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INTERNATIONAL FINANCE

SEMESTER - 4

MASTER OF COMMERCE
(Finance Specialisation)

BLOCK - 1

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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MASTER OF COMMERCE

INTERNATIONAL FINANCE

Block 1

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COURSE INTRODUCTION

This is the third course of M.Com. Programme of fourth semester Finance and Accounts specialisation . This course “INTERNATIONAL FINANCE” of M. Com. 4th semester has been structured to give the learners a broad idea about the financial markets and services.The course is designed keeping in mind the present changes in the international financial system. This course will equips corporate treasurers and finance managers with the conceptual understanding of global financial markets, instruments and products. It enables them to analyze market opportunities and associated financial risks, and also familiarizes them with the available funding avenues.

The course has 15 units and is divided into two blocks: Block 1 and Block 2.

Block 1 consist of 7 units discussing the basics of international financial management, international monetary system, exchange rate, international financial institutions, balance of payment, foreign exchange market and theories of foreign exchange rate movement.

Block 2 concentrates on mamangement of foreign exchange risk, management of foreign exchange translation, management of foreign exchange transaction exposure, management of economic exposure, multilateral development banks, international financial instruments, international banking and EURO dolar market.

Each unit of these blocks includes some along-side boxes to help you know some of the difficult, unseen terms. You may find some boxes marked with: “LET US KNOW”. These boxes will provide you with some additional interesting and relevant information. Again, you will get “CHECK YOUR PROGRESS” questions. These have been designed to self-check your progress of study. It will be helpful for you 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 each unit. This will help you in making your learning more active and efficient. And, at the end of each section, you will get “CHECK YOUR PROGRESS” questions. These have been designed to self-check your understanding.

BLOCK INTRODUCTION:

This is the first block of the course of "INTERNATIONAL FINANCE" of M. Com. 4th semester Finance and Accounts specialisation. This Block Contains 7 units and is primarily a learner oriented Self learning material, as it satisfies the requirements of the learners in the filed of International Finance.

This block comprises of the following seven units:

UNIT 1: International Financial Management

UNIT 2: International Monetary System

UNIT 3: Exchange Rate

UNIT 4: International Financial Institutions
Development Banks

UNIT 5: Balance of Payments

UNIT 6: Foreign Exchange Market

UNIT 7: Theories of Foreign Exchange Rate Movement and International Parity Condition

UNIT 1: INTERNATIONAL FINANCIAL MANAGEMENT

UNIT STRUCTURE

1.1 Learning Objective

1.2 Introduction

1.3 Meaning and scope of international financial management

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- 1.4.1 Features of international business
- 1.4.2 Motivations of international business
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1.9 Further Reading

1.10 Model Questions

1.1 LEARNING OBJECTIVES

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

- Know the meaning and scope of international financial management
- State the meaning and benefits of international business

- Describe the meaning and impact of foreign direct investment
- Know the meaning and characteristics of multinational corporations
- Explain the objective and advantages and disadvantages of multinational corporations

1.2 INTRODUCTION

International business activity has been in existence for hundreds of years. It is seen that the firms today are becoming multinationals through a gradual process. A firm tries to exploit factor advantages internationally and to attempt to reduce the competitive threats by others. Companies gradually increase their commitment to international business. The sequence normally involves exporting, setting up an international operations department, establishing a marketing subsidiary, entering into licensing agreements and eventually creating facilities for manufacturing abroad. Trading and making money through the exchange of foreign currency is termed as International financial management, also known as international finance. It is the management of finance in an international business environment. The main objective of international financial management is to maximise shareholder wealth. This particular unit tries to discuss the meaning, scope, need and various aspects of International Financial Management.

1.3 MEANING AND SCOPE OF INTERNATIONAL FINANCIAL MANAGEMENT

Business activity among the countries has been in existence for thousands of years, but with the increase in the global trade and interdependency among the countries the importance of international trade and international trade has increased many folds. Exchange of goods/services, financial resources, technology development and skilled manpower is the reality of today's international finance. Almost all develop nations and fast developing nations are export oriented. A huge part of their GDP comes from export. International finance is associated with the systematic effort to facilitates the free flow of goods and services, across national boundaries.

Since international finance involves MNCs, national government's rules and regulations regarding flow of capital across the borders of the country the area is vivid and complex.

With the increasing trade among the countries specially after adopting the economic liberalisation by the countries the world economy is getting more integrated. Much of the trade liberalization has come from the development of free-trade areas such as that of the European Union (EU), North American Free Trade Agreement (NAFTA). Similarly, rapid growth of trade has occurred among the members of the Association of South East Asian Nations (ASEAN). This regionalization of trade has important currency implications, making the trend of para-mount importance to international finance.

International finance is defined as the set of relations for the creation and using of funds (assets), needed for foreign economic activity of international companies and countries. The definition of international finance as the combination of monetary relations, that develop in process of economic agreements - trade, foreign exchange, investment - between residents of the country and residents of foreign countries, is not exhaustive. It does not reflect all the essential features, that are generated by the set of conditions outside the company (i.e. the external environment of the international business), which effects on their activity in practice.

International finance, as a subject of special disciplines, reflect the economic aggregate of time and uncertainty, regarding the decisions, that touches several different countries, taking into account that every sovereign country has the own currency, business laws and political systems.

International finance is one of the main subsystems of the world economy, which makes a decisive impact on the national and global economy. At the same time, the international finance functions as an integral system, the elements of which are:

- the international monetary system, which is characterized by the components: the national and reserve currency, international collective currencies, the conditions of mutual convertibility, currency

parity, exchange rate, national and international regulatory mechanisms of exchange rates;

- international payments that serve the movement of goods and factors of production, financial instruments, and the balance of payments, which reflect all the transactions related to international payments;
- international financial markets and the mechanisms of trading by specific financial instruments – currency, loans, securities;
- international taxation, as the method of mobilization of funds;
- international financial management of MNC, where international investment, risk management, transnational financing etc. take the main place.

1.4 INTERNATIONAL BUSINESS

International business means producing, buying and selling of goods and services across the geographical and political boundaries. Such production, buying and selling of goods may be done by government or private enterprises. International business is a broad term which includes international movement of capital, personal, intellectual property, technology and know-how. Business houses cross the national border to expand their business activities like trading, manufacturing, mining, construction, agriculture, banking, insurance, health, communication etc. It has many options of doing business, which includes:

- Exporting goods and services
- Overseas production of goods and services
- Licensing and franchising
- Foreign investment
- Providing managerial services to companies in the host country.

1.4.1 Features Of International Business

Following are the features of international trade:

- **Integration of economics:** International business integrates economies of different countries. It uses finance of one country, technol-

ogy of another country, labour and infrastructure from another country.

- **Large scale operation:** In international business the players operate in a large scale. Production, distribution and marketing are done in a large scale.
- **Economic benefits to countries:** international business brings benefits to the participating countries. Poor countries get capital and technological support from the rich countries. It promotes industrialization and generates employment.
- **Competition:** In international business competition is very high. The competition is basically developed and developing countries.

1.4.2 Motivations of international business

- **Higher Profit:** The prime objective of any business is to earn profit. In the domestic market scope of earning profit is limited. International market promises higher profit to business. Objective of earning higher profit motivate the business to expand its operation in foreign countries. There are companies like HP, P&G etc who earn more than half profits from foreign business.
- **Huge production:** Some company has huge production capacity which produces goods more than the domestic markets demand. In such cases, producers are forced to sale their products in international market.
- **Scarcities:** In any country of the world all required resources are not available. If a country is rich in one resource, it may not have many other resources. For example, India produce huge quantity of rice and onion but it is not self-dependent in crude oil. India depends on other countries which are rich in crude oil for meeting its oil requirements. In this way international business helps different countries in filling up the shortage of resources.
- **International cooperation:** International business helps in maintaining good relation among the trading countries. Due to interna-

tional business a company from one country studies culture, tradition, test, preference, problems and requirements.

- **Availability of human resources:** Now a day's companies from develop countries establishing their plants in developing and less develop countries. This is due to availability of cheap human capital in developing and less develop countries. This reduces cost of production and increase income and employment.
- **Nearness to raw- material:** Availability of raw material in a particular region attracts companies from different parts of the country. For example, British Petroleum Company is a UK based company operating in Kuwait, UAE and many other countries due to availability of crude oil in those countries.
- **Volume of consumers:** Highly populated countries like India, China etc. attract foreign companies as demand in such populated countries cannot be meet domestically.
- **Increase in market shares:** Big corporate houses with huge capital investment and production capacity try to increase market shares by expanding business in foreign countries.

1.4.3 Benefits of International Business

There are various benefits of international business. It brings benefits to both host countries as well as foreign companies which are discussed below:

2.4.3.1 Benefits to the Nations

- **Improves standard of living:** International business makes available quality goods and advance technology to the customer of various countries. This increase satisfaction of the consumers and improves their living standard. It makes available different types of products to consumers.
- **Earnings of foreign exchange:** In the era of globalization economic strength of country depends upon its foreign exchange re-

serve. International business helps a nation in earning foreign exchange.

- **Opportunity to domestic business:** International business brings opportunities to the domestic industries and trading concerns. This includes transfer of technology, management skills, market intelligence, product development etc. International business also helps the traders by making verity of goods available for sales.
- **Optimum use of resources:** Countries generally produce those goods in large quantities, in which the country is specialized and can produce at low cost. This helps the country to export the surplus left after meeting domestic demand. This encourages the country to produce more which in turn ensures optimum utilization of resources.
- **Specialisation and division of labour:** International business leads to specialization and division of labour. Due to international trade some countries in the world emerge as special hub for some specific products. For example, Japan for automobiles and electronic, Brazil for coffee, India for textile and garments etc.
- **Explore untapped areas of business:** International business helps in exploring new areas of market in a country. There are certain areas which need huge investment and high technology to explore, for example, mining and exploration of crude oil. This is difficult for a poor country to invest such a huge amount, in such case international business is very helpful.

2.4.3.2 Benefits to the Corporate

- **Wide market:** When a company expands business to foreign countries, it widens the customer base of that company. When a company joins in international business it need not depend upon customers of a single country. For example, Cadbury, Havells, Toyota etc. companies are having more customers in foreign market compared to the domestic market.

- **Increase profit:** A company can increase sales volume by expanding their business to other countries which ultimately leads to increase in profit. A company can also increase profit by selling the same product in foreign market.
- **Reduce risk:** Companies which are engaged in international business operates in many countries. This reduces both financial risk and political risk of the company because loss or threats arise in one country is mitigated by profit and opportunities of another country.
- **Growth prospect:** International business increase growth prospect of a company. After meeting the domestic demand one company can enter in to foreign market for better opportunity. This led to increase in the customer base and sales of the company.
- **Economies of large- scale operation:** Companies which has business in many countries operates in very large scale. Such companies produce huge quantity of goods hence purchases, dispatch, storage etc. are done in large scale. This brings the benefits of large scale operation to the companies which reduce cost.

1.4.4 Fields of International Business

There are various ways through which a business firm can enter in to international business. They are called modes of entering in to international business. Some of them may be discussed as follows:

- **Exporting:** One of the oldest modes of doing international business is export and import of goods and services. Export is direct sales of goods and services by one country to another country. It can be done directly by the business firm by directly approaching the foreign buyers or indirectly through export houses. Exporting requires coordination among exporter, importer, transport provider, banks and government. Export business requires list legal formalities and relatively less complex compared to other forms of doing international business. For doing export a export license is mandatory.

- **Licensing and Franchising:** Licensing is a contractual agreement between two parties, licensor and licensee, whereby licensor permits licensee to use its intellectual property to manufacture goods according to specification, on payment of certain fee known as royalty. The property licensed includes-patent, trademark, copyright, technology, technical know-how, specific skills etc. in other words, licensing gives right to the licensee to use intellectual property for creating products. The licensee earns good revenue with low investment through licensing. Generally, developing and less develop country use this rout for bringing new technology from develop countries.

  Under franchising, an independent organization called franchisee operates the business under the name of another company called the franchisor. In such an agreement franchisee pay a fee to the franchisor. Here franchisor is the real owner of the property. This is also one kind of licensing but, here, franchisor can exercise more control over the franchisee as compared to that in licensing. In franchising franchisee has to pay a fixed amount and royalty based on sales.
- **Contract Manufacturing:** Contract manufacturing is outsourcing entire or a part of a manufacturing process. In contract manufacturing an organization make products for another company under a contract. In pharmaceutical and electronic fields many products are manufactured by contract manufacturers. For example, Flextronics Corporation is a huge company with factories in more than 30 countries. This company produce Xbox game machine for Microsoft, router for Cisco, printer for HP etc. The company for whom the product is produced is known as “original equipment manufacturer”.
- **Joint Ventures:** Joint venture is an entity formed by two or more parties to undertake economic activity. The parties agree to create a new entity and share the revenue, expenses and ownership. It is very common mode of entering in to international market. A joint

venture can be organizing as a partnership firm, a corporation or any other forms of business which the participating firms choose to select. For example, Bajaj Allianz General Insurance is a joint venture between Bajaj Finserv Limited of India and Allianz of Munich, UK again Tata AIG General Insurance Company Ltd. is a joint venture between Tata group of India and American International Group of USA.

- **Direct Investment:** Foreign Direct Investment is an investment made by a company based in one country, in to a company based on another country. Companies making direct investment have a significant degree of influence and control over the company in to which the investment is made. FDI gives a high degree of control in the operation. It involves transfer of resources including financial capital, human capital and technology. FDI may come through the acquisition of an existing company or by establishing a new entity. Entry through FDI mode is risky and requires huge investment of resources and commitment.

FDI plays a very important role in international business. FDI is a major source of external finance for countries with limited amount of capital. FDI plays a very important role in internationalizing business. FDI has many advantages like, improves foreign exchange position of the country, generate employment, help in capital formation, increase tax revenue etc.



CHECK YOUR PROGRESS

1. Mention two benefits of international business.

.....

.....

2. Wat is mean by contract manufacturing

.....

.....

1.5 FOREIGN DIRECT INVESTMENT

When a company takes controlling ownership in a business entity in another country it is called Foreign Direct Investment (FDI). With FDI, foreign companies are directly involved with day-to-day operations in the other country. This means they aren't just bringing money with them, but also knowledge, skills and technology. Generally, FDI takes place when an investor establishes foreign business operations or acquires foreign business assets, including establishing ownership or controlling interest in a foreign company.

A foreign direct investment (FDI) is a purchase of an interest in a company by a company or an investor located outside its borders. Generally, the term is used to describe a business decision to acquire a substantial stake in a foreign business or to buy it outright in order to expand its operations to a new region.

In simple words, foreign direct investment is an investment made by a company or individual who is an entity in one country, in the form of controlling ownership in business interests in another country. FDI could be in the form of either establishing business operations or by entering into joint ventures by mergers and acquisitions, building new facilities etc. Foreign direct investment complements domestic investment and fills the gap between resources available and required domestically. It not only brings capital but also transfers technology, organizational and other skills to the country.

1.5.1 Trends of FDI In India

FDI is the direct investment by foreign capitalists and business institutions in other countries. FDI can be either in the form of establishing business operations or by entering into joint ventures by mergers and acquisitions, building new facilities etc. The essence of FDI is ownership control and management of business. There are mainly three types of FDIs, viz. horizontal, vertical and conglomerate. A horizontal investment would entail establishment of the same business in a foreign country. A vertical

investment is made when a slightly differentiated business is established in a foreign country. Finally, a conglomerate investment
is made when the business is unrelated to its existing business. In FDI, investors can be an individual, firm, company, institutions etc. and FDI can assume one of the following: (i) the formation of a concern in which the foreign investors or foreign companies have a majority share, (ii) the formation of a subsidiary of a concern of the investing country in the host country, (iii) the organisation of a firm in the capital importing that is financed fully by some established concern in the investing country, (d) the creation of fixed assets by the nationals of the investing country in the capital importing country and (e) the setting up of an autonomous corporation by the investing country for the specific purpose of operating other concerns.

Foreign direct investment (FDI) in India seems to be petering out with the inflows growth rate recording a five-year low of 3 per cent at USD 44.85 billion in 2017-18. According to the latest data of the Department of Industrial Policy and Promotion (DIPP), FDI in 2017-18 grew by only 3 per cent to USD 44.85 billion. Foreign inflows in the country grew by 8.67 per cent in 2016-17, 29 per cent in 2015-16, 27 per cent in 2014-15, and 8 per cent in 2013-14. However, FDI inflows recorded a negative growth of 38 per cent in 2012-13. According to experts, it is critical to revive domestic investments and further ease of doing business in the country to attract foreign investors.

An UNCTAD report has recently stated that the foreign direct investment in India decreased to USD 40 billion in 2017 from USD 44 billion in 2016 fiscal. However, outflows from India, the main source of the FDI in South Asia, more than doubled to USD 11 billion, the report stated. UNCTAD Secretary-General Mukhisa Kituyi said, “Downward pressure on the FDI and slowdown in global value chains are a major concern for policy makers worldwide, and especially in developing countries”. The main sectors that received maximum foreign inflows in the last fiscal include services (USD 6.7 billion), computer software and hardware (USD 6.15 billion), telecommunications (USD 6.21 billion), trading (USD 4.34 billion), construction (USD

2.73 billion) automobile (USD 2 billion) and power (USD 1.62 billion). Mauritius has emerged as the largest source of FDI in India with USD 15.94 billion in 2017-18 followed by Singapore (USD 12.18 billion), Netherlands (USD 2.8 billion), the US (USD 2.1 billion) and Japan (USD 1.61 billion). Further, the data showed that the FDI equity inflow of USD 44.8 billion in 2017-18 is the highest ever for any financial year. FDI is important as India would require huge investments in the coming years to overhaul its infrastructure sector to boost growth. Decline in foreign inflows could put pressure on the country's balance of payments and may also impact the value of the rupee.

The share of the top 10 investing countries in India along with their cumulative FDI equity inflow and percentage of total FDI equity inflow from April 2000 to December 2018 has been shown in Table.

Table-1

Top Ten FDI Source Countries for India During 1991-2000

Country	Value	Total
USA	19905	20.61
Mauritius	8620	12.04
UK	4742	6.62
Japan	3143	4.40
Germany	2471	3.45
Australia	1893	2.64
Netherlands	1620	2.26
Singapore	1205	1.68
Switzerland	912	1.27
Canada	758	1.03

Table-2

Top Ten FDI Source Countries for India During 2000-2018

Country	Value	Total
Mauritius	132408	32
Singapore	79747	19
Japan	29519	7
UK	26494	6

USA	24759	6
Netherlands	26433	6
Germany	11420	3
Cyprus	9861	2
France	6593	2
UAE	6054	1

Table 1 shows that the USA tops the list with 20.61 per cent of total FDI in India followed by Mauritius (12.04 per cent), UK (6.62 per cent), Japan (4.40 per cent), Germany (3.45 per cent), Australia (2.64 per cent), the Netherlands (2.26 per cent), Singapore (1.68 per cent), Switzerland (1.27 per cent) and Canada (1.03 per cent) during 1991–2000. These top 10 investing countries together hold 56 per cent of the total FDI in India. The share of the top 10 investing countries in India along with their cumulative FDI equity inflow and percentage of total FDI equity inflow from April 2000 to December 2018 has been shown in Table 2. All these source countries have together held 84 per cent of the total FDI equity inflows. The fall in the inflows from the USA is partly due to the USA investors' investment in India through Mauritius to get tax advantages that emanate from the treaty.

1.5.2 Impact of Foreign Direct Investment

The increased role of Foreign Direct Investment (FDI) in developing and emerging economies has raised expectations about its potential contribution to their development. FDI can bring significant benefits by creating high-quality jobs and introducing modern production and management practices. Many governments in the world have developed policies to further promote inward FDI. However, empirical studies on the role of FDI in the growth process have yielded conflicting result. Let us discuss both positive and negative impact of FDI.

1.5.3.1 Positive Impact of Foreign Direct Investment

Foreign Direct Investment (FDI) is favoured on the following grounds:

- **Promotes competition:** Competitive policies undertaken by the host country to attract the FDI often reduce cost of production in the host

country. It reduces the monopoly power and encourages competition among the domestic producers which ultimately leads to higher productivity and higher efficiency.

- **Spillovers associated with FDI**: The Spillovers associated with FDI in the form of technology, skills, introduction of new products enhances the industrialisation in the host country.
- **Positive externality**: The positive externality in terms of higher efficiency of domestic financial market, domestic goods and services markets, improved resource allocation are main sources of economic growth. If FDI is made for infrastructural development, then it benefits the industrial sector of the host country.
- **Transfer of managerial capacity:** In the case of FDI, investors have the managerial efficiency which can easily transmit to the economy of host country.
- **Availability of advance know-how:** FDI involves transfer of scientific, technical, managerial and administrative skills over latest techniques of production from foreign country to the host country which accelerate the pace of economic growth of host country.
- **Continuous flow of foreign capital:** There is continuous flow of capital in foreign direct investment as it involves long term commitments of foreign investors. This continuous flow capital helps the host country to continue its growth.
- **Larger tax reserves:** The increase in production and foreign trade due to FDI increases the public revenue of the host Foreign Investment country. This increase in tax revenues can be divested to the execution of various development programmes.
- **Creation of employment:** Setting up of new plant and enterprises and diversification of activities by foreign investors help in creation of employment opportunity in the host country.
- **Higher income generation:** As FDI increases the productivity, it results in higher real wages and expansion of employment opportunities.

- **Growth of indigenous enterprises:** The FDI promotes growth of indigenous enterprises. The foreign enterprises or investors encourage the domestic producers to set up small scale ancillary units. This could be obtained either through providing financial technical assistance or indirectly through expansion in demand for goods and services of the ancillary units.
- **Reinvestment of profit:** Foreign investors reinvest a part of their profit financing their projects. This generates higher capital for nation which is essential for economic growth of the host country.
- **Expansion of market:** A major drawback of Less Develop Countries (LDCs) is its smaller extent of market. FDI facilitates expansion of market from domestic to international level by internationalising trade with greater scope, specialisation, sophistication and economies of scale.

1.5.3.2 Negative Impact of Foreign Direct Investment

Despite of tremendous positive impact, Foreign Direct Investment also have some negative impacts as well. They are:

- **Heavy cost:** The host country bears a heavy high cost for promoting FDI. It has to provide land, water, power and other basic facilities and these facilities are provided on the ground of development rebate on undistributed profits, additional depreciation allowances, subsidies, supply of inputs and tax holidays for some specific period.
- **Lop-sided development**: Generally, foreign investors prefer to invest in the industries of mass communication and industries of extraction so the growth in possible only in these industries while in capital goods industries, public utilities and import substitution industry, the growth is sluggish. Hence, FDI promote lop-sided development.
- **Economic exploitation**: FDIs are responsible for the exploitation of the human and natural resources and markets of the LDCs. The manufactured goods are exported to their own country by the for-

eign investor at very low price. This is an economic exploitation of the host country's product.

- **No skill formation:** There should be transfer of technical know-how from foreign country to host country. But in reality, the foreign investors are not intended to train the indigenous labour. There is no skill formation among the indigenous labour and they remain productively inefficient.
- **No transfer of technology:** Though it is expected the transfer of technology from foreign country to host countries, but in actual practice the foreign investors try to hide their latest technology from the indigenous producers of that country. Sometimes obsolete plants and equipment are thrust upon the LDCs in the form of transfer of turn-key projects. Sometimes, the technology transferred by foreign investments is not match with the resource endowment of the host country. Thus, there is no an efficient technology that supports the growth of host country.
- **Low employment generation:** LDCs form conducive environment to attract FDI. They believe that FDI could generate employment opportunities as well as the income of the people of the LDCs. So, they form competition policies like reduction of tax rate, low labour cost, tax holiday to attract more and more FDI. When FDIs take place there is employment generation, but this benefit does not go straight to the labour force of the LDCs. They only offer very few lower grade jobs to the host country while upper grade and well paid posts are kept reserve for their own labour. Thus, FDI create only little employment opportunity for the host countries.
- **Discouragement for domestic capital and enterprise:** Foreign investors grab the more profitable investment projects which has negative effect on the domestic investors. Thus, FDI discourages the domestic investors.
- **Uncertainty:** The main motive of foreign investors is the profit. When there is prosperity, more FDIs take place when there is re-

cession or depression less FDIs take place. Thus, the FDIs depends on the movement of business cycle of the host country. FDIs are uncertain and not dependent as for long term expansion of the economy. Hence, FDIs are generally quoted as fair weather friend.

- **Concentration of industries:** FDIs are done mainly in the areas of oil, coal, ores, service sectors including banks, legal services while FDIs are less in other sectors. Thus, FDIs result in concentration of industries only at some selected sectors while other sectors remain backward. The sectors grow fast and others remain as they are. So, FDIs promotes regional or geographical inequalities in the host country.
- **Emergence of monopolies:** Though it is assumed that more FDIs means more competition among the investors, producers and industries, but in reality this is seldom realised. In many cases FDIs promote monopoly. The foreign investors generally deprive the indigenous small investors of the host country. They are also technically skilful, innovators and they also acquire patent, rights easily. Thus, FDIs emerge as powerful monopoly and exploit the host countries factors of production and people.
- **Political domination:** In case of FDIs, foreign investors have ownership. When foreign investors start assuming control over some vital or key sectors, they interfere with economic and political decision making process of LDCs. Most of the time they define terms and conditions which favour the interest of their mother counties rather than the host countries.

1.4 MULTINATIONAL CORPORATIONS

Multinational Corporations (MNCs) are those that have business operations in two or more countries. These companies are often managed from and have a central office headquartered in their home country, but with offices worldwide. Simply exporting goods to be sold abroad does not make a company a multinational.

The massive growth of multinational companies from international company to Global company, to transnational company, gave way to the

renewed and necessary significance to international finance. Every country, on the growth path, transverse to financial aspects to a great extent to increase their economic growth and GDP. The main players in the international finance are multinational corporations, who are stronger than the national governments.

International finance encompasses, other than MNCs, the foreign exchange markets, international methods of payments, international financial markets, exchange rates, international risk management and so on. The financial management globally necessitates the international movement of FDI and capital inflows through foreign institutional investors.

1.4.1 Characteristics of A Multinational Corporation

The following are the common characteristics of multinational corporations:

1. **Network of branches:** Multinational companies maintain production and marketing operations in different countries. In each country, the business may oversee multiple offices that function through several branches and subsidiaries.
2. **Very high assets and turnover:** To become a multinational corporation, the business must be large and must own a huge amount of assets, both physical and financial. The company's targets are high, and they are able to generate substantial profits.
3. **Continued growth:** Multinational corporations keep growing. Even as they operate in other countries, they strive to grow their economic size by constantly upgrading and by conducting mergers and acquisitions.
4. **Sophisticated technology:** When a company goes global, they need to make sure that their investment will grow substantially. In order to achieve substantial growth, they need to make use of capital-intensive technology, especially in their production and marketing activities.
5. **Control:** In relation to the previous point, the management of offices in other countries is controlled by one head office located in

the home country. Therefore, the source of command is found in the home country.

6. **Right skills:** Multinational companies aim to employ only the best managers, those who are capable of handling large amounts of funds, using advanced technology, managing workers, and running a huge business entity.
7. **Forceful marketing and advertising:** One of the most effective survival strategies of multinational corporations is spending a great deal of money on marketing and advertising. This is how they are able to sell every product or brand they make.
8. **Good quality products:** Because they use capital-intensive technology, they are able to produce top-of-the-line products.

1.4.2 Objectives of MNCs

Following are the objectives of MNCs:

- To earn huge profit by expanding the business beyond the boundaries of the home country.
- Producing goods in those countries where cost of production is minimum.
- Achieve greater efficiency in production in local markets and then exporting the products.
- Create an international corporate image.
- Capture lucrative international market.
- Make best use of technological advancement.

1.4.3 Advantages of Multinational Corporations

Advantages for the host country

- The investment level, employment level, and income level of the host country rises due to the operation of MNCs.
- MNCs bring with them the most sophisticated technology about production process while transferring modern machinery and equipment to the developing countries. Such transfer of technology is assumed to be desirable and productive for the host country.

- The MNCs bring entrepreneurial abilities, management experience, skills and techniques to the host country specially to the developing countries and make human capital of the host country skilful and efficient.
- The business volume of domestic traders and market intermediaries of the host country increased due to operation of MNCs.
- MNCs create competition among domestic companies and thus increase their competitiveness and quality.
- The host country can lessen imports and increase exports due to goods produced by MNCs in the host country. This lead to increase in the foreign exchange reserve of the host country.
- Level of industrial and economic development increases due to the growth of MNCs in the host country.
- By paying duties and taxes MNCs contribute towards the national exchequer of the host country and fill the gap between targeted government tax revenues and locally raised taxes.
- MNCs help to improve the standard of living in their host countries.
- MNCs pay high dividend's, motivating resource mobilization among investors in the host countries.

Advantages for the home country

- MNCs create opportunities for marketing the products produced in the home country throughout the world.
- They create employment opportunities to the people of home country both at home and abroad.
- It gives uplift to the industrial responsibilities of home country.
- MNCs help to maintain favourable balance of payment of the home country by transferring income in the forms of profit, royalty and management contract from host countries.
- Home country can also get help of foreign culture as well as communication brought by MNCs.

1.4.4 Disadvantages of Multinational Corporations

Though MNCs bring many advantages there are many arguments against the MNCs. Following are the reasons due to which MNCs are said to be disadvantageous or harmful.

Disadvantages for the host country

- MNC's may relocate the technology which has become obsolete in the home country.
- MNCs harm employment in those countries where supply of labour is excessive by using capital intensive technology and make the employment problem more serious.
- The tremendous power of MNCs may pose threat to the sovereignty of the host country. The greatest example in this regard is the East India Company, which came to India to do business and later on rule India for more than 200 years.
- MNCs may destroy the domestic industry by monopolizing the host country's market and reduce competition.
- The main objectives of MNCs are profit maximization and not the development of the host country.
- MNCs interfere directly or indirectly in the political and administrative system of the host country.
- In order to gain more money, MNCs may use non-renewable natural resources of the host country in a large extent.
- A big amount of money moves to foreign countries in terms of payments towards profits,dividends and royalty which create unfavourable balance of payment position.

Disadvantages for the home country

- MNCs shift huge capital from the home country to various host countries causing undesirable balance of payment.
- MNCs may not create employment opportunities to the people of home country if it takes the geocentric approach.

- As investments in foreign countries is more approving and hence MNCs may avoid the home countries' industrial or economic development.
- They prefer to participate in the production of mass consumption and non-essential items.



CHECK YOUR PROGRESS

3. Mention two objectives of MNC.

4: Give any two arguments in favour of multinational corporations for the host country.

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5: Give two arguments against multinational corporations for the home country.

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1.7 LET US SUM UP

In this unit we have discussed the following points:

- International finance is defined as the set of relations for the creation and using of funds (assets), needed for foreign economic activity of international companies and countries.
- International business means producing, buying and selling of goods and services across the geographical and political boundaries.
- There are various ways through which a business firm can enter in to international business.
- Foreign Direct Investment is an investment made by a company based in one country, in to a company based on another country.
- FDIs are responsible for the exploitation of the human and natural resources and markets of the LDCs.

- The United Nations estimates that there are more than 35,000 MNCs, with the largest 100 of these possibly being responsible for approximately 16 percent of the world's productive assets.



1.8 ANSWER TO CHECK YOUR PROGRESS

Ans to Q. No.1. Two benefits of international trade are-

a) International business makes available quality goods and advance technology to the customer of various countries.

b) International business helps in exploring new areas of market in a country.

Ans to Q. No.2. Contract manufacturing is outsourcing entire or a part of a manufacturing process.

Ans to Q. No.3. Following are the two objectives of MNCs:

a) To earn huge profit by expanding the business beyond the boundaries of the home country.

b) Producing goods in those countries where cost of production is minimum.

Ans to Q. No.4.

a) The investment level, employment level, and income level of the host country rises due to the operation of MNCs.

b) MNCs bring with them the most sophisticated technology about production process while transferring modern machinery and equipment to the developing countries.

Ans to Q. No.5.

a) MNCs shift huge capital from the home country to various host countries causing undesirable balance of payment.

b) MNCs may not create employment opportunities to the people of home country if it takes the geocentric approach.



1.9 FURTHER READING

1. International Business -V.K. Bhalla, Publisher- S Chand
2. International Business -Text and Cases -Cherunilam, F., Publisher- PHI Learning Pvt. Ltd.
3. Multinational Financial Management -Shapiro, A. C., Publisher- Prentice Hall of India



1.10 MODEL QUESTIONS

1. State the meaning and scope of international financial management.
2. What is international business? State the benefits of international business.
3. Describe the meaning and impact of foreign direct investment (FDI).
4. Write a note on the present trends of FDI in India.
5. What are multinational corporations? State the characteristics of multinational corporations.
6. Explain the objective of multinational corporations.
7. Describe the advantages and disadvantages of multinational corporations.

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UNIT-2: INTERNATIONAL MONETARY SYSTEM

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Meaning of International Monetary System

2.4 Evolution of International Monetary System

- 2.4.1 Gold Standard
- 2.4.2 Reasons for the collapse of gold standard

2.5 The Bretton Woods System

- 2.5.1 The breakdown of the Bretton Woods System

2.6 Smithsonian Agreement

2.7 The Present Scenario of International Monetary System

- 2.7.1 Advantages of current international monetary system
- 2.7.2 Shortcomings of current international monetary system

2.8 International Capital Movements

- 2.8.1 Types of international capital movements

2.9 Let us Sum Up

2.10 Answer to Check Your Progress

2.11 Further Reading

2.12 Model Questions

2.1 LEARNING OBJECTIVES

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

- State the meaning of international monetary system
- Make evaluation of gold standard
- Critically examine the working of Bretton Woods System
- Describe the present scenario of international monetary system
- Know the meaning and types of international capital movements

2.2 INTRODUCTION

Most countries have national currencies that are not typically accepted as legal payment beyond their borders. Therefore, to facilitate international economic exchange the need for the International Monetary System (IMS) arisen. This particular unit discusses about the meaning, need, evolution and present scenario of International Monetary System.

2.3 MEANING OF INTERNATIONAL MONETARY SYSTEM

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 this unit, we shall discuss the evolution of international monetary system-gold standard, Bretton Woods agreement, Smithsonian agreement and meaning and types of international capital movements

2.4 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:

2.4.1 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.

Merits of Gold Standard

Following were the merits of gold standard:

- **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 of Gold Standard

Following are the demerits of gold standard:

- 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.

2.4.2 Reasons For the Collapse of Gold Standard

After the end of World War-I, 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.

After World War II, the United States of America emerged as the new political and economic superpower. On the question of gold standard, the Bretton Woods Agreement was signed wherein, the dollar remained fixed to gold at $35 an ounce while currencies of participating nations which included Britain, France, Germany etc. agreed to an adjustable fixed exchange rate to the dollar. While these countries maintained gold reserves, they preferred settling the international balances in dollars which was rarely converted to gold.

In 1971, President Nixon announced the end of the Bretton Woods agreement and the non- convertibility of US dollars into gold. This meant that there would be no international conversion of dollars to gold and the end of the gold exchange standard.

2.5 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 mid1960s. During this period, world output increased and with the reduction of tariffs under the GATT, world trade also rose.

2.5.1 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 broke down. 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.

2.6 SMITHSONIAN AGREEMENT

The Smithsonian Agreement was an agreement signed by 10 top industrialized countries in 1971to regulate international payment and exchange at that moment. The agreement made an amendment to the fixed exchange rates stipulated in the 1944 Bretton Woods Agreement. When the Smithsonian Agreement was signed in 1971, it created a new standard to the U.S dollar in which the currencies of the other nine countries that signed the agreement were pegged to the U.S dollar. The 10 countries that signed the Smithsonian Agreement were; Netherlands, Japan, Belgium, Sweden, France, Canada, Germany, Italy, the United Kingdom, and the United States. As contained in the agreement, the currencies of the above countries are allowed to fluctuate against the US dollar by 2.25%.

The Smithsonian Agreement was a revision of the 1944 Bretton Woods Agreement; this agreement saw to the amendment of fixed exchange rates. This agreement also contributed to the emergence of Forex markets. As a result of the Smithsonian Agreement, the US dollar was partially devalued as it was pegged against the currencies of countries that signed the deal. This agreement devalued the U.S. dollar by 8.5% relative to gold. The insufficiency of gold to meet global demands for international reserves during the 1960s was a major factor that gave rise to the Smithsonian Agreement. This agreement, however, became mandatory in 1971 when the then U.S president, Richard Nixon prohibited exchange of US dollars for gold. The Smithsonian Agreement was signed by a group of ten countries popularly called G10.



CHECK YOUR PROGRESS

1: Mention two demerits of gold standard.

2: How many countries signed the Smithsonian Agreement?

2.7 PRESENT SCENARIO OF 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.

2.7.1 Advantages of Current International Monetary System

Following are few advantages of the International Monetary System-

- 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.

2.7.2 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 eco-

nomic 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.

2.8 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.

2.8.1 Types of International Capital Movements

International capital movements are classified in the following ways:

- **Direct and Portfolio**: Capital flows refer to the movement of money for the purpose of investment, trade, or business operations. Capital flows are transactions involving financial assets between international entities. Direct investment is seen as a long-term investment in the country's economy, while portfolio investment can be viewed as a short-term move to make money. Direct investment is likely only suitable for large corporations, institutions, and private equity investors. Direct investment involves establishing a direct business interest in a foreign country, such as buying or establishing a manufacturing business, building warehouses, or buying buildings. Direct capital investments may take many forms.

  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.



CHECK YOUR PROGRESS

3: Mention two advantages of current international monetary system.

4. The movement of indirect capital is known as portfolio investment. (True or False)



2.9 LET US SUM UP

In this unit we have discussed the following points:

- The first phase of the International Monetary System was the Classic Gold Standard from 1816 to 1914.
- Gold because of its universal acceptability worked as a medium of exchange.
- 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 Smithsonian Agreement was an agreement signed by 10 top industrialized countries in 1971to regulate international payment and exchange at that moment.
- International capital movements (or flows) refer to the outflow and inflow of capital from one country to the other.



2.10 ANSWER TO CHECK YOUR PROGRESS

Ans to Q No 1. Two demerits of gold standard are:

a) Gold standard leaves no room for monetary policy to correct the monetary imperfections existing within the country.

b) 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.

Ans to Q No 2. Ten countries signed the Smithsonian Agreement.

Ans to Q No 3. Two advantages of current international monetary system are:

a) IMS enhances financial stability and maintains the price level on a global scale. It also boosts global growth.

a) International Monetary System mobilizes money across countries and determines the exchange rate.

Ans to Q No 4. True



2.11 FURTHER READING

International Business -Text and Cases -Cherunilam, F. (2013). PHI Learning Pvt. Ltd.

Multinational Financial Management -Shapiro, A. C. (2003). Prentice Hall of India



2.12 MODEL QUESTIONS

1. Meaning of International Monetary System
2. Write a note on evolution of International Monetary System
3. What is Gold Standard? State the reasons for the collapse of Gold Standard.
4. Write a brief note on the Bretton Woods System. Explain the reasons for the breakdown of the Bretton Woods System.
5. discuss the present Scenario of International Monetary System. What are its advantages and disadvantages?
6. What are International Capital Movements? Describe the various types of international capital movements.

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UNIT-3 EXCHANGE RATE

UNIT STRUCTURE

3.1 Learning Objective

3.2 Introduction

3.3 Meaning of Exchange Rate

3.4 Fixed Exchange Rate

3.5 Flexible Exchange Rate

3.6 Determination of Exchange Rate

3.6.1 Determination of Fixed Exchange Rate Under Bretton Wood System

3.6.2 Determination of Floating Exchange Rate

3.7 Fixed Vs. Floating Exchange Rate

3.8 Relative Merit and Demerit of Fixed and Flexible Exchange Rate System

3.8.1 Merits of Fixed Exchange Rate System:

3.8.2 Demerits of Fixed Exchange Rate System

3.8.3 Merits of Flexible Exchange Rate:

3.8.4 Demerits of Flexible Exchange Rate:

3.9 General Agreement on Tariffs and Trade (GATT)

3.10 Advantages and Disadvantages of The GATT

3.10.1 Advantages of GATT

3.10.2 Disadvantages of GATT

3.11 Let Us Sum Up

9.12 Answers to Check Your Progress

9.13 Model Questions

3.1 LEARNING OBJECTIVE

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

3.2 INTRODUCTION

Different countries have different currencies. For example, Indian currency is Rupee, USA's currency is US Dollar. Hong Kong has 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.

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. In this unit we will discuss mechanisms of exchange one country's currency with the currencies of different countries and also about GATT agreement.

3.3 MEANING OF EXCHANGE RATE

All international trade transactions 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 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.

The rate of exchange or foreign exchange rate is the rate at which currency of one country is exchanged with currency of another country. A rise in the exchange rate or reduction in the value of domestic currency with respect to the foreign currency is called depreciation of the domestic currency in relation to the foreign currency. A fall in exchange rate or an increase in the value of the domestic currency in terms of another currency is called appreciation of the domestic currency. For example, when exchange rate of rupee vis a vis US$ goes up from Rs.70 per 1$ to Rs.72 per 1$, it is depreciation of Indian rupee. Similarly, a fall of exchange rate from Rs.70 per 1$ to Rs.68 per 1$ is appreciation of rupee.

3.4 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 Example-

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.

3.5 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.



CHECK YOUR PROGRESS

Q. 1: Define fixed exchange rate.

Q.2: Define flexible exchange rate.

3.6 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 systems – 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.

3.6.1 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”. 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 dollars Countries 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 them-

selves 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.

3.6.2 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

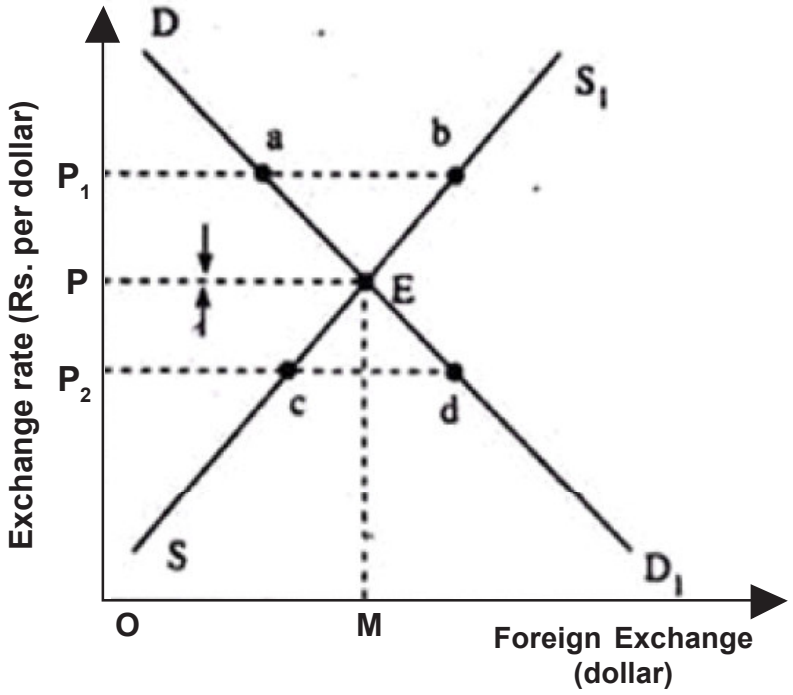
have to pay more in terms of rupee. This means that these goods are because costly and it discourages import on the part of India. Indians will find investment in abroad less profitable. So the demand for dollar will decrease. Again when price of dollar falls in terms of rupee we will have less rupee per unit of dollar. So the buying of foreign goods becomes cheaper as we have to pay fewer rupees now 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-1 DD1 and SS1 curves intersect at point E. The foreign exchange rate thus determined is OP.

Figure 1: 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 OP1 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.



CHECK YOUR PROGRESS

Q.3: Mention two determinants of floating exchange rate.

3.7 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 e.g. 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 rumour about change in government policy.

3.8 RELATIVE MERIT AND DEMERIT OF FIXED AND FLEXIBLE EXCHANGE RATE SYSTEM

3.8.1 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 capital 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 domes-

tic 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.

3.8.2 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 led 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, for example- 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.

3.8.3 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 govern-

ment should exert influences as little as possible in the economy. So individuals can act according to their own economic interest.

3.8.4 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 dampening 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: Mention two difference of fixed exchange rate and flexible exchange rate.

3.9 GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT)

The General Agreement on Tariffs and Trade (GATT), signed on October 30, 1947, by 23 countries, was a legal agreement minimizing barriers to international trade by eliminating or reducing quotas, tariffs, and subsidies while preserving significant regulations. The GATT was intended to boost economic recovery after World War II through reconstructing and liberalizing global trade.

The GATT went into effect on January 1, 1948. Since that beginning it has been refined, eventually leading to the creation of the World Trade Organization (WTO) on January 1, 1995, which absorbed and extended it. By this time 125 nations were signatories to its agreements, which covered about 90% of global trade. The General Agreement on Tariffs and Trade (GATT) held eight rounds in total from April 1947 to December 1993, each with significant achievements and outcomes.

The central principles common to the GATT 1994 are very important. They can be discussed as below -

Most-Favoured Nation (MFN)

The MFN rule is basic to the whole edifice of the GATT. Stated in Article I of the GATT, it requires that if one GATT (now WTO) signatory grants to another country “more favourable treatment” (such as a reduction in the customs duty payable on imports of a particular product), it must immediately and unconditionally give the same treatment to imports from all signatories.

In other words, all GATT/WTO members are entitled to receive the most favourable treatment given by any member or to put it the other way round, they are entitled not to be discriminated against.

This MFN, or non-discrimination, obligation applies to customs duties and charges of any kind connected with importing and exporting, as well as to internal taxes and charges, and to all the rules by which such duties, taxes and charges are applied. The major, and continuing, exceptions to the MFN rule are Article XXIV (discussed below), which allows members of customs unions and free trade areas to give more favourable treatment to imports from one another, and a 1979 decision which permits preferences for and among developing countries.

Tariff reductions and bindings

The second core principle is that the members undertake commitments in which they state the maximum level of import duty or other charge or restriction that they will apply to imports of specified types of goods. These commitments, or “bindings” may result initially from bilateral negotiations, in which (for instance) the government concerned has agreed to another country’s request that it reduce the import duty on certain products. However, the commitments are then recorded in national schedules which, through the provisions of Article II, become part of each country’s obligations under the GATT and, because of the operation of the MFN rule, apply to imports from any member.

The provisions of Article II, combined with technical rules in Article XXVIII on modifying schedules, provided the basis under which most of the developed countries took part in successive rounds of GATT negotiations to reduce their tariffs, binding their results in progressively more constraining schedules. Developing countries to a great extent stood aside from this process, and many had no schedule of bindings at all. Under the WTO all members are required to have schedules, and the proportion of products subject to bindings is generally much higher than before. The Article II and XXVIII rules will continue to guide negotiations under the WTO for the reduction of barriers to trade in goods.

National treatment

The rule of national treatment, in Article III of the GATT, is also of fundamental importance. It complements the MFN rule. Whereas Article I, by requiring MF N treatment, puts the products of all of a country's trading partners on equal terms with one another, the national treatment principle puts those products on equal terms also with the products of the importing country itself. It says that, once imports have passed the national frontier (and in so doing have paid whatever import duty is imposed) they must be treated no worse than domestic products. Internal taxes or other charges on the imports must be no higher than on domestic products, and laws and regulations affecting their sale, purchase, transportation, distribution or use must be no less favourable than for goods of national origin.

Tariffs preferred

The national treatment principle means that protection of the domestic supplier of a product should be given only through action at the frontier. A further set of GATT rules has the shared aim of restricting even frontier protection, as far as possible, to the single instrument of import duties. Quantitative restrictions on imports, and on exports, are in general banned by Article XI, although a number of provisions in this and other articles state exceptions to this general rule. Alternative forms of protection (usually in the form of duties) that are permitted if domestic industries are threatened by imports that are subsidized or dumped (GATT 1947 Article VI) are also elaborately regulated by further Uruguay Round agreements.

Transparency

A further principle carried over to GATT 1994 is that of transparency. Multilateral review and transparency is a major element in the WTO itself (i.e. in the Agreement Establishing the WTO). It is retained also in general requirements imposed by GATT Article X for trade policies and regulations affecting trade in goods, and in more specific requirements built into many other Uruguay Round agreements.



CHECK YOUR PROGRESS

Q.5: In which year the GATT was signed.

3.10 ADVANTAGES AND DISADVANTAGES OF THE GATT

Following are the advantages and disadvantages of GATT.

3.10.1 Advantages of GATT

- **Encourages international trade:** The GATT reduced tariffs, which boosted trade among countries. As they traded more freely with each other, more countries saw the benefits of free trade and wanted to join the agreement. By the time the GATT was replaced by the WTO, more than 100 countries had joined the original 23 signatories.
- **Reduces the likelihood of war:** By increasing trade, the GATT promoted world peace. It set the stage for the European Union (EU). Despite the EU's problems, it has helped to prevent wars among its members. The general idea is that, if your economy depends on trade with another country, then you're less likely to go to war with that county. The more countries trade with each other, the less likely war becomes.
- **Improves communication:** In addition to reducing the chances of war, the GATT provided incentives for countries to better communicate with one another. Even average citizens are more likely to learn a foreign language these days, since it allows them to access larger consumer markets than they have domestically. For instance, many people learn English, the language of the world's largest consumer market, which allows them to work for call centers for companies based in English-language countries.8

3.10.2 Disadvantages of GATT

- **Domestic industries may struggle to compete:** Low tariffs can destroy some domestic industries, contributing to high unemployment in those sectors. Governments with more money or policy power can manipulate industries for their benefit more than smaller countries can. A rich country can spend money subsidizing industries to make them more competitive on a global scale. Another example comes from the Nixon administration. When it took the U.S. dollar off the gold standard in 1973, it lowered the value of the dollar, compared to other currencies. That further lowered the international price of U.S. exports. Other countries didn't have the same tools to make their exports more competitive.
- **Exposes more of the world to risks within a given domestic industry:** By the 1980s, the nature of world trade had changed. The GATT did not address the trade of services that allowed them to grow beyond a single country's ability to manage them. For example, financial services became globalized. Foreign direct investment had become more important. As a result, the collapse of U.S. investment bank Lehman Brothers threatened the entire global economy. Central banks scrambled to work together to address the 2008 financial crisis. They were forced to provide liquidity for frozen credit markets.
- **Governments cede some level of control to an international agreement:** Like other free trade agreements, the GATT reduced the rights of a nation to rule its own people. The agreement required them to change domestic laws in order to gain trade benefits. For example, India had allowed companies to create generic versions of drugs without paying a license fee. This helped more people afford medicine. However, since other countries had stricter requirements, this also led to disputes with other GATT countries.



3.11 LET US SUM UP

In this unit we have discussed the following points:

- Exchange rate is the rate at which one currency is exchanged for the other. Generally, two types of exchange rate prevail 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.



3.12 ANSWERS TO CHECK YOUR PROGRESS

Answer to Q.No.1: Fixed 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.

Answer to Q.No.2: Flexible Exchange Rate is determined by demand and supply of different currencies in foreign exchange rate.

Answer to Q.No.3: Demand for a supply of foreign currency

Answer to Q.No.4:

a. 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.

b. 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 rumour about change in government policy.

Answer to Q.No.5: 1947



3.10: MODEL QUESTIONS

1. Define different types of exchange rates.
2. Discuss the process of determination of floating exchange rate
3. Discuss the merits and demerits of fixed exchange rate.
4. Discuss the merits and demerits of floating exchange rate.
5. Make a critical evaluation of GATT.

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UNIT-4: INTERNATIONAL FINANCIAL INSTITUTIONS /DEVELOPMENT BANKS

UNIT STRUCTURE

4.1 Learning objective

4.2 Introduction

4.3 Meaning of international financial institutions

4.4 Institutions in international financial system

4.5 The World Bank Group

4.6 The World Bank

- 4.6.1 Membership in the World Bank
- 4.6.2 Objectives of the World Bank
- 4.6.3 Functions of the World Bank
- 4.6.4 Economic reform programmes of the World Bank
- 4.6.5 Products and services of World Bank
- 4.6.6 Role of World Bank accelerating sustainable and inclusive economic growth

4.7 International Monetary Fund

- 4.7.1 Organization and management of IMF
- 4.7.2 Objectives of IMF
- 4.7.3 Functions of IMF
- 4.7.4 Key activities of IMF
- 4.7.5 IMF supported programmes
- 4.7.6 Instruments used
- 4.7.7 Special Drawing Rights (SDR)
- 4.7.8 Capital of IMF
- 4.7.9 IMF and India

4.8 Let's sum up

4.9 Answers to check your progress

4.10 Further Reading

4.11 Model questions

4.1: LEARNING OBJECTIVES

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

- Know the meaning of international financial institutions
- Mention the institutions in international financial system
- State the meaning of World Bank Group
- Describe the meaning, objective and functions of World Bank
- Enumerate the Economic Reform Programmes of World Bank
- Mention the products and Services of World Bank
- Discuss the role of World Bank accelerating sustainable and inclusive economic growth
- State the meaning, organization, objectives and functions of IMF
- State the meaning of Special Drawing Rights

4.2 INTRODUCTION

For promoting public and private investment to foster economic and social development in developing and transitioning countries international financial bodies were founded by groups of countries. They were called International Financial Institutions (IFIs). The traditional objectives of some of these institutions such as the World Bank and the IMF were to entail elevation of poverty in developing countries, enhancing measures that promote economic growth and protection of the environment. Today, international financial institutions play a major role in the social and economic development programs of the nations in the world with developing or transitional economies. This role includes advising on development projects, funding them and assisting in their implementation. This chapter discusses about two major IFIs namely the World Bank and the IMF.

(Other IFIs including Asian Development Bank along with IDA, IFC, NDB etc. will be discussed in Unit 12 of Block II)

4.3 MEANING OF INTERNATIONAL FINANCIAL INSTITUTIONS

International Financial Institutions (IFIs) are the financial institutions that have been established or chartered by more than one country according to international laws. Their owners or shareholders or members are generally national governments and other international institutions or organizations. The most prominent IFIs are creations of multiple nations, although some bilateral financial institutions (created by two countries) exist and are technically IFIs. The best known IFIs were established after World War II to assist in the reconstruction of Europe and provide mechanisms for international cooperation in managing the global financial system.

4.4 INSTITUTIONS IN INTERNATIONAL FINANCIAL SYSTEM

There are a number of institutions who are taking part in the international financial system. These institutions can be classified into the following categories:

- National banks and domestic financial institutions which deal in foreign currencies and foreign credits
- Regional or multi-national banks or corporations dealing in international markets and borrowing/ lending in these markets
- Regional finance and development corporations and banks such as the Asian Development Bank (ADB), Commonwealth Finance Corporation (CFC), Latin American Development Bank (LADB), Bank for International Settlements, etc.
- International brokers of repute
- International financial organisations in the World Bank Group consist of the International Monetary Fund (IMF), International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC), International Development Agency (IDA) and The International Centre for Settlement of Investment Disputes (ICSID).

4.5 THE WORLD BANK GROUP

The World Bank group consists of five organizations. However, Together, IBRD and IDA make up the World Bank. The organizations are:

1. **The International Bank for Reconstruction and Development (IBRD):** The International Bank for Reconstruction and Development (IBRD) lends to governments of middle-income and creditworthy low-income countries.

2. **The International Development Association (IDA):** The International Development Association (IDA) provides interest-free loans, called credits and grants to governments of the poorest countries.

3. **The International Finance Corporation (IFC):** The International Finance Corporation (IFC) is the largest global development institution focused exclusively on the private sector. We help developing countries achieve sustainable growth by financing investment, mobilizing capital in international financial markets, and providing advisory services to businesses and governments.

4. **The Multilateral Investment Guarantee Agency (MIGA):** The Multilateral Investment Guarantee Agency (MIGA) was created in 1988 to promote foreign direct investment into developing countries to support economic growth, reduce poverty, and improve people's lives. MIGA fulfills this mandate by offering political risk insurance (guarantees) to investors and lenders.

5. **The International Centre for Settlement of Investment Disputes (ICSID):** The International Centre for Settlement of Investment Disputes (ICSID) provides international facilities for conciliation and arbitration of investment disputes.

4.6 THE WORLD BANK

The World Bank is the main lending organization of the World Bank Group. The World Bank Group is a family of five multilateral institutions focused on economic development whose overarching mission is global poverty reduction. The World Bank is one of the Bretton Woods twins. However, it is not a bank in the conventional sense of the word. Instead, it consists of two organizations. One is the International Bank for Reconstruction and Development (IBRD), which provides loans, credit grants. The second is the International Development Association (IDA), which provides low or no-interest loans and grants to low-income countries. The World Bank is owned by 189 member countries. As the largest development bank in the world, it supports the World Bank Group's mission by providing loans, guarantees, risk management products, and advisory services to middle-income and creditworthy low-income countries, as well as by coordinating responses to regional and global challenges. The World Bank was conceived in July 1944 at the United Nations Monetary and Financial Conference in Bretton Woods, United States. The World Bank Group is headquartered in Washington, D.C. It has more than 10,000 employees in more than 120 offices worldwide.

Today the Bank Group's work touches nearly every sector that is important to fighting poverty, supporting economic growth, and ensuring sustainable gains in the quality of people's lives in developing countries. On critical issues like climate change, pandemics, and forced migration, the Bank Group plays a leading role because it is able to convene discussion among its country members and a wide array of partners. It can help address crises while building the foundations for longer-term, sustainable development. As demand for its services has increased over time, the Bank Group has risen to meet them. For perspective, the World Bank made four loans totaling $497 million in 1947, as compared to 302 commitments totaling $60 billion in 2015.

4.6.1 Membership in the World Bank

There are 189 member countries that are shareholders in the IBRD, the primary arm of the World Bank Group (WBG). To become a member, however, a country must first join the International Monetary Fund (IMF). Joining the IMF comes with a variety of responsibilities that help it carry out its functions. There is an obligatory subscription fee, which is equivalent to 88.29% of the quota that a country has to pay to the IMF. The president of the World Bank comes from the largest shareholder, which is the United States, and members are represented by a board of governors. The five largest shareholders are the U.S., U.K., France, Germany, and Japan.

4.6.2 Objectives of the World Bank

Although one of the Bank's early functions was to assist in bringing about a smooth transition from wartime to peaceful economies, economic development soon became the Bank's main object. Today, the goal of the World Bank is to promote economic development that benefits poor people in developing countries. Loans are provided to developing countries to help reduce poverty and to finance investments that contribute to economic growth. Some World Bank loans finance changes in the structure of countries' economies to make them more stable, efficient, and market oriented. The overall objectives of the World Bank are:

- To provide long term capital to its member nations for economic development and reconstruction.
- To helps in inducing long term capital for improving the balance of payments and thereby balancing international trade.
- To help by providing guarantees against loads granted to large and small units and other projects for the member nations.
- To ensure that the development projects are implemented and to bring a sense of transparency for a nation from war-time to a peaceful economy.
- To promote the capital investment for member nations by providing a guarantee for capital investment and loans.

- To provide the guarantee and to provide loans for promotional activities on specific conditions.

4.6.3 Functions of the World Bank

As an international financial institution the World Bank's major job is to give loans and grants to low and middle-income countries to support their economies. The major functions of World Bank are as follows:

- The World Bank offers innovative financial solutions, knowledge and advisory services to governments at the national and sub-national levels.
- It helps the war-divested countries by granting them loans for reconstruction.
- It finances investments across all sectors and provides technical support and expertise at each stage of a project.
- It provides extensive experience and the financial resources of the bank help the poor countries increase their economic growth, reducing poverty and a better standard of living.
- It helps the underdeveloped countries by granting development loans.
- It also provides loans to various governments for irrigation, agriculture, water supply, health, education, etc.
- It promotes foreign investments to other organizations by guaranteeing the loans.
- The world bank also provides economic, monetary, and technical advice to the member countries for any of their projects.
- It encourages the development of of-industries in underdeveloped countries by introducing various economic reforms.
- Its advisory services in public debt and asset management help governments, official sector institutions, and development organizations build institutional capacity to protect and expand financial resources.
- Its investments include roads, power plants, schools, and irrigation networks, as well as activities like agricultural extension services, training for teachers, and nutrition-improvement programs for children and pregnant women.

- The World Bank also provides technical assistance to help governments make specific sectors of their economies more efficient and more relevant to national development goals.

4.6.4 Economic Reform Programmes of the World Bank

The World Bank was originally tasked with rebuilding the economies of postwar Europe. More than seventy years later, it has expanded its reach into nearly all of the world's developing countries. The Bank provides a wide range of financial products and technical assistance and also helps countries share and apply innovative knowledge and solutions to the challenges they face. Since 1947, the World Bank has funded over 12,000 development projects, via traditional loans, interest-free credits, and grants. In recent decades, the bank's primary focus has shifted from partnering with middle-income nations on growth-related programs and trade liberalization toward global poverty alleviation. These efforts take place in the world's poorest countries, particularly those in Africa and in middle-income countries, such as China and India, where many of the world's poor reside. In 2013, the bank set a goal to end extreme poverty, experienced by people living on $1.25 or less per day, by 2030. Other priorities for the bank include reconstruction in post-conflict nations and transnational issues, including public health and environmental concerns.

4.6.5 Products and Services of World Bank

The World Bank provides a suite of financial products and technical advice and analysis to address development challenges, helping countries find solutions to achieve sustainable and inclusive development. It assists its clients with financing public projects and programmes, supporting policy reform, providing technical advice and analysis, managing financial risks, attracting and financing private sector investments.

a) Financing

The World Bank finances government programs to support achievement of country development objectives, and support policy and institutional reforms of national and subnational governments by providing budget financing and global expertise. It also finances public projects to build physical and social infrastructure, and develop institutional capacity. There are three types of financing:

- **Investment Project Financing:** Investment project financing provides financing to governments for activities that create the physical/social infrastructure necessary to reduce poverty and create sustainable development.

- **Development Policy Financing:** Development policy financing provides budget support to governments or a political subdivision for a program of policy and institutional actions to help achieve sustainable, shared growth and poverty reduction.

- **Programme for Results:** Programme for result links disbursement of World Bank funds directly to the delivery of defined results, helping countries improve the design and implementation of their own development programs and achieve lasting results by strengthening institutions, enhancing systems, and building capacity.

b) Advice and Analytics

The World Bank undertakes analytical and advisory activities to inform country, regional and global development agenda in line with its commitment to the twin goals of eliminating extreme poverty and boosting shared prosperity in a sustainable manner.

- **Advisory Services and Analytics (ASA):** Advisory Services and Analytics (ASA) are non-lending activities that help external clients or audiences advance a development objective. The World Bank provides ASA to support design or implementation of better policies, strengthen institutions, build capacity, inform development

strategies or operations, and contribute to the global development agenda. ASA outputs include analytical reports, policy notes, hands-on advice, and knowledge-sharing workshops or training programs. ASA related to private sector development at times are prepared jointly with IFC and MIGA.

- **Reimbursable Advisory Services (RAS):** Reimbursable Advisory Services (RAS) are ASA provided in response to a request from, and paid for by, the recipient of the service (client), under a legal agreement. In providing RAS, the Bank's purpose is to expand the options available to member countries of all income levels, including those that have graduated from the Bank. RAS clients can be central governments; subnational governments; state-owned enterprises; non-governmental and other not-for-profit organizations (such as chambers of commerce); and multilateral institutions, including development banks and regional organizations.

4.6.6 Role of World Bank Accelerating Sustainable and Inclusive Economic Growth

The World Bank supports investments in countries that underpin long-term growth and that help to meet the needs of their citizens. The Bank works with policy makers to develop markets, institutions, and economies that are stable, equitable, and efficient. It helps countries to meet their essential infrastructure needs in a way that ensures sustainability. Through analysis, advice, financial instruments, convening power, and crucially, a solid evidence base, it provides its clients with the tools to make informed development decisions for lasting impact.

- **Pursuing low-carbon energy:** The World Bank works with governments to provide low-carbon options for energy access that fit every country's circumstances, including renewable sources like solar. For example, the Bank is providing more than $1 billion in lending for India's solar projects, including a rooftop solar initiative that will deliver electricity to millions. Through off-grid solutions, over 1 million households in Ethiopia are gaining access to energy, mostly

with solar lanterns and home systems. Smart grids are boosting the uptake of renewable energy in Turkey, Ukraine, and Vietnam.

- **Providing safe water and sanitation for all:** As the world's largest multilateral source of financing for water in developing countries, the World Bank is committed to working closely with partners to achieve the vision of "A Water-Secure World for All." The Bank prioritizes the sustainability of water investment, and supports financing that includes mobilizing private capital to move toward safe water and sanitation for all. The work promotes inclusive access to the benefits of water, institutions that manage water equitably, and resilience to help countries cope with the impact of external shocks on water. In Bangladesh, for example, a rural water supply and sanitation project has provided nearly 1.2 million people with access to improved water sources and hygienic latrines.

- **Reaping the benefits of digital technologies:** The rapidly changing digital economy is becoming a critical driver of economic growth, investment, and job creation, so the adoption of digital technology by traditional industries is important for improving productivity and opening access to new markets. The World Bank supports countries and their citizens as they take advantage of these opportunities. This support includes expanding affordable Internet access to the more than 4 billion people who remain unconnected, developing digital infrastructure, and building the digital skills and institutions necessary to participate in the digital economy. In October 2016, the Bank launched a new Digital Development Partnership (DDP) with participants from the public and private sectors to operationalize the lessons of the 'World Development Report 2016: Digital Dividends'. The DDP will help to close the global digital divide to ensure that everyone can reap the economic and social benefits of connectivity.

- **Growing through better transport connectivity:** Transport enables the movement of people, goods, and ideas around the globe, and provides better access to economic opportunities, such as jobs. Transport also plays a major role in social inclusion. Rural roads can unlock a world of opportunities for isolated communities, while urban transport that benefits low-income com- munities can promote access to affordable ways to reach jobs. Ensuring that such outcomes are sustainable means tackling climate change mitigation in this sector which accounts for 23 percent of the world's energy-related CO_2 emissions, by supporting the development of low-carbon, efficient transport systems.

- **Partnering with the private sector on infrastructure:** The World Bank is committed to helping governments make informed decisions about improving access to quality, sustainable infrastructure services, including where appropriate, using public-private partnerships. Several initiatives occurred to support good decision making by policy makers on infrastructure projects, often in collaboration with other multilateral development banks (MDBs) or development partners. In April 2017, the second Global Infrastructure Forum took place under the theme Delivering Inclusive, Sustainable Infrastructure. Expanding knowledge was also a priority. With partners from across the multilateral development community, the Bank released an updated online 'Public-Private Partnerships: Reference Guide', which included new contributors and the addition of topics ranging from environmental and social issues to risk mitigation and credit enhancement.

- **Boosting agriculture to create jobs:** Roughly 80 percent of the world's extreme poor live in rural areas and depend largely on farming to make a living. Because the food system currently provides more jobs than any other sector in many countries, boosting agriculture can be one of the most powerful tools against poverty. For example, the Bank-supported Bihar Rural Livelihoods Project, popu-

larly known as 'JEEViKA', improved the livelihoods of more than 1.8 million women from rural households in Bihar, India. The project established 'one-stop shops' for agriculture, which connected farmers with credit, inputs, agricultural training, and farmer field schools.

- **Strengthening protection for natural resources:** Through the development of natural capital accounts, the World Bank is helping clients to better manage rapidly depleting natural resource assets, which typically make up about 36 percent of total wealth in developing countries. Work on environmental sustainability promotes strong governance of marine and coastal resources by supporting sustainable fisheries and aquaculture, establishing protected coastal and marine areas, and reducing ocean pollution.

- **Promoting investment through reforms to reduce risk:** Reducing real or perceived risks to investors across macroeconomic, business, and financing dimensions is a prerequisite for creating markets that can attract the investment needed to create opportunity. In the Arab Republic of Egypt, for example, the World Bank has provided a series of development policy loans to support a reform program that is helping the country to recover from a downturn in investment. The reforms introduced by the government have boosted confidence in the Egyptian economy. In Haiti, with World Bank Group support, the government secured $203 million in actual investments and support for 15,800 new direct jobs in the country's garment sector.

- **Tapping new sources of financing:** Stable and diversified financial markets are also an essential building block for achieving inclusive, sustainable growth. In an environment where long-term bank financing is becoming increasingly scarce, countries need to tap into new sources of financing to meet their development needs. Together with IFC, the World Bank launched the Joint Capital Markets Initiative. It promotes capital market development in emerging countries by supporting liquid, diverse, long-tenor financing and well-

regulated local capital markets. This new initiative will ensure that countries receive end-to-end analytical, advisory, and financing support for developing their markets.

- **Mobilizing domestic resources for effective services:** Countries that can effectively deliver services grow faster, innovate, and respond more quickly to internal and external shocks. But without a sufficient revenue base, governments have difficulty funding basic state services, such as road construction, health care, and public safety. The World Bank's Global Tax Team has stepped up its work in coordinating across institutions on international tax issues and delivering country-based interventions. In Armenia, for example, the Bank is helping the government to strengthen tax collection to overcome some of the setbacks it incurred during the financial crisis.

- **Facilitating trade and integration:** Increased trade integration has helped to drive economic growth in developing economies in recent decades, lifting millions out of poverty. The World Bank works with governments to design and implement policies to maximize trade competitiveness in both goods and services. For example, the Great Lakes Trade Facilitation Project is facilitating cross-border trade between the Democratic Republic of Congo and its neighbors in eastern and southern Africa by reducing costs, time wasted, and harassment to improve the operating environment at the border for traders. The project targets the constraints faced by small-scale traders, especially women, in cross-border trade. It seeks to improve land and lake border facilities and develop systems to better connect farmers to regional markets.



CHECK YOUR PROGRESS

1. Answer as directed:

a) The most prominent IFIs are creations of multiple nations. (True or False)

b) The World Bank is one of the Bretton Woods twins. (True or False)

c) A non-member country of International Monetary Fund can become a member of World Bank. (True or False)

d) Total number of members of World Bank at present is _____. (Fill in the gap)

e) Head office of the World Bank is located in _____. (Fill in the gap)

f) India is not a founder member of World Bank. (True or False)

4.7 INTERNATIONAL MONETARY FUND

The International Monetary Fund (IMF) is the inter-governmental organisation established to stabilize the exchange rate in international trade. It helps the member countries to improve their Balance of Payment (BOP) condition through the adequate liquidity in the international market, promote the growth of global monetary cooperation, secure financial stability, and facilitate international trade. It is one of the Bretton Woods twins, which came into existence in 1945, is governed by and accountable to the 189 countries that make up its near-global membership.

In July 1944, representatives of 44 nations met in Bretton Woods, New Hampshire, USA, to draw up a plan for the post-World War II economic order. Their goal was to avoid a repetition of the destructive policies that could spark another conflict. So they created two international institutions namely International Monetary Fund (IMF) and International Bank for Reconstruction and Development (IBRD) or World Bank. These two international institutions are known as the Bretton Woods twins. The International Monetary Fund was established to promote international monetary cooperation. Its Headquarters is in Washington, D.C. The IMF started functioning on 1st March 1947. Ever since, the IMF has played a vital role in maintaining global economic stability and ensuring broadly shared prosperity. India was a founding member of the IMF. As of now, the IMF has 189 member countries.

4.7.1 Organization and Management of IMF

The IMF is an autonomous organisation and is affiliated to U.N.O. As per Fund Agreement, the headquarters of the IMF should be located in that country which usually possesses the highest quota of capital of the IMF. Accordingly, the head office of the IMF is located in Washington. At the initial stage, the IMF had 30 countries as its members. Today, the total membership of the IMF rose to 189. Since inception, the management of the IMF is rested on two bodies:

a) Board of Governors, and

b) Board of Directors.

The management of the Fund is carried out by the Board of Executive Directors under the direction of the Managing Director. There are 21 Executive Directors of the Board, out of which 7 are permanent and 14 are elected from the remaining members. The permanent members are from the USA, UK, France, Germany, Japan, Italy and Canada. Every member country appoints one Governor to participate in the meeting of the Board of Governors. The Board of Governors makes the general policy to carry on day-to-day working of the IMF. The Board of Directors of the IMF holds the meeting at the office in Washington. One of the Directors is designated as the Managing Director of IMF. He is the chief executive.

4.7.2 Objectives of IMF

The main objectives of IMF, as noted in the Articles of Agreement, are as follows:

1. **To Promote International Monetary Cooperation:** The most important objective of the Fund is to establish international monetary cooperation amongst the member countries through a permanent institution that provides the machinery for consultation and collaborations in various international monetary problems and issues.
2. **To Ensure Exchange Stability:** Another important objective of the Fund is to ensure stability in the foreign exchange rates by main-

taining orderly exchange arrangement among members and also to rule out unnecessary competitive exchange depreciations.

3. **Balanced Growth of Trade:** Another important objective of the IMF is to promote international trade so as to achieve its required expansion and balanced growth. This would ensure development of production resources and thereby promote and maintain high levels of income and employment among all its member countries.
4. **Eliminate Exchange Control:** One of the important objectives of the Fund is to eliminate or relax exchange controls imposed by almost each and every country before the Second World War as a device to deliberately fix the exchange rate at a particular level. Such elimination of exchange controls was made so as to give encouragement to the flow of international trade.
5. **Multilateral Trade and Payments:** To establish a multilateral trade and payment system in respect to current transactions between members in place of the old system of bilateral trade agreements was another important objective of the IMF.
6. **Balanced Growth:** Another most important objective of the IMF is to help the member countries, especially the backward countries, to attain balanced economic growth by exchanging the level of employment.
7. **Correction of BOP Maladjustments:** IMF also to help the member countries in eliminating or reducing the disequilibrium or maladjustments in balance of payments. Accordingly, it gives confidence to members by selling or lending Fund's foreign currency resources to the member nations.
8. **Promote Investment of Capital:** Finally, the IMF also has the objective to promote the flow of capital from richer to poorer or backward countries so as to help the backward countries to develop their own economic resources for attaining higher standard of living for its people, in general.

4.7.3 Functions of IMF

To promote the stability of the international monetary and financial system the IMF performs various important functions. They are:

- **Exchange Stability:** The first important function of the IMF is to maintain exchange stability and thereby to discourage any fluctuations in the rate of exchange. The IMF ensures such stability by making necessary arrangements like enforcing declaration of par value of currency of all members in terms of gold or US dollar, enforcing devaluation criteria, up to 10 per cent or more by more information or by taking permission from IMF respectively, forbidding members to go in for multiple exchange rates and also to buy or sell gold at prices other than declared par value.
- **Eliminating BOP Disequilibrium:** The Fund is helping the member countries in eliminating or minimizing the short-period equilibrium of balance of payments either by selling or lending foreign currencies to the members. The IMF also helps its members towards removing the long period disequilibrium in their balance of payments. In case of fundamental changes in the economies of its members, the IMF can advise its members to change the par values of its currencies.
- **Surveillance:** With a view to assess its member country's economic conditions the IMF closely monitors their economic and financial developments and holds a policy dialogue with a member country on a regular basis usually once in a year with a view to providing policy recommendations. The IMF also reviews global and regional developments and outlook based on information from individual consultations. The IMF publishes such assessments on multilateral surveillance through the World Economic Outlook and the Global Financial Stability Report on a semi-annual basis.
- **Financial assistance:** The IMF lends to its member countries facing balance of payments problems in order to facilitate the adjustment process and restore member countries' economic growth and stability through various loan instruments or 'facilities'. An IMF loan

is usually provided under an 'arrangement,' requiring a borrowing country to undertake the specific policies and measures to resolve its balance of payments problem as specified in a 'Letter of Intent.' Most IMF loans are primarily financed by its member countries through payments of quotas. Thus, the IMF's lending capacity is mainly determined by the total amount of quotas. Nevertheless, if necessary, the IMF may borrow from a number of its financially strongest member countries through the New Arrangements to Borrow (NAB) or the General Arrangements to Borrow (GAB) to supplement the resources from its quotas.

- **Technical Assistance:** The IMF is also performing a useful function to provide technical assistance to the member countries. Such technical assistance in given in two ways, i.e., firstly by granting the members countries the services of its specialists and experts and secondly by sending the outside experts. The IMF provides technical assistance to help member countries strengthen their capacity to design and implement effective policies in four areas, namely:
  - i) monetary and financial policies,
  - ii) fiscal policy and management,
  - iii) statistics and
  - iv) economic and financial legislation.

  In addition to technical assistance, the IMF also offers training courses and seminars to member countries at the IMF Institute in Washington D.C., and other regional training institutes (Austria, Brazil, China, India, Singapore, Tunisia and United Arab Emirates).
- **Credit Facilities:** IMF is maintaining various borrowing and credit facilities so as to help the member countries in correcting disequilibrium in their balance of payments. These credit facilities includebasic credit facility, extended fund facility for a period of 3 years, compensatory financing facility, supplementary financing facility, special oil facility, trust fund, structural adjustment facility etc. The

Fund also charges interest from the borrowing countries on their credit.

- **Stabilize Economies:** The IMF has an important function to advise the member countries on various economic and monetary matters and thereby to help stabilize their economies.
- **Maintaining Balance Between Demand and Supply of Currencies:** IMF is also entrusted with an important function to maintain balance between demand and supply of various currencies. Accordingly, the fund can declare a currency as scarce currency which is in great demand and can increase its supply by borrowing it from the country concerned or by purchasing the same currency in exchange of gold.
- **Maintenance of Liquidity:** To maintain liquidity of its resources is another important function of the IMF. Accordingly, there is provision for the member countries to borrow from the IMF by surrendering their own currencies in exchange. Again for the accumulation of less demand currencies with the IMF, the borrowing countries are directed to repurchase their own currencies by repaying its loans in convertible currencies.
- **Determination of Par Value:** IMF enforces the system of determination of par values of the currencies of the member countries. As per the Original Articles of Agreement of the IMF every member country must declare the par value of its currency in terms of gold or US dollars. Under the revised Articles, the members are given autonomy to float or change exchange rates as per demand supply conditions in the exchange market and also at par with internal price levels.

4.7.4 KeyActivities of IMF

The IMF supports its membership by providing:

i) Policy advice to governments and central banks based on analysis of economic trends and cross-country experiences;

ii) Research, statistics, forecasts, and analysis based on tracking of global, regional, and individual economies and markets;

iii) Loans to help countries overcome economic difficulties;

iv) Concessional loans to help fight poverty in developing countries; and

v) Technical assistance and training to help countries improve the management of their economies.

4.7.5 IMF Supported Programmes

To restore economic stability and growth of the countries hit by crisis, the International Monetary Fund assists them by providing financial support. It also provides precautionary financing to help prevent and insure against crisis. IMF's lending toolkit is consciously refined to meet countries' changing needs.

The IMF provides broad support to the Low Income Countries (LICs) through surveillance and capacity-building activities, as well as concessional financial support to help them achieve, maintain, or restore a stable and sustainable macroeconomic position consistent with strong and durable poverty reduction and growth. Concessional support through the Poverty Reduction and Growth Trust (PRGT) is currently interest free.

Surveillance activities involve the continuous monitoring of members' economic and financial policies. Discussions with country authorities focus on how their economic policies affect stability and explore desirable policy adjustments.

Capacity-building activities focus largely on how low income countries (LICs) can boost domestic revenues, manage public finances and monetary policy, regulate the financial system, and develop statistical systems to help them implement sound policies and good practices, as well as progress toward the United Nations' Sustainable Development Goals.

4.7.6 Instruments Used

All IMF members access to the General Resources Account on non-concessional terms, but the IMF also provides concessional financial support through the (PRGT), which is better tailored to the diversity and needs of LICs. Poverty reduction strategies that detail policies to promote growth and reduce poverty are essential to IMF-supported programs in LICs. The PRGT has these three concessional lending facilities:

- **Extended Credit Facility (ECF):** The Extended Credit Facility (ECF) provides financial assistance to the countries with protracted balance of payments problems. It supports countries' economic programs aimed at moving toward a stable and sustainable macroeconomic position consistent with strong and durable poverty reduction and growth. The ECF may also help catalyze additional foreign aid. Sustained medium- to long-term engagement in case of protracted balance of payments problems

- **Standby Credit Facility (SCF):** The Standby Credit Facility provides financial assistance to low-income countries with short-term balance of payments needs. The SCF was created under PRGT as part of a broader reform to make the Fund's financial support more flexible and better tailored to the divers needs of LICs, including in times of shocks or crisis.

- **Rapid Credit Facility (RCF):** Rapid financial support (RCF) provides low-access, rapid, and concessional financial assistance to LICs facing an urgent BoP need, without *ex post* conditionality, when a full program is not deemed necessary or feasible and the need is urgent. It can provide support in a wide variety of circumstances, including shocks, natural disasters, and emergencies resulting from fragility. The RCF also provides policy support and may help catalyze foreign aid.

For policy advice and signaling, countries may request nonfinancial assistance under the Policy Support Instrument (PSI), which helps LICs that are in a broadly stable macroeconomic position and thus not in need of IMF financial assistance. The PSI can expedite access to the SCF if needed.

4.7.7 Special Drawing Rights (SDR)

The Special Drawing Rights (SDR) is an international reserve asset, created by the International Monetary Fund (IMF) in 1969 to supplement its member countries' official reserves. Special Drawing Rights, usu-

ally denoted as SDR, refers to a monetary reserve currency created by the IMF and used across the globe. The SDR was commissioned with a vision of becoming a highlighting aspect of international reserves. It operates as a substitute for the present money reserves of the member countries of the IMF. It was devised in response to concerns about the limitations of gold and dollars as the sole means of settling international accounts. The SDRs contribute to growth in global liquidity by enhancing the standard reserve currencies.

The IMF uses an SDR as an artificial currency instrument and depends upon it for internal accounting purposes. SDR is set up from a basket of popular currencies across the globe. The IMF assigns SDRs to its member countries, showing full faith and support by their governments. The SDR is re-evaluated every five years. A member country must get access to official reserves to get involved in the SDR system. Such official reserve consisted of the reserves of gold and globally accepted foreign currencies belonging to the central bank or government. These could be used to buy the local currency in foreign exchange markets to maintain a stable exchange rate. However, the international supply of the two principal reserves, such as the U.S. dollar and gold was not sufficient to support growth in global trade and the ongoing related financial transactions. This lacking prompted member countries to form an international reserve asset under the guidance of the IMF. The value of the SDR is calculated from a weighted basket of major currencies, including the U.S. Dollar, Chinese Yuan, Japanese Yen, the Euro, and British Pound. Its value is outlined in U.S. Dollars.

The SDR is not a currency or a claim against the IMF assets. Rather, it is a prospective claim against the openly usable currencies belonging to the IMF member states. The IMF's Articles of Agreement fixes a freely usable currency as broadly used in international transactions and is often traded in foreign exchange markets. The member states of IMF that hold SDRs can swap them for freely usable currencies by two methods. They can agree among themselves for voluntary swaps. Alternatively, the coun-

tries with stable economies or more substantial foreign currency reserves may buy SDRs from the less-privileged country members as per the IMF's instructions. The IMF member countries can borrow SDRs from its resources at favourable interest rates. It is mostly done to adjust their balance of payments to advantageous positions. Apart from acting as a supplemental reserve asset, the SDR acts as the unit of account of the IMF.

4.7.8 Capital of IMF

The capital of the IMF consists of the aggregate of the quotas allotted to member countries. Each member pays either 20 percent of the quota or 10 percent of its entire gold and dollar holdings. The member countries are allowed to pay their quota in their national currency.

The Fund has appointed certain central banks as its gold depositors, where members can deposit the gold to the credit of the Funds. These gold depositors are the Federal Reserve Bank of New York, the Bank of England, the Bank of France and the Reserve Bank of India. The IMF utilises its gold holdings to acquire dollars and other currencies for its operations.

4.7.9 IMF and India

India is one of the founding members of the IMF. It is also among the top 10 countries in the IMF. The IMF has played a very crucial role in the Indian economy. It has provided economic assistance whenever required by India. Furthermore, at the time of determination of policies, it provides appropriate consultancy. Earlier India was among the first five countries that had the highest quota in the IMF. Because of this status, India has been given a permanent position among the executive board of directors of IMF.



CHECK YOUR PROGRESS

2. Write True or False:

a) Total number of members of IMF at present is189.

b) Head office of the IMF is located in China.

c) India is one of the founder members of IMF.



4.8 LET US SUM UP

- International Financial Institutions (IFIs) are the financial institutions that have been established by more than one country according to international laws.
- There are a number of institutions who are taking part in the international financial system.
- International financial organisations in the World Bank Group consist of IMF, IBRD, IFC, IDA and ISCID.
- The World Bank is one of the Bretton Woods twins.
- To become a member, a country must first join the International Monetary Fund.
- World Bank's major job is to give loans and grants to low and middle-income countries to support their economies.
- The International Monetary Fund was established to promote international monetary cooperation.
- The Special Drawing Rights (SDR) is an international reserve asset, created by the International Monetary Fund (IMF) in 1969.



4.9 ANSWER TO CHECK YOUR PROGRESS

1. (a) True (b) True (c) False (d) 189
   (e) Washington D. C. (f) False
2. (a) True (b) False (c) True



4.10 FURTHER READING

1. International Business -V.K. Bhalla, Publisher- S Chand
2. International Business -Text and Cases -Cherunilam, F., Publisher- PHI Learning Pvt. Ltd.
3. Multinational Financial Management -Shapiro, A. C., Publisher- Prentice Hall of India



4.11 MODELQUESTIONS

1. What are International Financial Institutions (IFIs)? Give an overview of various Institutions in International Financial System.
2. In which year the World Bank was established?
3. What were the twins of Bretton Woods Conference?
4. Write a brief note on 'World Bank' or IBRD.
5. Write a brief note on International Monetary Fund.
6. Discuss the objectives and functions of International Monitory Fund.
7. Explain the objectives and functions of World Bank.

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UNIT 5: BALANCE OF PAYMENTS

UNIT STRUCTURE

5.1 Learning Objectives

5.2 Introduction

5.3 Concept of Balance of Trade

5.4 Concept of Balance of Payment

5.5 Structure of Balance of Payment

5.6 Equilibrium in Balance of Payment

5.7 Causes of Disequilibrium in Balance of Payment

5.8 Methods of Correcting Disequilibrium

5.9 Economic Development and BoP

5.10 Let Us Sum Up

5.11 Further Reading

5.12 Answers to Check Your Progress

5.13 Model Questions

5.1 LEARNING OBJECTIVES

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

- define balance of trade
- explain the concept of Balance of Payment
- discuss the structure of Balance of Payment of a country
- discuss the causes of disequilibrium in Balance of Payment
- explain the measures for correcting the disequilibrium in Balance of Payment
- discuss the relationship between economic development and Balance of Payment.

5.2 INTRODUCTION

In this unit we are going to discuss the concepts related to Balance of Payments.We will discuss Concept of Balance of Trade,Structure of Balance of Payment, Causes of Disequilibrium in Balance of Payment. The

balance of payments is the record of all international trade and financial transactions made by a country's residents.

The balance of payments has three components. They are the current account, the financial account, and the capital account. The current account measures international trade, net income on investments, and direct payments. The financial account describes the change in international ownership of assets. The capital account includes any other financial transactions that don't affect the nation's economic output. Let us discuss these concepts in details in the following sections.

5.3 CONCEPT OF BALANCE OF TRADE

Perhaps you are aware that a country performs different economic transactions with other countries. The most common forms of these transactions are import and export. Let us first define these two terms. Import means bringing goods or services from one country into another. Generally, a country imports those goods or services which it cannot produce economically within the country or produce lesser quantity than the demand in the country. For example, India imports crude oil, gold etc. from other countries against which India has to make payments in foreign exchange.

On the other hand, export means sending goods or services to another country for sale against which the exporting country earns an income. In simple words, if a country imports goods, it has to make payments and if a country exports goods it will receive payments in terms of foreign exchange.

At this point, it is important to have a discussion on ‘Balance of Trade’. In simple terms, Balance of Trade shows the difference between the value of export and import of a country. It is also known as trade balance or international trade balance, which indicates the relative strength of a country in terms of economy. The effects of export and import in terms of balance of trade may be stated as: when a country’s import is more than its exports, it is said that the country has a negative or unfavourable balance of trade or trade deficit. If the country’s export is more than its import, it is said that the country has a positive or favourable balance of trade or trade surplus. The

balance of trade includes only the exports and imports of visible items like, clothes, machines etc.

Though balance of trade is one of the ways to measure an economy's strength, the favourable or unfavourable trade balance of a nation is to be considered in relation to stage of economic development of the nation, **business cycle** and other economic indicators. Generally, during recession, countries prefer to export more as it creates jobs, reduces unemployment, generate income and stimulate demand in the country. It helps the country to recover from the recessionary waves. During the period of business expansion, countries prefer to import more as it leads to price competition and limits inflation.



CHECK YOUR PROGRESS

Q 1: Define Balance of Trade.

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5.4 CONCEPT OF BALANCE OF PAYMENT

In this section, we will discuss about balance of payment. Balance of Payment is a statement of receipts and payments in terms of balance of trade (visible items), **invisible items** and capital transfer for a specified period. Thus, balance of payments or balance of international payments is a more comprehensive statement. It includes all the transactions done by individuals, companies and the government entities with the individuals, companies and the government entities of the rest of the world. According to Reserve Bank of India, "Balance of Payment is a statistical statement that shows

1. Transactions in goods, services and income between an economy and the rest of the world,
2. Changes of ownership and other changes in that economy's monetary gold, special drawing rights (SDRs), and financial claims on and liabilities to the rest of the world, and

3. Unrequited transfers." (https://economictimes.indiatimes.com)/definition/balance-of-payment).



CHECK YOUR PROGRESS

Q 2: Define Balance of Payment.

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5.5 STRUCTURE OF BALANCE OF PAYMENT

The balance of payment statement of a country is prepared by dividing the statement into two sides, the debit side and the credit side. It is prepared on the basis of **double entry system of book- keeping**. The items which generate income are entered on the credit side and the items which results in outflow of fund are recorded on the debit side of the Balance of Payment statement. However, there is a difference between business accounting and BoP accounting as the credits are shown on the left side and debits are shown on the right side.

The main items shown on the credit side are exports of goods and services, transfer (unrequited) receipts in the form of gifts, grants etc. from the foreigners, borrowings from abroad, investment made by foreigners in the country, the official sale of reserve assets, gold to foreign countries and international agencies.

The main items recorded on the debit side of the BoP are import of goods and services, transfer (unrequited) payments to foreigners in the form of gifts, grants etc. lending to foreign countries, investment by residents of the country in foreign countries, official purchase of reserve assets, gold from foreign countries and international agencies.

The BoP statement is divided mainly as Current Account and Capital account. Let us discuss these-

Current Account: In current account, the transactions related to exports and imports of visible and invisible items are included. These transactions results in actual transfer of goods and services and affect national income, expenditure and output. If exports are more than imports,

the current account shows surplus balance. If imports are more than exports, the current account shows deficit balance and accordingly it shows a country's earnings and payments in terms of foreign currency.

Capital Account: The financial transactions of capital account results in change in a country's foreign assets and liabilities. It consists of short-term and long- term (having maturity of one or more than one year) lending and borrowings, both private and government. Private transactions are in the form of direct, portfolio and short- terms. Government transactions are in the form of loans received from or granted to foreign countries. The inflows, for example, borrowings and direct investment from foreign countries are recorded on the credit side. The outflows, for example, lending and direct investment in foreign countries are recorded on the debit side. Like current account, capital account also shows a balance.

Another component of capital account is the 'Foreign Exchange Reserve' (Forex). It shows the reserve of foreign currencies which may be in the form of gold, dollar, pounds, **Special Drawings Rights** (SDRs). These are financial assets of the government, hold by the central bank of the country.

If the deficit of the current account of the BoP exceeds the inflow of capital account, then foreign exchange from the reserve account is used to meet the deficit. This is indicated by a plus (+) sign in BoP. On the other hand, any surplus in BoP account is transferred to the foreign exchange reserve. This transfer is indicated by minus (-) sign in the BoP account.

Errors and Omissions

The errors any occur due to some statistical discrepancy and omission may occur due to non- recording of certain transactions.



CHECK YOUR PROGRESS

Q 3: What is the current account of BoP?

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5.6 EQUILIBRIUM IN BALANCE OF PAYMENT

Equilibrium is that state of the balance of payment over the relevant time period which makes it possible to sustain an open economy without severe unemployment on a continuing basis.

Whether the Balance of Payments is in equilibrium or not, it can be justified with this help of the three following test:

(i) Decrease in Foreign Exchange: If gold continuously flows from the country, it may be assumed that the balance of payments is in disequilibrium. At present the decrease in foreign exchange reserves of our country indicate such a situation.

(ii) Increase in Foreign Debts and Loans:If the amount of foreign debts and loans increase, that indicates the balance of payment of the country is in disequilibrium i.e., exports are less than imports,

(iii) Decrease in Foreign Exchange Rates:If the foreign exchange rates of a country decrease, it may be said that the country is suffering from the disequilibrium in the balance of payments position.

5.7 CAUSES OF DISEQUILIBRIUM IN BALANCE OF PAYMENT

Disequilibrium in BoP means there is either surplus or deficit in the BoP. When exports are more than imports, there is surplus and when imports are more than exports, there is deficit in the BoP. The disequilibrium arises mainly in current account and the capital account is used to settle the position of imbalance. Accordingly, the country's forex may increase or decrease and represents the strength or weakness of the economy.

Now let us discuss the certain causes of disequilibrium in Balance of Payment.

- **Development and Investment Programmes:** Generally, developing countries face the problem of disequilibrium in BoP in the form of deficit BoP. This is mainly because of the development programmes of the developing countries which need continuous import of capital goods,

some raw- materials not locally available, skilled labour etc. On the other hands, their exports are minimal as the economy of these countries are primarily agriculture- based and the supplier of raw-materials.

- **Demonstration effect:** The demonstration effect also causes disequilibrium in BoP. When the people of developing countries try to imitate the consumption pattern of the developed countries, it leads to import of foreign goods whereas their export remain stsgnant.
- **Changes in Foreign Exchange Rates:** Any change in the foreign exchange rate may also create a situation of disequilibrium in BoP. The overvaluation of a country's currency makes import cheaper and export dearer. Therefore, the country imports more than export creating adverse BoP. If the country's currency is undervalued, it encourages exports and discourages imports creating favourable BoP.
- **Trade cycle:** The phase in trade cycle results in disequilibrium in BoP. During the period of depression, the exports and imports of a country generally comes down. Due to decrease in domestic production, the export may fall drastically creating adverse BoP. During boom period, both exports and imports increase. If the country exports more, it will create a surplus and if the country imports more, it will create deficit in BoP.
- **Price- Cost Structure:** The price and cost structure of the exporting industries of a country may create disequilibrium in BoP. High cost of labour, raw- materials etc. increases the price of export items. It reduces the export potentialities and subsequently creates disequilibrium in BoP.
- **International Lending and Borrowing:** The international borrowing and lending also create disequilibrium in BoP. If a developing country borrows large funds from other countries and international organizations, it may have a favourable BoP. But such a situation is unlikely to happen as these countries heavily depend on the import of capital goods, skilled labour etc. and exports raw- materials. The

borrowings from the foreign countries may temporarily reduce the deficit in BoP. At the same time, a developed country which lends heavily to other foreign countries and imports heavily will also have a deficit BoP.

- **Population Explosion:** The population explosion, generally faced by the developing countries is also a cause for creating deficit in BoP. Such countries tend to import more including food items resulting huge import bills.
- **Political factors:** Political factors within the country may cause deficit in BoP. Political instability and disturbance creates uncertainty in the minds of foreign investors and results in withdraw of foreign capital creating adverse BoP.



CHECK YOUR PROGRESS

Q 4: State two causes of disequilibrium in BoP.

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DO YOU KNOW

Disequilibrium in the BoP means there is either surplus or deficit balance in BoP and it occurs due to various reasons. Now, let us discuss the implications of disequilibrium in BoP. A disequilibrium in BoP either in the form of surplus or deficit is not desirable for a country. However, the favourable or unfavourable BoP is to be considered in the light of various factors like duration, source, location etc. A surplus in both current and capital account is desirable for a country but such a position is most unlikely to occur. A deficit in both current and capital account is not desirable. If there is a deficit in the BoP account, a sum equal to the deficit is taken from the official reserves account bringing the BOP into equilibrium. When surplus is moved to the foreign exchange reserve, it is displayed as minus in that specific year's balance of payment account. The minus sign (-) signifies a rise in forex and plus sign (+) exhibits the borrowing of foreign exchange from the forex account in order to meet the deficit.

5.8 METHODS OF CORRECTING DISEQUILIBRIUM

In this section we will discuss the different methods to correct the disequilibrium in BoP. These methods are –

- **Deflation:** Deflation means reducing the volume of money in the economy to reduce the prices and the money income of the people. The central bank by applying different methods, like raising the bank rate, by selling the securities in open market etc. reduce the volume of credit in the economy. This will result in falling prices and money income of the people. It will discourage imports and encourage exports. Besides that a high interest rate will attract foreign funds and this will help in correcting disequilibrium in BoP.
- **Depreciation:** BoP disequilibrium may be adjusted by depreciating the exchange value of home currency. It means fall in the rate of exchange of home currency (e.g. Indian Rupee) in terms of another currency (e.g. US Dollar). In other words, more Indian Rupee will be required to buy a unit of US Dollar. This will make export cheaper and import costlier in India.
- **Devaluation:** Devaluation means reduction of the external value of a currency by the government. The difference between devaluation and depreciation lies in the fact that devaluation is done by government whereas depreciation is the result of market mechanism. However, the net result of both these two methods is the same i.e. decrease in the value of the home currency in terms of a foreign currency. Thus, it will discourage imports and encourage exports. It will reduce deficit in BoP.
- **Exchange control**: Exchange control is used as a weapon to correct the deficit in BoP. Under this method, control is exercised over the use of foreign exchange. The central bank of a country ask the exporters to surrender the foreign exchange earnings and it is rationed out to the licensed importers and in this way certain restrictions are imposed on imports.
- **Export promotion**: To remove the disequilibrium in BoP, the

government should encourage exports which will help in earning foreign currency. The various export promotion measures are reduction in export duties, provision of export subsidies, incentives for exports etc.

- **Discouraging imports**: In correcting disequilibrium in BoP, certain measures to discourage imports may become necessary, like imposition of import duties, fixing import quotas, import substitution etc.

5.9 ECONOMIC DEVELOPMENT AND BoP

There is a close relationship between economic development and BoP. To be more specific, the deficit or surplus balance in BoP is closely related with the stage of economic development that a country attaints at a particular point of time. If we consider the components of current account, the deficit occurs due to higher imports than exports, whereas surplus occurs due to higher exports than imports. In capital account, if borrowings of a country are more, the country will face a situation of unfavourable BoP as foreign liability along with interest will be a heavy burden on the country.

A developing country, in the initial period of development has to depend on other countries in respect of import of machinery, technical know- how etc. This, of course, increases the import bill. On the other hand, its exports are minimal and therefore, foreign exchange earnings are very low. If the country is primarily an agrarian country and due to lack of export- oriented industries, their performance on export front is not so encouraging. The total result is more imports than exports which leads to disequilibrium in BoP. Taking the example of India, in its initial time of development , after independence, the exports were insignificant whereas imports were very high that created a huge deficit in BoP. As the country made progress in economic front and with the encouragement of export- oriented industries and various measures to control import, gradually the deficit in BoP shows a declining trend. Thus, there exist a strong connection between economic development and BoP.



5.10 LET US SUM UP

In this unit we have discussed the following aspects-

- Balance of Trade also known as trade balance or international trade balance shows the difference between the value of export and import of a country. It indicates the relative strength of a country in terms of economy.
- Balance of Payment is a statement of receipts and payments in terms of balance of trade (visible items**),** invisible items and capital transfer for a specified period.
- Balance of Payment includes all the transactions done by individuals, companies and the government entities with the individuals, companies and the government entities of the rest of the world.
- The Balance o Payment statement is divided mainly as Current Account and Capital account.
- In current account, the transactions related to exports and imports of visible and invisible items are included.
- The financial transactions of capital account results in change in a country's foreign assets and liabilities. It consists of short- term and long- term (having maturity of one or more than one year) lending and borrowings, both private and government.
- The different causes of disequilibrium in Balance of Payment are – Development and Investment Programmes, Demonstration effect, Changes in Foreign Exchange Rates etc.
- The different methods of correcting disequilibrium in Balance of Payment are – Deflation, Depreciation, Exchange control etc.
- The deficit or surplus balance in Balance of Payment is closely related with the stage of economic development that a country attaints at a particular point of time.



5.11 FURTHER READING

1) Paul R.R. (1998). *Money, Banking and International Trade*. Kalyani Publishers, New Delhi.

2) Dewett K.K. (1998). *Modern Economic Theory*. S. Chand & Company Ltd., New Delhi.



5.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Balance of Trade also known as trade balance shows the difference between the value of export and import of a country. When a country's import is more than its exports, it is said that the country has a negative or unfavourable balance of trade or trade deficit. If the country's export is more than its import, it is said that the country has a positive or favourable balance of trade. The balance of trade includes only the exports and imports of visible items like, clothes, machines etc. and indicates the relative strength of a country in terms of economy.

Ans to Q No 2: Balance of Payment is a statement of receipts and payments in terms of balance of trade (visible items**),** invisible items and capital transfer for a specified period. Balance of payments is a comprehensive statement that includes all the transactions done by individuals, companies and the government entities with the individuals, companies and the government entities of the rest of the world.

Ans to Q No 3: Current account includes the transactions related to exports and imports of visible and invisible items. These transactions results in actual transfer of goods and services and affect national income, expenditure and output. If exports are more than imports, the current account shows surplus balance. If imports are more than exports, the current account shows deficit balance and accordingly it shows a

country's earnings and payments in terms of foreign currency.

Ans to Q No 4: (a) Development and Investment Programmes

(b) Changes in Foreign Exchange Rates



5.12 MODEL QUESTIONS

1: Define Balance of Payment.

2: Discuss the different causes of disequilibrium in Balance of Payment.

3: Discuss the measures for correcting disequilibrium in Balance of Payment.

4: Differentiate between Balance of Trade and Balance of Payment.

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UNIT 6: FOREIGN EXCHANGE MARKET

UNIT STRUCTURE

6.1 Learning Objectives
6.2 Introduction
6.3 Concept of Foreign Exchange Market
6.4 Functions of Foreign Exchange Market
6.5 Dealers in the Foreign Exchange Market
6.6 Exchange Rate
6.7 Advantages and Disadvantages of Fixes and Flexible Exchange Rate
6.8 Exchange Quotations
6.9 Merchant Rate
6.9.1 Basis for Merchant Rates
6.10 Transactions in the Foreign Exchange Market
6.11 Let Us Sum Up
6.12 Further Reading
6.13 Answers To Check Your Progress
6.14 Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit, you will able to-

- discuss the concept of foreign exchange market
- outline the functions of Foreign Exchange Market
- describe the dealers in the Foreign Exchange Market
- explain Exchange Rate and also discuss the Advantages and Disadvantages of Fixes and Flexible Exchange Rate
- discuss Exchange Quotations
- learn about transactions in the Foreign Exchange Market

6.2 INTRODUCTION

In this unit we are going to discuss about foregien exchage market.

We will discuss the concepts like concept of foreign exchange market,

Functions of Foreign Exchange Market, Dealers in the Foreign Exchange Market, Exchange Rate its advantages and Advantages and Disadvantages of Fixes and Flexible Exchange Rate, Exchange Quotations, Merchant Rate and Transactions in the Foreign Exchange Market.

Foreign Exchange Market is a decentralized worldwide market in which currencies are traded.The foreign exchange market is the market in which participants are able to buy, sell, exchange and speculate on currencies. Foreign exchange markets are made up of banks, commercial companies, central banks, investment management firms, hedge funds, and retail forex brokers and investors. Let us discuss these concept in detail in the following section.

6.3 CONCEPT OF FOREIGN EXCHANGE MARKET

The foreign exchange market is a market in which currencies are bought and sold against each other. In other words, foreign exchange market is the market where the currency of one country is exchanged for the currency of another country. The market is an over the counter market. There is no single market place or an organized exchange (like a stock exchange) where traders meet and exchange currencies. According to Kindelberger, “Foreign exchange market is a place where foreign money are bought and sold.”

Foreign exchange market is the largest financial market. Foreign exchange markets were primarily developed to facilitate settlement of debts arising out of international trade. The largest foreign exchange market is London followed by New York, Tokyo, Zurich and Frankfurt. The markets are situated throughout the different time zones of the globe in such a way that when one market is closing the other is beginning its operations. Thus at any point of time one market or the other is open. Therefore, it is stated that foreign exchange market is functioning throughout 24 hours of the day.

There are two foreign exchange markets. Viz. the retail market and the wholesale market. In the retail foreign exchange market, Retail traders buy or sell currency for their genuine business/personal requirements. Individuals like tourists, foreign students, patients traveling to other countries

for medical treatment; small companies, small exporters and importers operate in the retail foreign exchange market. Money transfer companies are also major players in the retail market. The wholesale foreign exchange market is also called the inter-bank market. In the whole sale market Commercial banks are the market makers. This market serves to smoothen the excessive purchases or sales made by individual banks.

6.4 FUNCTIONS OF FOREIGN EXCHANGE MARKET

The foreign exchange market performs the following three functions:

a) **Transfer function:** The basic function of the foreign exchange market is to facilitate the conversion of one currency into another, i.e., to transfers purchasing power between two countries. It is the primary function of this market. Various instruments such as telegraphic transfers, bank drafts and foreign bills are used for transferring the purchasing power.

b) **Credit function:** Another function of foreign exchange market is to provide credit for promotion of foreign trade. Foreign exchange market provide credit by discounting bills of exchange arising out of foreign trade. Bills of exchange, with maturity period of three months, are generally used for international payments. Credit is required for this period in order to enable the importer to take possession of goods, sell them and obtain money to pay off the bill.

c) **Hedging function:** The third function of foreign exchange market is to hedge foreign exchange risk. Hedging means the avoidance of a foreign exchange risk. The exchange rates (price of one currency expressed in another currency) under free market situation can go up and down. Under this condition, a person or a firm undertakes a great exchange risk if there are huge amounts of net claims or net liabilities which are to be met in foreign currency.

For this the exchange market provides facilities for hedging anticipated or actual claims or liabilities through forward contracts in exchange. A forward contract is a contract to buy or sell foreign exchange

against another currency at some fixed date in the future at a price agreed upon now. Through hedging, the foreign exchange market tries to protect the interest of the persons dealing in the market from any such unforeseen changes in the exchange rate.

6.5 DEALERS IN THE FOREIGN EXCHANGE MARKET

Foreign exchange market is the largest market in the world. It operates 24 hours in a day and spread all over the world. Following are the important dealers of foreign exchange market in India:

Central Bank: Central banks of the country intervene in the foreign exchange market in order to maintain the exchange rate within a certain range. The central banks also execute the policies of the government. It act as the custodian of foreign exchange reserves.

Acceptance Houses: Acceptance houses also operate in foreign exchange market. They accept bills on behalf of their customers and helps in foreign remittance.

Foreign Exchange Dealers: Foreign exchange dealers are banks and non-banking financial institutions. Brokers are agents which merely match buyers and sellers and get a fee. They make profit from the spreads between the buying and selling prices. Before the invent of internet, brokers, dealers and clients were communicating over telephone or telex and through satellite communication. These dealers are also known as market makers. As market makers, these dealers stand willing at all time to buy and sell currencies at the quoted rate. Dealers do not necessarily make markets for all currency but specialize in some currency pair. Dealers also trade foreign exchange as part of their own proprietary trade. In proprietary trading, dealers invest their own capital and undertake currency trading. Unlike the smaller margin received by dealers from the bid-ask spread, in proprietary trades, dealers expect a larger profit margin.

Foreign exchange dealers trade among themselves through direct dealing and through brokers. In case of direct dealing, two dealers contact each other directly and undertake a trade. Like any other traders, dealers may contact brokers for executing their proprietary trades if these dealers want anonymity in trading. In India, Reserve Bank of India gives permission to an entity to act as authorized dealer in foreign exchange.

Brokers: In the foreign exchange market banks do not deal directly with each other. The brokers bring together the buyers and sellers of foreign exchange. If a bank wants to buy or sell foreign exchange, it informs the broker the amount. If the broker succeeds in carrying out the transaction, he receives a commission from the selling bank.

Brokers help clients to get a better rate on the currency trade by making available different quotes offered by dealers. Traders can compare rates and accordingly take a decision. Communication between brokers and clients are done through dedicated telephone lines. A broker continuously remains active and connected to dealers to get latest quotes, depth of the market. The broker compares the rates offered by the dealers and provides the best rates to the clients. With the emergence of communication technology, now most of the deals are happening in electronic brokering system.

Hedgers: Hedgers are traders who undertake foreign exchange trading because they have assets or liability in foreign currency. For example, when an importer requiring foreign currency, sells domestic currency to buy foreign currency, he is termed as a hedger. The importer has a foreign currency liability. Similarly, an exporter sells foreign currency and buys domestic currency is a hedger. The exporter has assets denominated in foreign currency. An MNC enters into a foreign currency forward contract so that it can repatriate its earning to parent company. An Indian company swapping its foreign currency interest payment obligations to INR interest obligation. All these are examples of hedging. Hedgers use the foreign currency market to hedge the risk associated with volatility in foreign exchange market.



CHECK YOUR PROGRESS

Q 1: Mention two functions of foreign exchange market.

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Q 2: Name two dealers of foreign exchange market.

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6.6 EXCHANGE RATE

The rate of exchange is the price of one currency stated in terms of another currency i.e. the rate at which one currency is exchanged for another. The rate of exchange expresses the external purchasing power of a home currency. E.g.- If one US dollar can be exchange for 60 Indian Rupees, than the rate of exchange is 1US $ = Rs.60 or Rs.1=1/60 US $=0.017 $. In a foreign exchange market, there exist different types of exchange rates. Following are the some major exchange rates:

1. **Spot Rate:** The spot rate is the current exchange rate for any currency. A spot foreign exchange rate is the rate of a foreign exchange contract (buying and selling of foreign exchange) for immediate delivery. This rate is also known as cable rate or telegraphic transfer rate. It is a straightforward rate without any ambiguity.The spot rate is quoted differently for buyers and sellers. For example, $1=60.31 for buyers and $1=Rs60.15 for the seller. This difference arises because of transportation charges, dealer's commission, insurance etc. These costs are to be borne by the buyers.
2. **Forward Rate:** Forward rates are exchange rates for currency exchanges that will occur at a future date. The forward exchange rate is settled now but the actual exchange of foreign exchange take place in the future. A forward contract is generally entered into by exporters and importers who are exposed to foreign exchange rate fluctuations. The forward rate is quoted at a premium or discount to the spot price. Forward dates are typically 30, 90, 180 or 360 days in the future.
3. **Long Rate:** Long rate of exchange is the rate at which the banks purchase or sells foreign currency bills which are payable at a specific future date. The long rate is determined on the basis of the interest on the delayed payment.
4. **Fixed Rate:** A fixed exchange rate, also known as the pegged exchange rate, is "pegged" or linked to another currency or asset (often gold) to derive its value. Such an exchange rate mechanism ensures the stability of the exchange rates by linking it to a stable currency itself.

Under fixed exchange rate system the rate of exchange between two or more countries does not vary or varies only within narrow limits. Under this system, the government or the Central Bank intervenes in the foreign exchange market so as to maintain the exchange rate stays close to an 'exchange rate target'.

5. **Flexible exchange rate:** In flexible exchange rate system value of one currency in terms of another is determined through the market forces of demand and supply. Under the flexible exchange rate system the rate of exchange is allowed to vary to suit the economic policies of the government. There are no restrictions on buying and selling of foreign exchange and the exchange rates are free to change according to the changed in the demand and supply of foreign exchange. A currency that uses a floating exchange rate is known as a floating currency.
6. **Dual Exchange Rate:** In dual exchange rate system, the currency rate is maintained separately by two values. One rates applicable for the foreign transactions and another for the domestic transactions. Such systems are normally adopted by countries that are transitioning from one system to another. This ensures a smooth changeover without causing much disruption to the economy.

6.7 ADVANTAGES AND DISADVANTAGES OF FIXED AND FLEXIBLE EXCHANGE RATE

ADVANTAGES OF FIXED EXCHANGE RATE:

1. **Exchange rate stability**: Under fixed exchange rate system exchange rate do not change automatically. Exchange rate stability is necessary for orderly devel-opment of the international economy and rapid growth of world trade. If the exchange rate is un-stable or variable, the exporters will not be certain about the price they would receive for the goods to be exported by them; the importers will not be certain about the price and the payments they have to make for their imports.
2. **Creates Confidence:** Since there is no fear of currency fluctuations,

fixed exchange rate creates confidence in the strength of the domestic currency and there is no fear of adverse effect of speculation on the exchange rate.

3. **Facilitate long term capital flow:** since uncertainty and risk of exchange rates volatility is rare in case of fixed exchange rate, hence it promote long-term capital flows.
4. **Impose discipline:** Fixed exchange rate serve as an anchor and imposes a discipline on monetary authorities to follow responsible financial policies within countries.
5. **Remove speculation:** Fixed exchange rate system eliminates speculative activities in foreign exchange transactions. In fixed exchange there is no possibility of panic flight of capital from one country to another.
6. **Good for developing nations:** Developing nations need economic stability for carrying out their planned development efforts. Flexible exchange rates disturb the process of economic development by disturbing inflow of foreign capital.
7. **Promotes economic integration of the world:** It has also been argued in favour of fixed exchange rate system that it is necessary for achieving economic integration of the world commu-nity. This is similar to a single common currency in a country which promotes economic integration of a nation in the sense that it facilitates communication, trade and free movement of finance be-tween different regions of a country.

DISADVANTAGES OF FIXED EXCHANGE RATE:

1. **Outdated System:** In today's economic situation fixed exchange rate system is not appropriate.Fixed exchange rate system was successful under favorable conditions of gold standard during 19^{th} century.
2. **Speculation Encouraged:** Under a fixed rate system, if a country faces huge BOP deficit then the possibility of speculation increases. If the speculators can guess that such BOP deficit will persist in the days ahead and the authority may go for a cut in foreign exchange

rate then these people will be more enthu-siastic to sell domestic currencies in the foreign exchange market. If such sale of home currencies continues for a longer period, the central bank will then be forced to reduce exchange rate, instead of keeping it at the old fixed rate. Under the circums-tance, speculators go on buying home currencies where exchange rates have been reduced. This will make these people to earn profit.

3. **Cost-price relationship not reflected:** The fixed exchange rate system does not reflect the true cost-price relationship between the currencies of different countries. Because, the exchange rate is not determine by the market forces i.e. demand and supply.
4. **International Competitive Environment By-passed:** The continuous changes in international competitive environment do not get reflected under the fixed exchange rate system. Thus, to make the home product more competitive in the foreign market, what is required is the change in domestic economic policies so that the country's export products get larger foothold in the foreign market. In other words, the fixed exchange rate system fails to gloss over the international competitive environment.
5. **Less flexibility**. In a fixed exchange rate, it is difficult to respond to temporary shocks. For example, if the price of oil increases, a country which is a net oil importer will see a deterioration in the current account balance of payments. But in a fixed exchange rate, there is no ability to devalue and reduce current account deficit.
6. **Burden on authority:** In fixed exchange rate system, country needs to have significant foreign exchange reserves and this imposes heavy burden on the monetary authorities for managing foreign exchange reserves. Monetary authorities lose the independence of monetary policy formulation to maintain exchange rate stability.

ADVANTAGES OF FLEXIBLE EXCHANGE RATE:

Following are the main advantages of flexible exchange rates system:

1. **Autonomy:** The fundamental argument in favour floating exchange

rate system is that it allows countries autonomy with respect to their use of monetary, fiscal and other policy instruments and at the same time external equilibrium is ensured because of flexible exchange rate.

2. **Flexibility:** Floating exchange rates gives the government and the monetary authorities' flexibility in determining interest rates. This is because interest rates do not have to be set to keep the value of the exchange rate within pre-determined bands.
3. **Maintain equilibrium:** Balance of Payments on current account disequilibrium can automatically be restored to equilibrium floating exchange rate regime and the scarcity or surplus of any currency is eliminated under floating exchange rate regime.
4. **Promote international trade:** Flexible exchange rate system does not permit exchange control and promote free trade. It removes restrictions on international trade and allows free movement of capital between countries.
5. **Reduce speculation:** In spite of strict exchange control currency speculation is encouraged under fixed exchange rate system. This destroys the stability in the exchange value of the home currency and makes devaluation of currency inevitable. This problem is minimized under flexible exchange rate system.
6. **Determine by Market forces:** Under the flexible exchange rate system, the foreign exchange rates are determined by the market forces of demand and supply. Market is cleared off automatically through changes in exchange rates and the possibility of scarcity or surplus of any currency does not exist.

DISADVANTAGES OF FLEXIBLE EXCHANGE RATE:

Following are the main drawbacks of the system of flexible exchange rates:

1. **Create instability and uncertainty:** Flexible exchange rates create conditions of instability and uncertainty which, in turn, tend to reduce the volume of international trade and foreign investment. Long-term foreign investments arc greatly reduced because of higher risks

involved.

2. **Hampering Investment:** Flexible exchange rate often discourages foreign investment. As exchange rate under flexible exchange rate system becomes unpredictable investors feel insecure to invest in foreign market.
3. **Adverse Effect on Economic Structure:** The flexible exchange rate system has serious repercussion on the economic structure of the country. Fluctuating exchange rates cause changes in the price of imported and exported goods which, in turn, destabilize the economy of the country.
4. **Unnecessary Capital Movements:** The system of fluctuating exchange rates leads to unnecessary international capital movements. By encouraging speculative activities, such a system causes large-scale capital outflows and inflows, thus, seriously disturbing the economy of the country.
5. **Depression Effects of Capital Movements:** Speculative capital movements caused by fluctuating ex-change rates may lead to the problem of extremely high liquidity preference. In a situation of high liquidity preference, people tend to hoard currency, interest rates rise, investment falls and there is large-scale unemployment in the economy.
6. **Inflationary Effect:** Flexible exchange rate system involves greater possibility of inflationary effect of exchange depreciation on domestic price level of a country. Inflationary rise in prices leads to further depreciation of the external value of the currency.
7. **Factor Immobility:** The immobility of various factors of production deprives the flexible exchange rate system of its advantages arising from the adoption of monetary and other policies for maintaining internal stability. Such policies produce desirable effects on production and employment only when supply of factors of production is elastic.



CHECK YOUR PROGRESS

Q 3: What is meant by exchange rate?

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6.8 EXCHANGE QUOTATIONS

Exchange rates can be quoted in either of the two ways;

(a) direct quotation (b) indirect quotation.

The quotation in which exchange rate is expressed as the price per unit of foreign currency in terms of the home currency is known as 'Home currency quotation' or 'Direct quotation'. It may be noted that under direct quotation the number of units of foreign currency is kept constant and any change in the exchange rate will be made by changing the value in term of rupees. For instance, US dollar quoted at Rs.48 may be quoted at Rs 46 or Rs.49 as may be warranted. The quotation in which the unit of home currency is kept constant and the exchange rate is expressed as so many unit of foreign currency is known as 'Foreign Currency quotation' or 'Indirect quotation' or simply 'Currency Quotation'. Under indirect quotation, any change in exchange rate will be effected by changing the number of units of foreign currency.

6.9 MERCHANT RATE

The foreign exchange dealing of a bank with its customer is known as 'merchant business' and the exchange rate at which the transaction takes place is the merchant rate. The merchant business in which the contract with the customer to buy or sell foreign exchange is agreed to and executed on the same day is known as ready transaction or cash transaction. As in the case of interbank transactions a value next day contract is deliverable on the next business day and a 'spot contract' is deliverable on the second succeeding business day following the date of the contract. Most of the

transactions with customers are on ready basis. In practice, the term 'ready' and 'spot' are used synonymously to refer to transactions concluded and executed on the same day.

6.9.1 Basis for Merchant Rates

When the bank buys foreign exchange from the customer, it expects to sell the same in the interbank market at a better rate and thus make a profit out of the deal. In the interbank market, the bank will accept the rate as dictated by the market. It can, therefore, sell foreign exchange in the market at the market buying rate for the currency concerned. Thus the interbank buying rate forms the basis for quotation of buying rate by the bank to its customer. Similarly, when the bank sells foreign exchange to the customer, it meets tele commitment by purchasing the required foreign exchange from the interbank market. It can acquire foreign exchange from the market at the market selling rate. Therefore the interbank selling rate forms the basis for quotation of selling rate to the customer by the bank. The interbank rate on the basis of which the bank quotes its merchant rate is known as the base rate.

6.10 TRANSACTIONS IN THE FOREIGN EXCHANGE MARKET

A very brief account of certain important types of transactions conducted in the foreign exchange market is given below:

Spot Market: The term spot exchange refers to the class of foreign exchange transaction which requires the immediate delivery or exchange of currencies on the spot. In practice the settlement takes place within two days in most markets. The rate of exchange effective for the spot transaction is known as the spot rate and the market for such transactions is known as the spot market.

Forward Market: The forward transactions is an agreement between two parties, requiring the delivery at some specified future date of

a specified amount of foreign currency by one of the parties, against payment in domestic currency be the other party, at the price agreed upon in the contract. The rate of exchange applicable to the forward contract is called the forward exchange rate and the market for forward transactions is known as the forward market.

The foreign exchange regulations of various countries generally regulate the forward exchange transactions with a view to curb the speculation in the foreign exchanges market. In India, for example, commercial banks are permitted to offer forward cover only with respect to genuine export and import transactions. Forward exchange facilities, obviously, are of immense help to exporters and importers as they can cover the risks arising out of exchange rate fluctuations be entering into an appropriate forward exchange contract. With reference to its relationship with spot rate, the forward rate may be at par, discount or premium.

If the forward exchange rate quoted is exact equivalent to the spot rate at the time of making the contract the forward exchange rate is said to be at par.

The forward rate for a currency, say the dollar, is said to be at premium with respect to the spot rate when one dollar buys more units of another currency, say rupee, in the forward than in the spot rate on a per annum basis.

The forward rate for a currency, say the dollar, is said to be at discount with respect to the spot rate when one dollar buys fewer rupees in the forward than in the spot market. The discount is also usually expressed as a percentage deviation from the spot rate on a per annum basis.

The forward exchange rate is determined mostly based on the demand for and supply of forward exchange. Naturally when the demand for forward exchange exceeds its supply, the forward rate will be quoted at a premium and conversely, when the supply of forward exchange exceeds the demand for it, the rate will be quoted at discount. When the supply is equivalent to the demand for forward exchange, the forward rate will tend to be at par.

Futures

While a focus contract is similar to a forward contract, there are

several differences between them. While a forward contract is tailor made for the client be his international bank, a future contract has standardized features the contract size and maturity dates are standardized. Futures cab are traded only on an organized exchange and they are traded competitively. Margins are not required in respect of a forward contract but margins are required of all participants in the futures market.An initial margin must be deposited into a collateral account to establish a futures position.

Options

While the forward or futures contract protects the purchaser of the contract from the adverse exchange rate movements, it eliminates the possibility of gaining a windfall profit from favorable exchange rate movement. An option is a contract or financial instrument that gives holder the right, but not the obligation, to sell or buy a given quantity of an asset as a specified price at a specified future date. An option to buy the underlying asset is known as a call option and an option to sell the underlying asset is known as a put option. Buying or selling the underlying asset via the option is known as exercising the option. The stated price paid (or received) is known as the exercise or striking price. The buyer of an option is known as the long and the seller of an option is known as the writer of the option, or the short. The price for the option is known as premium.

Swap operation

Commercial banks who conduct forward exchange business may resort to a swap operation to adjust their fund position. The term swap means simultaneous sale of spot currency for the forward purchase of the same currency or the purchase of spot for the forward sale of the same currency. The spot is swapped against forward. Operations consisting of a simultaneous sale or purchase of spot currency accompanies by a purchase or sale, respectively of the same currency for forward delivery are technically known as swaps or double deals as the spot currency is swapped against forward.

Arbitrage

Arbitrage is the simultaneous buying and selling of foreign currencies with intention of making profits from the difference between the exchange

rate prevailing at the same time in different markets

Forward Contract

Forward contracts are typical OTC derivatives. As the name itself suggests, forward contracts are transactions involving delivery of an asset or a financial instrument at a future date.

Regulation of Foreign Exchange

Traditionally Indian foreign exchange market has been a highly regulated one. Till about 1992-93, government exercised absolute control on the foreign exchange market. In 1973 the government of India enacted Foreign Exchange Regulation Act (FERA) which strictly controlled any activities in any remote way related to foreign exchange. FERA was introduced during 1973 and came in to force from 1st January, 1974, when foreign exchange was a scarce commodity. FERA was a very rigid Act, It prescribed a policy – "nothing (foreign exchange transactions) is permitted unless specifically mentioned in the act". Post liberalization, the Government of India, felt the necessity to liberalize the foreign exchange policy. Hence, On June 1, 2000, the Foreign Exchange Management Act, 1999 (FEMA) was brought in force to replace the then existing FERA. FEMA expanded the list of activities in which a person/company can undertake foreign exchange transactions. Through FEMA, government liberalized the export-import policy, limits of FDI (Foreign Direct Investment) & FII (Foreign Institutional Investors) investments and repatriations, cross-border M&A and fund raising activities. Prior to 1992, Government of India strictly controlled the exchange rate. After 1992, Government of India slowly started relaxing the control and exchange rate became more and more market determined. The socialist pattern of governance and license raj system of Post independence made the Indian companies noncompetitive in the international market, leading to decline in export. Simultaneously India import bill was escalating because of capital goods, crude oil & petrol products increased the foreign exchange outgo leading to sever scarcity of foreign exchange.

FEMA had become the need of the hour to support the pro-liberalisation policies of the Government of India. The objective of the Act is to consolidate and amend the law relating to foreign exchange with the

objective of facilitating external trade and payments for promoting the orderly development and maintenance of foreign exchange market in India.

Features of FEMA

Following are the some of the important features of FEMA

i. It is consistent with full current account convertibility and contains provisions for progressive liberalisation of capital account transactions.

ii. It is more transparent in its application as it lays down the areas requiring specific permissions of the Reserve Bank/Government of India on acquisition/holding of foreign exchange.

iii. It classified the foreign exchange transactions in two categories, viz. capital account and current account transactions.

iv. It provides power to the Reserve Bank for specifying, in , consultation with the central government, the classes of capital account transactions and limits to which exchange is admissible for such transactions.

v. It gives full freedom to a person resident in India, who was earlier resident outside India, to hold/own/transfer any foreign security/ immovable property situated outside India and acquired when s/he was resident.

vi. This act is a civil law and the contraventions of the Act provide for arrest only in exceptional cases.

vii. FEMA does not apply to Indian citizen's resident outside India.



CHECK YOUR PROGRESS

Q 4: In which year FEMA was brought in force?

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6.11 LET US SUM UP

- Foreign exchange market is the market where the currency of one country is exchanged for the currency of another country.

- There are two foreign exchange markets. Viz. the retail market and the wholesale market.
- A fixed exchange rate, also known as the pegged exchange rate, is "pegged" or linked to another currency or asset (often gold) to derive its value.
- The foreign exchange dealing of a bank with its customer is known as 'merchant business' and the exchange rate at which the transaction takes place is the merchant rate.
- On June 1, 2000, the Foreign Exchange Management Act, 1999 (FEMA) brought in force to replace the then existing FERA.



6.12 FURTHER READING

1) Paul R.R. (1998). *Money, Banking and International Trade*. Kalyani Publishers, New Delhi.

2) Dewett K.K. (1998). *Modern Economic Theory*. S. Chand & Company Ltd., New Delhi.



6.13 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Two functions of foreign exchange market are transfer function and hedging function.

Ans to Q No 2: Two dealers of foreign exchange market are central band and brokers.

Ans to Q No 3: The rate of exchange is the price of one currency stated in terms of another currency i.e. the rate at which one currency is exchanged for another.

Ans to Q No 4: FEMA was brought in force in the year 2000.



6.14 MODEL QUESTIONS

1. Write a note on Foreign Exchange Market
2. Name the dealers involved in Foreign Exchange Market
3. Write five points of advantages and disadvantages of Fixed Exchange Rate
4. Explain five advantages and disadvantages of Flexible Exchange Rate
5. What are the functions of Foreign Exchange Market
6. Write some features of FEMA
7. Define Merchant Rate. Explain its basis
8. Explain the transaction conducted in the Foreign Exchange Market

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Unit 7: THEORIES OF FOREIGN EXCHANGE RATE MOVEMENT AND INTERNATIONAL PARITY CONDITION

UNIT STRUCTURE

7.1 Learning objective

7.2 Concept of Purchasing Power Parity

7.2.1 Absolute Purchasing Power Parity

7.2.2 Relative Purchasing Power Parity

7.3 International Fisher

7.4 Interest Rate Parity

7. 5 Let us sum up

7.6 Answer to check your progress.

7.7 Further Reading

7.8 Model Questions

7.1 LEARNING OBJECTIVE

After going through this unit, you will able to:

- Explain Purchasing Power Parity Theory
- Discuss International Fisher Theory
- Calculate of International Fisher Effect
- Explain Interest Rate Parity Theory

7.2 INTRODUCTION

Theories of exchange rates determination have changed since the exchange ratesystem shifted to the floating rates system. Traditional theories, developed during the period of fixed exchange rates, including the elasticity approach and the absorption approach, focused mainly on the real sector. However, especially in the current period of floating exchange rates, the monetary sector is another important element determining exchange. Exchange rate is a function of many a thing. On the basis of these factors many theories have been formulated to determine the rate of ex-

change between different currencies. Some of the important theories we will discuss here in this unit are Purchasing Power Parity (PPP) theory, International Fisher theory and Interest Rate Parity theory.

7.2 CONCEPT OF PURCHASING POWER PARITY

Purchasing Power Parity (PPP) theory was promoted by Swedish Economist Gustav Cassel in the years following the First World War (1921-1922) to determine the rate of Exchange, when the exchange rates are free to fluctuate, the rate of exchange between two currencies in the long run will be determined by their respective purchasing powers. In other words of Cassel, "the rate of exchange between two currencies must stand essentially on the quotient of the internal purchasing powers of these currencies".

In simple words, for determining exchange rates under PPP theory first of all a group of certain commodity's are selected as representative of all commodities available for consumption. Only such commodities are selected which is generally used for consume by the general public and which is generally available in the market. The prices of the commodities are determined in terms of money prevailing of various countries. Therefore exchange rate between two currencies are determined on the basis of the ratios of their purchase prices of the commodities in two countries.

It should be noted that the purchasing power parity theory is determined by comparing general price-levels and not the price-levels of internationally traded goods. Prices of exports and imports must remain at the same level in every country (barring of course, cost of transport) tariffs etc. Moreover, they are often the result of changes in exchange rates. Hence, it is easy to verify the theory by comparing wholesale standards.

The theory is an explanation of monetary adjustment and states that if the essential condition of international trade remains unchanged, foreign exchange rates will reflect those price-changes. But the conditions of international trade never remain the same. In particular, the barter terms of trade are constantly changing owing to changes in the demand for foreign goods, changes in the conditions of supply of exported goods, changes in the vol-

ume of foreign loans, changes in the costs of transport and in every item in the invisible balance of trade.

Further, we should take the case of a country which borrows from another. The increased supply of the foreign currency in the first country's foreign exchange market will raise the value of the own currency in terms of the currency of the lending country. This change in the exchange rates will not always be reflected in suitable changes in the price-levels of the two countries.

There are two versions of the PPP theory – absolute purchasing power parity theory and relative purchasing power parity theory.

7.2.1 Absolute PPP

The absolute PPP theory is closely related to the **law of one price** which suggests that a product that is easily and freely traded in a perfectly competitive global market should have the same price everywhere, once the prices at different places are expressed in the same currency. Suppose 10 units of commodity X, 12 units of commodity Y and 15 units of commodity Z can be bought through spending Rs. 1500 and the same quantities of X, Y and Z commodities can be bought in the United States at an outlay of 25 dollars. It signifies that the purchasing power of 25 dollars is equivalent to that of Rs. 1500 in their respective countries. That can form the basis for determining the rate of exchange between rupee and dollar.

The law of one price proposes that the price (P) of the product measured in in domestic currency will be equated to the price (P_f) of the product measured in the foreign currency through the current spot exchange rate (e): P = e . P_f

7.2.1 Relative PPP

While absolute PPP theory is based on the absolute prices of goods in the two countries, the relative purchasing power parity between two countries states that the percentage change in the bilateral exchange rate is equal to the difference in the percentage change in the national price levels over any given period of time. In other words, the absolute PPP is a statement about

absolute prices and exchange rate level, the relative PPP is a statement about price and exchange rate changes over time.

The essence of the PPP theory is clearly expressed S.E Thomas as follows: “while the value of the unit of one currency in terms of another currency is determined at any particular time by the market conditions of demand and supply, in the long run, that value is determined by the relative values of the two currencies as indicated by their relative purchasing power over goods and services (in their respective countries). In other words, the rate of exchange tends to rest at that point which expresses equality between the purchasing tends of the two currencies. This point is called the purchasing power parity”.

Effects of PPP Thus according to the purchasing power parity (PPP) theory, the exchange rate between one currency and another is in equilibrium when their domestic purchasing powers at the rate of exchange are equivalent. For example, If Price of 500 selected commodities in India is Rs 5000 and in America is $100 (Suppose). The ratio between Indian and American currency would be 5000 Rupees and 100 Dollar i.e. Rs 50 and $1 dollar. It means exchange rate, would be determined as 50 Rupees equal to $1. Once the equilibrium is established, the market forces will operate to restore the equilibrium if there is some deviation. For example, if the exchange rate changes to $1 = Rs. 51.50 when the purchasing powers of these currencies remain stable, dollar holder will convert dollar into rupees because, by doing so, they can save Rs 1.50 when they purchase a commodity worth $1. This will increase the demand for the Indian currency and the supply of dollars will increase in the foreign exchange market and eventually, the equilibrium rate exchange will be re-established.

A change in the purchasing power of currencies will be reflected in their rate of exchange. The index number of prices may be made use of to determine the purchasing power parity. If there is a change in prices (i.e. the purchasing power of the currencies), the new equilibrium rate of exchange can be found out by the following formula.

$$ER = \frac{Er \times P_d}{P_f}$$

Where, ER = Equilibrium exchange rate

Er = Exchange rate in the reference period

P_d = Domestic price index

P_f = foreign country's price index

Demerits

The purchasing power parity theory is subject to the following major criticisms:

1. **Group of Selected Commodities:** The quality of goods and services, Standard of living importance and necessity may vary from country to country. Therefore, assuming them as representative group of commodities is unrealistic.
2. **Errors in calculating Price level**: For calculating inflation, index number methods is used but in reality many difficulties are faced during calculation of index numbers viz. selection of base year, collection of price data of commodities and difference on the method of collection of price data in different countries etc. it may cause various errors in calculating price levels in different countries.
3. **No Transportation Cost:** The theory is rendered further unrealistic by ignoring the cost of transportation in international trade.
4. **Inconsistent with restricted Trade**: The purchasing power parity theory ignores the international trade restriction. It assumes that international trade is free from all barriers. Therefore it may be an unrealistic one.
5. **Effects of demand and supply of Exchange Rate:** Exchange rate of foreign currencies are changed automatically by their demand in the international market while index number calculates the estimated price level on certain data and the PPP theory proposed the change exchange rates announced latter on cannot be

considered as real exchange rate although it is treated as the official exchange rate. When the exchange rate is determined largely by demand and supply conditions, any theory that does not pay adequate attention to these aspects proves to be unsatisfactory.

6. **Ignoring international capital movement:** The purchasing power parity theory ignores the effects of international capital movement on the foreign exchange market. International capital movements may cause changes in the exchange.

7. **Effects of Exchange Rate :** In reality the price level is effected by the change in rate of exchange. PPP theory ignores the impact of changes in the exchange rates on the prices.

Merits

Despite its many defects and deficiencies, the purchasing power parity theory exposes some very important aspects of exchange rate determination.

1. It indicates the relationship between the internal price levels and exchange rates.
2. It explains the state of the trade of a country as well as nature of its balance of payments at a particular time.
3. Further, the theory is applicable, to some extent, to all sort of monetary standards.



Check your progress

1. Who introduced PPP theory?
2. What is absolute Purchasing Power Parity?
3. What is relative Purchasing Power Parity?
4. Mention any two criticisms of PPP theory.

7.3 INTERNATIONAL FISHER EFFECT

The International Fisher Effect or IFE is an exchange-rate theory designed by the famous American economist Irving Fisher in the 1930s which states that for any two countries an expected change in the future spot rate between two currencies leads to a difference in approximately equal amount but in the opposite direction between the two countries' nominal interest rates. The relationship between the percentage change in the spot exchange rate over time and the differential between comparable interest rates in different national capital markets is known as the international Fisher effect. The international Fisher effect, more generally known as the "Fisher-open," assumes the appreciation or depreciation of currency prices which are closely related to differences in nominal interest rates. Thus, the rational for IFE is that the currency of the country with higher nominal interest rate will depreciate against the other country's currency due to the increase in inflation rate in that country.

The International Fisher Effect is the international counterpart of the Fisher Effect. International Fisher should not be confused with the Fisher Effect as the Fisher Effect states that the nominal interest rate reflects a real interest rate and an anticipated rate of inflation. The Fisher International Effect states that the nominal interest rate differential between two countries reflects the anticipated rate of currency depreciation of the exchange rate. The two Fisher effects are similar in that they both claim that interest rates reflect anticipations of future economic events. The two Fisher effects are different since the first Fisher Effect applies to a single economy, while the second Fisher International Effect applies to two economies. Thus, International Fisher Effect can be seen as a combination of the generalized version of the Fisher Effect and the relative version of the Purchasing Power Parity. The generalized version of the Fisher Effect states that the real interest rates across countries will be equal due to the possibility of arbitrage. If the real rate is equal between different countries, it follows that the differences in their

observed nominal rates must arise from differences in expected inflation. The relative version of the Purchasing Power Parity implies that inflation differential will be offset by exchange rate changes. The International Fisher Effect proposes that the changes in the spot rate of exchange between two currencies will be equal to the differences in their nominal interest rates.

For example, a rise in the Swedish inflation rate relatively to the US will cause a depreciation of the Swedish krona relative to the US dollar (i.e. PPP). The nominal interest rate in Sweden will also rise relative to the US nominal interest rate (i.e. Fisher Effect).

Briefly, the theory asserts that the higher interest rate country's currency is expected to depreciate until the real returns of investments are equalized across countries. It was recognized on the basis that interest rates are independent of other monetary variables and that they provide a strong indication of the performance of the currency of a specific country. An expected change in the current exchange rate between any two currencies is approximately equivalent to the difference between the two countries' nominal interest rates for that time. The nominal risk free interest rate (i.e., developed economy government issued debt) consists of a real interest rate plus and an inflation expectation. The International Fisher Relation connects the difference in nominal risk free interest rates between countries to their expected inflation rates. In other words, as per Fisher, the exchange rate movements are caused by anticipated inflation rate differentials.

Although Fisher's theory was criticized on many grounds but it provides a useful rule of thumb. If the inflation rate is likely to change, it is a fairy good bet that interest rates will also change.

The rational is extended to substantiate a view that, the nominal interest rate differential must equal to the expected inflation rate differential in two countries which is the expected change in exchange rate.

Nominal interest rate differential = Expected inflation rate differential. Simply, a country with a higher interest rate will also tend to have a higher inflation rate. This increased amount of inflation should cause the currency in the country with the high interest rate to depreciate against a country with lower interest rate. For example, some countries experience a higher interest rate than their trading partner (interest rate in Germany is less than that in India; while in the US, interest rate is lower than even in Germany). The latter countries expect that they would experience depreciation in their currencies. Countries with high rates of inflation will generally have high nominal rates of interest too. This at least partially serves to allow investors to obtain a high enough 'real rate' of return, where inflation is relatively high.

The International Fisher Effect suggests the following:

- Changes in interest rates reflect changes in anticipated inflation rates and interest rate differential provide an unbiased predictor of future changes in spot exchange rates.
- Currencies with higher interest rates will depreciate because the higher nominal rates reflect higher expected inflation.
- Given the free movement of capital internationally, the real rate of return in different counties will equalize as a result of adjustments to spot exchange rates.
- The International Fisher Effect reinforces the Interest Rate Parity and the Purchasing Power Parity theories by highlighting the inflation element in nominal interest rates.

Fisher formula

$$(1 + \text{Nominal interest rate}) = (1 + \text{Real rate}) \times (1 + \text{Inflation rate})$$

7.3.1 Calculation of International Fisher Effect

Let us take the example of two economies; the Dollar (USA) and Yen (Japan).

The rate of exchange for the currency pair USDJPY is 106.800. The interest rate of Japan is 4% while the USA's is 5%.

If we adhere to the rule of the IFE that a country with high interest rates will have higher inflation, then we expect the USA currency to depreciate in value.

Therefore, we calculate the future spot rate (E). To do so, we take the current spot rate and multiply it by the ratio of the current foreign interest rate to the domestic interest rate.

Therefore,

E = 106.800 (1.04/1.05)

E = 105.780

What we have above is the future spot exchange rate of the USDJPY. As per the IFE, the currency of Japan will lose value in the future. This is shown in the drop in the spot exchange rate from the initial 106.800 to 105.780.

In the above scenario, current investors of the USD will receive lower interest rates on the dollar, but they will make profits from the increase in the value of the USD versus the JPY.

7.3.2 Significance of International Fisher Effect

1. **Forecast of Future Currency Movements:** The International Fisher Effect helps in predicting long-term of future currency movements. Earlier, all the predictive indicators in existence were purely based on interest rates which could only forecast price movements for up to 1 year making it insignificant and unusable for some financial sectors.
2. **Helps in making Lending Decisions:** International Fisher Effect helps lenders such as banks in making correct lending decisions. It helps the lenders to make a profit out of the granted loans by charging an appropriate interest rate which is more than the inflation rate of their economy. This calculation is important even when giving interest-free loans since factors such as inflation has its effect and the loan should still retain its purchasing power once it has been repaid.

7.3.3 Limitations of the International Fisher Effect

Below are some of the limitations of the International Fisher Effect:

1. It makes long term Predictions only: One of the major limitations of the IFE is that it can only make forecasts for the long term. Therefore, it cannot be used in analysing financial performances for short term periods.

2. Uncovered interest parity: It can make almost accurate currency movement predictions but it has no method of telling when the effects will start. As such, while it might make true conclusions, the users cannot have a specific time to watch. It can, therefore, be said to be unreliable in giving specific timelines.

3. Uncontrolled Exchange Rates: In recent time of economic formations, the effectiveness of International Fisher Effect has somewhat decreased. In earlier days it was common for most nations to control their exchange rates because of trade and economic purposes. Today, though, most currencies are free-floating, meaning the countries no longer control them.

4. Interest Rates used to Determine Inflation: Most central banks are turning to inflation targeting as opposed to interest rate targets in determining their interest rates. In short, they are now using inflation rates to make their predictions and conclusion. As such, the International Fisher Effect is rendered useless since its defining formula is disrupted where this new development is used.

5. Other Factors affecting Exchange Rates: Studies have confirmed that there are multiple other country characteristics that affect exchange rate movements besides inflation. They include government controls, exchange rate risks and income levels. Therefore, while the derived [expected] appreciation or depreciation of a currency's movement might be accurate, depending solely on it to make forecasts is subject to significant errors.



Check your progress

5. What is international Fisher effect**?**

7.4 INTEREST RATE PARITY THEORY

Interest Rate Parity (IRP) is a theory used to explain the value and movements of exchange rates. It is also known as the asset approach to exchange rate determination. It suggests a strong relationship between interest rates and the movement of currency values. The interest rates prevailing in two countries affect the exchange rate between currencies of those countries. Say, the interest rates in India and in the US will drive the exchange rate between dollar and rupee. Thus, the theory is a very effective tool for the traders that provide the linkage between the foreign exchange markets and the international money markets.

As per the IRP, the interest rate differential between two countries is equal to the differential between the forward exchange rate and spot exchange rate.

Spot rate – Also called forex spot rate, it is the current exchange rate or current price of a currency pair in the market.

Forward rate – Forward rates are fixed for forward contracts, also known as future contracts. This is the projected value of a currency pair in a future date.

For example, if the domestic interest is 8% and foreign interest rate is 5%, this means that the market expects the foreign currency to appreciate by 3% or conversely investors expect the domestic currency to depreciate by 3%. Understanding interest rate parity meaning is important if one does trade in currencies.

In an efficient market, if the interest rates in two countries are different, the exchange rates between the two countries will move in such a way as to bring about parity in interest rates. This will offset the apparent interest rate differentials, thereby denying any arbitrage opportunity. This implies that high interest rate in one country will be offset by depreciation of the currency of that country. If, for example, the interest rates in India are higher than that in the US, the India rupee will depreciate against the US dollar.

According in the Interest Rate Parity Theory, it is argued that forward rate would reflect the interest rate. In the absence of it, arbitrage opportunities would open up and a shrewd investor could make a lot of money. The knowledge and understanding of the concept of arbitrage and its operation in the field of international finance is very important.

Arbitrage means the existence of two different prices in two markets for the same commodity lets traders lock in profits. Let us understand the same with an example.

Suppose a fruit cake costs Rs10 in Bakery A and Rs12 in Bakery B. We know a cake is eatable whenever it is brought or sold (assuming other thongs remain constant). One would buy 100 pieces of cake in Bakery A and sell 100 pieces of cake in Bakery B making a profit of Rs200 per day for no effort. The action of buying and selling push up the demand for cakes in Bakery A and their supply in Bakery B. In line with the law of demand and supply, the price of cake goes up in Bakery A and it comes down in Bakery B. Over time, the two prices would catch up and arbitrage would dissolve. This is an example of 'arbitrage over space'.

We could also have an 'arbitrage over time'. Say, for example, the time value of money is 6 percent and a cake costs Rs10 today, it would cost Rs10.6, a year later. If we know that it would cost, Rs 11 a year later, we would borrow Rs 10 today at per 6 percent, buy a cake, and sell it a year later at Rs 11. Then we would pay the interest and repay the principal amounting to Rs10.60 and pocket the difference of Rs0.40. However, if one knew that it would cost less, say Rs10.40 a year later, it would be available to sell cakes today at Rs10, invest the proceeds at 6 percent get Rs10.60, a year later and buy cakes at Rs10.40. Thus, Rs0.20 would be earned in the bargain.

'Arbitrage over space' in forex refers to the price of currency in two countries.

'Arbitrage over time' refers to the prices in the two markets, spot and forward.

One can identify arbitrage opportunities in either of the following two ways:

(i) Compute the ideal forward price (theoretical price) and compare in with the existent forward price (actual forward rate). If the two are not equal, there could be an arbitrage opportunity.

(ii) Compute the ideal home country interest rate (theoretical interest rate) for the given forward rate and compare it with the actual home country rate (actual interest rate). If the two are not equal, there could be an arbitrage opportunity.

Criticism of the Theory of Interest Rate Parity:

The Theory of Interest Rate Parity is criticised on the following ground:

Availability of funds that can be used for arbitrage is not infinite. Additionally, the importance of capital movements, when they are available, depends on the credit conditions practiced between the financial places. It also depends on the freedom of actions of different operators as per the exchange control rules of the country in vogue.



Check your progress

6. For what purpose Interest Rate parity Theory is used?

7. What is mean by arbitrage over time ?



7.5 Let Sum Up

In this unit, we have discussed the following aspects:

- Foreign exchange rate can be determined by using PPP theory, International Fisher and Interest rate parity theory.
- According to PPP theory “exchange rate between two currencies are determined on the basis of the ratios of their purchase prices of the commodities in two countries”.

- There are two versions of the PPP theory absolute purchasing power parity theory and relative purchasing power parity theory.
- The Fisher effect model says nominal interest rates reflect the real rate of return and expected rate of inflation.
- Interest rate parity theory is a link between the exchange rate and interest rate to determine foreign exchange rate.



7.6 ANSWER TO CHECK YOUR PROGRESS.

Ans. To Q.No.1. Swedish Economist Gustav Cassel.

Ans. To Q.No.2. The absolute PPP theory is closely related to the law of one price which suggests that a product that is easily and freely traded in a perfectly competitive global market should have the same price everywhere, once the prices at different places are expressed in the same currency.

Ans. To Q.No.3. The relative purchasing power parity between two countries states that the percentage change in the bilateral exchange rate is equal to the difference in the percentage change in the national price levels over any given period of time.

Ans. To Q.No.4. a) No satisfactory explanation of short term changes in exchange rates is provided by the theory.

b) The theory goes contrary to general experience. Critics point out that there has hardly been any case when the rate of exchange between two currencies has been equivalent to the ratio of their purchasing powers.

Ans.to Q.No.5. It states that for any two countries an expected change in the future spot rate between two currencies leads to a difference in approximately equal amount but in the opposite direction between the two countries' nominal interest rates.

Ans.to Q.No.6. Interest Rate Parity (IRP) is a theory used to explain the value and movements of exchange rates.

Ans.to Q.No.7. Arbitrage over time refers to the prices in the two markets, spot and forward.



7.7 FURTHER READING

1. International Economics : Dominic Salvatore
2. International Economics : Francis Cherunilam



7.8 MODEL QUESTIONS

1. Discuss Purchasing Power Parity Theory.
2. Explain the merits and Demerits of PPP Theory
3. Elaborate International Fisher Effect along with its limitations.
4. Explain the significance of International Fisher Theory.
5. Discuss Interest Rate Parity Theory.

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