditionalities of the IMF pertains to the area of budgetary deficit, subsidies, reduction in custom duties, liberalisation of foreign investment, industrial policy, privatisation, etc. In January, 1991, India received \$ 0.79 billion as the first credit tranche of a Stand - By Arrangement for three months. At the same time India got the first credit of \$ 1.09 billion under Compensatory and Contingency Financing Facility (CCRR), followed by the second loan of \$ 220 million in July 1991 and a third loan of \$ 639 million in September, 1991. The IMF approved a stand-by credit of \$2.2 billion to be disbursed to India at various stages over a 20 month period from November, 1991 to June 1993. Normally, member countries get only 50 to 60 per cent of their quotas in loans. But India received more than 100 per cent of its quota. India's quota at that time was \$ 3.01 billion and its gross drawing from the Fund from January, 1991 to June, 1993 were \$ 3.5 billion. This shows the IMF's confidence in the Indian economy.

At present, India's quota in IMF is 4,185.2 million SDR, which represents 1.96 per cent of the total IMF quota. Today, India occupies 13th position in the quota allotment of IMF. In view of the increasing foreign exchange reserves, India made advance repayments. During 1996-97, 1997-98 and 1998-99, the repayments made by India stood at 975 million SDRs, 618 millions SDRs and 393 millions SDRs respectively. In 2004-05 it was 1189 million SDRs.

Besides receiving the financial assistance to meet the deficit in its balance of payments, India has benefited in certain other respects from the membership of the IMF. India has been purchasing foreign currencies from the Fund from time to time in accordance with its requirements. This has helped a lot in promoting the economic development of India. By virtue of being a member of the Fund. India is also a member of the World Bank. India has been receiving financial aid from the World Bank for its various development projects. As a member of the Fund, India can seek the expert

advice of the Fund for solving the economic problems. IMF has also been providing short term training (courses) to Indian personnel on monetary, fiscal, banking, exchange rate and balance of payments policies. Thus, as a member of the IMF, India has gained much.

2. THE WORLD BANK

The World Bank, a sister institution of the International Monetary Fund (IMF) came into existence since 1945. International Bank for Reconstruction and Development (IBRD) is the other name for World Bank.

2.1 OBJECTIVES

The objectives of the World Bank are the following:

1) The Bank aims to assist in the reconstruction and development of member countries by facilitating the investment of capital for productive purposes. It encourages the development of productive facilities and resources in less developed countries. It helps to restore the economies destroyed or disrupted by war.

(2) It aims to promote private foreign investment. When it is not available on reasonable terms, the Bank itself provides finance for productive purposes out of its own capital, funds raised by it and its other resources.

(3) It aims to promote the long range balanced growth of international trade and the maintenance of equilibrium in balance of payments. For this purpose, it encourages the international investment for the development of the productive resources of the member countries. Thereby helps to raise the productivity, the standard of living and conditions of labour in member countries.

4) The World Bank arranges loans by itself for the member countries or guarantees the same when it comes through international funding agencies for large, small and urgent useful projects.

Check Your Progress

5. What is the other name of World Bank?

5) And the Bank helps to co-ordinate its policies with the impact of international investment on business conditions in the member countries. It helps for a smooth transition from a war time to peace time economy.

The World Bank comprises both the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA).

2.2 THE WORLD BANK GROUP

In addition to IBRD and IDA, three other organisations make up the World Bank Group. They are: the International Finance Corporation (IFC), the Multinational Investment Guarantee Agency (MIGA) and the International Centre for Settlement of Investment Disputes (ICSID).

2.3 MEMBERSHIP OF THE WORLD BANK

The member countries of the International Monetary Fund automatically are made the members of the World Bank. At present (2006), there are 186 members.

2.4 RESOURCES OF THE BANK

There are three main sources of funds for the Bank. They are 1) Subscriptions paid up by member countries 2) bond floatations on the world's financial markets and 3) net earnings on the Bank's assets. The IBRD raises almost all of its money (95%) by selling bonds. The remainder of IBRD financing comes from the initial capital contributions of World Bank member countries. IDA, on the other hand, is government funded, primarily by the G7 countries (France, Japan, Britain, Italy, United States, Canada and Germany). The IBRD accounts for approximately 80 per cent of the World Bank's lending to governments and IDA accounts for the remaining 25 per cent.

2.5 ORGANISATION OF THE WORLD BANK

The structure of the World Bank consists of the Board of Governors, the Board of Executive Directors, the Advisory committee, the Loan

committee, the president and other members of the staff. The Board of Governors is the supreme policy making body of the Bank with all the powers vested in it. The Board consists of one Governor and alternate Governor appointed for five years by each member country. The voting power of each Governor is related to the financial contribution of the Government which he represents. The Board meets annually to chalk out the general policies of the Bank.

The Board of Executive Directors consists of 21 members. Of these, five members are appointed by the five largest shareholders of the World Bank, namely the U.S.A. the U.K. West Germany, France and Japan, the remaining sixteen members are elected by the Board of Governors. The Board of Executive Directors meets regularly once a month to carry on the routine work of the Bank.

The President of the Bank is elected by the Board of Executive Directors. He is the Chief Executive of the Bank. He is responsible for the conduct of the day-to-day business of the Bank. He is assisted by a number of senior Vice-presidents and Directors of various departments and regions. There is an Advisory Committee appointed by the Board of Directors. It consists of seven members, who are experts in different branches of banking. There is also another committee known as the Loan Committee. This committee is consulted by the Bank before any loan is extended to a member country.

2.6 LENDING OPERATIONS

The World Bank makes loans to its member countries in any one or more of the following ways.

1. by granting or participating in direct loans out of the own funds.
2. by granting loans out of funds raised in the market of a member or otherwise borrowed by the bank.
3. by guaranteeing in whole or part, the loans made by private investors through the investment channels.

However, the total outstanding amount of the loan or guaranteed by the Bank is not to exceed 100 per cent of its total subscribed capital, reserves and surpluses.

2.7 TYPES OF LENDING

The World Bank provides different types of financing to countries. These include loans from the International Bank for Reconstruction and Development (IBRD) and credits and grants through the International Development Association (IDA).

The type of financing provided is determined by country's level of need. The money that is borrowed by governments has to be used for specific projects and programmes.

(i) IBRD Loans - Countries that borrow from IBRD have more time to repay than if they borrow from a commercial bank - 15 to 20 years with a three-to-five-year grace period before repayment of principal begins. IBRD offers loans to countries with the per capita income of less than \$ 5,185. In the fiscal year 2002, IBRD provided loans, totaling \$11.5 billion in support of 96 projects in 40 countries. IBRD loans and IDA, credits are typically accompanied by non-lending services to ensure the most effective use of funds.

(ii) IDA Credits - IDA's interest-free credits have a 35-40-year repayment period with a 10-year grace period. Currently, to be eligible for IDA assistance, a country must have a per capita gross national income of \$875 or less. In the fiscal year 2002, IDA provided \$ 8.1 billion in financing for 133 projects in 62 low-income countries.

In the fiscal year 2003, IBRD and IDA put together have financed \$ 18.5 billion to member countries.

2.8 LENDING INSTRUMENTS

The Bank has two basic types of lending instruments - investment loans and adjustment loans. Investment loans have a long-term focus (5 to

10 years), and finance goods, works, and services in support of economic and social development projects in a broad range of sectors. Adjustment loans have a short-term focus (1 to 3 years) and provide quick-disbursing external financing to support policy and institutional reforms. Both investment and adjustment loans are used flexibly to suit a range of purposes and are occasionally used together in combining different types of operations.

2.9 INVESTMENT LENDING

Investment loans provide financing for a wide range of activities aimed at creating the physical and social infrastructure necessary for poverty alleviation and sustainable development. Over the past two decades, investment lending has, on average, accounted for 75 to 80 per cent of all Bank lending.

The nature of investment lending has evolved over time. Nowadays investment lending has come to focus more on institution building, social development, and building the public policy infrastructure needed to facilitate private sector activity, projects range from urban, poverty reduction to rural development; water and sanitation; natural resource management; post-conflict reconstruction education; and health.

(i) Eligibility : Investment loans are available to International Bank for Reconstruction and Development (IBRD) and International Development Association (IDA) borrowers not in arrears with the Bank Group.

(ii) Disbursement : Funds are disbursed against specific foreign or local expenditures related to the investment project, including pre-identified equipment, materials, civil works, technical and consulting services, studies and incremental recurrent costs. Procurement of these goods, works and services is an important aspect of project implementation. To ensure satisfactory performance, the loan agreement may include conditions of disbursement for specific project components.

(iii) Loan Categories : The large majority of investment loans are either Specific Investment Loans or Sector Investment and Maintenance Loans. Adaptable Program Loans and Learning and Innovation Loans were recently introduced to provide more innovation and flexibility. Other instruments tailored to borrowers, specific needs are Technical Assistance Loans, Financial Intermediary Loans and Emergency Recovery Loans.

2.10 ADJUSTMENT LENDING

Adjustment loans provide quick-disbursing assistance to countries meeting foreign lending assistance to support structural reforms in a economy as a whole. They support the policy and institutional changes needed to create an environment conducive to sustained and equitable growth. Over the past two decades, adjustment lending has accounted, on average, for 20 to 25 percent of total Bank lending.

Adjustment loans are focusing more on structural, financial sector, reform of social policies and they help to improve public sector resource management. Also they help to promote competitive market structures, correct the taxation and trade reform policies, create an environment conducive to private sector investment, encourage private sector activity and promote good governance.

(i) Eligibility : IBRD & IDA loans are available to all the members who are not in arrears to the Bank. Further to be eligible for a Adjustment loan, the country should allow the Bank to monitor its policy and institutional reform actions. Further, the country should have a satisfactory macro economic management. Finally, the country should co-ordinate with the IMF in agreeable manner by promptly settling its dues to the IMF and by carrying out the directions issued by the Fund from time to time.

(ii) Disbursement : Funds are disbursed to member countries in stages into their special deposit account. Every stage of loan disbursement depends on the member country passing the reform legislations and progress of a satisfactory macro economic policy as suggested by the Bank.

The Bank has prepared a positive list of specific imports and a negative list of imports of prohibited expenditure.

(iii) Loan Categories : Structural and Sector Adjustment loans are the most commonly used adjustment instruments. Other types of adjustment loans, designed to respond to specific borrower needs are Programmatic and Special Structural Adjustment Loans, and Rehabilitation Loans.

2.11 GRANTS

The World Bank Group offers a limited number of grants to facilitate development projects. The grants are designed to encourage innovation, co-operation between organizations and to increase the participation in projects of local stakeholders.

The grants are either funded directly or managed through partnerships. Listed below are the range of mechanisms through which the Bank distributes grants.

(i) Development Market place

Early stage seed funding is provided to entrepreneurs with poverty fighting ideas to promote their development projects. Entrepreneurs are linked with partners that have the resources to help them implement their proposals. Since 1998, more than \$16 million has been awarded to 330 ground breaking projects identified through global competitions.

ii) Development Grant Facility (DGF)

The DGF establishes grant making as an integral part of the Bank's development strategy. It sets out the overall strategy of using grants to encourage innovation, produce partnerships and broaden the scope of the Bank's services.

iii) Global Environment Facility (GEF)

An international mechanism for providing new and additional grants to achieve global environmental benefits in climate change, biodiversity, international waters and ozone-layer depletion.

iv) InfoDev

A global programme managed by the Bank to promote innovative applications of information and communication technologies to improve the living standards of low-income communities in developing countries. The programme pools intellectual, technical and financial resources of public and private institutions from across the globe to assist promising projects and initiatives.

v) Japan Policy and Human Resource Development Fund (PHRD)

The Fund's objectives are to reduce poverty in developing countries by funding social development activities like improvements to education, health, nutrition, water, sanitation and social, protection. Grants can also be awarded to enhance the participation of civil society, promote the role of and increase innovative use of information technology.

(vi) Japan Social Development Fund (JSDF)

The Japan Social Development Fund (JSDF) is a grant facility established by the Japanese Government and the World Bank in June 2000. The \$95 million fund assists countries to effectively tackle the poverty and social consequences that resulted from the 1997-1999 global economic and financial crises.

(vii) Multilateral Fund for the Implementation of the Montreal Protocol

The fund was established to help developing countries meet the costs of eliminating the production and consumption of ozone-depleting chemicals.

(viii) Social Funds

Social Funds directly finance small community-managed projects which help empower the poor and vulnerable. They are valuable in directly reaching people at the local level. Social Funds have been used globally for a variety of urgently needed tasks including water supply and sewerage rehabilitation, school and health post construction, nutritional programmes

for mothers and infants, building rural roads and supporting small enterprises. Total World Bank funding to the end of the 2005 financial year will be \$ 3.7 billion. With donor and government co-financing included, this total will rise to \$ 8.9 billion.

(ix) Small Grants Programme

These are limited grants usually managed through the Bank's country offices. They help organizations distribute information about development in forums outside the Bank's own operations.

x) Official Cofinancing

Cofinancing is where Bank funds or guarantees are associated with funds provided by third parties for a particular project or programme.

(xi) Trust Funds

There are 850 active trust funds that disburse over \$1 billion a year for development-related activities. Donors entrust the funds to meet specific objectives such as preserving biodiversity, relieving debt in heavily indebted poor countries, supporting vaccination and immunization programmes to reduce the incidence of communicable diseases like malaria and creating initiatives to cut the emission of greenhouse gases.

2.12 OTHER ACTIVITIES OF THE BANK - ANALYTIC AND ADVISORY SERVICES

While the World Bank is best known as a financier, one of its most important roles is in providing analysis and advice on the following in order to create lasting policy improvements.

World Bank staff in each country undertake studies and reports, known as 'Economic and Sector Work'. These reports are designed to provide a thorough understanding of the country's development problems.

Additional studies include reviews of economic policies, fiscal spending, environmental reviews and other specific topics.

Further discussion of development issues is promoted through workshops and other events. These events increasingly bring together groups such as government, media, and civil society organizations to discuss a range of development issues.

The World Bank's Development Economics group, led by its chief economist, also undertakes the research that informs the Bank's work on broad issues such as the environment, poverty, trade and globalization.

2.13 BUILDING CAPACITY

To ensure lasting results in countries, the World Bank also enhances the capability within countries to sustain economic development programmes. This knowledge sharing effort is mostly carried out through the World Bank Institute (WBI), which conducts programmes to enhance the skills and development of its clients, staff, and partners.

These programmes take the form of courses, policy consultations, partnership with training and research institutions worldwide, and the support of knowledge networks related to international development. WBI is the home of one of the world's most extensive distance learning networks. Advisory services are available for information and knowledge by topic-be it environmentally and socially sustainable development, health, nutrition and population, the financial sector, or law and justice. In some cases, toolkits are available for other development practitioners to use, for example, in project design, management and monitoring, legal, financial, and procurement requirements, gender, food and nutrition and resettlement safeguards.

2.14 PREVENTING CORRUPTION

Since 1996 the Bank has begun more than 600 specific anti-corruption programmes and governance initiatives in client countries. The World Bank works with countries in their anti-corruption efforts and has a number of mechanisms to prevent corruption and fraud in Bank-financed

projects. The Department of Institutional Integrity has a 24 hour Fraud and Corruption Hotline.

2.15 OPERATIONS EVALUATION

The World Bank helps the borrowers in the member countries through post-evaluation of the assisted projects. The Bank has set up the Operations Evaluation Department (OED) for this purpose and such projects are also subject to performance audit by staff of OED.

2.16 SETTLEMENT OF INVESTMENT DISPUTES

The Bank has set up International Centre for Settlement of Investment Disputes (ICSID) which settles investment disputes between foreign investors and their host countries. The Bank has successfully mediated in solving many international investment disputes such as the River Water Dispute between India and Pakistan and Suez Canal issue between Egypt and the U.K.

2.17 GLOBAL GOODS : Over the past few years, the World Bank has put significant resources into activities meant to have global impact. One is debt relief, and under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative, 26 poor countries have received debt relief which will save them \$41 billion over time. The money these countries save in debt repayments will instead be put into housing, education, health, and welfare programmes for the poor.

The World Bank, along with 184 countries and numerous organizations has committed to an unprecedented global partnership to fight poverty. The Millennium Development Goals define specific targets in terms of school enrolments, child mortality, maternal health, disease and access to water to be met by 2015. Among numerous other global partnerships, the World Bank has put supporting the fight against HIV/AIDS at the top of its agenda. It is the world's largest long-term financier of HIV/AIDS programmes. Current Bank commitments for

HIV/AIDS amount to more than \$1.3 billion, with half of that for sub-Saharan Africa.

2.18 THE VARIETY OF WORK ON THE GROUND

The Bank is currently involved in more than 1,800 projects in virtually every sector and developing country. These are as diverse as providing microcredit in Botswana and raising AIDS awareness in communities in Guinea, supporting education of girls in Bangladesh and improving health care delivery in Mexico, helping East Timor to rebuild upon independence or India to rebuild Gujarat after a devastating earthquake.

2.19 INDIA AND THE WORLD BANK

India is one of the founder member of the World Bank. As of June, 2003, India is the largest single cumulative recipient of World Bank assistance with lending totaling over \$59 billion. Since 1950, the Bank has extended assistance to India for 445 projects, in roughly equal amounts from IBRD and IDA. Loans from IBRD total approximately \$ 30 billion and credits from IDA total about \$ 29 billion equivalent.

The World Bank has been assisting India in the projects relating to the development of ports, oil exploration including the Bombay High and gas power projects, air craft, coal, iron, aluminum, fertilizers, railway modernisation, technical assistance, Industrial Development and Financial Corporation, etc. The Bank has not been only merely a lending institution for India but has also served as a counsel whom India has often approached for advice in difficulties. The Aid India Consortium of 12 developed countries which has been giving aid to India for its development plans at the instance of World Bank has been renamed in 1994 as India Development Fund (IDF) with broader scope for development aid. The Bank's assistance strategy to India during 1995-98 covered extent and depth of reforms targeting malnutrition, illiteracy, lack of education skills, family planning, child health, access to means of production, etc. Also projects like the

overheads such as bridges, roads and transport system, power generation, safe drinking water facilities and housing came under its assistance. The Bank helped India to solve amicably its river water dispute with Pakistan. The World Bank has been assisting India in its planned economic development by granting loans, conducting field surveys, rendering expert advice, sending mission, study teams, etc.

2.20 THE WORLD BANK GROUP IN INDIA

The 2001-2004 India Country Assistance Strategy-the World Bank Group's roadmap for its assistance to a given country was approved in 2001 . This document outlines the World Bank Group's development priorities and indicates the type and level of assistance to be provided. This strategy is closely aligned with the government of India's poverty reduction strategy which emphasizes growth with social justice and equity. The main pillars of the poverty reduction strategy are articulated below.

1. The Bank helps to improve government effectiveness in specific sectors of the economy. It emphasises on fiscal reforms to tackle the perennial problems of inefficiency, corruption and poor budgetary management. It aims to help the delivery of public services like health, education, infrastructure and economic management.

2. It promotes private sector oriented growth. It helps to promote adequate infrastructure of the economy through an expanded role for the private sector and by better public sector management and increased funding. It helps to accelerate rural growth and to improve competitiveness in the industry. It helps to focus on the promotion of financial sector development through selective activities.

3. The Bank helps the government in its poverty reduction strategies, It tries to ensure improved livelihood for the poor masses for the country. It helps to remove the constraints for the poor people in participating and sharing the fruits of development by focusing on two areas viz., health and education.

4. The Bank helps to promote gender equity. It is cosponsoring the District primary Education programme with the government of India to give quality education for children in the low literacy districts.

5. The Bank helps the government in reducing the morbidity and mortality rates in infants, children, women and the general adult population. It tries to improve the quality of population, nutrition policies, consolidating disease control efforts and trying to up grade health system. It has embarked on Reproductive and Child Health Project in this area. It helps the government of India in its family welfare programme. It also helps to prevent communicable and non-communicable diseases. It pays more attention to environmental health issues such as air and water pollution.

The Bank also helps to construct rural projects in the country. It has arranged to construct community based projects, like water supply and sanitation projects in states like Karnataka and Kerala. It tries to eliminate rural poverty by enabling increased access to natural resource in an environmentally sound manner. It shares knowledge and imparts the best practices with the rural poor.

As on date the Bank is engaged in formulating a country assistance strategy for the period 2004-2008.

2.21 CRITICAL APPRAISAL OF THE WORKING OF WORLD BANK

The World Bank has been quite successful in achieving its principal objective of reconstruction and development. Since 1970's it has been funding more to developing countries not only for the infrastructure investment but also for raising the productivity and standard of living of the poor people.

However, many criticisms have been leveled against the working of the Bank.

1. It is alleged that the World Bank charges a very high rate of interest on its loans, even when its loans are guaranteed by Governments of

the borrowing member countries and there is no risk of loss of capital. Recently the Bank has adopted a new procedure related to the cost of borrowing for calculating the interest rate and front end fee.

2. The Bank's lending procedure is faulty, because it lays emphasis on the repaying capacity of the borrowing country before granting any loan. As the project is completed with the loan assistance the repaying capacity of the borrower increases gradually.

3. As the World Bank is a non-political and non-partisan institution, it is expected to treat all members equally and not to discriminate against some and in favour of others in the granting of loan. It should give loans purely on merit basis. However, in practice, loans have not been given purely on merit and economic considerations. It is to be noted that since the fiscal year 1990, the lending policy of the Bank has been directed more towards the developing countries and for the development of agriculture and rural development, energy, transportation, communications, water supply, sewage, human resource development, environment, etc.

4. It has also been criticised for its failure to meet fully the financial needs of the developing countries. Its loans have just touched the fringe of the total capital requirements for their economic and social uplift. In spite of the establishment of the International Development Association (IDA) in 1960 to increase the Bank's loan assistance to poor countries, the Bank has not been successful in raising the productivity and standard of living of their people.

5. The introduction of Structural Adjustment Facility and Enhanced Structural Adjustment Facility (ESAF) has made the terms of the loans of the World Bank much tighter to the member countries. The borrowing country is required to follow an action programme set out in a letter of development policies such as open trade reform in public budgeting and debt management, revision of price policies, better planning of public

investment and management of public enterprises, etc. In other words, the loans are released only conditionally.

2.22 SUGGESTIONS

Some suggestions to make World Bank work more effectively particularly for the developing countries are as follows.

1. Avoiding the dominance of the developed countries in the management of World Bank. As the contribution of the developed countries are the major source of funds, it would be very difficult to realise this. It is suggested that a change in the attitude of the developed countries can help to achieve a smooth transformation.

2. The developing countries availing World Bank loans are of two categories. One developed enough to afford the stiff terms demanded by it and two as poor enough to qualify for concessionary funds from the IDA. But as many countries remain uncertainly between the two, it is suggested to create a new loan window-an Intermediate Assistance Fund (IAF) which could help such intermediary countries.

3. ANSWERS TO CYP QUESTIONS

1. Refer 1.1
2. Refer 1.1
3. Refer 1.17
4. Refer 1.17
5. Refer 2

4. MODEL QUESTIONS FOR GUIDANCE

10 Marks Questions (One page answer)

1. What are the major objectives of IMF?
2. Mention the organisational structure of IMF.
3. Explain the major credit facilities extended by IMF.
4. Define SDRs. What are the uses of SDRs.

5. State the various objectives of the World Bank.
6. What are the major limitations of the World Bank?

20 Marks Questions (Three page answer)

1. Explain the objectives and functions of the IMF, critically examine its achievements.
2. Explain briefly the working of the world bank. What contribution has it made for the economic development of India?

UNIT - 9

WTO AND ITS IMPACT ON INDIA

Space for Hints

INTRODUCTION

The world had experienced the rigour and problems of an extensive pattern of trade barriers in the 1930's and during the second world war. So the Allied Powers thought of having a liberal world trading system after world war II. Though the US congress did not favour the liberal trading system, many countries favoured extensive tariff negotiations for trade concessions and they met at Geneva and established a system called General Agreements on Tariff and Trade (GATT). GATT came into force from January 1, 1948. To take decisions on all matters related to multilateral trade agreements a new organisation called World Trade Organisation came into force on January 1, 1995 and GATT is now a part of WTO.

This unit gives you an outline of how countries want to trade with other nations concessionally without tariff, to settle trade disputes, called for consultations, waived trade obligations and even authorised retaliatory measures.

UNIT OBJECTIVES : After studying this unit you will be able

- To understand what GATT is what is its origin and what are its functions,
- To learn how GATT became WTO and its structure, functions and similar other works,
- To understand how WTO helps developing countries in the world market.

UNIT STRUCTURE

1. GATT - Establishment

1.1 Administrative Machinery of GATT

1.2 Agreement Aims

- 1.3 The Binding of Tariff Concessions
- 1.4 Quantitative Controls on Imports
- 1.5 Subsidies and Other Measures
- 1.6 Tariff Negotiations
- 1.7 1960 - 62 Tariff Conference
- 1.8 Kennedy Round (1964 - 1967)
- 1.9 Tokyo Round September (1975 - 1979)
- 1.10 GATT and Settlement of Disputes
- 1.11 GATT And Services
- 1.12 The Uruguay Round (1986 - 1994)
- 1.13 Dunkel Draft
- 2. The World Trade Organisation (WTO)
 - 2.1 Evolution of WTO
 - 2.2 Difference between GATT and WTO
 - 2.3 Structure of WTO
 - 2.4 Objectives
 - 2.5 Functions of WTO
 - 2.6 WTO Agreement
 - 2.7 India and WTO
 - 2.8 Benefits to India
 - 2.9 Disadvantages to India
 - 2.10 Criticisms
 - 2.11 Conclusion
- 3. Answers to CYP Questions
- 4. Model Questions for Guidance

1. GATT - ESTABLISHMENT

Following the second World War, the trading countries convened in Havana (Cuba) and agreed to form an International Trade Organisation (ITO) based on the charter negotiated there. But the U.S. Senate failed to ratify ITO and therefore, it could not be established. As a substitute, the

Check Your Progress

1. Expand GATT.

countries decided to set up an informal association known as the General Agreement on Tariff and Trade (GATT) to serve as a frame work or multilateral tariff negotiations. The agreement was signed by 23 countries on October 30, 1947 at Geneva. It came into effect from January 1, 1948.

1.1 ADMINISTRATIVE MACHINERY OF GATT

The GATT originally intended as a purely temporary arrangement, has been developed into a permanent international arrangement. Its headquarters is at Geneva. The increasing responsibilities of the GATT made it necessary to strengthen the organisation entrusted with the task of administration. Consequently in 1960, the contracting parties decided to set up a Council of Representatives. The function of the Council is to consider urgent matters between the session of GATT as well as to conduct regular business consisting of the supervision of the Work of Committees and preparation for the GATT sessions. The Council of Representatives composed of nominated representatives of the contracting parties had increased from 23 in 1947 to 118 in 1994.

1.2 AGREEMENT AIMS

GATTs rules of conduct were based, upon the following fundamental principles.

- i. The principle of non discrimination embodied in the most favoured nation clause.
- ii. A general prohibition of non tariff means of protection such as quotas and export subsidies except for dealing with balance of payments difficulties.
- iii. The concept of consultation aimed at avoiding damage to the trade in the interest of the contracting parties.

1.3 THE BINDING OF TARIFF CONCESSIONS

The tariff concession contained in the original schedule annexed to the General Agreement (usually known as 'bound' rates) came into force in

Check Your Progress

2. When did GATT come into existence?

1958 for 3 years until the end of 1950. After the expiry of the three-year period, a contracting party could modify or withdraw any concession by negotiation and agreement. Withdrawal by negotiation involves offering compensation by another tariff concession. The first session in 1947 produced nearly, 45,000 concessions, reductions or bindings in tariff rates. In subsequent sessions, the number has increased to more than 60,000.

1.4 QUANTITATIVE CONTROLS ON IMPORTS

According to Article XI of the Agreement, the contracting parties are prohibited from imposing the quantitative import restriction. But a country can resort to quantitative restrictions in order to protect its external balance of payments position. The problem of deficits in the external balance of payments forced many countries to impose controls either on the bilateral or global quota basis only. The year 1958 saw a complete reviewing of all import restriction that were applied for balance of payments reasons. Countries maintaining such controls are now required to consult the GATT (WTO) on the nature of the balance of payments difficulties and the possible effects of restrictions on the economic of other contracting parties. The year 1959 witnessed of ending of long period of those quantitative controls which were imposed due to the balance of payments difficulties. The contracting parties at the Tokyo Session held in November 1959 declared their intention to dismantle the remaining import controls. Significant progress has since been made.

1.5 SUBSIDIES AND OTHER MEASURES

The stand of GATT on subsidies varies with the type of subsidy. The industrial countries have agreed to a complete ban on export subsidies for industrial products. But the developing countries are not bound by this agreement. In principle, members are required to avoid subsidies on exports of 'primary' products and if they use them not to do so in such a manner so as to secure more than an equitable share in the trade of the commodity concerned. Regarding the production subsidies, the members are free to grant them provided they notify the other parties of any such subsidy.

1.6 TARIFF NEGOTIATIONS

Eight main tariff negotiating conferences have taken place during the period of GATT. The first conference was held at Geneva in 1947. The eighth was held at Uruguay.

1.7 1960 - 62 TARIFF CONFERENCE

Two factors had strongly influenced the decision to hold the tariff negotiation conference in 1960.

i. The need on the part of the EEC member countries to re-negotiate certain rates of duty found in the GATT schedules in order to bring their existing countries tariffs into line with the new external tariff of the EEC.

ii. It was desirable to hold further general round of tariff negotiations so as to negotiate with EEC on its new common tariff. The first part of the conference was devoted to negotiations about the modifications or withdrawal of existing tariff commitments. The second part was concerned mainly with the negotiation of new tariff concessions. It is estimated that 4,400 concessions were negotiated by all the countries covering trade value of about 2,000 million.

1.8 KENNEDY ROUND (1964 - 1967)

The U.S. Trade Expansion Act of October 1962, sponsored by President Kennedy, empowered the U.S. Government to negotiate tariff reduction upto 50 percent and prepared the way for the opening of the Kennedy Round of trade negotiations at Geneva in May 1964. These negotiations embraced a much wider field than any of previous GATT Conferences and the ultimate agreement of tariff reduction is linked with the solution to other problems arising in the negotiations. These included tariff disparities, agricultural problems exceptions and non-tariff barriers. In the tariff field alone, the result of the negotiations has several times greater than the achievements of the previous conference.

The following are some of the difficulties encountered in the Kennedy Round negotiation which went on for five years:

1. Administrative problems were created by the fact that the EEC negotiated as one unit. In some sense, this Round was a US - EEC bargaining session.

2. The cumbersome decision - making process within the EEC delegation was a stumbling block in the Round. The nine countries must meet at their Brussels headquarters and hammer out a common position that they can take to Geneva. If GATT's session required US - EEC compromise, the change must go back to the EEC headquarters and to the nine capitals for further bargaining and approval. These administrative procedures clearly made any substantive differences difficult to resolve. For instance, the EEC is the major foreign market for US. Agricultural exports, absorbing annually \$ 1 billion of grain in commercial shipments. So the American delegation insisted at first that there could be on industrial agreement without an agricultural one. But the EEC trade position on agriculture was a by product of the internal level of support. Internal EEC bargaining over the level of support tested for over two years. More than two years of the Kennedy Round were lost in this direction.

1.9 TOKYO ROUND SEPTEMBER (1975 - 1979)

The Kennedy Round negotiations on multilateral trade negotiations were held in 1967. A ministerial meeting was held in Tokyo from 12th to 14th September, 1973 to launch the negotiations. The meeting concluded with the unanimous adoption of the Tokyo Declaration by the 102 developed and developing countries represented at the meeting. The Tokyo Declaration is a broad statement of aims and principles and provides the essential basis on which multilateral negotiations can go forward. The Declaration expressed the long - awaited decision of the trading countries to open a new round of multilateral trade negotiations within the framework of

GATT. The declaration established the Trade Negotiations Committee to plan and direct the negotiations. The Tokyo Round of Negotiations ended in December 1979.

1.10 GATT AND SETTLEMENT OF DISPUTES

GATT's greatest success has been in the field of settlement of disputes among its members. Any member having any complaint on other member can bring its complaints to the annual meeting. The parties to the disputes first attempt a bilateral settlement of their dispute. When this is not possible the contracting parties form a Working Committee. After a careful study of the problem, the committee makes a recommendation or a ruling which should be implemented by the offending member country. If the offending member does not comply with the ruling, the aggrieved party can retaliate by withdrawing concessions allowed by it to the offending country. For example, Chile, a major exporter of natural nitrate complained to the annual meeting of the GATT against Australia. That is, an Australian Subsidy on the production of a competing artificial fertiliser was nullifying Chilean tariff concession granted to Australia. The GATT members recommended Australia to modify its subsidy arrangements. Australia complied with GATT's recommendation by modifying her subsidy policy. Such instances are many.

However, it does not mean that GATT was successful in every case. One of the most conspicuous case of GATT's failure to persuade U.S. to modify its important restrictions on dairy products even though such import controls nullified concessions granted to such members by the United States. So GATT members authorised Netherlands to impose compensating restrictions on the imports of wheat flour from the United States. In 1953 the members have set up, a panel to act as an informal court to settle disputes.

1.11 GATT AND SERVICES

Space for Hints

In the 1984 Annual Meeting of GATT

United States wanted GATT, which limits barriers to trade in manufactured and agricultural goods, to begin looking at trade in services and high technology as well as the effects of exchange rate fluctuations on world commerce. It also urged for a new round of global negotiations. Developing countries rejected the US proposal saying such issues could be dealt with only if the industrial nations first lowered their import barriers against exports from the third world. But the US is now urging for the inclusion of World Trade in Services. Service industries now furnish 22.3 million jobs in the US compared with 19.3 million in manufacturing.

Since the growth of the service industries is determined by access to capital and technology, much of the world market in services is under the control of the transnational corporations. Technological developments have revolutionised the service industries such as hotel management, technical consultancies, banking, insurance and information technologies. Inclusion of service under GATT will not only swamp the ascent services sector in the developing countries but may also create new relations of dependence.

1.12 THE URUGUAY ROUND (1986 - 1994)

As a result of the conflicting interests on the issue there is a tussle between developing countries, led by India and Brazil and the United States which has threatened to boycott GATT if it does not set its way. The results of past negotiations including the Tokyo Round concluded in 1980 have not been satisfactorily applied where developing countries are concerned. During the Punta Del Este Conference (Uruguay - 1986), the U.S. made a tough bid to bring trade in services into the ambit of the proposed eighth round of global trade negotiations. GATT has had to be more wary in exerting pressure, ever since 1947, on the industrialised countries for securing the gradual dismantling of tariff and other barriers.

The period was one of conflict between the three major trading blocs viz., the United States, the European Community and Japan. The US - EC disputes largely centered on agricultural issues regarding markets which the US had traditionally regarded as its own. At the same time, the US was attempting to induce the Japanese to open up their domestic market to foreign goods, and to American goods in particular, while the European Community was attempting to limit Japanese export growth.

Japan also favoured a new round, preferring multilateral negotiations to the prospect of continued bilateral pressure from the US and the EC. Other countries were concerned about the tendency of the 'big three' to ignore GATT principles. The Agricultural - exporting countries were concerned about the impact of subsidised US production and the EC's subsidized exports on world markets. The developing countries interest were in securing greater preferences, reducing the impact of VER and particularly in textiles and clothing and agricultural trade. There were several negotiating groups dealing with specific sectors such as Agriculture, Services, Textiles and clothing, TRIPS and TRIMS. At the end of 1991, the then Secretary General of the GATT, Arthur Dunkel, tabled a Draft Final Act widely known as the Dunkel Text. It contains the proposal for the World Trade Organisation (WTO) that has come into being in 1995.

A report of the GATT was published in 1994. The Results of the Uruguay round of Multilateral Trade Negotiations, was suggestive of the fact that the developing countries have ended up giving more than what they received from the industrial countries. While a comparison of percentage cuts in tariff by the developed countries showed that the poorer countries have not always got the same deal as the rich nations. What matters as the stimulus to exports was the decline in the tariff - inclusive price in the importing country. The average 37 per cent reduction on the tariffs on all goods imported from developing countries translated into a marginally lower decline of 2.34 per cent in the tariff inclusive price.

1.13 DUNKEL DRAFT

The Dunkel proposals encompass many areas including the following.

There are three types of provisions which are related to agriculture. One is about the trade in agricultural goods. Second is concerned with agricultural policies which bear upon trade. Third is about the patenting of seed plants and micro organisms.

Fourth is about the public distribution system. Fifth is about the export of developing countries in textiles and clothing. This has been subject to fixing quotas by the developed countries written into the Multi Fibre Agreement.

Dunkel Draft has also provided for the removal of restrictions on foreign investments. It further brings into the negotiating knot the trade in services such as banking, insurance, tele-communications etc.,

2. THE WORLD TRADE ORGANISATION (WTO)

2.1 EVOLUTION OF WTO

The Uruguay Round of GATT negotiations concluded on April 15, 1994 at Marrakesh, Morocco. India, along with 123 ministers besides the EC countries signed the Final Act consists of:

- i. the WTO Agreement which covers the formation of the organisation and the rules governing its working; and
- ii. the Ministerial decisions and declarations which contain the important agreements covering trade in goods, services, intellectual property and plurilateral trade.

They also contain the dispute settlement rules and trade policy review system. The WTO Agreement is in fact the Uruguay Round agreements whereby the original GATT is now a part of WTO agreement

Space for Hints

Check Your Progress

3. When was GATT merged into WTO?

which came into force from January 1, 1995. There were 77 member countries of the WTO on January 1, 1995 which had increased to 142 by 2001. India is one of the founder members. Now there are 153 countries in WTO as members in 2008.

2.2 DIFFERENCE BETWEEN GATT AND WTO

- i. The GATT had no legal status whereas the WTO has a legal status. It has been created by international treaty ratified by the governments and legislatures of member states.
- ii. In GATT only those who signed the agreement could be penalised on default. The agreements which form part of the WTO are permanent and binding on all members.
- iii. In GATT, there used to be long, protracted negotiating rounds which took decades to complete. In WTO decisions on agreements are time bound.
- iv. The GATT rules applied to trade in goods and services. The WTO covers not only trade in goods and services but also trade related aspects of intellectual property rights and a number of other agreements.

2.3 STRUCTURE OF WTO

The structure or organisation of WTO is headed by the ministerial conference composed of representatives of all members which meet at least once every two years. It takes decisions on all matters under any of the Multilateral Trade Agreements. There is a General Council Composed of representative of all the members to oversee the operation of the WTO Agreement and ministerial decisions on a regular basis. The General Council sits in Geneva on an average of once a month. There are many Councils for many sections. These councils, in turn, have their subsidiary bodies the councils and subsidiary bodies meet as and when necessary to carry out their respective functions.

Check Your Progress

4. What is the major difference between GATT and WTO?

2.4 OBJECTIVES

The main objectives of WTO are the following:

- i. To make positive efforts designed to ensure that developing countries, especially the least developed among them, secure a share in the growth in international trade.
- ii. To raise standard of living, ensuring full employment and large and steadily growing volume of real income and effective demand and expanding the production and trade in goods and services.
- iii. To allow for the optimal use of the world's resources in accordance with the objectives of sustainable development.
- iv. To reduce tariffs and other barriers to trade and the elimination of discriminatory Treatment in international trade relations.

2.5 FUNCTIONS OF WTO

- i. It facilitates the implementation, administration and operation of the objectives of the Agreement and of the Multilateral Trade Agreements.
- ii. It provides the forum for negotiations among its members concerning their multilateral trade relations and in matters relating to the agreements.
- iii. It administers the understanding on Rules and Procedures governing the settlement of Disputes of the Agreement.
- iv. It co-operates with the IMF and the World Bank and its affiliated agencies with a view to achieving greater wherence in global economic policy making.

2.6 WTO AGREEMENT

The Agreement establishing the WTO consists of the following few which embody the results of the Uruguay Round of the Multilateral Trade Negotiations.

1. Multilateral Agreements on Trade in Goods: GATT Rules 1994
2. General Agreements on Trade in Services
3. Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS)
4. Plurilateral Trade Agreements
5. Trade Related Investment Measures (TRIMS) etc.

2.7 INDIA AND WTO

No other issue in recent times has generated so much heat than the likely repercussions of the new international economic order on world economy in general and developing countries in particular. The ultimate setting up of the WTO is expected to bring about substantial gains in world trade and increased income from liberalisation, improved market access and greater export opportunities, besides greater predictability of the trading environment. The Government of India has also been harping on this tune. In this section, we study the likely favourable and unfavourable effects of the new economic order on the Indian economy.

2.8 BENEFITS TO INDIA

i. Assuming that India's market share in world exports improves from 0.5 per Cent to 1 percent and that we are able to take advantage of the opportunity thus created, the government believes that the trade gains may conservatively be placed at 2.7 billion U.S. dollars, extra exports per year. However, the above estimates suffer from several infirmities.

ii. The phasing out of the MFA (Multi-Fibre Arrangements) by 2005 will benefit India as the exports of textiles and clothings will increase. While the developed countries had demand a 15 years period, the developing countries, (including India) had insisted on a 10 year period.

When quotas are removed, they will be beneficial not only for India, but for everyone else. There will therefore be considerable competition from China, Vietnam, Pakistan, Bangladesh, Indonesia and Malaysia. The

question, thus basically boils down to evaluating the competitiveness of India's garment exports. In this respect, India does not fare well vis-a-vis its competitors.

iii. The third benefit that India expects relates to the improved prospect, for agricultural exports as a result of likely increase in the world prices of agricultural product, due to reduction in domestic subsidies and barriers to trade. While on the one hand earnings from agricultural exports are likely to increase, on the other hand India has ensured that all major programmes, for the development of agriculture will be exempted from the disciplines in the agricultural Agreement. India hopes that the reduction of subsidies in USA and the European Community will enable it to increase its earnings from agricultural exports.

iv. The Uruguay Round Agreement has strengthened multilateral rules and disciplines. The most important of these relate to antidumping, subsidies, and counter vailing measures, safeguards and disputes settlement. This create a more favourable environment for India in the new world economic order.

2.9 DISADVANTAGES TO INDIA

The gains expected by the Government of India on account of tariff reductions on goods may also not materialise as the number of goods of export interest to India is very small. The most serious disadvantages to India are likely to flow from Agreements pertaining to the TRIPS and TRIMS.

a) TRIPS agreement increases the area of coverage under the patent system such as drugs, agriculture, plants and animals, etc. The developed countries are able to invest in R and D and patented process and products. In all such cases, developing countries would have to pay royalties. The domestic prices of such goods, especially of drugs and medicines would increase and burden the consumers. b) A change in the patent laws of developing countries in accordance with the TRIPS agreement would

further lead to brain drain which would prove costly for such countries. c) The TRIPS agreement does not clarify whether members can ban the commercial exploitations of environmentally injurious technologies while granting patent protection or whether this can give rise to non-violation type complaints. d) The implications and consequences of the TRIPS agreement suggest that the emerging international system for the protection of intellectual property rights is bound to be inequitable and inimical for the developing countries.

a) The Agreement on TRIM's is a weak one. One article lays down that developing countries can deviate from the provisions temporarily. The right to regulate foreign companies and trade balancing measures have in no way been curtailed if there are valid reasons such as adverse balance of payments.

b) Though foreign direct investment is not mentioned, yet it is feared that MNCs would try to control high priority areas in developing countries. The Agreement also deals with discriminatory import restrictions c) On the whole, the TRIMS Agreement has reduced the decision making powers of national governments. For instance, they cannot specify local contents in domestic manufacturing of foreign concerns and cannot restrict the percentage of imported inputs in its exported products.

2.10 CRITICISMS

There are many loopholes in these Agreements. In agriculture, as it allows subsidy only upto 10% of the value of production, it would be almost impossible for the governments of developing countries to give price support to particular agricultural commodities. The removal of all restrictions on imports would adversely affect the farming community. Prices of farm products in international markets are not determined by competition but by the corporations of the developed countries which procure and sell them. The agreement relating to textiles and clothing, the gains to underdeveloped countries are likely to be delayed. The services

sector in developing countries would have to face unequal competition from the vast resources which the firms of developed countries possess.

2.11 CONCLUSION

The Dispute Settlement Board of the WTO has been actively functioning. So far more than 100 disputes have been brought to it and many have been settled by it. All member countries have praised the WTO for its transparent dispute settlement process and procedures without any pressure from the 'big' powers. So we can conclude that the formation of the WTO provide greater transparency, predictability and security in international trade relations to developing countries.

3. ANSWERS TO CYP QUESTIONS

1. Refer 1
2. Refer 1.1
3. Refer 2
4. Refer 2.2

4. MODEL QUESTIONS FOR GUIDANCE

10 Marks Questions (One page answer)

1. What are the objectives of GATT?
2. Explain the functions of GATT.
3. What are the objectives of WTO?
4. Mention the various functions of WTO.
5. Mention the benefits of WTO to India.
6. Explain the various disadvantages of WTO to India.

20 Marks Questions (Three page answer)

7. Make a brief evaluation of GATT
8. What is GATT? Explain its objectives and functions.
9. Explain the structure and objectives of WTO.
10. Discuss the advantages and disadvantages of WTO to India.
11. Write a critical note on WTO.

UNIT - 10

INDIA'S FOREIGN TRADE

Space for Hints

INTRODUCTION

The present unit examines the role of foreign trade in India's economic development since the beginning of the planning era. More than six decades have passed since India started on the path of planned economic development from 1950-51. During this period important changes have taken place in the volume, composition and direction of its foreign trade. It also deals with the new trade policy adopted by the Government of India and Policy adopted by the Multi National Corporations in the development of the economy.

UNIT OBJECTIVES: After studying this unit, you will be able

- To understand the volume, composition and direction of foreign trade,
- To know the new trade policy adopted by the Government of India in the development of the economy, and
- To understand the role played by the multinational corporations in the economic development of India.

UNIT STRUCTURE

1. India's Foreign Trade

1.1 Introduction

1.2 Value of India's Foreign Trade

1.3 Composition of Foreign Trade

1.4 Direction of India's Exports

2. New Trade Policy

2.1 Decanalisation

2.2 Convertibility of Rupee on Current Account

2.3 Export Processing Zones (EPZs)

2.4 Special Economic Zones (SEZs)

2.5 Concessions and Exemptions

2.6 Trade Policy 2002 - 2007

2.7 Evaluation of New Trade Policy

3. Multinational Corporations

3.1 Growth of MNCs - Reasons

3.2 MNCs and their Domination

3.3 Foreign Collaboration and MNCs

3.4 Harmful Effects of the Operations of MNCs on Indian Economy

3.5 Control Over MNCs

4. Answers to CYP Questions

5. Model Questions for Guidance

1. INDIA'S FOREIGN TRADE

1.1 INTRODUCTION

Many countries have won independence since World War II. They have adopted large scale programmes of industrialisation to build up the industrial sectors of their economies and to reduce their dependence for manufactured goods on the developed countries. By foreign trade, it is meant, large scale import substitution, direct controls on imports and investments and overvalued exchange rates. The Indian government after Independence felt that Indian exports faced a stagnant world demand and foreign trade with other countries was marginal.

The post 1960 period witnessed adoption of programmes of import liberalisation and export promotion in many developing countries. Japan, Singapore, Hongkong, South Korea, and Taiwan have adopted a policy of import liberalisation and export promotion with remarkable success. Encouraged by the success models of these countries, the Government of India adopted for a policy of liberalisation in recent years. The 1990-91 trade policy reforms opened up the economy to foreign trade and linked the Indian economy with the global economy. The present section of this lesson discusses the value, structure, direction and trends in India's foreign trade.

1.2 VALUE OF INDIA'S FOREIGN TRADE

TABLE 10.1
VALUE OF EXPORTS AND IMPORTS SINCE
1950-51 (in Mill. U.S.\$)

Year	Exports	Imports	Trade Balance
1950-51	1269	1273	-4
1960-61	1346	2353	-1007
1970-71	2031	2162	-131
1980-81	8486	15869	-7383
1990-91	18143	24075	-5932
2000-2001	44560	50536	-5976
2001-2002	43827	51413	-7586
2002-2003	52719	61412	-8693
2003-2004	63843	78150	-14307
2004-2005	83535	111516	-27981
2005-2006	103091	149166	-46075
2006-2007	126361	185749	-59388
2007-2008	159007	239651	-80644

Source : RBI Annual Report 2007-08.

Table 10.1 gives us the value of India's exports, imports and trade balance. A close observation reveals that both exports and imports increase from the beginning. The trade balance is on the increase and reaches to the tune of -80644 million U. S. dollars. It is mainly because of the nature of the commodities which we export and import.

1.3 COMPOSITION OF FOREIGN TRADE

Composition of foreign trade includes exports and import of a country during a period of time. An analysis of the composition of foreign trade of a country enables us to analyse the progress of that country and the rate and speed of structural changes operating in it. The speed with which a country changes its pattern of trade (leading to a decline in imports of manufactured goods and increase in exports of such goods) indicates the pace of development in that country.

The main traditional exports in India were primary goods like jute, tea, cotton, hides and skins, manganese ore, mica, etc. The bulk of imports constituted the manufactured products. However, during the planning era, the progressive industrial development and the fast swift economic progress have ushered in a number of changes in the composition of foreign trade.

Check Your Progress

1. What do you know about composition of trade?

TABLE - 10.2
COMPOSITION OF INDIA'S EXPORTS - (1950-51 TO 2007-08)

Sl.No.	Items	1950-51		1960-61		1970-71		1980-81		1990-91		2007-08	
		Value (Rs.in crore)	Share of Exports	Value (Rs.in crore)	Share of Exports	Value (Rs.in crore)	Share of Exports	Value (Rs.in crore)	Share of Exports	Value (Rs.in crore)	Share of Exports	Value (Rs.in crore)	Share of Exports
1.	Agricultural and allied products	290.8	48	284	44.23	484	31.73	20.57	30.7	317	19.40	25016	15.65
2.	Ores and minerals	60.6	10	52	8.09	164	10.68	414	6.20	1497	4.60	3005	1.88
3.	Manufactures goods	163.8	37	291	45.32	772	50.29	3746	55.80	23736	72.91	127532	79.92
4.	Minerals, fuels and lubricants (incl.Coal)	12.12	2	7	1.09	13	0.85	28	0.40	948	2.91	3399	2.13
5.	Others	4.53	3	8	1.24	99	6.45	466	6.90	55	0.17	609	0.38

Source : Economic Surveys, Various Issues

Check Your Progress

2 What are the major items of exports that India does?

1.4 DIRECTION OF INDIA'S EXPORTS

The direction of exports depicts the countries to which the Indian goods were exported. India's export trading partners had been divided into five major groups and the share of India's exports for the six sub-periods had been presented in the Table 10.3.

TABLE - 10.3
DIRECTION OF INDIA'S EXPORTS – 1950-51 TO 2007-08
(PERCENTAGE SHARE IN TOTAL EXPORTS)

		1950-51	1960-61	1970-71	1980-81	1990-01	2007-08
I.	OECD	68.2	66.1	50.1	46.6	53.5	57.6
1.1	BU	40.1	36.2	18.4	21.6	27.5	25.1
1.1.1	UK	28.2	26.9	11.1	5.09	6.5	6.0
1.2	North America	20.2	18.7	15.3	12.0	15.6	24.3
1.2.1	U.S.A	18.1	16.0	13.5	11.1	14.7	22.7
1.3	Other OECD Countries	10.1	10.1	15.2	10.6	10.4	5.8
1.3.1	Japan	1.2	5.5	13.3	8.9	9.3	4.5
II.	OPEC	4.1	4.1	6.4	11.1	5.6	10.6
2.1	Iran	0.8	0.8	1.7	1.8	0.4	0.4
2.2	Iraq	0.5	0.5	1.0	1.4	0.2	0.4
2.3	Saudi Arabia	0.5	0.5	0.9	2.5	1.3	2.0
2.4	Kuwait	0.5	0.5	1.0	1.4	0.2	0.4
III.	Eastern Europe	8.4	7.0	21.0	22.0	17.9	3.0
3.1	G.D.R	0.6	0.5	1.5	0.7	-	-
3.2	Romania	0.3	0.2	0.9	0.9	0.3	Negligible
3.3	Russia	4.9	4.5	13.7	18.3	16.1	2.5
IV.	Other LDCs	13.9	14.6	19.8	19.2	16.8	25.1
4.1	Africa	6.6	6.3	8.4	5.2	2.1	3.0
4.2	Asia	6.5	6.9	10.8	13.4	14.3	20.4
4.3	Latin America	2.1	1.6	0.7	0.5	0.4	10.7
V.	Others	9.0	8.0	2.6	1.0	6.2	3.6
VI.	Total	100.00	100.00	100.00	100.00	100.00	100.00

Source : Economic Surveys, (Various Issues).

2. NEW TRADE POLICY

Space for Hints

The period after 1991 has been marked by a substantial liberalisation of the trade policy. A new reformed trade policy was the need of the hour to make the Indian exports competitive in the international market. Reforms were undertaken due to many aspects among which the pressure of international agencies, as a part of economic stabilisation policy and for structural adjustment programmes. When India joined World Trade Organisation as a founder member, it had become obligatory on her part to remove all quantitative restrictions on imports and reduce import tariffs in order to open up the economy to world trade and the forces of globalisation.

Substantial simplification and liberalisation in all these respects has been carried out during the reform period. By 1996, 6161 tariff lines were made free. The number increased to 8066 in the year 2000. The Export-Import (Exim) policy 2000-01 removed quantitative restrictions on 714 items and by 2001-02 restrictions on the remaining 714 items were removed. The tariff structure was rationalised. In 1993-94, 94-95 and 95-96 budgets substantial cuts in import duties were made. The maximum rate of duty was reduced from 110 per cent to 85 per cent, 65, 50, 40, 35, 15 and 5 per cent. However, a surcharge of 10 per cent was imposed in the budget 2000-01, which was withdrawn in 2001-02. The peak customs duty rate had declined from 38.5 per cent to 35 per cent. The government has announced that by the year 2004-05, there would be only two basic rates of customs duties, viz., 10 per cent covering generally raw materials, intermediaries, components and 20 per cent covering generally final products. In 2002-03, the peak customs duty rate has been reduced from 35 per cent to 30 per cent.

2.1 DECANALISATION

In 1990-91 the supplementary trade policy decanalised 16 export items and 20 import items. By decanalisation it is meant instead of routing these export and import articles through the public sector agencies, the

Check Your Progress
3. What is meant by trade policy?

government allowed them to be routed through any agency, public or private. The Exim Policy 2000-01, placed rice, wheat, maize, petrol, diesel and urea under a special list and allowed them to be imported only through State Trading Agencies.

2.2 CONVERTIBILITY OF RUPEE ON CURRENT ACCOUNT

The objective of exchange rate management in India has been to ensure that the external value of Rupee is realistic and credible. Subject to the objective, the exchange rate policy is guided by the need to reduce excess volatility to prevent the emergence of destabilising speculative activities, help maintain adequate level of reserves and to develop an orderly foreign exchange market. India before the reform period, pegged the rupee to a basket of currencies of the countries which are her major trading partners. This was called floating exchange rate system.

(a) Partial Convertibility of the Rupee

The government in 1992-93 budget brought the Liberalised Exchange Rate Mechanism System (LERMS) . There was a partial convertibility of rupee, a dual exchange rate was fixed under which 40 per cent of the foreign exchange earnings were to be surrendered at the official exchange rate while the remaining 60 per cent were to be converted at a market determined rate. The foreign exchange converted was used for the import of essential items like crude oil, petroleum products, fertilizers and life saving drugs.

(b) Full Convertibility on Trade Account

In 1993-94, the budget introduced full convertibility of the rupee on trade account. The dual exchange rate system was abolished and an unified exchange rate was introduced. A 100 per cent conversion was extended for almost the entire merchandise trade transaction viz., (1) export and import of goods. (2) All receipts either on current or capital account of balance of payments.

(c) Full Convertibility on Current Account

This is defined as the freedom to buy or sell foreign exchange for the following international transactions: (1) All payments in connection with foreign trade (2) Payments due as interest on loans, and as net income from other investments (3) payments of moderate amount of amortization of loan or for depreciation of direct Investments and (4) Moderate remittances for family living expenses.

India achieved full convertibility on current account on August 19, 1994 when the RBI further liberalised initial payments and accepted obligations under Article VIII of the IMF under which India is resisted to give up the use of exchange restrictions on current international transactions as an instrument managing balance of payments. Many other relaxations of restrictions on current account followed in the subsequent years. Major relaxation in exchange control, more liberal indicative ceilings for release of foreign exchange by authorised dealers for basic travel quota, studies abroad, medical expenses, casual remittance, donations, release of exchange for persons proceeding on employment abroad, greater flexibility in the Exchange Earner Foreign Currency (EEFC) accounts, greater flexibility for remittances for purchases of foreign services by residents, etc.

Union budgets subsequently began to open up certain capital transactions. In 2002-03, the following measures were announced. There will be full convertibility of deposit schemes for NRIs. They are free to repatriate in foreign currency their current earnings in India under appropriate certification. Indian companies may invest abroad upto US \$ 100 million on an annual basis through automatic route. In the case of joint-ventures, the Indian companies can make overseas investments without approval upto 50 per cent of their net worth. Corporates with proven track record were allowed to contribute funds from their exchange earnings for setting up chairs in educational institutions abroad and for other welfare measures. Indian Mutual Funds will now be allowed to invest in rated

securities in countries with fully convertible currencies within the existing limits. Prepayment of external commercial borrowings (ECBs) is permissible to the extent of balances available in the EEFC accounts. A foreign currency convertible bond scheme under the automatic route upto US dollar 50 million were anvil.

(d) Trading Houses

The government also permitted the setting up of Trading Houses with 51 per cent of foreign equity for promoting exports. Under the 1992-97 trade policy, the export and trading houses were authorised to give themselves self certification under the Advanced Licensed System. The 1994-95 policy introduced a new category of trading houses called Super Star Trading Houses. To attain the status of super star trading house, an exporter has to register an average FOB value of exports of Rs.925 crore during the preceeding 3 years or Rs. 1387.50 crore during the preceeding year. These houses will be entitled for membership of apex consultative bodies concerned with trade policy and promotion, representation in trade delegations, special permission for overseas trading and special import licences at enhanced rate.

2.3 EXPORT PROCESSING ZONES (EPZs)

The units undertaking to export their entire production of goods may be set up at Export Processing Zones (EPZs), Electronic Hardware Technology Park (EHTP), Software Technology Park (STP) and Export Oriented Units (EOUs). EPZs are special enclaves, separated from the Domestic Tariff Area (DTA) by fiscal barriers and are intended to provide an internationally competitive, duty free environment for export production at low cost. The Government had further liberalised this scheme by (i)enhancement of tax holiday from 5 years to 10 years(ii) higher domestic access (iii) positive Net Foreign Exchange earning as percentage of exports has been introduced for EOU/EPZ units having investment above Rs. 5 crore, (iv) EOU/EPZ/ EHTP/STP Units having an investment of Rs.5 crore

and above in plant and machinery to be treated as star units (v) amortisation of capital goods over eight years instead of five years for star units (vi) import / procurement of raw materials without payment of duty for making capital goods.

2.4 SPECIAL ECONOMIC ZONES (SEZs)

The Export - Import Policy for the year 1999 - 2000 proposed the setting up of Free Trade Zones (FTZs) in the country from July 1999. The idea was to insulate the zones from bureaucratic interference and export restrictions. But this could not be implemented. The Exim Policy for the year 2000-01 proposed the creation of Special Economic Zones (SEZs), based on the highly successful Chinese model. The government ensured hassle free manufacturing and trading activities for the purposes of exports. These units were to be treated as being outside the custom territory. Sales in Domestic Tariff Area by these units would be permitted only on payment of full custom duty. The first two SEZs in the country are to be based at Pipavan in Gujarat and Tuticorin in Tamil Nadu.

The Government also established Export Promotion Industrial Parks (EPIPs) in 1994. The State Governments were required to create the infrastructural facilities for export oriented production. So far 11 parks were established. In 2001, the Exim policy introduced the concept of Agri Export Zones (AEZs) for the promotion of agricultural exports. AEZs would have the state of art services such as pre-post harvest treatment and operations, plant protection, processing, packaging and storing and related research and developments. These Zones were recognised as Status holders and were free to avail the facilities from various export promotion schemes under the Exim policy.

In 2001-02, the Market Access Initiative Scheme was introduced by which indepth market studies for select products in chosen countries abroad were undertaken to collect data for promotion of exports from India, for promoting Indian products and Indian brands in the international market by

display, display in certified leading departmental stores, exhibitions, trade fairs, etc. Upgradation in the quality of products, which was demanded by the foreign markets, intensive publicity campaign were also part of the scheme.

2.5 CONCESSIONS AND EXEMPTIONS

The liberalisation era offered bounties of tax benefits and exemptions to liberalise imports and promote exports in the five year Exim policy 1992-97 and Exim policy 1997-2002 serving as the basis for such concessions from time to time on an annual basis. These policies are reviewed and modified. Successive annual budgets also extended a number of tax benefits and exemptions to the exporters. These include reduction in the peak rate customs duty of 30 per cent, significant reduction in duty rates for critical imports for the information technology sector, which is an important export sector, grant of concession for building infrastructures by way of 10 years tax holidays, facilities in tax benefits under section 80 HHC, reduction in the customs duty on specified equipments for ports and airports to 10 per cent and a good number of tax benefits for three integral part of 'convergence revolution', viz., the information technology sector, tele communication sector and the entertainment industry.

2.6 TRADE POLICY 2002 - 2007

The Government has announced the new five year Export Import policy covering the Tenth Five Year Plan period 2002-07 on March, 31, 2002. The policy continued with the medium term export strategy announced in January 2002 to raise India's share in global trade to 1 per cent by 2007 from the present 0.67 per cent. The projected growth would demand increasing exports from \$46 million to \$80 million over the Tenth Five Year Plan period. The main initiatives announced in the Exim policy 2002-07 are as follows:

1. Already all quantitative restrictions on all imports have been removed. The present policy removes all quantitative restrictions on all exports except jute and onion.

2. The Government concentrates on the export of 106 items identified in the medium term export strategy. These items include engineering goods, electrical goods, textiles, chemicals, jewellery and items for repairs, etc.

3. Major thrust has been given to agricultural exports and transport assistance for the export of fresh and processed fruits, vegetables, floriculture, poultry and dairy products, wheat and rice.

4. Work has already started on the setting up of 15 of these 20 product specific Agri Export Zones. The Special Economic Zones have proposed to be made as a model agency to achieve high export growth of 11.9 per cent per annum compounded annually for the next 5 years. The Units in these zones have been granted a number of concessions and exemptions like enhanced income-tax benefits, central and state sales tax exemption and removal of restrictions on external commercial borrowings. Indian banks have been allowed to set up overseas banking units (OBUs) in SEZs. These OBUs will be foreign branches of Indian banks located in India so that these are exempted from almost all Reserve Bank's restrictions on banks. Therefore, they will be able to provide cheaper finance to exporter in SEZs.

5. Special incentives are being provided to identify three towns in India -Thirupur for hosiery, Paniput for woollen blanket and Ludhiana for woollen knitwear exports. They are being developed as industrial clusters. Priority will be given to fill up infrastructural gaps in these clusters besides bestowing all benefits of all the Exim policy schemes of their choice.

(6) To promote greater participation of states in export promotion, the Centre has increased the fund allocation under the Assistance to States for Infrastructural Development for Exports (ASIDE) scheme and

announced linking of outlays to gross exports and the rate of growth of exports. For the year 2002-03, Rs.330 crore have been approved under the scheme, wherein the states are required to utilize the amount for developing complementary and critical infrastructure like roads, connecting production centres with ports, inland container depots, and container freight station and equity participation in infrastructure projects. The Government has also increased the allocation under Market Access Initiative (MAI) scheme to Rs.42 crore in 2002-03.

(7) A new programme called Special Focus on Cottage sector and Handicrafts has been launched under which initially Rs.5 crore have been earmarked for promoting cottage sector exports under Khadi and Village Industries Commission (KVIC). These units will be entitled to the benefit of Export House Status and achieving an average export performance of Rs.5 crore as against Rs.15 crore for others.

(8) Computer companies, manufacturing or assembling computers in the country will be able to import both capital and raw materials at lower duty rates to sell in the domestic market. The export obligation on the part of the manufacturers against their imports have been removed. The Indian manufacturers will be able to be on par with those in China free trade zone the Dubai Jebel Ali free trade zone.

(9) Special benefits have been given to status holders like export houses, trading houses and star trading houses like 100% retention of foreign exchange in external accounts. Priority finance for medium and long term capital, exemption from compulsory negotiations of documents through banks, enhancement in normal repatriation period from 180 days to 360 days and customs clearance for both exports and imports on self declaration basis.

(10) The customs duty on import of rough diamonds has been removed. The licensing regime for rough diamonds has also been abolished.

(11) Silver and gold jewellery have been brought under OGL (Open General License or free list of imports). The policy also shifted more than 50 items to OGL like medical bandages, postage stamps, poppy seeds, maize and some other crude drugs used for homeopathy treatment. With this, the quantitative restrictions have been brought down to the minimum. This includes combat equipments, several varieties of arms and ammunition, wild life products, etc.,

(12) The government has also encouraged foreign direct investment by relocation of industrial plants from foreign countries to India without the requirement of license, whose depreciated value should be more than Rs.50 crore.

(13) The Duty Entitlement Pass Book Scheme would be reviewed once a full pledged value added tax regime enters a statute book.

(14) Changes have been made in the Export Promotion of Capital Goods (EPCG) Scheme where in licences of Rs.100 crore or more will now have a 12 year export obligation period with 5 year moratorium.

(15) To make the Indian exports competitive, the Exim policy states that the Port Market Value (PMV) verifications for granting DEPB credit would be dispensed with except in cases of misuse. All export schemes are to be simplified. Maximum fee limit for application under various schemes was also reduced : The same day licensing policy will come into operation in all Director General of Foreign Trade (DGFT) regional offices. All these 32 offices of the DGFT have been fully computerised and on line transaction of the exporters can be made.

2.7 EVALUATION OF NEW TRADE POLICY

The trade policy reforms initiated in 1991 have drastically changed the foreign trade scenario have resulted in the shift from inward oriented to outward oriented policy. The government has resorted to a massive cutting down of import tariff and allowed more liberal imports of a number of

goods hitherto totally banned or restricted. However, there are three issues according to Deepak Nayyar, are of fundamental or strategic importance in planning for industrialisation viz., the relative importance of home market, the nature or the degree of state intervention and acquisition and development of technology. According to Nayyar, in terms of appropriate strategy for industrialisation in the home market, striking a balance between import substitution and export promotion is the equivalent of walking on two legs; if such a balance is struck, it could produce a spectacular export performance leading to rapid economic growth. Regarding state intervention policy, Nayyar states that the experience of India illustrates it is possible for state intervention to create an oligopolistic situation in a competitive environment just as Republic of Korea. As far as technology issue is concerned, Nayyar states that this requires the formulation of a policy regime for the import of technology (planning for acquisition of technology, measures for its absorption, adaptation, diffusion, etc.) allocating resources for research and development and evolving state procurement policies.

This discussion points out the fact that these macro economic inter connections between the foreign trade sector and the overall process of planning for industrialisation are crucial. The problems of foreign trade sector can be resolved to a greater extent through improved performance and a better management of the domestic economy.

3. MULTINATIONAL CORPORATIONS

Multinational Corporations (MNCs) are huge industrial organisations which extend their industrial or marketing operations. They operate through a net work of their branches or their Majority Owned Foreign Affiliates (MOFAs). They are also known as Transnational Corporations (TNCs). They do not aim for maximisation of profit from one or two products alone, instead, they operate in a number of fields over a number of products and over a number of countries. There are now 40,000 TNCs operating through

Check Your Progress

4. What is meant by MNCs from your understanding?

2,50,000 overseas affiliates. The resources are unfathomable and the sales of 200 top corporations only account for 28.3 per cent of the World GDP in 1998. The sales of these 200 MNCs were put at \$7.1 trillion in 1998, from 182 countries.

According to a Study by the Washington based Institute of Policy Studies, that of the 100 largest economies of the world, 51 are corporations and 49 are countries. With the gigantic economic power, the MNCs hold their sway over the world economy, they command huge capital resources and latest technologies and world wide good will. They are in a position to sell any product, they manufacture in any country. People in the underdeveloped countries vie with each other to buy the products of these corporations and prefer their products brushing aside identical products which are produced indigenously.

3.1 GROWTH OF MNCs - REASONS

(1) **Expansion of market territory** because of its large sizedness. As a result, its international image builds up and it is able to extend its activity beyond the physical contours of the country, in which it is incorporated.

(2) **Marketing superiorities** : (a) it possesses more reliable and upto date market information system (b) it enjoys market reputation and faces less difficulty in selling its products (c) It can undertake more effective advertising and sale promotion techniques (d) It has efficient warehousing facilities due to lower inventory requirements.

(3) **Financial superiorities** (i) it has huge financial resources at its disposal, utilizing funds generated in one country into another country. (ii) it has easier to external capital markets and it is able to raise more international resources.

(4) **Technological superiority**: The underdeveloped countries consider the transfer of superior technology from MNCs as useful. The

reasons are (i) Industrialisation is out of reach of these underdeveloped countries with their meagre resources and (ii) local manpower, materials, even when optimally exploited cannot bring industrial progress on their own. (iii) Encouraging local companies, would require heavy imports of raw materials, capital equipment, machinery and technical knowledge and the import bill will be heavy to be borne by the poverty ridden underdeveloped countries. When MNCs are allowed in the country, they bring their own infrastructure. (iv) The underdeveloped countries have to meet stiff international standard quality specifications for selling their products in global markets. MNCs, with their broad, world wide marketing networks help them to produce such standard goods.

(5) **Product innovations** : MNC's Research and Development departments are constantly engaged in developing new products and superior designs of existing products which facility national companies do not enjoy.

3.2 MNCs AND THEIR DOMINATION

MNCs have a very strong hold over Indian economy even two decades ago. These corporations held 53.7 per cent of the assets of the giant sector in India. A number of companies were also under foreign domination in one way or another. Western foreign capital dominated and control the country's big business in the mid 1960's.

The MNCs in India have raised a major part of investment resources from within the Indian economy. A study revealed that between 1956 and 1975 in the Indian economy, foreign sources contributed only 5.4 per cent of the financial resources of the major industrial companies whereas 94.6 per cent were contributed by domestic sources. Between 1974 -1983, several of the major TNCs obtained no foreign funds. The exact position is that MNCs generate most of the capital from within the country itself but repatriate large amounts of the profits to their home countries.

3.3 FOREIGN COLLABORATION AND MNCs

The modus operandi of MNCs participation is collaboration with Indian industries. The collaboration agreements are made between Indian companies and foreign parties involve sale of technology as well as use of foreign brand names for the final products. Nearly all of the new industries, large or medium size group, privately or publically owned, set up after Independence had some collaboration agreement. In the liberalisation era after 1980's, there has been a substantial spurt of foreign collaborations. Between 1981-88, 6165 collaborations were approved. In the generous 'reform period between 1991 to October 2001, there were 7116 foreign technology collaborations and 13,640 foreign direct investment proposals. The inflow of foreign capital in the country during that period was to the extent of Rs.1,05,413 crores. However, foreign collaboration policy of the government has been criticised on the following grounds.

(1) Non-essential products which will serve only the high income group or, which could be provided indigenously like vacuum flask, lipstick, tooth paste, cosmetics, ice creams, biscuits, dry batteries, readymade garments, etc. were produced with foreign collaboration. Thus, the country's resources were wasted.

(2) The same or similar technology was imported again and again which otherwise could have been avoided by encouraging the local enterprises to learn the technology. Repetitive payments have to be made for the import of same technology over and again.

(3) In order to earn foreign exchange and governments eagerness to acquire foreign participation, foreign collaborators dictated terms of agreements in their favour against Indian interest. When the foreign companies imported equipment, they had an implicit tie up with the designers and suppliers not only in price mark-up but also in over import of equipment. Sometimes, indigenously available equipments were imported.

They also remain idle for want of spares at time. Obsolete technology was also clandestinely imported.

(4) The terms of payment were also drawn up so as to squeeze out the maximum payment under one head or another. (5) There were several restrictive and exploitative clauses in the agreements such as (i) technology cannot be passed on to anyone else even after the expiry of the agreement. (ii) Manufacturing is to be carried out according to the specifications of the agreement and no local adaptations can be made (iii) control over overseas purchase, vested directly or indirectly only through the collaborator. (iv) production was tightly controlled with supervision of the foreign technicians. (v) Controls over the pricing and marketing of the products were exercised. A fixed commission or specified firms chosen by the collaborator were to be made the sole selling agents (vi) Right to export was also restricted that only to certain specific countries or products can be exported on certain preconditions (vii) Foreign Collaborations have helped the growth of monopolies. Big business houses in India joined hands with foreign collaborations as the possession of foreign links often conferred strategic advantages like patents, foreign exchange, resources, etc. to enable the big business houses to diversify and expand.

3.4 HARMFUL EFFECTS OF THE OPERATIONS OF MNCs ON INDIAN ECONOMY

Following are the arguments against the operations of the MNCs in India.

(1) Payment of Dividends and Royalty

A large sum of money flew out of the country in terms of payment of dividends, profit, royalties, technical fees and interest to the foreign investors. In 1989, the foreign remittances were accounted to the extent of Rs.813.5 crores, about 3/5 of the private corporate or 215 of the factory sector dividends were paid out by foreign firms in the mid 1980's.

(2) Distortion of Economic Structure

MNCs can inflict heavy damage on the host country such as suppression of Domestic entrepreneurship, extension of oligopolistic practices, supplying the economy with unsuitable technology and unsuitable products, worsening the income distribution by distorting the production structure to meet the requirements of high income elites. According to modern Marxist economists, foreign investments and MNCs open up the doors of neoimperialism and exploitation.

(3) Political Interference

Because of their dominating role in the economies of the underdeveloped countries, the MNCs influence the decision making process in these countries. The underdeveloped countries were dumped with transfer of industrial development and technology not in harmony with the interest of the host countries. The autonomy and sovereignty of the host countries are in danger.

(4) Technology Transfer not Conducive to Development

The Research and development activities of the MNCs which were centralized in parent countries have to be maintained by the host country at their costs. The host countries have to pay royalties and technical fees to the parent firms. Moreover, the MNCs do not transfer their first line or most advanced technology unless under compulsion. The foreign technology transferred was capital intensive in nature which is unuseful from the point of view of a labour surplus economy. If the host country continues to import technology, it will have to face stiff and giant sized unemployment mounting and growth rate of the country will be stagnant.

3.5 CONTROL OVER MNCs

The government agencies such as (1) the Ministry of Company Affairs (2) The RBI, (3) The Ministry of Industrial Development and (4) the Ministry of Finance control the activities of MNCs in India. The control is

not in co-ordination with each other and haphazard. There is no objective criteria for approving applications and the procedure resorted to by the various ministries is lengthy and cumbersome. The Industrial Licensing Policy Enquiry committee Report in imports 1968 felt that the of foreign technology were over priced and were designed to perpetrate dependence. In the light of this revelation, the Government took the following steps to tighten foreign imports.

1. Some industries, producing inessential articles were not allowed to import technology.

2. Where domestic capacity of production was adequate, no technology should be imported. In case of foreign imports the maximum rate of royalty was laid down. Though foreign investment was allowed in principle, the sanction of individual cases was a matter of administrative decision. The tenure of agreements was reduced from 10 to 5 years and renewals were discouraged. Export and other marketing restrictions in the agreement were not admissible and often obligation to export certain proportion certain of the output is insisted. The right to sublicense the technology was given to the importer. The approval of foreign technology import was subject to CSIR's ability to supply the technology indigenously. Finally, the enactment of passing of the Foreign Exchange Regulation Act (FERA) led to the effective curbing of MNC's exploitative activities in the Indian economy.

4. ANSWERS TO CYP QUESTIONS

1. Refer 1.3
2. Refer Table 10.2
3. Refer 2
4. Refer 3

5. MODEL QUESTIONS FOR GUIDANCE

10 Marks Questions (One page answer)

1. Explain the salient features of India's export composition.
2. What are the main reasons for the growth of MNCs?
3. Bring out the various harmful effects of MNCs.

20 Marks Questions (Three page answers)

4. Analyse the latest trends in the volume, composition and direction of India's foreign trade.
5. Discuss the new trade policy of India.
6. Critically examine the role of MNCs in India.

ABOUT THE UNIVERSITY EXAMINATION

As we have already mentioned in the Introduction, 'International Economics' is one among the two subjects under part III on which you have to write the examination at the end of your second year course. The examination duration will be 3 hours and the maximum marks is 100. The Question Paper will consist of two sections namely Section A and Section B. In Section A, you will be given 8 questions and you have to answer any 4 questions and each answer will carry a maximum of 10 marks. That is, maximum marks for answers to questions in Section A is $4 \times 10 = 40$. In section B, you have to answer any 3 questions out of 6 questions and each will carry 20 marks. That is, $3 \times 20 = 60$. Therefore, the **maximum marks** for the subject is $40 + 60 = 100$. The **passing minimum** for the subject is **35 marks**.

Eligibility for the Degree

(i) A candidate will be eligible for B.A. Degree by completing 3 years and passing all the prescribed examinations.

(ii) A candidate shall be declared to have passed the course if he/she scored a minimum of 35% marks in each subject.

(iii) A candidate shall have been declared to have passed in

(a) I class, if he/she obtains an average of 60% and above.

(b) II class, if he/she obtains an average of 50% and above but less than 60%.

(c) III class, if he/she obtains an average of 35% and above but less than 50%

UNIVERSITY EXAMINATION QUESTION PAPERS

INTERNATIONAL ECONOMICS

(For those who joined in July 2003 and after)

OCTOBER 2005

Time: Three hours

Maximum: 100 marks

SECTION A - (4 × 10 = 40 marks)

Answer any FOUR questions.
All questions carry equal marks.

1. பன்னாட்டு வாணிபத்தின் முக்கியத்துவத்தை விளக்குக.
Explain the importance of international trade.
2. வட்டார வாணிபத்திற்கும் பன்னாட்டு வாணிபத்திற்கும் உள்ள வேறுபாட்டை விளக்குக.
Distinguish between intra-regional trade and international trade.
3. வாணிப வீதங்களின் பல்வேறு கருத்துக்களை விளக்குக.
Explain the different concepts of terms of trade.
4. காப்புக் கொள்கைக்கு எதிரான வாதங்களைத் தருக.
Argue against protection.
5. அயல் நாட்டு செலுத்து நிலைக்கும், வாணிப நிலைக்கும் உள்ள வேறுபாடு யாது?
What is difference between balance of payments and balance of trade?
6. பங்கு அளவின் பல்வேறு வகைகளை விளக்குக.
Explain the various forms of quotas.
7. நிலையான மாற்று வீதத்தின் நன்மைகளைக் கூறுக.
What are the merits of fixed exchange rate?
8. செலவாணிக் கட்டுப்பாட்டின் நோக்கங்கள் யாவை?
What are the objectives of exchange control?

SECTION B - (3 × 20 = 60 marks)

Answer any THREE questions.
All questions carry equal marks.

9. ஒப்பீட்டுச் செலவுக் கோட்பாட்டை விவரி.
Describe the comparative cost theory.

10. பன்னாட்டு வாணிபத்தினால் ஏற்படும் லாபங்கள் யாவை? லாபத்தை நிர்ணயிக்கும் காரணிகளை ஆராய்க.
What are the gains from international trade? Analyse the factors that determine the gains from trade.
11. பாதக செலுத்து நிலையை சரி செய்யும் முறைகளை விவரிக்க.
Elucidate the methods of correcting adverse balance of payment.
12. வாணிப நிலை என்றால் என்ன? எவ்வாறு அது பொருளாதார முன்னேற்றத்தை பாதிக்கிறது?
What is meant by terms of trade? How does it affect the economic development?
13. பன்னாட்டு பண நிதியின் நோக்கங்களையும் செயல்பாட்டையும் விளக்குக.
Explain the objectives and functions of International Monetary Fund.
14. கடந்த பத்து ஆண்டுகளில் இந்தியாவின் வெளி நாட்டு வாணிபத்தில் ஏற்பட்ட முக்கியமான மாற்றத்தினை வெளிக் கொணர்.
Bring out the important changes in India's foreign trade during the last decade.

MAY 2006

SECTION A - (4 × 10 = 40 marks)

Answer any FOUR questions.

All questions carry equal marks.

Answer should be not less than a page.

1. வட்டார வாணிபம், பன்னாட்டு வாணிபம் இடையில் நிலவும் ஒற்றுமைகள் யாவை?
What are the similarities between inter regional and international trade?
2. பன்னாட்டு வாணிபத்திலிருந்து பெறும் நன்மை எவ்வாறு தீர்மானிக்கப்படுகிறது?
How is the gain from international trade determined?
3. பொருப்புப் பங்கின் வகைகள் யாவை?
What are the types of quotas?
4. அன்னிய செலுத்து நிலையின் அடிப்படைச் சமநிலை இன்மை என்றால் என்ன?
What is fundamental disequilibrium in the balance of payments?
5. தடையுள்ள வாணிபத்தின் சாதக பாதக விவாதங்களைக் கொணர்.
Give arguments for and against protection.
6. அன்னிய செலாவணிக்கட்டுப்பாட்டின் நன்மை தீமைகளை சுருக்கமாக குறிப்பிடுக.
Briefly point out the merits and demerits of exchange control.

7. உலக வங்கியின் செயல்பாட்டை சுருக்கமாக விளக்குக.
Briefly explain the working of the World Bank.

8. WTO-வின் நோக்கங்களை விளக்குக.
Explain the objectives of WTO.

SECTION B - (3 × 20 = 60 marks)

Answer any THREE questions.

All questions carry equal marks.

Answer should be not less than 3 pages.

9. நவீன பன்னாட்டு வாணிபக் கோட்பாட்டை திறனாய்வு செய்க.
Discuss critically the Modern Theory of International Trade.

10. வாணிப வீதம் என்றால் என்ன? வாணிப வீத குறியீடு உயர்வதால் ஒரு நாடு நல்ல நிலை அல்லது மோசமான நிலையை அடையுமா?
What are terms of trade? Does a rise in the terms of trade index make a country better or worse off?

11. தடையில்லா வாணிபத்தின் நன்மைகளை ஆதரிக்கும் விவாதங்களை முழுமையாக விவாதி. வளர்ச்சி குறைந்த நாடுகளுக்கு இக்கொள்கையை ஆதரிக்கிறாயா?
Discuss fully the arguments advanced in support of free trade would you support the policy of free trade for an under developed country.

12. IMF எவ்வாறு அன்னியச் செலாவணி மாற்று வீதத்தைத் தீர்மானிக்கிறது என்பதை விளக்குக.
Explain how is the rate of Exchange determined by IMF.

13. GATT-ன் நோக்கங்களையும் சாதனைகளையும் திறனாய்வு செய்க.
Discuss critically the objectives and achievements of GATT.

14. இந்திய பன்னாட்டு வாணிபத்தின் கொள்ளளவு, அமைப்பு முறை மற்றும் திசை வழி காலப்போக்கை ஆய்வு செய்க.
Analyse the latest trends in the volume, composition and direction of India's foreign trade.

OCTOBER 2006

SECTION A - (4 × 10 = 40 marks)

Answer any FOUR questions.
Each answer should not be less than a page.

1. உள்நாட்டு வாணிபத்திற்கும். பன்னாட்டு வாணிபத்திற்கும் உள்ள வேற்றுமைகளை எழுதுக.
Write about the differences between internal trade and international trade.
2. ரிக்கார்டோவின் ஒப்பீட்டுச் செலவு பன்னாட்டு வாணிபக் கோட்பாட்டை விவாதிக்க.
Discuss Ricardo's comparative cost theory of trade.
3. வாணிப வீதத்தால் ஏற்படும் வகைகளைக் கூறுக.
What are the different types of terms of trade?
4. பங்களவு என்றால் என்ன? அதன் வகைகள் யாவை?
What is meant by quoter? What are its types?
5. பின்தங்கிய நாடுகளின் சமமற்ற அயல்நாட்டு செலுத்துதல் நிலையைத் தீர்க்கும் ஒரு சரியான கொள்கை நாணய மாற்று குறைப்பு - நீங்கள் இதை ஒப்புக் கொள்கிறீர்களா?
Devaluation is a suitable policy for less developed countries with balance of payment disequilibrium - Do you agree?
6. அந்நியச் செலவாணி அங்காடி என்றால் என்ன? மறைமுக பரிவர்த்தனையின் வகைகளைக் கூறுக.
What is foreign exchange market? List the invisible items of exchange?
7. மாற்றுவிதக் கட்டுப்பாடு என்றால் என்ன? அதன் தேவையை எழுதுக.
What is exchange control? Write the need for exchange control.
8. வாணிபத்தால் ஏற்படும் பயன்களை எழுதுக.
Explain in gains from trade.

SECTION B - (3 × 20 = 60 marks)

Answer any THREE of the following.

9. உலக வங்கியின் நோக்கங்களையும் பணிகளையும் எழுதுக.
Write down the functions and objectives of IBRD.
10. முன்னேறிவரும் நாடுகளின் புனரமைப்பு மற்றும் முன்னேற்றத்தில் உலக வங்கியின் செயல் ஆற்றலின் முக்கியத்துவத்தை விவரி.
Discuss the role of World Bank in the reconstruction and development of developing countries.

11. காட் ஒப்பந்தத்தினால் இந்திய வாணிபத்தில் ஏற்படும் விளைவுகளைக் கூறுக.
Explain the effects of GATT on Indian Trade.
12. WTO-ன் பணிகளைக் கூறுக. இந்தியாவில் ஏற்படும் அதன் விளைவுகளை விவரி.
Explain the functions of WTO. Write down its effects on India.
13. ஏற்றுமதி அதிகரிப்பு மற்றும் இறக்குமதி பதிலீட்டை அதிகரிக்கச் செய்யும் வழிகள் யாவை?
Explain export promotion and import substitution measures.
14. இந்திய பொருளாதார வளர்ச்சியில் அயல்நாட்டு வாணிபத்தின் பங்கினைக் கூறுக.
Explain the role of Foreign Trade in Indian Economic Growth.

OCTOBER 2007

SECTION A - (4 × 10 = 40 marks)

Answer any FOUR questions.

Each answer should not be less than a page.

1. பன்னாட்டு வாணிபத்தின் நன்மை தீமைகளை ஆராய்க.
Discuss the advantages and disadvantages of international trade.
2. ஹெக்சர்-ஒலின் பன்னாட்டு வாணிபக் கோட்டினை திறனாய்வு செய்க.
Critically examine Heckshen-Ohlin's theory of international trade.
3. வாணிபம் என்பது வளர்ச்சியின் உந்து சக்தி-விளக்குக.
Trade is an engine of growth-Explain.
4. 'ஒரு நாட்டின் வணிக வீதத்தை நிர்ணயிக்கக் கூடிய காரணிகள் யாவை?
What factors determine the terms of trade of a country?
5. காப்புவரிக் கொள்கைக்கு ஆதரவான கருத்துக்களைத் தருக.
Argue the case for protection policy.
6. பாதக அயல்நாட்டுச் செலுத்து நிலைக்கான காரணங்கள் யாவை?
What are the causes for the unfavourable balance of payments situation?
7. வாங்குந் திறன் கோட்பாட்டின் நன்மை தீமைகளை விளக்குக.
Explain the merits and demerits of the purchasing power parity theory.
8. அந்நியச் செலவாணி கட்டுப்பாடு முறைகள் யாவை?
What are the measures of exchange control?

SECTION B - (3 × 20 = 60 marks)

**Answer any THREE questions.
Each answer should not be less than 3 pages.**

9. பன்னாட்டு நாணய நிதியியத்தின் பணிகளை விளக்குக.
Explain the functions of IMF?
10. உலக வங்கியின் குறிக்கோள்களை கூறுக.
Explain the objectives of World Bank.
11. உலக வர்த்தக அமைப்பின் பணிகள் யாவை?
What are the functions of WTO?
12. இந்தியாவின் ஏற்றுமதி அதிகரிப்பு நடவடிக்கைகள் யாவை?
Explain the export promotion measures in India.
13. காட் ஒப்பந்தத்தினால் இந்திய வாணிபம் மற்றும் பொருளாதாரத்தின் மீதான விளைவுகளை ஆராய்க.
Examine the effects of GATT proposals on Indian trade and economy.
14. பன்னாட்டு வாணிபத்தின் நன்மைகளைக் கூறுக.
Write about the advantages of foreign trade.

OCTOBER 2008

SECTION A - (4 × 10 = 40 marks)

**All questions carry equal marks.
Answer should be not less than a page.**

1. வட்டார வாணிபத்திற்கான காரணங்கள் யாவை?
What are the reasons for inter-regional trade?
2. நிகர பண்டமாற்று, மொத்த பண்டமாற்று வாணிப வீதத்தை வேறுபடுத்துக.
Distinguish between net barter and gross barter terms of trade.
3. வாணிபத்திலிருந்து பெறும் நன்மைகளின் பல்வேறு இயல்புகளை விவரி.
Explain the various nature of gains from trade.
4. பொறுப்புப் பங்கின் பல்வேறு விளைவுகளை விளக்குக.
Explain the different effects of quotas.
5. 'மாற்று வீதம்' என்றால் என்ன?
What is meant by 'Rate of Exchange'?

6. GATT என்றால் என்ன?

What is GATT?

7. 'அன்னியச் செலுத்துநிலை எப்போதும் சமநிலையில்'- விவாதி.

'Balance of Payments always balance' - Comment.

8. உலக வங்கியின் பணிகள் யாவை?

What are the functions of World Bank?

SECTION B - (3 × 20 = 60 marks)

Answer any THREE questions.

All questions carry equal marks.

Answer should be not less than 3 pages.

9. ஒப்பீட்டு நன்மைக் கருத்தை விவாதி. பெர்டின் ஆலின் இதன் மீது செய்த முன்னேற்றங்கள் யாவை?

Discuss the doctrine of comparative advantage. What improvements have been made on it by Bertin Ohlin?

10. மார்ஷலின் வாய்ப்புக் கோட்டைப் பயன்படுத்தி வாணிப வீதத்தின் சமநிலையை தீர்மானிப்பதை விவரி.

Using Marshall's offer curves, explain the determination of equilibrium terms of trade.

11. பொதுவாக எல்லா நாடுகளும் பன்னாட்டு வாணிபத்தின் மேல் எவ்வாறு தடைகளை புகுத்துகின்றன?

What are restrictions on international trade imposed by virtually all countries?

12. சுங்க வரியின் விலை விளைவு, வாணிப வீத விளைவு ஒப்பிடுக.

Compare between price effect and terms of trade effect of tariffs.

13. மறைமுக மாற்றுவித கட்டுப்பாட்டின் குறைபாடுகள் யாவை?

What are the limitations of indirect methods of exchange control?

14. WTO-வின் முக்கிய இயல்புகளை விவரி. இது எவ்வாறு GATT-லிருந்து வேறுபடுகிறது?

Explain the main features of the WTO. How does it differ from the GATT?

MAY 2009

SECTION A - (4 × 10 = 40 marks)

Answer any FOUR questions.
All questions carry equal marks.
Answer should be not less than a page.

1. பன்னாட்டு வாணிபம் வட்டார வாணிபம் வேறுபடுத்துக.
Differentiate between International and Inter regional trade.
2. 'வாணிபம் வளர்ச்சியின் ஒரு இயந்திரம்' எனும் கருத்தை விளக்குக.
Mention the concept of 'trade as an Engine of growth'.
3. வாணிப வீதத்தை பாதிக்கும் காரணிகள் யாவை?
What factors affect terms of trade?
4. தடையில்லாத வாணிபத்திற்கான பொருளாதார விவாதங்கள் யாவை?
What are the economic arguments for free trade?
5. சுங்க வரியின் வகைகள் யாவை?
What are the types of tariffs?
6. அன்னியச் செலுத்துநிலையில் நிலவும் பல்வேறு சமன்பாட்டு இன்மைகள் யாவை?
What are the different types of disequilibrium in the balance of payments?
7. பொன் திட்டத்தின் கீழ் அன்னியச் செலுத்து நிலை வீதம் எவ்வாறு தீர்மானிக்கப்படுகிறது?
How is rate of exchange determined under the gold standard?
8. உலக வங்கியின் நோக்கங்கள் யாவை?
What are the objectives of World Bank?

SECTION B - (3 × 20 = 60 marks)

Answer any THREE questions.
All questions carry equal marks.
Answer should be not less than 3 pages.

9. தொன்மைக் கால பன்னாட்டு வாணிபக் கொள்கையை திறனாய்வு செய்க.
Discuss critically the classical theory of international trade.
10. ஒரு தடையுள்ள வாணிபக் கொள்கையில் நிலவும் சாதக பாதக விவாதங்களைக் குறிப்பிடுக.
Give an account of arguments advanced for and against a protectionist policy.

11. பொருப்புப் பங்கின் விலை விளைவு, வாணிப வீத விளைவுகள் ஒப்பிடுக.
Compare between price effect and terms of trade effects of quotas.
12. மாறுகின்ற அன்னியச் செலாவணி வீதத்திற்கான விவாதங்கள் யாவை?
What are the arguments fro fluctuating exchange rate?
13. எந்த அளவிற்கு GATT தனது நோக்கத்தை அடையும் திறன் உள்ளதாக இருந்தது?
திறனாய்வு செய்க.
How far the GATT was able to achieve its objectives? Discuss critically.
14. 1990-லிருந்து இந்தியாவின் அன்னியச் செலுத்துநிலையை விளக்குக. இதனைச் சரிசெய்ய என்ன நடவடிக்கைகள் மேற்கொள்ளப்பட்டன?
Explain India's balance since 1990. What measures have been adopted to correct it?

