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BLOCK 2

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BLOCK INTRODUCTION

This is the second block of the course “International Economics”. In the previous block, we already studied the first seven units of the course. This block contains the remaining seven unis of the course, i.e., from Unit 8 to Unit 14. In Unit 8, we have discussed tariff. After going through this unit, you will able to know the meaning and types of tariff, explain the effects of tariffs under partial equilibrium, acquire a detailed idea of effects of tariff under general equilibrium for a small as well as large country and also to determine the optimum tariff. In the next unit, we have disussed different non-tariff interventions. In this unit, a few important concepts like import quotas, its types and effects have been discussed. Further, distinction between import quotas vs. import tariff has also been discussed. Moreover, various quota controversies in less developed countries as well as other non-tariff quota barriers to trade have also been discussed. Finally, the issue of dumping-multilateralism and WTO’s role in it has been taken up. In Unit 10, theory of customs union has been discussed. This unit deals with the important discussions like economic integration and its types, trade creation and trade diversion as well as dynamic trade creation and trade diversion. Unit 11 deals with balance of payments. This is one of the most important concepts in International Economics. Here, important concepts like the distinction between the current account and capital account of a country, how equilibrium and disequilibrium occurs in a country’s BOP, the concepts of fixed and flexible exchange rate have been discussed. Finally, the monetary approach to Balance of Payment has been critically examined. Unit 12 of the course is on foreign trade multiplier. Thus, in this unit, meaning and concept of foreign trade multiplier, contractionary effect of increase in imports on national income as well as foreign trade repercussion and foreign income repercussion have been discussed. Finally, the deficiencies of foreign trade multiplier has been discussed. Unit 13 of the course is on determination of exchnage rate. Here the meaning of exchange rate, its different types, distinction between fixed and flexible exchange rates and their relative merits and demerits have been discussed. Finally, certain policy instrumens have been discussed which can help in bringing a balance between internal and external imbalances. The last unit of the course is on international monetary order. Here, various concepts like classic gold standard, Bretton Woods system, international capital movements, as well as objectives, organisation and functions of IMF have been discussed. Further, the concept like special drawing rights have been dealt with. Finally the issue of international liquidity has been taken up. Thus, on an overall, this course will be helpful in gaining a thorough insight into the theoretical as well as many empirical and policy issues relating to the branch of International Economics.

While going through a unit, you will notice some along-sode boxes, which have been included to help you know some of the difficult, unseen terms. Some ‘ACTIVITY’ (s) has been included to help you apply your own thoughts. Again, we have included some relevant concepts in ‘LET US KNOW’ along with the text. At the end of sections, you will get ‘CHECK YOUR PROGRESS’ questions. These have been designed to self-check your progress of study. It will be better if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with ‘ANSWERS TO CHECK YOUR PROGRESS’ given at the end of the units.

UNIT 8: THEORY OF INTERVENTIONS – I (TARIFF)

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Types of Tariff

- 8.3.1 Classification on the Basis of Criterion
- 8.3.2 Classification on the Basis of Purpose
- 8.3.3 Classification on the Basis of Discrimination
- 8.3.4 Classification on the Basis of Products
- 8.3.5 Classification on the Basis of Retaliation

8.4 Arguments for Tariff

8.5 Effects of Tariff under Partial Equilibrium

8.6 Effects of Tariff under General Equilibrium

- 8.6.1 General Equilibrium analysis of Tariff in a Small Country
- 8.6.2 General Equilibrium analysis of Tariff in a Large Country

8.7 Optimum Tariff

- 8.7.1 Optimum Tariff with Retaliation
- 8.7.2 The Optimum Tariff Formula

8.8 Let Us Sum Up

8.9 Further Reading

8.10 Answers to Check Your Progress

8.11 Model Questions

8.1 LEARNING OBJECTIVES

After going through this unit, you will be able to

- know the meaning and types of tariff
- explain the effects of tariffs under partial equilibrium
- have a detailed idea of effects of tariff under general equilibrium for a small as well as large country
- determine the optimum tariff.

8.2 INTRODUCTION

The free international trade can maximize world output and benefits for all the nations. However, partially all the nations are imposing various restrictions and regulations on the free flow of the goods and services. Since these restrictions and regulations are on the nation's trade and commerce, these are known as 'trade or commercial policies'. The best known and most widely used form of commercial policy instrument is tariff or customs duty.

A tariff is a duty or tax imposed by the government of a country upon the traded commodity as it crosses the traded commodity as it crosses the national boundaries. It can be imposed upon both the exported and imported commodities.

An import tariff is a duty on the imported commodity, while an export tariff is a duty on the exported commodity. The countries generally extends to maximize their exports, avoids export tariff. Hence import tariffs become more important than the export tariff. Tariffs can be expressed in absolute or relative terms, they may be discriminatory or non discriminatory, may be impose on export or import, they may be promoted by considerations of revenue or protection to domestic industries.

8.3 TYPES OF TARIFF

Tariffs are of different types. It can be classified into different groups as discussed below.

8.3.1 Classification on the Basis of Criterion

On the basis of the criterion for imposition, the tariff can be classified as Specific tariff, Ad Valorem tariff, Compound tariff and Sliding scale tariff.

- **Specific Tariff: S**pecific tariffs are those which are assessed on the basis of the physical weight of the product which is imported or exported. It is the fixed amount of money per unit or according to the weight or measurement of the commodity

imported or exported. Specific tariff cannot belevied on very precious goods like diamond, modern art painting, jewelry etc.

- **Ad Valorem Tariff:** Ad Valorem tariff is levied as a fixed percentage of the value of the traded commodity measured by their money price. Ad Valorem is a Latin word meaning 'on the value'. It is levied only on those products, value of which is disproportionately higher than compared to their physical characteristics such as weights or measurement. International comparison of tariff can be possible through ad valorem tariff.
- **Compound Tariff:** Compound tariff is a combination of both specific and ad valorem tariff. It not only imparts a greater elasticity to resources but also assures a more effective protection to the home industries.
- **Sliding Scale Tariff:** The import duties which vary with the prices of the commodities are sliding scale effect.

8.3.2 Classification on the Basis of Purpose

On the basis of this classification the tariff may be of two types i.e. Revenue tariff and Protective tariff.

- **Revenue Tariff:** Revenue tariff is imposed primarily to produce revenue for the government. With the introduction and expansion of income taxes and other direct taxes the importance of tariffs as a source of revenue has considerably gone down in developed countries. But in less developed countries revenue tariff is still prevalent. Yet, generally revenue tariff is not possible.
- **Protective Tariff:** If the tariff is imposed to protect the home industries from the competition of foreign produced goods, these are known as protective tariff. If the domestic demand for the imported good is strong, then there will be possibility of struggling for imported goods. Again this type of tariff can make the home industry lethargic and inefficient to compete with the foreign product.

8.3.3 Classification on the Basis of Discrimination

On the basis of discrimination, tariff may be of non discriminatory and discriminatory type.

- **Non-Discriminatory Tariff:** Non discriminatory tariff which is also known as 'single column tariff' is a uniform tariff rate that is applicable to all commodities irrespective of the country of origin. This tariff is not elastic enough to adjust according to the changing needs of the industries of the home country.
- **Discriminatory Tariff:** Discriminatory tariff which is also known as double column tariff have varying tariff rates exist for different commodities. The products originating from favoured countries are subject to a lower tariff rate than those of other countries.

The double column tariff can be further classifies as

i) General and Conventional tariff and ii) Maximum and Minimum tariff.

While the general tariff is determined by the state legislature, conventional tariff is determined through commercial agreement of the home country with the other countries. Again, while the minimum tariff rate is applied to the products originating from the 'most favoured countries, maximum tariff is applied to the purpose of improving of bargaining position of home country vis-à-vis foreign countries. These tariffsare fixed by the legislature.

8.3.4 Classification on the Basis of Products

On the basis of the criterion of exported or imported type of good, the tariff is imposed.

- **Import Duties:** If the home country imposes tariff upon the products of the foreign countries as they enter its territory, it is import duty.
- **Export Duties:** If the products of the home country become subject to tax as they are exported, it is export duty.



LET US KNOW

Some countries like USA have prohibited export duties by law.

8.3.5 Classification on the Basis of Retaliation

On the basis of retaliation, tariff may be retaliatory tariff and countervailing tariff.

- **Retaliatory Tariff:** If a foreign country has imposed tariffs upon the exports from the home country and the later imposes tariffs against the productsof the former, the tariff resorted by the home country will be regarded as the retaliatory tariff.
- **Countervailing Tariff:** If the foreign country has been exporting large quantities of its products in market of home country on the strength of export subsidies the home country can be neutralize the 'Unfair advantage' enjoyed by foreign products through imposing duties upon them as they enter the territory of the home country.

8.4 ARGUMENTS FOR TARIFF

A country can impose tariff if it is favourable for them. Many of the arguments for tariffs are non economic. They are often based on national, political, emotional and strategic grounds. Tariff will provide reservation and expansion of the home market.Tariff will help keeping money at home country.Tariff helps pauper labour of the country. It counteracts foreign law wages. It counteracts superior technology power.Tariff helps for ensuring the defense or national security of a country.Tariff ensures the national self sufficiency for the home country. Imposition of tariff ensures standard of living by protecting high wages. Full employment can be maintained if tariff is imposed by a country. Tariff is essential to protect an infant industry which in turn protects the infant country.



CHECK YOUR PROGRESS

Q 1: Define tariff. (Answer in about 40 words)

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Q 2: Why the tariff is called trade or commercial policies? (Answer in about 20 words)

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Q 3: On what basis the tariff are classified? (Answer in about 20 words)

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Q 4: What is discriminatory tariff? (Answer in about 40 words)

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Q 5: State whether the following statements are True (T) or False (F)

Tariff is imposed only for the exported commodities (T/F)

Q 6: Justify the necessity of tariff. (Answer in about 100 words)

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8.5 EFFECTS OF TARIFF UNDER PARTIAL EQUILIBRIUM

The effects of tariff can be analysed by using partial or micro economic analysis and general or macro economic analysis.

When a small country imposes tariff on import of the product that competes with the product of the small domestic industry, the tariffs can neither effect the international prices (as the country is small) nor can it affect the rest of the country (as the industry is small). In that case partial equilibrium analysis becomes appropriate.

Assumption:

The effects of tariffs under a partial equilibrium system can be analysed on the basis of the following assumptions.

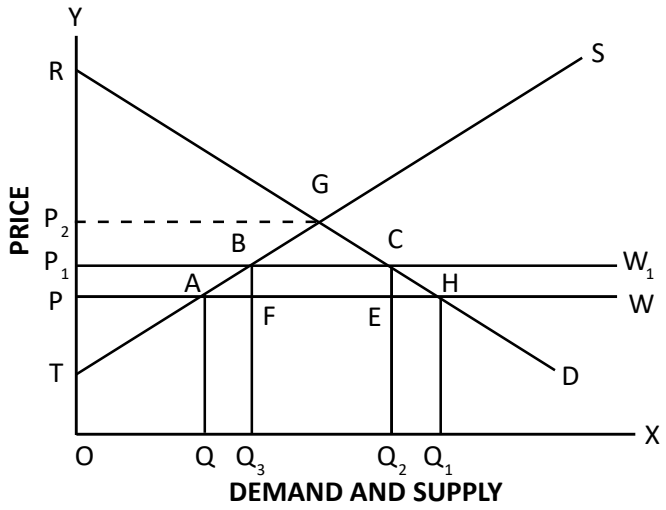
- The demand and supply curve of the given commodity are concerned with the home country that imposes import tariff.
- The given demand and supply curves remain constant.
- There is no change in consumers' taste, prices of other commodities and money incomes of the consumer.
- There is an absence of technological improvements, externalities and other factors that result in changes in cost conditions.
- No tariff is imposed by the home country on the import of materials that are required for producing the given commodity.
- There is no change in the foreign price of the commodity.
- There is an absence of transport costs.

Charles P.Kindleberger has mentioned eight effects of tariff in a partial equilibrium approach. They are discussed below.

Protective or Production Effect:

The imposition of tariff may be intended to protect the home industry from the foreign competition. As tariff restricts the flow of foreign products, the home products find an opportunity to increase the domestic production or import substitutes. Ellsworth termed the production effect as import substitution effect.

Figure 8.1: Protective Effect



Diagrammatically it is assumed that the world supply of the given commodity is perfectly elastic so that it is available at the constant price and the world supply is perfectly elastic. The domestic production of the commodity is assumed to be at an increasing cost. Therefore the domestic supply curve is positively sloping. The domestic demand curve slopes negatively.

In the figure demand and supply curve are assumed along the horizontal axis and price along the vertical axis. D and S are the domestic demand and supply curves of the given commodity respectively. Originally PW is the world supply curve of the commodity and the pre tariff price is OP. At the price OP, the domestic supply curve is OQ and demand is OQ_1. The gap OQ_1 between demand and supply is met through import of the commodity from abroad. IfPP_1 per unit tariff is imposed on import, the price rises to OP_1 and the world supply curve shifts to P_1W_1. At this higher price, the demand is reduced from OQ_1 to OQ_2 whereas the domestic supply expands from OQ to OQ_1. Thus the domestic production of import substitutes takes place to the extent of OQ_3. This is protective, production or import substitution effect. The increased domestic production reduces the demand for foreign product from OQ_1 to Q_2Q_1. In case the per unit tariff were PP_2 causing the price rise to OP_2, the domestic production would have expanded large enough to meet fully the domestic demand. In such situation imports would have been reduced to zero.

Consumption Effect:

The imposition of import duty on a particular commodity has the effect of reducing consumption and also net satisfaction of the consumers. The imposition of tariff increases the price from OP to OP_1 in the diagram and reduces the consumption of good from OQ_1 to OQ_2 leading to net loss in consumer satisfaction by the area of $PHCP_1$.Kindleberger has called the combined protective and consumption effects as the trade effect.

Revenue Effect:

The imposition of tariff provides revenues to the government. In the diagram above, with the original OP price there was no revenue generation. With the imposition of PP_1 tariff (or BF) revenue receipts become BCEF.

Redistribution Effect:

The imposition of tariff causes reduction in consumer surplus, it provides a large producer surplus or economic rent to domestic producers and revenues to the government. This is redistribution effect which can be shown as,

Loss in Consumer's Surplus = RHP – RCP1 = PHCP1

Gain in Producer's Surplus = TBP1 –TAP = PABP1

Gain in Revenue to the Government = BCEF

Net Loss = PHCP1 – (PABP1 + BCEF)

= ΔBAF + ΔCEH

Kindleberger calls this net loss as the '**deadweight losses'** due to tariff.

Terms of Trade Effect:

The traditional theorists believed that tariff led to an improvement in the terms of trade of the tariff imposition countries. But modern theorists believed that imposition of tariff depend upon the elasticity of demand and supply of products of the two trading countries. If the foreign supply of a good is perfectly elastic or if the foreign supplierare ready to supply the product at a constant price, the imposition of tariff is not likely to improve the terms of trade for the tariff imposing country.

Competitive Effect:

The imposition of tariff can facilitate the growth of an infant industry which otherwise is not possible in a position to face the face competition.

Income Effect:

The imposition of tariff reduces the demand for foreign products. The amount of money not spent on imported goods may either be spend on the home products or saved. If there is the existence of surplus productive capacity in the home country this excess money will increase production, employment and income of the home country.

Balance of Payments Effect:

When tariff is imposed by a country upon foreign products, the home produced goods become relatively cheaper than the imported goods. The price effect caused by tariff reduces imports from other countries and caused increased production and purchase of home produced goods. That leads to a reduction in the balance of payments deficit of the home country.



LET US KNOW

An offer curve is a curve showing the quantity of one type of product that an agent will export for each quantity of another type of product that it imports. It was developed by economists Edgeworth and Marshall.

8.6 EFFECTS OF TARIFF UNDER GENERAL EQUILIBRIUM

In a study of general equilibrium analysis, a study is made of the effects of tariff on consumption, production, trade and welfare. When a country imposes tariff, not only a specific product or sector but practically every sector of the economy get effected in one way or the other until the economy reaches a new equilibrium. The general equilibrium analysis of tariff is made from the view point of a small country and a large country.

8.6.1 General Equilibrium Analysis of Tariff in a Small Country

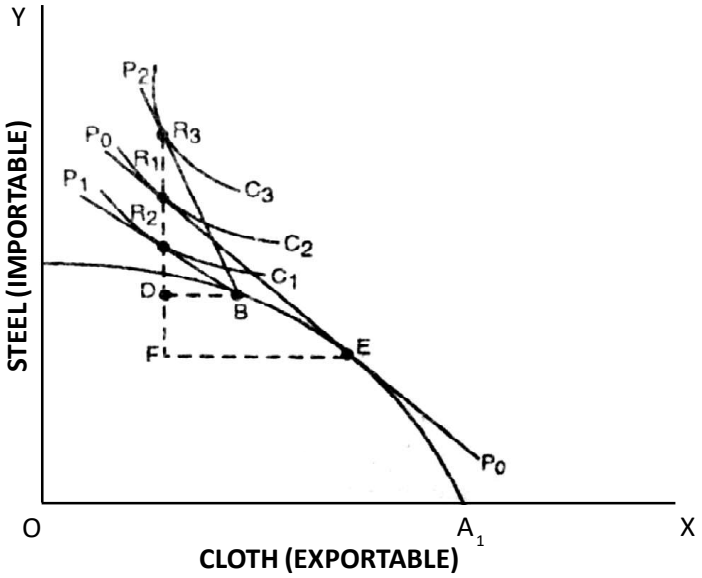
When the tariff imposing country is small, the domestic price of the imported commodity will rise by the full amount of tariff for the individual consumers and producers in that small tariff imposing country. The international price of the commodity will however remain unaffected.

Assumptions: The general equilibrium analysis for a small country can be anlysed on the basis of following assumptions.

The trade of two commodities cloth and steel takes place between two countries i.e. home country A and foreign country B. The imposition of tariff by the home country upon imported commodity steel raises the price of steel for domestic producers and consumers upto the full amount of tariff. World price of steel remains unaffected. The revenue collected by the government through tariff is spent by the government to subsidies public consumption.

The production and consumption effects of tariff upon country A can be analysed diagrammatically, as has been shown with the help of Figure 8.2.

Figure 8.2: General Equilibrium Analysis of Tariff



In Figure 8.2, the production possibility curve related to two commodities cloth and steel is AA_1. In the absence of international trade, the group of consumption and production equilibrium is B. In the conditions of free international trade, P_0P_0 is the international exchange ratio line and the production equilibrium point is E. The consumption equilibrium point is R_1 that lies on the community indifference curve C_2. In this situation country A exports FE quantity of cloth and imports R_1F quantity of steel. If tariff is imposed but the world prices of commodity remain the same, the international exchange ratio line is P_1B which is parallel to the original international exchange ratio line P_0P_0. Now production equilibrium shifts to B where country A produces a larger quantity of steel domestically. This is the production or protective effect of tariff. The consumption equilibrium shifts from R_1 to R_2 where the international exchange ratio line P_1B becomes tangent to a lower community indifference curve C_1. It shows that tariff has caused a reduction in the welfare of tariff imposing small country. The shift in consumption point from

R_1 to R_2 signifies the consumption effect of tariff. After tariff, country exports BD quantity of cloth and imports R_2D quantity of steel.

Thus, in the case of a small tariff imposing country, the import tariff has adverse effects. Firstly, since world prices of exchanged commodities remain unchanged, tariff fails to bring about an improvement in terms of trade for the home country A. Secondly, although there is an increased production of import substitutes within the home country yet the diversion of resources from the production of cloth, in case of which the country was enjoying comparative advantage and was having specialization, shows the misallocation of resources and consequent loss to country A. Thirdly, the shift of the consumption equilibrium to a lower community indifference curve indicates loss in welfare for the tariff imposing country. Fourthly, tariff not only reduces imports but also the exports of the tariff imposing country. The reduction in the volume of trade is not only a loss to the tariff imposing country but also for the rest of the world.

8.6.2 General Equilibrium Analysis of Tariff in a Large Country

If the tariff imposing country is large, the reduced demand for imports subsequent upon the imposition of tariff may reduce the world demand for the product in such a great extent that the price of importable goods falls. In such a situation the fall in import price relative to export price causes a change in the international price ratio and brings about an improvement in the terms of trade of the tariff imposing large country.

The production effect, consumption effect and terms of trade effect due to tariff can be analysed with the help of same Figure 8.2. If tariff causes a fall in the price of the importable commodity, the international exchange ratio line shifts to P_2B which is steeper than the exchange ratio line P_0P_0 or P_1B. In this case, the production equilibrium takes place at B and consumption equilibrium occurs at R_3 where P_2B becomes tangent to the higher community indifference

curve C_3. The large tariff imposing country A imports R_3F quantity of steel and exports BD quantity of cloth. A higher ratio of imports to exports indicates that the terms of trade become favourable for the tariff imposing country A. The production or protective effect is in the form of increased domestic production of import commodity steel owing to shift in the production equilibrium from E to B. No doubt lesser production of cloth involves misallocation of resources and reduced specialization in production, yet the country A is better off because of positive consumption and terms of trade effect. The shift of consumption equilibrium to the highest community indifference curve C_3 signifies a gain in welfare despite reduction in specialization and diversion of resources towards the production of import substitute. This is the positive consumption effect. In the case of a large tariff imposing country, since there is a fall in price of imports relative to export prices, there is an improvement in the terms of trade. This is the positive terms of trade. Hence the imposition of tariff by a large country, despite the reduction in the volume of international trade, leaves it a net beneficiary from the policy of tariff.



CHECK YOUR PROGRESS

Q 7: What is the affect of tariff imposed by a small country? (Answer in about 50 words)

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Q 8: Discuss income effect of partial tariff. (Answer in about 60 words)

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Q 9: What is general equilibrium analysis of tariff? (Answer in about 50 words)

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Q10: What is the effect of imposing tariff by a large country? (Answer in about 75 words)

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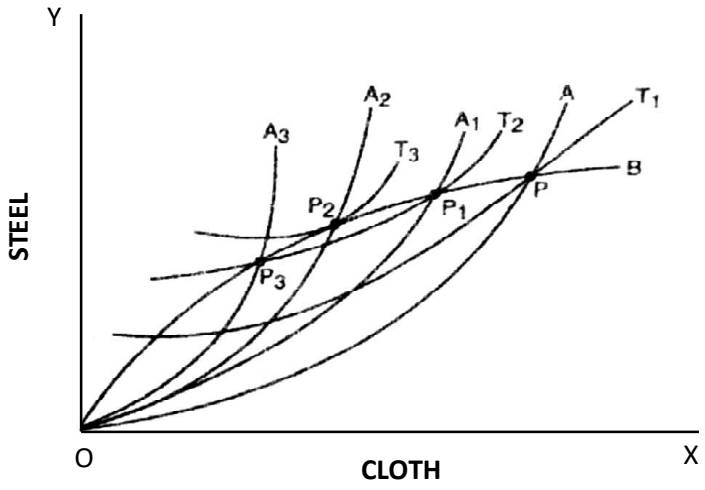
8.7 THEORY OF OPTIMUM TARIFF

According to the theory of optimum tariffs a country can go on increasing the tariffs and bring about improvements in its terms of trade and economic welfare until it reaches a point of tangent between its own highest trade indifference curve and the foreign country's or the rest of the world's offer curve. A country can maximize its level of economic welfare by optimizing rather than maximizing its terms of trade, because economic welfare will be maximized not when the terms of trade are optimized. The problem therefore is one of teaching the tariff height at a level where the country's terms of trade are optimized. This is the point of optimum tariffs, which is achieved exactly when the country reaches a point of tangency between its own trade indifference curve and the foreign country's offer curve.

It is of course true that tariff in certain situation may fail to improve the terms of trade of a given country. There is however a widespread belief that tariff can improve the terms of trade. Tariff results in gain for the tariff imposing home country in the form of improvement in the terms of trade. At the same time tariff involve cost in the form of reduction in the volume of trade. So long as the gain from tariff is more than the cost of it, the welfare of the tariff imposing country increases and it is worthwhile for it to raise tariff. In case the cost of tariffs for the society is more than the gains from tariff there may be reduction in the level of economic welfare and the worsening of terms of trade. In such a situation it is appropriate for the tariff imposing country to reduce tariff. The point of optimum tariff is reached when tariff does not further increase and net benefit to the given country and the level of economic welfare has become maximum. The point of optimum tariffs is determined where the trade indifference curve of the tariff

imposing home country becomes tangent to the offer curve of the foreign country.

Figure 8.3: Determination of Optimum Tariff Rate



In Figure 8.3, originally OA is the offer curve of home country A and OB is the offer curve of country B. T_1, T_2 and T_3 are the trade indifference curves of country A.Before the imposition of tariff, the exchange takes place at P. This point lies on the trade indifference curve T_1. As tariff is imposed the offer curve of country A shifts to OA_1 and exchange takes place at P_1. This point occurs at the higher trade indifference curve T_2. Thus tariff result in an improvement in terms of trade and welfare. If there is a further increase in tariff, country A's offer curve shifts to OA_2 and given the offer curve OB of country B, the exchange take place at P_2. The point occurs at the higher trade indifference curve T_3. P_2 is the point of tangency between the trade indifference curve T_3 and foreign country B's offer curve OB. Compared with point P_1, there is a further improvement in the terms of trade and welfare. In case country A raises the tariff still further, its offer curve shifts to the left to OA_3. Given the offer curve of country B as OB, exchange takes place now at P_3. The point shows that terms of trade improve further but this point lies on a lower trade indifference curve T_2. Although the terms of trade in this situation improve, yet there is worsening in respect of the level of welfare. In such a situation it is appropriate for the home country to reduce

tariff and move back to point P_2 where the welfare is maximum. Thus P_2 is the point of optimum tariff which corresponds with maximum welfare.

8.7.1 Optimum Tariff with Retaliation

It has been implicitly assumed that foreign country does not retaliate. But in reality the possibility of retaliation cannot be ruled out. In practice both the countries are likely to lose due to tariff. The tariff action, particularly retaliatory tariff may or may not permit the improvement in terms of trade, but one thing is definite that it will reduce sharply the volume of trade and lower the level of welfare. Hence, it is better for both the trading countries to avoid disastrous beggar-my-neighbor tariff policies. The lowering down of tariff walls can no doubt affect adversely the terms of trade but the expansion in trade volume and consequent increase in welfare will certainly be highly desirable from the point of view of both trading countries.

8.7.2 The Optimum Tariff Formula

The economists and financial administrators have remained concerned with the determining the rate of tariff that can ensure the improvement in terms of trade consistent with the maximization of welfare. They have performed to call such a rate of tariff. The economists including Robert Heller, Scammel and Kindleberger have attemptedto work out a precise formula for specifying the optimum tariff. Kindleberger has stated the formula for optimum tariff as,

$$T_0 = 1/ e\text{-}1$$

Where, T_0 denotes the optimum rate of tariff and e stands for elasticity of the offer curve of the foreign country at a specific point.

The co-efficient e or elasticity of offer curve can be measured as,

$$e = \frac{-(\%\text{ change in imports})}{(\%\text{ change in Exports}) - (\%\text{ change in imports})} - 1$$

As long as foreign country's offer curve is less than unit elastic, it is worthwhile for the home country to raise tariff and thereby improve the terms of trade and increase the level of welfare. As long as the offer curve of the foreign country is more than unit elastic, it is desirable for the home country to lower tariffs; suffer adverse terms of trade but at the same time achieve a higher level of welfare. It can now be concluded that the point of optimum tariff lies somewhere over that region of foreign country's offer curve where the co-efficient e is equal to unity.



CHECK YOUR PROGRESS

Q 11: How much tariff can be imposed as per the theory of optimum tariff? (Answer in about 50 words)

.....

.....

Q12: State whether the following statements are True (T) or False (F)Both the home country and foreign countries are likely to lose due to tariff.

Q13: Where does the point of optimum tariff lies? (Answer in about 25 words)

.....

.....



8.8 LET US SUM UP

- A tariff is a duty or tax imposed by the government of a country upon the traded commodity as it crosses the traded commodity as it crosses the national boundaries. It can be imposed upon both the exported and imported commodities.
- An import tariff is a duty on the imported commodity, while an export tariff is a duty on the exported commodity.

- Tariff can be of various types. On the basis of the criterion for imposition, the tariff can be classified as Specific tariff, Ad Valorem tariff, Compound tariff and Sliding scale tariff.On the basis of purpose tariff may be of two types i.e. Revenue tariff and Protective tariff.On the basis of discrimination, tariff may be of non discriminatory and discriminatory type.On the basis of the criterion of products exported or imported tariff is imposed.On the basis of retaliation, tariff may be retaliatory tariff and countervailing tariff.
- Revenue tariff is imposed primarily to produce revenue for the government. With the introduction and expansion of income taxes and other direct taxes the importance of tariffs as a source of revenue has considerably gone down in developed countries. But in less developed countries revenue tariff is still prevalent.
- Arguments for tariff can be mentioned on the ground of reservation and expansion of home market, keeping money in home market, protection of labour and wage rate, maintaining full employment, protecting infant industry, ensuring national security, technology.
- When a small country imposes tariff on import of the product that competes with the product of the small domestic industry, the tariffs can neither effect the international prices (as the country is small) nor can it affect the rest of the country (as the industry is small). In that case partial equilibrium analysis becomes appropriate.
- The traditional theorists believed that tariff led to an improvement in the terms of trade of the tariff imposition countries. But modern theorists believed that imposition of tariff depend upon the elasticity of demand and supply of products of the two trading countries.
- When the tariff imposing country is small, the domestic price of the imported commodity will rise by the full amount of tariff for the individual consumers and producers in that small tariff imposing country. The international price of the commodity will however remain unaffected.

- If the tariff imposing country is large, the reduced demand for imports subsequent upon the imposition of tariff may reduce the world demand for the product in such a great extent that the price of importable goods falls. In such a situation the fall in import price relative to export price causes a change in the international price ratio and brings about an improvement in the terms of trade of the tariff imposing large country.
- According to the theory of optimum tariffs a country can go on increasing the tariffs and bring about improvements in its terms of trade and economic welfare until it reaches a point of tangent between its own highest trade indifference curve and the foreign country's or the rest of the world's offer curve.
- The point of optimum tariff is reached when tariff does not further increase and net benefit to the given country and the level of economic welfare has become maximum.



8.9 FURTHER READING

1. K.C. Rana & K.N. Verma, *International Economics*, Vishal Publishing Co.
2. H.G. Mannur, *International Economics*, Vishal Publishing House Pvt Ltd
3. Dominick Salvator, *International Economics*, John Wiley & Sons, Inc.



8.10 ANSWERS TO THE CHECK YOUR PROGRESS

Ans to Q No1: A tariff is a duty or tax imposed by the government of a country upon the traded commodity as it crosses the traded commodity as it crosses the national boundaries. It can be imposed upon both the exported and imported commodities.

Ans to Q No 2: As the tariff restrictions and regulations are on the nation's trade and commerce, hence these are known as 'trade or commercial policies'.

Ans to Q No 3: The tariffs are classified on the basis of their purpose, discriminatory policies, products and retaliation.

Ans to Q No 4: Discriminatory tariff which is also known as double column tariff have varying tariff rates exist for different commodities. The products originating from favoured countries are subject to a lower tariff rate than those of other countries.

Ans to Q No 5: False

Ans to Q No 6: Tariff is necessary for a country. Tariff will help keep money at home country by providing reservation and expansion of home market. Tariff helps pauper labour of the country. It counteracts foreign law wages. It counteracts superior technology power. Tariff helps for ensuring the defense or national security of a country. Tariff ensures the national self sufficiency for the home country. Imposition of tariff ensures standard of living by protecting high wages. Full employment can be maintained if tariff is imposed by a country. Tariff is essential to protect an infant industry which in turn protects the infant country.

Ans to Q No 7: When a small country imposes tariff on import of the product that competes with the product of the small domestic industry, the tariffs can neither effect the international prices (as the country is small) nor can it affect the rest of the country (as the industry is small).

Ans to Q No 8: The imposition of tariff reduces the demand for foreign products. The amount of money not spent on imported goods may either be spend on the home products or saved. If there is the existence of surplus productive capacity in the home country this excess money will increase production, employment and income of the home country.

Ans to Q No 9: When a country imposes tariff, not only a specific product or sector but practically every sector of the economy get effected in one way or the other until the economy reaches a new equilibrium. This is discussed in general equilibrium analysis of tariff.

Ans to Q No 10: If the tariff imposing country is large, the reduced demand for imports subsequent upon the imposition of tariff may reduce the world demand for the product in such a great extent that the price of importable goods falls. In such a situation the fall in import price relative to export price causes a change in the international price ratio and brings about an improvement in the terms of trade of the tariff imposing large country.

Ans to Q No 11: According to the theory of optimum tariffs a country can go on increasing the tariffs and bring about improvements in its terms of trade and economic welfare until it reaches a point of tangent between its own highest trade indifference curve and the foreign country's or the rest of the world's offer curve.

Ans to Q No 12: True

Ans to Q No 13: The point of optimum tarifflies somewhere over that region of foreign country's offer curve where the co-efficient e is equal to unity.



8.9 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words**)**

Q 1: Discuss the productive or production effect of tariff.

Q 2: How the general equilibrium of tariff can be achieved for a large country.

Q 3: Write the formula for calculating optimum tariff.

Essay type Questions (Answer each question in about 350 – 500 words**)**

Q 1: What are the types of tariff?

Q 2: Discuss the effects of tariffs under partial equilibrium.

Q 3: How the general equilibrium tariff for a small country can be achieved?

Q 4: Explain the theory of optimum tariff.

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UNIT 9 : THEORY OF INTERVENTIONS-II (NON- TARIFF)

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Objectives of Import Quotas

9.4 Types of Import Quotas

9.5 Effects of Import Quotas

9.6 Other Non-Tariff Quota Barriers to Trade

9.7 Export Subsidy

9.8 Dumping and WTO

9.9 The Role of The WTO in Anti-Dumping

9.10 Multilateralism and WTO

9.11 Let Us Sum Up

9.12 Further Reading

9.13 Answers to Check Your Progress

9.14 Model Questions

9.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- define the concepts like import quotas, concept, types and effects of import quotas
- distinguish betweenimport quotas vs. import tariff
- discuss the quota controversies in less developed countries
- describe other non-tariff quota barriers to trade
- explain the concept dumping-multilateralism and WTO's role in it.

9.2 INTRODUCTION

In the previous unit, you have studied about the tariff barriers imposed by the countries. In this chapter you are going to study the non tariff barriers that are imposed by the countries. They are another way to restrict the

entry of a particular good or commodity in a country. One such form is import quotas.

In simple words, by quota we mean a particular quantity as stated under a set of terms.Again, import quotasare a form of restrictions that are stated by the government on the import of a particular quantity of goods within its boarder. It can be on the number of a particular goods or its monetary value. They are different from the tariff and custom. Tariffs and customs are specific fees that is imposed on the trade of a particular commodity whereas import quotas aim at restricting the quantity of goods coming within the country. Sometimes it is also imposed on the cumulative value of the commodity that a country imports or exports for a specific period.

Meaning of Import Quotas: The import quota means physical limitation of the quantities of different products to be imported from foreign countries within a specified period of time, usually one year. The import quota may be fixed either in terms of quantity or the value of the product.

For instance, the government may specify that 60,000 colour T.V. sets may be imported from Japan. Alternatively, it may specify that T.V. sets of the value of Rs. 50 crores can be imported from that country during a given year.

You must be wondering why they are being used by the government. What impact do they have on the economy. They are used for varied purpose by the government of a country. They generally help the regulation of the volume of trade. It can be used to promote the domestic industry where the government tries to reduce the competition from foreign imported goods by imposing import quotas. Usually the supplier has achieved economies of scale and as such is able to supply the product at a lesser cost in the importing country. When the competition is between the imported and domestically produced good is there consumers will definitely purchase that which is less costly of the two. When these import restriction are imposed it increases the cost of the suppliers of the products who wants to sell the product in the country. It is seen the domestic industries try to increase the production to cater to the domestic demand the industries. To

increase the production the organisations have to invest in the production capacities. Naturally the investment induces money in the economy. Moreover the increase in the production capabilities requires more workers too which in turn increases the level of employment in the country. And we see the increased circular flow of money in the economy by the boost given by the government to the domestic industries through imposing restrictions on competitor's goods coming inside the country. So you see the impact of import quotas and how it affects the whole economy. This will lead to the increase in the output by that industry growth.

Due to continuous two years of drought which affected the production of pulses in India , the government in March, 2015 allowed duty free imports of pulses . But, it was seen that in 2016-17 nearly 6.6 million tones of pulses were imported In March, 2018. Pulses traders in India staged a demonstration asking the government to stop even the restricted imports of the pulses within the country. The reason was the decreasing prices of the pulses which was going even below the minimum support price. As we are all aware of the law of supply, when supply is more prices of the commodity falls. The same was happening with the imports of pulses in the country. At the time the government of India had set an import quota of 5 million tons annually. The traders were demanding to terminate such a quota. Two straight years of drought pushed up pulse prices in 2015 and forced New Delhi to allow duty-free imports. But record imports of 6.6 million tonnes in the 2016-17 fiscal year led to a crash in local prices.As part of its efforts to curb imports, the government started fixing import quotas in 2018.Farmers in Russia, Canada, Australia and Myanmar mainly rely on Indian demand.

9.3 OBJECTIVES OF IMPORT QUOTAS

- To regulate the price level of the commodities in the country.
- To discourage consumption of luxury goods by the upper class of the society.

- To provide protection to domestic industry from competition faced by imported goods.
- To provide opportunity of growth of domestic industry to cater the domestic demand that is left unattended with the imposition by import quotas.
- To ensure that speculative imports of commodity doesn't take place.
- To reduce the balance of payment deficit faced by the country resulting from more outflow of money through imports.
- To secure the foreign exchange reserve of the country this has to be given in exchange of the imported goods.
- To improve the international bargaining position of the country by allowing larger quotas to friendly nations who give more favorable treatment to the country's goods.
- To strike back against the restrictive trade policies adopted by other countries.

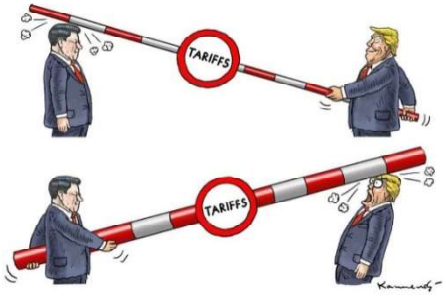
ADVANTAGES OF QUOTA:

- The impact of the quota is known with certainty by the government.
- It leads to foreign exchange reserves savings.
- It helps in developing the domestic industry.
- It ensures protection of critical domestic industries from competition.
- It enables the government to regulate the price level of the commodity in the country.
- It helps the government to correct the deficit balance of payment.
- It ensures in securing international bargaining position by the country.

DISADVANTAGES OF QUOTA

- It does not have any direct revenue benefit for the government.
- Quotas lead to loss on the part of consumers as the prices of the commodities increases.
- It results in the delinking of the domestic and international market.

9.4 TYPES OF IMPORT QUOTAS



Tariff or Custom Quota: Tariff or custom quotas are those quotas which specify a particular quantity of the commodity that can be imported within the country. For the specified quantity the rate of import duty is either fixed at a very low rate or it may be considered as duty free in the country. Beyond this quantity the tariff rates increases. Usually these tariff quotas are the result of the economic policies of the government or the result of the agreement between countries.

Table 9.1: Advantages and Disadvantages of Import Quota

Advantages	Disadvantages
● It categorizes the imports into quotas. ● Higher the quantity of imports higher will be the tariff. ● Tariff quotas do not discourage the imports but reduce the quantity of imports, thereby saving on the essential foreign currency. ● It also helps in keeping a check on the prices of domestic product as the domestic organisations can only charge up to the amount of the custom duty charged	● The gain of no or low tariffs is enjoyed by the exporting country. ● The low prices might affect the domestic industry adversely. ● It creates societal divide in the country where the affluent can enjoy the product while the lower sections of the society are not able to afford it.

Unilateral Quota: This type of quota specifies the total quantity of the product that can be imported within the country for a specified time. It is not the result ofany agreement by the government of the country but it's a decision that is taken by the government in lieu of its economic policies.It can be broadly classified into two categories (a) global quota and (b) allocated quota. In the case of global quota, the entire quantity to be imported may be

obtained from any one or more countries during the specified period. Under the allocated quota system, the total quantity of import quota is allocated or distributed among the different exporting countries on the basis of certain criteria.

Table 9.2: Advantages and Disadvantages of Unilateral Quota

Advantages	Disadvantages
● The global quota system allows the importing country to import even entire quota from anyone country. This greatly improves the bargaining position of the importing country. The exporting countries compete among themselves to capture the market of the importing country. They offer their products at lower prices and assure more favourable terms of trade compared with the rival countries.	● The advantages of this types of quota is mostly derives by the neighboring or nearby nations. ● Moreover the advantages are often taken by the advanced and most developed countries rather than the less developed ones. ● When the quota is declared by the government the importers may go for stocking of the particular product resulting in pile up which inadvertently results in the reduction of the prices of the product in the initial stages. ● It has been observed by economist that due to decrease in prices there is a rise in demand of the product in the home country but as supply cannot be increased there is rise in prices of the product. ● One major disadvantage of global quota system is it does not provide adequate protection to the home industries from foreign competition.

In view of the above defects of global unilateral quota, the countries have developed preference for the allocated quota. But even the allocated quota system is not free from drawbacks. Some important drawbacks are:

- The main drawbacks in the allocated unilateral quota are- Firstly, this system results in avoidable rigidity in the sources of supply of imports.
- Secondly, this system may not prove to be cost and quality efficient. Some quota may be allocated, for political reasons, to such countries where the cost is relatively higher and the quality of the product is somewhat inferior.
- Thirdly, as the exporting countries are assured of their share in the import quota, there is possibility of foreign firms indulging in monopoly practices. Fourthly, the system is often criticised as discriminatory and creates a sense of grievance among some of the trading partners.

Bilateral Quota: In case of the bilateral quota system, the import quota is fixed after negotiations between the importing and exporting countries. Haberler has called the bilateral quotas as agreed quotas.

Table 9.3: Advantages and Disadvantages of Bilateral Quota

Advantages	Disadvantages
● As the quotas are fixed after negotiations among the countries, there is discrimination against one or the other country. ● There is no possibility of excessive fluctuations in imports and prices. ● The exporting countries are not likely to resort to monopolistic practices. ● It is not arbitrary. Therefore, it may not provoke opposition and retaliation by the foreign countries.	● This system promotes the formation of international cartels. ● It opens the floodgate of corruption on an extensive scale. ● The exporting countries, after securing the desired quota, may raise the prices of their products to the detriment of importing countries. ● This system greatly intensifies competition. ● It is an open invitation to monopolies in the exporting countries.

Mixing Quota: Under this system, which is also known as indirect quota, the domestic producers in the quota-fixing country are required to make use of domestic raw materials along with the imported raw material in a specified proportion.

Table 9.4: Advantages and Disadvantages of Mixing Quota

Advantages	Disadvantages
● It affords protection to the producers of raw materials. ● It saves the valuable and scarce foreign exchange resources of the country. ● It induces the domestic processing of semi-finished goods and manufacturing of finished goods.	● If the domestic materials, which are required to be used in a fixed proportion along with imported materials, are of poor quality, there is a danger of deterioration in the quality of production in the quota-enforcing country. ● It causes deviation from the principle of comparative cost advantage and thus results in inefficiency and higher cost structure.

Licensing of Imports: The government of a country may prescribe any one of the systems of import quota. The most crucial aspect of any system of fixation of quota is its administration. For this purpose, the government may follow the mechanism of issuing licenses to different categories of importers on the basis of specific terms, conditions and norms.

Table 9.5: Advantages and Disadvantages of Licensing Imports

Advantages	Disadvantages
● The licensing authority can have an effective control over the volume of imports. ● The system tends to discourage the speculation in foreign exchange. ● It does not permit wide fluctuations in prices. ● It assures continuous supply of scarce products from abroad and prevents domestic shortages in a more efficient manner. ● This system has a great deal of flexibility and is easily adaptable to changing situations. ● It ensures the economical use of foreign exchange resources of the country.	● This system generally favours the established, and prevents the entry of new importers. Thus the system of licensing of imports tends to encourage the growth of monopolies in the import trade. ● This system promotes bureaucratic corruption, favouritism and nepotism. ● Another defect of the system is that it tends to create 'premium market' for licenses. Some of the unscrupulous importers transfer their licenses to the others and pocket substantial amounts of premium. This practice increases greatly the prices of imported goods and can intensify the inflationary condition within the quota enforcing country. ● The licensing tends to make the system more rigid. ● It causes concentration of economic power in the hands of small and privileged groups of established importers.

9.5 EFFECTS OF IMPORT QUOTAS

- **Effect on Price:** You need to understand that before imposing of an import quota it is but obvious that the goods were freely allowed to be imported within the country by paying a tariff. As such the domestic demand which was not met through the domestic production was fulfilled by the increase in supply through imports. Now when the restriction is put on the import of a particular

commodity the demand does not decreases but the supply is restricted as such when the supply decreases as compared to demand the prices increases. As such the imposition of import quota increases the price of a commodity.

- **Effect on Production:**Another effect of import quotas is on the production of the commodity by the domestic industry. The supply decreases due to the imposition of import quotas but the demand has not decreased. This leads to the increase in price of the commodity. As price of the commodity rises due to increase in demand,the entrepreneurs see more profit in the opportunity. This profit motive induces the entrepreneurs to produce more of the commodity and also its substitutes. Moreover, it also attracts the new entrepreneurs to enter the industry in hope of profit. The increased domestic production due to import quota is called as the protective or production effect.
- **Effect on Consumption:**What do you think will be the effect on the consumers? Being a consumer yourself what would you do if your favorite brand of chocolate becomes more costly? Definitely you would try to reduce your consumption. The same effect happens collectively to all the consumers. As such the imposition of import quotas lead to the decrease in the consumption in the country due to increased price.
- **Effect on Revenue of the Government:**Unlike tariff, the revenue effect of import quota is complex and difficult to determine. If the government follows the policy of auctioning the import licenses, the revenue accruing to the government increases significantly. Such a revenue effect is equivalent to the revenue effect in the event of equivalent tariff. But in fact the governments do not auction the import licenses in recent times.

In such an event, the revenue effect is either captured by the domestic importers or foreign exporters, or shared between the domestic importers and foreign exporters in some proportion. It is, therefore, not easy to quantify exactly what the revenue effect of import quota will be and to which group or groups will it accrue and in which proportion.

- **Redistributive Effect:**When the import quotas are imposed, two parties are effected directly the consumers and the producers. It is seen that due to the increase in prices the consumers demand decreaseswhich lead to the loss on the consumers' surplus. On the other hand, we have producers who gain from the import quotas as the business becomes more lucrative due to the increase price and the profit margin. As such we see a redistributive effect in the country. Before the imposition of quota the consumers were gaining while after the imposition of the import quota the producers gain is more.
- **Balance of Payments Effect:**What do you think will be the effect on balance of payment. When we allow imports within a country we have to pay to the exporting country as such the money flows out of the economy. If we are not exporting as much this creates a balance of payment deficit. When more money flows out of the country through way of imports and less money flows in by way of exports this creates a deficit of Balance of Payment. As such another effect of the imposition of import quota is the reduction of BOP deficit.
- **Terms of Trade Effect:**The imposition of import quota can influence the terms of trade of a country in a favourable or unfavourable way depending upon the elasticity of the offer curve or monopolistic and monopoly power of the importing and exporting countries respectively. If the offer curve of importing country is elastic or it has a monopsony power, the terms of trade will become favourable to it.

On the contrary, if the offer curve of exporting country is elastic or it has some monopolistic control on the given commodity, the terms of trade are likely to become favourable for it and unfavourable for the importing country.

It is possible that the terms of trade effect of import quota may be uncertain and indeterminate. In the words of Kindelberger, *"As in the case of bilateral monopoly—with a monopoly buyer and a monopoly seller, the outcome is theoretically indeterminate."*

Table 9.6: Import Quotas vs Import Tariff

S.No	Tariff	Quota
1	Both Tariffs and Quota leads to increase in the prices of product in the home country	
2	Both Tariffs and Quotas leads to reduction in imports and consumption in the home country.	
3	Both Tariffs and Quotas increases domestic output by promoting the domestic industries.	
4	Tariff leads to generation of government's revenue.	Quota on the other hand leads to the creation of monopolies of those exporters who hold export license.
5	Does not restricts imports	Sets a predetermined quantity that can come in the country.
6	Maintains links between domestic and international prices.	Here in Quota the link is removed.



CHECK YOUR PROGRESS

Q 1: An activity that is being done to restrict numbers or monetary values of goods imported and exported during a specific time-period is known as

(a) tariff

(b) taxes

(c) quota

(d) embargo

Q 2: A tariff that is levied as a fixed charge per units of imports is known as

(a) specific tariff

(b) ad valorem tariff

(c) import tariff

(d) export tariff

Q 3: Which of the following is not a non-tariff barrier?

(a) A quota on apparel.

(b) A tax equal to 12% of value on imported oil.

(c) A voluntary export restraint on cars.

(d) A regulation requiring government agencies to favor domestically producers.

(e) The threat to levy a tariff on imports that are sold at an unfairly low price.

Q 4: When the United States imposed a VER on cars from Japan

(a) Japanese firms were the recipients of the rents from the quantitative restriction.

(b) Japanese car companies responded by lowering the U.S. prices of their cars.

(c) Japanese car companies responded by lowering the quality of the cars they sold in the U.S.

(d) It was implemented by the U.S. levying a 25% tariff on cars from Japan.

(e) The effect was to restrict U.S. imports from all foreign countries.

Q 5: The main difference between a tariff and a quota is a.

(a) quota reduces the quantity of imports more than a tariff.

(b) A tariff raises the price of imports more than a quota.

(c) A quota does not harm domestic consumers.

(d) A tariff does not harm foreign producers.

(e) A tariff generates government revenue, while a quota, unless it is sold, does not.

Q 6: Import quotas are most commonly administered

(a) By permitting all imports until the quota is filled for the year, then none after that.

(b) By taxing imports.

(c) By auctioning import licenses to the highest bidder.

(d) By granting import rights to domestic firms.

(e) By granting import rights to foreign firms or governments.

Q 7: What happens if a quota has been keeping the domestic price above the world price, but then the world price rises above what has been the domestic price?

(a) The country begins to export the good.

(b) The tariff-equivalent of the quota becomes negative.

(c) The government must subsidize imports to keep them from falling below the quota.

(d) The domestic price rises above the world price, to keep the tariff-equivalent of the quota constant.

(e) Quota rents become zero.

Q 8: Which of the following is not a non-tariff barrier?

(a) A quota on apparel.

(b) A tax equal to 12% of value on imported oil.

(c) A voluntary export restraint on cars.

(d) A regulation requiring government agencies to favor domestically producers.

(e) The threat to levy a tariff on imports that are sold at an unfairly low price.

Q 9: Which two of the following are the most likely effects of the imposition of a tariff on an imported good?

(a) The domestic price of the imported good will fall

(b) Overseas production of the good may be stimulated

(c) Overseas employment will rise

(d) The domestic price of the imported good will rise

(e) Gain of tax revenue by the government

Q 10: Which two of the following are arguments used by critics of free trade?

(1) Free trade does not take into consideration productivity differences between countries

(2) Free trade may lead to unemployment

(3) Free trade often ignores the effects of monopoly elements on consumer welfare.

(4) Free trade can only work within trading block.

(5) Free trade reduces international specialization.

(a) (1) and (3)

(b) (2) and (5)

(c) (2) and (4)

(d) (2) and (3)

(e) (3) and (5)

Q 11: Which two of the following are regarded as the main aims of the World Trade Organisation (WTO)?

(1) To eliminate discrimination in world trade

(2) To provide financial assistance to countries with debt

(3) To reduce tariff barriers

(4) To make 'infant industry' protection illegal

(5) To help give preferences to smaller economies

(a) (1) and (3)

(b) (2) and (5)

(c) (3) and (4)

(d) (4) and (5)

(e) (2) and (4)

Q 12: A situation where countries export a product at a price below the cost of its production.

(a) New protectionism

(b) Dumping

(c) Price skimming

(d) Price discrimination

(e) Full cost pricing

Q 13: Anti-dumping cases initiated by the WTO have increased significantly since the mid-1990s.

(a) True

(b) False

Q 14: Trade creation describes the situation where the removal of tariff barriers between members of the trading bloc now enables various products to be purchased at lower prices, thereby stimulating intra-regional trade.

(a) True

(b) False

Q 15: The imposition of a tariff will only create a net welfare gain if the demand for the imported product is elastic.

(a) True

(b) False

Q 16: The average tariff rate on goods in the industrialised world is less than 5%.

(a) True

(b) False

Q 17: Measures designed to protect the manufacturing sector are much more widespread than similar measures to protect the service sector.

(a) True

(b) False

9.6 OTHER NON-TARIFF QUOTA BARRIERS TO TRADE

- **Quantity Restrictions, Quotas and Licensing Procedures:**Under this system, the maximum quantity of different commodities which would be allowed to be imported over a period of time from various countries is fixed in advance.The quantity allowed to be imported or quota fixed normally depends upon the relations of the two countries and the need of the importing country.Quotas are very often combined with Licensing System to regulate the flow of imports over the quota period as also to allocate them between various importers and supplying countries. In this system a license or a permit has to be obtained from the Government to import the goods mentioning the quantity and the country from which to import.

- **Foreign Exchange Restrictions:**Under this type of non tariff barrier it is the responsibility of the importer to ensure that adequate foreign exchange to import the goods. This has to be done by getting a clearance from the exchange control authority of the country. Then only he can proceed to finalize the contract with the supplier of goods.
- **Technical and Administrative Regulations:**Another type of Non tariff barriers is the imposition of technical and administrative regulations on the import of certain goods. Technical restrictions are the set standards which have to be confirmed by the goods which can be allowed in the country. Whereas Administrative restrictions related to the adherence to the laid procedure by the country.
- **Consular Formalities:**Large number of countries demands that shipping documents must accompany the consular documents such as:(a) Certificate of origin,(b) Certified invoices, (c) import certificates etc.

  Sometimes, it is also insisted that such documents should be drawn in the language of importing countries. In case the documentation is faculty and is not drawn in the language of the importing country heavy penalties are imposed. Fees charged for such documentation are quite heavy.
- **State Trading:**In socialistic countries import and export transactions are handled by certain State Agencies. These agencies carry international trade strictly according to Government Policies. In India some articles decided by the government is imported only through the State Trading Corporation (STC). Export of raw materials such as iron ore, mica are handled by MMTC (Minerals and Metals Trading Corporation).
- **Preferential Arrangement:**These are agreements between agreeing countries to give preferential treatment to the member countries by setting a lower tariff rate, which usually would have been higher for other non member countries.

9.7 EXPORT- SUBSIDY

Subsidy: You might have usually come across the word subsidy. You must have heard about the gas subsidy being reduced by the government making it more costly for the consumers or about the subsidy on pesticides and fertilizers for the farmers to reduce their cost of production. In both the cases it is an incentive given by the government either to the consumers of a product or the producers of the product to facilitate the supply of particular goods and services.

Table 9.7: Different Types of Subsidies:

Production Subsidy	Consumption Subsidy	Export Subsidy
When government of a country provides subsidies in order to promote the production of a particular product like the solar panels, less electricity using bulbs etc. It is called as production subsidy. The benefit is received by the producers.	This type of subsidy is provided to the consumers of a particular commodity. Like the government ration shop which provide subsidized food products.	It is a subsidy given to the exporters to promote the export of certain products. The government on the other hand, earns valuable foreign currency through exports

Table 9.8: Advantages and Disadvantages of Subsidies

Advantages	Disadvantages
● Subsidies are helpful in lowering of the prices; so, the goods are affordable to the public. ● It also helps in controlling of inflation. ● Subsidies help in sustaining those industries which require support and are essential for the long term well being of the country. ● They help in ensuring greater supply of goods.	● Shortage of supply may arise due to increased demand which industries might be unable to fulfill. ● Success of the subsidies might be difficult to measure due to the cost incurred by the government and the overall impact on the industry. ● The cost born by the government has to be paid by the revenue received from taxes as such the burden is born by the citizens of the country.

Export subsidy: Export subsidy is the term used to denote the subsidies given by the government to promote exports. It can be through direct payments or by providing easy loans o the producers and exporters, tax relief to the exporters or international advertising by the government. As a result of these facilities the overall cost of the product exported is reduced and hence the foreign importer has to pay less than the domestic consumers. Sometimes the government also promotes export subsidy when there is more production of a commodity in the country.



LET US KNOW

At the WTO's Tenth Ministerial Conference, which was held in Nairobi, Kenya from 15 to 19 December 2015, the WTO member states agreed to eliminate export subsidies for agricultural products; least-developed nations had until the end of 2018 to eliminate agricultural export subsidies (until 1 January 2017 in relation to cotton exports), while developed nations agreed to eliminate most such subsidies immediately.



CHECK YOUR PROGRESS

Q 18: An export subsidy should have the opposite effect of?

(a) A government budget deficit

(b) Capital flight

(c) An increase in Private saving

(d) A tariff

Q 19: True or false

(a) _____GovernmentSubsidy can be an effective non-tariff barrier to reduce the volume of imports by encouraging domestic production. (T/F)

(b) _____Unlike a tariff, a subsidy does not generate tax revenues directly. (T/F)

(c) _____Increased spending on subsidies may cause a growing budget deficit. (T/F)

9.8 DUMPING AND WTO

The term dumping is used to denote practice adopted by the exporters or business organisations whereby they lower the price of the exported product. This price is lower than the price offered in the home country and sometimes it can be lower than the cost of production too. To compensate the lower prices offered in the host country the exporter chargers a higher price to the domestic consumers. All this is done to gain the international market share and with a strategic motive to have a dominant long term profits. Initially when the prices of the imported goods are lower than the domestic goods the consumers will demand the cheaper ones. Slowly when the domestic organisations won't find demand for their product they will slowly move out of the business. This in turn will destroy the domestic industry and once the domestic competition is destroyed, the exporter will have a monopoly and will charge a higher price. At times the exporter is backed by the government of the country by providing subsidies, duty backs and cash incentives. Under the rules are WTO is termed as legal unless the dumping prices affects the producers of the country. If the injurious effect can be established than it is considered as illegal and anti dumping duty is imposed on the exporter. It is equal to the price difference between the exporters home market and the host market.

Example: In November 2017, the Trump Administration imposed an 18 percent tariff on Canada's $5.9 billion of softwood lumber exports. It said some provinces allowed loggers to cut down trees on government-owned land at reduced rates. The U.S. Commerce Department said the dumping injured the American lumber industry. The action sent lumber prices to a 23-yearhigh.Trump first announced the tariff in April, 2017. The threat was enough to reduce imports of Canadian softwood lumber. The tariff was retroactive for 90 days. Many companies hesitated to purchase lumber that could face a 20% surcharge.Canadian loggers say there is no unfair subsidy. They pay the government for the logs and plant trees to replace the ones taken. In April, 2019, the World Trade Organization observed that the United States violated international trade rules in the way it calculated the tariff.

Table 9.9: Advantages and Disadvantages of Dumping

Advantages	Disadvantages
● Dumping helps in capturing the international market by the home country. ● It helps in jobs creation in the home country. ● It helps in becoming global industry leader by curbing the competition. ● There is also temporary advantage to the consumers of the host country as they get the product at lower price.	● It puts the home country's consumers at a loss. ● It is a cost that is incurred by the government of the country which has to be paid in the form of subsidies from the citizens money collected through taxes. ● It might take years to crush the domestic industries. ● It may lead to trade wars between the countries. ● The host country might be censored by the international organisation like UN and WTO.



CHECK YOUR PROGRESS

Q 20: International dumping may involve?

(a) selling goods to foreigners at a price below that charged domestic consumers

(b) selling goods to foreigners at a price below the cost of production

(c) antidumping duties being levied on the imported, dumped goods

(d) All of the above

Q 21: The form of dumping that represents the greatest potential net welfare loss the for importing national is?

(a) predatory dumping

(b) sporadic dumping

(c) persistent dumping

(d) yearend dumping

Q 22: Which company in the United States would likely be most concerned about Brazil's dumping of steel in the U.S market?

(a) General Motors, the manufacturer of automobiles

(b) Tennessee Mining Co. an iron-ore mining company

(c) Caterpillar Corp the producer of earth moving equipment

(d) Sneva Construction Co. The builder of skyscrapers

Q 23: Similar to import tariffs import quotas tend to result in?

(a) higher prices and reduced imports

(b) increased government revenue

(c) increased consumer surplus

(d) decrease producer surplus

9.9 THE ROLE OF THE WTO IN ANTI-DUMPING

Most countries are members of the WTO. Member countries adhere to the principles laid down during negotiations of the General Agreement on Tariffs and Trade. That was a multilateral trade agreement that preceded the WTO. Countries agreed that they won't dump and that they won't enforce tariffs on any one industry or country. To install an anti-dumping duty, WTO members must prove that dumping has occurred.

The WTO is specific in its definition of dumping. First, a country must prove that dumping harmed its local industry.

It must also show that the price of the dumped import is much lower than the exporter's domestic price. The WTO asks for three calculations of this price:

- The price in the exporter's domestic market.
- The price charged by the exporter in another country.
- A calculation based on the exporter's production costs, other expenses, and reasonable profit margins.

The disputing country must also be able to demonstrate what the normal price should be. When all these have been put in place, then the disputing country can institute anti-dumping tariffs without violating the GATT multilateral trade agreement.

For example, the Canadian lumber dispute has been ongoing since 1982. In 2004, the WTO ruled that the United States failed to prove Canadian lumber imports harmed the U.S. lumber industry.

9.10 MULTILATERISIM AND WTO

Since its establishment in 1995, the World Trade Organization (WTO) has embodied the multilateral trading system. Despite successes in some areas, including the effective settlement of numerous trade disputes and the conclusion of new multilateral trade agreements, the WTO currently faces serious challenges to its legitimacy and its effective functioning. Of particular concern is the US blockage of new appointments to the WTO's Appellate Body (AB), which fulfils a key role in the WTO dispute settlement system. This impasse could soon paralyse the practical enforcement of multilateral trade rules, which would undermine the rules-based system. In addition, certain countries' contentious trade practices cannot be addressed under existing WTO rules, and rules on transparency are not fully complied with. The WTO has also had limited success in adding new issues to its trade agenda, and the 2001 Doha round was inconclusive. This has led many countries to pursue their own trade agreements outside the WTO's multilateral framework. The EU is a key supporter of the multilateral trading system and seeks to address the challenges that the WTO faces. In September 2018, the Commission published a concept paper on WTO reform, in particular in the areas of rule-making, regular work and transparency, and dispute settlement. Other countries have also been working on WTO reform, sometimes together with the EU. A meeting of 13 WTO members, including the EU, to discuss reform proposals was due to take place in Canada on 24 and 25 October 2018. The European Parliament strongly supports the multilateral trading system and has expressed its support for efforts to reform the WTO. Parliament's International Trade Committee is currently drafting an own-initiative report on the matter.



9.11 LET US SUM UP

- Non-tariff barriers can be more restrictive for trade than actual tariffs. During the second half of the 20th century, multilateral trade rounds dramatically reduced tariffs.
- Non-tariff barriers refer to any measures, other than customs tariffs, that regulate imports or exports into a country Industrialized countries use non-tariff barriers to protect local industries against foreign competition.
- Common examples of non-tariff barriers include licenses, quotas, embargoes, foreign exchange restrictions, and import deposits.
- Non-tariff barriers are trade barriers that restrict the import or export of goods through means other than tariffs.
- The World Trade Organization (WTO) identifies various non-tariff barriers to trade, including import licensing, pre-shipment inspections, rules of origin, custom delayers, and other mechanisms that prevent or restrict trade.
- A 2009 study of the trade policies of 91 countries found that non-tariff barriers were equivalent to a 12% tariff barrier across the sample.
- The UN Conference on Trade and Development found non-tariff barriers contribute more than twice as much as tariffs to overall market access trade restrictiveness.
- Some non-tariff measures are not actually barriers; instead they can increase the volume of trade. For instance, a country might require that all food items have to be labelled in a certain way.
- While this might introduce an administrative burden (and a cost) on imported goods, it might also give consumers more confidence to buyif they can see that foreign products conform to local standards.



9.12 FURTHER READING

(1) Cherunilam Francis: International Economics (4th Edition) 2006 Tata McGraw-Hill Companies

(2) Krugman Paul and Maurice Obstfeld: International Economics: Theory and policy, latest edition, Pearson Education

(3) Rana, K. C. &Verma, K. N. (2009). International Economics. New Delhi: Vishal Publishing Co.

(4) Salvatore, Dominick: International Economics, John Wiley

(5) Sodersten B O & Reed Geoffrey: International Economics, 2003 McMillan Press Ltd.



9.13 ANSWERS TO CHECK YOUR PROGRESS

1 (c)	**2 (b)**	**3 (b)**	**4 (a)**	**5 (e)**
6 (e)	**7 (e)**	**8 (b)**	**9 (d & e)**	**10 (d)**
11 (a)	**12 (b)**	**13 (a)**	**14 (a)**	**15 (b)**
16 (a)	**17 (b)**	**18 (d)**		



9.14 MODEL QUESTIONS

Q 1: What is the World Trade Organization (WTO)? How does it help foster multilateral trade?

Q 2: Explain the role of the WTO in facilitating global trade relations among nations. Is the WTO successful in this role?

Q 3: State true or false and justify your answer: Although the Uruguay Round of multilateral trade negotiations succeeded in reducing nontariff trade barriers, it could not achieve reductions in tariff trade barriers.

Q 4: The Anti-Dumping Agreement of the World Trade Organization (WTO), commonly known as the AD Agreement, governs the application of anti-dumping measures by WTO member countries.Who benefits from this Agreement? How can this Agreement help a company?

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UNIT 10: THEORY OF CUSTOMS UNION

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Types of Economic Integration

10.4 The Theory of Customs Union: Trade Creation and Trade Diversion

- 10.4.1 Trade Creation
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10.6 European Economic Community

- 10.6.1 Objectives of EEC
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10.7 South Asian Association for Regional Cooperation

- 10.7.1 Objectives of SAARC
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- 10.7.3 Trade and Economic Cooperation among SAARC Countries
- 10.7.4 Assessment of SAARC

10.8 Let Us Sum Up

10.9 Further Reading

10.10 Answers to Check Your Progress

10.11 Model Questions

10.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- put forward the meanings of economic integration and its types
- explain the meaning oftrade creation and trade diversion
- elaborate the static effects of trade creation and trade diversion
- examine the dynamic trade creation and trade diversion.

10.2 INTRODUCTION

Largely because it is easier to obtain agreement among a small number of countries with common economic interests and political ties, the movement for attaining economic integration by formation of regional blocs has achieved considerable momentum in recent decades. The second best theoretical analysis that has led to the treatment of the issue of the effects of preferential tariff cuts.Tinbergen defines international economic integration as *"the creation of most desirable structure of international economy, removing artificial hindrances to the optimum operation and introducing deliberately all desirable elements of coordination or unification."* This is a vague, as well as an exhaustive definition. It is vague, because, it refers to 'the creation of most desirable structure' and does not specify the nature of structure for international economic integration. It is very exhaustive because it relates economic integration to the 'International economy' and not to group of countries. According to *Salvatore*, *"economic integration refers to commercial policy of discriminatively reducing or eliminating trade barriers only among the nations joining together."* International economic integration, therefore, refers to a decision or process whereby two or more countries combine into a larger economic region by removing discontinuities and discriminations existing along national frontiers, and by establishing certain elements of co-operation and co-ordinations between them.

10.3 TYPES OF ECONOMIC INTEGRATION

The degree of economic integration ranges from preferential trade arrangements to free trade areas, customs unions, common markets, and economic unions.

- **Preferential Trading System:** It was the earliest form of economic integration among 48 Commonwealth countries of the British Empire established in 1932. It aimed at giving preferential treatment to the member nations by reducing tariffs on imports from each other but retaining higher tariffs on imports from outside the Commonwealth Preference System. This was a loose form of economic integration which ended after the formation of GATT Rules.
- **Free Trade Area:** The free trade area is a loose form of economic integration wherein the member countries remove tariffs and other trade barriers among themselves, but each member retains its own tariff, trade restrictions and commercial policies with non-member countries. But measures are taken to prevent imports from outside the area via the country with the lowest external tariff. In a free trade area, the member countries need not have common frontier with each other. The economic integration is simply based on infra-area trade. The European Free trade Association (EFTA) and the Latin American Free Trade Area (LAFTA) which was superseded in 1980 by the Latin American Integration Association (LAIA) are examples of free trade area of regional economic integration.
- **Customs Union:** In a customs union, the participating countries adopt a common external tariff and commercial policy on imports from the outside world and abolish all tariffs and trade barriers among themselves. Thus in a custom union, all members act as a unit in their trade relations with non-member countries. The European Community (EC) is a customs union. The free trade area and custom union are similar in that there is tariff-free movement of goods among the members. But they differ in that while a free trade area permits each member to retain its own tariff against non-members, the customs union adopts a common external tariff against them.
- **Common Market:** The common market is a unified single market area among nations in which there is free movement of goods, services and factors of production. In a common market, product and factor market are integrated. In fact, the common market carries

further the principle of customs union by allowing free movements of labour and capital along with goods among member countries. The EC is also a common market.

- **Economic Union:** The Economic Union is the highest form of economic integration among nations. Besides the integration of product and factor markets as in the common market, it involves harmonisation of monetary, fiscal and other policies such as exchange rate, transportation, industrial, social policies, etc. Thus there is significant degree of co-ordination among the members of an economic union in the adoption of a common external tariff and domestic economic policies. The EC aims at the ultimate formation of such an economic union.



CHECK YOUR PROGRESS

Q 1: What is meant by International Economic Integration? (Answer in about 30words)

.....

.....

Q 2: Differentiate between Free Trade Area and Custom Union? (Answer inabout 40 words).

.....

.....

10.4 THE THEORY OF CUSTOMS UNION: TRADE CREATION AND TRADE DIVERSION

The pioneering study of the theory of customs unions was made by Jacob Viner. In the beginning, customs unions had been viewed favorably. The reasoning was as follows: free trade maximizes welfare; customs unions are a move toward free trade; therefore, they will increase welfare even though they might not maximize it. Viner showed this conclusion to be incorrect. He introduced, instead, the key concepts of trade creation and trade diversion.

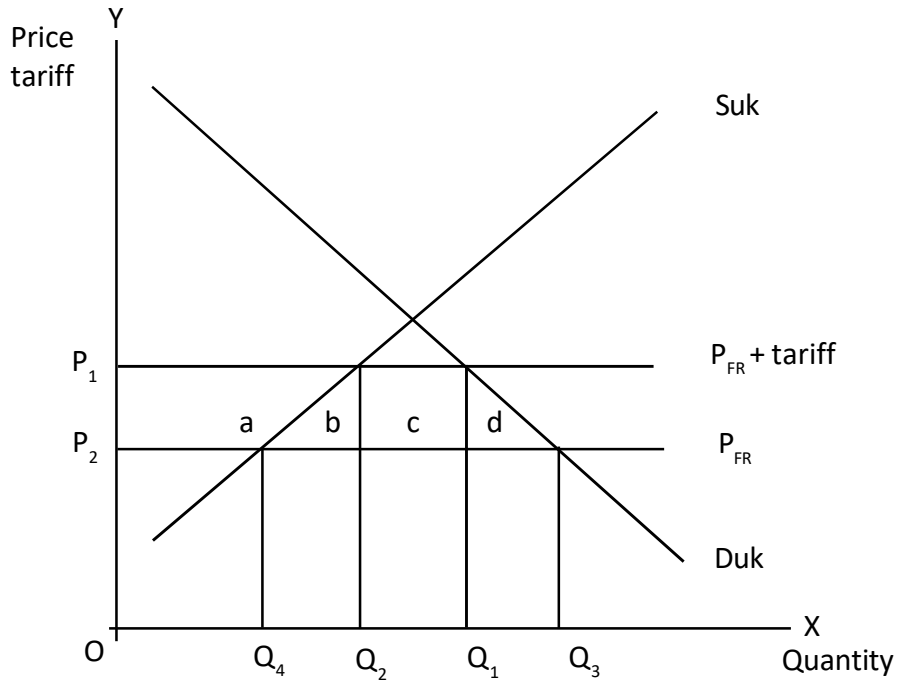
10.4.1 Trade Creation

Trade creation occurs when some domestic production in a nation that is a member of the customs union is replaced by lower-cost imports from another member nation. Assuming that all economic resources are fully employed before and after formation of the customs union, this increases the welfare of member nations because it leads to greater specialization in production based on comparative advantage. A trade-creating customs union also increases the welfare of non-members because some of the increase in its real income (due to its greater specialization in production) spills over into increased imports from the rest of the world.

The trade creation effect of a customs union is illustrated in Figure 10.1. The figure is based on the assumption that France is the most efficient producer of wine. After joining the EC it is now possible to import wine from France without paying the tariff. This will lead to an efficiency gain to UK consumers. Before joining the EC the UK had to pay the French price plus the tariff, P_1. At P1 the UK produced Q_2, consumed Q_1, and therefore imported $Q_1 - Q_2$. With the removal of the tariff the price falls to P_2. Consumption increases to Q3 and domestic production falls to Q_4. Imports have therefore increased to Q_3 - Q_4. Trade has been created.

The gain in welfare from the removal of the tariff can also be demonstrated in the diagram above. There has been an increase in consumer surplus of areas a + b + c + d. On the other hand, there has been a reduction in the producer surplus of UK wine producers of area a and a loss in government tariff revenues of area c. This means there will always be a net gain of b + d when trade creation occurs as a result of a country joining a trading bloc.

Figure 10.1: Trade Creation



10.4.2 Trade Diversion

Trade diversion occurs when lower-cost imports from outside the customs union are replaced by higher cost imports from a union member. This results because of the preferential tradetreatment given to member nations. Trade diversion, by itself, reduces welfare because it shifts production from more efficient producers outside the customs union to less efficient producers inside the union. Thus, trade diversion worsens the international allocation of resources and shifts production away from comparative advantage. A trade-diverting customs union results in both trade creation and trade diversion, and, therefore, can increase or reduce the welfare of union members, depending on the relative strength of these two opposing forces. The welfare of non-members can be expected to decline because their economic resources can only be utilized less efficiently than before trade was diverted away from them. Thus, while a trade-creating customs union leads only to trade

creation and unequivocally increases the welfare of members and non-members, a trade-diverting customs union leads to both trade creation and trade diversion, and can increase or reduce the welfare of members (and will reduce the welfare of the rest of the world).

Assume the most efficient producer of lamb in the world is New Zealand – a country outside of the EC. Also assume that before membership the UK had an identical tariff on lamb from any country, it would therefore import lamb from New Zealand rather than the EC. After joining the EC the removal of the tariff made the EC lamb cheaper as the tariff remains on the New Zealand lamb. Consumption is therefore switched to the higher cost EC lamb. This will lead to a reduction in worldwide efficiency. As far as the UK is concerned there will be gains and losses in welfare.

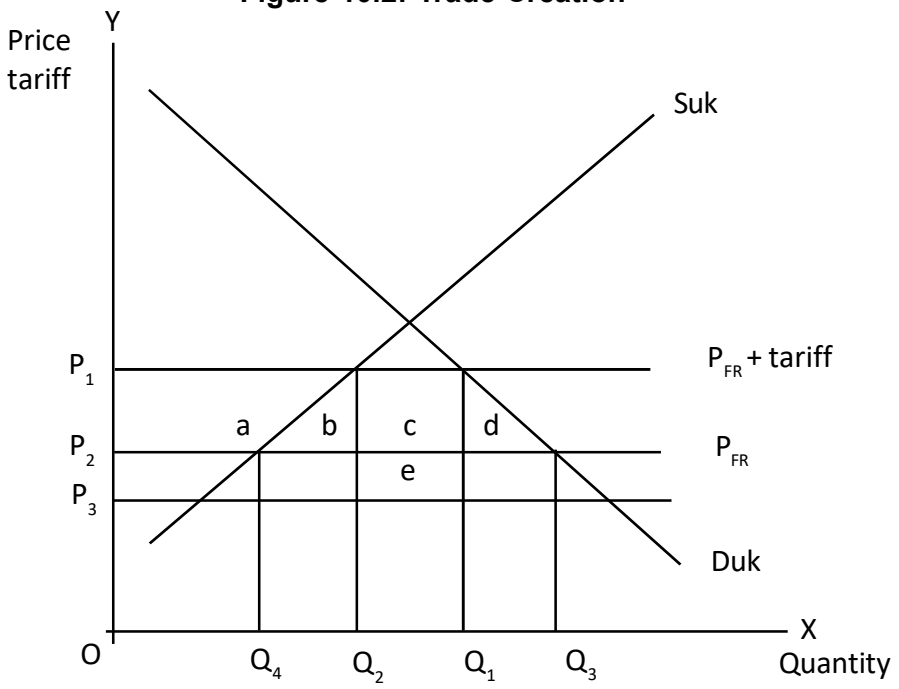
In the Figure 10.2, before joining the EC the UK was importing lamb from New Zealand at price P_1 (the New Zealand price the tariff). At this price the UK consumed Q_1, produced Q_2 domestically and therefore imported the remainder $Q_1 – Q_2$. On joining the EC, it is now possible to consume the EC tariff free price of P_2 (this is above the New Zealand tariff free price of P_3). It is possible to state the gains and losses in welfare:

There has been an increase in consumer surplus of areas a + b + c + d.

There has been a reduction in the producer surplus of UK lamb producers of area a.

There will be a loss of government tariff revenue of c + e.

Figure 10.2: Trade Creation



10.4.3 Net Welfare Effect

The above analysis shows that trade creation leads to a welfare gain and trade diversion to a welfare loss inUK as a result of the formation of custom union. The net welfare effect is the difference between the welfare gains and the welfare loss. This is measured on the diagram as the difference between the sum of the two triangles (b + d) and the rectangle (e).

- If (b + d) = e, there is neither net gain nor net less in UK's welfare.
- If (b + d)>e, its net welfare increases.
- If (b + d)< e, there is a net loss in its welfare.

Thus, in terms of the net welfare effect if the trade creation effect predominates, the customs union is made better off or if the trade diversion effect predominates it is made worse off. It the two effects happen to be equal, the gains and losses are equally distributed between the members of the union. Consequently, the net welfare effect of the customs union depends on which of these two effects is stronger.



CHECK YOUR PROGRESS

Q 3: What is meant by trade creation and trade diversion? (Answerin about 40 words)

.....

.....

Q 4: State the net welfare effects of acustom union on the domestic economy. (Answer in about 40 words).

.....

.....

10.5 EFFECTS OF CUSTOMS UNIONS

The effects of customs unions can be classified broadly into two categories, viz., Static Effects and Dynamic Effects.

10.5.1 Static Effects

The trade creation and trade diversion effects of a customs union discussed above are static in nature which lead to gain and loss in welfare. Hence, the static effects of customs unions are following:

- **Effect on Welfare:** The formation of a customs union will change the amount and pattern of production, consumption, and trade. It will also alter the distribution of income among nations and among individuals within each nation. If a union leads to a more efficient use of resources so that given inputs lead to greater output, it is customary to gloss over the distributional effects, and to conclude that welfare is increased. Generally, the formation of a union will cause some shifts to less efficient and other shifts to more efficient production. A comparison of the efficiency gains and losses is necessary to determine the net effect. The discriminatory reduction in tariffs affects consumption by making goods from member countries cheaper relative to domestic goods and to imports from countries outside the union. As a result, a member country will

tend to substitute imports from other union members for both domestic goods, and imports from non-members. Some of the shifts in consumption will increase welfare by increasing the efficiency of exchange (consumption), while others will reduce it, so the net effect again depends upon comparison of the increases and decreases.

- **Effect on Production:** The formation of a customs union may affect the efficiency of production in several ways. It may increase efficiency because of a better allocation of production, that is, a better division of labour among countries in accordance with the principle of comparative cost. It may increase efficiency because of internal and external economies of scale, intensified competition, and lessened uncertainty. According to Viner's analysis of production effects, if the union shifts production from a higher cost source to a lower cost source, it creates trade and this constitutes a movement towards free trade. On the other hand, if production is shifted in the reverse direction from lower cost to higher cost sources, this constitutes trade diversion, and is a movement away from free trade. Given that such shifts may take place, the efficiency with which resources are utilized will be altered, and the overall effect may be to increase or decrease productive efficiency.
- **Effect on Consumption:** The effect of the formation of a customs union will be clear from Table 10.1.

Table 10.1: Effects of Formation of Customs Union on Consumption

Country	Production Cost
UK	100
New Zealand	80
France	90

It can be seen that, in the numerical example given above, the price of the product fell in UK after the formation of the union between UK and France (from 100 dollars to 90 dollars. Accordingly, one would expect that the consumption of the product in UK would increase, assuming that the demand curve possesses some elasticity. Even in the second case where trade diversion occurred, imports into UK rose and providing that the member-country from whom the imports are obtained has a lower production cost than the importing member, some gain will accrue to UK. However, as Lipsey shows, Viner implicitly assumed that goods were consumed in some fixed proportion, which was invariant with respect to relative prices. But once we abandon this assumption and allow relative price changes to alter consumption patterns, then obviously economic welfare will be affected, just as economic welfare is affected by changes in production patterns.

10.5.2 Dynamic Effects

Besides the static welfare effects, the nations forming a customs union are likely to receive several important dynamic benefits. In fact, Scitovsky, Balassa and Corden have given more importance to the dynamic effects of forming a customs union than to the static effects.

- **Increased Competition:** The most significant dynamic effect of customs union is the increase in intensity of competition within the union. Earlier in the sheltered markets, the monopolistic and oligopolistic industries had become sluggish and complacent. After the formation of customs union, as they are exposed to competition from rival firms within the union, they have to operate in the most efficient way or face the risk of elimination.
- **Economies of Scale:** When a customs union is formed, expansion in the size of market, increased competition, increased specialization and consequent enlargement of plant

size lead to the emergence of internal and external economies of scale. This is evident from the experience of the countries of European Community (EC). The formation of EC resulted in economies of scale due to reduction in the range of differentiated products, increase in production run, pooling of skilled labour, capital resources, research and management.

- **Stimulus to Investment:** The expansion of market and more intensified competition stimulates investment activity. The need for introducing new techniques and accelerated depreciation of the existing plants and equipment step up greatly the rate of investment. In addition, there is also strong stimulus to foreign investment. Many non-member countries set up their plants in the territory of union members so that their products can evade the tariff barriers.
- **Movement of Productive Factors:** After the formation of customs union, or more particularly, the common market, there is free movement of labour, capital and enterprise within the entire region of the common market. This ensures the optimal utilization of resources, increase in factor productivity and consequent rise in the growth rate of the economies of all the countries in the union.
- **Technological Advance:** As a customs union is formed, expansion in the size of market, greater competition, need for increasing the scale of production and achieving higher factor productivity, make the firms and industries develop very strong urge to imitate, to innovate and to make commercial application of technical, scientific and managerial innovations. The intense technological developments tend to push up the rate of economic growth as well.
- **Improvements in the Terms of Trade:** The formation of the customs union results in raising of external tariffs against the outside world and consequent reduction in imports from abroad. This tends to raise the bargaining power of the union members

against the rest-of-the-world. The improvement in the terms of trade brings about also an improvement in the balance of payments position of the member countries.

- **Reduction of Risk and Uncertainty:** The foreign transactions often involve high degree of risk. The complexity of trade regulations, unilateral changes by countries in the tariff and non-tariff trade restraints and foreign exchange regulations create much uncertainty. The economic integration reduces to a significant extent, risk and uncertainty particularly in respect of the inter-member transactions.

10.6 EUROPEAN ECONOMIC COMMUNITY

European Economic Community (EEC), organization established (1958) by a treaty signed in 1957 by Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany (now Germany); it was known informally as the Common Market. The EEC was the most significant of the three treaty organizations that were consolidated in 1967 to form the European Community (EC; known since the ratification [1993] of the Maastricht treaty as the European Union).

In 1958, Britain proposed that the Common Market be expanded into a transatlantic free-trade area. After the proposal was vetoed by France, Britain engineered the formation (1960) of the European Free Trade Association (EFTA) and was joined by other European nations that did not belong to the Common Market. Beginning in 1973, EFTA and the EEC negotiated a series of agreements that would insure uniformity between the two organizations in many areas of economic policy, and by 1995, all but four of EFTA's members had transferred their memberships from EFTA to the European Union. One of the first important accomplishments of the EEC was the establishment (1962) of common price levels for agricultural products. In 1968, internal tariffs (tariffs on trade between member nations) were eliminated and a common external tariff was fixed.

The list of members in the EEC are as follows:

Table 10.2: List of EU Countries

Austria	Italy
Belgium	Latvia
Bulgaria	Lithuania
Croatia	Luxembourg
Cyprus	Malta
Czechia	Netherlands
Denmark	Poland
Estonia	Portugal
Finland	Romania
France	Slovakia
Germany	Slovenia
Greece	Spain
Hungary	Sweden
Ireland	

10.6.1 Objectives of EEC

Generally, the objectives of the EEC may be listed as follows:

- The abolition of tariff and non-tariff quantitative and other restrictions with regard to the import and export of goods between the member States.
- The abolition of all restrictions upon services and capital between the member states and the free movement of persons.
- The establishment of common customs tariff and of a common commercial policy towards the non-member countries.
- The establishment of common farm policy and common transport policy.
- The establishment of a system to ensure that competition shall not be distorted in the common farm policy and common market.
- Application and coordination of economic policies of the member states for remedying their balance of payment disequilibria.

- The creation of European social fund for improving the possibilities of employment for the workers and for ensuring a rise in their standard of living.
- The approximation of the legislation of the member states to the extent necessary for the efficient functioning of the common market.

10.6.2 Organizational Structure of EEC

The organizational structure of EEC is made up of

- The executive commission,
- The council of ministers,
- The European parliament,
- The court of justice,
- The economic and social committee, and
- The monetary committee.

The Executive Commission: The executive commission of the European Union is the very important institution. It is independent of the national governments of the member countries. They have autonomy in their functions. The executive commission undertakes work in relation to initiation, evolution and execution of the economic policies of the community. The commission's directives bind the members. It can overrule any policies of the member governments which contradict the desired objectives of the European union.

The Council of Ministers: The council of ministers is comprised of the foreign ministers of the member countries of European Union. This body takes major decisions on political issues.

The European Parliament: The European parliament is basically a consultative body. It consists of members representing the national parliaments of the member countries. On an average, it holds eight sessions in a year. Now the members of European union are selected by direct election.

The Court of Justice: The court of justice is situated in Luxembourg. Any disputes, arising out of the different provisions of

Treaty of Rome are settled in the court of justice. It can overrule the decisions taken by the national courts on matters related to EEC policies.

The Economic and Social Committee: The economic and social committee consists of the representatives from professional organizations, workers and employers.

The Monetary Committee: The monetary committee is constituted by experts and central bank officials of the member countries of the EEC. It advises the executive commission and the council of ministers on international monetary.

10.6.3 BREXIT

BREXIT is an abbreviation used to denote Britain's exit from 28-nation European Union (EU), the world's biggest trading bloc. The shocking announcement was made in June, 2016, after a referendum in which 52% of people chose to leave the EU. The UK government is planning to invoke Article 50 of the Treaty on European Union, which officially withdraws UK from the EU, in March 2017. As soon as Article 50 is triggered, the UK will have 2 years to negotiate its withdrawal. For the time being UK is still part of the EU. The aftermath of the referendum British PM David Cameron, who was continuously opposing BREXIT, resigned and was immediately succeeded by Theresa May. The Sterling pound also reached a 30-year low. Theresa May has set up a government department, headed by veteran Conservative MP David Davis, to take responsibility for BREXIT. As of November 28th the British government could face a legal challenge over whether BREXIT would trigger a departure from the EU single market, which is a trade route allowing the free movement of goods, services, money and people within the European Union, as if it was a single country.

10.6.4 India and EEC (Economic Relation)

The EU is India's largest regional trading partner while India was the EU's 9th largest trading partner in 2017. India's bilateral

trade (both in goods and services) with EU in 2017 (Jan-Dec) stood at €117.2billion ($132.44 billion) which include bilateral trade in goods of €85.9billion ($97.01) and trade in services €31.3 billion ($35.37billion), India's exports in goods in 2017 stood at €44.2billion ($49.95 billion) while India's imports from the EU stood at €41.7billion ($47.12 billion). In 2017, the trade balance in goods was in India's favour by €2.5 billion ($2.83 billion). India's bilateral trade in goods for the period Jan-Oct 2018 with the EU stood at €76.3billion with India's exports valued at €38.9billion and imports at €37.4. The EU continued to be one of the largest source of Foreign Direct Investment (FDI) for India with inflows valued at €5.054 billion ($5.71billion) in 2017. In order to diversify and boost our bilateral trade, India and the EU are negotiating a bilateral Broad-based Trade and Investment Agreement (BTIA) since 2007. During the last India-EU Summit held in October 2017, the two sides expressed their shared commitment to strengthen the bilateral economic partnership. In order to promote and facilitate investment flow from the EU, an Investment Facilitation Mechanism has been established in July 2017 for close coordination. The India-EU Joint Commission dealing with economic and commercial issues meets annually, as do its three Sub-Commissions on Trade, Economic and Development Cooperation. A Macroeconomic Dialogue on Financial Services Regulations has also been instituted and takes place annually.

10.6.5 Future of India and EEC Relations

The lack of global leadership during the pandemic, with Russia, China and the US not rising to the occasion, created a vacuum that India might like to fill. The EU as a bloc of 28 countries is India's one of the largest (3rd) regional trading partner while India was the EU's 9th largest trading partner in 2018-19. The 15th Summit between India and the European Union (EU) was held in a virtual format on 15th July 2020. The Summit laid foundations for a deeper

and more strategic cooperation between the European Union and India in times to come. Though there was no sign of an FTA between the EU and India in the immediate future and no condemnation of China, there still were a lot of things to cheer about. Both the EU and India have agreed to deepen cooperation in areas like climate change, maritime security, digital economy, connectivity, research and innovation, water and climate action, and civil nuclear cooperation.

As the global supply chain transitions from its over-dependence on China, India emerges as the most natural ally for the EU in this regard. Furthermore, Europe's dependence on China for life-saving drugs has been starkly evident during these pandemic times. A mélange of India's vast manufacturing capacities coupled with European expertise in research and development would profit both the regions. Correspondingly, a similar strategic alliance in the information and communications technology front could range from building strategic autonomy in the digital sphere to investments in emerging and disruptive technologies.

Family-owned Indian firms are doing well in Europe given the given shared democratic values, commonality of philosophy and the complementary nature of offerings. However, the European companies throws many challenges for Indian firms in terms of New investment barrier introduced at the EU level, the Non-existence of the EU trade treaty and heterogeneous market, acquisition financing & lack of information networks. From Europe's perspective addressing these challenges may require structural and political changes.

This is a problem that European companies face in India. India is a sub-continent and like the EU, it is not a fully integrated market. It is not the same to do business in the state of Maharashtra or in the state of Rajasthan. Taxation, for instance, is not harmonized across India and this has been one of the major problems impacting foreign but also Indian companies. The approval of the GST- Goods

and Services Tax is a major step in a good direction.On a positive note, due to the financial market development in India, it is less prone to any financial crisis as against China and this makes India a better investment destination than her neighbour.

The recent endorsement of "EU-India Strategic Partnership: A Roadmap to 2025" talks about a common roadmap to guide joint action and further strengthen the EU-India Strategic Partnership over the next five years. The agenda discussed in the roadmap talks about non-proliferation and disarmament, maritime security, counter-terrorism (including counter-radicalization, anti-money-laundering and countering terrorism financing) and cybersecurity. EU-India Human Rights Dialogue is also a key tool to promote shared values of human rights and fundamental freedoms and convene regular meetings to forge mutual understanding and discuss human rights issues – including women's rights and empowerment and child rights.

A regulatory dialogue is being initiated via the already established EU-India Joint Working Group on pharmaceuticals, biotechnology and medical devices. A need for a dialogue on customs through the Joint Customs Cooperation Committee is critical.Also, India and the EU share a mutual interest in reciprocal mobility of talent. The EU-India cooperation should also foster innovation by promoting networking between EU and Indian innovators, start-ups, incubators, and accelerators by setting up joint platforms, both offline and virtual, and engaging in coaching, training and staff exchanges. Highly qualified workers could be integrated into Indian and EU-led innovation system industries and help maintain technology-based leadership and the sharing of best practices, internationalization of small and medium enterprise, and contributing to the global value chain.The future of India-EU relations looks very bright since the potential has not been tapped.

10.7 SOUTH ASIAN ASSOCIATION FOR REGIONAL COOPERATION

The South Asian Association for Regional Cooperation (SAARC) was established on 8tn December, 1985 by the heads of states or Governments of Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. Afghanistan became a member of SAARC during the Fourteenth SAARC Summit held in Delhi, India in April 2007. SAARC aims to promote the welfare of the peoples of South Asia and to improve the quality of their life through economic growth, social progress and cultural development in the region. So far 18 SAARC Summits have taken place. The areas of cooperation under the SAARC cover Agriculture and Rural Development, Health and Population Activities, Women, Youth and Children, Environment and Forestry, Science and Technology, Transport and Human Resource Development. The country hosting the SAARC Summit holds the chair of the Association. Nepal, who hosted the Eighteenth Summit in November, 2014 is the current chairperson of the Association.

The First Summit of the leaders of the seven SAARC member nations was held at Dhaka in Bangladesh. So far Eighteen SAARC Summits have been held.

Table 10.3 SAARC Summits held since 1985

Summit	City (Country)	Year
First SAARC Summit	Dhaka (Bangladesh)	1985
Second SAARC Summit	Bangalore (India)	1986
Third SAARC Summit	Kathmandu (Nepal)	1987
Fourth Summit	Islamabad (Pakistan)	1988
Fifth SAARC Summit	Male' (Maldives)	1990
Sixth SAARC Summit	Colombo (Sri Lanka)	1991
Seventh SAARC Summit	Dhaka (Bangladesh)	1993
Eighth SAARC Summit	New Delhi (India)	1995
Ninth SAARC Summit	Male' (Maldives)	1997
Tenth SAARC Summit	Colombo (Sri Lanka)	1998

Eleventh SAARC Summit	Kathmandu (Nepal)	2002
Twelfth SAARC Summit	Islamabad (Pakistan)	2004
Thirteenth SAARC Summit	Dhaka (Bangladesh)	2005
Fourteenth SAARC Summit	New Delhi (India)	2007
Fifteenth SAARC Summit	Colombo (Sri Lanka)	2008
Sixteenth SAARC Summit	Thimphu (Bhutan)	2010
Seventeenth SAARC Summit	Addu City (Maldives)	2011
Eighteenth SAARC Summit	Kathmandu (Nepal)	2014
Nineteenth SAARC Summit	Islamabad (Pakistan)	2016 (Postponed)

The Nineteenth SAARC Summit was supposed to be held in November 2016 in Pakistan. But it was cancelled due to friction among member countries. The new date has not been decided. SAARC secretariat/ head quarter is in Kathmandu (Nepal). SAARC secretariat coordinates and monitors the activities of its member nations. The secretariat is headed by the Secretary General who is appointed from member countries in alphabetic order for a three year term. The SAARC secretariat and member nations observe 8th December as the SAARC day. India being territorially the biggest, population-wise the largest, development-wise and industrially the most developed state of South Asia has played and continues to play a big role in the SAARC programmes.

10.7.1 Objectives of SAARC

The objectives of the association as defined in the SAARC Charter are:

- To promote the welfare of the people of South Asia and to improve their quality of life.
- To accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realize their full potentials.
- To promote and strengthen collective self-reliance among the countries of South Asia.

- To contribute to mutual trust, understanding and appreciation of one another's problems.
- To promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields.
- To strengthen cooperation with other developing countries.
- To strengthen cooperation among themselves in international forums on matters of common interests; and
- To cooperate with international and regional organizations with similar aims and purposes.

Cooperation in the SAARC is based on respect for the principles of sovereign equality, territorial integrity, political independence, noninterference in internal affairs of the member states and mutual benefit. Regional cooperation is seen as a complement to the bilateral and multilateral relations of SAARC members. Decisions are taken on the basis of unanimity. Bilateral and contentious issues are excluded from the deliberations of SAARC.

10.7.5 Principal Organs

- **Meeting of Heads of State or Government**: Meetings are held at the Summit level, usually on an annual basis.
- **Standing Committee of Foreign Secretaries**: The Committee provides overall monitoring and coordination, determines priorities, mobilizes resources, and approves projects and financing.
- **Secretariat**: The SAARC Secretariat was established in Kathmandu on 16 January 1987. Its role is to coordinate and monitor the implementation of SAARC activities, service the meetings of the association and serve as a channel of communication between SAARC and other international organizations.

The Secretariat comprises the secretary-general, seven directors, and the general services staff. The secretary-general is

appointed by the Council of Ministers on the principle of rotation, for a non-renewable tenure of three years.

10.7.6 Trade and Economic Cooperation among SAARC Countries

SAARC has taken various steps to expand trade and economic cooperation among member countries in core areas. Of these, SAARC Preferential Trading Arrangement (SAPTA) and South Asian Free Trade Area (SAFTA) are more important.

SAARC Preferential Trading Arrangement (SAPTA): The Agreement on SAARC Preferential Trading Arrangement (SAPTA) which envisages the creation of a Preferential Trading Area among the seven member states of the SAARC, namely Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka was signed in Dhaka in April 1993. The idea of liberalizing trade among SAARC countries was first mooted by Sri Lanka at the sixth Summit of the South Asian Association for Regional Co-operation (SAARC) held in Colombo in December 1991. It was agreed that SAPTA is a stepping stone to higher levels of trade liberalization and economic co-operation among the SAARC member countries. The objective of the SAPTA is to promote and sustain mutual trade and the economic co-operation among the member states through exchange of trade concessions. SAPTA therefore is the first step towards higher levels of trade and economic co-operation in the region.

SAPTA specified four negotiating approaches namely, product by product basis, across the board tariff reduction, sectoral basis and direct trade measures. However it was agreed that tariff concessions would initially be negotiated on a product - by- product basis. The agreement also provides for negotiation of tariff concessions to be an ongoing process. The SAPTA envisages that concessions on tariff para-tariff and non tariff measures will be negotiated step -buy step improved and extended in successive stages.

South Asian Free Trade Area (SAFTA): The most significant aspect of the12th SAARC Summit (Jan. 4-6, 2004) at Islamabad, the Capital City of Pakistan, was the signing of a historic Agreement on Free Trade. The leaders of India, Pakistan, Bangladesh, Bhutan, Maldives, Nepal and Sri Lanka have agreed upon to create a 'South Asian Free Trade Area' (SAFTA). SAFTA came into force since January 1, 2006 replacing South Asian Preferential Trade Agreement (SAPTA) which was operative among SAARC countries, since December 7, 1995. SAPTA was the success of 8th SAARC conference held in New Delhi in 1995 where this new concessional trade system of SAPTA was approved. SAPTA was the factor which really opened all positive possibilities to establish SAFTA. The purpose of the SAFTA is to encourage and elevate common contract among the countries such as medium and long-term contracts. Contracts involving trade operated by states, supply and import assurance in respect of specific products etc. It involves agreement on tariff concession like national duties concession and non-tariff concession.

The main objective of the agreement is to promote competition in the area and to provide equitable benefits to the countries involved. It aims to benefit the people of the countries by bringing transparency and integrity among the nations. The SAFTA was also formed in order to increase the level of trade and economic cooperation among the SAARC nations by reducing the tariff and barriers and also to provide special preference to the Least Developed Countries (LDCs) among the SAARC nations to establish framework for further regional cooperation.

The exports under SAFTA have been witnessing considerable upward trend since the launching of the Trade Liberalisation Programme (TLP). As of 20 September 2013, the total f.o.b. value of exports by Member States under SAFTA has reached about US$ 3 billion since launching of SAFTA Trade LiberalisationProgramme (i.e. July 2006). Still intra-SAARC trade flows under SAFTA are far

below the potential. For smooth functioning of the SAFTA, customs notifications for implementing Trade LiberalisationProgramme(TLP) are issued as per the agreed timeline by the Member States. While reduction in the size of Sensitive Lists is important to increase the quantum of regional trade, efforts are being made to take out those products out of the Sensitive Lists that are of export interests to the SAARC Member States for trade within South Asia.

10.7.7 Assessment of SAARC

Achievements of SAARC: Major achievement of SAARC include:

- **Free Trade Area (FTA):** SAARC is comparatively a new organization in the global arena. The member countries have established a **Free Trade Area (FTA)** which will increase their internal trade and lessen the trade gap of some states considerably.
- **SAPTA: South Asia Preferential Trading Agreement** for promoting trade amongst the member countries came into effect in 1995.
- **SAFTA: A Free Trade Agreement** confined to goods, but excluding all services like information technology. Agreement was signed to reduce customs duties of all traded goods to zero by the year 2016.
- **SAARC Agreement on Trade in Services (SATIS):** SATIS is following the GATS-plus 'positive list' approach for trade in services liberalization.
- **Establishment of Major Institutions:** Due to the formation of SAARC, many important institutions have been established in different countries like SAARC University in India and a food bank and an energy reserve in Pakistan.
- **Neighbourhood first:** It gave importance to the notion that primacy to the country's immediate neighbours.
- **Regional stability:** SAARC can help in creation of mutual trust and peace within the region.

- **Global leadership role:** It offers India a platform to showcase its leadership in the region by taking up extra responsibilities.
- **Game changer for India's Act East Policy:** by linking South Asian economies with South East Asian will bring further economic integration and prosperity to India mainly in the Services Sector.

Failures of SAARC: Even though the process of trade liberalization between SAARC countries has made a good beginning, yet the following are the obstacles in its way:

- The biggest obstacle in the way of SAARC trade is that every member country is afraid of India's superior status because it possesses the largest natural, financial, technical and manpower resources in the region. Naturally, its output of various commodities and export potential are the highest among the SAARC members and its trade balance is also favourable with them.
- With the removal of trade barriers among SAARC countries, informal (illegal) trade in goods has increased. As a result, bilateral trade balances have been adversely affected between the member states.
- There are many commodities with large intra-trade which have not been included in the list of tariff concessions.
- Many commodities on which trade concessions have been given are not traded among SAARC countries.
- Escalated tension and conflict between India and Pakistan have severely hampered the prospects of SAARC.
- The implementation of SAFTA has not been satisfactory till date. Further, this Agreement is only confined to goods, excluding all services like information technology.
- Due to lack of transport facilities, high transit duty, etc., intra-regional trade has not been increasing, especially among India, Pakistan and Bangladesh.



10.8 LET US SUM UP

- Tinbergen defines international economic integration as "the creation of most desirable structure of international economy, removing artificial hindrances to the optimum operation and introducing deliberately all desirable elements of coordination or unification."
- The degree of economic integration ranges from preferential trade arrangements to free trade areas, customs unions, common markets, and economic unions.
- Preferential Trading System was the earliest form of economic, integration among 48 Commonwealth countries of the British Empire established in 1932.
- The free trade area is a loose form of economic integration wherein the member countries remove tariffs and other trade barriers among themselves, but each member retains its own tariff, trade restrictions and commercial policies with non-member countries.
- In a customs union, the participating countries adopt a common external tariff and commercial policy on imports from the outside world and abolish all tariffs and trade barriers among themselves.
- The common market is a unified single market area among nations in which there is free movement of goods, services and factors of production.
- The Economic Union is the highest form of economic integration among nations.
- The pioneering study of the theory of customs unions was made by Jacob Viner. In the beginning, customs unions had been viewed favorably. The reasoning was as follows: free trade maximizes welfare; customs unions are a move toward free trade; therefore, they will increase welfare even though they might not maximize it.
- Viner showed this conclusion to be incorrect. He introduced, instead, the key concepts of trade creation and trade diversion.

- Trade creation occurs when some domestic production in a nation that is a member of the customs union is replaced by lower-cost imports from another member nation.
- Trade diversion occurs when lower-cost imports from outside the customs union are replaced by higher cost imports from a union member. This results because of the preferential trade treatment given to member nations. Trade diversion, by itself, reduces welfare because it
- The effects of customs unions can be classified broadly into two categories, viz., Static Effects and Dynamic Effects



10.9 FURTHER READING

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(2) Krugman, P. (2018). International Trade: Theory and Policy. Delhi: Pearson.

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10.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: International economic integration, refers to a decision or process whereby two or more countries combine into a larger economic region by removing discontinuities and discriminations existing along national frontiers, and by establishing certain elements of co-operation and co-ordinations between them.

Ans to Q No 2: The major distinction between free trade area and customs union is that in a free trade area there is no common external tariff imposed. On the other hand, customs union is an arrangement in which there is zero duty between members on imports of goods and services, and common external tariff.

Ans to Q No 3: Trade creation occurs when some domestic production in a nation that is a member of the customs union is replaced by lower-cost imports from another member nation.

On the other hand, trade diversion occurs when lower-cost imports from outside the customs union are replaced by higher cost imports from a union member. This results because of the preferential trade treatment given to member nations.

Ans to Q No 4: In terms of the net welfare effect if the trade creation effect predominates, the customs union is made better off or if the trade diversion effect predominates it is made worse off. It the two effects happen to be equal, the gains and losses are equally distributed between the members of the union. Consequently, the net welfare effect of the customs union depends on which of these two effects is stronger.



10.11 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Differentiate between preferential trade system and free trade area.

Q 2: How custom union is different from economic union?

Q 3: Briefly explain the welfare effect of customs union.

Q 4: Differentiate between trade creation and trade diversion.

Q 5: How did SAARC come into existence?

Q 6: Explain various objectives of SAARC.

Q 7: Write down the principle organs of SAARC.

Q 8: Write a short note on SAPTA.

Q 9: How did EEC come into existence?

Q 10: What are the main objectives of EEC?

Q 11: Write a short note on Brexit.

Q 12: Briefly explain India's trade relations with EEC.

Essay-type Questions (Answer each question in about 300-500 words)

Q 1: What do you mean by economic integration?Explain various types of economic integration.

Q 2: Diagrammatically explain trade creation and trade diversion of custom union.

Q 3: Explain various static and dynamic effects of customs union.

Q 4: Explain various steps undertaken to expand trade and economic cooperation among SAARC countries.

Q 5: Explain various achievements and failures of SAARC.

Q 6: Write a detailed note on history and organisational structure of EEC.

Q 7: Explain India's relationship with EEC.Also write a note on future of their relationship.

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UNIT 11: BALANCE OF PAYMENTS

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Balance of Payment

- 11.3.1 Meaning and Definition
- 11.3.2 Difference between BOP and BOT
- 11.3.3 Components

11.4 Equilibrium and Disequilibrium in BOP

- 11.4.1 Disequilibrium in BOP
- 11.4.2 Equilibrium in BOP

11.5 Process of Adjustment

- 11.5.1 Fixed Exchange Rate
- 11.5.2 Flexible Exchange Rate

11.6 A Critical Review of the Monetary Approach to the theory of BOP

11.7 Let Us Sum Up

11.8 Further Readings

11.9 Answers to Check Your Progress

11.10 Model Questions

11.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the Balance of Payment account of the country
- differentiate between the current account and capital account of the country
- explain how equilibrium and disequilibrium occurs in a country
- describe the concepts of fixed and flexible exchange rate.
- critically examine monetary approach to Balance of Payment.

11.2 INTRODUCTION

In this unit we will discuss the concepts ofBalance of Payment. Balance of Paymentgenerally takes into account all the monetary

transactions with the rest of the world. It is basically the signal of country's potential of trade with other countries and it can be used to evaluate the country's performance in international competition.Balance of Payment includes all the external transactions i.e. exports and imports of goods and services, foreign investment, loans, foreign aid, foreign capital, financial transfers by the residents of the country with the outside world. All these transactions are recorded on the basis of double entry book-keeping method. It means each economic transaction is recorded as credit (all the receipts from abroad) and debits (all the payments to abroad).

Balance of Paymenthas two parts: Current account and Capital account. Current account takes into account all the transactions relating to trade in goods and services and unilateral transfers. All the short run and long run financial transactions are included in capital account. Errors and Omissions are added largely for balancing these accounts equal in accordance with the principle of double entry book-keeping so that the Balance of Paymentof country is always in balance in accounting sense. In this unit, we shall also discuss Causes of deficit in Balance of Payment and its measures to correct, Fixed and Flexible Exchange Rate and its monetary approach.

11.3 BALANCE OF PAYMENT

As we have already discussed theBalance of Payment is the trade relations of a country with outside the world,which deals all the international receipts and payments. It plays an important role in national income accounts for an open economy. In this section we will discuss the meaning and some important definitions along with other components.

11.3.1 Meaning and Definitions

Balance of Paymentis a systematic record of flow of goods, services, gifts and assets between the residents of a country and residents of other countries during a particular period of time, usually a calendar year. So Balance of Paymentis a statistical record of all economic transactions of a nation with other nations of the world.

According to Kindelberger,*"Balance of Paymentof a country is a systematic record of all economic transactions concerning goods, services and capital flow between its residents and residents of foreign countries".*

According to Benham,*"Balance of Paymentof a country is a record of the monetary transactions over a period with rest of the world".*

The Balance of Payment of a country is a systematic record of all economic transactions between the residents of a country and the rest of the world. It presents a classified record of all receipts on account of goods exported, services rendered and capital received by residents and payments made by them on account of goods imported and services received from the non-residents or foreigners.

11.3.2 Difference between Balance of Payment and Balance of Trade

International transactions mainly relates to two concepts:- Receipts and Payments. Balance of Trade is defined as the difference between the value of goods and services exported out of a country and value of goods and services imported into the country. On the other hand Balance of Paymentnot only deals with exports and imports but also includes the financial transfers. In short, Balance of Trade deals with exports and imports of visible items but Balance of Paymentdeals with all types of economic transactions visible, invisible and capital transfers.

Table 11.1: Balance of Trade vs Balance of Payment

BALANCE OF TRADE	BALANCE OF PAYMENT
1. It is narrow concept. 2. It deals with country's exports and imports of physical goods with rest of the world. 3. Balance of Trade can be favorable or unfavorable. 4. Deficit of Balance of Trade can be met by Balance of Payment. 5. It gives a partial view of economic position of a country.	1. It is a broad term. 2. It deals with country's exports and imports of physical goods but financial/capital transfer also. 3. Balance of Paymentis always in balance. 4. Deficit of Balance of Payment can't be met by Balance of Trade. 5. It gives a clear view of economic status of a country.



LET US KNOW

Is Balance of Payment is always in balance?Balance of Payment is always in equilibrium because of the double entry system. Under this receipts (credit (+)) side is always equal to payment side (debits (-)). Practically deficit or surplus of current account is restored with capital account. If current account is in deficit then it is maintained by surplus of capital account and surplus of capital account is used to meet the deficit of capital account. That's why Balance of Payment is always in balance.

11.3.3 Components

Balance of Payment account ofa country is based on the principle of double entry book-keeping. This is divided into current account, capital account and other items i.e. official reserve transactions and errors and omissions.

Current Account:

The current account of a country records all the transactions relating to exports and imports of goods and services and unilateral transfers.

Current account = (Visible +Invisible Exports)-(Visible+ Invisible Imports)



Double Entry Book Keeping:It means every transaction has to parts. Every transaction involves a debit (+) entry in one account and credit (-) entry in another account. Debitshave received value and credit has given value.

Different types of service transactions (invisible goods) are included in current account. These services consist of commercial undertakings, travel and transportation, insurance, services of experts (like doctors, teachers etc),Income and payment of foreign investment, transfer payments (gifts, donations, foreign aid, pensions etc) etc.Unilateral transfers or unrequited receipts are those receipts which the residents of a country receive for free without making any present or future payment in return.

Trade of exports and imports of visible items is called as Merchandise Trade Balance and trade of exports and imports of invisible is called as Service Trade Balance. Exports are shown on the credit(+) side and imports are on debit (-)side because exports are receipts of foreign payments and imports our payment to foreigners for goods and services rendered. If the exports of goods and services exceed the imports of goods and services, the Balance of Paymentis said to be favorable but if imports of goods and services exceed the export of goods and services then Balance of Payment said to be in deficit. Receipts of unilateral items are recorded as positive items while payments as negative items.

Capital Account:



Portfolio investments are acquisition of an asset that does not give the purchaser control over it. **FDI** is the act of purchasing an asset and at the same time accruing control of it.

As we discussed above current account reflect nation's net income but the capital account reflects the net change in the ownership of national assets. The capital account concerned with the short term and long term international flow of loans and investments and represents a change in the country's foreign assets and liabilities between the residents of the country with the rest of the world. Capital account deals with short-term and long-term capital movement with a maturity of ranging between three months to less than one year and one year or more respectively. There are two types of transactions in capital account- Private and Government. Private transactions include- direct, portfolio and short-term investment and government transactions consist of loan to and loan from foreign official agencies.

All the capital transactions like borrowing from foreign countries and FDI by foreign countries which cause inflow of foreign exchange into country are positive items or receipts from foreigners. On the other hand lending to another country and FDI in foreign country which cause flow of foreign exchange out of the country are negative items or debit because they are payments to foreign countries. The net value of the balance of FDI and portfolio investment defines the balance on capital account.

Official Reserve Transactions:

These transactions are different from all other transactions because these are carried out only by government by keeping in mind the international economic policy. This account measure the change in nation's liquidity and non-liquid liabilities and change in nation's official reserve assets during the year. Increase in official reserves is reflected as positive(+)and decrease in such reserves reflected as negative(-)in Balance of Payment accounts.

Errors and Omissions:

Errors and Omissions are added largely as balancing item so the total credits and debits of three accounts must equal in accordance with the principle of double entry book-keeping.



LET US KNOW

- **Visible and invisible items:** Visible items are those Physical material goods which can be seen like export and import of cloth,Tea, machinery. Invisible items are those non-materialistic goods whose exports and imports are not visible. It generally includes services of doctor,teacher, engineers etc..
- **Assets and liabilities:-**Assets are all those receivable items which company enjoys like cash, equipment, building etc. Generally assets generate profit. Liabilities are future obligation of a firm or all the payable are considered as liabilities.

- **Capital movement:-** It is a flow of financial resources from one country to another for adjusting Balance of Payment equilibrium.
- **Exchange rate:** This is price of a currency which is determined by demand and supply forces like price of any commodity.
- **Depreciation:** A decrease in the value of currency relative to other currencies which make import dearer and exports cheaper.
- **Appreciation:**An increase in the value of currency relative to other currencies which make imports cheaper and export dearer.
- **Export promotion:** It means export duties should be withdrawn and special concession or facility should be given to export oriented industries to increase the domestic demand in foreign countries.
- **Import substitution:** It means imported goods are produced indigenously.



CHECK YOUR PROGRESS

Q 1: Mark the statement as True(T) or False(F).

i. Balance of Payment deals with all the economic transaction usually in a particular time period generally one year. (T/F)

ii. Current account is a part of capital account. (T/F)

Q 2: What do you mean by Balance of Trade ?(Answer in about 40 words)

.....

.....

Q 3: Define the Capital Account. (Answer in about 40 words)

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11.4 EQULIBRIUM AND DISEQUILIBRIUM IN BALANCE OF PAYMENT

Balance of Payment should always be in balance. If the exports of any country are equal to its imports then Balance of Payment is in balance

otherwise if exports (receipts)are more than imports (payments) or imports (payments)are more than exports (receipts) then be Balance of Payment is said to be in disequilibrium.

11.4.1 Disequilibrium in Balance of Payment

Balance of Paymentcan either in surplus or in deficit. Disequilibrium in Balance of Paymentcan be of cyclical, structural, fundamental, temporary or any other. But there are certain reasons of disequilibrium in Balance of Payment. The causes of disequilibrium in Balance of Paymentare as under:

- **Due to natural calamities** like famines, drought, earthquake, floods etc. Balance of Payment of underdeveloped countries can be in disequilibrium because generally in these situations imports of country leads in comparison to exports.
- **Overvaluation** or **undervaluation** of foreign currency leads to disequilibrium in Balance of Payment. Foreign goods become cheaper and exports become dearer due to over valuation of a domestic currency. On the contrary undervaluation makes Balance of Paymentfavourable by encouraging exports and reducing imports.
- **Price fluctuation** is also a cause of disequilibrium in Balance of Payment. If there is inflation then due to rise in prices, exports fall and demand for imports increase. That leads to disequilibrium in Balance of Payment.
- **Economic stage** of any country also impact on Balance of Payment. If economy is developing, it imports raw material, machinery, capital equipment etc. and exports raw material then it will have deficit in Balance of Payment.
- If there is **fall in foreign demand** for domestic goods due to change in fashion, taste, habit, preferences etc. then it leads to fall in exports and hence adverse Balance of Payment.
- **Cyclical fluctuations** like depression or boom also cause disequilibrium in Balance of Payment.

- If national income of any country increases, it will lead to **more demand for imports** and will create a deficit in Balance of Payment. If economy is already at full employment level then due to inflationary rise in price imports will be more than exports and disequilibrium in Balance of Payment.
- **Political instability** in a country creates uncertainty among foreign investors which leads to outflow of capital and retards its inflow causing disequilibrium in Balance of Payment.

11.4.2 Equilibrium in Balance of Payment

In this we will discuss how disequilibrium in Balance of Paymentwill adjust automatically by adopting certain policy measures:

- Under flexible exchange rate if a country **depreciates its domestic currency** in terms of foreign currency then it stimulate exports and reduce imports because exports become cheaper and import costlier in International Market.
- If country is not following flexible exchange rate, government of country "lowers the value of its currency"**(devaluation)** in terms of foreign currencies then exports are expected to rise while imports are expected to fall. This causes expenditure to be switched from foreign to domestic goods as the country's exports rise.
- **Deflation** is an important measure to correct Balance of Payment. Under this central bank of the economy control the volume of credit by using quantitative and qualitative measures of credit control. These measures bring down the price and monetary income of the people. Fall in domestic price stimulate exports and reduction in imports.
- By adopting **non-monetary measures** the government may control the disequilibrium in Balance of Payment. The government may impose restrictions on imports by levying of import duties, fixation of quota, import substitution, export promotion or by encouraging foreign investment in domestic country.

- Balance of Paymentis said to be in equilibrium when domestic interest rate is equals to the **world interest rate**. If domestic interest rate is higher than the world rate, there will be capital inflows and Balance of Paymentdeficit is corrected.



CHECK YOUR PROGRESS

Q 4: Check the statement whether true (T)or false (F)

i. Balance of Payment only deals with Exports and Imports of visible items. (T/F)

ii. Import substitution is a measure to control disequilibrium in Balance of Payment. (T/F)

Q 5: Why disequilibrium occurs in Balance of Payment. (Answer in about 40 words)

.....

.....

Q 6: How does equilibrium in Balance of Payment can be corrected? (Answer in about 50 words)

.....

.....

11.5 PROCESS OF ADJUSTMENT

Under the process of adjustment here we will discuss how the disequilibrium in Balance of Payment will be adjusted through Fixed and Flexile Exchange Rate.

11.5.1 Fixed Exchange Rate

Fixed Exchange rate technically called as “Pegged Exchange rate” means value of currency is fixed against the value of another country or fixation of par value of the currency in terms of Gold. This Exchange rate is not determined by Demand and supply conditions of the market but by the Government. The international Gold Standard of Fixed Exchange Rate operated between 1880-1914; the external

value of currencies was denominated in terms of Gold. The central bank of the country uses Open Market Mechanisms to buy or sell gold at specified price. Under this system exchange rate was fixed on the basis of parity of weight of gold contained in their respective currency units. The rate at which the currency was fully convertible into gold is called as Mint Price of Gold or Gold Parity.

For e.g. 1 Pound= 5 Grains of Gold

1 Dollar = 1 Grains of Gold

Hence, 1 Pound= 5 Dollars

1 Dollar=1/5 Pound

Exchange rate worked out with the help of following formula:

Exchange rate of A country=Gold contents per unit of Currency A

Gold contents per unit of currency B

For instance, before World War I America and England's currency was fully convertible into gold and they were following Gold Standard. While gold grains contained in a pound was 113.0016 and a dollar contained gold grains 23.2200. Then according to formula:

1 pound = 113.0016 grains of gold per pound = 4.866$

23.2200 grains of gold per dollar

Exchange rate: 1£=US$4.8665

But the actual rate of exchange could vary above and below mint parity by the cost of shipping gold between two countries. Some expenses are incurred on packing, shipping, insurance etc. Gold exporting countries would like to export gold only when rate of exchange is more than the cost of shipping gold. Suppose, Balance of Payment between the US and England is unfavourable to America which causes the price of pound to rise against the dollar. Now due to shipping cost(0.02) exchange rate become 1£=4.886$ instead of 4.866 $. So trade will take place only when US is ready to pay $4.886 in exchange for 1 pound(£1). This is US gold export point or upper gold point(mint par and shipping cost) for the US and lower import point for England. On the contrary if Balance of Payment become unfavourable to England then rate of exchange between two

countries will fall i.e. 1£=$4.866-0.02=$4.846.It means 1£=$4.846 is that lower limit below which if rate of exchange has a tendency to fall, gold will begin to flow from England to US.The exchange rate under gold standard was determined by the forces of demand and supply between the gold points with the objective to keep the Balance of Payment in equilibrium. If country has deficit in Balance of Payment, it means out flow of gold to surplus country. This reduced country's money supply thereby bringing a fall in general price level. This in turn would increase its exports and reduce its imports and vice versa.

11.5.2 Flexible Exchange Rate

Flexible Exchange Rate is determined by demand and supply of different currencies in foreign exchange rate. Flexible Exchange Rate is determined like a price of a commodity by the forces of demand and supply without any Government intervention.

Demand for Foreign Exchange: Foreign Exchange is for many purposes like to pay for imports, loans, for investment purpose etc. Demand for foreign exchange has a negative slope because of inverse (-) relation between rate of exchange and demand for foreign currency. It means, if rate of exchange is high, less goods and services will be imported (i.e. less demand for Foreign Exchange)and vice versa.

Supply of Foreign Exchange: Supply of Foreign exchange is governed by many factors like exports to foreign countries, loans and investments from abroad etc.Supply of foreign exchange has a positive (upward +ve slope) which shows positive relation between these both. If there is a rise in the rate of exchange, supplies of foreign exchange will also increase and vice-versa.So if there is disequilibrium in balance of payment then equilibrium can automatically be achieved with the help of flexible exchange rate (market forces of demand and supply)by appreciation or depreciation of countries currency in case of surplus or deficit in balance of payment respectively.

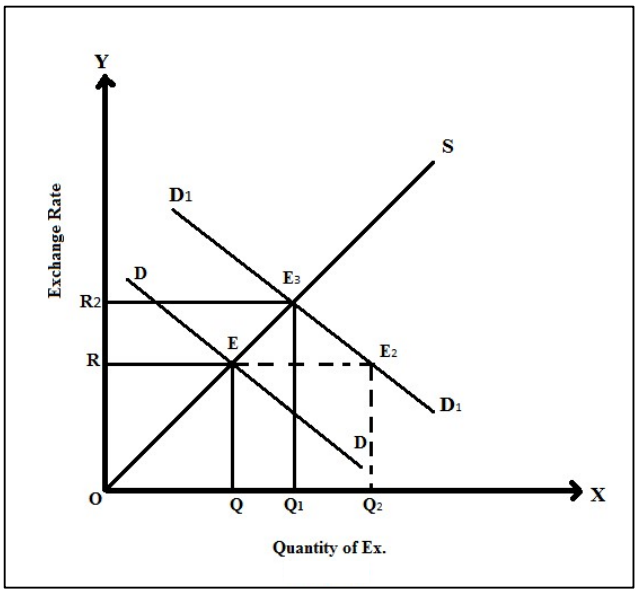
Now this analysis will be discussed with the illustration. The analysis is based on following assumptions:

- There are two countries India and the US.
- Prices are Flexible.
- Balance of Payment is automatically adjusted by change in Exchange Rate.
- Free trade between the two countries.

Equilibrium Rate of Exchange determined wheredemand for Foreign Exchange is equal to Supplyof Foreign Exchange. In Figure 11.1, DD is the Demand Curve of US for Foreign Exchange Reservesrepresenting its demand for Indian imports and SS is a Supply Curve of US for foreign exchange representing its exports to India. E is the point ofequilibrium where demand for foreign exchangeOE is equal to supply of foreign exchange OQ.

Suppose if there is disequilibrium in balance of payment of US in relation to India.The increase in demand for Indian import will shift DD to D1D1and deficit equals EE2. Here depreciation in US dollar and appreciation of Indian Rupees results import prices of Indian rupee increase in US and export prices of US dollar falls. Now new equilibrium is determined at E3, new exchange rate OR2,deficit in Balance of Payment is eliminated. Now,when exchange rate rises to OR2,due to depreciation or appreciation of currency, US goods

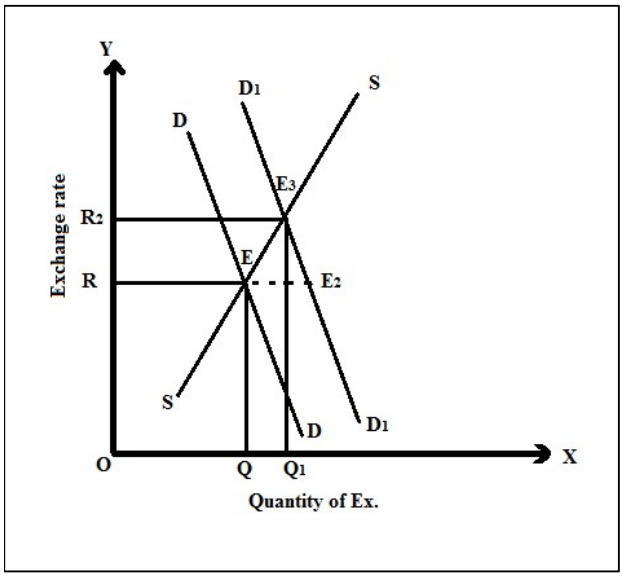
Figure 11.1: Determination of Equilibrium Exchange Rate



become cheaper in India and Indian goods become expensive in US. Due to change in relative prices it tends to raise the US exports to India i.e. EE3 along the supply curve SS. At the same, the higher price of Indian goods in terms of dollar tends to reduce demand for Indian goods and to switch demand to domestic goods in the US from capital E2 to E3 along the new demand curve D1D1. Thus incipient deficit EE2 in Balance of Payment is removed by increase in foreign exchange supplied by QQ1 and decrease in foreign exchange demanded by Q2Q1, so that balance of payment equilibrium is achieved at OR2 and OQ1.

The above analysis is based on the assumption of relative elasticity of demand and supply of foreign exchange. In order to measure the equilibrium of Balance of Payment we have to take the impact of elasticity also. In Figure 11.2,less elastic demand and supply are shown on DD and SS respectively and equilibrium exchange rate at OR. Now, if deficitin Balance of Payment develops equal to EE2, a large amount of depreciation of dollar and appreciation of rupee is required for restoration of equilibrium because of inelasticity of foreignexchange of demand and supply. The equilibrium will be established though relative price movements in the two countries as explained above at E3 with a very high rate of foreign exchange OR2. But such a high rate of depreciation would

Figure 11.2: Determination of Equilibrium Exchange Rate (with Elasticity)



lead to very high price changes in the two countries thereby tending to disrupt their economies.



CHECK YOUR PROGRESS

Q 7: State whether True (T) or False (F)

i. In fixed Exchange-rate currency of a country is fully convertible into gold.(T/F)

ii. Flexible exchange rate is controlled by Government.(T/F)

Q 8: Explain Pegged Exchange Rate (Answer in about 40 words).

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11.6 MONETARY APPROACH TO THE THEORY OFBALANCE OF PAYMENTS

This theory is associated with the names of Robert Mundell and Harry Johnson but became fully developed during the 1970's. According to this theory if any disturbance occurs in Balance of Payment, it can only be corrected by monetary measures. So disequilibrium in Balance of Payment is always and everywhere a monetary phenomenon.

Assumptions:

- One price for homogeneous goods in different countries, after allowing for transport Cost.
- There is perfect substitution in both the product and capital market.
- Full employment.
- The demand for money is a stock demand.
- Money multiplier is applicable on supply on money.
- The level of output of a country is exogenously determined.

Explanation: By assuming above assumptions, theory is based on demand for money and supply of money relationship. The demand for money is a stable function of Income(Y), Price(P)and inverse function of rate of interest(i).

$$M_D = f(Y,P,i)$$

The supply of money consists of domestic credit(D) and country's Foreign Exchange Reserve(R) which is multiple of monetary base.

$M_S=D+R$

Equilibrium is, where, $M_D=MS$

$M_D=D+R$(Because, MS=D+R)

The disequilibrium in Balance of Payment occurs when there is a change in countries Foreign Exchange Reserve.

$\Delta R=DM_D - \Delta D$

DM_D= Change in demand for money

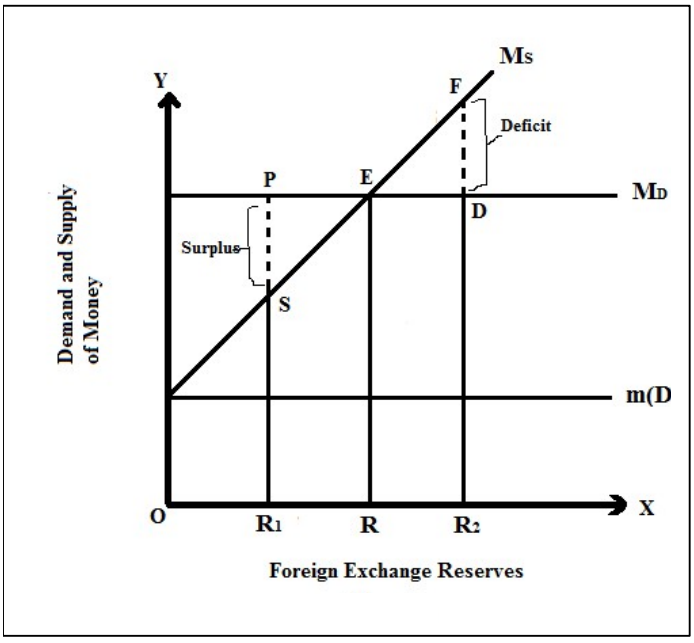
ΔD= Domestic credit.

Now we will discuss how the disequilibrium in Balance of Payment will automatically be corrected with Fixed or Flexible Exchange Rate under this monetary approach.

Firstly, under fixed exchange rate regime if $M_D=M_S$, it shows Balance of Payment is zero. Now, suppose if there is an increase in supply of money i.e. $M_S>M_D$ but no change in demand. Then people will be having more cash which tends to raise the demand for imported goods (i.e. Balance of Payment is in deficit)and increase in expenditure in both current and capital account. In this situation the monetary authority undergoes the sale of Foreign Exchange Reserve and purchase of domestic currency and will continue this process until $M_D=M_S$. On the other hand if $M_S<M_D$ then monetary authority will buy exchange reserve in exchange for domestic currency. So,there will be inflow of foreign exchange reserve and increase in domestic supply until $M_D=M_S$.

This can be explained with the help of Figure 11.3. In this on OX-axis Foreign Exchange Reserve and on OY-axis Demand and Supply of money are shown.MD is a stable Demand curve and MS is the supply curve. m(D) is the

Figure 11.3: Exchange rate of Balance of Payment



monetarybase which is multiple of domestic credit, D whichis also constant, that's why MS starts from Point C.E is the point of equilibrium where OR is Foreign Exchange Reserves. If $M_S < M_D$ i.e., surplus in Balance of Payment. It leads to increase inForeign Exchange Reserve from OR_1 to OR and established equilibrium at E. If $M_S > M_D$ (defcit inBalance of Payment) it shows decrease in Foreign Exchange Reserves from OR_2 to OR and decrease the supply of money so as to establish equilibrium at point E.

Secondly under Flexible Exchange Rate, if Balance of Payment in deficit or surplus then without any inflow or outflow of foreign exchange reserves demand for money and exchange rate will automatically adjust the process by appreciation or depreciation of the currency. Suppose monetary authority increases the money supply $M_S > M_D$. It shows people have large cash balances thereby raising prices of domestic goods and imported goods then depreciation of domestic currency and a rise in exchange rate. Byincreasing the prices in turn increase the demand for money and equilibrium will be re-established between demand for money and supply of money i.e., $M_S = M_D$ without any outflow of Foreign Exchange Reserve. The opposite will happen when $M_S < M_D$ and equilibrium in Balance of Payment will be determined without any inflow of Foreign Exchange Reserves.

Criticisms: In above theory we have discussed how the disequilibrium in Balance of payment can be achieved with the help of fixed and flexible exchange rate but still there are some drawbacks of the theory which are discussed below:

- The theory is based on the assumption of stable demand for money. The demand for moneyis a stable in long run but in short it is unstable.
- The assumption of full employment is not practically applicable.
- The law of identical or one price also does not hold good. Because when the productive factors are diverted to sector producing non-trade goods, the excess demand for non-traded goods will spill over into reduced supplies of traded goods. It will lead to higher imports and disturb the law of one price for all traded goods.

- The principle of single/one price is actually not applicable due to market imperfections. There maybe price differentials between trading countries and government imposed many restrictions on domestic and international trade.
- This approach neglects many real and structural factors which are the reasons of disequilibrium in Balance of Payment but this only concentrate on domestic credit.
- The assumption of sterilisation of currency flows is not possible under Fixed Exchange Rate exchange rate has also been opposed by critics. They argue, "The sterilisation of currency flows is entirely possible if the private sector is willing to adjust the composition of wealth portfolio with regard to the relative importance of bonds and money balance or if the public sector is prepared to run a higher budget deficit whenever it has a Balance of Payment deficit with which to contend".

Conclusion: Despite the criticisms, the monetary approach is more realistic to traditional theory. In traditional theory Balance of Payment adjustment was through gold flow and consequent effect upon prices, international trade and payments but this modern theory takes into consideration both the change in domestic and international monetary base and their effects upon production, income and expenditure.



CHECK YOUR PROGRESS

Q 9: Take the following statements whether True(T)or False(F).

i. If $M_D = M_D$,then Balance of Payment is in equilibrium.(T/F)

ii. The demand for money is a unstable function of Income, Price and Rate of interest.(T/F)

Q 10: Write the assumptions of monetary approach to the balance of payment.(Answer in about 30 words).

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Q11. How equilibrium is self correcting under flexible exchange rate in monetary approach of Balance of Payment (Answer in about 40 words)

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11.7 LET US SUM UP

- Balance of Payment includes all the external transactions i.e. exports and imports of goods and services, foreign investment, loans, foreign aid, foreign capital, financial transfers by the residents of the country with the outside world. All these transactions are recorded on the basis of double entry book-keeping method.
- Balance of Trade deals with exports and imports of visible items but Balance of Payment deals with all types of economic transactions visible, invisible and capital transfers.
- The current account of a country records all the transactions relating to exports and imports of goods and services and unilateral transfers.
- The capital account concerned with the short term and long term international flow of loans and investments and represents a change in the country's foreign assets and liabilities between the residents of the country with the rest of the world.
- Balance of Payment should always be in balance. If the exports of any country are equal to its imports then Balance of Payment is in balance otherwise if exports (receipts) are more than imports (payments) or imports (payments) are more than exports (receipts) then be Balance of Payment is said to be in disequilibrium.
- Fixed Exchange rate is not determined by Demand and Supply conditions of the market but by the Government. The international Gold Standard of Fixed Exchange Rate operated between 1880-1914; the external value of currencies was denominated in terms of Gold.

- Flexible Exchange Rate is determined like a price of a commodity by the forces of demand and supply without any Government intervention.
- Disequilibrium in Balance of Payment will automatically be corrected with Fixed or Flexible Exchange Rate under the monetary approach.



11.8 FURTHER READING

(1) Jhingan, M.L (2003), Macro Economc Theory. Delhi: Vrinda Publications (P)Ltd.

(2) Jhingan, M.L and Jhingan, B.K(2019), International Economics. Delhi: Vrinda Publications (P)Ltd.

(3) Krugman, Paul, Obstfeld, Maurice and Melitz Marc (2017), International Economics: Theory and Policy, Pearson India Education Service Pvt. Ltd.

(4) Salvatore, Dominic (2004), International Economics. New Delhi: Wiley India(P)Ltd.



11.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: (i) True (ii) False

Ans to Q No 2: Balance of Trade is defined as the difference between the value of goods and services export out of a country and value of goods and services imported into the country.Balance of Trade deals with exports and imports of visible items.

Ans to Q No 3: The capital account concerned with the short term and long term international flow of loans and investments and represents a change in the country's foreign assets and liabilities between the residents of the country with the rest of the world. There are two types of transactions in capital account- Private and Government.

Ans to Q No 4: (i) False (ii) True

Ans to Q No 5: There are certain reasons of disequilibrium in Balance of Payment. The causes of disequilibrium in Balance of Paymentare as Natural Calamities, Overvaluation or Under-valuation, Price Fluctuations, Economic change, Cyclical Fluctuations, Political Instability, Change in fashion, taste or habbits etc.

Ans to Q No 6: Deflation is an important measure to correct Balance of Payment through which the central bank of the economy can control the volume of credit by using quantitative and qualitative measures of credit control.Devaluation or by adopting other non-monetary measures govt. can correct Balance of Payment.

Ans to Q No 7: (i) True (ii) False

Ans to Q No 8: Fixed Exchange rate technically called as "Pegged Exchange rate" means value of currency is fixed against the value of another country or fixation of par value of the currency in terms of Gold. This Exchange rate is not determined by Demand and supply conditions of the market but by the Government.

Ans to Q No 9: (i) True (ii) False

Ans to Q No 10: 1. One price for homogeneous goods in different countries
2. There is perfect substitution in both the product and capital market.
3. Full employment.
4. The demand for money is a stock demand.
5. Money multiplier is applicable on supply on money.
6. The level of output of a country is exogenously determined.

Ans to Q No 11: If Balance of Payment is in deficit or surplus then without any inflow or outflow of foreign exchange reserves demand for money and exchange rate will automatically adjust the process by appreciation or depreciation of the currency.



11.10 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words).

Q 1: Write a note on Balance of Payment.

Q 2: Is Balance of Payment is always in equilibrium?

Q 3: Explain Capital Account.

Q 4: Define Flexible Exchange Rate.

Essay-type Questions (Answer each question in about 300-500 words).

Q 1: What is Balance of Payment? Explain its components.

Q 2: What are the causes of disequilibrium in Balance of Payment? How it can be corrected?

Q 3: Critically explain the Monetary Approach to the theory of Balance of Payment.

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UNIT 12: FOREIGN TRADE MULTIPLIER

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 The Concept of Foreign Trade Multiplier

12.3.1 Contractionary Effect of Increase in Imports on National Income

12.4 Foreign Trade Repercussion

12.4.1 Implications of Foreign Repercussion

12.4.2 Foreign Income Repercussion

12.5 Foreign Trade Repercussion Effect of Increase in Investment and Export

12.6 Deficiencies of Foreign Trade Multiplier

12.7 Let Us Sum Up

12.8 Further Reading

12.9 Model Questions

12.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- derive the meaning and concept of foreign trade multiplier
- discuss the contractionary effect of increase in imports on national income
- elaborate on foreign trade repercussion as well as draw their implications
- discuss foreign income repercussion
- narrate foreign trade repercussion effect of increase in investment and export
- outline the deficiencies of foreign trade multiplier.

12.2 INTRODUCTION

This unit basically deals with the concept of foreign trade multiplier. The foreign Trade Multiplier is also known as the export multiplier, which operates like the investment multiplier of Keynes.

As the classical economists viewed income effect on BOP only as an accompaniment of price changes. But the fact is that the gold movements of the 19th century exerted only minor impacts on price and interest rate levels, that prompted economists to look for alternate explanations for balance of payments adjustment under a fixed exchange system. The Keynesian theory of income determination, published in the 1930s exposed that under a system of fixed exchange rates the influence of income changes in surplus and deficit nations will help restore payment equilibrium automatically often via the working of the multiplier.

In this units, the concept of foreign trade multiplier has been discussed. Here we shall discuss the contractionary effect of increase in imports on national income, foreign trade repercussion as well as draw their implications, the effects of foreign trade repercussion in investment and export and finally the deficiencies of foreign trade multiplier shall be discussed. at trade leads to gain in welfare between the trading countries.

12.3 THE CONCEPT OF FOREIGN TRADE MULTIPLIER

The Keynesian theory says that as export increase there is an increase in the incomes of all persons associated with the export industries. These inturn, create demand for goods. But this is dependent upon their marginal propensity to save and the marginal propensity to import. The smaller these two marginal propensities the larger will be the value of the multiplier, and vice versa.

Assumptions: The foreign trade multiplier has certain assumptions given as under:

- There is full employment in the domestic economy.

- There is direct link between domestic and foreign country in exporting and importing goods.
- The country is small with no foreign repercussion effects.
- It is on a fixed exchange rate system.
- The multiplier is based on instantaneous process without time lags.
- There is no accelerator.
- There are no tariff barriers and exchange controls.
- Domestic investment remains constant.
- Government expenditure is constants.
- The analysis is applicable to only two countries.

The foreign trade multiplier process can be explained with the help of an example. Suppose, the exports of the country increase. To begin with the exporters will sell their products to foreign countries and receive more income. In order to meet the foreign demand, they will engage more factors of production to produce more. This will raise the incomes of owners of factors of production. This process will continue and the national income increase by the value of the multiplier. The value of the multiplier depends on the value of the marginal propensity to save and the marginal propensity to import, there being an inverse relation between the two propensities and the export multiplier.

According to the principles of multiplier, if the marginal propensity to consume is greater than zero an increment in investment will increase the income greater than the incremental investment though successive rounds of spending.

A closed Economy is in Equilibrium when

$$Y-C+I=C+S$$

Where: Y= National income, C= Consumption, S= Saving, I= Investment

It is clear from the equation that I=S

Equality between savings and investment is a must for equilibrium because savings represent leakage from the income stream where as investment is an injection of income when I=S, whatever is leaked out of

the income flow is made good by injecting an equivalent amount by way of investment.

In an open economy, there are two important variables to be considered they are export and imports. Imports, like saving, represent leakage. When we import money flows out of the country, hence, is considered as leakage. On the other hand, export represents expenditure in our economy by other nations,which reflect injections to the economy.

In an open economy, conditions for equilibrium represented as

$$S+M=I+X$$

In an open economy equilibrium level of income can be represented as;

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

As mentioned earlier, exports like investment, are an injection of income, they represent spending on domestic goods and services and so are a source of income for domestic factors of production. Hence, like investment exports might also have a multiplier effect. If there is no leakage from this additional income from exports, it will go multiplying itself infinitely. But also there are two possible leakages. A part of the newly injected income is likely to be possible leakages. Apart of the newly injected income is likely to be saved. When income rises imports may also rise savings and imports, thus, represent the two possible leakages from the income brought in by the increase in exports. Hence, the foreign trade multiplier can be represented as;

$$Kf= 1/(S+M)$$

Where Kf stand for export multiplier, Sfor marginal propensity to save, and M for marginal propensity to import.

In closed economy, the investment multiplier

$$K= 1/S$$

And In an open economy, as there is an additional leakage in imports, the foreign trade multiplier is Kf = 1/(S+M)

It is clear from the above equation that smaller the leakage is, smaller is the marginal propensities to save and import. And greater the multiplier effects an increase in exports.

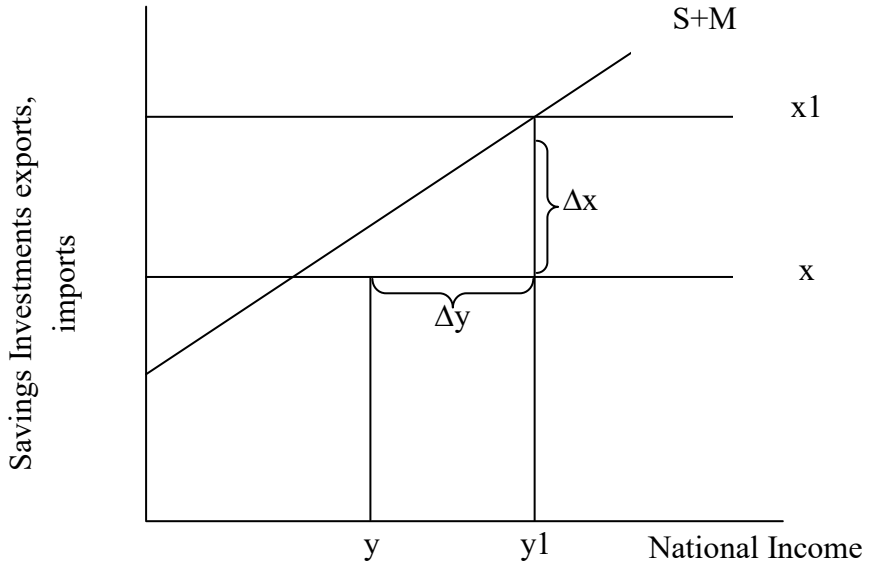
For Example, If S=0.2 and M= 0.2 then

Kf=1/(0.2+0.2) = 1/0.4=2.5

If S=0.3 and M=0.2

then Kf = 1/0.5=2

Figure 12.1: The Concept of Foreign Trade Multiplier



The concept of foreign trade multiplier can be illustrated diagrammatically as shown in Figure 12.1. In the Figure 12.1, the horizontal line marked x represents exports. The savings and imports functions is represented by the line with a positive slope marked as S+M. Suppose the economy is in equilibrium at Y level of income, where savings and imports are equal to exports. Let us assume that there is an autonomous increase in export so that exports schedule is shifted from x to x1. This autonomous increase in exports may be caused by a change in the taste/needs abroad in favour of our exports goods. The increase in exports cause an injection of income to the economy. This will cause the income of the exporting country to rise by more than the amount of the export injection because people spend some or most of all additional income on domestic goods and services only part of the additional income will leak out by lays of savings and imports support that the autonomous increase in exports amount to Rs. 500 crore and the income saved out of it and used for additional imports

add up to Rs.250 crore. Then the total expansion of income will be Rs. 1000 crore (because S+M=0.5).

As shown in Figure 12.1, new equilibrium is established at y, level of income where savings and imports are equal to the new level of exports. Given fig. depicts the multiplier effects of the autonomous increase in exports because “Y is greater than “X. The expansionary effect on national income from a given increase in exports depends on the slope of the saving-import schedule. This slope depends on the marginal propensities to save and import. The smaller the sum of these propensities, the smaller will be the slope of the schedule and the larger the expansionary effect of an increase in exports on national income.

12.3.1 Contractionary Effect of Increase in Imports on National Income

An autonomous rise in imports on national income will have inverse effect to that of an autonomous increase in exports. We can assume that due to an increase in the preference for foreign goods over domestic goods imports rise. This reflect a fall in demand for domestic goods and this fall in the demand for domestic goods will lead to a fall in production as well fall in employment. Due to this, income and aggregate demand for domestic goods will fall resulting in a fall in income and aggregate demand. This fall in income through the multiplier effect will continue until finally a new equilibrium is reached at a lower national income.

This can be illustrated with the help of Figure 12.2.

Given, Kf = 1/0.5=2

Figure 12.2: Contractionary Effect of an Autonomous Increase in Imports on National Income

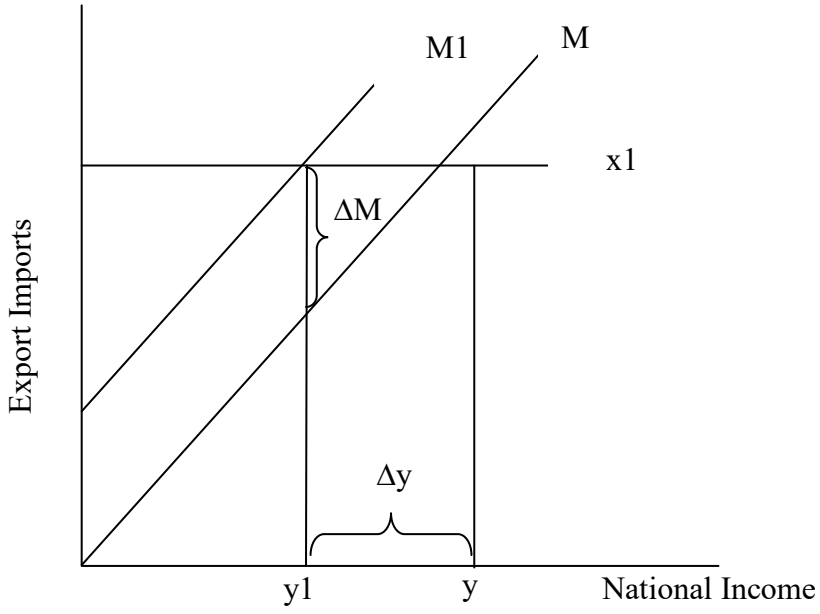


Figure 12.2 shows that, the contractionary effect of an autonomousincrease in imports on national income. X represents the export schedule and M represents the import schedule: Initially economy is at Y, equilibrium. An autonomous increase in import shift the import schedule from into M, and new equilibrium is set at a lower level of income, Y1. That the increase in imports has a multiplier effect on the contraction of income is evident from the fact the “Y is greater than “M.

After studying the foreign trade multiplier and its working it is clear that its assumptions have limitation, its works only for small countries or countries with limited foreign trade. But in reality countries involve with other countries of the world beyond these assumptions. That is countries linked with each other indirectly. As well, country’s exports or imports affect the national income of the other country, which in return, effects the foreign trade and national income of the first country.

12.4 FOREIGN TRADE REPERCUSSION

The foreign multiplier has been studies in the case of only one country. But the countries of the world are inter related with each other through trade. That is, a country's exports or imports effect the national income of the other country which in turn, affect the foreign trade and national income of the first country. This is known as foreign trade repercussion or the back wash effect. The smaller the country in relation to the other trading partner, the negligible is the foreign repercussion. But the foreign repercussions will be high in the case of a large country because a change in the national income of such a country will have significant foreign repercussion or back wash effect.

In other words, we can say that, the foreign trade repercussion effect refers to a situation in which a change in one country's macro-economic variables relative to another country will induce a chain reaction in both of their economics when the one country's economy improves, imports rise. That means exports of other countries rise and their GDP increase.

12.4.1 Implications of Foreign Repercussions

- The foreign repercussion effects suggest a mechanism for the transmission of income disturbances between trading countries. If a country is small, it will be affected by change in income of other countries that will alter the demand for its exports. But it will not be able to transmit its own income disturbances to the latter.
- If country is large, it may transmit its own income disturbances to other countries and, in turn, be affected by income disturbances in them. It implies that a boom or slump in one country has repercussion on the income of other countries. Thus swings in business cycles are likely to be internationally contagious, as happened in the 1930s and 2008.
- The repercussion effects also suggest that since the backwash effects ultimately peter out automatic income changes cannot

eliminate completely the current account BOP deficit or surplus produced by an automatic disturbance.

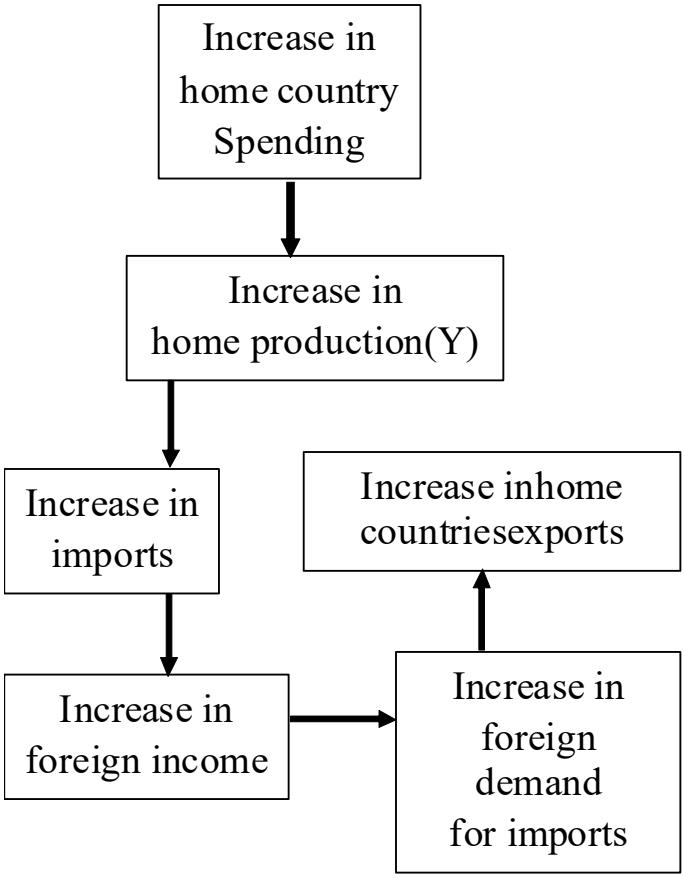
- The policy implications of the backwash effects suggest that export promotion policies raise national income in the trading partners at a lower rate than by an increase in domestic investment. The export promotion measures rise national income via the simple foreign trade multiplier, whereas increase in domestic investment policies raise national income many times in multiplier rounds via the repercussion effects.

12.4.2 Foreign Income Repercussions

We know that, imports act as a leakage for the home country. As assumed that whatever is spent on imports is permanently lost as a component of aggregate demand for domestic product. This assumption can be suitable for small countries with negligible volume of trade when a nation's import is large and if it has exportable in demand abroad, the import could result in foreign income repercussions leading to an increase in the hoe country's exports.

Better understand by a given example, suppose country A has large imports from B, the as a result income in country B will increase and reflect an increase in the aggregate demand, a part of which is likely to be for goods and services of A we can say that the imports of A result in a demand for A's exports, depending on B's marginal propensity to import from A.

Figure 12.3:Flow Chart showing Foreign Income Repercussions



12.5 FOREIGN TRADE REPERCUSSION EFFECT OF INCREASE IN INVESTMENT AND EXPORT

In an open economy, the total investment of income injection consists of domestic investment and foreign investments or exports. The total leakage consists of savings and imports. Hence the equilibrium can be expressed as;

$$I+X = M+S$$

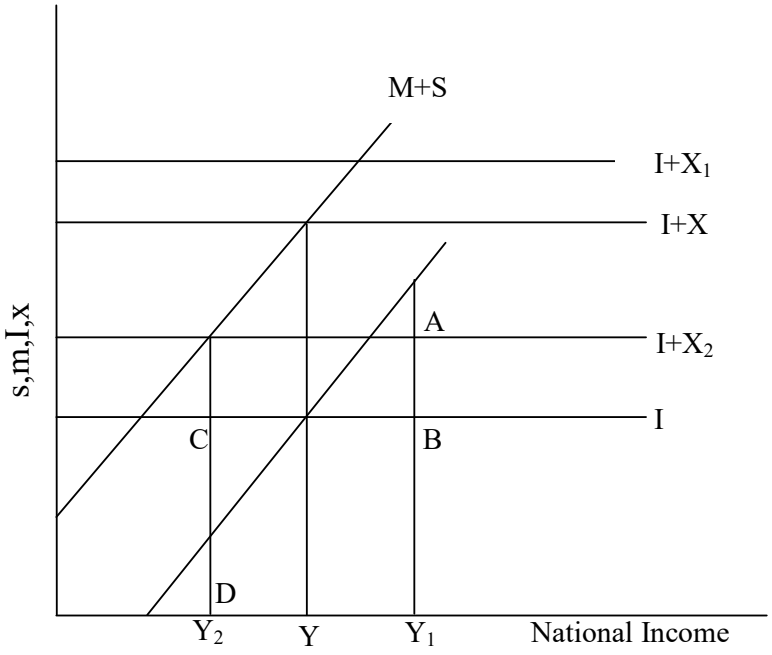
This can be illustrated with the help of Figure 12.4.

In the figure I represents the schedule of domestic investment, where X exports and M+S is imports + saving andI+X is investment + exports.

In Figure 12.3, the economy is in equilibrium at y level of income. At this income level there is also equilibrium in the balance of current account

because, it is clear from the figure, that saving equal domestic investment (S=I) and exports equal to imports (X=M).

Figure 12.4: Foreign Trade Repercussion Effect of Increase in Investment and Export



The shift of the export domestic investment schedule from I+X to I+X, represents an autonomous increase in exports. The resultant expansionary multiplier effect established new equilibrium at y, where once again the exports plus domestic investment equal savings plus imports. At the new equilibrium, there is however, no equilibrium in the balance of the current account because the total saving are now larger than domestic investment. The difference between savings and domestic investment at y_1 is given by the distance A-B. This implies the exports are larger than imports by the same amount and that the country exports capital.

A fall in exports will have a contractive effect on national income suppose that the domestic investment plus exports has fallen to $I+X_2$. This causes the income to contract to y_2 where new equilibrium is established. At this level of income, domestic investment is larger than saving by the distance C-D, indicating that the imports are larger than exports by the same amount and that the country has a deficit in its balance of current account.

12.6 DEFICIENCIES OF FOREIGN TRADE MULTIPLIER

- In the concept of foreign trade multiplier, it is assumed that the changes in foreign trade and investment are autonomous is wrong. A rise in exports does not always lead to increase in national income. On the contrary, certain imports, such as capital goods, have the effect of increasing national income.
- It is not necessary that an increase in exports or imports always means of an injection or leakage of income. For example, imports of capital goods or production inputs will facilitate increase in output may reflect as leakage.
- The concept of foreign trade multiplier is based on the assumption of full employment which is also wrong. There is less than full employment in every economy. Thus the foreign trade multiplier does not find clear expression in an economy with less than full employment.
- This assumption is also considered unrealistic that the government expenditure is constant. In fact, government always interferes through monetary and fiscal policies which affect exports, imports and national income.
- If is also assumed that international trade is free of barriers, which is also not true. In reality, such trade restrictions exist which restrict the operations of the foreign trade multiplier.
- Other drawback of this foreign trade multiplier is that, it is a static concept and that is based on the two country model. But the economists have shown that the foreign trade multiplier can be used to analysis the propagation of income in a dynamic context and that it can be extended to multi-century trade.

Despite of these limitations and criticisms the foreign trade multiplier is a powerful tool of economic analysis which helps in formulating policy measures.



12.7 LET US SUM UP

- The concept of foreign trade multiplier is based on the Keynesian theory of income determination.
- Like investment, injection of income by exports can have multiplier effect on income.
- Foreign trade multiplier is effected by marginal propensities to save and import.
- When a country's or imports affect the national income of the other country which in turn, affects the foreign trade and national income of the first country. This is known as foreign repercussion or back wash effect.
- Some part of the export income earned by the foreign country may be spent on imports from the home country.
- Export foreign repercussions effect has policy implications mostly.



12.8 FURTHER READING

1. M.L. Jhingan, International Economics, Konark publishers Pvt. Ltd.
2. Francis Cherunilam, International Economics, Tata McGraw-Hill publishing company Limited New Delhi.



12.9 MODEL QUESTIONS

Q 1: Explain foreign trade multiplier.

Q 2: What is the foreign repercussion effects?

Q 3: What are the limitations of foreign trade multiplier discuss.

Q 4: Discuss the working of foreign trade multiplier?

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UNIT 13: DETERMINATION OF EXCHANGE RATE

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Determination of Exchange Rate

13.3.1 Determination of Fixed Exchange rate under Bretton Wood System

13.3.2 Determination of Floating Exchange Rate

13.4 Fixed vs Flexible Exchange Rate

13.5 Policies for Achieving Internal and External Equilibrium Simultaneously under Alternative Exchange Rate Regimes

13.6 Relative Merits and Demerits of Fixed and Flexible Exchange Rates in the Context of Growth and Development in Developing Countries

13.6.1 Merits and Demerits of fixed exchange rate system

13.6.2 Merits and demerits of flexible exchange rate system

13.7 Let Us Sum Up

13.8 Further Reading

13.9 Model Questions

13.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- know about exchange rate and its kind
- discuss fixed and floating exchange rate determination
- differentiate between the two and their relative merits and demerits
- discuss the external and internal balance and the policy instruments to bring about that balances.

13.2 INTRODUCTION

Different countries have different currencies. For example Indian currency is called Rupee, USA's currency is called US Dollar. Hong Kong has the currency Hong Kong Dollar; UK has Pound Sterling and so on.

These currencies act as legal tender or have universal acceptability within the domestic territory of the country. Not all the national currencies are internationally acceptable in the settlement of international transactions. If one has to make international payments then domestic currency is of no use. All such payments should be made in terms of foreign exchange and preferably in American Dollar as it is the strongest of all foreign currencies. Foreign Exchange is a term that refers to foreign money which is internationally acceptable by all the trading nations of the world. Therefore to facilitate all the transactions of export and import of goods and services of one country with the rest of the world, there must be a mechanism of exchange one country's currency with the currencies of different countries.This can be understood with the help of an example. Let us suppose that rupee is the national or home currency and dollar is the only foreign exchange that is internationally acceptable by all the countries. To convert domestic currency to foreign currency there must be a price established between the two currencies. The price of foreign exchange or the "foreign exchange rate" is the amount of domestic currency that must be paid per unit of foreign exchange. Or in other word it is the rate at which one country's currency is exchanged for another country's currency. When you exchange your rupee for another type of currency, say dollar, you're basically buying dollar. The exchange rate is just the cost of one form of currency in another form of currency. For example, you need 75 .04 rupees to buy one US dollar and 91.83 rupees to buy one pound sterling. Or else we can say dollar costs 75.04 rupees and pound sterling costs 91.83 rupees. The U.S. dollar dominates many world financial markets today. Many exchange rates are expressed in terms of U.S. dollars. The U.S. dollar and the euro make up about half of all currency exchange transactions across the world.

13.3 DETERMINATION OF EXCHANGE RATE

Now the question here is how exchange rate is determined. According to Purchasing power parity theory put forwarded by Gustav Cassel long ago, exchange rate is determined by the relative purchasing

powers of the two currencies reflecting parity between them. According to this theory the rate of exchange tends to rest at the point which expresses equality between the respective purchasing powers of the two currencies. This point is called the purchasing power parity. For example if a commodity X costs Rs 100 in home country and the same commodity costs USD 1 in the foreign country, then the exchange rate between the two currencies will be USD 1 = 100 Rupees. If the price of commodity X in home country increases from Rs 100 to 150 , and that of X remains same in USA, Then the exchange rate will be USD 1 = 150 Rupees. Thus, under a system of autonomous paper standards the external value of a currency is said to depend ultimately on the domestic purchasing power of that currency relative to that of another currency. In other words, exchange rates, under such a system, tend to be determined by the relative purchasing power parities of different currencies in different countries.This explanation is highly simplistic and ignores the factors behind the foreign exchange rate determination. However to analyse foreign exchange rate determination in a much deeper way we have two system – fixed and flex exchange rate system. There are basically two kinds of exchange rate— fixed and floating exchange rate and based on these there are two methods of determining exchange rate. Most of the developed countries having stable economy use a floating exchange rate. For example, the United States, Canada, and Great Britain all use floating exchange rates.



LET US KNOW

Fixed Exchange Rate: A movable or adjustable peg system is a system of fixed exchange rates, but with a provision for the revaluation (usually devaluation) of a currency. For example, between 1994 and 2005, the Chinese Yuan renminbi (RMB) was pegged to the United States dollar at RMB 8.2768 to $1. China was not the only country to do this; from the end of World War II until 1967, Western European countries all maintained fixed exchange rates with the US dollar based on the Bretton Woods system.[8] But

that system had to be abandoned in favor of floating, market-based regimes due to market pressures and speculation, according to President Richard M. Nixon in a speech on August 15, 1971, in what is known as the Nixon Shock. Fixed exchange rates use a standard, such as gold or another precious metal, and each unit of currency corresponds to a fixed quantity of that standard that should (theoretically) exist.For example, in 1968 the U.S. Treasury determined that it would buy and sell one ounce of gold at a cost of $35. Other countries would establish their own cost for the equivalent ounce Smaller or developing countries with economies that might be unstable from time to time tend to use a pegged or fixed exchange rate. Pegged exchange rates are set and artificially maintained by the government. The term "pegged" refers to the fact that rates are pegged to another country's currency, often the U.S. dollar. Pegged exchange rates don't fluctuate from day to day. Governments must make continual adjustments to keep their pegged rate stable. This means they must keep large reserves of foreign currency to accommodate fluctuations in supply and demand.

Floating Exchange Rate: Floating exchange rates are determined by the market based upon supply and demand. Here the underlying concept is that foreign exchange rate is a price of one currency in terms of another and like price of any other commodities this is too govern by the forces of demand and supply. The currency in question become more valuable if its demand is more than available supply or we can say that price of that currency will go up. And if the supply is more than the demand, the value of that that currency fall. This means that people no longer wish to keep their wealth in terms of that currency. They will prefer to hold their wealth in some other form, preferably in another currency. Many factors can affect a floating exchange rate. Some of the major factors include inflation, interest rates, unemployment rates, foreign investment, and trade ratios.



CHECK YOUR PROGRESS

Q 1: What is meant by Exchange Rate? What is the present exchange rate between US Dollar and Indian Rupee?

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13.3.1 Determination of Fixed Exchange Rate under Bretton Wood System

The world has witnessed a complex and highly volatile foreign exchange environment today. This is because currency exchange rates constantly vary in response to even a small change in global economic conditions. But previously it was not like this. The exchange rate was fixed and more or less stable. . The international monetary system has undergone a change from a fixed exchange rate to a floating or flexible exchange rate in due course. Under Bretton Wood system the exchange rate was fixed exchange rate. After the great depression Followed by Second World War, many countries abandoned gold standard where country's currency was directly linked with the available gold. As a result a new system was evolved out similar to a gold standard and sometimes described as a "gold exchange standard".



LET US KNOW

What is Bretton Wood System

In 1944, as World War II was drawing to a close, representatives of forty-four countries met at Bretton Woods in the U.S.'s White Mountain National Forest, in New Hampshire. Led by the British economist John Maynard Keynes and Harry Dexter White from the U.S. Treasury, they hammered out an agreement they hoped would form the basis of a new financial world order. The "Bretton Woods" system of internationally fixed exchange rates was born out

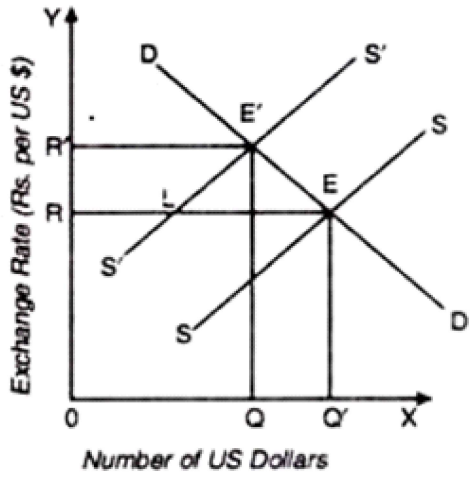
of the conference, as was the International Monetary Fund (IMF) and the World Bank The Agreement was developed by delegates from 44 countries at the United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire.

This new international monetary order was established by the Bretton Woods Agreements. The Bretton Woods Agreement was negotiated in July 1944 under the leadership of J.M Keynes and Harry Dexter to establish a more stability in International monetary system. Following the agreement at Bretton Wood, International Monetary Fund (IMF) was set up to administer the new fixed exchange rates system. The USA was to fix a parity or par value for its dollar in terms of gold, whereas other countries were required to fix parities for their currencies in terms of dollarsCountries following this new system would settle their international payments in dollars: but the U.S. would settle its own international payments in gold. Since US dollar was tied to gold, the currencies of other countries with fixed exchange rate with US dollar automatically got pegged (that is, fixed) with a certain gold value. The USA Government made a commitment to maintain the convertibility between dollar and gold at a fixed rate, whereas other countries agreed to maintain the convertibility of their currencies with US dollar. Therefore, under the Bretton Woods System, gold was the basis for the U.S. dollar and other currencies were pegged to the U.S. dollar's value. Under this system, many countries fixed their exchange rates relative to the U.S. dollar and central banks could exchange dollar holdings into gold at the official exchange rate of $35 per ounce; this option was not available to firms or individuals. Or in other words, all currencies pegged to the dollar thereby had a fixed value in terms of gold and dollar itself is fixed with certain amount of gold. All of the countries in the Bretton Woods System agreed to a fixed peg against the U.S. dollar with diversions of only 1% allowed. Countries were required to monitor and maintain their currency pegs which they achieved primarily by using their currency to buy or sell U.S. dollars

as needed. The Bretton Woods System, therefore, stabilize the volatile nature of foreign exchange rate which helped international trade relations.

To keep the exchange rate stable and fixed under the Bretton Woods system, the Governments (or their Central Banks) were to keep with themselves reserves of internationally accepted foreign currencies. So here the government intervention is must. This can be explained with the help of a diagram. Here we talk about two countries India and US. And want to explain how government tries to maintain exchange rate between these two countries at a fixed level. In Figure 13.1, DD is the demand for US dollars and SS is the supply curve of US Dollar. Along the X-axis the quantity of US dollars and on the Y- axis, the value of US dollar in terms of Indian rupees is measured.

Figure 13.1: Government Intervention to Maintain the Exchange Rate at Fixed Level.



Suppose the Government of India is committed to maintain the exchange rate of its currency with US $ at OR level which is also assumed to be the equilibrium exchange rate as determined by demand for and supply of dollars. Now, suppose the demand of the USA for Indian exports greatly declines. As a result there is a scarcity of US dollar supply which causes a shift of dollar supply curve from SS to S'S'. Now, since the demand for dollar remains

unchanged as there is no change in import, at the exchange rate OR the quantity supplied of US dollars falls to RL whereas the quantity demanded of dollars continues to be RE. This means that demand for dollar exceeds supply causing a temporary disequilibrium. If market forces are allowed to work freely then it will work in its own way appreciating the price of US dollar in terms of rupees. Or in other words the Indian rupee will depreciate. And exchange rate will be at OR' level. However in fixed exchange rate system government intervention does not allow market forces to work freely. In order to maintain the exchange rate of rupee in terms of dollar at OR level, and to prevent it from depreciating, the Government or Central Bank must sell US dollars from its foreign exchange reserves to increase the supply of US dollars in the market. And hence original equilibrium at OR level will be restored. This is how the exchange rates remained fixed despite the frequent changes in demand for and supply of their currencies.

Fixed exchange rate system under the Bretton Woods arrangement came under heavy pressure during the sixties and it ultimately collapsed in the early seventies. As seen above, under the Bretton Woods System the US dollar became internation-ally accepted currency in which reserves of the countries were kept for international transactions.Before the Bretton Woods System gold was accepted as international medium of exchange. Under the Bretton Woods System, the US dollar also assumed the role of international currency for three reasons. These are as follows:

- The United States emerged as the strongest economy after World War II
- The United States had accumulated a large stock of gold.
- As under the Bretton Woods System, the dollar was converted into gold at a fixed rate (that is, $35 per ounce), it was considered 'as good as gold'. The United States had been following the policy of selling and buying gold to other countries at a fixed exchange rate of $35 per ounce during 1934 and 1971.

Again during 1950s, the BOP position of US was adverse. So they started their gold reserve to make international payments. However the supply of gold is limited and is not adequate to meet the needs of rapidly increasing international trade. As a result soon US was running short of gold and other countries had more of both i.e. dollar and gold. Doubts on dollars and widespread fear led many countries to convert their dollar reserve to gold which accentuate the problem more. Therefore, in view of the large and persistent deficit in balance of payments, it was decided by the US Government to withdraw convertibility of dollar into gold at the rate of $35 per ounce on August 15, 1971. This brought about the collapse of the Bretton Woods System and so the fixed exchange rate regime. And conse-quently the regime of floating or flexible exchange rate has started.



CHECK YOUR PROGRESS

Q 2: Write true or false

a) Fixed exchange rate was prevailing under Bretton Wood System.

b) Bretton Wood system was collapsed due to Shortage of Gold reserve in USA.

13.3.2 Determination of Floating Exchange Rate

A floating exchange rate is a regime where the currency price of a nation is set by the foreign exchange market based on supply and demand relative to other currencies. This is in contrast to a fixed exchange rate, in which the government entirely or predominantly determines the exchange rate. Now let us discuss how exchange rate is determined under floating exchange rate regime.

We know that foreign exchange rate is a price, which like the price of any other commodity is determined by the demand for a supply of foreign currency. Actually all the foreign receipts earning

and borrowing constitute the foreign exchange supply and all the foreign payments – spending and lending constitute foreign exchange demand

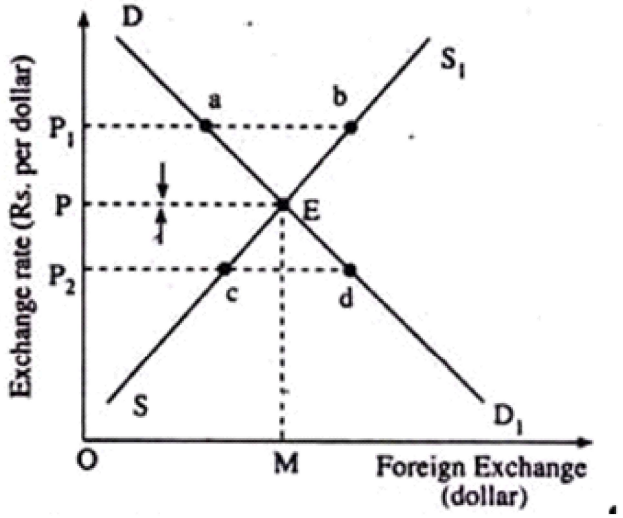
Demand for Foreign Exchange: Demand for foreign exchange arises for many reasons. The demand for foreign exchange arises to make payments for buying foreign goods and services, to make unilateral transfer payments, to hold deposits in overseas bank, to make long and short term lending to foreign residents, firms and governments etc.The demand for foreign currency also arises if individuals and firms wanting to purchase assets in the foreign country, that is, desire to invest in bonds and equity shares of the foreign companies or build factories, sales facilities or houses in the foreign country. In short, the demand for foreign exchange constitutes the demand for import of foreign goods and services and export of capital goods. Now the question is that how demand curve of a foreign currency say dollar in terms of home currency say rupee look like. When price of dollar in terms of rupee increase we can have more rupees per unit of dollar. So to buy American goods we have to pay more in terms of rupee. This means that these goods are because costly and it discourages import on the part of India. Indians will find investment in abroad less profitable. So the demand for dollar will decrease. Again when price of dollar falls in terms of rupee we will have less rupee per unit of dollar. So the buying of foreign goods becomes cheaper as we have to pay fewer rupeesnow than before. It encourages imports and investment. And hence demand for dollar will go up. So we have found that at a higher price of dollars, the fewer quantity of dollars is demanded for imports from the USA and at a lower price of dollar, the greater quantity of dollars is demanded for imports from the USA by the Indians. This makes the demand curve for dollars downward sloping

The supply of foreign exchange: The supply of foreign exchange is available through foreign money earn by exporting goods and services, receiving unilateral transfer payments from abroad, and

short term and long term capital inflow. Besides, the foreign firms and individuals who want to buy assets in home country, such as bonds and equity shares of home country's companies or wish to make loans to the individuals and firms of home country will also supply dollars. The supply of foreign exchange thus derives from the credit transactions in the BOP current and capital account in the home country. Now if the price of dollar in terms of rupee increases we will have more rupees per unit of dollar As a result Indian goods become cheaper to the foreigners and they will import more. This means that our exports will increase. Foreigners will also find that investment is now more profitable. Thus, a high price or exchange rate ensures larger supply of foreign exchange. Conversely, a low exchange rate causes exchange rate to fall. Thus, the supply curve of foreign exchange is positive sloping.

Now the equilibrium exchange rate will be determined when demand for foreign exchange will be exactly equal to the supply of foreign exchange.Now we can bring both the demand and supply curves together to determine foreign exchange rate. The equilibrium exchange rate is determined at that point where the demand for foreign exchange equals the supply of foreign exchange. In the Figure 13.2, DD_1 and SS_1 curves intersect at point E. The foreign exchange rate thus determined is OP.

Figure 13.2: Determination of Equilibrium Exchange Rate

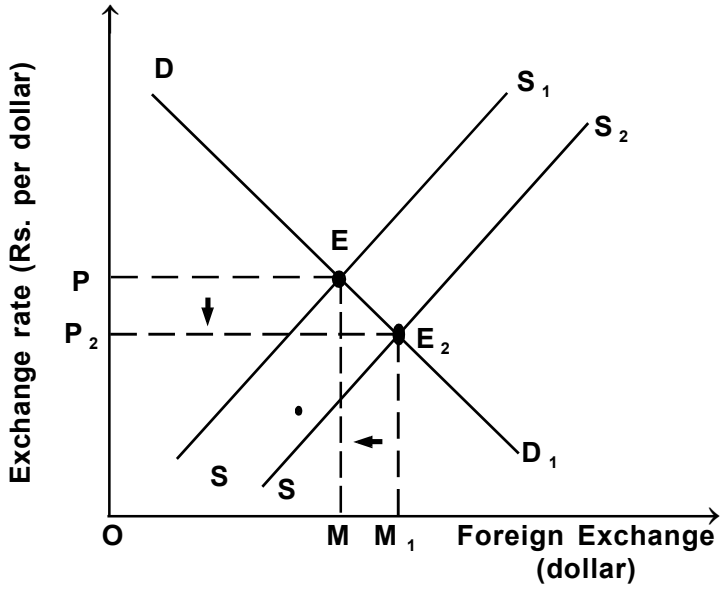


At this rate, quantities of foreign exchange demanded (OM) equals quantity supplied (OM). The market is cleared and there is no incentive to change the rate determined. If the current exchange rate OP_1 exceeds the equilibrium rate of exchange (OP), there occurs an excess supply of dollar by the amount 'ab'. Now the bank and other institutions dealing with foreign exchange, experience abundance of dollar. This would lower the exchange rate and that will increase the demand for dollar and eventually excess supply will be wiped out .Thus, exchange rate will tend to fall until OP is reached. Similarly, an excess demand for foreign exchange by the amount 'cd' arises if the exchange rate falls below OP, i.e., OP. Banks would then experience a shortage of dollars to meet the demand. The competition to buy the scarce dollars would result in the rise of exchange rate and the process will continue until it reaches the equilibrium exchange rate OP or at the point where demand for foreign exchange is equal to the supply of foreign exchange. The exchange rate that we have determined is called a floating or 'flexible exchange' rate.

Effect of Change in demand and supply on equilibrium exchange rate: In the floating exchange rate regime the change in demand and supply of foreign exchange affect equilibrium exchange rate. Let us assume that national income of the country in question rise. As a result, demand for imports of goods and services increases and, hence, demand for dollar rises. These results in a shift in the demand curve, exchange rate rises as determined by the intersection of the new demand curve and supply curve. Similarly, as a result of export promotion measures of government, let us suppose that export increases which attracts foreign exchange to the nations. If this follows an increase in national income of the USA, the supply curve would then shift rightward. Consequently, dollar depreciates and rupee appreciates. This has been explained with the help of Figure 13.3. If the supply curve shifts from SS_1 to SS_2 as shown in the figure, and demand remains constant, the new

exchange rate thus determined would be OP_2. New exchange rate is settled at that point where the new supply curve SS_2 intersects the demand curve at E_2.

Figure 13.3: Change in Equilibrium exchange Rate following a change in supply





LET US KNOW

A system of flexible exchange rate may not necessarily be ideal since frequent changes in demand and supply forces cause frequent as well as violent changes in the exchange rate and uncertainty may prevail. To prevent this awkward situation, government or the monetary authority intervenes in the foreign exchange rate. It may keep the exchange rate fixed. Often 'managed exchange rate' is suggested. Under this system, exchange rate as usual is determined by the demand for and the supply of foreign exchange. But the central bank of the country intervenes in the foreign exchange market when the situation demands. If rupee depreciates in terms of dollar, the RBI would then sell dollars and buy rupee in order to reduce the downward pressure in the exchange rate.



CHECK YOUR PROGRESS

Q 3: Define floating exchange rate. (Write within 40 words)

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13.4 FIXED VS. FLOATING EXCHANGE RATE

Fixed and flexible exchange rates are the two regimes of exchange rates. The differences between these two are summarized below:

- Fixed exchange rate is a rate where government deliberately fixed or pegged its currency with a foreign currency or a basket of foreign currency (a stronger currency say American Dollar.) It is determined by Central Bank of any country. However flexible exchange rate is determined by the free play of market forces. This means that demand and supply of foreign exchange determines flexible exchange rate.
- In fixed exchange rate regime it is the government who influenced the foreign exchange rate.However in floating exchange rate there is no government intervention in determining the exchange rate.
- Fixed exchange rate is fixed. So fewer chances are there for business and trade uncertainty. Here the exchange rates are not allowed to float freely in the market. But in case of flexible exchange rate exchange rate may vary frequently depending on the prevailing market situation or the condition of demand and supply of foreign exchanges. Here the exchange rates are allowed to float freely in the market thus creating an environment of risk and uncertainty that definitely hamper the overall trade scenario.
- In fixed exchange rate regime, a reduction in the par value of the currency is termed as devaluation and a rise as the revaluation. On the other hand, in the flexible exchange rate system, the decrease in currency price is regarded as depreciation and increase is termed as appreciation.

- Speculation is very common in the flexible exchange rate as the rate changes frequently. However, in the case of fixed exchange rate speculation takes place only when there is a rumor about change in government policy.

13.5 POLICIES FOR ACHIEVING INTERNAL AND EXTERNAL EQUILIBRIUM SIMULTANEOUSLY UNDER ALTERNATIVE EXCHANGE RATE REGIMES

An external equilibrium refers to balance of payments equilibrium of a country whereas internal equilibrium refers to the state of full employment. It is desirable for an economy to achieve both internal and external balance. In fact it is one of the major goals of macroeconomic policies of many countries.

It was Johnson who pointed towards the range of policy instruments for bringing about both internal and external balance. He called them expenditure-reducing or internal policies, and expenditure-switching or external policies.

A deficit in the balance of payments implies that import of goods and services is more than export which leads an excess of expenditure over income. To correct it, expenditure and income should be brought into equality. To curb excess expenditure, the purchasing power of the people needs to be checked. So that aggregate demand of the people becomes low. Expenditure-reducing policies aim at reducing aggregate demand through higher taxes and interest rates. It in turn reduces expenditure and output. The reduction in expenditure and output again reduces the domestic price level. This gives rise to switching of expenditure from foreign to domestic goods. Because, in comparison to foreign country, the goods of home country become cheaper. Eventually import has reduced and balance of payments equilibrium is achieved. Expenditure-switching policies aim at increasing the demand for domestic goods and to change expenditure from imported goods to domestic goods. Export has increased as such expenditure-switching increases domestic output. So long as the marginal

propensity to spend is less than unity, it will improve the country's balance of payments

To achieve both objectives of internal and external balance simultaneously, a judicious combination of expenditure-reducing and expenditure-switching instruments is needed. For instance, if the economy is already at the full employment level, a policy of devaluation may cause inflation within the economy. So expenditure- switching policy of devaluation must be accompanied by expenditure-reducing policies of tighter fiscal and monetary controls to maintain full employment and balance of payments equilibrium.

13.6 RELATIVE MERIT AND DEMERIT OF FIXED AND FLEXIBLE EXCHANGE RATE SYSTEM IN THE CONTEXT OF DEVELOPING ECONOMY:

13.6.1. Merits and demerits of Fixed exchange rate system:

Merits of fixed exchange rate system:

- Under the regime of fixed exchange rate stability in exchange rate is achieved. Exchange rate stability is important for smooth functioning of international trade. It is also very important for developing country to maintain a stable exchange rate as they normally suffer from BOP deficit. With the exchange rate fixed it eliminates the environment of risk and uncertainty from the world trade and allow the steady development of the same.
- Under the system of fixed exchange rate capital movement is of private firms are facilitated. A stable currency does not involve any uncertainties about capi-tal loss on account of changes in exchange rate. Therefore, fixed exchange rate system would attract foreign capital investments. Foreign firms are likely to invest in developing countries whose currencies are stable following a fixed exchange rate. This is important for any developing country as these countries depends on foreign investment for economic development.

- In a fixed exchange rate system, it is highly unlikely that capital will flow from the country because the people lost faith in domestic currency. This kind of situation is detrimental for the growth of developing economy.
- One of the merits of fixed exchange rate system is that it helps to control inflationary pressure which is common in most of the developing countries. Generally governments of different countries, especially developing countries are tempted to adopt loose monetary policy to increase employment and to create optimism in the business. Fixed exchange rate system forces the Governments to achieve price stability by taking effective anti-inflationary measures. This is because in the case of fixed exchange rate, inflation will cause balance of payments deficits and result in loss of international reserves.
- We know that financial markets are not well developed in many developing countries. Fixed exchange rate system promotes growth of internal money and capital markets. It creates a secured and certain environment. So individuals, companies and institutions are ready to lend to and borrow from the internal money and capital markets and thereby strengthening the market many more extent.

Demerits of fixed exchange rate system

- There are major loopholes in fixed exchange rate system which brought the collapse of the system in 1971. Countries with deficit balance of payments are forced to devalue their currency in order to meet the deficit as their gold and foreign exchange reserves are depleted. But countries with surplus balance of payments having excess gold and foreign exchange reserves are not revaluing their currency in the fear of losing business. This lead to inflationary pressure in these countries.
- One of the major problems of fixed exchange rate is that at what level exchange rate will be fixed. If the equilibrium exchange rate is adopted then due to change in economic condition that

rate will change frequently and it no longer becomes fixed. Moreover,, for the Government it is difficult to find such an equilibrium exchange rate of a foreign currency in terms of the national currency. If the exchange rate of a national currency in terms of the foreign currency, say US dollar, is fixed at a higher level, there will be deficit in the balance of payments (BoP). And if it is fixed at a lower level , there will be a surplus in Balance of Payments. A deficit BOP leads to contraction of all economic activities and imports will be discouraged. However a surplus BOP will lead t increase inflationary pressure in the country.

13.6.2 Merits and Demerits of Flexible Exchange Rate:

Merits of flexible exchange rate:

- One of the merits of flexible exchange rate is that it always ensures the equilibrium in the balance of payments. Unlike fixed exchange rate system, there is no problem of undervaluation and overvaluation of currencies. Whenever there is deficit in balance of payments, it will depreciate (that is, its value will fall) which on the one hand will make exports cheaper and thereby encourage them and on the other will make the imports costlier than before which will tend to discourage them. Thus, increase in exports and decline in imports as a result of depreciation will lead to the automatic correction in the balance of payments.On the other hand, whenever there is surplus in the balance of payments, the exchange rate will appreciate means the value of currency will increase in terms of foreign currency. So exports become costlier and hence will tend to reduce exports and raise imports. This again will tend to automatically restore the balance of payments equilibrium.
- Flexible exchange rate does not necessarily show large fluctuations. The advocate of flexible exchange rate argued that problem of undervalued and overvalued currency found in fixed exchange rate system is not found in flexible exchange rate

regime. Moreover, the changes in exchange rate will occur as result of change in demand and supply condition which is not that frequent.

- One important merit of flexible exchange rate system is that it ensures individual freedom. It is based on the philosophy that government should exert influences as little as possible in the economy. So individuals can act according to their own economic interest.

Demerits of flexible Exchange Rate :

- Flexible exchange rate creates a situation of uncertainty. Due to frequent change in the exchange rate exporters are uncertain about the receipt and importers are uncertain about the payments. So it hampers the foreign trade and capital movement between the nations. But this view was argued buy Friedman and according to him exchange rate is not unstable but the underlying conditions that influences foreign trade changes frequently.
- Under the flexible exchange rates since the rate is quite uncertain, exporters and importers are unable to take proper decisions regarding exports and imports of goods. Obviously, this has a damp-ening effect on the volume and growth of foreign trade.
- Another demerit of the flexible ex-change rates is that they have an inflationary impact on the economy. Whenever due to deficit in balance of payments, the currency depreciates; the prices of imports go up. The higher prices of imported materials raise the prices of industrial products and thus generate cost-push inflation. Again if there is a surplus in BOP positions it also contributes to demand pull inflation

To conclude, there are merits and demerits of both fixed and flexible exchange rate system. Which kind of exchange rate systems suits an economy depends on circumstances and characteristics of the economy. Long back when Bretton Woods System

representing the fixed exchange rate system was abandoned, it is not perfectly free flexible exchange rate system that has been adopted. Instead managed flexible exchange rate is adopted which is a mixture of both fixed and flexible exchange rate. Under the managed float system, the exchange rates are flexible to a certain extent. Government or the monetary authority intervene in the demand and supply of foreign exchange by buying and selling of foreign currency to keep the exchange rate at desired level.



CHECK YOUR PROGRESS

Q 4: Write one merit and demerit of fixed exchange rate.

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.....

Q 5: Write one merit and demerit of flexible exchange rate.

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13.7 LET US SUM UP

- Exchange rate is the rate at which one currency is exchanged for the other. Generally, two types of exchange rate prevails one is fixed and another is floating.
- Fixed exchange rate is a rate which is fixed by the monetary authority or the government. Here a country's exchange rate is pegged or fixed with another currency or basket of foreign currencies. This system was prevalent under Bretton Wood Agreement in post war period but collapsed after 1971.
- The floating exchange rate system is a system where there is no government intervention. Here the exchange rates are allowed to float freely in response to the demand and supply of foreign exchange. This system is criticized for being unstable.

- Today in the complex economic world to maintain internal and external balance we use a managed floating exchange rate system where exchange rates are no doubt determined by the interaction of demand and supply of foreign exchange.
- The demand and supply of foreign exchange may be influenced by Government or monetary authority to establish the desired exchange rate.



13.8 FURTHER READING

(1) K.C. Rana & K.N. Verma, International Economics, Vishal Publishing Co.

(2) H.G. Mannur, International Economics, Vishal Publishing House Pvt Ltd

(3) Dominick Salvator, International Economics, John Wiley & Sons, Inc.



13.9 MODEL QUESTIONS

Q 1: What do you mean by exchange rate? What are the different types of foreign exchange rate?

Q 2: Which exchange rate do you think better for developing country like India? Give reason.

Q 3: Explain the fixed exchange rate regime under Bretton Wood System.

Q 4: Explain with the help of diagram the determination of floating exchange rate.

Q 5: Compare and Contrast Fixed and Floating Exchange Rate.

Q 6: What is internal and External Balance? Which policy measures are used to achieve external and internal balance simultaneously?

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UNIT 14: INTERNATIONAL MONETARY ORDER

UNIT STRUCTURE

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14.2 Introduction

14.3 Evolution of International Monetary System

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14.13.5 Merits and Demerits of SDRs
14.14 International Liquidity
14.14.1 Problem of International Liquidity
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14.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- put forward critically examine the working of Bretton Woods System
- describe the present international monetary system
- the meaning and types of international capital movements
- explain the importance of foreign direct investment (FDI) and foreign portfolio investment (FPI)
- analyse the factors affecting international capital flows
- evaluate the objectives, working as well as achievements and failures of IMF
- analysethe features, working, merits and limitations of SDRs
- discuss the meaning of international liquidity as well as explain the different problems associated with it.

14.2 INTRODUCTION

International Monetary System (IMS) is a well-designed system that regulates the valuations and exchange of money across countries. It is a well-governed system looking after the cross-border payments, exchange rates, and mobility of capital. This system has rules and regulations which help in computing the exchange rate and terms of international payments. In other words, International Monetary System mobilizes the capital from one nation to another by felicitating trade. There are many participants like MNCs (Multinational Corporations), investors, financial institutions, etc. in the International Monetary System.

The main purpose of the International Monetary System today is, to enhance high growth in the world with stable price levels. Earlier the scope was only up to exchange rates, now the system has a broader scope by taking financial stability into consideration. International Monetary System has established International Monetary Fund (IMF) and the World Bank in the year 1944. This is the concluding unit of the course. In this unit, we shall discuss the international monetary system.

14.3 EVOLUTION OF INTERNATIONAL MONETARY SYSTEM

Over the past 75 years, the International Monetary System has modified according to the prevailing conditions. The scope has evolved over the years, but the purpose of the system has remained constant. The evolution of the International Financial Architecture is as follows:

14.3.1 Classic Gold Standard

The first phase of the International Monetary System was the Classic Gold Standard from 1816 to 1914. In the initial years of the Gold Standard, only a few countries adopted this standard. Later almost all countries accepted it. Usually, coins and bullions of gold were useful during this standard. This gold standard gave birth to a fixed exchange rate system with minimal fluctuations. Because of the most fixed exchange rate, International trade saw a boost during this time. Gold Standard also made all countries of the world abide by strict monetary policy. This standard was helpful in correcting trade imbalances in the country. The other name of Classic Gold Standard is International Gold Standard.

14.3.2 Merits and Demerits of Gold Standard

Merits:

- **Acceptability:** Gold because of its universal acceptability worked as a medium of exchange. People had a complete confidence on any currency based old standard or easily convertible in gold.

The exchange rates of currencies of different countries could easily be determined when the per value was expressed in terms of gold.

- **Stability of Exchange rate:** Gold Standard in whatever version lead to the automatic stability in exchange rates among the countries. The fixed exchange rate among the countries facilitated the international capital movement and thereby lead to the expansion of world trade. This can be exemplified as if one Dollar has 15 gms of gold and 1 Rupee consisted of 1 gm. In other wordsRs.15=1dollar.
- **Automatic Adjustments:** The adverse or favourable balance of payments used to get automatic adjustment under gold standard. A country e.g. with favourable BOP may get more gold in return for its exports. This will lead to currency & credit expansion which in turn will lead to a rise in prices, profit margins and consequently to greater investment, production and employment. The incomes will rise so will costs. Increase in incomes in India will lead to more demand of goods from other countries at the same time high costs will decrease exports to other countries. The reverse can be the case when it is adverse BOP. In this way we can say that gold standard required no government support for getting equilibrium in the Balance of payments of a country.
- **Stability in prices:** There used to be stability in internal prices under gold standard. The variation in prices was directly related to the gold reserve with the country and to international trade. The import of gold would lead to increase in prices and the export of gold fall in prices. This increase or decrease in prices could never be too much. Thus under gold standard there would be stability in prices.
- **Confidence in people:** Gold standard created confidence in the public in so far as the currencies could easily be converted

into gold. Its easy acceptance as a medium of payment further increased their confidence.

Demerits:

- Gold standard leaves no room for monetary policy to correct the monetary imperfections existing within the country.
- The gold standard causes international inflationary or deflationary tendencies. The credit expansion or contraction may spread to other countries and very often the central bank of a country can't neutralise it.
- It is deflationary in the sense that the gold losing country will feel better to contract the currency and it is quite possible that gold receiving country may not expand currency. The gold losing country may undergo deflation but there is no guarantee that gold receiving country will undergo inflation.
- Under gold standard the exchange rates are stabilised at the cost of internal economic stability. A country can't have its price stability as per its own monetary policy.
- The gold standard worked at the time of peace but during the period of war or economic crises it failed.

14.3.3 Reasons for the Collapse of Classic Gold Standard

After the end of World WarI, the Classic Gold Standard collapsed. During World War, many countries printed more money in order to finance their military requirements. As a result of this, the money in circulation exceeded the gold reserves of the country and so, those countries have to give up on Classic Gold Standard. The only United States of America didn't give up on Classic Gold Standards.

14.4 THE BRETTON WOODS SYSTEM

During the period preceding World War I, almost all the major national currencies were on a system of fixed exchange rates under the international gold standard. This system had to be abandoned during World

War I. There were fluctuating exchange rates from the end of the War to 1925. Efforts were made to return to the gold standard from 1925. But it collapsed with the coming of the Great Depression. Many countries resorted to protectionism and competitive de-valuations—with the result that world trade was reduced to almost half. But depression completely disappeared during World War II. In July 1944, the allied countries met at Bretton Woods in the USA to avoid the rigidity of the gold standard and the chaos of the 1930s in international trade and finance and to encourage free trade. The new system was the present International Monetary Fund (IMF) which worked out an adjustable peg system. Under the Bretton Woods system exchange rates between countries were set or pegged in terms of gold or the US dollar at $ 35 per ounce of gold. This related to a fixed exchange rate regime with changes in the exchange within a band or range from 1 per cent above to 1 per cent below the par value. But these adjustments were not available to US which had to maintain the gold value of dollar. If the exchange rate hit either of the bands, the monetary authorities were obliged to buy or sell dollars against their currencies. Large adjustments could be made where there were “fundamental disequilibrium” (i.e. persistent and large deficits or surpluses) in BOP with the approval of the IMF and other countries. Member countries were forbidden to impose restrictions on payments and trade, except for a transitional period. They were allowed to hold foreign reserves partly in gold and partly in dollars. These reserves were meant to incur temporary deficits or surpluses by member countries, while keeping their exchange rates stable. In case of a BOP deficit, there was a reserve outflow by selling dollar and reserve inflow in case of a case BOP surplus.

Reserve outflows were a matter of concern under the Bretton Woods system. So the IMF insisted on expenditure reducing policies and devaluation to correct BOP deficit. Temporary BOP deficits were also met by borrowing from the Fund for a period of 3 to 5 years. A country could borrow from the Fund on the basis of the size of its quota with it. The loans made by the IMF were in convertible currencies.

The first 25 per cent of its quota was in gold tranche which was automatic and the remaining under the credit tranches which carried high

interest rates. To provide long-term loans the World Bank or International Bank for Reconstruction and Development (IBRD) was set up in 1946 and subsequently it's two affiliates, the International Finance Corporation (IFC) in 1956 and International Development Association (IDA), in 1960. For the removal of trade restrictions, the General Agreement on Tariffs and Trade (GATT) came into force from January 1948. To supplement its resources, the Fund started borrowing from the ten industrialised countries in order to meet the requirements of the international monetary system under General Agreements to Borrow (GAB) from October 1962. Further, it created Special Drawing Rights (SDRs) is January 1970 to supplement international reserves to meet the liquidity requirements of its members. The Bretton Woods system worked smoothly from 1950s to mid 1960s. During this period, world output increased and with the reduction of tariffs under the GATT, world trade also rose.

14.4.1 The Breakdown of the Bretton Woods System

The following are the principal causes and sequences of the breakdown of the Bretton Woods system.

- **Built-in Instability:** The Bretton Woods System had a built-in instability that ultimately led to its breakdown. It was an adjustable peg system within plus or minus 1 per cent of the par value of $ 35. In case of fundamental disequilibrium, a country could devalue its currency with the approval of the IMF. But countries were reluctant to devalue their currencies because they had to export more goods in order to pay for dearer imports from other countries. This led countries to rely on deflation in order to cure BOP deficits through expenditure-reducing monetary-fiscal policies. The UK often restored to deflation such as in 1949, 1957 and 1967.
- **The Triffin Dilemma:** Since the dollar acted as a medium of exchange, a unit of account and a store of value of the IMF system, every country wanted to increase its reserves of dollar which led to dollar holdings to a greater extent than needed.

Consequently, the US gold stock continued to decline and the US balance of payments continued to deteriorate. Robert Triffin warned in 1960 that the demand for world liquidity was growing faster than the supply because the incremental supply of gold was increasing little. Since the dollar was convertible into gold, the supply of US dollars would be inadequate in relation to the liquidity needs of countries. This would force the US to abandon its commitment to convert dollars into gold. This is the Triffin Dilemma which actually led to the collapse of the Bretton Woods System in August 1971.

- **Lack of International Liquidity:** There was a growing lack of international liquidity due to increasing demand for the dollar in world monetary markets. With the expansion of world trade, BOP deficits (and surpluses) of countries increased. This necessitated the supply of gold and of the dollar. But the production of gold in Africa was increasing very little. This led to larger demand and holdings of the dollar. Countries also wanted to have more dollar holdings because they earned interest. As the supply of dollars was inadequate in relation to the liquidity needs of countries, the US printed more dollars to pay for its deficits which other countries accepted as reserves.
- **Mistakes in US Policies:** The BOP deficits of the US became steadily worse in the 1960s. To overcome them, the policies adopted by the US government ultimately led to the world crises. Rising US government expenditure in the Vietnam War, financing of US space programme and the establishment of the "Great Society" (social welfare) programme in the 1960s led to large outflow of dollar from the US. But the US monetary authority did not devalue the dollar. Rather. it adopted monetary and fiscal measures to cut its BOP deficit.
- **Destabilising Speculation:** Since countries with 'fundamental disequilibrium' in BOP were reluctant to devalue their currencies and also took time to get the approval of the IMF, it provided

speculators an opportunity to resort to speculation in dollars. When devaluations were actually made, there were large doses of devaluation than originally anticipated. This was due to destabilising speculation which made controls over capital flows even through monetary-fiscal measures ineffective. This was the immediate reason for the UK to devalue the pound in 1967.

- **Crisis of Confidence and Collapse:** The immediate cause of the collapse of the Bretton Woods System was the eruption of a crisis of confidence in the US dollar. The pound had been devalued in November 1967. There was no control over the world gold market with the appearance of a separate price in the open market. The immediate cause for the collapse of the Bretton Woods System was the rumour in March 1971 that the US would devalue the dollar. This led to a huge outflow of capital from the US. On 15 August 1971, the US suspended the conversion of dollars into gold when some small European central banks wanted to convert their dollar reserves into gold at the US. It refused to intervene in the foreign exchange markets to maintain exchange rate stability and imposed a 10% import surcharge. Thus, the main cause of breakdown of the Bretton Woods System was the problems of liquidity, adjustment and confidence. The increase in liquidity (international reserves) was in the form of dollars arising from BOP deficits of the US. But the US was unable to adjust its deficits and excessive dollars accumulated in foreign countries, there was a crisis of confidence in the dollar and the Bretton Woods System brokedown.

Between 15 August 1971 and the Smithsonian Agreement of 18 December 1971, 48 countries including the United States, Japan and a large number of European countries abandoned fixed exchange rates. The 'Group of Ten' industrial countries met at the Smithsonian Institution in Washington on 18-19 December, 1971

and agreed to a new system of stable exchange rate with wider bands. As a first step towards realignment of major currencies, the US, devalued the dollar by 8 per cent, the Japanese revalued the yen by 17 per cent and the Germans their mark by 14 per cent. The Smithsonian Agreement widened the margin of fluctuations of the exchange rates to 2.25 per cent above or below the new parities of central rates. It officially devalued the dollar against gold from $ 35 to $ 38 per ounce. In 1973, the band was widened to 4.5 per cent. The Smithsonian Agreement broke down following the devaluation of the US dollar by 10% in February, 1973.

Another development took place in Europe when the EEC countries decided to limit the fluctuation of their currencies relative to each other to a smaller band. This came to be known as “the snake in the tunnel”. Under this arrangement, the EEC currencies were tied together and could fluctuate within narrow limits in relation to one another but could fluctuate in relation to other currencies within the limits set by the band proposals.

14.5 THE PRESENT INTERNATIONAL MONETARY SYSTEM

After the downfall of the Bretton Woods System, there has not been any formal International Monetary System in place. The present-day International Financial Architecture is a managed float system. All the currencies of all the countries can freely float against one another in an open market under the managed float system. The government intervenes only when the currency needs to be stabilized. Managed Float System is in place since 1976 with the Jamaica Agreement. Later in 1980, the International Financial Architecture was regulated by G-5 countries. This G-5 group has currently turned into G-20, with a group of 20 countries managing the exchange rate on managed float system.

14.5.1 Advantages of Current International Monetary System

Following are few advantages of the International Monetary Market

- IMS enhances financial stability and maintains the price level on a global scale. It also boosts global growth.
- International Monetary System mobilizes money across countries and determines the exchange rate.
- This system encourages the governments of respective countries to manage their Balance of Payment by reducing the trade deficit.
- IMS is a well-regulated system that makes the whole process of international trading smooth.
- This system relocates the capital from one country to another by enhancing cross-border investments.
- International Financial Architecture provides liquidity to the countries of the world.
- This system tries and avoids any short or long-run disruptions in the world economy.

14.5.2 Shortcomings of Current International Monetary System

One of the most important shortcomings of the present International Monetary System is that it is incompetent in avoiding global financial crises. There have been four serious financial crises over the past few years. Mexico in the years 1994 and 1995 has suffered from major economic and financial downfall. These crises came to an end in December 1996. Similarly, in the year 1997, Southeast Asia had suffered from a major economic breakdown. Russia and Brazil also had to go through serious financial crises in the year 1998 and 1999 respectively. In 2007-2009, the Global Economic Crisis questioned the current International Financial Architecture. There have been many such major financial

breakdowns over the past few years, which the International Financial Architecture was unable to avoid.

The second criticism with respect to the current International Financial Architecture is that sometimes the exchange rate remains misaligned. Managed Float System, sometimes gets misaligned due to either internal or external factors.

14.6 INTERNATIONAL CAPITAL MOVEMENTS

The international trade and the movements of productive resources such as labour, capital and technology are substitutes for one another. A relatively capital-abundant country like the United States can export either capital-intensive commodities or export capital itself.

International capital movements (or flows) refer to the outflow and inflow of capital from one country to the other. They do not relate to the movement of goods or payments for exports and imports between countries. It is necessary to distinguish the international capital movements from the payments for imports. The capital movements may either be meant for financing the deficits in the BOP or for bringing about a net increase in productive capacity in the economy. In the latter situation, the international capital movements can be treated as a factor of production. If the sufficient inflow of capital fails to take place from abroad, the productive activity is likely to be adversely affected.

In this connection, it must be recognised that only real capital movements are significant from the point of view of the allocation of resources. It means the countries depending on the inflow of foreign capital to maintain and/or to raise the level of economic activity should have capital inflow of the magnitude which is more than the offset of the domestic price movements.

They take place through government, private and international organisations or agencies. They are of various types which are explained below.

14.6.1 Types of International Capital Movements

International capital movements are classified in the following ways:

- **Direct and Portfolio:** The flow of direct capital means that the concerns of the investing country exercise de facto or de jure control over the assets created in the capital importing country by means of that investment. Direct capital investments may take many forms. The formation in the capital importing country of a subsidiary of a company of the investing country; the formation of a concern in which a company of the investing country has a majority holding; the formation in the capital importing country of a company financed exclusively by the present concern situated in the investing country; setting up a corporation in the investing country for the specific purpose of assembling the parent product, its distribution, sales and exports; or the creation of fixed assets by investing in infrastructures like power, refineries, railways, etc. in the capital importing country. Such companies or concerns are known as Transnational Corporations (TNCs) or Multinational Corporations (MNCs).

The movement of indirect capital, known as portfolio investment consists mainly of the holdings of transferable securities (issued or guaranteed by the government of the capital importing country), shares or debentures by the nationals of some other country. Such holdings do not amount to a right to control the company. The shareholders are entitled to the dividend only. In recent years, multilateral indirect capital investments have been evolved. The nationals of a country purchase the bonds of the World Bank floated for financing a particular project in some LDC.

- **Private and Government Capital:** Private capital movements refer to lending and borrowing from abroad by private individuals and institutions. Private capital is generally guaranteed by the government or the central bank of the borrowing country. Profit

motive is the driving force of private capital movements. On the other hand, government capital movements imply lending and borrowing between governments. Such capital movements are under the direct control of governments, in fact, governments are important international lenders. They make stability loans, loans to finance exports and imports, and particular projects.

- **Home and Foreign Capital:** Home capital is concerned with investments made abroad by residents of the country. On the other hand, foreign capital implies investments made by foreigners in the country. Thus home capital refers to the outflow of capital, while foreign capital is concerned with the inflow of capital. The balance of payments account of a country shows the distinction between the two.
- **Foreign Aid:** It refers to public foreign capital on hard and soft terms, in cash or kind, and inter-governmental grants. Foreign aid is tied and untied aid. Aid may be tied by source, project, and commodities. Untied aid is a 'general purpose aid' and is also known as programme aid or non-project aid.
- **Short-Term and Long-Term Capital Movements:** Short term international capital movements consist of such credit instruments that have a maturity of less than one year. The short term capital movements can take place through currency, demand deposits, bills of exchange, commercial papers and time deposits up to a maturity of one year. The long-term capital movements take place through credit instruments having a maturity of more than one year. Long-term capital movements occur through the purchase or sale of long term securities or bonds. These sales or purchases may be undertaken by the individuals or corporations in the foreign countries or by foreign individuals or corporations in the home country. The long- term capital movements may also take place in the form of loans procured from the international financial institutions such as IMF and IBRD.

14.7 MOTIVES FOR INTERNATIONAL CAPITAL FLOWS

While the motives for both types of foreign investments are basically the same, direct foreign investments require additional explanations not provided by the basic model that explains international portfolio investments.

14.7.1 Motives for International Portfolio Investments

The basic motive for international portfolio investments is to earn higher returns abroad. Thus, residents of one country purchase bonds of another country if the returns on bonds are higher in the other country. This is the simple and straight forward outcome of yield maximization and tends to equalize returns internationally. According to the basic (two-nation) Heckscher—Ohlin model, returns on capital are originally higher in the nation having the lower overall capital-labor ratio. Residents of one country may also purchase stock in a corporation in another country if they expect the future profitability of the foreign corporation to be greater than that of domestic corporations. The explanation that international portfolio investments occur to take advantage of higher yields abroad is certainly correct as far as it goes. The problem is that it leaves one important fact unexplained. It cannot account for observed two-way capital flows. That is, if returns on securities are lower in one nation than in another nation, this could explain the flow of capital investments from the former nation to the latter but is inconsistent with the simultaneous flow of capital in the opposite direction, which is often observed in the real world.

To explain two-way international capital flows, the element of risk must he introduced. That is, investors are interested not only in the rate of return but also in the risk associated with a particular investment. The risk with bonds consists of bankruptcy and the variability in their market value. With stocks, the risk consists of bankruptcy, even greater variability in market value and the possibility

of lower than anticipated returns. Thus, investors maximize mums for a given level of risk and generally accept a higher risk only if returns are higher.

For example, suppose that we deal with stocks and measure risk by the variability (variance) of returns about the average. Suppose also that both stocks A and B have a rate of return of 30 percent on average, but there is a fifty-fifty chance that the yield will be either 20 percent or 40 percent on stock A and 10 percent or 50 percent on stock B. Stock B is then clearly riskier than stock A. Since both stocks have the same yield on the average. Investors should purchase stock A to minimize risks. However, if the yield on stock A falls when the yield on stock B rises and vice versa, then by holding both stocks, the investor can still receive a yield of 30 percent on average but with a much lower risk. That is, the risk of a lower than average yield on stock A at any point is more or less matched by the tendency for the yield on stock B to be higher than average at the same time. As a result, the risk of a portfolio including both stock A and stock B is substantially reduced.

Portfolio theory thus tells us that by investing in securities with yields that are inversely related over time, a given yield can be obtained at a smaller risk or a higher yield can be obtained for the same level of risk for the portfolio as a whole. Since yields on foreign securities (depending primarily on the different economic conditions abroad) are more likely to be inversely related to yields on domestic securities, a portfolio including both domestic and foreign securities can have a higher average yield and/or lower risk than a portfolio containing only domestic securities.

To achieve such a balanced portfolio, a two-way capital flow may be required. For example, if stock A (with the same average yield but lower risk than stock B) is available in one country, while stock B (with yields inversely related to the yields on stock A) is available in another country, investors in the first nation must also purchase stock B (i.e. invest in the second nation), and investors in

the second nation must also purchase stock A (i.e., invest in the first nation) to achieve a balanced portfolio. Risk diversification can thus explain two-way international portfolio investments.

Throughout the preceding discussion, it was implicitly assumed that investors know precisely the average return on stocks and their variability. In reality, this is seldom known in advance. Thus, investors must determine for themselves (from their market knowledge and intuition) what the average returns and variabilities are likely to be in deciding which stocks to purchase. Since different individuals can have different expectations for the same stocks, it is possible that some investors in each nation think that stocks in the other nation are a better buy. This provides an additional explanation for two-way international portfolio investments.

14.7.2 Motives for Direct Foreign Investments

The motives for direct investments abroad are generally the same as for portfolio investments, that is, to earn higher returns (possibly resulting from higher growth rates abroad, more favorable tax treatment, or greater availability of infrastructures) and to diversify risks. Indeed, it has been found that firms with a strong international orientation, either through exports or through foreign production and/or sales facilities, are more profitable and have a much smaller variability in profits than purely domestic firms.

Although these reasons are sufficient to explain international portfolio investments, they leave one basic question unanswered with regard to direct foreign investments. That is, they cannot explain why the residents of a nation do not borrow from other nations and themselves make real investments in their own nation rather than accept direct investments from abroad. After all, the residents of a nation can be expected to be more familiar with local conditions and thus to be at a competitive advantage with respect to foreign investors. There are several possible explanations for this. The most important is that many large corporations (usually in monopolistic

and oligopolistic markets) often have some unique production knowledge or managerial skill that could easily and profitably be utilized abroad and over which the corporation wants to retain direct control. In such a situation, the firm will make direct investments abroad. This involves horizontal integration, or the production abroad of a differentiated product that is also produced at home. For example, IBM has a particular computer technology over which it wants to retain direct control but which it can easily duplicate abroad so as to serve the foreign market better (by adapting to local conditions) than through exports. IBM does not want to license foreign producers because it wants to retain complete control over its trade secrets and patents and to ensure consistent quality and service. Even if IBM were willing to negotiate licensing agreements with foreign producers, this would not be feasible in view of the very rapid rate of technological innovations in the field. The situation is basically the same for General Electric, Nokia, Toyota, and many other multinational corporations, and it is the motive behind most direct foreign investments in manufacturing in developed nations.

Another important reason for direct foreign investments is to obtain control of a needed raw material and thus ensure an uninterrupted supply at the lowest possible cost. This is referred to as vertical integration and is the form of most direct foreign investments in developing countries and in some mineral-rich developed countries. Thus, American and foreign corporations own mines in Canada, Jamaica, Venezuela, Australia, and other nations, and foreigners own some coal mines in the United States. Vertical integration involving multinational corporations can also go forward into the ownership of sales or distribution networks abroad, as is the case with most of the world's major automobile producers.

Still other reasons for direct foreign investments are to avoid tariffs and other restrictions that nations impose on imports or to take advantage of various government subsidies to encourage direct foreign investments. Examples of the former are the large-scale

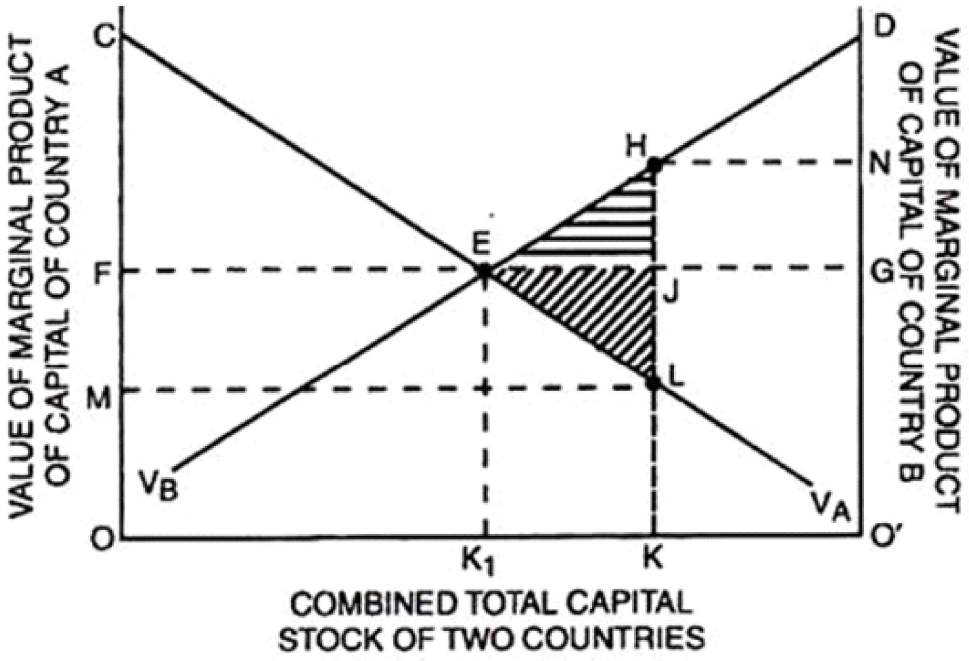
direct investments made by U.S. firms in the EU countries and some direct foreign investments in manufacturing in developing nations. Examples of the latter are the direct foreign investments made in developing nations and in depressed regions of some developed nations. Other possible reason for direct foreign investments are to enter a foreign oligopolistic market so as to share in the profits, to purchase a promising foreign firm to avoid its future competition and the possible loss of export markets, or because only a large foreign multinational corporation can obtain the necessary financing to enter the market.

The regional distribution of foreign direct investments around the world also seems to depend on geographical proximity or established trade relations. For example, the United States is the main supplier of foreign direct investments to Latin America, Bangladesh, Pakistan, the Philippines, and Saudi Arabia; foreign direct investments from the European Union flow mostly to Ghana and Morocco in Africa, Brazil in Latin America, India, Sri Lanka, and Vietnam in Asia, and to the former communist countries in Eastern Europe; and Japan is the main supplier of foreign direct investments to South Korea, Singapore, Taiwan, and Thailand.

14.8 OUTPUT AND WELFARE EFFECTS OF INTERNATIONAL CAPITAL FLOWS

The international capital flows result in output and welfare effects upon the investing and host countries. It is supposed that country A is the investing country and B is the host country. The welfare and output effects on account of transfer of capital from A to B can be analysed through Figure 14.1.

Figure 14.1: Output and Welfare Effects of International Capital Flows



In Figure 14.1, OO' is the combined total capital stock of the two countries A and B. Originally OK is the capital stock of country A and O'K is the capital stock of country B. V_A is the value of marginal product of capital curve for country A and V_B is the value of marginal product of capital curve of country B. Both the curves slope negatively indicating that the marginal products of capital in the two countries are diminishing. The value of marginal product of capital represents the return or yield on capital. The investing country A, in isolation, invests its entire capital stock OK domestically at a yield KL or OM. The total product is OCLK. Out of it, OKLM goes to the owners of capital and the rest MLC to the owners of the other factors like land and labour. Country B (host country), in isolation, invests its entire capital stock O'K domestically at a yield O'N or HK. Out of the total product O'DHK, O'NHK goes to capital and the remaining DHN to the other co-operating factors.

If the free international movement of capital is permitted, there will be flow of capital from country A to country B because of higher yield or return on capital from country B than in A. If KK_1 capital flows from country

A to B, the return on capital in the two countries gets equalised (EK_1 = OF = O'G). In this situation, the total product in country A is $OCEK_1$. To it should be added K_1EJK as the total return on foreign investments. The total national income amounts to OCEJK. It shows a net gain for country A as EJL. The total return to capital increases to OFJK and the return to other factors decreases to CEF.

In the case of host country B, there is an inflow of capital from foreign country A to the extent of KK_1. The rate of return on capital falls from O'N to O'G. The total product in country B rises from O' DHK to O' DEK_1. Thus the total product in this country rises by K_1EHK. Out of it, K_1EJK goes to the foreign investors. The net gain in total product accruing to country B is EJH. The total return to domestic owners of capital falls from O'NHK to O'GJK. The total return to other factors rises from DHN to DEG.

Considered from the viewpoint of either the countries taken together or the whole world, the total product increases from OCLK + O'DHK to $OCEK_1$ + O'DEK_1 or the addition in total product of the whole world amounts to EJL + EJH = ELH. Thus the international capital flows raise the efficiency in the allocation of resources internationally and the world output and welfare get increased. Greater is the steepness of the curves V_A and V_B, the greater can be the gain from the international capital flows.

14.9 FACTORS AFFECTING INTERNATIONAL CAPITAL MOVEMENTS

The following factors affect international capital movements:

- **Rate of Interest**: The most important factor which affects international capital movements is the difference among current interest rates in various countries. Capital flows from that country in which the interest rates are low to those where interest rates are high because capital yields high returns there.
- **Speculation**: Speculation related to expected variations in foreign exchange rates or interest rates affects short-term capital movements. When the speculators feel that the domestic interest rates will increase in future, they will invest in short-term foreign

securities to earn profit from the possibility of fall in bond prices. This will lead to the outflow of capital. On the contrary, if the possibility is of fall in domestic interest rates in future, the foreign speculators will invest in securities at a low price at present. This will lead to the inflow of capital in the country. Similarly, if there is the likelihood of devaluation of the country's currency in future, the domestic speculators will try to change the currency into foreign securities. This will lead to the outflow of capital. On the other hand, if the foreign exchange rate is expected to rise, there will be an inflow of capital in the country.

- **Expectations of Project**: A foreign investor always has the profit motive in his mind at the time of making capital investment in the other country. Where the possibility of earning profit is more, capital flows into that country. Similarly, a foreign entrepreneur keeps expected profit in view while investing in various projects in a country. He will invest in that project where the expected profit is more as compared to a less profitable project. This leads to larger inflow of capital.
- **Bank Rate:** A stable bank rate of the central bank of a country also influences capital movement because market interest rates depend on it. If the bank rate is low, there will be outflow of capital. On the contrary, if the bank rate is high, there will be inflow of capital in the country.
- **Production Costs:** Capital movement depends on production costs in other countries. In countries where labour, raw materials, etc. are cheap and easily available, more private foreign capital flows into them. The main reason of huge capital investment in Korea, Singapore, Hong Kong, and other developing countries by the multinational corporations is low production costs there.
- **Economic Conditions**: The economic conditions in a country especially size of the market, availability of infrastructure facilities like the means of transportation and communication, power and other resources, efficient labour, etc. encourage the inflow of capital there.

- **Political Stability:** Political stability, security of life and property, friendly relations with other countries, etc. encourage the inflow of capital in the country.
- **Taxation Policy**: The taxation policy of a country also affects its inflow of capital. To encourage the inflow of foreign capital, the taxation policy should avoid double taxation, should not burden entrepreneurs heavily, give tax relief, etc. to new industries and foreign collaborations.
- **Foreign Capital Policy:** The government policy relating to foreign capital also affects capital movements. If the government provides facilities of transferring profit, dividend, royalty, interest, etc., to foreign investors, there will be inflow of capital in the country. Similarly, soft foreign exchange contracts and fiscal, monetary and other policies which encourage foreign capital are helpful in the inflow of capital.
- **Marginal Efficiency of Capital:** The marginal efficiency of capital is positively linked with the inflow of capital. Foreign investors generally compare in the marginal efficiency of capital with the interest rate in different countries and prefer to invest in that country where the rate of return is likely to be high.

14.10 INTERNATIONAL MONETARY FUND

International Monetary Fund (IMF) is an international monetary institution established by different countries after the World War II with an objective of providing exchange stability throughout the world and increasing liquidity so that balanced multilateral trade is promoted through the cooperation of the member nations.

Various historical conditions and events that led to the establishment of IMF are summarised below:

- Gold standard functioned with reasonable success and provided a medium of international payments before World War 1.
- The onset of World War I forced most of the countries to abandon gold standard and put restrictions on the movement of gold as well as goods.

- After the World War I, some countries came back on the gold standard but the gold standard could not work well between the period 1919-1931.
- The world faced the Great Depression of the thirties between 1929 to 1936. Prices, profits, share prices, production, employment and income of the leading countries fell very low. Competitive devaluation, tariffs and exchange controls were adopted by the nations.
- World War II (1939-45) further disrupted the pattern of international trade and dislocated the economies of the world.

After the world wide depression and the World War II, it was recognized that (a) the gold standard could not be restored in future; and (b) lack of any mechanism like the gold standard would generate instability of exchange rates and discourage international trade and investment. Therefore, the monetary authorities of the world felt the need for international cooperation to establish a stable international monetary order. With this objective, a conference of 44 major countries was held at Bretton Woods, New Hampshire, in July 1944. The result of this conference was the establishment of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). These two institutions are known as 'Bretton Woods' twins'.

The Bretton Woods System provided a compromise between fixed and floating exchange rate system. It was a modified gold exchange standard in which the member countries maintained adjustable pegs relative to U.S. dollars. The U.S. undertook to exchange gold for dollars with foreign central banks at a fixed rate. The new system aimed at (a) establishing international harmony and exchange rate stability associated with the gold standard; and (b) allowing individual countries the freedom to pursue their own macroeconomic policy. The Bretton Woods System of adjustable pegging faced recurrent crises and finally collapsed in 1973. The fundamental defect of the system was its own contradictory framework. The three basic features of the system, i.e., constant exchange rates, autonomous national macroeconomic policies, and international capital mobility, could not continue together for a long time. Despite the collapse of

the Bretton Woods System, the IMF, which founded as part of this system, still plays an important role as an international financial institution.

14.10.1 Objectives of IMF

Basically, the purpose of the IMF was to (a) achieve the international advantages of the gold standard without subjecting nations to its internal disadvantages; and (b) achieve internal advantages of paper standard while avoiding its international disadvantages.

The main objectives of the Fund, as summarized in the Articles of Agreement, are as follows:

- To promote international monetary cooperation through a permanent institution that provides the machinery for consultation and collaboration on international monetary problems.
- To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
- To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciations.
- To assist in the establishment of a multilateral system of payments in respect to current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- To give confidence to members by the Fund's resources available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
- In accordance with the above, to shorten the duration and lesson the degree of disequilibrium in the international balance of payments of members.

14.10.2 Organisation of IMF

The IMF came into existence in December 1945 and started functioning in March 1947. It is an autonomous organisation and is affiliated to the U.N.O. It has its main office in Washington. Initially, the IMF had 30 countries as its members. As on April 30, 1986, the membership of the Fund was 149, covering nearly all the non-communist nations of the world.

The management of the Fund is under the control of two bodies: (a) Board of Governors and (b) Board of Executive Directors. The Board of Governors is the general body of management consisting of one Governor and an Alternate Governor for each member country. The Board of Governors has the responsibility of formulating the general policies of the Fund. The Board of Executive Directors controls the day-to-day activities of the Fund. Currently, it consists of 22 directors; six of these directors are appointed by the members having the largest quotas, namely, the United States, the United Kingdom, West Germany, France, Japan and Saudi Arabia, and the remaining sixteen directors are elected by other nations. The Managing Director is the chairman of the Board of Executive Directors as well as the head of the staff of the Fund.

14.10.3 Functions or Working of IMF

The main functions and operations of the IMF arc given below:

- **Maintaining Exchange Stability:** One of the basic objectives of the IMF was to establish reasonable exchange stability and to discourage fluctuations in the exchange rates. The main arrangements made by the Fund to ensure stability in the exchange rate are as given below:
  - Each member country declares a par value of its currency in terms of gold as a common denominator or in terms of U.S. dollars.
  - Members agree to keep up the free convertibility of their currencies at not more than 1% above or below its par value.

- When devaluation becomes necessary a member may desaloe up to 10% by merely informing the Fund, but greater or subsequent change requires the approval of the governing body.
- Members are forbidden to go in for multiple exchange rates.
- Members are forbidden to buy or sell gold at prices other than the declared par value.
- The fund acts as the international lender of the last resort and provides financial assistance to member countries to meet temporary deficits in their balance of payments.

➢ **Determination of Par Values:** The original Articles of Agreement of the IMF, under the Bretton Woods System of adjustable pegging, required every member country to declare par value of its currency in terms of gold or U.S. dollars. The U.S. dollar was convertible into gold. The Articles allowed the member countries to make adjustments in the par value of their currencies for correcting disequilibrium in their balance of payments. A Country can make adjustments up to 10% by simply informing the IMF. However, for changes more than 10%, but below 20%, the country was required to obtain prior approval from the IMF. For any change exceeding 20%, the approval by the two-third members of the Fund was necessary. Generally, the permission was given whenever a fundamental disequilibrium in the balance of payments was to be corrected. The fund discouraged the competitive currency devaluation. It could terminate the membership of a country if it changed the par value of its currency without its approval.

Under the revised Articles of Agreements of the IMF, the member countries are given autonomy regarding exchange arrangements. The exchange rates are allowed to float or change according to the demand and supply conditions in the exchange market and also on the basis of internal price levels. This, however,

does not mean that complete instability in the exchange rates is allowed. The Articles require the IMF to exercise surveillance to ensure proper working of the international monetary system.

Under the surveillance arrangements of the Fund, the member countries are expected to follow three norms:

- They should avoid manipulating exchange rates to prevent balance of payments adjustments or to gain competitive advantages over other members.
- They should intervene in the exchange market, if necessary, to counter disorderly short term movements in the exchange value of their currency.
- In adopting an intervention policy, they should take into account the interest attic other members.

- **Credit Facilities:** In order to help the member countries to correct disequilibrium in their balance of payments, the IMF operates various borrowing facilities.
  - *Basic Credit Facility:* The IMF provides financial assistance to its member nations to overcome their temporary difficulties relating to balance of payments. A member nation can purchase from the Fund other currencies of SDRs. in exchange for its own currency, to finance payment deficits. The loan is repaid when the member repurchases its own currency with other currencies or SDRs. A member can unconditionally borrow from the Fund in a year equal to 25% of its quota. This unconditional borrowing right is called the reserve tranche. It addition, four tranches (each equal to 25% of the quota) are available to a country. Thus, a member country has the basic credit facility of 5 tranches (i.e., 125% of its quota) from the Fund. In other words, the borrowings from the IMF should not increase the currency of a member country with the Fund more than 200% of its quota.

- *Extended Fund Facility:* In September 1974, the IMF started extended fund facility to assist the member countries with sever balance of payments problem for long periods. Under this arrangement, the IMF provides additional borrowing facility up to 140% of the member's quota, over and above the basic credit facility. The extended facility is limited for a period up to 3 years and the rate of interest is low, i.e. from 4% to 6.5%.
- *Compensatory Financing Facility:* In 1963, IMF established compensatory financing facility to provide additional financial assistance to the member countries, particularly primary producing countries facing shortfall in export earnings. In 1981, the coverage of the compensatory financing facility was extended to payment problem caused by the fluctuations in the cost of cereal inputs.
- *Buffer Stock Facility:* The buffer stock financing facility was started in 1969. The purpose of this scheme was to help the primary producing countries to finance contributions to buffer stock arrangements for the stabilisation of primary product prices.
- *Supplementary Financing Facility: Under* the supplementary financing facility, the IMF makes temporary arrangements to provide supplementary financial assistance to member countries with payments problems relating to their present quota sizes. The IMF has borrowing agreements with 14 lenders to provide different currencies for supplementary financing.
- *Special Oil Facility:* In 1974, the IMF established a temporary credit facility called Special Facility to extend credit to countries with payments difficulties caused by oil price hikes. The facility was terminated in 1976.

- *Trust Fund:* The IMF has sold gold in public auctions at prices much above the price prevailing in the market. Part of the profits so earned has been used to establish a Trust Fund in 1976 for making conditional loans to the less-developed countries with payments problems.
- *Structural Adjustment Facility:* The IMF established in March 1986 Structural Adjustment Facility (SAF) to provide additional balance of payments assistance on concessional terms to the poorer member countries. In December 1987, the Enhanced Structural Adjustment Facility (ESAF) was set up to augment the availability of concessional resources to low income countries. The purpose of SAF and ESAF is to help the poor countries to undertake strong macroeconomic and structural programmes to improve their balance of payments positions and promote economic growth.

- **Balancing Demand and Supply of Currencies:** Another important function of the IMF is to maintain balance between demand and supply of various currencies. Articles of Agreement empower the IMF to declare a currency which is in great demand as scarce currency and ration its supply among the buyers. The Fund can increase the supply of the scarce currency by borrowing it from the country concerned or by purchasing it in exchange for gold. The country concerned is authorised to revalue its scarce currency to restore equilibrium.
- **Maintenance of Liquidity:** Another important function of the IMF is to maintain liquidity of its resources. The member countries borrow from the Fund by giving their own currencies in exchange. In order to avoid the accumulation of such less demanded currencies with the Fund, the borrowing countries are required to repurchase their own currencies by repaying their loans in convertible currencies.
- **Interest Charges:** The IMF charges interest from the borrowing nations for the credit provided to them. The interest rate for the

first tranche is nominal, but it increases as the amount of loan increases. The purpose is to discourage the member countries from excess borrowings.

- **Technical Assistance:** The IMF also provides technical assistance to member countries on financial matters. Such assistance is made available through the services of specialists and experts. In this regard, the Fund operates two specialized departments: (a) Central Banking Services Department; and (b) Fiscal Affairs Department. These departments provide consultation and guidance to the members.
- **Allocation of Profits:** The IMF allocates 20% of its profits to the countries whose currencies with the Fund in a particular year is 75% of its quota. The remaining 80% of the profits are distributed among the members in proportion of their quotas.

14.11 CRITICAL APPRAISAL OF IMF

Achievements: The IMF has been quite successful and its working quite satisfactory in many fields as discussed below:

- **Expansion of Fund:** Since its inception, the IMF has progressed greatly both in membership and resources. Initially, the Fund started with only 30 members with quotas totaling $ 7,000 million. In April 1986, the membership has increased to 149 quotas aggregating about SDR 90 billion. During 1948 to 1986, the member countries have purchased various currencies from the Fund equal to SDR 97 billion.
- **Provision of Credit:** The performance of the IMF has also been satisfactory in respect of the provision of financial assistance to its member countries. IMF's total outstanding credit increased from SDR 8038 million 1980 to SDR 34640 million in 1986. Most of the facilities are specially meant for helping the developing countries.
- **Exchange Stability:** The IMF has been making sincere efforts to promote exchange stability among the member countries. The exchange stability as experienced during the IMF era is definitely

superior to the chaotic condition of fluctuating exchange rates. Under the IMF system, exchange stability does not mean rigidity of exchange rates. The IMF aims at combing the merits of stability with flexibility in the exchange management.

- **Expansion of World Trade:** The IMF has contributed to the expansion of international trade in the following ways: (a) By providing credit facilities to member countries, the Fund has reduced the necessity of imposing trade and exchange controls. (b) The IMF helps the deficit countries to correct their disequilibrium in balance of payments. (c) The IMF also promotes world trade by providing facilities for multilateral trade and payments.
- **Machinery for Consultation:** The IMF machinery set up for providing expert guidance to the member countries in monetary matters has proved very useful. The fiscal and financial policies of the member countries are formulated keeping in view the guidelines suggested by the Fund.
- **Increase in International Liquidity:** With the establishment of the scheme of SDRs., the IMF has increased the international liquidity. It provides credit to the needy countries through its two accounts, i.e. the General Account and the Special Drawing Account.
- **Reform of International Monetary System:** The IMF attempts to reform international monetary system. In July 1972, the IMF set up the Committee on Reform of the International Monetary System and Related Issues, known as the Committee of Twenty, which submitted its report in June 1974 and its recommendations were implemented. In January 1976, the Ministerial Committee of the Board of Governors of the IMF agreed to adopt a package of measures to reform the world's monetary system, including the steps to help the developing countries.

Failures: Various achievements of the IMF do not imply that all in well with the fund. On the contrary, the actual functioning of the Fund suffers from many failures. Important among them are:

- The Fund has failed to achieve its basic objectives of international exchange stability. In fact, the IMF leas not put any ban on exchange fluctuations. It simply opposes and discourages them. If a member country insists on changing the par value of its currency to correct the deficit in its balance of payments position, the Fund generally allows it. Moreover, the Fund could not prevent competitive devaluation of currencies. In 1949, about two dozen countries devalued their currencies simultaneously. Similarly, in 1970, devaluation of currencies and exchange fluctuations became a common feature.
- The Fund has failed to establish a stable and sound international monetary system. The Bretton Woods system of adjustment pegging collapsed in 1971. The world saw the most serious monetary crisis marked with rapidly fluctuating exchange rates. At present the system of managed floating rates has been adopted by most of the countries.
- The problem of international liquidity has also not been adequately solved. The increase in the liquidity through General Agreements to borrow has been insufficient.
- Prof. Williams has pointed out that thc1MF provides only short-term credit facilities, whereas most of the countries suffer from long-term problem of balance of payments.
- The IMF quota has not been revised. The share of quotas in relation to world trade has been fast declining. The quotas have declined from 16% of the world trade in 1965 to 4% in 1981.
- The Fund has not been able to remove restrictions on trade. Even after four decades of its existence, most of the member countries make extensive use of the trade and exchange controls.
- The Fund has adopted especially favourable attitude towards the U.S.A. Most of its decisions are taken to protect the interest of the U.S.A.

- The Fund has been criticised as being Rich Men's Club because of the dominance of rich countries. The rich member countries have larger quotas and therefore greatly influence the policies and decisions of the IMF.
- The underdeveloped countries and the developing countries do not get adequate financial help from IMF because of its biased method of determining quotas. Credit should be extended not on the basis of quotas but on the basis of need.
- The IMF has also been criticised for interfering in the economic policies of the poor countries by imposing various restrictions.

14.12 IMF AND LESS DEVELOPED COUNTRIES

The IMF has special responsibility to assist the less developed countries or developing countries to correct balance of payments deficits and to maintain monetary stability at home. Recently, the Fund has also been playing a significant role in helping these countries in their development schemes by increasing international liquidity and extending technical assistance.

Various measures taken by the IMF to assist the less develop member countries are as follows:

- The IMF has been extending liberal financial assistance to these countries to correct balance of payments disequilibrium and maintain monetary stability at home.
- It has been providing developmental funds to these countries to assist them in their economic development programmes.
- The Fund has been giving technical assistance to these countries in organising their monetary, fiscal and exchange system.
- It has set special oil facility to help the member countries seriously affected by rising oil prices.
- The establishments of Trust fund, Subsidy Fund, Compensatory Financial facility, Supplementary Financial facility, etc. are other measures taken by the IMF to assist the developing countries.

- It has cooperated with other international organisations, such as the World Bank, and the General Agreement on Tariffs and Trade (GATT) to promote economic development of primary goods producing countries.
- In March 1986, the IMF set up a Structural Adjustment Facility (SAF) to provide additional balance of payments assistance on concessional terms to low income members.

IMF and India: India provides a good example of what the IMF has been doing for the less developed countries. Indian was one of the nations which participated in the Bretton Woods conference in 1944 where the decision to set up the IMF was taken. Thus, India is founder member of the Fund. Originally, India was a permanent member of the Fund's Board of Directors because it had the 5th largest subscription quota, the amount of the quota was $440, 25% of which was to be paid in gold. At present, according to the Eight General Review of the IMF 1983. India's quota is SDR 2207 million, of which SDR 500 million are in gold and dollars. India's position has come down to ninth. The initial par value fixed by India with the Fund in 1946 was Rs. 3.30 per U.S. dollar, which was later changed to Rs. 4.76 in 1949, Rs. 7.50 in 1966 and Rs. 8.25 in 1978. At present, the external value of Indian rupee is not fixed but varies with the changing conditions of demand and supply in the exchange market. India has been one of the main beneficiaries of the Fund's financial assistance. The IMF has assisted India continuously and liberally to solve its payments and development problems.

- During 1948-49, India borrowed $100 million from the IMF to cover the balance of payments deficits. This amount was paid back by 1956-57.
- In 1957, India received credit worth $200 million from the IMF to meet its temporary balance of payments problems arising out of its development programmes.
- Another credit facility to the tune of $ 250 million was granted to India from the IMF in 1961.

- In 1980-81, India received biggest ever loan of SDR 5 billion from the IMF under the Extended Fund Facility. However, due to better economic conditions, India used SDR 3.9 billion and returned the balanced to the IMF.
- India is also eligible to seek assistance from the Enhanced Structural Adjustments Facility (ESAF) set up in 1987 for providing concessional assistance to poor countries enabling them to undertake economic programmes to improve their balance of payments position and foster economic growth.
- Substantial withdrawals have been made from the IMF from 1990-91 onwards under one or other facility. Besides the Reserve tranche drawings $ 666 million, India drew $ 1814 million from the Fund in 1990-91. In 1991-92 the drawl was $1240 million. India made a 20 month standby arrangement with the Fund in October 1991 for a total loan of $ 2262 million.
- With effect from January I, 1997, India subscribed to the Special Data Dissemination Standards (SDDS) of the IMF. The SDDS aims at streamlining the statistical system of the country.

Despite various shortcomings, the IMF has been able to achieve to a reasonable extent its broad objectives by securing the advantages of both (a) the gold standard by maintaining comparative exchange stability and (b) the managed paper standard by maximising employment and promoting economic development, and (c) by carefully avoiding the disadvantages of both gold standard and paper standard. The failures and defects of the fund are mainly due to the vested interest and non-cooperation of member nations. Future of the IMF thus depends upon the sincere and cooperative attitude of the members.

14.13 SPECIAL DRAWING RIGHTS (SDRs)

The establishment of the scheme of Special Drawing Rights (SDRs) is a significant attempt of the International Monetary Fund (IMF) to reform the international monetary system and to solve the problem of international liquidity. After the World War II, the gold standard was replaced by the

currency standard. But, the continued use of the pound sterling and the U.S. dollar as the key reserve currencies proved unsatisfactory, because of the deficits in the balance of payments of the U.S. and the U.K. There was a serious problem of the international liquidity, i.e., the inadequate growth of monetary reserves. In such conditions, the need arose for a new reserve asset. The introduction of SDR as a new international reserve asset by the IMF is a welcome step in the right direction.

The scheme for creating Special Drawing Rights (SDRs) was outlined at Annual Meeting of the IMF in October 1967 at Rio de Janeiro (Brazil). The detailed proposals of the scheme were approved by the Board of Governors in April 1965 and the Special Drawing Account came into being on August 6, 1969. The basic idea behind the SDR scheme was to establish a new reserve asset whose quantity could be consciously adjusted in response to the world's need for international reserves. The objective of creation of the SDR was to assure an adequate, but not excessive, growth of monetary reserves.

Under this scheme, the IMF has the power to grant SDRs to member nations on a specified basis. Allocation of SDRs is made annually by the collective decision of the participating countries on the basis of their quotas. Possession of SDRs entitles a country to obtain a defined equivalent of currency from other participating countries. The IMF can create new SDRs from time to time in response to the need for additional international reserves. The newly created SDRs are allocated among member nations in proportion to their IMF quotas. When a member's SDR balance falls below its total allocation, it must pay interest to the IMF on the difference. Similarly, the members are paid interest by the IMF on SDR holdings in excess of allocations. Thus, by creating SDRs, the IMF aims at increasing the availability of resources to the member countries without putting additional strain on its own resources.

14.13.1 Features of SDRs

The following are the salient features of SDRs:

- **Additional Reserve Asset:** The SDRs scheme provides a new international asset, in addition to the traditional assets, i.e., gold, key currencies. Now, the member countries of the IMF can hold and use SDRs along with gold and key currencies as international reserves.
- **Cheque-Book Currency:** In the physical sense, SDRs are a cheque-book currency and are created with the strokes of pen. They are simply book keeping entries at the IMF in accounts for the member countries and the Fund itself. They are just like coupons which can be exchanged for currencies needed by the holder of SDRs for making international payments.
- **Transferable Asset:** SDRs are transferable assets. The member countries are required to provide their currencies in exchange for SDRs. A country can acquire convertible currency from the designated country in exchange for SDRs. Designated country is that which has strong balance of payments or large reserves.
- **Backing of SDRs:** SDRs are a liability of the IMF and asset of the holders. There is no backing for SDRs in the form of an asset like key currency. The real backing is the undertaking given by the member countries to abide by the SDR regulations. The country which agrees to the creation of SDRs is obliged to drawal and other countries are obliged to accept them as unit of adjustment.
- **Basis of SDRs:**The creation of SDRs is based on the fundamental principle of credit creation in the banking system. The SDR scheme is an extension of this principle to the international level. The IMF can create new SDRs without any increase in deposits of gold or currency by the participating countries. Thus, issue of SDRs means an increase in world's monetary reserves.
- **Allocation of SDRs:** The SDRs are allocated to the member countries in proportion to their quotas in the IMF. The lion's share

goes to the developed countries and the developing countries get only about a quarter.

- **Special Drawing Account:** Under the changed rules, the IMF maintains two separate accounts: (a) General Account: It deals with the general transactions of the IMF relating to quotas, subscriptions, ordinary drawings, etc. (b) Special Drawing Account: It deals with SDR transactions. The SDRs are created as a percentage of existing resources (quotas).
- **Paper Gold:** Initially the scheme envisaged that the SDRs' would be a sort of paper gold. Their value was fixed in terms of gold. But, since 1974, the SDR has been valued on the basis of a currency basket.
- **Fiduciary Reserve System:** The SDR scheme proposes a purely fiduciary resen e system. SDRs are regularly created by the IMF, accepted by the member countries as paper gold reserves and used for the settlement of international payments.
- **Interest-Bearing Asset:** SDRs are an interest-bearing asset The IMF pays interest to the countries holding SDRs and charge interest from the countries using SDRs.
- **Use of SDRs:** Under the SDR scheme, the participating countries will use SDRs to meet their balance of payments requirements or to improve their adverse reserve position. SDRs are not to be used for exchange with other currencies to reinforce foreign exchange reserves.
- **Limited Use of SDRs:**Ordinarily, a country can use SDRs up to 70% of the allotted authorization during a given five years. The remaining 30% is to be held for emergencies. Thus, a restraint has been put on the member countries so that they do not rush into using SDRs without drawing upon their other forms of resources.
- **Units of Account:**Use of SDRs as a unit of account has also started. Some countries have pegged their currencies to SDRS.

OPEC countries, and some airlines, monetary organizations and banks are using SORB as unit of account.

14.13.2 Valuation of SDRs

The original SDR scheme envisaged that SDRs would be a sort of paper gold. The value of SDR was fixed in terms of gold. Initially, the unit value of SDR was determined equal to 0.88867 grains of fine gold or equal to one U.S. dollar. Later on, in 1974, due to general floating of exchange rates, the standard basket technique was adopted and the value of SDR was fixed in terms of a basket of 16 major currencies. Since 1981, the standard basket is composed of the currencies of world's five largest exporting countries. The list of currencies in the basket and their weights are revised at the end of every five years. The currencies and their share in the total weight for 1986-90 are: U.S. dollar (42%); Deutsche Mark (19%) ; Japanese Yen (15%); French Franc (12%): and Pound sterling (12%). The value of SDR is calculated daily on the basis of market exchange rates. For 1989- 90, the average annual value of SDR was SDR 1 = Rs. 19.262 or $ 0.75. In 1997-98, it moved to: SDR 1 = Rs. 50.076 or $ 1.364.

14.13.3 Working of SDRs

Whenever the IMF finds that there is a need to increase international liquidity, the SDRs are created and allocated to the members in proportion to their quotas. The first creation and allocation of SDRs was during 1970-72, totaling SDRs 9.3 billions. Again, the IMF created and allocated SDRs to the tune of 4 billion each in the 1979, 1930 and 1981. Thus, there is now in existence a total of SDRs 21.3 billion.

Originally there have been three major ways in which the members could use SDRs:

- **Transactions with Designation:** A member country may use its SDRs to obtain foreign exchange from other member country

designated by the Fund. The Fund designates a member country, with a strong balance of payments and reserve position, to provide currency in exchange for SDRs to the country wishing to convert its SDRs.

- **Transactions by Agreement:** A member country may use its SDRs to obtain balances of its ONVII currency held by another participant country by agreement with that participant.
- Under these two uses, the member nations are expected to utilise their SDRs to meet adverse balance of payments, and not to change the composition of exchange reserves.
- **Transactions with General Account:** SDRs can be used by member countries in operations and transactions conducted through the IMF's General Account (i.e. in settling transactions with the IMF). Since 1978, however, the IMF has allowed its members to use SDRs in a variety of other voluntary transactions and operations by agreement among themselves.

These additional uses of SDRs are:

- In swap arrangements, a member country may transfer SDRs to another member country in exchange for equivalent amount of currency or another monetary asset (other than gold) with an agreement to reverse the exchange at a specified future date and at an exchange rate agreed to by the members
- In forward transactions, in which Members can buy or sell SDRs for delivery at a future date against a currency or another monetary asset (other than gold) at an exchange rate agreed to by the members
- In loans of SDRs, at interest rates and maturities agreed to by the parties. Repayment of loans and payment of interest may be made with SDRs.
- In the settlement of financial obligations.
- As security for performance of financial obligations.
- In making donations (grants).

- In order to improve the working of SDRs, the IMF has taken the following measures.
- In value of SDRs has been linked with the standard basket of the currencies of the world's five largest exporting countries.
- In order to encourage the countries to hold SDRs, the rate of interest has been increased from 1.5% to 3.99% in 1981.
- To promote the wider use of SDRs, ten official financial institutions have been designated as 'other holders' of SDRs.
- The Fund uses the SDRs as its unit of account.
- The IMF intends that SDRs should become the principal international-reserve asset.

14.13.4 SDRs in India

Allocations of SDRs to India were of the order of Rs. 75.4 crores (i.e. 100.5 million U.S. dollars) in 1970-71; and Rs. 120.5 crores (i.e., 152.4 million U.S. dollars) in 1980-81. These SDRs have been directly allocated in the Government of India's account and have been largely used for repurchase from the Fund and paying of interest. India's reserves of SDRs, which were SDR 149 million in 1970-71, SDR 491 million in 1980-81, SDR 76 million in 1990-91 stood at SDR 56 million in 1995-96.

14.13.5 Merits and Demerits of SDRs

The SDR scheme has become popular because of the following merits:

- SDR scheme is a simple and flexible scheme which provides a new international reserve asset and a stable international currency, unaffected by the price changes in the national economies.
- The scheme ensures adequate, but not excessive, growth of monetary reserves without requiring an increase in gold supply or having the obligation of key currency countries.

- The countries using SDRs are not required to repay according to a fixed schedule. However, it is obligatory for them to restore their position in due course of time.
- The SDRs can be used unconditionally. In other words, the user countries are not required to make changes in their domestic economic policies.
- Unlike the ordinary drawings on the IMF, which have to be repaid and thus lead to a temporary increase in international liquidity, the SDRs cause permanent increase in liquidity.
- Holding of SDRs is beneficial to a country because they are an interest earning asset.
- The SDR scheme avoids the confidence problem faced under the currency reserve standard.
- The SDR scheme implies a partial demonetization of gold. It relieves the world monetary authorities from maintaining a market value of gold.
- The SDRs have the characteristic of genuine international currency. It has been willingly accepted by the member nations as a medium of exchange between the central banks.

In spite of great popularity of the SDR scheme, it has also been criticised due tothe following drawbacks:

- The allocation of SDRs is not just and on equitable basis. They are allocated among the memb2r countries in proportion to their quotas, and not according to their needs. This type of allocation specially favours the developed countries. Prof V.K.R.V. Rao has rightly observed: “An international costless reserve asset has thus been used to give more to those who have more and less to those who have less.”
- In spite of the creation of this new reserve asset, the liquidity problem of inadequate reserves still continues. The SDRs are not linked with the liquidity of the countries.

- The less developed countries are not provided sufficient SDRs to meet their increasing requirements of international reserves, largely because of heavy oil bills.
- The scheme is purely fiduciary in nature. There is every likelihood of reduction in the public confidence in the SDRs.
- Unrestricted SDRs as an international reserve asset to finance the payment deficits may lead to widespread global inflation.

14.14 INTERNATIONAL LIQUIDITY

International liquidity is defined as the aggregate stock of internally acceptable assets held by the central bank to settle a deficit in a country's balance of payments. In other words, international liquidity provides a measure of a country's ability to finance its deficit in balance of payments without resorting to adjustment measures. Shortage of liquidity hampers the expansion of global trade and its surplus leads to global inflationary pressures.

International liquidity is generally used as a synonym for international reserves. Such reserves include a country's official gold stock holdings, its convertible foreign currencies, SDRs, and its net reserve position in the IMF. Economists like Heller and McKinnon use a broader definition of international liquidity to include international borrowings, commercial credit operations, and the international financial structure in a country's reserves. This definition implies international availability of liquidity and the possibility of obtaining credit from financial institutions operating in international financial markets. Thus, in the broader sense, international liquidity includes private as well as official holdings of international liquidity assets.

In the literature on international liquidity distinction is made between owned and borrowed reserves, and between conditional and unconditional reserves. Foreign exchange surplus, after meeting all current and capital account obligations of the country with the rest of the world, are "owned" reserves. Similarly, the official gold stock of a country constitutes its owned reserves. Capital imports in the form of borrowings from abroad and direct

investments by foreign countries constitute borrowed reserves. Both owned and borrowed reserves are the source of international liquidity.

Unconditional international liquidity consists of a country's official gold stock, holdings of its foreign currencies and SDRs, its net position in the IMF, and private holding of international assets. In all such cases, liquidity assets are available to the country without any conditions or restrictions on their use. But in the case of borrowed reserves, the lender country may impose conditions or restrictions on the use of liquid assets by the borrowing country. Many international financial institutions provide funds on conditional basis for specific projects and on specified repayment provisions. All these are cases of conditional liquidity. This is done to avoid the misuse of liquidity by the borrowing country.

14.14.1 Problem of International Liquidity

The (need or) problem of international liquidity arises because the demand for international liquidity is rising more than its supply, thereby implying shortage of international liquidity. The principal causes for the shortage of international liquidity are the following:

- **BOP Deficits:** There have been increasing BOP deficits of the majority of countries in the world. In particular, after the opening of LDCs to world markets, these countries have been facing persistent BOP deficits. Too much dependence on exports has exposed these economies to international fluctuations in the demand for and prices of their products. They have become unstable due to international cyclical instability. On the other hand, their import requirements have been on the increase in order to develop. As a result, they are faced with foreign exchange constraints. This has necessitated larger inflow of aid and foreign investment. Consequently, debt serving and interest on debt have risen and payments of dividends, profits and royalties on private direct foreign investment have grown, thereby leading to decline in the net inflow of foreign capital. All these have led to further shortage of foreign exchange reserves.

- **High Tariff Barriers:** The exports of LDCs to developed countries have not been increasing, thereby adversely affecting their export earnings. One of the reasons for the non-expansion of their exports has been high tariff barriers imposed by the developed countries on their exports, especially by their regional groups like the EEC. At the same time, the LDCs are trying to-cut down their essential imports from the developed countries by means of exchange controls, high tariffs, import quotas and similar protectionist devices in order to conserve foreign exchange. This has adversely affected their development process.
- **Attitude of Developed Countries:.** The majority of developed countries have surplus in their balance of payments. They are creditors of LDCs and do not take any interest in getting rid of their surplus so as to increase international liquidity.
- **Unequal Distribution of International Reserves:** The distribution of international reserves is biased and favours the developed countries. It is primarily based on their quotas in the IMF. Whenever the IMF quotas are revised, the larger share goes to the developed countries. It is the developing countries whose need for international liquidity is far greater which suffer from its shortage.

14.14.2 Measures to Solve the Problem of International Liquidity

The following measures have been suggested to solve the problem of international liquidity.

- **Promoting Export Expansion:** Developing countries should reduce BOP deficit by promoting export expansion. The choice lies in concentrating the expansion of primary or secondary products or both. The expansion of secondary products requires import substitution for export expansion. These policies will earn them foreign exchange.

- **Limiting Exports:** They should ban non-essential consumer goods, and limit imports of specific goods by selective tariffs, physical quotas, etc. This policy will enable them to conserve foreign exchange.
- **Changing Official Exchange Rate:**A developing country can change its official exchange rate by devaluing its currency so that its export prices are lowered and import prices are increased. This will help in earning foreign exchange.
- **Restrictive Monetary-Fiscal Policies:** By following restrictive monetary and fiscal policies, a developing country can reduce domestic demand for products which will lower import prices, reduce inflationary pressures and BOP deficit.
- **Reduction in BOP Surplus:** The majority of developed countries have BOP surplus which they should reduce by (a) accepting the national currencies of developing countries for payments; (b) removal of trade barriers to the products of developing countries; and (c) accepting products of developing countries in exchange for their products, as was done by the erstwhile USSR.
- **Expanding International Reserves:** The IMF should expand international reserves by fresh allocation of larger quotas to member countries. In particular, all new issues of SDRs should be distributed to developing countries so that they may pay then to developed countries to solve their foreign exchange problem.



14.15 LET US SUM UP

- International Monetary System (IMS) is a well-designed system that regulates the valuations and exchange of money across countries. It is a well-governed system looking after the cross-border payments, exchange rates, and mobility of capital.

- The first phase of the International Monetary System was the Classic Gold Standard from 1816 to 1914.
- After the end of World War I, the Classic Gold Standard collapsed.
- During the period preceding World War I, almost all the major national currencies were on a system of fixed exchange rates under the international gold standard. This system had to be abandoned during World War I. There were fluctuating exchange rates from the end of the War to 1925. Efforts were made to return to the gold standard from 1925. But it collapsed with the coming of the Great Depression.
- After the downfall of the Bretton Woods System, there has not been any formal International Monetary System in place.
- The present-day International Financial Architecture is a managed float system. All the currencies of all the countries can freely float against one another in an open market under the managed float system. The government intervenes only when the currency needs to be stabilized.
- One of the most important shortcomings of the present International Monetary System is that it is incompetent in avoiding global financial crises. There have been four serious financial crises over the past few years.
- The international trade and the movements of productive resources such as labour, capital and technology are substitutes for one another. A relatively capital-abundant country like the United States can export either capital-intensive commodities or export capital itself.
- The flow of direct capital means that the concerns of the investing country exercise de facto or de jure control over the assets created in the capital importing country by means of that investment.
- Private capital movements refer to lending and borrowing from abroad by private individuals and institutions.

- Home capital is concerned with investments made abroad by residents of the country. On the other hand, foreign capital implies investments made by foreigners in the country.
- Foreign Aid refers to public foreign capital on hard and soft terms, in cash or kind, and inter-governmental grants. Foreign aid is tied and untied aid.
- Short-term international capital movements consist of such credit instruments that have a maturity of less than one year. The short term capital movements can take place through currency, demand deposits, bills of exchange, commercial papers and time deposits up to a maturity of one year. The long-term capital movements take place through credit instruments having a maturity of more than one year.
- The basic motive for international portfolio investments is to earn higher returns abroad.
- The motives for direct investments abroad are generally the same as for portfolio investments, that is, to earn higher returns (possibly resulting from higher growth rates abroad, more favorable tax treatment, or greater availability of infrastructures) and to diversify risks.
- The international capital flows result in output and welfare effects upon the investing and host countries.
- International Monetary Fund (IMF) is an international monetary institution established by different countries after the World War II with an objective of providing exchange stability throughout the world and increasing liquidity so that balanced multilateral trade is promoted through the cooperation of the member nations.
- The IMF has special responsibility to assist the less developed countries or developing countries to correct balance of payments deficits and to maintain monetary stability at home. Recently, the Fund has also been playing a significant role in helping these countries in their development schemes by increasing international liquidity and extending technical assistance.

- The establishment of the scheme of Special Drawing Rights (SDRs) is a significant attempt of the International Monetary Fund (IMF) to reform the international monetary system and to solve the problem of international liquidity.
- International liquidity is defined as the aggregate stock of internally acceptable assets held by the central bank to settle a deficit in a country's balance of payments. In other words, international liquidity provides a measure of a country's ability to finance its deficit in balance of payments without resorting to adjustment measures.



14.16 FURTHER READING

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14.17 MODEL QUESTIONS

A. Short Questions (Answer each question in about 150 words).

Q 1: Writer a short note on the evolution of International Monetary System.

Q 2: Discuss the merits and demerits of gold standard.

Q 3: Discuss the reasons for the collapse of classic gold standard.

Q 4: Write a short note on the Bretton Woods System.

Q 5: Why did the Bretton Woods System breakdown? Discuss.

Q 6: Make a critical assessment of the present international monetary system.

Q 7: Discuss the different types of international capital movements.

Q 8: Discuss the different motives for international portfolio investments.

Q 9: Prepare a short note on output and welfare effects of international capital flows.

Q 10: Discuss the different that affect the international capital movements.

B. Essay-type Questions (Answer each question in about 500 words).

Q 1: Make a critical appraisal of the contribution of IMF towards the development process of the Less Developed Countries, with special reference to India.

Q 2: Discuss the concept of Special Drawings Rights. Discuss its merits and demerits. Discuss its implications for India.

Q 3: Discuss the problem of international liquidity and put forward a few measures to overcome it.

Q 4: Discuss the functions and organization of IMF. Make a critical appraisal of IMF.

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Regarding the course as mentioned above, we would like to know your opinions and comments so as to improve the quality of self learning materials in future. Please respond to the following statements by ticking the number you feel most reflect your opinion. After completion of the additional comments, please detach the page and send/mail the same to us at the address given below.

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1. Approximately how many hours did you spend for studying the units in the course?

2. Please give your opinions (by √ mark) to the following items based on your reading of the block:

Sl. No.	Statements	Strongly Agree	Agree	Neither Agree nor Disagree	Disagree	Strongly Disagree
I.	The SLMs of the course fulfil the learning objectives set out in the beginning of each unit					
II.	The units of the SLM could satisfy my academic needs and expectations					
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VI.	Used enough Illustrations (Diagrams, tables etc.) for conceptual clarity					
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VIII.	The self check questions are very helpful					
IX.	The Possible/model questions and the answers to check my progress have benefited me a lot					

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