INTERNATIONAL ECONOMICS

Syllabus for B.A.Economics, Non-Semester (DD & CE)

UNIT – I

Differences between international trade and internal trade, Benefits of international trade and defects - Free trade: Meaning – Arguments for and against- Protection: Meaning -Arguments for and against – Kinds of Protection and Role of Protection in UDCs

UNIT – II

Theories of International Trade**:** Adam smith's Classical Theory, Ricardo's Comparative Cost Theory, Heckscher-Ohlin's Modern Theory and Samuelson's Factor-Price Equalization Theory

UNIT – III

Balance of payments - Meaning and Balance of trade and Balance of payments –Structure of a Balance of payment – Types of disequilibrium of balance of Payments - Causes and Methods of correcting disequilibrium

UNIT–IV

Meaning of Foreign exchange and Exchange Rate, Determination: Mint parity theory – Purchasing power party theory – Balance of payment Theory– Fixed and Flexible Exchange Rate: Merits and Demerits- Exchange Control- Objective- Methods

UNIT – V

IMF – Objectives– structure– Functions –World Bank (IBRD) –Objectives – structure – Functions - Trade Agreements: GATT, UNCTAD and WTO

Reference Books:

D.M. Mithani, International Economics –Himalayas Publishing House, Delhi, 2003

Singh &Agarwal, International Economics –SanjeevaPrakashan, Meerut

Devairakkam, International Economics- D.S.R.Publications, Tirunelveli, 2001.

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INTERENATIONAL TRADE

Introduction:

International economics is concerned with the effects upon economic activity of international differences in productive resources and consumer preferences and the international institutions that affect them. It seeks to explain the patterns and consequences of transactions and interactions between the inhabitants of different countries, including trade, investment and migration.

International trade is also a branch of economics, which, together with international finance, forms the larger branch of international economics. Trading is a value added function of the economic process of a product finding its market, where specific risks are to be borne by the trader, affecting the assets being traded which will be mitigated by performing specific functions.

International Trade is usually referred to the exchange of goods, and services across international borders or territories. In most countries, it represents a significant share of gross domestic product (GDP). In 2010, the value of international trade achieved 19 trillion (current US) dollars, i.e. about 30% of the world GDP. That is, about one third of the produced goods and services are exchanged internationally around the world.

Inter-regional trade refers to trade between regions within a country. It is what Ohlin calls inter-local trade. Thus Inter-regional trade is domestic or internal trade. International trade is a branch of Economics which is concerned with the exchange of goods between people belonging to different countries and it has to be distinguished from the trade which is carried on within the political boundaries of any particular nation. A controversy has been going on among economists whether there is any difference between domestic trade and international trade. The fundamental principles in both the cases are the same. Whether it is internal trade or international trade, it arises due to specialization in production. Trade helps specialization in production both possible and profitable.

There are a few important distinctions between domestic trade and international trade.

The points of differences are,

1. Within the country, the monetary unit is the same and it will be accepted for all transactions. The problem of rate of exchange, availability of foreign money, exchange, availability of foreign money, exchange control, etc, make international trade very much different from internal trade.
2. Within a country there are no restrictions on the movement of the goods from one place to another. But as far as international trade is concerned, there are import as well as expert restrictions in many forms such as tariffs, grants, subsides, quotas, agreements, etc.
3. International trade is conditioned by the law of the land both commercial and non-commercial whereas external trade is subjected not only to the laws of the importing and exporting countries but that of countries through which the goods pass in transit.
4. Factors of production are perfectly mobile within a country. On the other hand, they are practically immobile between countries. As a result, the cost of production tends to be the same in all parts of the country whereas it differs from country to country giving rise to different prices. Adam Smith, David Ricardo and other economists have pointed out this is as the most important distinction between internal and international trade.

5. In the case of internal trade the monetary and fiscal policies followed by the Central Bank and the Government affect the trade uniformly, whereas international trade is affected by the monetary and fiscal policies of more than one Central Bank and more than one Government.
6. In internal trade people possess a very good knowledge about the conditions of trade, quality of the products, cost of production etc, whereas in external trade such complete knowledge is rarely available
7. As far as internal trade is concerned, there exist not many differences in languages, customs, usages, trade conditions, etc. However differences in language, customs, usages, trade conditions, affect international trade considerably.
8. External trade is subjected to greater risks such as marine risk, political risk, commercial risk, etc, whereas internal trade is fairly free from these risks.
9. Internal trade is mostly monetary in character, whereas international trade is more or less barter (i.e,) exchange of goods for goods. Imports are paid in terms of exports including gold and silver
10. Trade between countries is having the problem of balance of payment which is perpetual while regions within a country have no such problems.

Despite the above differences which are more or less handicaps, international trade is carried on as it has a number of advantages. It is an open secret that international trade has existed in the world since the beginning of civilization and from time to time many a hindrance has been removed, though new ones have appeared.

Benefits of international trade:

Countries involve themselves in international trade when it is profitable to do so. The advantages that a country and its people may derive are many.

1. It enables people to use commodities which are not produced in their own country.
2. Different countries of the world have different advantages in the production of different commodities and international trade enables the rest of the world to reap the advantages possessed by particular country. Thus quality products are made use of by the entire world at cheap prices.
3. International trade comes in handy to relieve poverty and famine on a universal level. Food, clothing, medicine and other essential requirements are imported from surplus areas to relieve want and scarcity.
4. International trade helps to dispose of the surplus products of a country and arrest fall in prices.
5. International trade helps to create goodwill and friendship between the nations of the world.
6. International trade has been solely responsible for the development of shipping and the improvements that have taken place in marine transport during the few years. .
7. It helps less developed countries to develop their economies by the sale of raw materials, food, articles and other items. In exchange they may import capital goods to industrialize the countries.
8. It helps to break monopolies which may otherwise develop in the case of industries producing scarce items.

9. It enables agricultural countries to export their raw materials and food articles in exchange of manufactures goods, machines and other items necessary for comfort and luxury.

Defects of international trade:

However international trade should not be considered as one without any defect.

1. It is an open secret that powerful counties subject the poor countries through international trade.
2. It is a hindrance to the growth of less developed countries in more than one way. If advanced countries stop buying raw materials from Udcs, they cannot import required goods.
3. During periods of war and other emergencies countries depend on international trade are put into serious troubles.
4. It is true that poor countries lose their basic mineral wealth by export of raw materials and bring ruin to their economies.
5. It is also true that international trade has the danger of unscrupulous dumping. Dumping is a method by which goods are sold cheaply in foreign market with a view to crush the foreign industry.
6. It is also possible that international trade may result in losses due to overproduction of a commodity for which a country is best suited.

FREE TRADE Vs PROTECTION

A trade policy of placing no restrictions on the movement of goods between countries is known as the policy of ‘Free Trade.’ Such a policy permits the flow of international commerce in its natural environment, free of artificial impediments.

Free Trade:

According to Adam Smith, the term 'free trade' is used to denote 'that system of commercial policy which draws no distinction between domestic and foreign commodities and, therefore, neither imposes additional burdens on the latter, nor grants any special favour to the former.' In other words, free trade implies complete freedom of international exchange. Under such policy, there are no barriers to the movement of goods between countries and exchange can take its perfectly natural course.

The policy of free trade, however, does not require the removal of all sorts of duties on commodities in international exchange. It insists that duties may be imposed exclusively for revenue and not at all for protection.

Classical economists like Adam Smith, Ricardo etc., were enamored of the policy of free trade, as a reaction against mercantilism dominating England and other continental countries in the sixteenth and seventeenth centuries.

A system of trade characterized by the absence of restriction is known as free trade. The classical economics were enamored of free trade and they developed the idea of free trade to the status of what came to be known as **Laissez Faire** Policy. The following advantages are claimed for free trade.

Features of free trade

Free trade policies generally promote the following features:

- Trade of goods without taxes (including tariffs) or other trade barriers (e.g., quotas on imports or subsidies for producers)
- Trade in services without taxes or other trade barriers
- The absence of "trade-distorting" policies (such as taxes, subsidies, regulations, or laws) that give some firms, households, or factors of production an advantage over others
- Unregulated access to markets
- Unregulated access to market information
- Inability of firms to distort markets through government-imposed monopoly or oligopoly power
- Trade agreements which encourage free trade.

Advantages of free trade:

1. Freedom of trade between countries helps the flow of goods from one country to another. Under free trade a country specializes in the production of those commodities which is relatively best suited and exports them in exchange for those imports which can obtain more cheaply. This maximizes the output of all participating countries because all gain from trade which increases the real national income of the world economy. Thus free trade leads to maximization of output income and employment.
2. Free trade secures the optimization of consumption. Consumer in each country are able to enjoy the consumption of those goods which itself cannot produce. This has the effect of raising their standard of living.
3. Only under free trade, the principles of international division of labour can be applied fully for the benefit of the entire world. Each country specializes in the production of those commodities for which it has abundant supply of natural resources. As a result, the existing resources in each trading country

are employed more productively and the resource allocation becomes more efficient. Thus international trade and division os labour leads to optimum utilization of resources.

4. When foreign trade is free from restrictions, the factors of production are able to earn more by seeking their most profitable employment. It is rightly said that a free trader is a world citizen and a world trader.
5. Under free trade, there will be goodwill and greater international co-operation among nations. To solve bilateral and multilateral trade problems, different countries come into contact with each other, hold trade talks with among each other.
6. Free trade also prevents the creation of injurious monopolies. Under free trade each country specializes in the production of a few commodities and the industries are of the optimum size so that the cost of production of each commodity is the maximum. Thus free trade ensures a lower price for exports as well as imports and the price mechanism under perfect market competition prevents the formation of monopolies.
7. According to Heberler, free trade has an educative value. International competition encourages home producers to sacrifice leisure in order to increase productivity. For this, they innovate and bring improvement sin organisation and methods of production.
8. Free trade leads to wide extent of markets for goods. As the demand for goods is not confined to one country but to a number of countries, the entire world becomes the market for all types of goods. This leads to the production of quality goods at low prices because of world competition.
9. It encourages the development of the means of transport and communications not only within the countries but also among countries. The

development of internet, E-Mail, E-Commerce has been possible due to more freed trade globally.

10. Free competition and trade encourage nations to produce the best and the cheapest products in order to gain more. It stimulates them to onvent new techniques and process of production, to find new markets, new sources of raw materials, etc.

It is the best policy for economic development in the following ways. (a) It leads to the importation of capital goods and raw materials; (b) It instills new ideas and brings technical knowhow, skills, managerial talents and entrepreneurship to the developing countries; (c) it facilitates the flow of foreign capital; and lastly it fosters healthy competition and checks inefficient and exploitative monopolies.

Though free trade is necessary to reap the full advantages of international trade, all countries are now restricting imports and encouraging exports and few trade no longer exists.

The decline of free trade can be attributed to the following reasons:

Disadvantages of free trade:

1. Under the system of free trade, economically backward countries face unequal competition with the economically advanced countries. In the context, the weaker country is always thrown to the wall and their industries suffer heavily. Therefore many countries have to abandon free trade and turn to protection.
2. In these days of cold war and international misunderstanding dependence on other countries may prove dangerous especially during wars and other

national and international emergencies. Thus free trade may not be in the interest of the countries in the long run.

3. Free trade presupposes specialization in some goods and may lead to lop-sided development of a country. Such lopsided development is not in the interest of a country at any time.
4. International trade has promoted inter-dependence of nations and this has been mainly responsible for the spreading of the effects of depression from one country to another.
5. Free trade presupposes the existence of Laissez Faire and the working of price mechanism under perfect competition. But these conditions do not exist in he present day world
6. Free trade leads to the emergence of international monopolies and local monopolies. Such monopolies developed with a spread of Multinational Corporation under free trade which proved harmful to other countries and the domestic interests.
7. Countries with better factor of endowments are able to produce certain commodities cheaper than others. This led to cut-throat competition in the world market under free trade. Certain countries like Japan resorted to the policy of dumping. Naturally, free trade policy led to the imposition of trade restrictions.

PROTECTION:

Protection refers to the foreign trade policy of encouraging home industries by paying bounties (or giving subsidies) to domestic producers, or more usually by imposing customs duties on foreign products. The term protection usually carries in a very loose sense the connotation of a tariff on imports; but it may refer to any policy that raises the price of import substitutes and safeguards the interest of domestic producers against foreign competition. Tariff system, i.e., customs duties, is an important and most common method of protection. By tariff barriers we mean only those taxes which are intended to restrict international trade. Protection is an established creed of modern trade policy. Yet it remains to be examined whether, protection is a healthy policy leading to an economic millennium or a policy abounding in hidden dangers.

Since the beginning of the 20^{th} century, protection has become a factor in trade. Trade restrictions in the form of tariffs, quotas, exchange control etc., have become too common. Among the nations of the world, U.S.A is the first country, Germany as the next country, where there was a strong reaction in favour of protection. Among the nations of the world U.S.A. is the first country where protectionism appeared in the early 19^{th} century after the end of the Napoleonic wars. Germany was the next country where there was a strong reaction in favour of protection. Subsequently many countries began to feel that the only weapon for reconstruction and development was protective tariffs.

Main arguments for the policy of protection: (Advantages)

1. **Infant industry argument:**

   According to J.S.Mill, a less advanced newly developing industry can hardly improve without being assisted by protective tariffs. It is said "nurse the baby, protect the child and free the adult". This statement indicates that once the industry becomes a major and is able to stand on its own legs, the duties should be removed

2. **Employment argument:**

There is a Keynesian school who advocate protection as a cure for unemployment. Restrictions of foreign imports will lead to expansion of domestic industries and more employment opportunities will be created.

3. **Self-sufficiency argument:**

Prof.Frederick List and others of the German School advocate protection in the interest of national self-sufficiency. During a war of during national emergencies, a nation should not be depending on other countries for her needs. Hence development of all industries irrespective of the cost of production is advocated by these people.

4. **Defence industries argument:**

Adam Smith advocates protection to build up military self-sufficiency. Tariffs and bounties must be to build up defence oriented industries producing tanks, guns, gun powder, defence food supply, military uniforms etc.

5. Key or basic industry arguments:

Basic industries like iron and steel, chemicals, cement and electrical are of paramount importance for industrialization as the products of these industries are used by other industries. They have therefore a strong case for protection, even if such industries do not enjoy any comparative advantages.

6. Keeping money at home argument:

This is essentially an eastern economic idea of Mahatma Gandhi and his followers. When we buy home-made hoods we retain the goods as well as money at home whereas when we import commodities we pay money to the foreigner and get only the goods. Therefore they advocate protection to keep the money also at home.

7. Revenue argument:

Tariffs are also levied to raise revenue for the state and there are those who advocate protection on fiscal grounds.

8. Conservation of national resources arguments:

Dr.Price points out the export duties are necessary to prevent undue export of essential raw materials. It is because of free trade that England and South Africa lost most of their gold and India its manganese and mica. India should have a high export tariff on iron ore, mica and other rare minerals in order to keep the national resources at home.

9. Bullionist argument:

According to the advocates, foreign trade is essentially to earn gold and so imports just be restricted and exports encourages at all costs. This mercantilist idea is obviously unsuitable today and if all are to sell and no one to buy, there will be no trade at all.

10. Anti-dumping arguments:

Protection by tariff becomes unavoidable when a country dumps things to capture market or wipe out an industry in the home country or to clear unsold stocks.

11. Diversification of industries argument:

According to this argument a balances economic development calls for diversification of industries. Dependence on one industry or few industries is always dangerous. To avoid such dangers, protection is advocated with a view to diversity protection.

12. Balance of trade argument:

A country with ill-developed (sick) industries will have to be importing most of the goods from foreign countries and as a result will always have an unfavorable balance of trade and the rate of exchange will turn against the country. In order to cut down the imports from abroad and save the rate of exchange, the country must develop her industry by offering protection.

13. Wages argument:

Protection is also sometimes advocated on the ground that it keeps out goods coming from countries where labour is cheap and thus eliminates injurious competition. Therefore it becomes necessary for a country with high wages to protect her industries to maintain the high level of wages.

14. **Most Favoured Nations Argument:**

In order to encourage imports from certain countries, some advocates recommend import duties on goods coming from other countries. The European Common Market, General Agreement on Tariffs and Trusts, Kennedy Round Pact etc. is a few institutions designed for this purpose.

Disadvantages of protection or Dangers of protection:

Protection is not to be accepted as an unmixed blessing. It is clear that most of the arguments adduced in favour of protection are coloured by prejudices rather than by reason. The positive dangers of protection against which safeguards must be raised are:

1. Protection makes the home producers lethargic and industries may stay undeveloped.
2. A really protective duty will bring about loss of revenue to the government and the state will be the loser.
3. The consumers in the home country are barely hit by protection and they are forced to undergo great sacrifices. They either suffer from rise in the prices of imported goods or forego the use of quality products.
4. Vested interests develop and protected industries grow into monopolies. Protection has always been abused and combinations in the form of trusts and cartels have often developed leading to international activities. Tariff is a said to be the mother of trusts.
5. Protection very often leads to corruption and even undeserving industries are given protection.
6. Under the comfort of protection industries feel secure and refuse to be deprotected even when protection is not called for.
7. Protection of home industries removes foreign competition and perpetuates weak and inefficient concerns. The result is that capital and labour that could be employed more productively elsewhere is diverted and there is the growth of industries in unsuitable areas.
8. Under protection the resources of the country artificially forced into certain channels and are not utilized in the remunerative manner. The result is reduction of national dividend.

9. While granting protection, discrimination is often made between one industry and another while granting protection. The step motherly treatment meted out to a large number of industries while fastering a few selected ones will not promote a healthy industrial growth.
10. Protection is not good neighborliness. It breeds international hatred and jealously.

Inspite of all the arguments against adoption of a policy of protection, it is fully justified in the case of an economically backward country whose countries are in a state of infancy. However, care should be taken that their protection actually stimulates and does not act as an opiate. Protection should be given only when the industry is ill and it should be discontinued as soon as the industry is restored to health and vigour.

FORMS OF PROTECTION OR PROTECTIONIST DEVICES

There are several ways in which protection may be given to domestic industries namely import duties, import quotas, subsides, bounties, exchange control etc.

1. **Import duties:**

   Import duties otherwise known as tariffs, are charged in goods which are a rival to similarly produced home articles. If the tariff is levied and calculated on the basis of the physical unit of the import, it is known as a **specific duty**. But if the duty is calculated on the basis of value of the imports it is known as an **ad-valorem duty**. A customs duty is known as a **compensatory duty**. If it is levied on imported goods for the purpose of raising the prices to protect the domestic produces from losses. **A counter veiling duty** may be levied on those imported goods which are made cheap by their home governments through subsidies or bounties. If customs duties are imposed solely to raise revenue for the state, they are referred to as **revenue duties**.

2. **Bounties:**

They refer to the grant of monetary help given by the government to struggling home industries to enable them to face foreign competition successfully and stand on their feet in due course of time. Bounties are also known by the term subsidies by the point of view of the consumers. Bounties are also known by the term subsidies by the point of view of the consumers. Bounties are preferable to import duties since they will not raise prices. However, bounties are a burden to the state and this burden is ultimately borne by the tax payers.

3. **Import Quotas:**

Import quota system is one of the important forms of trade restrictions today. Under the quota system a limit is placed upon the amount of foreign foods that are allowed into the home market. The government carefully estimates the expected annual requirement of the commodity that cannot be produced within the country and grants licenses or permits to importers for importing the commodities. Quotas system has an advantage over the tariff system as the prices of the imports will not be raised. But the government has to incur a lot of expenditure on their administration.

4. **Exchange control:**

The chief object of exchange control is to restore balance of payments in the country's trade. Exchange control takes many forms such as devaluation of the currency or its depreciation or deflation. Under exchange control foreign exchange earnings of the citizens are collected and rationed out to those people who want to import goods from aboard on a priority basis.

In the recent past, all these four methods of restricting imports have been tried in India with a good measure of success. The most popular of these is the import tariffs. Next in importance come import quotas and then exchange control. Bounties as a method of protection have not become very popular in India.

PROTECTION IN UNDERDEVELOPED COUNTRIES(UDCs)

Protection has special appeal for underdeveloped countries because

a) They want to have a larger share of the gains from international trade.
b) Increase the rate of capital formation.
c) Promote industrialization.
d) Reduce unemployment.
e) Maintain equilibrium in the balance of payments.

a) **Terms of trade:**

The increase in the gains from international trade of an udu is based on the terms of trade argument. Under developed countries produce primary goods and the development countries produced the manufactured goods. The developed countries gain in the form of higher wages and profit by exporting manufactured goods to the underdeveloped countries at higher prices while the gains in food and raw materials produced by the underdeveloped countries. Therefore underdeveloped countries should adopt the policy of protection which raises export prices of their products. This will improve their terms of trade and improvement in the terms of trade will increase the income of the country and it will be in a position to import larger quantities of capital goods.

b) **Capital Formation:**

One of the principal sources of capital formation in Udcs is to increase the domestic savings for further investment. Domestic savings can be raised by restricting the importation of consumer goods by imposing prohibitive import duties. As a result the consumption expenditure of the people is reduced which is equivalent to increase in savings? This increase in savings can be utilized for importing capital goods. Thus for capital formation, the savings ratio should be increased by a reduction in the imports of consumer goods through protection duties and capital goods by the same value should be imported.

c) **Industrialization:**

Protection is advocated to support a general programme of industrialization in Udcs. There is such urgency for industrialization because the economics of such countries are heavily dependent upon the production and export of primary goods. Low process of these goods against the manufactures goods of developed countries have led to the worsening of the terms of trade of Udcs. Therefore such countries should diversity their economics by a policy of industrialization so that dependence on primary goods should be removed. For this purpose, they need to develop import substitution and export promotion industries by the policy of protection.

d) **Reduce Unemployment**:

In an UDC, there is wide difference between wages of agricultural workers and industrial workers. Due to underemployment in rural areas, wages tend to be low in agriculture as the marginal product of labour is negligible or zero. As a result, there is a gap in prices and costs between agriculture and industry. A policy of protection to industries will compensate for this gap by providing employment to the surplus labour force in industry. Since agriculture is less productive than industry, real income can be raised by factor redistribution through a policy of protection in Udcs.

e) Balance of Payments:

One of the principal objectives of protection in an Udcs is to prevent disequilibrium in the balance of payments. The imposition of tariffs leads to the restriction of imports and encouragement of exports, thereby making the balance of payments favourable for the country.

THEORIES OF INTERNATIONAL TRADE

International trade theories are simply different theories to explain international trade. Trade is the concept of exchanging goods and services between two people or entities. *International trade* is then the concept of this exchange between people or entities in two different countries. People or entities trade because they believe that they benefit from the exchange. They may need or want the goods or services. While at the surface, this many sound very simple, there is a great deal of theory, policy, and business strategy that constitutes international trade.

International trade theory provides explanations for the pattern of international trade and the distribution of the gains from trade. The theory convinces most economists of the benefits of liberal trade. But many non-economists oppose liberal trade. Opponents include some who may have encountered trade theory but nevertheless fall prey to fallacious reasoning. This article attempts to convey why trade theory is so persuasive to economists and also to deal with why many non-economists are not persuaded.

CLASSICAL THEORY OF INTERNATIONAL TRADE

Adam Smith is the first classical economist advocated the principle of absolute advantage as the basis of international trade. He extolled the virtues of free trade. These are the result of the advantages of division of labour and specialization both at the national and international levels. The division of labour at the international level requires the existence of absolute differences in costs. Every country should specialize in the production of that commodity which it can produce more cheaply than others and exchange it for the commodities which cost less in other countries. According to Adam Smith, “Whether the advantage which one country has over another been natural or acquire, is in this respect of no consequence”.

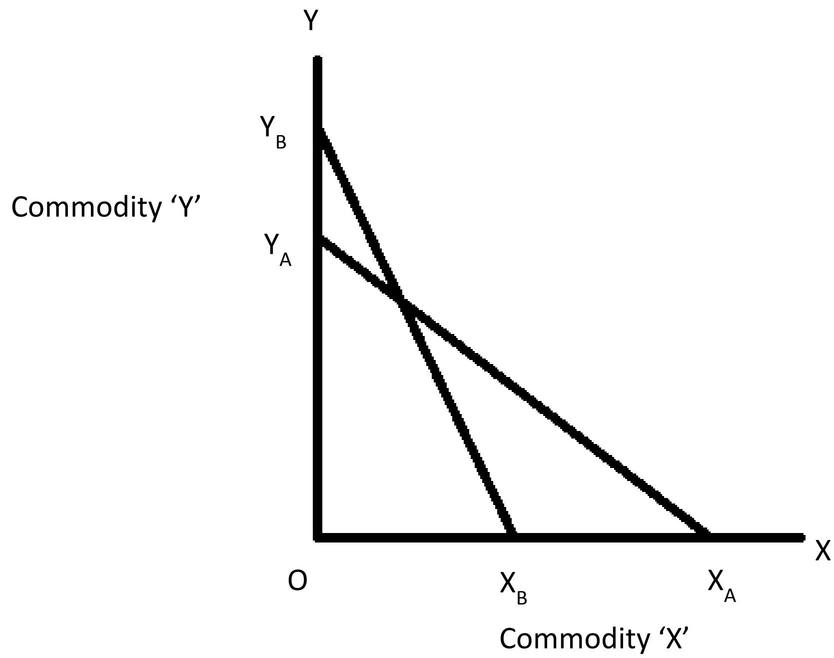
To illustrate, let there be two countries A and B having absolute differences in costs in producing a commodity each X and Y respectively at an absolute lower cost of production than the other.

Country X	Commodity Y	Commodity
A	10	5
B	5	10

The table reveals that country A can produce 10x or 5y with one unit of labour and country can produce 5x or 10y with one unit of labour. In this case, country A has an absolute advantage in the production of x(10x > 5x) and country B has an absolute advantage in the production of y for (10y> 5y). Trade between the two countries will benefit both, which is shown in the table given below.

Country	Production before Trade		Production after Trade		Gains from Trade	
Commodity	X	Y	X	Y	X	Y
A	10	5	20	-	+10	-5
B	5	10	-	20	-5	+10
Total Production	15	15	20	20	+5	+5

The above table reveals that before trade both countries produce only 15 units of the two commodities by applying one labour unit on each commodity. If A is to specialize in producing commodity X and use both units of labour on which its total production will be 20 units of X. Similarly if B is to specialize in the production of commodity Y alone, its total production will be 20 units of Y. The combined gain to both countries from trade will be 5 units of X and Y. This can be illustrated by the diagram.



This figure illustrates absolute differences in costs with the help of production possibility curves. Y_A X_A is the production possibility curve of country A which shows that it can produce either OX_A of commodity X or OY_A of commodity Y. Similarly country B can produce OX_B of commodity X or OY_B of commodity Y. The figure also reveals that A has an absolute advantage in the production of commodity X ($OX_A > OX_B$) and country B has an absolute advantage in the production of commodity Y ($OY_B > OY_A$).

But Adam Smith has been criticized by others. According to Ellsworth, Smith assumes that international trade requires a producer of exports to have an absolute advantage that is,an exporting country must be able to produce with a given amount of capital and labour, a larger output than any rival but this basis of trade is not realistic because there are many underdeveloped countries which do not possess absolute advantage in the production of any commodity and yet they have trade relation with other countries. Thus Smith's analysis is weak and unrealistic.

RICARDO'S THEORY OF COMPARATIVE DIFFERENCES IN COSTS

According to David Ricardo it is not the absolute but the comparative differences in costs that determine trade relation between two countries. Production costs differ in countries because of geographical division of labour and specialization in production. Due to differences in climate, natural resources, geographical situation and efficiency of labour a country can produce one commodity at a lower cost than the other. In this way, each country specializes in the production of that commodity which its comparative cost of production is the least. Therefore when a country enters into trade with some other country, it will export those commodities in which its comparative production costs are less and will import those commodities in which its comparative production costs are high. This is the basis of international trade, according to Ricardo.

It follows that each country will specialize in the production of those commodities in which it has the greatest comparative advantage or the least comparative disadvantage. Thus the country will export those commodities in which its comparative advantage is the greatest and import those commodities in which its comparative disadvantage is the least.

In this theory, we are concerned with labour cost of production. We can divide the cost of production differences between the countries into three kinds.

1. Absolute cost differences.
2. Equal cost differences.
3. Comparitive cost differences.

Assumptions:

1. There are only two countries say Japan and Portugal.
2. They produce the same two commodities say Wine and Terylene.
3. There are similar tastes in both the countries.
4. Labour is the only factor of production.
5. The supply of labour is unchanged.
6. All units of labour are homogeneous.
7. Prices of two commodities are determined by labour cost.

8. Commodities are produced under the law of constant cost.
9. Technological knowledge is unchanged.
10. Trade between the countries takes place on the basis of barter system.
11. Factors of production are perfectly mobile within a country but are immobile between countries.
12. There is free trade between the countries.
13. No transport cost in carrying trade is involved.
14. All factors of production are fully employed in both the countries.
15. The international market is perfect.

1. Absolute cost differences:

Let us assume that one day's labour can produce four meters of Terylene and one bottle of Wine in Japan and a similar one day's labour can produce one meter of Terylene and four bottles of Wine in Portugal. This will mean that Japan has an absolute advantage in the production of Terylene and Portugal has an absolute advantage in the production of Wine. This is explained as below.

Japan	One day labour produces	4mts of Terylene	Labour cost ratio
	One day labour produces	1 bottle of Wine	4:1
Portugal	One day labour produces	1mt of Terylene	
	One day labour produces	4 bottles of Wine	1:4

By this arrangement, both the countries will benefit 4 bottles of Wine produced in Portugal can be exchanged for 16mts of Terylene in Japan. (In Japan 1 bottle of Wine = 4mts of Terylene). Similarly, 4mts of Terylene produced in Japan can be exchanged for 16 bottles of Wine in Portugal. (In Portugal 1mt Terylene = 4 bottles of Wine).

2. Equal cost differences:

Japan	One day labour produces	2mts of Terylene	Labour cost ratio
	One day labour produces	1 bottle of Wine	2:1
Portugal	One day labour produces	4mt of Terylene	4:2
	One day labour produces	2 bottles of Wine	= 2:1

In the above example, both in the production of Wine and Terylene Portugal have equal advantage over Japan (2:1).Therefore, countries do not stand to benefit by international trade. Therefore, under equal cost differences, international trade cannot take place.

3. Comparative cost differences:

According to Ricardo 'It pays countries to specialize in the production of those goods in which they possess comparative advantages or least comparative disadvantages'.

If one day's labour in Portugal produces 4 bottles of Wine and 3 meters of Terylene. The similar labour unit in Japan produces 1 bottle of Wine and 2 meters of Terylene. It is clear that Portugal has an absolute advantage over Japan in the production of both Wine and Terylene.

Japan	One day labour produces	2mts of Terylene	Labour cost ratio
	One day labour produces	1 bottle of Wine	2:1
Portugal	One day labour produces	3mt of Terylene	
	One day labour produces	4 bottles of Wine	3:4

However, Portugal has a comparative advantage in the production of wine over Terylene and it will specialize in Wine production and leave Terylene to be produced by Japan. Similarly, Japan has the least comparative disadvantage in the production of Terylene and it will concentrate in the production of Terylene leaving wine to be produced by Portugal. Both the countries stand to profit by the new arrangement.

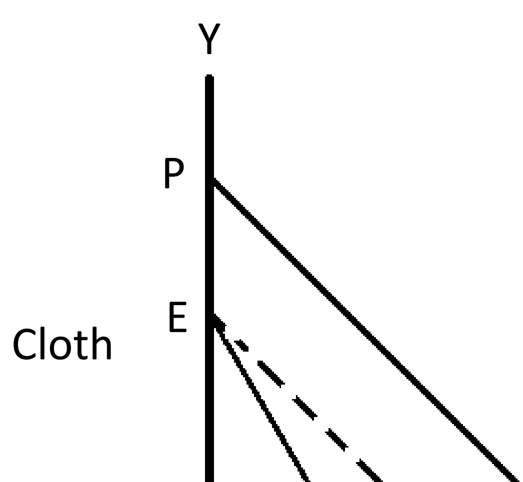
Japan

Before trade one day's Labour produces	2mts of Terylene + 1 bottle of Wine
After trade one day's Labour produces	2 mts of Terylene + $2^{2/3}$ bottle of Wine
	Gain = $1^{2/3}$bottles of Wine

Portugal

Before trade one day's Labour produces	3mts of Terylene + 4 bottles of wine
After trade one day's Labour produces	8 mts of Terylene + 4 bottles of wine
	Gain = 5mts of Terylene

Comparitive advantage position of both the countries is illustrated by the diagram as given below.



O G R L X

Wine

PL - Production possibility curve of Portugal

EG - Production possibility curve of Japan.

Portugal enjoys an absolute advantage in the production of both Wine and cloth over Japan. It produces OL of Wine and OP of Cloth as against OG of Wine and OE of Cloth produced by Japan. But the slope of ER which is parallel to PL reveals that Portugal has a greater comparative advantage in the production of Wine because of it gives up the resources required to produce OE of Cloth, it can produce OR which is greater than OG of Wine of Japan. On the other hand, Japan has the least comparative disadvantage in the production of OE of Cloth. Thus Portugal will export OR of Wine to Japan in exchange for OE of Cloth from Japan.

Criticisms:

1. This theory is described because it is based on number of assumptions which are not applicable to a dynamic world.
2. This theory presupposes free trade which however is not the order of the day.
3. It is believed that both commodities in both countries are subjected to constant return and therefore constant cost.
4. The theory suffers badly under the assumption that labour alone is a factor of production.
5. The theory also presupposes that wages in Portugal and Japan are equal.
6. The theory has also failed to take into account the quality of the products produced in the two countries.

7. The theory has also ignores the cost of transporting things from country to country.
8. There is also an assumption in this theory that there is perfect mobility of factors of production within the country.
9. This is highly impossible that a textile machine may be converted to a wine industry at short notice.
10. Only two countries are involved in trade and that the trade in one two commodities.
11. The theory fails to note that it is not the supply alone that decides the volume of international trade but the conditions of demand also.
12. This theory is based on the assumption of full employment. This assumption makes the theory static.
13. The theory neglects the role of technological innovations in international trade.
14. Complete specialization will be impossible on the basis of comparative advantage in producing commodities entering international trade.
15. It is an incomplete theory. It simply explains how two countries gain from international trade. But it fails to show how the gains from trade distributed between the two countries.
16. Prof.Ohline has criticized that the principle of comparative advantage is not applicable to international trade alone rather it is applicable to all trade.

Despite these weaknesses the theory has stood the test of the times. Its basic structure has remained intact even though many refinements have been made over it.

THE MODERN THEORY OF FACTOR ENDOWMENT

Vertin Ohlin criticized the classical theory of international trade and formulated the general equilibrium or factor Endowment or factor proportion theory of international trade. It is also known as the Modern theory of international Trade or the Hecksher – Ohlin theorem.

Hecksher – Ohlin Theory:

The Hecksher – Ohlin theorem states that the main determinant of the pattern of production specialization and trade among regions is the relative availability of factor supplies. The theory now says that countries that are rich in capital will export capital intensive goods and countries that have much labour will export labour intensive goods. The main cause of trade between regions is the difference in prices of commodities.

Assumptions:

1. It is a two-by-two-by-two model (i.e.) there are two countries (A & B) two commodities (X&Y) and two factors of production (capital & labour).
2. There is perfect competition in commodity as well as factor markets.
3. There is full employment of resources.
4. There are quantitative differences in factor endowments in different regions but qualitatively they are homogeneous.
5. The production functions of the two commodities have different factor intensities (i.e.) labour intensive and capital intensive.
6. The production functions are different for different commodities but are the same for each good in both countries. It means that the production function of commodities X is different from commodity Y. But the technique used to produce commodity X in both countries used to produce commodity Y I both the countries is the same.
7. Factor intensities are non-reversible.
8. There is perfect mobility of factors within each region but internationally they are immobile.
9. There are no transport costs.
10. There is free and unrestricted trade between the two countries.
11. There are constant returns to scale in the production of each commodity in each region.
12. Preferences of consumers and their demand pattern are identical in both countries.
13. There is no change in technological knowledge.

Given these assumptions Hecksher – Ohlin contend that the immediate cause of international trade is the difference in relative commodity prices caused by differences in relative demand and supply of factors as a result of differences in factor endowments between two countries.

H.O. Theorem is explained in terms of two definitions

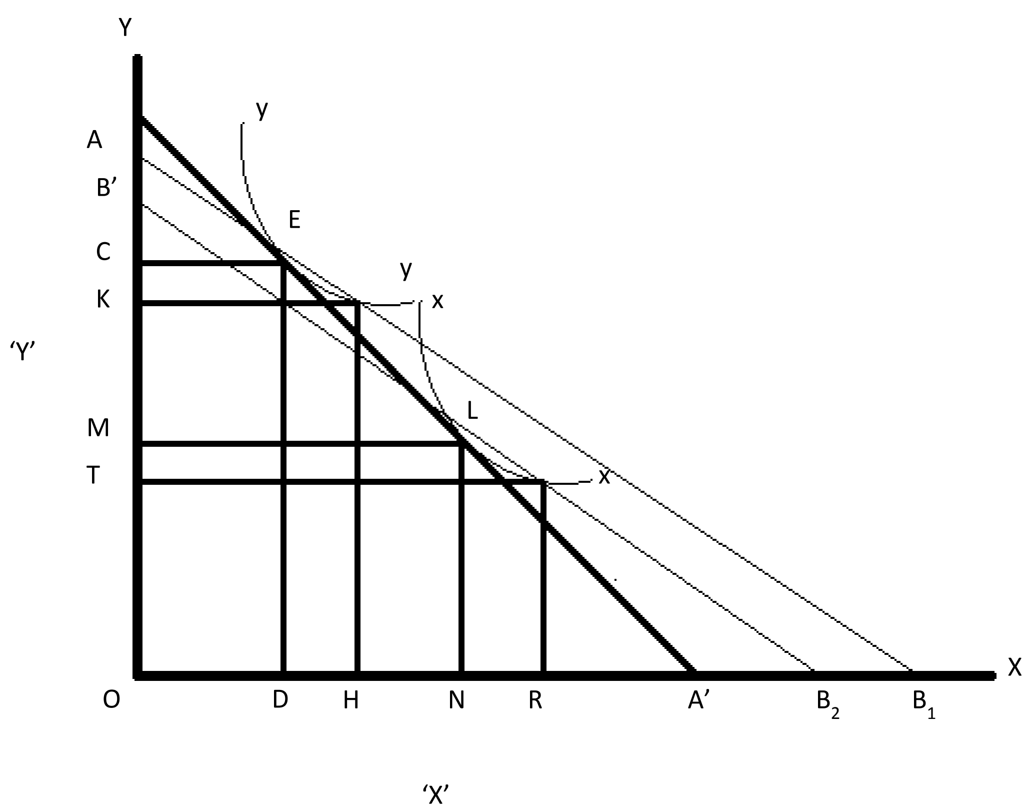
1. Factor abundance in terms of the price criterion.

2. Factor abundance in terms of physical criterion.

1. Factors abundance in terms of factor prices:

H.O. explains richness in factor endowment in terms of factor prices. According to their definition, if capital is relatively cheap in country A, the country is abundant in capital. If labour is cheap in country B the country is abundant in labour. Thus country A will export the capital intensive goods and country B will export labour intensive goods. This is illustrated in the following figure.

Let C be the labour intensive commodity taken on the horizontal intensive commodity taken on the vertical axis. XX is the isoquant of commodity X and YY that of commodity Y. They are the same for both the countries A and B.



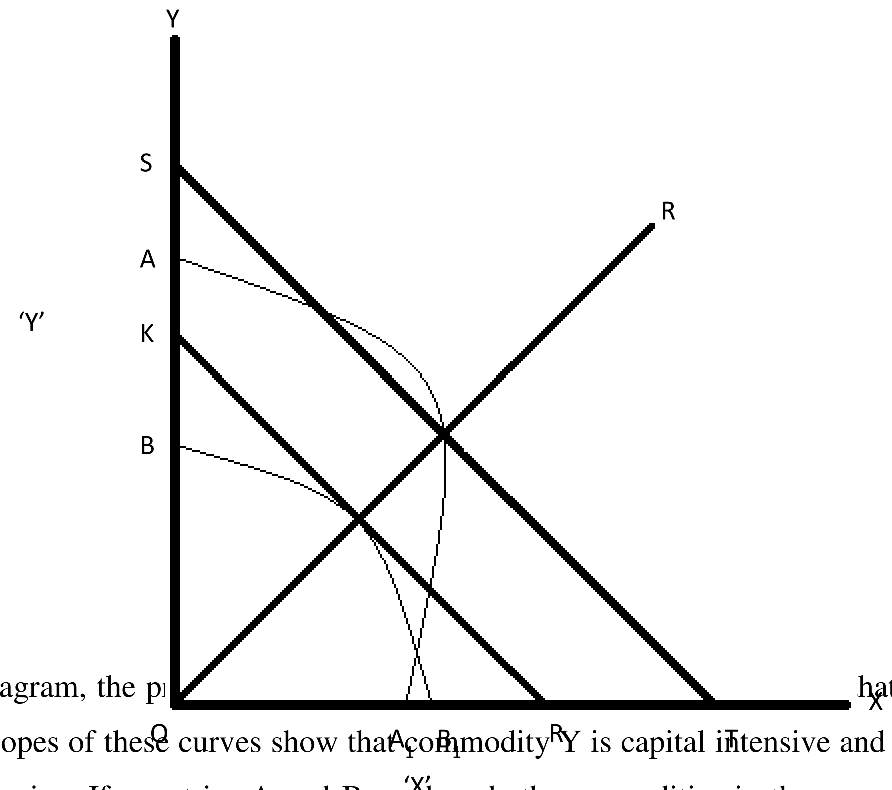
The relative factor prices in country A for both the commodities are given by the factor prices line AA. Assuming that each isoquant represents one unit of the respective commodity then one unit of Y will be produced with OC amount of labour at point E where the iso-cost line AA is tangent to the isoquant YY. By the same reasoning we find that the cost of producing one unit of commodity X in country A is OM amount of capital and ON amount of labour. Since capital is abundant and cheap in country A, it will specialize in the production of the capital intensive commodity. This is clear from the figure where in order to produce one unit of Y, it uses more amount of capital OC with OD of labour at point E on the iso-quant yy while at point L on the iso-quant xx, it uses less amount of capital OM with more of labour ON in order to produce one unit of X. Hence country A will produce and export the relatively capital abundant and cheap commodity Y to the other country B.

In order to find the cost of producing one unit of each commodity in country B where labour is relatively cheap and abundant, draw a flatter factor price line BB tangent to the isoquant YY at point G. A similar factor price line $B_2B_2$is drawn parallel to BB which is tangent to the isoquant XX at point S. How it requires OK amount of capital and OH amount of labour to produce one unit of commodity Y in country B and OT amount of capital and OR amount of labour to produce one unit of commodity X in this country. Since labour is cheap and abundant in country B, it will specialize in the production of the labour intensive commodity X. So it will produce commodity X at point S on the isoquant xx, which requires more amount of labour OR with less amount of capital OT than commodity Y which requires less amount of labour OH with more amount of capital OK at point G on the isoquant yy. Hence country B will export commodity X to country A in exchange for commodity Y.

This establishes H.O. theorem that the capital abundant country will export the relatively cheap capital - intensive commodity and the labour abundant country will export the relatively cheap labour intensive commodity.

Factor Abundance in physical terms:

Another way to explain the Ohlin theorem is in physical terms of factor abundance. If country A is relatively capital abundant and country B is relatively labour abundant then measures in physical amounts CA/LA > CB/LB, where of capital and labour respectively in country A CB/LB are the total amount of capital and labour in country B. This is explained in the following diagram.



In the diagram, the p hat of country B is BB_1. The slopes of these curves show that commodity Y is capital intensive and commodity X is labour intensive. If countries A and B produce both commodities in the same proportion, they will produce both commodities on the same proportion, they will produce along the ray OR. Country A will be producing at point E on its production possibility curve AA_1 and country B at point F on its production possibility curve BB_1. If both produce at their respective points, country A will produce commodity Y which is cheaper in it than in country B. Country B will produce commodity X which is cheaper than in country A. This is clear from the fact that the slope of country A's production possibility curve at E is steeper and that of country B's production possibility curve at F is flatter. This is proved by the slope of the price line ST of country A which is steeper than the price line KR of country B which is flatter. Thus the capital abundant country A has a bias in favour of capital intensive commodity Y from the production side and the labour abundant country B has a bias in favour of the labour intensive commodity X from the production side.

Superiority over classical theory:

The H.O. theorem is an improvement over the classical theory of international trade in many aspects.

1. The H.O. theory is superior to the classical theory in that it regards international trade as a special case of inter-regional or inter-local trade as distinct from the classical theory which considers international trade totally different from domestic trade.
2. The H.O. analysis is cast within the framework of the realistic general equilibrium theory of value. It frees the classical theory from the defunct and unrealistic labour theory of value.
3. The H.O. model takes two factors (i.e) labour and capital as against the one factor (labour) of the classical model and is thus superior to the latter.
4. Again the H.O. theory is superior to the Ricardial theory is that it regards differences in factor supplies as basis for determining the pattern of international trade while the Ricardial theory takes no notice of it.
5. The H.O. Model is more realistic because it is based on the relative prices of factors which in turn influence the relative prices of goods. While the Ricardian theory considers the relative price of goods only.
6. The H.O. theory considers differences in relative production of labour and capital as the basis of international trade while the classical theory takes the productivity of labourers alone. Hence the former is more realistic than the latter.
7. Another merit of the M.O. model is that it is based on differences in factor endowments in different countries as against the quality of one factor labour in the classical theory. Thus the former is superior because it lays emphasis but also on the quantity of factors in determining international values.
8. According to Samuelsson, the Ricardian theory could not explain the causes of different in comparative advantage. The merit of H.O. theory lies in explaining the same satisfactorily.
9. The classical theory demonstrates the gains from trade between two countries. This is related to the welfare theory. On the basis of trade. It thus partakes of the positive theory.

10. According to Heberler, the H.O. theory is a location theory which highlights the importance of the space factor in international trade while the classical theory regards the different countries as space less markets. Thus the former theory is superior to the latter.
11. The H.O. theorem is explicitly based on the assumption of production functions of the two countries. On the other hand the classical theory is based on differences in the production of the trading countries.
12. The H.O. model is more realistic than the classical theory in that the former leads to complete specialization in the production of one commodity by one country and of the other commodity by the second country when they enter into trade with each other. By contrast, the trade between two countries may or may not lead to complete specialization in the classical theory.

Criticism:

1. Ohlin has been criticized for presenting two-by-two-by-two model based on over simplified assumption.
2. Like the classical theory, the H.O. model is static in nature.
3. The theory assumes the existence of homogenous factors in the two countries which can be measured for calculating V factor endowment ratios. But in reality no two factors are homogenous qualitatively between countries.
4. Again, the H.O. model assumes homogenous production techniques for each commodity in the two countries. But production technique is different for the same commodity in the two countries.
5. Ohlin assumes that relative factor prices reflect exactly relative factor prices reflect exactly relative factor endowments. It implies that in the determination of factor prices supply is more important than demand.
6. Prof.Haberler regards Ohlin's theory as, by a large a partial equilibrium analysis.
7. Wijan holds maintains that the right approach is to start with commodity prices rather that factor prices.
8. Ohlin theory has been characterized as ' somewhat vague and conditional'

Despite these criticisms the theory is definitely an improvement over the classical theory as it attempts to explain the basis of international trade in the general equilibrium settings.

FACTOR PRICE EQUALISATION THEOREM

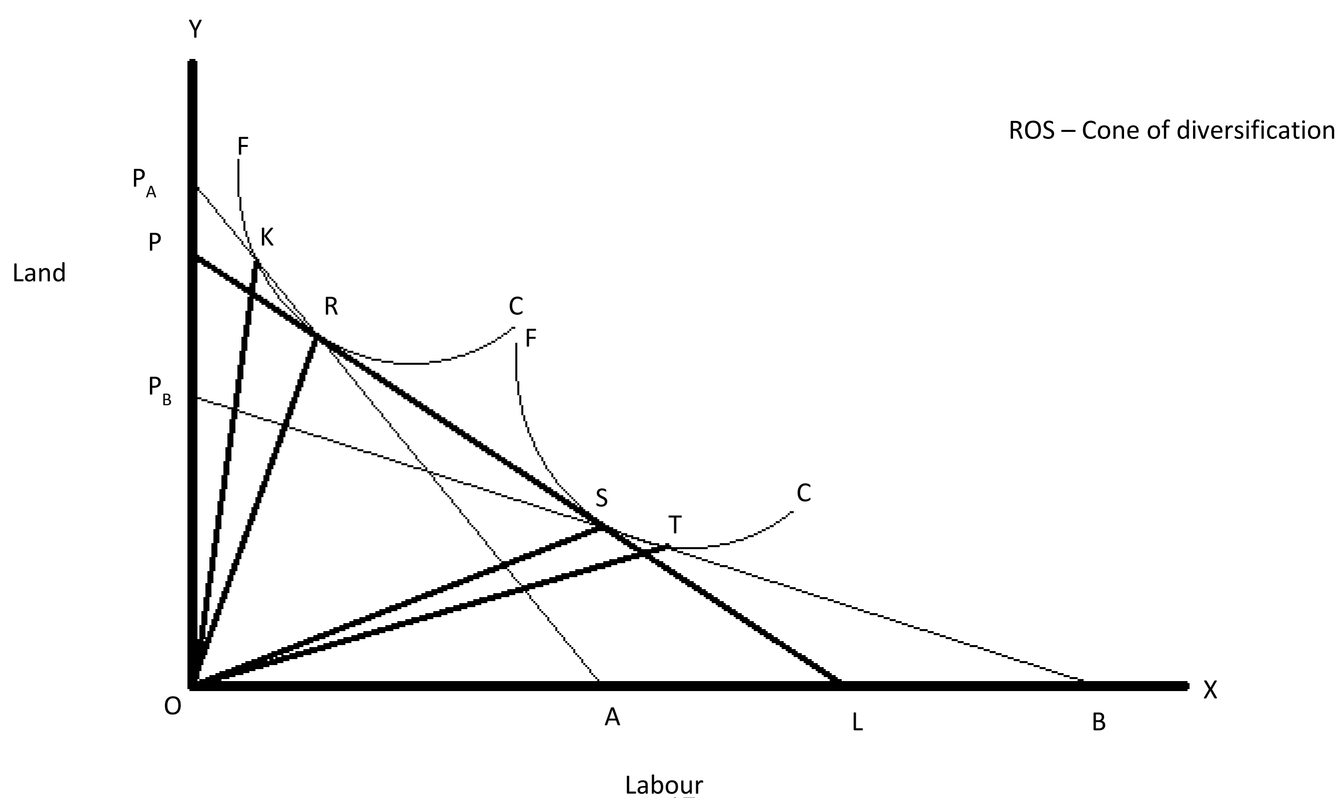
It was Samuelson who in his two articles in the economic journal that few commodity trades will lead to complete factor price equalization. The Samuelson's theorem is based on the following hypothesis or **assumptions.**

1. There are only two countries say A (America) and B(Britain).
2. They produce and trade two commodities say food and cloth.
3. There are two factors of production, land and labour be produce these commodities.
4. The production function of each commodity is homogenous of degree one and hence subject to Euler's theorem. In other words they show constant returns to scale.
5. The factors of production are subject to the law of Diminishing Marginal Productivity.
6. Factor intensities are different for each commodity. In other words production functions have constant elastics of substitution. Thus food is relatively land-intensive and clothing is relatively labour intensive.
7. The technical production function for each commodity is the same in the two countries.
8. Land and labour inputs are assumed to be qualitatively identical in the two countries.
9. There is perfect competition with absence of tariffs and transport costs.
10. Factors of production do not move between the two countries.
11. The quantities of factors of production used in production are assumed to be constant.
12. Both countries produce both commodities with both factors of production. It implies that no country moves so far as to specialize completely in one commodity.

Given these assumptions real factor price must be exactly the same in both countries and indeed the proportion of inputs used in food production in America must equal that in Britain and similarly for clothing production. Samuelson gives the following "intuitive proof" of the theorem. Assuming perfect competition the ratio of the price of food to clothing in each country will be equal to the ratio in each country of the marginal cost of producing food to the marginal cost of manufacturing clothing. Moreover, there will be one price for food and one price for clothing in the two countries because it is assumed that trade is free and unrestricted and there are no transport costs.

As prices reflect marginal costs, if prices are equal in the two countries, marginal costs must be also equal. Thus the marginal cost of producing food and clothing is the same in America and Britain. Again assuming identical production functions the marginal productivity of labour is the same in the two countries. And since rewards to factors reflect marginal productivity wages must be equal in the two countries. The same reasoning applies to the other factor, land.

To test Samuelson's intuitive proof, let us suppose that the wage rate is lower in Britain than in America. Since costs are exclusively determined by factor prices, the cost of labour-intensive clothing in Britain would be lower. It will increase the demand for clothing in America. As the production of clothing expands, it raises wages relative to the rent of land. An increase in the ratio of wages to rent must in a competitive market push up the price of labour-intensive clothing relatively to land intensive food in Britain. The same reasoning applies to the production of food and clothing in America. We may conclude with Samuelson that under perfect competitive "the same commodity price ratio must-even in countries of quite different total factor endowments-lead back to a common unique factor-price ratio a common unique way of combining the inputs in the food and clothing industries and a common set of absolute factor process and marginal productive.



The factor price equalization theorem is illustrated in the above diagram in terms of Prof.Lerner's slightly modified presentation. FF is the isoquant for food and CC is the isoquant for clothing. They represent the production function of the two commodities in both countries. Rays OR and OS form what Chapman calls the "cone of diversification" which is ROS in the figure. Assuming that the after-trade factor price ratio for the two commodities in America and Britain is represented by the line PL. It is tangent to the isoquant FF at R and to the isoquant CC at S. Suppose that the pre-trade relative factor price of food and clothing in America are indicated by the slope of the dotted line P_AL_A. This line is tangent to the isoquant FF at point K. It forms the endowment ray OK. If the endowment ray lies outside the cone ROS as it shows in our diagram. America will be completely specialized in the production of land intensive food. But factor prices will not be equalized. Here the land and labour ratio of producing a unit of food is high and the cost of production is also high. This is because the marginal productivity of land in value terms is lower than its rent and the marginal productivity of labour in value terms is higher than its wage. Thus America's domestic factor price ratio are inconsistent with the after trade factor price ratios of food and clothing. Therefore it is only by using relatively more labour and less land at point R on the international price line PL at K on P_AL_A that the marginal productivity of land equals its rent.

Now suppose the domestic factor price ratios of the two commodities in Britain are represented by the slope of the dotted line P_BL_B which is tangent to the isoquant CC at T. It forms the endowment ray OT since this endowment ray also lies outside the cone ROS in the figure. Britain will become completely specialized in the production of labour intensive clothing. But factor-prices will not be equalized. In other words, clothing being labour-intensive the marginal productivity of labour in value terms is lower than its wage and the marginal productivity of land is higher than its rent. Thus the domestic price ratios of producing clothing and food in Britain are inconsistent with the after trade factor price ratio or two commodities. Therefore by employing relatively less labour and more land at point S on the international price line PL than at T on P_BL_B that the marginal productivity of labour equals its wage.

Thus by using OR land/ labour ratio in the production of food and OS land/ labour ratio in the production of clothing the factor prices are equalized in America and Britain at the international price ratio given by the slope of the PL line in the figure. At points R and S the land and labour ratios equal the slopes of the lines OF and OS. The marginal products of land and labour for clothing associated with equilibrium point S are 1/OP and 2/OL. Similarly for food. The price of clothing at point S is equal to wages XOL which is equal to rent XOP.

The same is the price for food at point R = wage x OL = rent x OP.

Hence factors prices of both commodities are equalized.

Criticism:

1. It is assumed that the two factors of production are available in both countries. But it is possible that only one factor is available in one country.
2. It also assumes that production functions are the same in the two countries. As a matter of fact, production functions are never identical.
3. The assumptions of the absence of transport cost are unrealistic.
4. It is based on the assumption of constant returns to scale. It is not correct.
5. It is assumed that no country specializes completely in the production of a single commodity. But there is every one of the country to specialize in the production of one commodity before factor price equalization occurs.
6. It is based on the two commodities and two factor assumptions. If the number of factors of production is more than the number of commodities the theorem will break down.
7. It is in reality a static theory.
8. In the real world there are increasing inequalities in factor incomes rather than equalities in them.
9. It is based on the assumption that the production functions differ in factor intensities. But it is possible that the two production functions do not have the same elasticity of substitution.

FOREIGN EXCHANGE

The term foreign exchange is capable of more than one meaning, according to the context in which the term is used. Casually it refers to the currency of a foreign country. Technically it refers to the mechanism of currency exchange. Politically the term is used to denote the balance of payments equilibrium. Scientifically foreign exchange refers to the various aspects of international money changing. Geoffrey Crowther defines it "as the process of exchanging the money of one country for the money of another". Prof.Evitl definition is "foreign exchange is the mechanism by which payments are effected between two countries having different monetary units". By far the best definition of the term is that of Hawtry Withers, chairman of the Federal Reserve Board of U.S.A. According to him, "Foreign exchange is the art and science of international money changing on the arts side it deals with the instruments of foreign exchange and on the science side it is the study of rate of exchange and the problems connected with it".

When people of a country trade with foreigners they must pay for their imports in foreign currencies and receive payments for their exports in home currencies. Thus there is a constant exchange of currencies which give rise to the problem of foreign exchange. For example, an Indian who sells cotton fabrics to a Britain importer will want payment to be made to him in Indian rupees. The Britain importer however, will make payment only in pound sterling. The foreign exchange mechanism makes it possible for the exchange of sterling pounds for rupees. This however is not an easy problem and there are various aspects to this transaction such as legal aspects commercial aspect accounting aspect as well as political aspect. A number of institutions make up the foreign exchange mechanism and they are discount houses, broken, firms, banks, money changers, exchange dealers and other.

In the example cited above, we discussed commercial transactions of exports. But commercial transaction a part there are other international settlement arising out of loans, interest payments, investments, shipping charges, banking charges, insurance charges, tourist expenditure, donations, capital movement etc also find a place in foreign exchange. These are commonly known as the invisible items of trade.

Rate of exchange:

Rate of exchange is the price of a unit of a country's money stated in the currency of another (i.e.,) the number of units of one currency which could be exchanged in the foreign exchange market for one unit of another currency. It is also known as the external value of the country's money. If, for instance the rate of exchange between the Indian rupee and the U.S. dollar is 32 Indian rupees = 1 U.S. dollar. Then the external value of the Indian rupee expressed in terms of U.S. dollar is 1 $ = 32 Rs.

When the rate of exchange of a currency is quoted in terms of the foreign currency for a unit of home currency it is known as **currency rate.** For example Rupee 1 = 32 dollars, is currency rate for India. For England will be pence rate as their money is expressed in terms of the foreign currency unit namely rupees. When the foreign currency unit is fixed and the home currency equivalent is changed according to the changes in the external value of the home currency it is known as **pence rate**. For example $ 1 = Rs. 31.50. Similarly 1£ = 124N.F. is pence rate for France, but currency rate for England.

Determination of exchange rate:

The important question in foreign exchange is what determines the rate of exchange between two currencies. The equilibrium rate of exchange, of course, will be determined in the foreign exchange market, when it is not controlled by the state in accordance to the general principles of the theory of value (i.e.,) by the interaction of the forces of demand for and supply of the foreign exchange. However, like normal price it is a long term rate of exchange. The market rate of exchange between currencies fluctuates widely under varying conditions around the long term rate of exchange. The different theories of determination of foreign exchange rates are discussed below.

Mint par of Exchange:

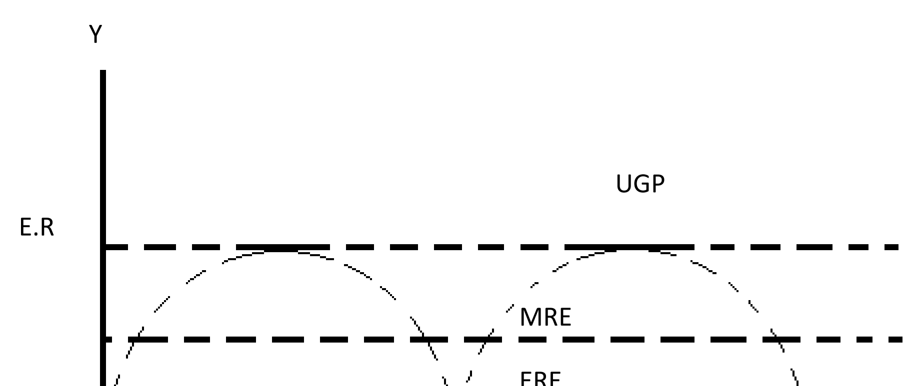
When two currencies are on **gold standard** the rate of exchange between them is the ratio between the quantities of pure gold the currencies contains or to which the currencies are linked by law. This basis is called the mint par of exchange. If for instance, a pound sterling contains 126 grams of pure fold and an U.S. dollar 26 grains of gold of the same purity, then the mint par will be 126/26 = 4.86 (1£ = $ 4.86). Similarly if the German mark contains 6 grains of pure gold, the rate of exchange between pound sterling and German mark will be 126/6 = 21 (1£=G.M.21).

But in actual practice, the rate of exchange will not be exactly equal to the mint par and will fluctuate above and below the par rate depending on the expenses of freight, packing, carriage insurance commission etc., involved in transporting gold from one country to another. The limit for the fluctuation of the rate of exchange are fixed by the gold points known as upper gold point and lower gold point.

Gold will be transported in settlement of transactions if found to be cheaper than obtaining foreign exchange by means of a draft or other foreign exchange instruments. For example, if the mint par is £1 = $ 4.86 and the cost of transporting gold worth New York to London is 26 cent, then New York banker will charge up to $ 5.12 (4.86+0.26) per pound £ for issuing a sterling draft on London. If the banker demands a rate higher than $ 5.12 per pound then gold will be exported at this point and the draft will not be purchased. The highest point to which the rate can go is the upper specie or gold export point. So much so gold export will be equal to mint par plus cost of transport.

Similarly, when the New York exporter discounts a bill drawn on London with the New York bank he will accept equivalent amount in dollar so long as the rate is mint par minus coast of transport of gold from London to New York. If the cost of transport if 23 cents or $0.26 for pound worth of gold, then the rate can go down to the limit of $ 4.60 per pound (4.86 - 0.26). If the rate goes below this level the New York exporter will import gold from London instead of discounting the bill. This lower rate is known as lower specie point or gold import point. So much so gold import point is equal to mint par minus cost of transport.

It should be remembered that the rates need not go up or go down by the exact cost of transport, but they will fluctuate between the upper and lower specie points, depending upon the supply and demand for currencies as shown in the accompanying diagram.



UGP = Upper Gold Point (£ 1 = $ 5.12)

LGP = Lower Gold Point (£ 1 = $ 4.60)

ERE = Equilibrium Rate of Exchange (£ 1 = $ 4.86) Mint par of exchange.

MRE = Market Rate of Exchange.

PURCHASING POWER PARITY THEORY

The purchasing power parity theory is one of the important theories of foreign exchange. It was first expounded by John Wheately and William Blakes. Later it was improved by Ricardo the classical economist. It was perfected and populated by Prof.Gustav Cassel, the Swedish economist. This theory was born out of a controversy and necessity. German writers pointed that inflation was due to the fall in the exchange value of a currency. Gustav Cassel disproved it by restating the purchasing power parity theory. He established that inflation was the cause of exchange depreciation and not vice versa. This theory was then applied to explain the determination of rate of exchange under **inconvertible paper currency system**.

This theory states that the rate of exchange between two countries is determined by the purchasing power of two countries. Cassel observes, ‘Our willingness to pay a certain price for foreign money must ultimately and essentially be due to the fact that this theory possesses a purchasing power as against commodities and services in that foreign country. On the other hand, when we offer so and so much of our money we are actually offering a purchasing power as against commodities and services in our country. Our valuation of a foreign currency in terms of our own therefore depends mainly on the relative purchasing power of the two currencies. “For example, £ 1 purchases a parker pen which can be purchased by $ 5 the rate of exchange will be £ 1 = $ 5. This is what is called the purchasing power parity. The rate of exchange between these two currencies is thus, the ratio between their equal purchasing powers.

Given the normal trade, the rate of exchange established on the basis of purchasing power parity remains unaltered as of these two currencies depends upon the price level in each country, the purchasing power changes for reason of inflations and deflation. Naturally when the purchasing power changes,the rate of exchange also changes. Ultimately, the new rate established will be equal to the old rate multiplied by the quotient of the degree of inflation in each country. For eg, the old rate is £ 1 = $ 5 and if inflation occurs 4 times in U.S.A. and two times in England then the new rate of exchange will be £ 1π 1X2 and $ 5X4 i.e., £ 2 is equal to $ 20 i.e., £ 2 = $ 10. As Cassel says, “this is the new parity which is called the purchasing power parity as it is determined by the quotient of the purchasing power”.

There will be fluctuations in the purchasing power from day to day, especially during the transition period either by sudden movements of capital or by seasonal purchases or by anticipated changes in the future. But the tendency will be towards that rate which will make the internal and external purchasing power equal. If equilibrium is not established in time, the changes in price either in England or in America will bring equilibrium in the rate of exchange. It can be explained with an example. Suppose now the rate of exchange is £ 1 = $ 15 instead of the normal rate £ 1 = $ 10, the dollar will be dear used. American goods will become dear to the Americans. As a result American exports will be encouraged and its imports will be checked. Conversely British exports will be checked and its imports stimulated. This transaction will make the British demand more American dollars to pay imports. The increased demand for dollar will raise the value of the dollar until the exchange rate settles at the actual rate of £ 1 = $ 10.

Criticism:

The importance of this theory lies in its validity. It tells us how the rate of exchange between two countries on inconvertible paper currency system is determined. It brings out the close relation between the internal price level and the external value of the currency. Over and above it has given the correct and the right view about the depreciation of the currency. However, it is not free from defects.

1. According to this theory, the rate of exchange is equal to the purchasing power of the two currencies. But Cassel answers this criticism by saying that the rate of exchange will adjust itself in the long run.
2. This theory assumes that there is a direct connection between the purchasing power of the currencies and the rate of exchange. But this is not so because the exchange rate is often affected by tariff speculation and capital movements.
3. This theory compares the general price levels in two countries without referring to the actual prices of internally and internationally traded goods. Internationally traded goods generally tend to have the same price. But the domestic goods will have altogether different prices.
4. The theory assumes that the prices of traded goods will move together. But this is not true.
5. It is extremely difficult to calculate the rate of exchange on the basis of the purchasing power parities, for no one can practically measure accurately the changes in the purchasing power of currencies.
6. The greatest weakness of this theory is that it falls to take into account invisible items such as long term capital interest, dividend, tourist expenditure, etc, in the balance of payment.
7. This theory at the most explains the ultimate factor namely the purchasing power rather than the immediate factors like tariff, supply and demand for foreign currency etc., that determine the rate of exchange.
8. An integral part of this theory is that the changes in price level bring about changes in the rate of exchange but not the rate exchange influencing the price level.

Conclusion:

Despite these criticisms, this theory is important because it furnishes the very basis for the determination of rate of exchange under inconvertible paper currency system. It can be applied to the other monetary standards too. It is superior to old theories which explain the determination of rate of exchange on the basis of balance of indebted between countries. Thus it stands as the best theory of foreign exchange.

BALANCE OF PAYMENT THEORY

The balance of payments theory holds that foreign exchange rate is determined by independent factors not related to internal price levels and the quantity of money as asserted by the purchasing parity theory. On the other hand free exchange rate tends to be such as to equate the demand for and supply of foreign exchange. For example the external value of rupee will depend upon the demand for and supply of rupee in the foreign exchange market. According to this theory the rate of exchange is determined by the demand for the supply of foreign exchange.

The demand for rupees comes from those who offer foreign exchange in order to obtain rupees, while the supply of rupees comes from those people, who are offering rupees to obtain foreign exchange. For example, The Indian exporters to Canada demand rupees against the claims of Canadian dollars; and the Indians importing Canadian products offer rupees for Canadian dollars. The interaction of Canadian dollar supply curve and Canadian dollar demand curve gives the equilibrium rate of exchange between Canadian dollars and rupees. The above illustration has been provided with import and export alone accounting for the demand for and supply of foreign exchange. However, there will also be invisible items, entering international trade and the demand for and supply of foreign exchange should constitute all the items that enter the balance of payments.

Demand for foreign exchange:

It arises from the debit side of the Balance of Payments. It is equal to the value of payments made to other country plus loans and investment made abroad.

Supply of foreign exchange:

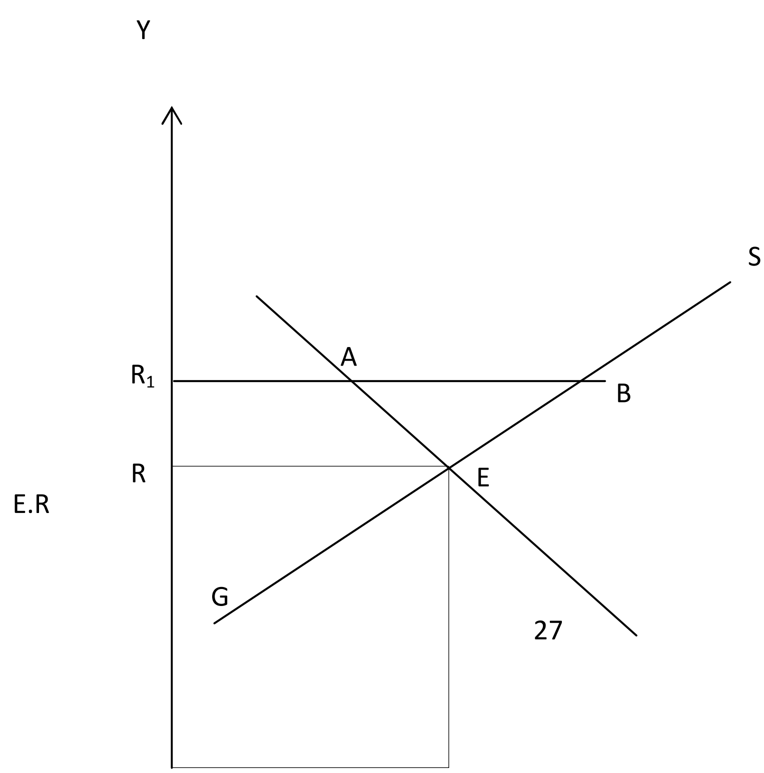
It arises from the credit side of the Balance Of Payments. It equals payments made by other country plus loan and investment made in this country.

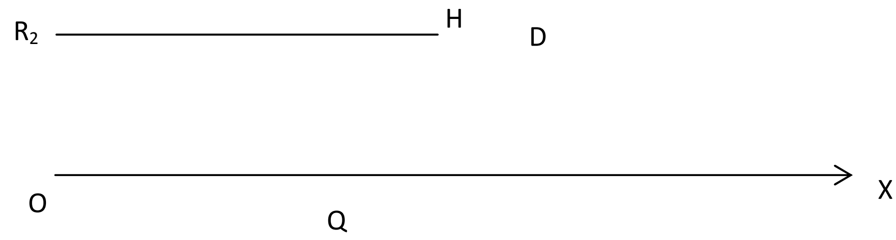
When BOP is unfavorable then demand for foreign exchange is more than its supply. Thus causes the external value of the domestic currency to fall. So the exchange rate falls.

When BOP is favorable the demand for foreign currency is less than its supply. This causes the external value of the domestic currency to rise. So the exchange rate rises.

When the exchange rate falls below the equilibrium rate exports increase and the disequilibrium of BOPs is eliminated. When the exchange rate rises above the equilibrium rate exports decline and the favorable BOP disappear and the equilibrium rate is established. Thus at any point the rate of exchange is determined by the demand for the supply of foreign exchange. This is shown in a diagram.

Balance of Payment Theory





dd&Sy of Foreign Currencies

DD is the demand curve. It slopes downwards because when the exchange rate raises the demand for foreign currency falls and vice versa. SS is the supply curve. It slopes upwards because when exchange rate falls, the account of foreign currency offered for sale will be less and vice versa. The two curves intersect at E where OR equilibrium rate is determined. At this rate the quantity of foreign exchange demanded and supplied equals OQ. E is also the point where the balance of payments is in equilibrium. Suppose the exchange rate is above to OR_1 the demand is less than supply ($R_1A < R_1B$). If the exchange rate is falling to OR_2 the demand is greater than supply ($R_2H > R_2G$) it shows unfavorable balance of payment.

Criticism:

1. Balance of payment is independent of the exchange rate.
2. It neglects the role of price level in influencing balance of payment.
3. It is based on unrealistic assumption of free trade.
4. Equilibrium rate of exchange may not be one of balance of payments. There is no tendency for balance of payments to be in equilibrium over the long run.

Exchange Control

Any kind of interference by the Government or its agents in the foreign exchange market is said to be exchange control. Though exchange control is adopted as a measure of solving adverse balance of payments, the main purpose of exchange control is to ensure the stability of exchange rates. Such a stability of exchange rate is necessary for the smooth running of trade and industry of any country.

In the history of exchange control, different countries have adopted the measure for different **purposes.**

Firstly, in order to prevent a run on foreign exchange, exchange control may be practiced.

Secondly, countries may adopt exchange control when the normal mechanism of the exchange market is found to be ineffective.

Thirdly, with a view to accumulate foreign exchange in order to acquire equipment or a machine at a later date, countries may go in for exchange control. A number of countries have adopted the measure for this reason in order to catch up with the technological developments taking place in other parts of the world

Fourthly, exchange control may be self imposed on a country when there is sufficient reason to freeze the assets of foreign nationals, foreign companies and foreign investments of all other kinds. In 1949 Government of India freeze the balances of all Japanese companies when they tried to close their business in India.

Fifthly, exchange control is said to go hand in hand with economic planning. Every plan has an element of foreign exchange, priorities and foreign exchange allotted accordingly. The success or failure of the plans depends on the effective implementation of exchange control.

Sixthly, exchange control may be adopted by a country to under value its currency with a view to increase its exports and decrease the imports or over value its currency to move with the trend of imports and exports.

Seventhly, exchange control may be adopted by a country tp prevent the import of foreign goods into the country and thus encourage local industries with a view to bring about increased level of economic activity and employment.

Exchange control may be adopted for various other reasons as well. For example to prevent excessive tourism, to safeguard home industries and avoid foreign money encouraging spying in the country exchange control may come in handy.

Methods of Exchange Control

There are a large number of exchange control methods; it is very difficult to enumerate all of them. In his book 'Exchange control' Paul Einzing has given as many as 41 different methods of exchange control. In fact the same method may be known by different names in different nations of the world. However exchange control methods are broadly classified as direct methods and indirect methods.

Direct Methods:

The direct method consists of intervention, restrictions and agreements.

1. Intervention:

Intervention refers to Governmental or Central Bank's interference in the foreign exchange market. The intervention may be by pegging operations and embargo on capital. Of these, pegging operations are adopted to stabilize the exchange value it moves away from the equilibrium rate of exchange. For instance, if the equilibrium rate of exchange rate is Re.1= 1s.6d. and the British demand for rupees increases while the Indian demand for British pound remains the same, the rate of exchange will move in favor of India. (may be Re. 1= 1sh. 10d.) . To bring down the exchange rate to the equilibrium level, Indian rupees have to be unloaded in the British market to increase the supply of rupees. This operation is known as "pegging down". The opposite of this, while the British pounds will be unloaded in Indian, is known as "Pegging up"

Embargo on capital will include prohibition of subscription to foreign government loans and shares of foreign companied. Transfer of capital belonging to emigrants may also be controlled under the embargo on capitals. Such capital transfers may be permitted in installments over a period of time as it is being done in the case of Anglo-Indian emigrants from India.

Of late exchange equalization accounts have been used as effective methods of exchange control. The account is a pool of funds of various currencies as well as gold, left in the hands of the central bank or the treasury, with which foreign currencies are bought and sold as the situation may demand. If a particular currency appreciates in value more of that currency will be released from the fund to control further appreciation. Similarly, when a particular currency depreciated in value more of that currency will be purchased out of the fund, in the foreign exchange market to offer exchange support for the currency.

2. Restrictions:

Exchange control by means of restriction may take three different forms, namely

i) centralization of all trading in foreign exchange, ii) blocked accounts and iii) multiple exchange system.

i) Centralization of all trading in foreign exchange:

As a wholesale dealer of foreign exchange all trading in foreign exchange are centralized in the hands of the central bank of the country. Foreign exchange for the purpose of imports or payments abroad is very much restricted as to their quantity and direction. In most of the developing countries, a list of priorities is prepared for release of foreign exchange.

ii) Blocked accounts:

Under this method, foreign exchanges are released for import only after earning the foreign exchange by exports. Similarly, foreign exchange earned by the foreigners is permitted to be used for purchase of goods in the home currency. Germany adopted this method in 1933 and gave it up after a period of ne year's bad experience with it.

iii) Multiple exchange system:

The system of multiple exchanges is another form of exchange control. It implies fixing different rates of exchange for the imports and exports of different commodities. To secure a good price for exports and reduce the volume of imports is the objective of this method. However it complicates the complicated foreign exchange mechanism and is nor to found to be.

3. Exchange Clearance Agreements:

This is the third broad classification of direct exchange control methods and four types of agreements are popular today among the nations of the world. The first known exchange clearance agreement was signed between Switzerland and Germany in 1939. This agreement was more or less a compensation agreement which lasted for a few years and then withered away.

The types of agreements that prevail among the countries of the world can be broadly being divided into four types. i) Compensation agreements, ii) Clearing agreements, iii) Payment agreements and iv) Standstill agreements.

i)Compensation agreements:

This is sort of an old fashioned barter where in goods are exchanged for goods at a fixed ratio. E.g. India-Pakistan cotton agreement falls under this head. Under this agreement, Pakistan cotton is exchanged for India's textiles on the quantity basis. However, this type of agreement is not at all popular and the most popular type is clearing agreements.

ii) Clearing Agreements:

This consists of an undertaking by two or more countries to buy and sell goods and services to each other at mutually agreed exchange rates against payments made by the buyer in their own currency and held at the respective Central Bank. The differences , if any at the end of the stipulated period is settled either by transferring gold or an acceptable third currency or by carrying forward the deficit to the renewed agreement or by an extra shipment of merchandise.

iii) Payment Agreements:

When a country has taken a big loan from another nation it often agrees to set aside a portion of its export towards repayment of the loan. Year after year, after earmarking that portion of foreign exchange, the balance available is taken for current transaction. These agreements have the merit of self liquidating the loans as the lender country has to purchase goods to the extent of the amount earmarked for repayment every year.

iv) Stand still Agreement:

Agreements may take the form of standstill agreements as well. By these agreements, repayment of loans and interest payments are postponed to a very distant date and they are not taken into account in the balance of payment year after year. This is also known as transfer moratorium.

2. Indirect Methods:

This consists mainly of i) Regulation of merchandise and ii) manipulating bank rate.

i)Regulation of merchandise:

Since ins outs of merchandise primarily affect the rates of exchange, a proper control on the rate will be by regulating the quantity of exports and imports. Imports are restricted by license, quotas or tariffs. Certain imports may be banned as well. Exports may be stimulated by bounties, subsidies, import entitlements and export promotion. To diversify foreign trade, exports to certain areas may be subsidized and imports from certain areas may be restricted.

ii) Manipulating bank rates:

Manipulating the bank rate is another indirect method. When the bank rate is raised, the interest rate also rises in the country and more capital from outside is likely to be brought about in. This will increase the supply of foreign exchange and regulate the rate of exchange. However retaliatory action on the part of other countries will neutralize the effects of such trade controls.

Merits of Exchange Controls:

1. Exchange control is very indispensable for the country, particularly during the period of war. During the war period, the country may have to import arms and ammunitions and other war materials on a very large scale. This may turn the rate of exchange of the currency of the country very adverse. Hence, exchange control is very essential to check this possibility.
2. Exchange control is essential for a country on the way of economic development. Countries on the course of economic development require large scale imports of machines, raw materials, finished and semi-finished goods and also technicians. This will result in the decline of the value of the currency and to check this trend, the country should exercise all methods of exchange control in order to import essential items for purposes of development.

3. Exchange control is useful in controlling the large scale movement of hot money amongst the countries of the world. The large scale movement of hot money creates several complications for the smooth functioning of the economy. Exchange control is essential for maintaining stability and smooth function of economy.
4. This enables the country to correct the adverse balance of payments, adopt independent economic policy and arrest violent fluctuations in the rate of exchange and also avoid depressionary trend.
5. Economic planning, development of domestic industries, self sufficiency in production, channelization of foreign trade in the desired manner etc., would be possible only through exercising effective exchange control.

Demerits of Exchange control:

1. Since the imports are deliberately curtailed through exchange control, exchange control will result in the contraction of foreign trade. Exports too will also decline in the long run due to exchange control, adopted for foreign countries.
2. Exchange control sacrifices the 'Principle of Comparative Cost'. Only in free trade, this is possible. Under 'Protectionism' administration of exchange control will become very expensive and it requires an army of competent officials.
3. Finally, the system of exchange control will become the source of corruption and it will encourage political and administrative favourism, nepotism and bribery, etc.

Future of Exchange Controls:

Though exchange control is practiced by both developed and developing countries and seems to be necessary to stabilize the exchange rate, exchange control does not solve the problem of foreign exchange. On the other hand, it reduces the volume of trade, checks the flow of capita, leads to smuggling, brings out retaliatory action and prevents people from the use of foreign trade. The effectiveness of exchange control depends very much on the cooperation of other countries by not taking retaliatory action. When all countries adopt exchange control the net benefit of that to any particular country will always be nil.

EXCHANGE RATE POLICY

Exchange rate policy

The exchange rate of an economy affects aggregate demand through its effect on exports and imports, and policy makers can exploit this connection. Exchange rates can be manipulated so that they deviate from their natural rate. Many economists regard exchange rate manipulation as a type of monetary policy.

Rates need to be held down to stimulate exports, and pushed up to reduce inflationary pressure. While the Bank of England does not specifically target the exchange rate, the MPC will consider exchange rates. Clearly, during times of inflationary pressure the MPC would prefer a relatively high rate as this reduces the price of imports and works to dampen inflationary pressure. However, the MPC must keep an eye on export competitiveness, and if rates move too high UK exports will become uncompetitive.

The basic types are a *floating*exchange rate, where the market dictates movements in the exchange rate; a *pegged float*, where a central bank keeps the rate from deviating too far from a target band or value; and a *fixed* exchange rate, which ties the currency to another currency, mostly more widespread currencies such as the U.S. dollar or the euro or a basket of currencies.

Fixed Rate and Flexible Exchange Rate:

The rate of exchange is the rate at which one currency is exchanged for another. It is the price of one currency in terms of another currency. The rate of exchange is fixed or fluctuating.

I. Fixed Exchange Rate:

A fixed exchange rate is also known as pegged exchange rate. The exchange rate is fixed by the monetary authorities by legislation or intervention in currency markets. They may buy or sell foreign currencies according to the needs of the country. They may appreciate or depreciate the national currency. All exchange transactions take place at the fixed exchange rate.

Case for Fixed Exchange Rate or Merits of Fixed Exchange Rate:

The following are arguments in favour of fixed exchange rate.

1. It increases production and leads to foster growth of the economy.

2. It makes prices of goods predictable and encourages international trade.

3. It promotes economic integration.

4. It encourages long term capital flow. There is no uncertainty and risks in this system.

5. It creates confidence in the strength of the domestic currency.

6.All speculative activities are controlled by the monetary authorities. There is no fear of any adverse effect of speculation on the exchange rate.

7. It serves as an anchor and imposes a discipline on monetary authorities to follow responsible financial principles within the country.

Case against Fixed Exchange Rate or Demerits of Fixed Exchange Rate:

The following are the arguments against the fixed exchange rate.

1. The fixed exchange rate policy is maintained at the cost of full employment and stable domestic prices.

2. The effects of unexpected disturbances in the domestic economy are transmitted abroad/

3. A country is required to maintain large reserves of foreign currencies.

4. Complicated exchange control measures are followed by the countries having fixed exchange rate. This will lead to misallocation of the resources of the economy.

5. It is difficult to keep the exchange rate fixed for a long time.

II. Flexible Exchange Rate:

A flexible exchange rate is also known as floating or fluctuating exchange rate. It is not fixed by the monetary authorities. Further it is established by the interaction of the market forces of demand and supply of the currency.

Case for Flexible Exchange Rate:

The following are the arguments in favour of flexible exchange rate.

1. It is simple in operation. It is fixed by the market forces of demand and supply.

2. Under a system of flexible exchange rates, adjustments in the balance of payment are smooth painless and continuous.

3. It preserves he autonomy of the domestic economic policies. Modern government s need not sacrifice their objectives of full employment and growth with stability in order to remove the balance of payments' disequilibrium.

4. There is no need to accommodate gold movements and capital flows between countries. 5. There is no need for foreign exchange reserves when exchange rates are freely fluctuating.

6. There is no need to have international institutional arrangements like the IMF for borrowing and lending short term funds to remove disequilibrium in the balance of payments.

7. It reinforces the effectiveness of the monetary policy.

8. It does not require the introduction of complicated and expensive trade restriction and exchange controls.

9. There is no need for forming customs unions and currency areas.

Case against Flexible Exchange Rate or demerits of Flexible Exchange Rate:

1.The market mechanism may fall to bring about an appropriate exchange rate.

2. It is difficult to define a freely fluctuating exchange rate.

3. It has a bias towards inflation.

4. It breaks up the world market.

II-FLUCTUATIONS IN EXCHANGE RATE:

The rate of exchange is seldom constant. It keeps on fluctuating from time to time. The long period rate of exchange is stable. The fluctuations in the rate of exchange in the short period spell out a large number of harmful effects on the volume of international trade.

Causes for the fluctuations in the rate of exchange in the short period:

1. Exchange in prices:

Change in internal price level results in changes in rate of exchange.

When the price level rises in the domestic country, domestic goods become dearer in the foreign market and the foreign goods become the cheaper in the domestic market. As a result, exports diminish and imports increase. This increases the demand for foreign currency and a new rate of exchange is established.

When the price level falls in the domestic country, the domestic goods become cheaper in the foreign market and the foreign goods become dearer in the domestic market. As a result, exports increase and imports diminish. This increases the demand for domestic currency and a new rate of exchange is established.

2. Change in Exports and Imports:

Changes in exports and imports result in changes in the rate of exchange.

When exports are more than imports, the foreign demand for domestic currency increases and the rate of exchange rises in favor of the domestic currency.

When imports are more than exports, the domestic demand for foreign currency increases and the rate of exchange rises in favor of the foreign currency.

3. Capital Movements:

The rate of exchange is influenced by capital movements.

When a country imports capital to a foreign country, the rate of exchange will move in its favor.

When a country exports capital to a foreign country, the rate of exchange will move against it.

4. Monetary Policy:

When the Central Bank raises the bank rate, more funds will flow into the country from abroad to earn a higher rate of interest. It will tend to raise the demand for the domestic currency and the exchange rate will move in favor of that country.When the Central Bank lowers the bank rate, foreign capital will be repatriated from the country. It will tend to raise the demand for the foreign currency and the exchange rate will move against the domestic country.

5. Issuing of credit instruments:

When an exchange bank issues banker's drafts or other instruments on its foreign branches, the demand for foreign currency increases and the rate of exchange will move against the domestic country.

When an exchange bank receives banker's drafts or other credit instruments from its foreign banker's, the demand for domestic currency increases and the rate of exchange will move in favor of the domestic country.

6. Arbitrage Operations:

Arbitrage operations include buying and selling in different stock of exchange of the world for speculative gains.

When the speculators buy or sell securities in the different stock exchanges of the world, they make speculative gains on account of the differences in their prices. Such arbitrage operations cause changes in the rate of exchange.

7. Stock Exchange Influences:

Stock exchange operations in foreign securities, debentures, stocks and shares, etc., exert significant influences on the exchange rate.

8.Structural Changes:

Structural changes are those changes which bring changes in the consumer demand for goods. They include technological changes, innovations etc.,

When structural changes take place in the domestic country, the foreign demand for domestic products increases. It implies increases in exports, greater demand for domestic currency, appreciations of its value and rise in the exchange rate of the domestic currency and vice versa.

9. Political Stability:

When there is political stability and the government is strong and efficient foreigners will have a tendency to direct their funds into the country. When capital flows into the country, the demand for domestic currency will rise and the rate of exchange will move in favor of the country.When there is no political stability and the government is weak and inefficient.

10. Policy Of Protection:

When the government follows a policy of protection with a view of giving encouragement to the domestic industries, imports are discouraged and the balance of payment of the country becomes favorable to it, as a result, the domestic demand for foreign currencies will go down and the rate of exchange will move in favour of the country.

11. Fiscal Policy:

When the government of a country resorts to deficit financing the internal value, the currency will decline. Foreign capital will flow out of the country. As a result, the rate of exchange will move against the country concerned**.**

INTERNATIONAL MONETARY INSTITUTIONS

After the breakdown of the International Gold Standard in the early thirties the world lost the most efficient automatic standard upon which nations had for long relied for restoring equilibrium in their balance of payments whenever it was disturbed.

Though some rough arrangements aiming at the stability of the foreign exchange rates were made between a certain countries through the technique of exchange stabilization fund established by each country's government, these arrangements did not work satisfactorily, especially after the Second World War. After the war restrictions on multilateral trade and payments increased in severity under the impact of the war and there existed all types of restrictions such as clearing agreements, blocked accounts, multiple exchange rates etc. There was no alternative arrangement comparable to the gold standard, and countries of the world faced three major problems, namely the question of restoration of stability in the monetary systems, reconstruction of the war devasted economics and development of under developed countries of the world.

After the Second World War the need for international monetary co-operation was very keenly felt and monetary experts of Britain and America came forward with their plans for the ailing monetary world. The British Plan took the shape of Keynes' Plan and American plan prepared by Harry White was known as the White Plan. Experts of 44 nations of the world met at the United Nations Monetary and Financial Conference held at Bretton Woods, New Hampshire, a summer resort in north eastern part of the United States of America, in a 22 days conference from the 1st to 22nd July 1944. Out of the deliberations of this conference sprang up the Brettonwoods twins- the International Monetary Fund and the International Bank of Reconstruction and Development – the former to solve the first problem namely the instability in the monetary systems and the latter to solve other two problems of reconstruction of the war devasted economies and development of under developed countries of the world.

International Monetary Fund (IMF)

Since the fall of the gold standard in 1931, rates of exchange between the currencies of the world were very unstable and the result was utter confusion. During the Second World War and later, the situation became so alarming, that statesmen and monetary experts were forced to work on a solution to this problem. Lord Keynes of the United Kingdom proposed a plan in 1943 on behalf of Britain for creating an international clearing union with BANCOR as the international currency acceptable all over the world. According to Keynes plan, countries could buy bancor and settle their obligation to each other. During the same period, Harry White, a monetary expert from America suggested the setting up of a fund which would have all the currencies of the member countries for sale to those who needed them. This plan was called the White Plan. In the Brettonwoods conference held from the 1st to the 22nd of July 1944, the basic elements of these two plans were finally merged into a common plan evolved to set up the International Monetary Fund. The Brettonwoods Act was passed for this purpose with Lord Keynes as the chairman of the meeting. Even though Keynes' plan was not fully accepted, it is no exaggeration to say I.M.F. is the brain child of 'Lord Keynes'.

The establishment of the Fund is a great landmark in the sphere of international monetary co-operation. The main **objectives of the Fund** mentioned in the Fund's Articles of Charter are as under:

1. To promote international monetary co-operation among the nations of the world.
2. To promote exchange stability and maintain orderly exchange arrangements among member countries.
3. To prevent competitive exchange depreciation between nations.
4. To provide for multilateral convertibility of the currencies and remove all exchange controls and restrictions.
5. To help member countries to correct maladjustments in balance of payment.
6. To advise member countries on the right steps to be taken by each country to stabilize exchange rates.

The Fund started operations in March 1947 with its Head office in Washington and its only branch in Paris. The Fund's initial capitals of 8000 million dollars was contributed by its members who were allotted quotas on the basis of gold and dollar holdings, national income, state of international trade, balance of payments position and the economic significance of the countries. On this basis U.S.A. was allotted the maximum quota of $2750 million, Quotas of other leading countries were as under,

Britain	$ 1300 million
Nationalist China	$ 550 million
France	$ 525 million
India	$ 400 million

Nicaragna paid the lowest quota of one lakh dollars. Fund's total membership on March 1, 1947 was only 40. Russia and her satellite countries have not joined the fund even though Russia attended the Brettonwoods conference and was allotted a quota of $ 1200 million. The founder members paid their quota partly in gold – a minimum of 25% of their quota or 10% of their actual holding of gold whichever were lower- and the balance in their own currencies. The allotted quota was subject to revision every five years and in October 1959, at the annual meeting of the Fund held at New Delhi a general increase of 50% in the quotas of all member countries with larger increases in the quotas of certain selected countries – Canada, Germany and Japan- were effected. With this change West Germany moved up in the ladder and came to occupy the third place, held up the nationalist China before.

Currency of each country was given a par value in terms of gold as a common denominator and any change in this ration was to be made only with the consent of the Fund. The Indian rupee was declared equal to 0.2686 grams of gold of 11/12 fineness in 1945, when India joined the Fund. This was lowered to 0.1866 grams of pure gold in June 1966 when the rupee was devalued for the second time.

Organisation and Structure of the Fund:

The structure of the Fund consists of a Board of Governors, an Executive Board, a Managing Director, a Council and a Staff with its headquarters in Washington, USA.Thereareadhoc and standing committee appointed by the Board of Governors and the Executive Board. This is also an interim committee appointed by the Board of Governors. The Board of Governors and the Executive Board are the decision-making organs of the Fund.The Board of Governors is at the top in the structure of the Fund.It is composed of one Governor and one alternate Governor appointed by each member. Normally a member appoints its Minister of Finance or the Governor of its Central Bank as its Governor. The alternate Governor can participate in the meetings of the Board. But he has the power to vote only in the absence of the Governor.

The Board of Governors meets annually in which the details of the Fund activities for the previous year are presented. Special meetings can be convened by any of the five members having 25% of the total voting right. There is a Managing Directors of the Fund who is elected by the Executive Directors. He is usually a politician or an important international Official. The Executive Board is a continuous session and meets several times a week. Besides acting as the Chairman of the Executive Board, the Managing Director is the head of the Fund and responsible for its organisation, appointment and dismissal.

The management of the Fund is vested in a Board of Governors consisting of one governor and one alternate governor for each member country. Normally the Board of Governors meets once a year to lay down the policies of the Fund. Each governor has a voting right of 250 votes plus one vote for every one lakh dollars of the quota. Thus on her present quota of 6000 million dollars (250 + 6000) India has 6250 votes.

However the Board of Governors delegates many of its powers to the Board of Executive Directors who number twenty, of whom one is nominated by each one of the five largest quota holding members – presently U.S.A., U.K., W.Germany, France and India – and the remaining 15 elected by other members of the Fund with the Latin American Republics electing at least two directors. The policies laid down by the Board of Executive Directors in who rests the real authority. The regular day to day working of the Fund is managed by a managing Director who is the Chairman of the Board of Directors. He has to be a person of extraordinary financial competence and should not be a governor or alternate governor for a member country. This post is rotated among the nationals of the member nations and at present Mr. Pierre – Paul Schweitzer of France is holding the post.

With large capital resources held in gold, U.S. dollars and the other currencies of member countries, the International Monetary Fund conducts its working with a view to promote exchange stability. To achieve this end the fund makes available foreign currencies to needy nations at the agreed parity rate of exchange upto a maximum of 25% of the quota per annum provided the total drawings at any one time do not exceed 200% of the quota. For purchases of foreign exchange in excess of this quota gold has to be tendered. How the fund's assistance helps country to stabilize her exchange rate can be understood with the help of the illustration and diagram given below.

In case a country faces a shortage of a particular currency to meet her foreign obligation, and on account of this the rate of exchange is likely to move against the country, the International Monetary Fund comes forward to grant a loan to save the situation and keep the exchange value of the currency stable. In the diagram below, we have a case of increase in imports from America, and India's demand for dollar goes up. Consequently the exchange moves up to Rs.8 per dollar. To maintain the comes in and gives an extraordinary loan; and the supply curve for dollar is shifted to the right, to the new position S_1 S_1 by which the rate of exchange is again brought down to Rs.7/- per dollar.

The Fund usually grants three types of loans against the security of the local currency. In the language of the fund, it is referred to as purchasing a foreign currency. The three **types of loans**are:

1. Short term loans to tide over temporary balance of payment deficits, as in the case in the illustration given above.
2. Stand by credits for periods ranging from 3 to 12 months, pending export of goods against firm orders received by exporters of the borrowing countries.
3. Convertibility assistance to save a currency from depreciation in extreme cases. This is a type of last resort loan to save a sinking currency.

It may be noted that the International Monetary Fund grants short term loans to enable countries to preserve the stability of the rate of exchange of their currencies As such the rate of interest charged on the loans are not low. There is a service charge of ¾% on all loans in addition to the rate of interest determined in each case on the basis of the loan amount, purpose of the loan and the period of the loan. When loans are renewed, the rate of interest is usually raised by ½%, in order to discourage such renewals. When a country's borrowings exceed the quota, there is a sliding scale of extra charges depending on the amount of the loan, the period of the loan and the purpose of the loan. These three varieties of charges are as a rule payable in gold even though relaxations from this rule are often made for under-developed countries. The fund declares dividends annually after meeting all the expenses and the dividends are payable in the currency of the country.

Effects of the quota system

The IMF's quota system was created to raise funds for loans. Each IMF member country is assigned a quota, or contribution, that reflects the country's relative size in the global economy. Each member's quota also determines its relative voting power. Thus, financial contributions from member governments are linked to voting power in the organization. This system follows the logic of a shareholder-controlled organization: wealthy countries have more say in the making and revision of rules. Since decision making at the IMF reflects each member's relative economic position in the world, wealthier countries that provide more money to the fund have more influence in the IMF than poorer members that contribute less; nonetheless, the IMF focuses on redistribution.

Quotas are normally reviewed every five years and can be increased when deemed necessary by the Board of Governors. Currently, reforming the representation of developing countries within the IMF has been suggested. These countries' economies represent a large portion of the global economic system but this is not reflected in the IMF's decision making process through the nature of the quota system. Joseph Stieglitz argues "There is a need to provide more effective voice and representation for developing countries, which now represent a much larger portion of world economic activity since 1944, when the IMF was created." In 2008, a number of quota reforms were passed including shifting 6% of quota shares to dynamic emerging markets and developing countries.

Functions of the Fund:

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

3. It is a reservoir of the currencies of all the member countries from which a borrower nation can borrow the currency of other nations
4. It also provides machinery for altering the par value of the currency of a member country. In this way, it tries to provide for an orderly adjustment of exchange rates, which will improve the long term balance of payments position of member countries
5. It also provides a machinery for institutional consultation
6. The Fund contributes to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all member nations
7. IMF may be described as a bank of Central banks of different countries, because it collects the resources of various central banks and assist them in times of emergency. However, the Fund cannot control the domestic economic and monetary policies of member nations
8. It maintains a multiple payment system through an orderly adjustment of exchange rates
9. The Fund renders technical assistance in two ways.

   (a) Fund experts assist in the formulation of appropriate monetary, fiscal and exchange policies or to legislation

   (b) Engaging of experts from outside the staff of the Fund to assist the member nations in various specialized fields.
10. The Fund gives training to the officials of Central Banks of member countries
11. The Fund co-operates with many International Organisationssuch as IBRD, GATT to promote economic development of primary producing countries. It also provides compensatory financing to help the UDC's whose export earnings decline temporarily.

Gold Standard and the Fund

The working of the fund clearly indicates that gold plays an important role and gold is retained as the basis of the fund's working. Viz. 25% of members' quota is payable in gold, parities of currencies are expressed in terms of gold in emergencies and so on. These facts have made well known economists like Prof. John H.Williams declare the fund a refined version of international gold standard. No wonder on the face of it, I.M.F. seems to be another form of gold standard. But actually it is not so and there is a number of difference between I.M.F and gold standard.

Gold parity under International Monetary Fund is one as under gold standard. It can be changed with the sanction of the fund to correct fundamental disequilibrium. Further the issue of currencies is not subjected to gold movements under the fund as it is under gold standard. In fact gold seldom moves from country to country. Thirdly, the values of world currencies are not at all affected by the production or otherwise of gold. In essence gold only occupies a secondary position or the position of a slave in the Fund. International Monetary Fund is a pool of national currencies and therefore cannot be regarded as gold standard. It is at best a substitute for gold standard.

International liquidity and the Fund

The term international liquidity refers to the readiness with which currencies of different countries are made available from the fund, to needy countries. The Fund is an important source of international liquidity, even though international liquidity as such is still a very much sought after pursuit. With the view to achieve wider international liquidity many a suggestion has been put forth from time to, time and the latest one is the Special Drawing Rights Scheme otherwise known as the ***Paper Gold System.***There have been other suggestions such as an international currency system of the type recommended by Lord Keynes the transformation of the Fund into a central bank of the world as suggested by Prof. Robert Triffin, or making available additional funds to the Fund by way of setting up Lender's club as suggested by Mr. Bernstein. Devaluation of dollar and devaluation of even gold have also been suggested to solve the problem of international liquidity, Let us examine each one of these proposals very briefly.

Lord Keynes's plan was to issue a world currency called *bancor* which will circulate as a currency acceptable all over the world and international indebtedness could be settled in this currency. This proposal was not fully accepted by the Brettonwoods conference and was modified to found the International Monetary Fund. There are monetary exports that harp on the Keynesian plan every today.

Prof. Triffin's plan was for setting up a central bank of the world in the place of the Fund, if necessary by converting the Fund, which would accept deposits from the nations of the world and enable member countries to settle their accounts by transferring money from one country's account to the another's.

Mr. Bernstem was for the formation of Lender's club consisting of a few leading nations of the world to make available additional funds for the Fund. In fact a sum of 6 billion dollars have already been made available this way in the year 1962 by 10 countries forming the Lender's club Belgium, Canada, France, West Germany, Italy, Japan, Netherlands, Sweden, United Kingdom and the United States of America.

The French Proposal has been for the resurrections of the traditional gold standard, Ex-President De Gualle advocated this, time and again, though without much of support from the major nations of the world, France's advocacy of 'back to gold' has been backed by the large reserve of gold that is accumulated in France – approximately 5,970,000 million dollars.

The proposal to devalue dollar as a means of solving liquidity problem has come up time and again from the French side. Devaluation of dollar, it is claimed will increase the price of Gold in terms of dollar and will make it possible for the countries of the world to obtain more dollars for their gold holdings. This suggestion has again been made in the recent years by many other delegates to the International Monetary Fund. However this proposal has been met with the vigorous opposition particularly from Russia, South Africa, Australia and other gold producing countries.

Prof. Fritz Machlup, the American Economist has recently suggested the devaluation of gold as a means to solve the problem of international Liquidity. According to this proposal, the dollar price of Gold will be reduced in two or three sages and this will mean unloading of the world with a view to get the present ruling price. Machlup expects that a proposal of this kind will make France, South Africa and Russia to rush their gold stocks to the world market and cash them as soon as possible and this will solve the major problem of World Liquidity. However, there has been no support for this proposal from any quarters.

Paper gold and Fund:

With the view to provide the much need international liquidity the fund has put forth its own proposal and this has taken the form of creation of Paper gold or **Special Drawing Rights(SDRs).**

In view of phenomenal growth of international trade in the last few years and the decline in the annual output of gold the need for supplementing the resources of the fund by the way of **Paper Gold** has arisen. The term Paper Gold refers to the resources made available to member countries by way of book entries under the special drawing rights in the book of I.M.F. the member countries can convert the paper gold into any currencies of the member countries of the fund. Paper gold is expected to be in the form of coupons or token or pay order or currency notes. Each unit of Paper Gold will be expressed in terms of a certain weight of gold of 11/12 fitness.

It is estimated that out of 1400 million dollars worth of gold mined out yearly in the noncommunist world, nearly 3/4th fundsits way into industrial or artistic uses or into the hand s of the hoarders or speculators and not into the official reserves of nations. The Special Drawing rights scheme to provide for paper gold was first mooted by the group of ten countries #, and was later discussed in detail at the Rio de Janeiro conference of the Group Ten countries it was decided to create 9.5 billion dollars of paper gold over the ensuing three year period, 3.5 billion in the first year and 3 billion dollars each year in the subsequent years,

Under the S.D.R. scheme every member country will have a paper claim or book entry credit with the fund with which she can clear 30% of her liability. As per present arrangements, the allotment of paper gold to member countries will be on the basis of quota held by the countries in the fund and this will enable developed countries to have more paper gold than others. It is roughly estimated that the paper gold allotment for U.S.A. will be to the order of 25% of the total available paper gold. India is expected be get an allotment of 3.5% of paper gold valued at 122 million dollars. This mode of allotting paper gold on the basis of quota held in the fund by the members has come in for criticisms and alternative proposals for the allotment on the basis of population, degree of backwardness, need of the country etc are in the air. A few African and Latin American countries have asked for paper gold to extent of double their quota in Fund. The next meeting of the fund is expected to discuss this in detail and decide on the basis of allotment of Paper gold.

Once paper gold is made available, the member countries can use them to meet their international obligation and convert them into any currency of the world, with in certain restrictions. This conversion can be made either with the International Monetary Fund or with another country having surplus of the required Currency, The country acquiring S.D.R. will be able to treat it as its asset exchangeable internationally for any currency of the Fund. Many Economists and Ministry of Finance have expressed their satisfaction with the arrangement and it is hoped that the paper gold will solve the problem of international liquidity to a great extent and pave the way for the issue of a world currency. However Prof. Robert Triffin of Yale University has recently expressed his apprehensions about the success full working of the system, though he has few supporters in this.

International Monetary Fund today:

The capital of the fund has been changed twice since its inception and today it stands at 21,000 million U.S. dollars and total membership is 107. The total outstanding loans as at the close of June 1967 is 6.5 million dollars out of which Britain alone has borrowed over $2400 million in thirteen currencies of the world.

The fund is often criticized as being under the influence of the United States of America, the biggest contributor of the capital and captain of the Hard currency area. It is also blamed for its failure to maintain the stability of exchange rates in a few cases because of lack of Co-operation from certain member countries like Indonesia and France. In the year 1948 France was devalued by 44% despite advice of IMF not to do so.

Thirdly the membership of the fund is still not global and important countries like Russia, East Germany, Republic of Hungary and China are out of the Fund.

Fourthly, the fund has not been success full in removing Exchange restrictions which are practiced by the entire member Countries.

In spite of these defects, International Monetary Fund makes a great step in international monetary Co-operation and it has been an important source of international Liquidity. By the term ‘International liquidity’ is meant all the resources that are readily made available to member countries for the purpose of financing their balance of payments deficits. The fund has also been able to maintain stable exchange rates, in most cases and it has succeeded to give the golden mean between fixed and adjustable exchange rates.

6. India and the Fund

India joined the International Monetary Fund on the 27th of December 1945 as an original member and notified the par value of rupee as equivalent to 0.268601 grams of gold of 11/12 fineness. This was lowered to 0.186621 grams of gold in 1949 and to 0.118489 grams of gold in 1966 when the rupee was devaluated by 36.5% on 6-6-1966.

As a founder member and holder of the fifth largest quota India has a permanent representative on the Fund's Execute Board. India was allotted a quota of $ 400 million at the beginning and this was raised to $ 600 million in 1958.

The fund has been especially good to India and India has made use of the facilities available to a marked extent. During the calendar year 1949 India purchased from the Fund foreign currencies amounting to Rs. 47.62 crores (roughly $ 100 million) to tide over balance of payment difficulties. This amount consisted of Canadian dollars, Deutsche marks, French francs, Italian lire and Japanese Yen. India was the first country to draw Japanese yen from the Fund. Besides major loans obtained for solving balance of payments deficits, India has often drawn stand by credits and this timely assistance has helped her to preserve the rate of exchange at critical times. India's outstanding by way of drawings and stand by credits amount to over 417.5 million dollars as on 1-4-1967.

Besides loan facilities the fund has made available the services of experts on many occasions and a few of the Fund's officials work in the Reserve Bank of India at all times. India has been a sincere member of the fund and has followed the advice of the fund in most cases. In the years to come the fund will need more of India's help and India will need more of Fund's assistance.

International Bank for Reconstruction and Development (IBRD) or World Bank

International Bank of Reconstruction and Development, otherwise known as World Bank, is the outcome of Brettonwoods agreement, along with International Monetary Fund. While International Monetary Fund supplies short term funds to tide over temporary balance of payment difficulties, World Bank provides either directly or indirectly, long term capital needed for reconstruction and/or development of national economics. The bank started operation in 1947 with its head office at Washington, U.S.A. Its motto is “poverty anywhere is a danger to prosperity everywhere.”

The World Bank Group is comprised of five separate entities: International Bank for Reconstruction and Development (IBRD, est. 1945), the International Finance Corporation (IFC, est. 1956), the International Development Association (IDA, est. 1960), the International Centre for the Settlement of Investment Disputes (ICSID, est. 1966) and the Multilateral Investment Guarantee Agency (MIGA, est. 1988). This webpage outlines key features of the two arms that are now collectively referred to as the World Bank: IBRD and IDA.

Organization:

Nearly 10,000 staff members perform the work of the IBRD and IDA, both at headquarters in Washington, DC, and in over 109 country offices. The World Bank is the third largest employer in Washington, DC.

The World Bank is owned by 186 member governments. Each member government is a shareholder of the Bank, and the number of shares a country has is based roughly on the size of its economy. This "one-dollar-one-vote" structure affords richer countries greater power in decisions-making processes at the institutions the poor, borrowing countries.

The United States is the largest single shareholder, with 16.41 percent of votes, followed by Japan (7.87%), Germany (4.49%), the United Kingdom (4.31%) and France (4.31%). The remaining shares are divided among the other member countries. All developing country borrowers have 39% of the voting share combined. The 47 sub-Saharan African nations command less than 6% of the votes.

The World Bank organizes its operations primarily through 27 Vice-Presidential Units. Six regional vice-presidencies control a large-degree of decision making on Bank operations within their own regions: Africa, East Asia & Pacific, Europe & Central Asia, Latin America & the Caribbean, Middle East & North Africa, and South Asia. Other vice presidencies include 7

"Network Vice Presidential Units"-responsible for certain cross-cutting issue areas such as the financial sector or private sector development. The rest 13 cover such areas as external affairs, development economics, legal, and human resources.

The authorized capital of World Bank is 10 billion, U.S. dollars contributed by member nations on the basis of the national income of the countries. Except Russia and her satellites most other nations of the world are members of the fund. Presently there are 107 member countries with U.S.A. as the major contributor of capital (2/3 rd).India’s share was initially 400 million dollars. However this was increased to 800 million as per the revised increase in quota in 1959.Member countries pay only 20% of their quota as paid up capital (2% in gold and 18% in home currency).

The governing body consists of one governor from each member country with one alternative governor in reserve for emergency purposes. The Governing Board meets once a year to lay down the policy of the bank. The day to day affairs are managed by the Executive Board of Directors consisting of 20 members, one each from the five permanent member nations (United States of America, United Kingdom, West Germany, France and India)and fifteen members elected from among the other member nations. The President of the Bank is also the Chairman of the Board of Executive Directors.

Objectives of the world Bank:

The following are the objectives of the World Bank

1. To assist in the reconstruction and development of its member-countries by facilitating the investment of capital for productive purpose
2. To promote private foreign investment by guarantees of and participation in loans and other investments made by private investors
3. To make loans for productive purposes out of its own resources or funds borrowed by it when private foreign capital is not available on reasonable terms and conditions

4. To promote the long-range growth of international trade and thereby, to maintain equilibrium in the balance of payments and
5. To improve the standard of living of the people in general and the conditions of labour in particular.

Types of assistance:

The sole function of the bank is to supply long term finance for the development of the economics of the member nations. This function is performed in any one of the following ways:-

(1) By sanctioning loans directly from the funds of the banks for urgent purposes.
(2) Providing loans to the needy countries by raising funds in the foreign money markets on bonds issued by the bank. The bonds of the bank are quickly subscribed as they have behind them the guarantee of all the member countries.
(3) By guaranteeing loans floated by member countries in foreign money markets.
(4) By arranging meetings of the lenders (when there are more than one lender involved) and helping them to study the loan details by providing explanations, information etc. Loan granted this way is known as consortium loans- Aid India Consortium is an example of this type. Austria, Belgium, Canada, France, West Germany, Italy, Japan, Netherlands, United Kingdom, United States, World Bank and IDA are members of the Aid India consortium otherwise known as Aid India Club
(5) By helping the borrowing members to utilize the borrowed money for importing scared goods from other member countries

Conditions for granting loans:

To merit loan from the World Bank or to obtain a guarantee from it there are a few conditions. They are:-

(1) The loan must be for a specific project which promises development. In the first stage the Bank’s experts will make a preliminary study of the project concerned and in the second stage detailed study will be made of the project by a body of experts. Only if they are fully satisfied the loan will be released.

(2) The borrowing country must prove that she cannot raise the loan within her territory or elsewhere.

(3) The bank must be satisfied as to the repaying capacity of the borrower.

(4) The loan must be for productive purposes. The bank will not consider-loan applications for the development of education, for instance, as if falls strictly under non-productive purposes.

(5) The loan amount must be for obtaining a foreign commodity for a project of projects of reconstruction and development.

(6) World Bank loans are granted only to governments concerned and not to private industries or individuals in the borrowing countries. When the governments re-lend their money to private borrowers they are forbidden from charging to the ultimate borrower an interest rate more than 7 ½ % per annum. In essence the bank conducts its operation on sound business principles and loans are granted on good risks basis.

(7) Ordinary repayment of all advances is to be made in the currency in which the money is borrowed. The rate of interest on direct loans varies from 7% to 7 ½ % and a commission for guarantee from 2 % to 3 ½ % per annum.

India and the World Bank

India has received all types of assistance from the World Bank and at one time India ranked as the largest single borrower. In the year 1964, India received over 800 million dollars from the bank, which was more than what was permitted under the rules governing the lending operations of the Bank. Of these over $ 500 million have been diverted for the development of railways, Domodar Valley Project, Tata Iron and Steel Company. Kothagudem Thermal Power Station and the Industrial Credit and Investment Corporation of India are some of the other major beneficiaries. India's present out standings is over 970 million dollars in 34 different loans. The Aid India Club which meets under the auspices of the World Bank has been so considerate to India that a number of consortium loans have been made available to India in the recent past with pledges amounting to $ 5470 million. The International Development Association an affiliate of the World Bank has been granting soft loans to India to get ahead in her social development programmes. Further India has received constant advice on different matters of economic interest. The role of the bank as a mediator in the Indus Basin water dispute between India and Pakistan is unforgettable.

Other Financial Institutions

Besides the World Bank, there are other international institutions which grant loans to developing countries. They were recently established to supplement the efforts of the World Bank. They are the International Finance Corporation (1956),the International Development Association (1960) and the Asian Development Bank(1966).

International Finance Corporation (IFC):

This is another affiliate of the World Bank, set up to encourage the growth of productive private enterprise in the member countries, particularly in the less developed countries. The Charter of IFC came into force in July 1961 when France and Western Germany joined with the USA and agreed to form the IFC. To start with, there were 31 countries in its membership including India.

IFC functions as a wing of the World Bank and the President of the Bank is the chairman of the Corporation's Board of Directors. Other office bearers of the bank are ex-officio office bearers of the corporation as well. Its authorized capital is 100 million dollars, subscribed by member countries in amounts proportionate to their subscriptions to the capital of the World Bank. The Corporation's investments are in productive enterprise in the member countries and its sectors such as agricultural, industrial, commercial and financial. Though in the early years most of the funds were invested in industrial sphere of late agricultural and other sectors are receiving due attention. The Corporation's loans are granted on the following considerations:

1. The proposals must be for the establishment, expansion or improvement of productive private enterprise,
2. It should be a project which would bring about a matching investment of private capital by other investors,
3. The estimated profitability of the investment both to IFC and its associate should be reasonably large,
4. Investments only in cases where sufficient private capital is not available on reasonable terms for some reason or other,

5. The prospective industry should have a competent management. IFC does not seek or accept a government guarantee of repayment on any of its investments. Mostly investments in private industry will be made in the forms of equity capital subscription. In exceptional cases loans may also be granted.

Since its inception, the Corporation has made a wide variety of investments in a number of projects in 35 countries of the world. As at the close of December 1967, the total investments rank 221 million dollars in six continents. Most of the loans have been granted to industries producing fertilizers, synthetic fiber, textiles, caustic soda, paper, cement ,electrical goods, automobile spares etc,. Loans have been made available to promote tourism and set up development finance companies in member nations. In recent years there has been considerable increase in investment which stood around 379 million dollars in the year ending June 1993. This was up by 65 percent compared to with a fiscal year 1992. IFC maintains that Asia holds good projects in natural resource-based industries and with the growing openness of China and India to foreign investments, a number of projects in oil, gas, mineral and agro-investments sectors are likely to be financed by its in coming years.

IFC has made reasonably large investments in the developing countries and has stimulated investments in the private sector as required in the objectives of the Corporation. Its performance is not to be judged altogether from the initial investments. It has helped to set up 17 Development Finance Corporations in the ember countries and has thus enabled development finance to come within the reach of many industries. In short it has served as a partner in progress and has met the crying need of the hour namely international flow of capital.

The World Bank and IFC

Though the IFC is the private sector arm of the World Bank, it is different from the World Bank in the following important respects:

(a) The IFC is an autonomous local entity having its own independent capital and compact and competent staff of financial and legal experts. It operates just like a private financial or investment firm. It can even hire the ire the consultants from outside for dealing with technical problems like market research etc. In contrast, the World Bank has been engaged in the economic and social development of the member countries by rendering them aid even at interest lower than the market rates.

(b) While the World Bank extends the fixed interest loans to the member countries, the IFC has alternative options of extending fixed interest loans and making investments in the equities.

(c) The World Bank has at its disposal substantial amount of funds for financing development projects and plans in the member countries. The IFC, in contrast, has limited financial resources which it offers to the private enterprises for facilitating their expansion in the LDCs.

India and IFC

India is a fonder member of the IFC. She has been receiving assistance in a variety of areas from the IFC since its inception. These include automobiles, shipping, electricity, cement, fertilizers, oil and gas, petro-chemicals, iron and steel, general manufacturing, and the financial sector. India is the second major client of IFC assistance. The IFC invested 48.1 million dollars in India, composed of loans of 25.4 million dollars and equity of 22.7 million dollars, covering 11 projects which included the expansion of manufacturing facilities in computer diskettes, polyester and textiles, agribusiness exports, etc. In the annual Reports of IFC, mention has been made that there has been ‘a sea change’ in India’s policies during the recent years and the IFC is very optimistic about the investment climate in India.

International Development Association (IDA)

For a long time the need was keenly felt , for an international lending institution to grant loan for projects which are socially necessary but not productive in the literal sense of the word. Cases like road construction, slump clearance, education etc., are unproductive and the World Bank is not permitted to finance these ventures under the rules.IDA, as an affiliate and complementary institution of the World Bank, has been set up specially to cater soft loans to the member countries in need of them and it started operations in November 1960 with one billion dollars, initial capital, contributed by member nations. Since its creation it has been granting generous loans to developing countries and it has earned the name ‘soft loan window’.

IDA is an affiliate of the World Bank and its administrative set up is similar to that of the Bank. The Board of Governors, Executive Directors and President of the World Bank hold ex-officio offices in the IDA. Its membership is open to all the members of the World Bank. On June 30, 1992, 142 countries were the members of this institution. Out of them, 24 of them designated as the developed countries and the remaining as the less developed countries. During the recent years, China and several East European countries too have joined this institution. Presently 179 countries are the members of the IDA.

Financial Assistance made available by IDA is marked with **four essentialfeatures.** They are:

1. IDA credits are interest free; a service charge of ¾% is made annually on the amounts withdrawn and outstanding. This is levied to meet the administrative expenses of the institution.
2. Repayment of credits granted by IDA generally begins after a repayment holiday of 10 years, called the period of grace. After the grace period, repayment is made in small percentages of anything around 3% of the loan per year and it is most convenient for underdeveloped countries. The repayment period, is very long, even going beyond 50 years at times.
3. IDA credits are not restricted for economic development or reconstruction in the strict sense of the word. They are for national development and they flow mostly in the direction of the less developed countries. India has been the single largest beneficiary of IDA. So far IDA has made available nearly 675 million dollars in the form of 19 different loans to India. Most of these funds have been used for the provision of rural electricity, road construction, provision of tube wells, provision of drainage facilities and slump clearance etc.
4. Credits of IDA are not necessarily for specific projects and the receiving countries are free to use the funds in any social development project in the country.

Capital structure:

Capital structure of the IDA is constituted by the subscription of member countries and supplementary resources. Initially, the subscription of member countries amounted to 1000 million US dollars. For the purpose of subscription and voting power, the member countries of the IDA have been classified into two categories: The developed countries come under Part I member countries that are required to pay their entire subscription quota in gold or freely convertible currencies which IDA can utilize for extending loans to the UDCs. Part II countries are less developed countries who were required to pay only 10 percent of their subscription quota in terms of gold and freely convertible currencies and remaining 90 percent in their local currencies which the IDA cannot use for granting loans without prior consent of the member country, the currency of whom is required for lending. The IDA can obtain supplementary resources from the Part I member-countries from time to time to augment its resources and undertake lending operations on a large scale.

Some of the Part I member countries are the USA, the UK, France, Netherland, Federal Republic of Germany, Canada, Australia, Sweden, Japan etc,. Some important Part II member countries are India, China, Pakistan, Brazil, Argentina, Indonesia etc, Regarding voting power, it should be understood that it is in proportion to the respective subscription quotas. Part I member countries (developed countries) although contributed 97 percent of the total resources of the IDA, yet enjoy 69 percent of the total voting power. It implies that the less developed countries have relatively greater decision-making power at the IDA.

Achievements of IDA:

In the period 1964-68, the IDA credits amounted to an annual average of 0.3 billion dollars which increased to 0.8 billion dollars during 1969-73 and 1974-78 respectively. The annual average recorded a substantial increase to 3.53 billion dollars during 1984-88. The annual average during 1990-94 almost doubled to 0.4 billion dollars. This level of lending was maintained in the subsequent three years, but it declined to 4.6 billion dollars in 1997. It again increased to 7.5 billion dollars in 1998 and declined to 6.8 billion dollars in 1999. The total amount of credit sanctioned during the fiscal years 2000 and 2001 was 4.4 billion and 6.8 billion respectively. The cumulative lending to 162 member countries during 1960-2001 amounted to 127 billion dollars. The countries are South Asia have been the major beneficiaries throughout, followed by East African countries and West African countries. It should be noted that IDA has treated countries in the South Asia region more favorably than in other regions of the world.

IDA and India:

India has been the largest recipient of IDA assistance. Up to the year of ending June 1992, the total credit flow from IDA to India was of the amount of 18919.6 million dollars. It approved 186 credit proposals from India. India remained the most prominent recipient of IDA soft loans till the mid1980s.The share of this country had been shrinking since the late half of 1980s. Some of the development projects in India helped by the IDA are: Rajasthan Canal Command Ares Project, Champal Command Project, Madhya Pradesh and Rajasthan Dairy Development Project, Development of Drought Prone Areas, Sindri Fertilizer Corporation, Godavari Barrage, etc. Since its inception, IDA has been making very vital contribution in social and economic development of India. All developing nations of the world look upon this soft loan window with great expectations.

Asian Development Bank (ADB)

The need for a development bank for the whole of Asia was keenly felt, mainly to supplement the resources that might be made available by the World Bank. The proposal for such an institution originated in the annual session of ECAFE * held at Manila in March 1963. After detailed discussions of the proposal for over three years, the Bank's Board of Governors, consisting of one representative for each sponsoring country, met in Tokyo on November 25th 1966 and the Asian Development Bank was formally set up. It was decided to have the Bank's head office at Manila, Philippines and Mr.Takeshi Wantanake; Japanese was nominated as the first chairman of the bank.

The Bank started its operation at Manila from 19th December 1966 with a capital $ 1000 million subscribed by both regional and non-regional members. At the time of inception of the bank regional or Asian members of the Bank were Afghanistan, Australia, Cambodia, Ceylon, China(Formosa), India, Japan, Korea, Laos, Malaysia, Nepal, Newzealand, Pakistan, Philippines, Vietnam, Singapore, Thailand, West Samoa and Indonesia. The non-regional members included Belgium, Canada, Denmark, West Germany, Italy, Netherland, Britain, United States, Austria, Finland, Norway and Sweden. Since the inauguration of the Bank a few other countries, both regional and non-regional have become members of the bank and on date the bank has thirty two members including thirteen non-regional members.

The capital of the Bank is subscribed by member nations and as per the Articles of Agreement half the capital should be paid in gold (or convertible currency) and the balance in the currency of the member, the payment being due in five equal annual installments. Besides subscription the bank has received substantial contributions particularly from non-regional countries to augment the resources of the bank.

The bank's lending operations are essentially to be concentrated on the granting of hard loans (i.e.) loans for specific projects and repayable in the currency in which the amount is borrowed. Further, loans will be granted only to members who cannot readily obtain assistance from other sources. The repaying capacity of the borrowing country will be paid due regard to. In essence, the bank will carry on its operations on sound banking principles.

The working of the Bank during the last two years has been very satisfactory and the annual report of the bank indicates progress in various directions. During the last two years the bank has completed a techno economic survey and a transport survey, of the region besides an Asian Agricultural Survey. The President of the Bank undertook a series of visits during 1967 to member countries to gain a more climate in each country. The bank has as at the close of December 1968, 270 staff members drawn from 20 countries, 14 regional and 6 non-regional.

On the lending side, the first ADB loan of US $ 5 million was made available to the Industrial Finance Corporation of Thailand against the guarantee of the Govt. of Thailand. This loan was for a period of 12 years and it carried an interest rate of 7 ¾ % per annum. The Bank of Ceylon has recently received a loan of 2 million US $ at 6 $^{7}/_{8}$% per annum for modernization of tea estates. This loan is for 15 years and the first installment is to begin after three years from the date

ADB and India

The ADB commenced lending to India in 1986, though it has been a founder member of the Bank. In the earlier period, loans to India were mainly for infrastructure sectors such as power, roads, ports, etc. In recent years, the emphasis has shifted to public resource management programme, urban environmental improvement and development, health and nutrition and housing finance.

ADB approved seven loans totaling 1.5 billion US dollars in 2001 to rehabilitate and reconstruct areas damaged by the Gujarat earthquake, develop the Western transport corridor and the West Bengal corridor, establish a private sector infrastructure facility at the state level and implement the Madhya Pradesh Power Sector development programme, etc.

ADB approved 12 technical assistance grants, of which 8 were for advisory purpose on capacity building for earthquake rehabilitation and reconstruction of housing, conducting the Madhya Pradesh integrated water resource management study, enhancing the corporate finance capability of the National Highways Authority of India and improving the accounting system of the Calcutta Municipal Corporation. Four were technical assistance grants to prepare the Kerala power sector development programme, Madhya Pradesh State road sector and integrated urban development projects, and public-private partnership on the National Highway Corridor. Five of the technical assistance grants approved in 2001 were funded by the United Kingdom.

Cumulative ADB lending to India as of 31st December 2001 was 10.45 billion US dollars. Of these, 'Energy' sector got the maximum of 35.8 percent: 'Transport & Communication sector got 24.9 percent: Social Infrastructure sector got 13.4 percent: 'Finance' sector 12.7 percent: Multisector 11.5 percent: Industry and Non-fuel Minerals 1.7 percent.

TRADE AGREEMENTS AND POLICY

The foreign trade of a country is powerfully affected by international conflicts and international agreements. Trade policy refers to measures which a country adopts for the purpose of regulating the exchange of goods with other countries in the context of economic development. Tariffs, quotas and exchange restrictions indicate the structural contents of a trade policy. Trade agreements arise from the trade policy of a country.

Trade agreements are of three types. They are (1) Bi-lateral agreement(2) Multilateral agreement and (3) General agreement.

1. Bilateral agreement:

When a country enters into trade agreement with another country for the sale and purchase of certain specific goods, the agreement is bilateral. Quantity rates and terms of payment are decided in the agreement and it will be for a definite period with provision for extension. Generally, political relations play a very important part in promoting or preventing bilateral agreements. Generally, through bilateral agreements, two countries are reducing the import duties. Sometimes they avoid tariff. They fix the fair price for imported and exported goods. If the price is decreasing they accept the situation during the period of agreements.

They decide any one of the monetary unit as the medium of exchange. India- Russia is an example of bilateral agreements.

2. **Multilateral Agreement**:

A country may have trade agreements with a number of countries for sale and purchase of goods. Such agreements are multilateral and are promoted by international trade organizations or associations. The trade relationship between more than two countries is called multilateral agreements. Generally those countries which are economically and geographically situated between them are having this type of agreements. From this they are having protection and also development in trade. For example, ECM (European Common Market)

3. **General agreement:**

It is similar to multilateral agreement. But general Agreement is meant for countries of the world which will enjoy the benefits of International trade. Example: GATT and UNCTAD**.**

The world had experienced the vigorous problems of an extensive pattern of trade barriers in the 1930's.After the Second World War many countries got down together to work on ways and means to promote international trade. Hence the need was felt for better international understanding and cooperation in economic sphere which resulted in the birth of General Agreement on trade and Tariffs (GATT).In 1947, 23 nations met at Geneva and drew up a plan for the reduction of import duties and also against future increase in duties by the negotiating countries. This came to be known as the General Agreement on Trade and Tariffs. It came into effect on a provisional basis on 1st January 1948 when other nations had also signed it.

General Agreement on Tariffs and Trade (GATT)

GATT is a multilateral treaty which has been signed by manyGovernments, known as contracting parties. The GATT is neither an organisation nor a court of justice. It is simply a multilateral treaty which now covers 80% of the world trade. It is a decision making body with a code of rules for the conduct of international trade and a mechanism for trade liberalisation. It is a forum where the contracting parties meet from time to time to discuss and solve their trade problems and also to negotiate to enlarge their trade. The GATT rules provide for the settlement of trade disputes call for consultations to reject / abandon trade obligations and even authorize retaliatory measures. A GATT is a permanent council of representatives with headquarters at Geneva. Its function is to call International Conferences to decide on trade liberalisation on a multilateral basis.It was an intergovernmental instrument, providing for rights and obligations in the field of commercial policy of the member countries with the principal object of promoting international trade and mutually advantageous arrangements by reducing trade barriers, customs, tariffs and discriminatory practices.

Objectives of GATT:

There seem to have been three basic objectives behind the establishment of the GATT.

1. To follow unconditional Most Favoured Nation (MFN) principle
2. To carry on trade on the principle of non-discrimination reciprocity and transparency
3. To grant protection to domestic industry through tariffs only
4. To liberalise tariff and non-tariff measures through multilateral negotiations.

The **ultimate aim** of establishing liberal world trading system is **to raise standard of living, ensure full employment, develop fully the resources of the world and expand production and exchange of goods on global level.**

Structure of GATT

The agreement takes the form of 38 'Articles' organized into four 'parts'.

Part I (Articles I and II) deals with the obligations of the contracting parties.

Part II (Articles III-XXIII) provides the code for 'fair' trade, such as various technical procedures and conditions under which tariffs may be employed (e.g. anti-dumping, for balance of payments reasons to safeguard domestic industry).

Part III (Articles XXIV- XXXV) details the procedures for the application and amendment of the agreement.

Part IV contains Articles XXXVI-XXXVIII, which deals with the trade of LDCs.

Principles of GATT:

1. ***Non-discrimination***: The basic principle of GATT is that of non-discrimination, contained in Article I. Contracting parties accept the so-called Most-Favored Nation (MFN) clause. This MFN clause rules out any preferential treatment among nations as far as trade policy is concerned, except those who are not members of the GATT.

   The MFN clause has played an important part in encouraging countries to negotiate on trade liberalization. They know that any deal that they negotiate with one country will not be undermined by that country striking a better deal with another, since any subsequent better deal must then be available to them. Confidence is also increased by the requirement that once agreed on, tariff reductions are bound.

   The non-discrimination principle is also embodied in the national treatment clause, which requires that, once the imported goods enter a country; they are subject to the same taxes, regulations, etc., which are applicable to the equivalent domestic goods.

2. ***Reciprocity***: The reciprocity obligation requires that a country receiving a concession from another country should offer an 'equivalent' concession in return. In its simple form reciprocity might involve two countries agreeing tariff reductions on each other's exports that would leave their bilateral balance of trade unchanged.
3. ***Transparency***: Article XI of the GATT forbids the use of direct control on trade, particularly quantitative restrictions, except under a few designated circumstances (such as a balance of payments crisis, allowed under Article XII).The rationale for banning quotas etc., is that quantitative restrictions is a less transparent instrument for reducing imports than a tariff. This has two aspects. First, when facing a tariff, producers exporting to the country concerned have clear information on the barrier they have to surmount in order to sell their goods and services, and may choose the volume they will supply subject to that information with a quantitative restrictions, on the other hand, they face uncertainty about the volume they will be allowed to export and about their net unit revenue. Second, with a tariff the price increasing effect is immediately apparent to consumers in the importing country, in that a 20 percent tariff necessarily means that that the domestic price is 20 percent higher than the

world price, whatever that may be. The price raising effect of a quota however may be less apparent unless information about the world price is readily available.

GATT Conferences: (Rounds of Global Trade Negotiations)

Since 1947, global conferences were held by the GATT for the purpose of global trade negotiations, and these conferences are called Rounds. The First conference on trade negotiations was held at Geneva in 1947, the Second at Annecy (France) in 1949, the Third at Torquay (England) in 1950-51, the Fourth at Geneva (Switzerland)in 1955-56, the Fifth at Geneva between 1961-62 (Dillon Round), the Sixth at Geneva, known as Kennedy Round, (1963-67), the Seventh at Tokyo (Japan) in 1973-79 and the Eighth at Punta del Este in Uruguay, known as Uruguay Round, which converted GATT into WTO, with effect from 1995. These conferences have led to reduction or stabilization of more than 60,000 tariff rates and to a number of non-tariff agreements among contracting parties having 80% of the world trade.

GATT and Developing Countries:

Before the Kennedy Round (1964-67) developing countries gained very little from the GATT except that they could use quantitative restrictions to correct disequilibrium in Balance of Payments and benefitted from tariff reduction by developed countries. But the principle of reciprocity for trade concessions went against the developing countries because they were unable to provide equivalent benefits to the developed countries. For instance, tariffs on total manufactured imports by developed countries averaged 11% but were 17% on those from developing countries. Moreover GATT did not take any initiate on trade barriers on agricultural and tropical producers of developing countries.

The concept of **'special and preferential'** treatment for developing countries was formally introduced into the General Agreement in 1957. Under it, negotiations would take into account the needs of Less Developed Countries (LDCs)for a more flexible use of tariff protection to assist their economic development and the special needs of the countries to maintain tariffs for revenue purposes. On the recommendations of the Heberler Report, the GATT started an action programme in 1958 which recommended that developed countries should reduce taxation and trade barriers on industrial and primary products of developing countries.

In 1963, the contracting parties agreed on a more flexible attitude towards LDCs. Accordingly, tariffs on tropical products like tea and timber were reduced or eliminated by developed countries.

In 1965, a new portfolio on trade and development was incorporated into the General Agreement dealing with the principle of non-reciprocity for developing countries. It states that, the developed contracting parties do not expect reciprocity or commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade less developed contracting parties. It further adds that the less developed contracting parties should not be expected in the course of trade negotiations to make contributions which are inconsistent with their individual development of financial and trade needs, taking into consideration part trade development.

The Kennedy Round (1964-67) bestowed some benefits to developing countries when 37 developed countries reduced tariffs on manufactured goods.

In 1970, the Generalized System of Preferences (GSP) was introduced which permitted developed countries to grant unilateral tariff preferences to developing countries. In June 1971, the GATT waived the MFN (Most Favoured Nations) Treatment obligation for developed countries for a period of 10 years to the extent needed to grant preferential treatment under the GSP which has been extended further.

However, it was in the Tokyo Round (1973-79) that a number of agreements on subsidies and countervailing duties covering agricultural, fisheries and forestry products; on customs valuation, on government procurement, on technical barriers to trade on import licensing, on dairy products, on penile meat and on civil aircraft.

Moreover, GATT rules also ban export subsidies and manufactured products by developed countries. On the other hand, they also export subsidies for economic development and industrialization by developing countries.

However trade textiles and clothing has been subjected to special restriction for nearly 4 decades by developed countries outside the GATT rules.

In 1974, the first Multi-Fibre Arrangement (MFA-I) was negotiated between the developed and developing countries for 4 years. It was renewed in 1978 (MFA-II) and in 1982 (MFA-III). In 1986 for 5 years, it was renewed (MFA-IV). It contains the right of the developed importing country to cut imports of specific products from developing countries. For the first time, a return to GATT rules is written into the MFA.

Despite special and preferential treatment for developing countries provided in GATT rules, they are being discriminated under the 'escape clause' and safe guard rules of the GATT.

Criticism of GATT:

1. From the beginning of the GATT, agriculture was treated as a special case. Almost, every developed country follows this policy which is inconsistent with GATT rules. But trade liberalisation for agricultural products has been much less than for manufacturers.
2. Developed countries have removed the majority of tariff barriers; rather they have devised new trade restriction. (i.e.) 'Low cost Suppliers', etc., which are outside the GATT rules. They are applied against developing and state trading countries and Japan.
3. The GATT's role is being undermined by concluding bilateral discriminatory and restrictive arrangements outside the GATT rules.
4. The increasing use of subsidized has been another important factor in side tracking the GATT.
5. The 'safeguard rules' of the GATT allow the contracting parties to grant protection in case of need
6. The GATT rules which permit the formation of customs union and free trade areas have been disforced and abused.
7. The GATT being a mandatory body does not possess any mechanism to get its rules implemented by contracting parties.

Despite these criticisms, 123 countries operate under the GATT rules while the remaining countries of the world benefit from them under the umbrella of MFN rules.

Suggestions for reform:

In November 1983, the Director General of the GATT appointed an independent group on the international trading system. In March 1985, the group issued a report entitled‘Trade policies for better future, proposals for action’.

Its **15 principal recommendations** are:

1. Open formulation and monitoring of trade policy and action
2. Clearer and fairer rules for agriculture and trade with no special treatment for particular countries or commodities
3. A time table and procedures to bring into conformity with that rules in all countries, also measures which are inconsistent with the GATT.
4. Trade in textiles and clothing should be subject to ordinary GATT rules
5. Rules on subsidies need to be revised
6. Improvement and vigorous application of GATT codes governing non-tariff distributions of trade
7. Clarified rules permitting customs, unions and free trade areas
8. Regular oversight and actions by the GATT secretariat which should collect and publish information
9. Limitations on applications of emergency for particular industry should continue to be non-discrimination
10. Greater integration of developing countries into the trading system with all rights and responsibility
11. Expansion of trade in services
12. GATT’s dispute settlement procedures should be reinforced by permanent roster of non-governmental experts
13. A new round of GATT negotiations should be launched to strengthen the multilateral Trading system and further open world markets
14. Establishment of a permanent ministerial level body of GATT to ensure high level attention to trade issue
15. A satisfactory resolution of the world debt problem, adequate flows of development finance, better international co-ordination of macro economic policies and greater consistency between trade and financial policies.

United Nations Conference on Trade and Development (UNCTAD)

The **United Nations Conference on Trade and Development** (**UNCTAD**) was established in 1964 as a permanent intergovernmental body. It is the principal organ of the United NationsGeneral Assembly dealing with trade, investment, and development issues.

The organization's goals are to "maximize the trade, investment and development opportunities of developing countries and assist them in their efforts to integrate into the world economy on an equitable basis." The creation of the conference was based on concerns of developing countries over the international market, multi-national corporations, and great disparity between developed nations and developing nations.

In the 1970s and 1980s, UNCTAD was closely associated with the idea of a New International Economic Order (NIEO).

The United Nations Conference on Trade and Development was established in 1964 to provide a forum where the developing countries could discuss the problems relating to their economic development. UNCTAD grew from the view that existing institutions like GATT (now replaced by the World Trade Organization, WTO), the International Monetary Fund (IMF), and World Bank were not properly organized to handle the particular problems of developing countries.

Membership

As of October 2012, 194 states are UNCTAD members. UNCTAD members are divided into four lists, the division being based on United Nations Regional Groups with six members unassigned: Armenia, Kiribati, Nauru, South Sudan, Tajikistan and Tuvalu. List A consists mostly of countries in the African and Asia-Pacific Groups of the UN. List B consists of countries of the Western European and Others Group. List C consists of countries of the Group of Latin American and Caribbean States (GRULAC). List D consists of countries of the Eastern European Group.

The lists, originally defined in 19th General Assembly resolution 1995 serve to balance geographical distribution of member states' representation on the Trade Development Board and other UNCTAD structures. The lists are similar to those of UNIDO, an UN specialized agency.

List A (100 members): India, **List B** (31 members), **List C** (33 members) and **List D** (24 members):

Objectives:

The objectives of UNCTAD are

(a) To reduce and eventually eliminate the trade gap between the developed and developing Countries, and

(b) To accelerate the rate of economic growth of the developing world.

Functions:

The main Functions of the UNCTAD are:

(i) To promote international trade between developed and developing countries with a view to accelerate economic development.

(ii) To formulate principles and policies on international trade and related problems of economic development.

(iii) To make proposals for putting its principles and policies into effect, (iv) To negotiate trade agreements.

(iv) To review and facilitate the coordination of activities of the other U.N. institutions in the field of international trade.

(v) To function as a centre for a harmonious trade and related documents in development policies of governments.

Activities:

The important activities of UNCTAD include

(a) Research and support of negotiations for commodity agreements;

*(b)*Technical elaboration of new trade schemes; and

(c) Various promotional activities designed to help developing countries in the areas of trade and capital flows.

The UNCTAD Conference – held every four years:

- UNCTAD I in Geneva, 1964
- UNCTADII in New Delhi, 1968
- UNCTAD III in Santiago, 1972
- UNCTAD IV in Nairobi, 1976 and Manila, 1979
- UNCTAD VI in Belgrade, 1983
- UNCTAD VIII in Cartagena, Colombia on 8–25 February 1992
- UNCTAD IX in Midrand, South Africa on 27 April – 11 May 1996
- UNCTAD X in Bangkok, Thailand on 12–19 February 2000
- UNCTAD XI in São Paulo, Brazil on 13–18 June 2004
- UNCTAD XII in Accra, Ghana on 21–25 April 2008
- UNCTAD XIII in Doha, Qatar on 21–26 April 2012

UNCTAD I 1964 GENEVA:

- To adopt a new international division of labour and make the external sector conductive to the developing countries.

- To improve invisible trade of developing countries through development of shipping, tourism, etc. Each developed countries contributes 1% of their income to the developing countries.

UNCTAD II 1968 NEW DELHI:

- To reappraise the economic situation and its implanting the recommendation of UNCTAD I
- Problems and measures of economic integration and trade and development among developing countries
- Special measures for economic and social upliftment of the last developed among the developing nations.

UNCTAD III 1972 SANTIAGO:

- Changes in shipping freight (i.e. 1/3 of total deficit in the balance of payment of L.D.C's was due to high shipping freights.
- Promotion to world trade new structure of world shipping in which the merchant marine of developing countries play an increasing and substantial role.

UNCTAD IV 1976 NAIROBI:

- Helping the poor countries by the developed countries
- Some kind of taxes may be disposed by the advanced nations to raise funds.

UNCTAD V 1979 MANILA:

- 150 member countries were participated in this conference.
- No concrete resolutions were passed but having some future consideration on monetary reforms.

UNCTAD VI 1983 BELGRADE:

- Attainment of new international economic order
- Monetary issues such as adequacy of fund resources, conditionality etc were discussed.
- Developed countries insisted on Liberalizations of trade policies by the developing nations

UNCTAD VII 1987 GENEVA:

- The developed countries express their desire to provide debt relief to the poor countries.

UNCTAD VIII 1992 COLOMBIA:

- 170 member countries agreed on board features of revitalising UNCTAD and to make it more effective in dealing with development related issues.
- It has agreed to create Trade and Development Board (TDB).
- Establishment of five ad hoc (created for a particular purpose only) group to support the committee & TDB

UNCTAD IX 1996 MIDRAND:

- Met at Midrand in South Africa in 1996 in which it discussed issues pertaining to WTO, sustainable development and debt relief to developing nations.

UNCTAD X 2000 BANGKOK (THAILAND):

- The effective integration of all countries in the international trading system
- Improving supply capabilities
- Overcoming the debt problem
- Strengthening the commitment to social development; ensuring women´s political, economic and social participation
- Generating adequate financial flows for development
- Undertaking institutional reforms; reducing financial volatility
- Focusing on central problems of acute poverty and growing inequality within and among nations
- Supporting knowledge-based development as a necessary element for effective participation of developing countries in the world economy

UNCTAD XI 2004 SAU PAULO, BRAZIL:

- The effective integration of all countries in the international trading system
- Improving supply capabilities; overcoming the debt problem
- Strengthening the commitment to social development
- Ensuring women´s political, economic and social participation

- ❖ Generating adequate financial flows for development
- ❖ Undertaking institutional reforms; reducing financial volatility
- ❖ Focusing on central problems of acute poverty and growing inequality within and among nations

UNCTAD XII 2008 ACCRA, GHANA:

- ❖ Food prices increases Diversification and value added Increasing the level of investment in technology and infrastructure Equitable distribution of rents:
- ❖ Harnessing development gains from windfall incomes Human resource development: Ensuring a stable macroeconomic framework Food safety and health standards Food safety and health standard
- ❖ The Secretary-General of UNCTAD is Dr.Mukhisa Kituyi (Kenya), who took office on 1 September 2013.

In performing its functions, the secretariat works together with member Governments and interacts with organizations of the United Nations system and regional commissions, as well as with governmental institutions, non-governmental organizations, the private sector, including trade and industry associations, research institutes and universities worldwide

Currently, UNCTAD has 194 member states and is headquartered in Geneva, Switzerland. UNCTAD has 400 staff members. It is a member of the United Nations Development Group. There are non-governmental organizations participating in the activities of UNCTAD.

ACHIEVEMENTS:

The most significant achievements included.

a) The agreement on Generalized System of Preferences (GSP) 1971

b) The setting up of the Global System of Trade Preferences among developing Countries (1989)

c) Negotiation of International Commodity Agreements

d) The establishment of transparent market mechanisms in the form of intergovernmental commodity expert and study groups, involving consumers and producers

e) The negotiation of the Common Fund for Commodities (1989)

f) The adoption of the resolution on the retroactive adjustment of terms of Official Development Assistance debt of low-income developing countries

g) The establishment of guidelines for international action in the area of debt rescheduling (1980)

h) The Programme of Action for Least Developed Countries for the 1990s and

i) The negotiation of convention in the area of maritime transport

Although for many limitations of UNCTAD could not fulfill all expectations but it has tried and still trying with its limited resources to do its work. For the cause of the developing countries the role of UNCTAD should be strengthen. To make it more dynamic and effective **some measures** should be taken like as follows:

a) The Third World countries should minimize their differences and have to sacrifice their own interest for the sake of other developing countries. It will be easier for UNCTAD to work in a co-operative atmosphere than of conflict.

b) UNCTAD should give emphasis those issues in which it possesses considerable expertise. Here the proposal is not to alter its earlier position, but to focus more strongly on specific matters which are covered little if at all by other organizations. In trade field UNCTAD should give importance on consensus building. As UNCTAD provides a universal forum for policy analysis, so for consensus on trade policy issue it can help to prepare ground for later negotiations within WTO. UNCTAD and WTO should co-operate with each other in the field of international trade. It is encouraging that two organizations have already started their co-operation. As the main functions of WTO are the implementation and negotiation of contractual trading rules and discipline, there is considerable scope for complementarily between WTO and UNCTAD.The policy analysis and consensus building functions of UNCTAD can make essential contribution to the intergovernmental consideration of trade issues to the point where they can be fruitfully negotiated in WTO.

c) In post cold war economic environment, the need for collective action by the Third World countries to meet the evolving challenges is more important than ever. UNCTAD is the only body in the UN which has some scope to deal with global economic issues from a development perspective. UNCTAD should be equipped for that purpose.

d) UNCTAD's monitoring and analytical capacities should be increased sufficiently.

e) Its efficiency in the area of foreign investment, technology transfer, competition policy regarding Multinational Corporation should be strengthening.

f) UNCTAD should prepare its answer for Third World country regarding liberalization and regional groupings.

UNCTAD is the only organization in the world which gives the impression of being trade and development in an integrated way which is very important.

World Trade Organization (WTO)

World Trade Organization (WTO)

The **World Trade Organization** (**WTO**) is an organization that intends to supervise and liberalizeinternational trade. The organization officially commenced on January 1, 1995 under the Marrakech Agreement, replacing the General Agreement on Tariffs and Trade (GATT), which commenced in 1948. The organization deals with regulation of trade between participating countries; it provides a framework for negotiating and formalizing trade agreements, and a dispute resolution process aimed at enforcing participants' adherence to WTO agreements, which are signed by representatives of member governments and ratified by their parliaments. Most of the issues that the WTO focuses on derive from previous trade negotiations; especially from the Uruguay Round (1986–1994).The organization is attempting to complete negotiations on the Doha Development Round, which was launched in 2001 with an explicit focus on addressing the needs of developing countries. As of June 2012, the future of the Doha Round remains uncertain: the work programme lists 21 subjects in which the original deadline of 1 January 2005 was missed, and the round is still incomplete. The conflict between free trade on industrial goods and services but retention of protectionism on farm subsidies to domestic agricultural sector (requested by developed countries) and the substantiation of the international liberalization of fair trade on agricultural products (requested by developing countries) remain the major obstacles. These points of contention have hindered any progress to launch new WTO negotiations beyond the Doha Development Round. As a result of this impasse, there have been an increasing number of bilateral free trade agreements signed. As of July 2012, there are various negotiation groups in the WTO system for the current agricultural trade negotiation which is in the condition of stalemate.

Structure or Organisation of WTO:

WTO is headed by the Ministerial Conference composed of representatives of all the members who meet at least once every two years. It carries out its functions of the WTO and takes actions necessary to this effect. It takes decisions on all matters under any of the Multilateral Trade Agreements. The Ministerial conference is the supreme authority of the WTO.

There is a General Council composed of representatives of all the members to oversee the operation of the WTO Agreement and ministerial decisions on a regular basis. There is the Council for trade in Goods, the Council for Trade in Services and the Council for Trade-related Aspects of Intellectual Property Rights (TRIPS)which operate under the General Council.The Secretariat of the WTO is headed by the Director General. The Ministerial Conference appoints the Director General and sets out his powers, duties, and conditions of service and terms of office. The Director of General appoints the members of staff of the secretariat and determines their duties and conditions of service. The Director General presents to the committee on budget, finance and administration, the annual budget estimates and financial statement of the WTO.

Objectives of WTO:

Important objectives of WTO are mentioned below:

(i) to implement the new world trade system as visualized in the Agreement;

(ii) to promote World Trade in a manner that benefits every country;

(iii) to ensure that developing countries secure a better balance in the sharing of the advantages resulting from the expansion of international trade corresponding to their developmental needs;

(iv) to demolish all hurdles to an open world trading system and usher in international economic renaissance because the world trade is an effective instrument to foster economic growth;

(v) to enhance competitiveness among all trading partners so as to benefit consumers and help in global integration;

(vi) to increase the level of production and productivity with a view to ensuring level of employment in the world;

(vii) to expand and utilize world resources to the best;

(viii) to improve the level of living for the global population and speed up economic development of the member nations.

Functions of WTO:

The former GATT was not really an organisation; it was merely a legal arrangement. On the other hand, the WTO is a new international organisation set up as a permanent body. It is designed to play the role of a watchdog in the spheres of trade in goods, trade in services, foreign investment, intellectual property rights, etc. Article III has set out the following five functions of WTO;

(i) The WTO shall facilitate the implementation, administration and operation and further the objectives of this Agreement and of the Multilateral Trade Agreements, and shall also provide the frame work for the implementation, administration and operation of the plurilateral Trade Agreements.

(ii) The WTO shall provide the forum for negotiations among its members concerning their multilateral trade relations in matters dealt with under the Agreement in the Annexes to this Agreement.

(iii) The WTO shall administer the Understanding on Rules and Procedures Governing the Settlement of Disputes.

(iv) The WTO shall administer Trade Policy Review Mechanism.

(v) With a view to achieving greater coherence in global economic policy making, the WTO shall cooperate, as appropriate, with the international Monetary Fund (IMF) and with the International Bank for Reconstruction and Development (IBRD) and its affiliated agencies.

Principles of the trading system:

The WTO establishes a framework for trade policies; it does not define or specify outcomes. That is, it is concerned with setting the rules of the trade policy games.
Five principles are of particular importance in understanding both the pre-1994 GATT and the WTO:

1. **Non-discrimination**. It has two major components: the most favoured nation (MFN) rule, and the national treatment policy. Both are embedded in the main WTO rules on goods, services, and intellectual property, but their precise scope and nature differ across these areas. The MFN rule requires that a WTO member must apply the same conditions on all trade with other WTO members, i.e. a WTO member has to grant the most favorable conditions under which it allows trade in a certain product type to all other WTO members."Grant someone a special favour and you have to do the same for all other WTO members." National treatment means that imported goods should be treated no less favorably than domestically produced goods (at least after the foreign goods have entered the market) and was introduced to tackle non-tariff barriers to trade (e.g. technical standards, security standards et al. discriminating against imported goods).
2. **Reciprocity**. It reflects both a desire to limit the scope of free-riding that may arise because of the MFN rule, and a desire to obtain better access to foreign markets. A related point is that for a nation to negotiate, it is necessary that the gain from doing so be greater than the

gain available from unilateral liberalization; reciprocal concessions intend to ensure that such gains will materialize.

3. **Binding and enforceable commitments**. The tariff commitments made by WTO members in a multilateral trade negotiation and on accession are enumerated in a schedule (list) of concessions. These schedules establish "ceiling bindings": a country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. If satisfaction is not obtained, the complaining country may invoke the WTO dispute settlement procedures.
4. **Transparency**. The WTO members are required to publish their trade regulations, to maintain institutions allowing for the review of administrative decisions affecting trade, to respond to requests for information by other members, and to notify changes in trade policies to the WTO. These internal transparency requirements are supplemented and facilitated by periodic country-specific reports (trade policy reviews) through the Trade Policy Review Mechanism (TPRM). The WTO system tries also to improve predictability and stability, discouraging the use of quotas and other measures used to set limits on quantities of imports.
5. **Safety valves**. In specific circumstances, governments are able to restrict trade. The WTO's agreements permit members to take measures to protect not only the environment but also public health, animal health and plant health.

Agreements:

The WTO oversees about 60 different agreements which have the status of international legal texts. Member countries must sign and ratify all WTO agreements on accession. A discussion of some of the most important agreements follows. The Agreement on Agriculture came into effect with the establishment of the WTO at the beginning of 1995. The AoA has three central concepts, or "pillars": domestic support, market access and export subsidies. The General Agreement on Trade in Services was created to extend the multilateral trading system to service sector, in the same way as the General Agreement on Tariffs and Trade (GATT) provided such a system for merchandise trade. The agreement entered into force in January 1995. The Agreement on Trade-Related Aspects of Intellectual Property Rights sets down minimum standards for many forms of intellectual property (IP) regulation. It was negotiated at the end of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in 1994.

The Agreement on the Application of Sanitary and Phytosanitary Measures—also known as the SPS Agreement—was negotiated during the Uruguay Round of GATT, and entered into force with the establishment of the WTO at the beginning of 1995. Under the SPS agreement, the WTO sets constraints on members' policies relating to food safety (bacterial contaminants, pesticides, inspection and labeling) as well as animal and plant health (imported pests and diseases). The Agreement on Technical Barriers to Trade is an international treaty of the World Trade Organization. It was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade, and entered into force with the establishment of the WTO at the end of 1994. The object ensures that technical negotiations and standards, as well as testing and certification procedures, do not create unnecessary obstacles to trade". The Agreement on Customs Valuation, formally known as the Agreement on Implementation of Article VII of GATT, prescribes methods of customs valuation that Members are to follow. Chiefly, it adopts the "transaction value" approach. In December 2013, the biggest agreement within the WTO was signed and known as the Bali Package

BALANCE OF PAYMENT

Balance of Trade:

International trade leads to international payments in settlement of international indebtedness. In the international trade experts pay for imports and every import is expected to be matched by a corresponding value of exports.

When exports and imports are equal during the given period of time, the balance of trade is said to be balanced i.e., the value of exports taken together is equal to the value of imports taken together. In other words there may be differences between the value of goods imported and goods exported. The difference is called balance of trade. If the value of exports is greater than the value of imports it is said to be favorable balance of trade. If imports value is more than exports value if is said to be unfavourable balance of trade. From this it is clear that balance of trade includes only visible items. However in international trade not only goods but also services are exported and imported.

Balance of payment:

Kindleberger has defined that "the balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting country and the residents of foreign countries during a given period of time". From the definition, the following conclusions can be drawn.

1. Balance of payments refers to the country's receipts and payments at a particular period of time.
2. The receipts of one nation are the payments of other country and vice versa.
3. According to double accounting system a country's total payments should be equal to the country's total receipts.

4. The transaction included in the balance of payment can be divided into (i) import and export of goods and services, (ii) receipts and payments of claims and dues.

Balance of trade vs Balance of payment:

1. The term balance of trade refers to the balance of merchandise goods only, i.e., only visible items are taken into account.
   Balance of payments includes invisible items, unilateral transfers and capital movement in addition to the visible items of trade.
2. Balance of trade refers to only a part of the balance of payment. The former is only a subset of the latter.
3. The balance of payment as a whole must balance as total credits are always equal to total debits. But balance of trade needs not to be in balance always.

When invisible exports and imports are taken along with visible items and all transaction between one country and the other is struck, it becomes balance of payments. Therefore balance of payment of a country is the record of its monetary transactions over a period of time. It is a statement of all payments which a country has got to make to foreigner and the payments which the country has got to receive from the foreigners.

The payment which a country has got to make to a foreign country is called the debit item and the payment the country has to receive is called the credit item in the balance of payments. In other words, the balance of payment is a record of credit and debit item of a country's foreign trade. When receipts are greater than payments it is said to be favorable balance of payment. When payment is greater receipt it is said to be unfavorable balance of payment. The following are the main debit and credit items in the balance of payment account.

Structure of Balance of Payments:

Credit	Debit
1. Value of goods exported	1. Value of goods imported
2. Payments received from foreigners	2. Payments made to the foreigners
3. Travel expenditures in the country by foreign tourists	3. Travel expenditure by country's nationals touring abroad.
4. Remittances by the country's nationals abroad	4. Remittances by the immigrants to their home countries.
5. Donations and charities received by national from abroad	5. Donations and charities given by national to foreigners
6. Interest and dividends received from abroad by nationals	6. Interest and dividends paid to the foreign nationals
7. Loans received from abroad	7. Loans repaid
8. Expenditure of the foreign embassies in the country	8. Expenditure of the country's embassies abroad
9. Foreign investments in the country	9. Repatriation of foreign investments
10. Capital transfer of people immigrating to the country	10. Capital transfer of people emigrating to other countries
11. Gold moving out of the country	11. Gold moving into the country
12. Royalties received from abroad by the nationals	12. Royalties paid to foreigners by nationals
13. Reparations received	13. Reparations paid

Movement of gold, movement of capital, leading and borrowing transactions, loan servicing, flight of hot money, purchase and sale of assets and similar capital transaction come under the capital account of the balance of payment. All others fall under the current account of the balance of payment which deals with payments for currently produced deals with payment of debts and loan transactions. Current account shows a debit, capital account will show how this balance is financed.

Types of balance of payments Disequilibrium:

Various types of balance of payments are as follows:

1. **Short-term Temporary Disequilibrium:**
   Temporary Disequilibrium in balance of payments may occur due to some temporary misfortunes like monsoon failure, locusts destroying the agricultural crops, earthquake affecting vital industries, prolonged strikes by labor unions, war with neighboring countries, etc. These will drastically affect production and export in the country, which may result in disequilibrium in balance of payments.
2. **Cyclical Disequilibrium:**
   This refers to situations when a deficit or surplus in balance of payments position of a country renews itself in a cyclical manner, i.e., deficits and surpluses occur alternatively. Cyclical fluctuations in prices, production, employment and incomes are endemic in the capitalistic economies. These changes bring periodic fluctuations in the exports and imports, thereby causing cyclical disequilibrium in balance of payments.
3. **Secular Disequilibrium (Long Period):**
   It may occur due to several causes. The economy may be moving from lower level to a higher stage of development in the process of planned economic development. This transition to a higher stage may occur due to rise in the rate of capital formation, advancement in technological field, increase in population, discovery of new sources of supply of vital metal or crude oil. As in the case of North Sea, off the coast of England.

4. **Structural Disequilibrium:**

It may occur when structural changes take place in the economy of a country. These structural changes may be due to changes in tastes of the people, changes in technology or changes in the fashion of the people preferring foreign goods to domestic goods and services. For example, a decline in foreign demand for Indian tea, because of changes in tastes of foreigners would affect production of tea, investment in tea plantations, production of related commodities and investment in those industries. Resources employed in tea and related industries will have to be shifted to production of goods for which demand has gone up because of changes in tastes of foreigners. If exports of Indian tea decline and her imports remain the same as before, there will be disequilibrium in the balance of payments of the country.

5. **Fundamental Disequilibrium:**

It may occur when there is a persistent deficit or surplus in the balance of payments of a country. This may occur because of radical change in the economic structure of a country greatly influencing its exports and imports, totally changing the composition of both; or it may occur due to radical structural changes in other countries or due to changes in monetary and fiscal policies of a country either in the country or in other countries

Causes of disequilibrium:

Disequilibrium in the balance of payments may be caused by a number of factors.

1.**Random variables:**

Random changes in trade, seasonal fluctuations, weather conditions etc., may cause temporary disequilibrium in the balance of payment of a country this equilibrium may correct themselves quickly.

2.**Fundamental economic changes:**

Changes in consumer's tastes and preferences within the country or abroad are known as fundamental economic changes. They may affect the country's imports or exports and cause disequilibria in the balance of payment of the country. Such disequilibria are called chronic or fundamental disequilibria.

3.**Technological changes:**

Technological changes may take place in the methods of production or products in the exporting or importing countries. As a result of technological changes, costs, prices and quality of the products change. This may affect the country's imports or exports.

4.**Change in national income:**

A change in the country's national income is also responsible for disequilibrium in the balance of payments of the country. If, for example, national income increases imports increase and as result a deficit is created. On the other hand, if national income decreases imports decrease and as a result a surplus is created.

5.**Inflation and deflation:**

The occurrence of inflation or deflation is another cause for disequilibrium in the balance of payment. When there is inflation in the country, its exports decrease and imports increase. As a result a deficit in the balance of payments is created. On the other hand, when there is deflation, its exports increase and imports decrease. As a result a surplus in the balance of payments is created.

6.**Stage of economic development:**

The stage of economic development may also be responsible for the disequilibrium in the country and balance of payments. If a country is passing through a phase of economic development, it exports cheap primary products and imports costly machineries, raw materials, capital equipment and technical knowhow. As a result, the balance or payment will have a deficit.

7.**Lending and borrowing**:

The lending and borrowing operations between countries also result in disequilibrium in the balance of payments. If a country gives loans and grants on a large scale to other countries, it will have a deficit, it will have a deficit. If a country receives loans and grants on a large scale, it will have a surplus.

Correction of adverse balance of payments:

Balance of payments must always balance. But it view of the peculiar economic and social conditions prevalent in different countries, gaps in the balance of payments are inevitable.

Methods of correcting adverse balance of payments:

1. **Deflation:**

An adverse balance of payment is due to an excess of demand for foreign goods. The basic remedy for such a situation is to curtail demand for foreign goods by restricting consumption. Deflation has the effect of reducing money incomes and thereby, the demand for foreign goods. It also reduces the money in the home country and thereby corrects and adverse balance of payment. Thus, by deflating its currency, a country can reduce its imports and increase its exports and thereby reserves of foreign exchanges.

2.**Exchange depreciation:**

The exchange depreciation refers to the decline in the rate of exchange of one currency in terms of another currency. This decline in the rate of exchange is brought about by the automatic forces of demand for and supply of foreign exchange. Exchange depreciation has the effect of restricting imports and encouraging exports and thereby of correcting a mile adverse balance of trade.

This method of correcting an adverse balance of payment through exchange depreciation was employed by Great Britain as early as in 1949 when the value of pound(£) was reduced from dollar($) 4.03 to $ 2.80 when exchange was depreciated the prices of imported goods in Great Britain in terms of pound rose up and the volume of imports dwindled considerably. Thus the statistical evidence process beyond count the practicability of the application of the divide of exchange depreciation to correct an adverse balance of payment. But exchange depreciation however, effective as a method of correcting an adverse balance of payment it may be, cannot be a better and permanent remedy. It is defective in many respects.

1. Exchange depreciation is suitable only to a country with a free exchange rate and not to a country with a fixed exchange rate.
2. Exchange depreciation makes international trade risky and hence it reduces its volume.
3. Exchange depreciation results in higher in higher prices and consequent rise in the cost of lying.
4. It means increase in money incomes which many ultimately bring about a grater flow of goods from foreign countries.

3.**Devaluation:**

Devaluation refers to a lowering of the external value of currency in terms of gold or other currencies. It may be used to correct a persistent adverse balance of payment. Such a lowering of the value of one currency in terms of gold or other currencies will make the domestic currency cheaper in the foreign market and the foreign currency costlier in the domestic market. Hence domestic goods will become cheaper in the foreign market and foreign goods costlier in the domestic market. Therefore exports will be stimulated and imports restricted. This is how the deficit in the balance of payments is wiped out and the equilibrium restored.

4.**Exchange control:**

Exchange control, a highly artificial method of correcting disequilibrium in the balance of payments of a country has been very variously defined. Exchange control refers to government regulation of exchange rate as well as restriction of conversion of the local currency against foreign currency. In the opinion of Paul Einzing there are 41 methods of exchange control. The chief methods of exchange control are intervention, restriction, exchange clearing agreements etc.

5.**Trade restrictions:**

Any disequilibrium in the balance of payments can be corrected also through trade restriction. Trade restrictions aim at restricting the volume of imports and promoting the volume of exports. By performing these two functions, they cut down the demand for imports and reduce or eliminate any imbalance of payments. There are **several forms of trade restrictions.**

- Tariffs-They are imposed in imported articles with a view to restrict foreign trade.

- Import quotas-There is the limits fixed by the Government of a maximum quantity of certain specified commodities to be imported during a given period of time.
- Import prohibitions- These refer to the complete prohibition of import of certain goods, generally non-essential luxury goods.
- Commercial agreements-These refer to the agreements entered into by a country with the rest of the countries with a view to increase its imports and restrict its imports.
- Export bounties- They are the concessional made to certain goods exported by the local government to boost up its exports.

6.**Other measures:**

A country can use capital imports to correct a deficit in its balance of payments. When capital is perfectly mobile within countries, a small rise in the domestic rate of interest brings a large in flow of capital. The balance of payments is said to be in equilibrium when the domestic interest rate equals the world rate.

A deficit in the balance of payments can also be corrected by encouraging exports of quality products and by reducing imports through increased production and productivity and by better marketing. The deficit in the balance of payment is removed when exports rise faster than imports.

Our desirable objective is a balanced balance of payment of a country. Any imbalance with an excess of export over imports or an excess of imports over exports, should be corrected with sure steps without any delay. It can be corrected with wither of or all the methods. But the choice of proper method has to be made in consideration of the particular economic situation of the country concerned and of the economic policies followed in it.

FOREIGN EXCHANGE

The term foreign exchange is capable of more than one meaning, according to the context in which the term is used. Casually it refers to the currency of a foreign country. Technically it refers to the mechanism of currency exchange. Politically the term is used to denote the balance of payments equilibrium. Scientifically foreign exchange refers to the various aspects of international money changing. Geoffrey Crowther defines it "as the process of exchanging the money of one country for the money of another". Prof.Evitl definition is "foreign exchange is the mechanism by which payments are effected between two countries having different monetary units". By far the best definition of the term is that of Hawtry Withers, chairman of the Federal Reserve Board of U.S.A. According to him, "Foreign exchange is the art and science of international money changing on the arts side it deals with the instruments of foreign exchange and on the science side it is the study of rate of exchange and the problems connected with it".

When people of a country trade with foreigners they must pay for their imports in foreign currencies and receive payments for their exports in home currencies. Thus there is a constant exchange of currencies which give rise to the problem of foreign exchange. For example, an Indian who sells cotton fabrics to a Britain importer will want payment to be made to him in Indian rupees. The Britain importer however, will make payment only in pound sterling. The foreign exchange mechanism makes it possible for the exchange of sterling pounds for rupees. This however is not an easy problem and there are various aspects to this transaction such as legal aspects commercial aspect accounting aspect as well as political aspect. A number of institutions make up the foreign exchange mechanism and they are discount houses, broken, firms, banks, money changers, exchange dealers and other.

In the example cited above, we discussed commercial transactions of exports. But commercial transaction a part there are other international settlement arising out of loans, interest payments, investments, shipping charges, banking charges, insurance charges, tourist expenditure, donations, capital movement etc also find a place in foreign exchange. These are commonly known as the invisible items of trade.

Rate of exchange:

Rate of exchange is the price of a unit of a country's money stated in the currency of another (i.e.,) the number of units of one currency which could be exchanged in the foreign exchange market for one unit of another currency. It is also known as the external value of the country's money. If, for instance the rate of exchange between the Indian rupee and the U.S. dollar is 32 Indian rupees = 1 U.S. dollar. Then the external value of the Indian rupee expressed in terms of U.S. dollar is 1 $ = 32 Rs.

When the rate of exchange of a currency is quoted in terms of the foreign currency for a unit of home currency it is known as **currency rate.** For example Rupee 1 = 32 dollars, is currency rate for India. For England will be pence rate as their money is expressed in terms of the foreign currency unit namely rupees. When the foreign currency unit is fixed and the home currency equivalent is changed according to the changes in the external value of the home currency it is known as **pence rate**. For example $ 1 = Rs. 31.50. Similarly 1£ = 124N.F. is pence rate for France, but currency rate for England.

Determination of exchange rate:

The important question in foreign exchange is what determines the rate of exchange between two currencies. The equilibrium rate of exchange, of course, will be determined in the foreign exchange market, when it is not controlled by the state in accordance to the general principles of the theory of value (i.e.,) by the interaction of the forces of demand for and supply of the foreign exchange. However, like normal price it is a long term rate of exchange. The market rate of exchange between currencies fluctuates widely under varying conditions around the long term rate of exchange. The different theories of determination of foreign exchange rates are discussed below.

Mint par of Exchange:

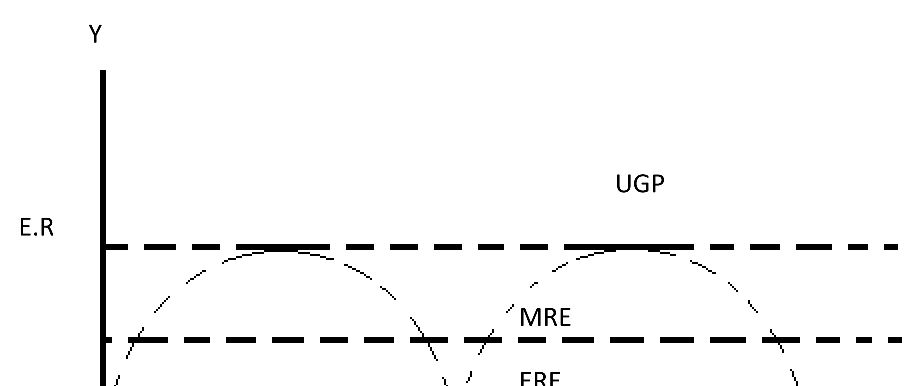
When two currencies are on **gold standard** the rate of exchange between them is the ratio between the quantities of pure gold the currencies contains or to which the currencies are linked by law. This basis is called the mint par of exchange. If for instance, a pound sterling contains 126 grams of pure fold and an U.S. dollar 26 grains of gold of the same purity, then the mint par will be 126/26 = 4.86 (1£ = $ 4.86). Similarly if the German mark contains 6 grains of pure gold, the rate of exchange between pound sterling and German mark will be 126/6 = 21 (1£=G.M.21).

But in actual practice, the rate of exchange will not be exactly equal to the mint par and will fluctuate above and below the par rate depending on the expenses of freight, packing, carriage insurance commission etc., involved in transporting gold from one country to another. The limit for the fluctuation of the rate of exchange are fixed by the gold points known as upper gold point and lower gold point.

Gold will be transported in settlement of transactions if found to be cheaper than obtaining foreign exchange by means of a draft or other foreign exchange instruments. For example, if the mint par is £1 = $ 4.86 and the cost of transporting gold worth New York to London is 26 cent, then New York banker will charge up to $ 5.12 (4.86+0.26) per pound £ for issuing a sterling draft on London. If the banker demands a rate higher than $ 5.12 per pound then gold will be exported at this point and the draft will not be purchased. The highest point to which the rate can go is the upper specie or gold export point. So much so gold export will be equal to mint par plus cost of transport.

Similarly, when the New York exporter discounts a bill drawn on London with the New York bank he will accept equivalent amount in dollar so long as the rate is mint par minus coast of transport of gold from London to New York. If the cost of transport if 23 cents or $0.26 for pound worth of gold, then the rate can go down to the limit of $ 4.60 per pound (4.86 - 0.26). If the rate goes below this level the New York exporter will import gold from London instead of discounting the bill. This lower rate is known as lower specie point or gold import point. So much so gold import point is equal to mint par minus cost of transport.

It should be remembered that the rates need not go up or go down by the exact cost of transport, but they will fluctuate between the upper and lower specie points, depending upon the supply and demand for currencies as shown in the accompanying diagram.



UGP = Upper Gold Point (£ 1 = $ 5.12)

LGP = Lower Gold Point (£ 1 = $ 4.60)

ERE = Equilibrium Rate of Exchange (£ 1 = $ 4.86) Mint par of exchange.

MRE = Market Rate of Exchange.

PURCHASING POWER PARITY THEORY

The purchasing power parity theory is one of the important theories of foreign exchange. It was first expounded by John Wheately and William Blakes. Later it was improved by Ricardo the classical economist. It was perfected and populated by Prof.Gustav Cassel, the Swedish economist. This theory was born out of a controversy and necessity. German writers pointed that inflation was due to the fall in the exchange value of a currency. Gustav Cassel disproved it by restating the purchasing power parity theory. He established that inflation was the cause of exchange depreciation and not vice versa. This theory was then applied to explain the determination of rate of exchange under **inconvertible paper currency system**.

This theory states that the rate of exchange between two countries is determined by the purchasing power of two countries. Cassel observes, 'Our willingness to pay a certain price for foreign money must ultimately and essentially be due to the fact that this theory possesses a purchasing power as against commodities and services in that foreign country. On the other hand, when we offer so and so much of our money we are actually offering a purchasing power as against commodities and services in our country. Our valuation of a foreign currency in terms of our own therefore depends mainly on the relative purchasing power of the two currencies. "For example, £ 1 purchases a parker pen which can be purchased by $ 5 the rate of exchange will be £ 1 = $ 5. This is what is called the purchasing power parity. The rate of exchange between these two currencies is thus, the ratio between their equal purchasing powers.

Given the normal trade, the rate of exchange established on the basis of purchasing power parity remains unaltered as of these two currencies depends upon the price level in each country, the purchasing power changes for reason of inflations and deflation. Naturally when the purchasing power changes,the rate of exchange also changes. Ultimately, the new rate established will be equal to the old rate multiplied by the quotient of the degree of inflation in each country. For eg, the old rate is £ 1 = $ 5 and if inflation occurs 4 times in U.S.A. and two times in England then the new rate of exchange will be £ 1π 1X2 and $ 5X4 i.e., £ 2 is equal to $ 20 i.e., £ 2 = $ 10. As Cassel says, "this is the new parity which is called the purchasing power parity as it is determined by the quotient of the purchasing power".

There will be fluctuations in the purchasing power from day to day, especially during the transition period either by sudden movements of capital or by seasonal purchases or by anticipated changes in the future. But the tendency will be towards that rate which will make the internal and external purchasing power equal. If equilibrium is not established in time, the changes in price either in England or in America will bring equilibrium in the rate of exchange. It can be explained with an example. Suppose now the rate of exchange is £ 1 = $ 15 instead of the normal rate £ 1 = $ 10, the dollar will be dear used. American goods will become dear to the Americans. As a result American exports will be encouraged and its imports will be checked. Conversely British exports will be checked and its imports stimulated. This transaction will make the British demand more American dollars to pay imports. The increased demand for dollar will raise the value of the dollar until the exchange rate settles at the actual rate of £ 1 = $ 10.

Criticism:

The importance of this theory lies in its validity. It tells us how the rate of exchange between two countries on inconvertible paper currency system is determined. It brings out the close relation between the internal price level and the external value of the currency. Over and above it has given the correct and the right view about the depreciation of the currency. However, it is not free from defects.

1. According to this theory, the rate of exchange is equal to the purchasing power of the two currencies. But Cassel answers this criticism by saying that the rate of exchange will adjust itself in the long run.
2. This theory assumes that there is a direct connection between the purchasing power of the currencies and the rate of exchange. But this is not so because the exchange rate is often affected by tariff speculation and capital movements.
3. This theory compares the general price levels in two countries without referring to the actual prices of internally and internationally traded goods. Internationally traded goods generally tend to have the same price. But the domestic goods will have altogether different prices.
4. The theory assumes that the prices of traded goods will move together. But this is not true.
5. It is extremely difficult to calculate the rate of exchange on the basis of the purchasing power parities, for no one can practically measure accurately the changes in the purchasing power of currencies.
6. The greatest weakness of this theory is that it falls to take into account invisible items such as long term capital interest, dividend, tourist expenditure, etc, in the balance of payment.
7. This theory at the most explains the ultimate factor namely the purchasing power rather than the immediate factors like tariff, supply and demand for foreign currency etc., that determine the rate of exchange.
8. An integral part of this theory is that the changes in price level bring about changes in the rate of exchange but not the rate exchange influencing the price level.

Conclusion:

Despite these criticisms, this theory is important because it furnishes the very basis for the determination of rate of exchange under inconvertible paper currency system. It can be applied to the other monetary standards too. It is superior to old theories which explain the determination of rate of exchange on the basis of balance of indebted between countries. Thus it stands as the best theory of foreign exchange.

BALANCE OF PAYMENT THEORY

The balance of payments theory holds that foreign exchange rate is determined by independent factors not related to internal price levels and the quantity of money as asserted by the purchasing parity theory. On the other hand free exchange rate tends to be such as to equate the demand for and supply of foreign exchange. For example the external value of rupee will depend upon the demand for and supply of rupee in the foreign exchange market. According to this theory the rate of exchange is determined by the demand for the supply of foreign exchange.

The demand for rupees comes from those who offer foreign exchange in order to obtain rupees, while the supply of rupees comes from those people, who are offering rupees to obtain foreign exchange. For example, The Indian exporters to Canada demand rupees against the claims of Canadian dollars; and the Indians importing Canadian products offer rupees for Canadian dollars. The interaction of Canadian dollar supply curve and Canadian dollar demand curve gives the equilibrium rate of exchange between Canadian dollars and rupees. The above illustration has been provided with import and export alone accounting for the demand for and supply of foreign exchange. However, there will also be invisible items, entering international trade and the demand for and supply of foreign exchange should constitute all the items that enter the balance of payments.

Demand for foreign exchange:

It arises from the debit side of the Balance of Payments. It is equal to the value of payments made to other country plus loans and investment made abroad.

Supply of foreign exchange:

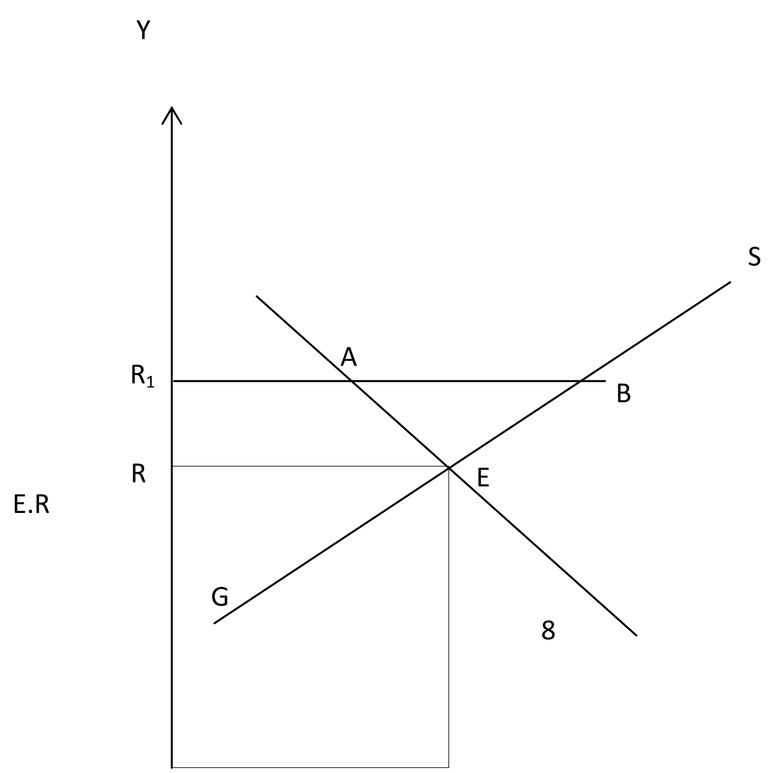
It arises from the credit side of the Balance Of Payments. It equals payments made by other country plus loan and investment made in this country.

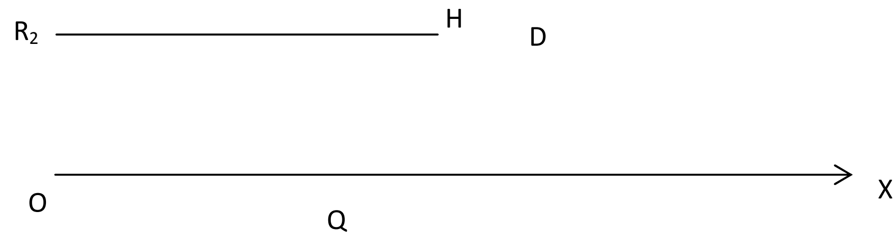
When BOP is unfavorable then demand for foreign exchange is more than its supply. Thus causes the external value of the domestic currency to fall. So the exchange rate falls.

When BOP is favorable the demand for foreign currency is less than its supply. This causes the external value of the domestic currency to rise. So the exchange rate rises.

When the exchange rate falls below the equilibrium rate exports increase and the disequilibrium of BOPs is eliminated. When the exchange rate rises above the equilibrium rate exports decline and the favorable BOP disappear and the equilibrium rate is established. Thus at any point the rate of exchange is determined by the demand for the supply of foreign exchange. This is shown in a diagram.

Balance of Payment Theory





dd&Sy of Foreign Currencies

DD is the demand curve. It slopes downwards because when the exchange rate raises the demand for foreign currency falls and vice versa. SS is the supply curve. It slopes upwards because when exchange rate falls, the account of foreign currency offered for sale will be less and vice versa. The two curves intersect at E where OR equilibrium rate is determined. At this rate the quantity of foreign exchange demanded and supplied equals OQ. E is also the point where the balance of payments is in equilibrium. Suppose the exchange rate is above to OR_1 the demand is less than supply ($R_1A < R_1B$). If the exchange rate is falling to OR_2 the demand is greater than supply ($R_2H > R_2G$) it shows unfavorable balance of payment.

Criticism:

1. Balance of payment is independent of the exchange rate.
2. It neglects the role of price level in influencing balance of payment.
3. It is based on unrealistic assumption of free trade.
4. Equilibrium rate of exchange may not be one of balance of payments. There is no tendency for balance of payments to be in equilibrium over the long run.

Exchange Control

Any kind of interference by the Government or its agents in the foreign exchange market is said to be exchange control. Though exchange control is adopted as a measure of solving adverse balance of payments, the main purpose of exchange control is to ensure the stability of exchange rates. Such a stability of exchange rate is necessary for the smooth running of trade and industry of any country.

In the history of exchange control, different countries have adopted the measure for different **purposes.**

Firstly, in order to prevent a run on foreign exchange, exchange control may be practiced.

Secondly, countries may adopt exchange control when the normal mechanism of the exchange market is found to be ineffective.

Thirdly, with a view to accumulate foreign exchange in order to acquire equipment or a machine at a later date, countries may go in for exchange control. A number of countries have adopted the measure for this reason in order to catch up with the technological developments taking place in other parts of the world

Fourthly, exchange control may be self imposed on a country when there is sufficient reason to freeze the assets of foreign nationals, foreign companies and foreign investments of all other kinds. In 1949 Government of India freeze the balances of all Japanese companies when they tried to close their business in India.

Fifthly, exchange control is said to go hand in hand with economic planning. Every plan has an element of foreign exchange, priorities and foreign exchange allotted accordingly. The success or failure of the plans depends on the effective implementation of exchange control.

Sixthly, exchange control may be adopted by a country to under value its currency with a view to increase its exports and decrease the imports or over value its currency to move with the trend of imports and exports.

Seventhly, exchange control may be adopted by a country tp prevent the import of foreign goods into the country and thus encourage local industries with a view to bring about increased level of economic activity and employment.

Exchange control may be adopted for various other reasons as well. For example to prevent excessive tourism, to safeguard home industries and avoid foreign money encouraging spying in the country exchange control may come in handy.

Methods of Exchange Control

There are a large number of exchange control methods; it is very difficult to enumerate all of them. In his book 'Exchange control' Paul Einzing has given as many as 41 different methods of exchange control. In fact the same method may be known by different names in different nations of the world. However exchange control methods are broadly classified as direct methods and indirect methods.

Direct Methods:

The direct method consists of intervention, restrictions and agreements.

1. Intervention:

Intervention refers to Governmental or Central Bank's interference in the foreign exchange market. The intervention may be by pegging operations and embargo on capital. Of these, pegging operations are adopted to stabilize the exchange value it moves away from the equilibrium rate of exchange. For instance, if the equilibrium rate of exchange rate is Re.1= 1s.6d. and the British demand for rupees increases while the Indian demand for British pound remains the same, the rate of exchange will move in favor of India. (may be Re. 1= 1sh. 10d.) . To bring down the exchange rate to the equilibrium level, Indian rupees have to be unloaded in the British market to increase the supply of rupees. This operation is known as "pegging down". The opposite of this, while the British pounds will be unloaded in Indian, is known as "Pegging up"

Embargo on capital will include prohibition of subscription to foreign government loans and shares of foreign companied. Transfer of capital belonging to emigrants may also be controlled under the embargo on capitals. Such capital transfers may be permitted in installments over a period of time as it is being done in the case of Anglo-Indian emigrants from India.

Of late exchange equalization accounts have been used as effective methods of exchange control. The account is a pool of funds of various currencies as well as gold, left in the hands of the central bank or the treasury, with which foreign currencies are bought and sold as the situation may demand. If a particular currency appreciates in value more of that currency will be released from the fund to control further appreciation. Similarly, when a particular currency depreciated in value more of that currency will be purchased out of the fund, in the foreign exchange market to offer exchange support for the currency.

2. Restrictions:

Exchange control by means of restriction may take three different forms, namely

i) centralization of all trading in foreign exchange, ii) blocked accounts and iii) multiple exchange system.

i) Centralization of all trading in foreign exchange:

As a wholesale dealer of foreign exchange all trading in foreign exchange are centralized in the hands of the central bank of the country. Foreign exchange for the purpose of imports or payments abroad is very much restricted as to their quantity and direction. In most of the developing countries, a list of priorities is prepared for release of foreign exchange.

ii) Blocked accounts:

Under this method, foreign exchanges are released for import only after earning the foreign exchange by exports. Similarly, foreign exchange earned by the foreigners is permitted to be used for purchase of goods in the home currency. Germany adopted this method in 1933 and gave it up after a period of ne year's bad experience with it.

iii) Multiple exchange system:

The system of multiple exchanges is another form of exchange control. It implies fixing different rates of exchange for the imports and exports of different commodities. To secure a good price for exports and reduce the volume of imports is the objective of this method. However it complicates the complicated foreign exchange mechanism and is nor to found to be.

3. Exchange Clearance Agreements:

This is the third broad classification of direct exchange control methods and four types of agreements are popular today among the nations of the world. The first known exchange clearance agreement was signed between Switzerland and Germany in 1939. This agreement was more or less a compensation agreement which lasted for a few years and then withered away.

The types of agreements that prevail among the countries of the world can be broadly being divided into four types. i) Compensation agreements, ii) Clearing agreements, iii) Payment agreements and iv) Standstill agreements.

i)Compensation agreements:

This is sort of an old fashioned barter where in goods are exchanged for goods at a fixed ratio. E.g. India-Pakistan cotton agreement falls under this head. Under this agreement, Pakistan cotton is exchanged for India's textiles on the quantity basis. However, this type of agreement is not at all popular and the most popular type is clearing agreements.

ii) Clearing Agreements:

This consists of an undertaking by two or more countries to buy and sell goods and services to each other at mutually agreed exchange rates against payments made by the buyer in their own currency and held at the respective Central Bank. The differences , if any at the end of the stipulated period is settled either by transferring gold or an acceptable third currency or by carrying forward the deficit to the renewed agreement or by an extra shipment of merchandise.

iii) Payment Agreements:

When a country has taken a big loan from another nation it often agrees to set aside a portion of its export towards repayment of the loan. Year after year, after earmarking that portion of foreign exchange, the balance available is taken for current transaction. These agreements have the merit of self liquidating the loans as the lender country has to purchase goods to the extent of the amount earmarked for repayment every year.

iv) Stand still Agreement:

Agreements may take the form of standstill agreements as well. By these agreements, repayment of loans and interest payments are postponed to a very distant date and they are not taken into account in the balance of payment year after year. This is also known as transfer moratorium.

2. Indirect Methods:

This consists mainly of i) Regulation of merchandise and ii) manipulating bank rate.

i)Regulation of merchandise:

Since ins outs of merchandise primarily affect the rates of exchange, a proper control on the rate will be by regulating the quantity of exports and imports. Imports are restricted by license, quotas or tariffs. Certain imports may be banned as well. Exports may be stimulated by bounties, subsidies, import entitlements and export promotion. To diversify foreign trade, exports to certain areas may be subsidized and imports from certain areas may be restricted.

ii) Manipulating bank rates:

Manipulating the bank rate is another indirect method. When the bank rate is raised, the interest rate also rises in the country and more capital from outside is likely to be brought about in. This will increase the supply of foreign exchange and regulate the rate of exchange. However retaliatory action on the part of other countries will neutralize the effects of such trade controls.

Merits of Exchange Controls:

1. Exchange control is very indispensable for the country, particularly during the period of war. During the war period, the country may have to import arms and ammunitions and other war materials on a very large scale. This may turn the rate of exchange of the currency of the country very adverse. Hence, exchange control is very essential to check this possibility.
2. Exchange control is essential for a country on the way of economic development. Countries on the course of economic development require large scale imports of machines, raw materials, finished and semi-finished goods and also technicians. This will result in the decline of the value of the currency and to check this trend, the country should exercise all methods of exchange control in order to import essential items for purposes of development.

3. Exchange control is useful in controlling the large scale movement of hot money amongst the countries of the world. The large scale movement of hot money creates several complications for the smooth functioning of the economy. Exchange control is essential for maintaining stability and smooth function of economy.
4. This enables the country to correct the adverse balance of payments, adopt independent economic policy and arrest violent fluctuations in the rate of exchange and also avoid depressionary trend.
5. Economic planning, development of domestic industries, self sufficiency in production, channelization of foreign trade in the desired manner etc., would be possible only through exercising effective exchange control.

Demerits of Exchange control:

1. Since the imports are deliberately curtailed through exchange control, exchange control will result in the contraction of foreign trade. Exports too will also decline in the long run due to exchange control, adopted for foreign countries.
2. Exchange control sacrifices the 'Principle of Comparative Cost'. Only in free trade, this is possible. Under 'Protectionism' administration of exchange control will become very expensive and it requires an army of competent officials.
3. Finally, the system of exchange control will become the source of corruption and it will encourage political and administrative favourism, nepotism and bribery, etc.

Future of Exchange Controls:

Though exchange control is practiced by both developed and developing countries and seems to be necessary to stabilize the exchange rate, exchange control does not solve the problem of foreign exchange. On the other hand, it reduces the volume of trade, checks the flow of capita, leads to smuggling, brings out retaliatory action and prevents people from the use of foreign trade. The effectiveness of exchange control depends very much on the cooperation of other countries by not taking retaliatory action. When all countries adopt exchange control the net benefit of that to any particular country will always be nil.

EXCHANGE RATE POLICY

Exchange rate policy

The exchange rate of an economy affects aggregate demand through its effect on exports and imports, and policy makers can exploit this connection. Exchange rates can be manipulated so that they deviate from their natural rate. Many economists regard exchange rate manipulation as a type of monetary policy.

Rates need to be held down to stimulate exports, and pushed up to reduce inflationary pressure. While the Bank of England does not specifically target the exchange rate, the MPC will consider exchange rates. Clearly, during times of inflationary pressure the MPC would prefer a relatively high rate as this reduces the price of imports and works to dampen inflationary pressure. However, the MPC must keep an eye on export competitiveness, and if rates move too high UK exports will become uncompetitive.

The basic types are a *floating*exchange rate, where the market dictates movements in the exchange rate; a *pegged float*, where a central bank keeps the rate from deviating too far from a target band or value; and a *fixed* exchange rate, which ties the currency to another currency, mostly more widespread currencies such as the U.S. dollar or the euro or a basket of currencies.

Fixed Rate and Flexible Exchange Rate:

The rate of exchange is the rate at which one currency is exchanged for another. It is the price of one currency in terms of another currency. The rate of exchange is fixed or fluctuating.

I. Fixed Exchange Rate:

A fixed exchange rate is also known as pegged exchange rate. The exchange rate is fixed by the monetary authorities by legislation or intervention in currency markets. They may buy or sell foreign currencies according to the needs of the country. They may appreciate or depreciate the national currency. All exchange transactions take place at the fixed exchange rate.

Case for Fixed Exchange Rate or Merits of Fixed Exchange Rate:

The following are arguments in favour of fixed exchange rate.

1. It increases production and leads to foster growth of the economy.

2. It makes prices of goods predictable and encourages international trade.

3. It promotes economic integration.

4. It encourages long term capital flow. There is no uncertainty and risks in this system.

5. It creates confidence in the strength of the domestic currency.

6.All speculative activities are controlled by the monetary authorities. There is no fear of any adverse effect of speculation on the exchange rate.

7. It serves as an anchor and imposes a discipline on monetary authorities to follow responsible financial principles within the country.

Case against Fixed Exchange Rate or Demerits of Fixed Exchange Rate:

The following are the arguments against the fixed exchange rate.

1. The fixed exchange rate policy is maintained at the cost of full employment and stable domestic prices.

2. The effects of unexpected disturbances in the domestic economy are transmitted abroad/

3. A country is required to maintain large reserves of foreign currencies.

4. Complicated exchange control measures are followed by the countries having fixed exchange rate. This will lead to misallocation of the resources of the economy.

5. It is difficult to keep the exchange rate fixed for a long time.

II. Flexible Exchange Rate:

A flexible exchange rate is also known as floating or fluctuating exchange rate. It is not fixed by the monetary authorities. Further it is established by the interaction of the market forces of demand and supply of the currency.

Case for Flexible Exchange Rate:

The following are the arguments in favour of flexible exchange rate.

1. It is simple in operation. It is fixed by the market forces of demand and supply.

2. Under a system of flexible exchange rates, adjustments in the balance of payment are smooth painless and continuous.

3. It preserves he autonomy of the domestic economic policies. Modern government s need not sacrifice their objectives of full employment and growth with stability in order to remove the balance of payments' disequilibrium.

4. There is no need to accommodate gold movements and capital flows between countries. 5. There is no need for foreign exchange reserves when exchange rates are freely fluctuating.

6. There is no need to have international institutional arrangements like the IMF for borrowing and lending short term funds to remove disequilibrium in the balance of payments.

7. It reinforces the effectiveness of the monetary policy.

8. It does not require the introduction of complicated and expensive trade restriction and exchange controls.

9. There is no need for forming customs unions and currency areas.

Case against Flexible Exchange Rate or demerits of Flexible Exchange Rate:

1.The market mechanism may fall to bring about an appropriate exchange rate.

2. It is difficult to define a freely fluctuating exchange rate.

3. It has a bias towards inflation.

4. It breaks up the world market.

II-FLUCTUATIONS IN EXCHANGE RATE:

The rate of exchange is seldom constant. It keeps on fluctuating from time to time. The long period rate of exchange is stable. The fluctuations in the rate of exchange in the short period spell out a large number of harmful effects on the volume of international trade.

Causes for the fluctuations in the rate of exchange in the short period:

1. Exchange in prices:

Change in internal price level results in changes in rate of exchange.

When the price level rises in the domestic country, domestic goods become dearer in the foreign market and the foreign goods become the cheaper in the domestic market. As a result, exports diminish and imports increase. This increases the demand for foreign currency and a new rate of exchange is established.

When the price level falls in the domestic country, the domestic goods become cheaper in the foreign market and the foreign goods become dearer in the domestic market. As a result, exports increase and imports diminish. This increases the demand for domestic currency and a new rate of exchange is established.

2. Change in Exports and Imports:

Changes in exports and imports result in changes in the rate of exchange.

When exports are more than imports, the foreign demand for domestic currency increases and the rate of exchange rises in favor of the domestic currency.

When imports are more than exports, the domestic demand for foreign currency increases and the rate of exchange rises in favor of the foreign currency.

3. Capital Movements:

The rate of exchange is influenced by capital movements.

When a country imports capital to a foreign country, the rate of exchange will move in its favor.

When a country exports capital to a foreign country, the rate of exchange will move against it.

4. Monetary Policy:

When the Central Bank raises the bank rate, more funds will flow into the country from abroad to earn a higher rate of interest. It will tend to raise the demand for the domestic currency and the exchange rate will move in favor of that country.When the Central Bank lowers the bank rate, foreign capital will be repatriated from the country. It will tend to raise the demand for the foreign currency and the exchange rate will move against the domestic country.

5. Issuing of credit instruments:

When an exchange bank issues banker's drafts or other instruments on its foreign branches, the demand for foreign currency increases and the rate of exchange will move against the domestic country.

When an exchange bank receives banker's drafts or other credit instruments from its foreign banker's, the demand for domestic currency increases and the rate of exchange will move in favor of the domestic country.

6. Arbitrage Operations:

Arbitrage operations include buying and selling in different stock of exchange of the world for speculative gains.

When the speculators buy or sell securities in the different stock exchanges of the world, they make speculative gains on account of the differences in their prices. Such arbitrage operations cause changes in the rate of exchange.

7. Stock Exchange Influences:

Stock exchange operations in foreign securities, debentures, stocks and shares, etc., exert significant influences on the exchange rate.

8.Structural Changes:

Structural changes are those changes which bring changes in the consumer demand for goods. They include technological changes, innovations etc.,

When structural changes take place in the domestic country, the foreign demand for domestic products increases. It implies increases in exports, greater demand for domestic currency, appreciations of its value and rise in the exchange rate of the domestic currency and vice versa.

9. Political Stability:

When there is political stability and the government is strong and efficient foreigners will have a tendency to direct their funds into the country. When capital flows into the country, the demand for domestic currency will rise and the rate of exchange will move in favor of the country.When there is no political stability and the government is weak and inefficient.

10. Policy Of Protection:

When the government follows a policy of protection with a view of giving encouragement to the domestic industries, imports are discouraged and the balance of payment of the country becomes favorable to it, as a result, the domestic demand for foreign currencies will go down and the rate of exchange will move in favour of the country.

11. Fiscal Policy:

When the government of a country resorts to deficit financing the internal value, the currency will decline. Foreign capital will flow out of the country. As a result, the rate of exchange will move against the country concerned**.**

INTERNATIONAL MONETARY INSTITUTIONS

After the breakdown of the International Gold Standard in the early thirties the world lost the most efficient automatic standard upon which nations had for long relied for restoring equilibrium in their balance of payments whenever it was disturbed.

Though some rough arrangements aiming at the stability of the foreign exchange rates were made between a certain countries through the technique of exchange stabilization fund established by each country's government, these arrangements did not work satisfactorily, especially after the Second World War. After the war restrictions on multilateral trade and payments increased in severity under the impact of the war and there existed all types of restrictions such as clearing agreements, blocked accounts, multiple exchange rates etc. There was no alternative arrangement comparable to the gold standard, and countries of the world faced three major problems, namely the question of restoration of stability in the monetary systems, reconstruction of the war devasted economics and development of under developed countries of the world.

After the Second World War the need for international monetary co-operation was very keenly felt and monetary experts of Britain and America came forward with their plans for the ailing monetary world. The British Plan took the shape of Keynes' Plan and American plan prepared by Harry White was known as the White Plan. Experts of 44 nations of the world met at the United Nations Monetary and Financial Conference held at Bretton Woods, New Hampshire, a summer resort in north eastern part of the United States of America, in a 22 days conference from the 1st to 22nd July 1944. Out of the deliberations of this conference sprang up the Brettonwoods twins- the International Monetary Fund and the International Bank of Reconstruction and Development – the former to solve the first problem namely the instability in the monetary systems and the latter to solve other two problems of reconstruction of the war devasted economies and development of under developed countries of the world.

International Monetary Fund (IMF)

Since the fall of the gold standard in 1931, rates of exchange between the currencies of the world were very unstable and the result was utter confusion. During the Second World War and later, the situation became so alarming, that statesmen and monetary experts were forced to work on a solution to this problem. Lord Keynes of the United Kingdom proposed a plan in 1943 on behalf of Britain for creating an international clearing union with BANCOR as the international currency acceptable all over the world. According to Keynes plan, countries could buy bancor and settle their obligation to each other. During the same period, Harry White, a monetary expert from America suggested the setting up of a fund which would have all the currencies of the member countries for sale to those who needed them. This plan was called the White Plan. In the Brettonwoods conference held from the 1st to the 22nd of July 1944, the basic elements of these two plans were finally merged into a common plan evolved to set up the International Monetary Fund. The Brettonwoods Act was passed for this purpose with Lord Keynes as the chairman of the meeting. Even though Keynes' plan was not fully accepted, it is no exaggeration to say I.M.F. is the brain child of 'Lord Keynes'.

The establishment of the Fund is a great landmark in the sphere of international monetary co-operation. The main **objectives of the Fund** mentioned in the Fund's Articles of Charter are as under:

1. To promote international monetary co-operation among the nations of the world.
2. To promote exchange stability and maintain orderly exchange arrangements among member countries.
3. To prevent competitive exchange depreciation between nations.
4. To provide for multilateral convertibility of the currencies and remove all exchange controls and restrictions.
5. To help member countries to correct maladjustments in balance of payment.
6. To advise member countries on the right steps to be taken by each country to stabilize exchange rates.

The Fund started operations in March 1947 with its Head office in Washington and its only branch in Paris. The Fund's initial capitals of 8000 million dollars was contributed by its members who were allotted quotas on the basis of gold and dollar holdings, national income, state of international trade, balance of payments position and the economic significance of the countries. On this basis U.S.A. was allotted the maximum quota of $2750 million, Quotas of other leading countries were as under,

Britain	$ 1300 million

Nationalist China	$ 550 million
France	$ 525 million
India	$ 400 million

Nicaragna paid the lowest quota of one lakh dollars. Fund's total membership on March 1, 1947 was only 40. Russia and her satellite countries have not joined the fund even though Russia attended the Brettonwoods conference and was allotted a quota of $ 1200 million. The founder members paid their quota partly in gold – a minimum of 25% of their quota or 10% of their actual holding of gold whichever were lower- and the balance in their own currencies. The allotted quota was subject to revision every five years and in October 1959, at the annual meeting of the Fund held at New Delhi a general increase of 50% in the quotas of all member countries with larger increases in the quotas of certain selected countries – Canada, Germany and Japan- were effected. With this change West Germany moved up in the ladder and came to occupy the third place, held up the nationalist China before.

Currency of each country was given a par value in terms of gold as a common denominator and any change in this ration was to be made only with the consent of the Fund. The Indian rupee was declared equal to 0.2686 grams of gold of 11/12 fineness in 1945, when India joined the Fund. This was lowered to 0.1866 grams of pure gold in June 1966 when the rupee was devalued for the second time.

Organisation and Structure of the Fund:

The structure of the Fund consists of a Board of Governors, an Executive Board, a Managing Director, a Council and a Staff with its headquarters in Washington, USA.Thereareadhoc and standing committee appointed by the Board of Governors and the Executive Board. This is also an interim committee appointed by the Board of Governors. The Board of Governors and the Executive Board are the decision-making organs of the Fund.The Board of Governors is at the top in the structure of the Fund.It is composed of one Governor and one alternate Governor appointed by each member. Normally a member appoints its Minister of Finance or the Governor of its Central Bank as its Governor. The alternate Governor can participate in the meetings of the Board. But he has the power to vote only in the absence of the Governor.

The Board of Governors meets annually in which the details of the Fund activities for the previous year are presented. Special meetings can be convened by any of the five members having 25% of the total voting right. There is a Managing Directors of the Fund who is elected by the Executive Directors. He is usually a politician or an important international Official. The Executive Board is a continuous session and meets several times a week. Besides acting as the Chairman of the Executive Board, the Managing Director is the head of the Fund and responsible for its organisation, appointment and dismissal.

The management of the Fund is vested in a Board of Governors consisting of one governor and one alternate governor for each member country. Normally the Board of Governors meets once a year to lay down the policies of the Fund. Each governor has a voting right of 250 votes plus one vote for every one lakh dollars of the quota. Thus on her present quota of 6000 million dollars (250 + 6000) India has 6250 votes.

However the Board of Governors delegates many of its powers to the Board of Executive Directors who number twenty, of whom one is nominated by each one of the five largest quota holding members – presently U.S.A., U.K., W.Germany, France and India – and the remaining 15 elected by other members of the Fund with the Latin American Republics electing at least two directors. The policies laid down by the Board of Executive Directors in who rests the real authority. The regular day to day working of the Fund is managed by a managing Director who is the Chairman of the Board of Directors. He has to be a person of extraordinary financial competence and should not be a governor or alternate governor for a member country. This post is rotated among the nationals of the member nations and at present Mr. Pierre – Paul Schweitzer of France is holding the post.

With large capital resources held in gold, U.S. dollars and the other currencies of member countries, the International Monetary Fund conducts its working with a view to promote exchange stability. To achieve this end the fund makes available foreign currencies to needy nations at the agreed parity rate of exchange upto a maximum of 25% of the quota per annum provided the total drawings at any one time do not exceed 200% of the quota. For purchases of foreign exchange in excess of this quota gold has to be tendered. How the fund’s assistance helps country to stabilize her exchange rate can be understood with the help of the illustration and diagram given below.

In case a country faces a shortage of a particular currency to meet her foreign obligation, and on account of this the rate of exchange is likely to move against the country, the International Monetary Fund comes forward to grant a loan to save the situation and keep the exchange value of the currency stable. In the diagram below, we have a case of increase in imports from America, and India's demand for dollar goes up. Consequently the exchange moves up to Rs.8 per dollar. To maintain the comes in and gives an extraordinary loan; and the supply curve for dollar is shifted to the right, to the new position S_1 S_1 by which the rate of exchange is again brought down to Rs.7/- per dollar.

The Fund usually grants three types of loans against the security of the local currency. In the language of the fund, it is referred to as purchasing a foreign currency. The three **types of loans**are:

1. Short term loans to tide over temporary balance of payment deficits, as in the case in the illustration given above.
2. Stand by credits for periods ranging from 3 to 12 months, pending export of goods against firm orders received by exporters of the borrowing countries.

3. Convertibility assistance to save a currency from depreciation in extreme cases. This is a type of last resort loan to save a sinking currency.

It may be noted that the International Monetary Fund grants short term loans to enable countries to preserve the stability of the rate of exchange of their currencies As such the rate of interest charged on the loans are not low. There is a service charge of ¾% on all loans in addition to the rate of interest determined in each case on the basis of the loan amount, purpose of the loan and the period of the loan. When loans are renewed, the rate of interest is usually raised by ½%, in order to discourage such renewals. When a country's borrowings exceed the quota, there is a sliding scale of extra charges depending on the amount of the loan, the period of the loan and the purpose of the loan. These three varieties of charges are as a rule payable in gold even though relaxations from this rule are often made for under-developed countries. The fund declares dividends annually after meeting all the expenses and the dividends are payable in the currency of the country.

Effects of the quota system

The IMF’s quota system was created to raise funds for loans. Each IMF member country is assigned a quota, or contribution, that reflects the country’s relative size in the global economy. Each member’s quota also determines its relative voting power. Thus, financial contributions from member governments are linked to voting power in the organization. This system follows the logic of a shareholder-controlled organization: wealthy countries have more say in the making and revision of rules. Since decision making at the IMF reflects each member’s relative economic position in the world, wealthier countries that provide more money to the fund have more influence in the IMF than poorer members that contribute less; nonetheless, the IMF focuses on redistribution.

Quotas are normally reviewed every five years and can be increased when deemed necessary by the Board of Governors. Currently, reforming the representation of developing countries within the IMF has been suggested. These countries’ economies represent a large portion of the global economic system but this is not reflected in the IMF's decision making process through the nature of the quota system. Joseph Stieglitz argues "There is a need to provide more effective voice and representation for developing countries, which now represent a much larger portion of world economic activity since 1944, when the IMF was created." In 2008, a number of quota reforms were passed including shifting 6% of quota shares to dynamic emerging markets and developing countries.

Functions of the Fund:

1. It functions as a short term credit institution.
2. It provides a machinery for the orderly adjustment of exchange rates
3. It is a reservoir of the currencies of all the member countries from which a borrower nation can borrow the currency of other nations
4. It also provides machinery for altering the par value of the currency of a member country. In this way, it tries to provide for an orderly adjustment of exchange rates, which will improve the long term balance of payments position of member countries
5. It also provides a machinery for institutional consultation

6. The Fund contributes to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all member nations
7. IMF may be described as a bank of Central banks of different countries, because it collects the resources of various central banks and assist them in times of emergency. However, the Fund cannot control the domestic economic and monetary policies of member nations
8. It maintains a multiple payment system through an orderly adjustment of exchange rates
9. The Fund renders technical assistance in two ways.

   (a) Fund experts assist in the formulation of appropriate monetary, fiscal and exchange policies or to legislation

   (b) Engaging of experts from outside the staff of the Fund to assist the member nations in various specialized fields.
10. The Fund gives training to the officials of Central Banks of member countries
11. The Fund co-operates with many International Organisationssuch as IBRD, GATT to promote economic development of primary producing countries. It also provides compensatory financing to help the UDC's whose export earnings decline temporarily.

Gold Standard and the Fund

The working of the fund clearly indicates that gold plays an important role and gold is retained as the basis of the fund's working. Viz. 25% of members' quota is payable in gold, parities of currencies are expressed in terms of gold in emergencies and so on. These facts have made well known economists like Prof. John H.Williams declare the fund a refined version of international gold standard. No wonder on the face of it, I.M.F. seems to be another form of gold standard. But actually it is not so and there is a number of difference between I.M.F and gold standard.

Gold parity under International Monetary Fund is one as under gold standard. It can be changed with the sanction of the fund to correct fundamental disequilibrium. Further the issue of currencies is not subjected to gold movements under the fund as it is under gold standard. In fact gold seldom moves from country to country. Thirdly, the values of world currencies are not at all affected by the production or otherwise of gold. In essence gold only occupies a secondary position or the position of a slave in the Fund. International Monetary Fund is a pool of national currencies and therefore cannot be regarded as gold standard. It is at best a substitute for gold standard.

International liquidity and the Fund

The term international liquidity refers to the readiness with which currencies of different countries are made available from the fund, to needy countries. The Fund is an important source of international liquidity, even though international liquidity as such is still a very much sought after pursuit. With the view to achieve wider international liquidity many a suggestion has been put forth from time to, time and the latest one is the Special Drawing Rights Scheme otherwise known as the ***Paper Gold System.***There have been other suggestions such as an international currency system of the type recommended by Lord Keynes the transformation of the Fund into a central bank of the world as suggested by Prof. Robert Triffin, or making available additional funds to the Fund by way of setting up Lender's club as suggested by Mr. Bernstein. Devaluation of dollar and devaluation of even gold have also been suggested to solve the problem of international liquidity, Let us examine each one of these proposals very briefly.

Lord Keynes's plan was to issue a world currency called *bancor* which will circulate as a currency acceptable all over the world and international indebtedness could be settled in this currency. This proposal was not fully accepted by the Brettonwoods conference and was modified to found the International Monetary Fund. There are monetary exports that harp on the Keynesian plan every today.

Prof. Triffin's plan was for setting up a central bank of the world in the place of the Fund, if necessary by converting the Fund, which would accept deposits from the nations of the world and enable member countries to settle their accounts by transferring money from one country's account to the another's.

Mr. Bernstem was for the formation of Lender's club consisting of a few leading nations of the world to make available additional funds for the Fund. In fact a sum of 6 billion dollars have already been made available this way in the year 1962 by 10 countries forming the Lender's club Belgium, Canada, France, West Germany, Italy, Japan, Netherlands, Sweden, United Kingdom and the United States of America.

The French Proposal has been for the resurrections of the traditional gold standard, Ex-President De Gualle advocated this, time and again, though without much of support from the major nations of the world, France's advocacy of 'back to gold' has been backed by the large reserve of gold that is accumulated in France – approximately 5,970,000 million dollars.

The proposal to devalue dollar as a means of solving liquidity problem has come up time and again from the French side. Devaluation of dollar, it is claimed will increase the price of Gold in terms of dollar and will make it possible for the countries of the world to obtain more dollars for their gold holdings. This suggestion has again been made in the recent years by many other delegates to the International Monetary Fund. However this proposal has been met with the vigorous opposition particularly from Russia, South Africa, Australia and other gold producing countries.

Prof. Fritz Machlup, the American Economist has recently suggested the devaluation of gold as a means to solve the problem of international Liquidity. According to this proposal, the dollar price of Gold will be reduced in two or three sages and this will mean unloading of the world with a view to get the present ruling price. Machlup expects that a proposal of this kind will make France, South Africa and Russia to rush their gold stocks to the world market and cash them as soon as possible and this will solve the major problem of World Liquidity. However, there has been no support for this proposal from any quarters.

Paper gold and Fund:

With the view to provide the much need international liquidity the fund has put forth its own proposal and this has taken the form of creation of Paper gold or **Special Drawing Rights(SDRs).**

In view of phenomenal growth of international trade in the last few years and the decline in the annual output of gold the need for supplementing the resources of the fund by the way of **Paper Gold** has arisen. The term Paper Gold refers to the resources made available to member countries by way of book entries under the special drawing rights in the book of I.M.F. the member countries can convert the paper gold into any currencies of the member countries of the fund. Paper gold is expected to be in the form of coupons or token or pay order or currency notes. Each unit of Paper Gold will be expressed in terms of a certain weight of gold of 11/12 fitness.

It is estimated that out of 1400 million dollars worth of gold mined out yearly in the noncommunist world, nearly 3/4th fundsits way into industrial or artistic uses or into the hand s of the hoarders or speculators and not into the official reserves of nations. The Special Drawing rights scheme to provide for paper gold was first mooted by the group of ten countries #, and was later discussed in detail at the Rio de Janeiro conference of the Group Ten countries it was decided to create 9.5 billion dollars of paper gold over the ensuing three year period, 3.5 billion in the first year and 3 billion dollars each year in the subsequent years,

Under the S.D.R. scheme every member country will have a paper claim or book entry credit with the fund with which she can clear 30% of her liability. As per present arrangements, the allotment of paper gold to member countries will be on the basis of quota held by the countries in the fund and this will enable developed countries to have more paper gold than others. It is roughly estimated that the paper gold allotment for U.S.A. will be to the order of 25% of the total available paper gold. India is expected be get an allotment of 3.5% of paper gold valued at 122 million dollars. This mode of allotting paper gold on the basis of quota held in the fund by the members has come in for criticisms and alternative proposals for the allotment on the basis of population, degree of backwardness, need of the country etc are in the air. A few African and Latin American countries have asked for paper gold to extent of double their quota in Fund. The next meeting of the fund is expected to discuss this in detail and decide on the basis of allotment of Paper gold.

Once paper gold is made available, the member countries can use them to meet their international obligation and convert them into any currency of the world, with in certain restrictions. This conversion can be made either with the International Monetary Fund or with another country having surplus of the required Currency, The country acquiring S.D.R. will be able to treat it as its asset exchangeable internationally for any currency of the Fund. Many Economists and Ministry of Finance have expressed their satisfaction with the arrangement and it is hoped that the paper gold will solve the problem of international liquidity to a great extent and pave the way for the issue of a world currency. However Prof. Robert Triffin of Yale

University has recently expressed his apprehensions about the success full working of the system, though he has few supporters in this.

International Monetary Fund today:

The capital of the fund has been changed twice since its inception and today it stands at 21,000 million U.S. dollars and total membership is 107. The total outstanding loans as at the close of June 1967 is 6.5 million dollars out of which Britain alone has borrowed over $2400 million in thirteen currencies of the world.

The fund is often criticized as being under the influence of the United States of America, the biggest contributor of the capital and captain of the Hard currency area. It is also blamed for its failure to maintain the stability of exchange rates in a few cases because of lack of Co-operation from certain member countries like Indonesia and France. In the year 1948 France was devalued by 44% despite advice of IMF not to do so.

Thirdly the membership of the fund is still not global and important countries like Russia, East Germany, Republic of Hungary and China are out of the Fund.

Fourthly, the fund has not been success full in removing Exchange restrictions which are practiced by the entire member Countries.

In spite of these defects, International Monetary Fund makes a great step in international monetary Co-operation and it has been an important source of international Liquidity. By the term ‘International liquidity’ is meant all the resources that are readily made available to member countries for the purpose of financing their balance of payments deficits. The fund has also been able to maintain stable exchange rates, in most cases and it has succeeded to give the golden mean between fixed and adjustable exchange rates.

6. India and the Fund

India joined the International Monetary Fund on the 27th of December 1945 as an original member and notified the par value of rupee as equivalent to 0.268601 grams of gold of 11/12 fineness. This was lowered to 0.186621 grams of gold in 1949 and to 0.118489 grams of gold in 1966 when the rupee was devaluated by 36.5% on 6-6-1966.

As a founder member and holder of the fifth largest quota India has a permanent representative on the Fund’s Execute Board. India was allotted a quota of $ 400 million at the beginning and this was raised to $ 600 million in 1958.

The fund has been especially good to India and India has made use of the facilities available to a marked extent. During the calendar year 1949 India purchased from the Fund foreign currencies amounting to Rs. 47.62 crores (roughly $ 100 million) to tide over balance of payment difficulties. This amount consisted of Canadian dollars, Deutsche marks, French francs, Italian lire and Japanese Yen. India was the first country to draw Japanese yen from the Fund. Besides major loans obtained for solving balance of payments deficits, India has often drawn stand by credits and this timely assistance has helped her to preserve the rate of exchange at critical times. India’s outstanding by way of drawings and stand by credits amount to over 417.5 million dollars as on 1-4-1967.

Besides loan facilities the fund has made available the services of experts on many occasions and a few of the Fund’s officials work in the Reserve Bank of India at all times. India has been a sincere member of the fund and has followed the advice of the fund in most cases. In the years to come the fund will need more of India’s help and India will need more of Fund’s assistance.

International Bank for Reconstruction and Development (IBRD) or World Bank

International Bank of Reconstruction and Development, otherwise known as World Bank, is the outcome of Brettonwoods agreement, along with International Monetary Fund. While International Monetary Fund supplies short term funds to tide over temporary balance of payment difficulties, World Bank provides either directly or indirectly, long term capital needed for reconstruction and/or development of national economics. The bank started operation in 1947 with its head office at Washington, U.S.A. Its motto is “poverty anywhere is a danger to prosperity everywhere.”

The World Bank Group is comprised of five separate entities: International Bank for Reconstruction and Development (IBRD, est. 1945), the International Finance Corporation

(IFC, est. 1956), the International Development Association (IDA, est. 1960), the International Centre for the Settlement of Investment Disputes (ICSID, est. 1966) and the Multilateral Investment Guarantee Agency (MIGA, est. 1988). This webpage outlines key features of the two arms that are now collectively referred to as the World Bank: IBRD and IDA.

Organization:

Nearly 10,000 staff members perform the work of the IBRD and IDA, both at headquarters in Washington, DC, and in over 109 country offices. The World Bank is the third largest employer in Washington, DC.

The World Bank is owned by 186 member governments. Each member government is a shareholder of the Bank, and the number of shares a country has is based roughly on the size of its economy. This "one-dollar-one-vote" structure affords richer countries greater power in decisions-making processes at the institutions the poor, borrowing countries.

The United States is the largest single shareholder, with 16.41 percent of votes, followed by Japan (7.87%), Germany (4.49%), the United Kingdom (4.31%) and France (4.31%). The remaining shares are divided among the other member countries. All developing country borrowers have 39% of the voting share combined. The 47 sub-Saharan African nations command less than 6% of the votes.

The World Bank organizes its operations primarily through 27 Vice-Presidential Units. Six regional vice-presidencies control a large-degree of decision making on Bank operations within their own regions: Africa, East Asia & Pacific, Europe & Central Asia, Latin America & the Caribbean, Middle East & North Africa, and South Asia. Other vice presidencies include 7 "Network Vice Presidential Units"-responsible for certain cross-cutting issue areas such as the financial sector or private sector development. The rest 13 cover such areas as external affairs, development economics, legal, and human resources.

The authorized capital of World Bank is 10 billion, U.S. dollars contributed by member nations on the basis of the national income of the countries. Except Russia and her satellites most other nations of the world are members of the fund. Presently there are 107 member countries with U.S.A. as the major contributor of capital (2/3 rd).India's share was initially 400 million dollars. However this was increased to 800 million as per the revised increase in quota in 1959.Member countries pay only 20% of their quota as paid up capital (2% in gold and 18% in home currency).

The governing body consists of one governor from each member country with one alternative governor in reserve for emergency purposes. The Governing Board meets once a year to lay down the policy of the bank. The day to day affairs are managed by the Executive Board of Directors consisting of 20 members, one each from the five permanent member nations (United States of America, United Kingdom, West Germany, France and India)and fifteen members elected from among the other member nations. The President of the Bank is also the Chairman of the Board of Executive Directors.

Objectives of the world Bank:

The following are the objectives of the World Bank

1. To assist in the reconstruction and development of its member-countries by facilitating the investment of capital for productive purpose
2. To promote private foreign investment by guarantees of and participation in loans and other investments made by private investors
3. To make loans for productive purposes out of its own resources or funds borrowed by it when private foreign capital is not available on reasonable terms and conditions
4. To promote the long-range growth of international trade and thereby, to maintain equilibrium in the balance of payments and
5. To improve the standard of living of the people in general and the conditions of labour in particular.

Types of assistance:

The sole function of the bank is to supply long term finance for the development of the economics of the member nations. This function is performed in any one of the following ways:-

(1) By sanctioning loans directly from the funds of the banks for urgent purposes.
(2) Providing loans to the needy countries by raising funds in the foreign money markets on bonds issued by the bank. The bonds of the bank are quickly subscribed as they have behind them the guarantee of all the member countries.
(3) By guaranteeing loans floated by member countries in foreign money markets.
(4) By arranging meetings of the lenders (when there are more than one lender involved) and helping them to study the loan details by providing explanations, information etc. Loan granted this way is known as consortium loans- Aid India Consortium is an example of this type. Austria, Belgium, Canada, France, West Germany, Italy, Japan, Netherlands, United Kingdom, United States, World Bank and IDA are members of the Aid India consortium otherwise known as Aid India Club
(5) By helping the borrowing members to utilize the borrowed money for importing scared goods from other member countries

Conditions for granting loans:

To merit loan from the World Bank or to obtain a guarantee from it there are a few conditions. They are:-

(1) The loan must be for a specific project which promises development. In the first stage the Bank's experts will make a preliminary study of the project concerned and in the second stage detailed study will be made of the project by a body of experts. Only if they are fully satisfied the loan will be released.
(2) The borrowing country must prove that she cannot raise the loan within her territory or elsewhere.
(3) The bank must be satisfied as to the repaying capacity of the borrower.
(4) The loan must be for productive purposes. The bank will not consider-loan applications for the development of education, for instance, as if falls strictly under non-productive purposes.
(5) The loan amount must be for obtaining a foreign commodity for a project of projects of reconstruction and development.

(6) World Bank loans are granted only to governments concerned and not to private industries or individuals in the borrowing countries. When the governments re-lend their money to private borrowers they are forbidden from charging to the ultimate borrower an interest rate more than 7 ½ % per annum. In essence the bank conducts its operation on sound business principles and loans are granted on good risks basis.

(7) Ordinary repayment of all advances is to be made in the currency in which the money is borrowed. The rate of interest on direct loans varies from 7% to 7 ½ % and a commission for guarantee from 2 % to 3 ½ % per annum.

India and the World Bank

India has received all types of assistance from the World Bank and at one time India ranked as the largest single borrower. In the year 1964, India received over 800 million dollars from the bank, which was more than what was permitted under the rules governing the lending operations of the Bank. Of these over $ 500 million have been diverted for the development of railways, Domodar Valley Project, Tata Iron and Steel Company. Kothagudem Thermal Power Station and the Industrial Credit and Investment Corporation of India are some of the other major beneficiaries. India’s present out standings is over 970 million dollars in 34 different loans. The Aid India Club which meets under the auspices of the World Bank has been so considerate to India that a number of consortium loans have been made available to India in the recent past with pledges amounting to $ 5470 million. The International Development Association an affiliate of the World Bank has been granting soft loans to India to get ahead in her social development programmes. Further India has received constant advice on different matters of economic interest. The role of the bank as a mediator in the Indus Basin water dispute between India and Pakistan is unforgettable.

Other Financial Institutions

Besides the World Bank, there are other international institutions which grant loans to developing countries. They were recently established to supplement the efforts of the World Bank. They are the International Finance Corporation (1956),the International Development Association (1960) and the Asian Development Bank(1966).

International Finance Corporation (IFC):

This is another affiliate of the World Bank, set up to encourage the growth of productive private enterprise in the member countries, particularly in the less developed countries. The Charter of IFC came into force in July 1961 when France and Western Germany joined with the USA and agreed to form the IFC. To start with, there were 31 countries in its membership including India.

IFC functions as a wing of the World Bank and the President of the Bank is the chairman of the Corporation’s Board of Directors. Other office bearers of the bank are ex-officio office bearers of the corporation as well. Its authorized capital is 100 million dollars, subscribed by member countries in amounts proportionate to their subscriptions to the capital of the World Bank. The Corporation’s investments are in productive enterprise in the member countries and its sectors such as agricultural, industrial, commercial and financial. Though in the early years most of the funds were invested in industrial sphere of late agricultural and other sectors are receiving due attention. The Corporation’s loans are granted on the following considerations:

1. The proposals must be for the establishment, expansion or improvement of productive private enterprise,
2. It should be a project which would bring about a matching investment of private capital by other investors,
3. The estimated profitability of the investment both to IFC and its associate should be reasonably large,
4. Investments only in cases where sufficient private capital is not available on reasonable terms for some reason or other,
5. The prospective industry should have a competent management. IFC does not seek or accept a government guarantee of repayment on any of its investments. Mostly investments in private industry will be made in the forms of equity capital subscription. In exceptional cases loans may also be granted.

Since its inception, the Corporation has made a wide variety of investments in a number of projects in 35 countries of the world. As at the close of December 1967, the total investments rank 221 million dollars in six continents. Most of the loans have been granted to industries producing fertilizers, synthetic fiber, textiles, caustic soda, paper, cement ,electrical goods, automobile spares etc,. Loans have been made available to promote tourism and set up development finance companies in member nations. In recent years there has been considerable increase in investment which stood around 379 million dollars in the year ending June 1993. This was up by 65 percent compared to with a fiscal year 1992. IFC maintains that Asia holds good projects in natural resource-based industries and with the growing openness of China and India to foreign investments, a number of projects in oil, gas, mineral and agro-investments sectors are likely to be financed by its in coming years.

IFC has made reasonably large investments in the developing countries and has stimulated investments in the private sector as required in the objectives of the Corporation. Its performance is not to be judged altogether from the initial investments. It has helped to set up 17 Development Finance Corporations in the ember countries and has thus enabled development finance to come within the reach of many industries. In short it has served as a partner in progress and has met the crying need of the hour namely international flow of capital.

The World Bank and IFC

Though the IFC is the private sector arm of the World Bank, it is different from the World Bank in the following important respects:

(a) The IFC is an autonomous local entity having its own independent capital and compact and competent staff of financial and legal experts. It operates just like a private financial or investment firm. It can even hire the ire the consultants from outside for dealing with technical problems like market research etc. In contrast, the World Bank has been engaged in the economic and social development of the member countries by rendering them aid even at interest lower than the market rates.

(b) While the World Bank extends the fixed interest loans to the member countries, the IFC has alternative options of extending fixed interest loans and making investments in the equities.

(c) The World Bank has at its disposal substantial amount of funds for financing development projects and plans in the member countries. The IFC, in contrast, has limited financial resources which it offers to the private enterprises for facilitating their expansion in the LDCs.

India and IFC

India is a fonder member of the IFC. She has been receiving assistance in a variety of areas from the IFC since its inception. These include automobiles, shipping, electricity, cement, fertilizers, oil and gas, petro-chemicals, iron and steel, general manufacturing, and the financial sector. India is the second major client of IFC assistance. The IFC invested 48.1 million dollars in India, composed of loans of 25.4 million dollars and equity of 22.7 million dollars, covering 11 projects which included the expansion of manufacturing facilities in computer diskettes, polyester and textiles, agribusiness exports, etc. In the annual Reports of IFC, mention has been made that there has been 'a sea change' in India's policies during the recent years and the IFC is very optimistic about the investment climate in India.

International Development Association (IDA)

For a long time the need was keenly felt , for an international lending institution to grant loan for projects which are socially necessary but not productive in the literal sense of the word. Cases like road construction, slump clearance, education etc., are unproductive and the World Bank is not permitted to finance these ventures under the rules.IDA, as an affiliate and complementary institution of the World Bank, has been set up specially to cater soft loans to the member countries in need of them and it started operations in November 1960 with one billion dollars, initial capital, contributed by member nations. Since its creation it has been granting generous loans to developing countries and it has earned the name 'soft loan window'.

IDA is an affiliate of the World Bank and its administrative set up is similar to that of the Bank. The Board of Governors, Executive Directors and President of the World Bank hold ex-officio offices in the IDA. Its membership is open to all the members of the World Bank. On June 30, 1992, 142 countries were the members of this institution. Out of them, 24 of them designated as the developed countries and the remaining as the less developed countries. During the recent years, China and several East European countries too have joined this institution. Presently 179 countries are the members of the IDA.

Financial Assistance made available by IDA is marked with **four essentialfeatures.** They are:

1. IDA credits are interest free; a service charge of ¾% is made annually on the amounts withdrawn and outstanding. This is levied to meet the administrative expenses of the institution.
2. Repayment of credits granted by IDA generally begins after a repayment holiday of 10 years, called the period of grace. After the grace period, repayment is made in small percentages of anything around 3% of the loan per year and it is most convenient for underdeveloped countries. The repayment period, is very long, even going beyond 50 years at times.
3. IDA credits are not restricted for economic development or reconstruction in the strict sense of the word. They are for national development and they flow mostly in the direction of the less developed countries. India has been the single largest beneficiary of IDA. So far IDA has made available nearly 675 million dollars in the form of 19 different loans to India. Most of these funds have been used for the provision of rural electricity, road construction, provision of tube wells, provision of drainage facilities and slump clearance etc.
4. Credits of IDA are not necessarily for specific projects and the receiving countries are free to use the funds in any social development project in the country.

Capital structure:

Capital structure of the IDA is constituted by the subscription of member countries and supplementary resources. Initially, the subscription of member countries amounted to 1000 million US dollars. For the purpose of subscription and voting power, the member countries of the IDA have been classified into two categories: The developed countries come under Part I member countries that are required to pay their entire subscription quota in gold or freely convertible currencies which IDA can utilize for extending loans to the UDCs. Part II countries are less developed countries who were required to pay only 10 percent of their subscription quota in terms of gold and freely convertible currencies and remaining 90 percent in their local currencies which the IDA cannot use for granting loans without prior consent of the member country, the currency of whom is required for lending. The IDA can obtain supplementary resources from the Part I member-countries from time to time to augment its resources and undertake lending operations on a large scale.

Some of the Part I member countries are the USA, the UK, France, Netherland, Federal Republic of Germany, Canada, Australia, Sweden, Japan etc,. Some important Part II member countries are India, China, Pakistan, Brazil, Argentina, Indonesia etc, Regarding voting power, it should be understood that it is in proportion to the respective subscription quotas. Part I member countries (developed countries) although contributed 97 percent of the total resources of the IDA, yet enjoy 69 percent of the total voting power. It implies that the less developed countries have relatively greater decision-making power at the IDA.

Achievements of IDA:

In the period 1964-68, the IDA credits amounted to an annual average of 0.3 billion dollars which increased to 0.8 billion dollars during 1969-73 and 1974-78 respectively. The annual average recorded a substantial increase to 3.53 billion dollars during 1984-88. The annual average during 1990-94 almost doubled to 0.4 billion dollars. This level of lending was maintained in the subsequent three years, but it declined to 4.6 billion dollars in 1997. It again increased to 7.5 billion dollars in 1998 and declined to 6.8 billion dollars in 1999. The total amount of credit sanctioned during the fiscal years 2000 and 2001 was 4.4 billion and 6.8 billion respectively. The cumulative lending to 162 member countries during 1960-2001 amounted to 127 billion dollars. The countries are South Asia have been the major beneficiaries throughout, followed by East African countries and West African countries. It should be noted that IDA has treated countries in the South Asia region more favorably than in other regions of the world.

IDA and India:

India has been the largest recipient of IDA assistance. Up to the year of ending June 1992, the total credit flow from IDA to India was of the amount of 18919.6 million dollars. It approved 186 credit proposals from India. India remained the most prominent recipient of IDA soft loans till the mid1980s.The share of this country had been shrinking since the late half of 1980s. Some of the development projects in India helped by the IDA are: Rajasthan Canal Command Ares Project, Champal Command Project, Madhya Pradesh and Rajasthan Dairy Development Project, Development of Drought Prone Areas, Sindri Fertilizer Corporation, Godavari Barrage, etc. Since its inception, IDA has been making very vital contribution in social and economic development of India. All developing nations of the world look upon this soft loan window with great expectations.

Asian Development Bank (ADB)

The need for a development bank for the whole of Asia was keenly felt, mainly to supplement the resources that might be made available by the World Bank. The proposal for such an institution originated in the annual session of ECAFE * held at Manila in March 1963. After detailed discussions of the proposal for over three years, the Bank's Board of Governors, consisting of one representative for each sponsoring country, met in Tokyo on November 25th 1966 and the Asian Development Bank was formally set up. It was decided to have the Bank's head office at Manila, Philippines and Mr.Takeshi Wantanake; Japanese was nominated as the first chairman of the bank.

The Bank started its operation at Manila from 19th December 1966 with a capital $ 1000 million subscribed by both regional and non-regional members. At the time of inception of the bank regional or Asian members of the Bank were Afghanistan, Australia, Cambodia, Ceylon, China(Formosa), India, Japan, Korea, Laos, Malaysia, Nepal, Newzealand, Pakistan, Philippines, Vietnam, Singapore, Thailand, West Samoa and Indonesia. The non-regional members included Belgium, Canada, Denmark, West Germany, Italy, Netherland, Britain, United States, Austria, Finland, Norway and Sweden. Since the inauguration of the Bank a few other countries, both regional and non-regional have become members of the bank and on date the bank has thirty two members including thirteen non-regional members.

The capital of the Bank is subscribed by member nations and as per the Articles of Agreement half the capital should be paid in gold (or convertible currency) and the balance in the currency of the member, the payment being due in five equal annual installments. Besides subscription the bank has received substantial contributions particularly from non-regional countries to augment the resources of the bank.

The bank's lending operations are essentially to be concentrated on the granting of hard loans (i.e.) loans for specific projects and repayable in the currency in which the amount is borrowed. Further, loans will be granted only to members who cannot readily obtain assistance from other sources. The repaying capacity of the borrowing country will be paid due regard to. In essence, the bank will carry on its operations on sound banking principles.

The working of the Bank during the last two years has been very satisfactory and the annual report of the bank indicates progress in various directions. During the last two years the bank has completed a techno economic survey and a transport survey, of the region besides an Asian Agricultural Survey. The President of the Bank undertook a series of visits during 1967 to member countries to gain a more climate in each country. The bank has as at the close of December 1968, 270 staff members drawn from 20 countries, 14 regional and 6 non-regional.

On the lending side, the first ADB loan of US $ 5 million was made available to the Industrial Finance Corporation of Thailand against the guarantee of the Govt. of Thailand. This loan was for a period of 12 years and it carried an interest rate of 7 ¾ % per annum. The Bank of Ceylon has recently received a loan of 2 million US $ at 6 $^{7}/_{8}$% per annum for modernization of tea estates. This loan is for 15 years and the first installment is to begin after three years from the date

ADB and India

The ADB commenced lending to India in 1986, though it has been a founder member of the Bank. In the earlier period, loans to India were mainly for infrastructure sectors such as power, roads, ports, etc. In recent years, the emphasis has shifted to public resource management programme, urban environmental improvement and development, health and nutrition and housing finance.

ADB approved seven loans totaling 1.5 billion US dollars in 2001 to rehabilitate and reconstruct areas damaged by the Gujarat earthquake, develop the Western transport corridor and the West Bengal corridor, establish a private sector infrastructure facility at the state level and implement the Madhya Pradesh Power Sector development programme, etc.

ADB approved 12 technical assistance grants, of which 8 were for advisory purpose on capacity building for earthquake rehabilitation and reconstruction of housing, conducting the Madhya Pradesh integrated water resource management study, enhancing the corporate finance capability of the National Highways Authority of India and improving the accounting system of the Calcutta Municipal Corporation. Four were technical assistance grants to prepare the Kerala power sector development programme, Madhya Pradesh State road sector and integrated urban development projects, and public-private partnership on the National Highway Corridor. Five of the technical assistance grants approved in 2001 were funded by the United Kingdom.

Cumulative ADB lending to India as of 31st December 2001 was 10.45 billion US dollars. Of these, 'Energy' sector got the maximum of 35.8 percent: 'Transport & Communication sector got 24.9 percent: Social Infrastructure sector got 13.4 percent: 'Finance' sector 12.7 percent: Multisector 11.5 percent: Industry and Non-fuel Minerals 1.7 percent.

TRADE AGREEMENTS AND POLICY

The foreign trade of a country is powerfully affected by international conflicts and international agreements. Trade policy refers to measures which a country adopts for the purpose of regulating the exchange of goods with other countries in the context of economic development. Tariffs, quotas and exchange restrictions indicate the structural contents of a trade policy. Trade agreements arise from the trade policy of a country.

Trade agreements are of three types. They are (1) Bi-lateral agreement(2) Multilateral agreement and (3) General agreement.

1. Bilateral agreement:

When a country enters into trade agreement with another country for the sale and purchase of certain specific goods, the agreement is bilateral. Quantity rates and terms of payment are decided in the agreement and it will be for a definite period with provision for extension. Generally, political relations play a very important part in promoting or preventing bilateral agreements. Generally, through bilateral agreements, two countries are reducing the import duties. Sometimes they avoid tariff. They fix the fair price for imported and exported goods. If the price is decreasing they accept the situation during the period of agreements. They decide any one of the monetary unit as the medium of exchange. India- Russia is an example of bilateral agreements.

2. Multilateral Agreement:

A country may have trade agreements with a number of countries for sale and purchase of goods. Such agreements are multilateral and are promoted by international trade organizations or associations. The trade relationship between more than two countries is called multilateral agreements. Generally those countries which are economically and geographically situated between them are having this type of agreements. From this they are having protection and also development in trade. For example, ECM (European Common Market)

3. **General agreement:**

   It is similar to multilateral agreement. But general Agreement is meant for countries of the world which will enjoy the benefits of International trade. Example: GATT and UNCTAD**.**

The world had experienced the vigorous problems of an extensive pattern of trade barriers in the 1930's.After the Second World War many countries got down together to work on ways and means to promote international trade. Hence the need was felt for better international understanding and cooperation in economic sphere which resulted in the birth of General Agreement on trade and Tariffs (GATT).In 1947, 23 nations met at Geneva and drew up a plan for the reduction of import duties and also against future increase in duties by the negotiating countries. This came to be known as the General Agreement on Trade and Tariffs. It came into effect on a provisional basis on 1st January 1948 when other nations had also signed it.

General Agreement on Tariffs and Trade (GATT)

GATT is a multilateral treaty which has been signed by manyGovernments, known as contracting parties. The GATT is neither an organisation nor a court of justice. It is simply a multilateral treaty which now covers 80% of the world trade. It is a decision making body with a code of rules for the conduct of international trade and a mechanism for trade liberalisation. It is a forum where the contracting parties meet from time to time to discuss and solve their trade problems and also to negotiate to enlarge their trade. The GATT rules provide for the settlement of trade disputes call for consultations to reject / abandon trade obligations and even authorize retaliatory measures. A GATT is a permanent council of representatives with headquarters at Geneva. Its function is to call International Conferences to decide on trade liberalisation on a multilateral basis.It was an intergovernmental instrument, providing for rights and obligations in the field of commercial policy of the member countries with the principal object of promoting international trade and mutually advantageous arrangements by reducing trade barriers, customs, tariffs and discriminatory practices.

Objectives of GATT:

There seem to have been three basic objectives behind the establishment of the GATT.

1. To follow unconditional Most Favoured Nation (MFN) principle
2. To carry on trade on the principle of non-discrimination reciprocity and transparency
3. To grant protection to domestic industry through tariffs only
4. To liberalise tariff and non-tariff measures through multilateral negotiations.

The **ultimate aim** of establishing liberal world trading system is **to raise standard of living, ensure full employment, develop fully the resources of the world and expand production and exchange of goods on global level.**

Structure of GATT

The agreement takes the form of 38 ‘Articles’ organized into four ‘parts’.

Part I (Articles I and II) deals with the obligations of the contracting parties.

Part II (Articles III-XXIII) provides the code for ‘fair’ trade, such as various technical procedures and conditions under which tariffs may be employed (e.g. anti-dumping, for balance of payments reasons to safeguard domestic industry).

Part III (Articles XXIV- XXXV) details the procedures for the application and amendment of the agreement.

Part IV contains Articles XXXVI-XXXVIII, which deals with the trade of LDCs.

Principles of GATT:

1. ***Non-discrimination***: The basic principle of GATT is that of non-discrimination, contained in Article I. Contracting parties accept the so-called Most-Favored Nation (MFN) clause. This MFN clause rules out any preferential treatment among nations as far as trade policy is concerned, except those who are not members of the GATT.

The MFN clause has played an important part in encouraging countries to negotiate on trade liberalization. They know that any deal that they negotiate with one country will not be undermined by that country striking a better deal with another, since any subsequent better deal must then be available to them. Confidence is also increased by the requirement that once agreed on, tariff reductions are bound.

The non-discrimination principle is also embodied in the national treatment clause, which requires that, once the imported goods enter a country; they are subject to the same taxes, regulations, etc., which are applicable to the equivalent domestic goods.

2. ***Reciprocity***: The reciprocity obligation requires that a country receiving a concession from another country should offer an 'equivalent' concession in return. In its simple form reciprocity might involve two countries agreeing tariff reductions on each other's exports that would leave their bilateral balance of trade unchanged.
3. ***Transparency***: Article XI of the GATT forbids the use of direct control on trade, particularly quantitative restrictions, except under a few designated circumstances (such as a balance of payments crisis, allowed under Article XII).The rationale for banning quotas etc., is that quantitative restrictions is a less transparent instrument for reducing imports than a tariff. This has two aspects. First, when facing a tariff, producers exporting to the country concerned have clear information on the barrier they have to surmount in order to sell their goods and services, and may choose the volume they will supply subject to that information with a quantitative restrictions, on the other hand, they face uncertainty about the volume they will be allowed to export and about their net unit revenue. Second, with a tariff the price increasing effect is immediately apparent to consumers in the importing country, in that a 20 percent tariff necessarily means that that the domestic price is 20 percent higher than the world price, whatever that may be. The price raising effect of a quota however may be less apparent unless information about the world price is readily available.

GATT Conferences: (Rounds of Global Trade Negotiations)

Since 1947, global conferences were held by the GATT for the purpose of global trade negotiations, and these conferences are called Rounds. The First conference on trade negotiations was held at Geneva in 1947, the Second at Annecy (France) in 1949, the Third at Torquay

(England) in 1950-51, the Fourth at Geneva (Switzerland)in 1955-56, the Fifth at Geneva between 1961-62 (Dillon Round), the Sixth at Geneva, known as Kennedy Round, (1963-67), the Seventh at Tokyo (Japan) in 1973-79 and the Eighth at Punta del Este in Uruguay, known as Uruguay Round, which converted GATT into WTO, with effect from 1995. These conferences have led to reduction or stabilization of more than 60,000 tariff rates and to a number of non-tariff agreements among contracting parties having 80% of the world trade.

GATT and Developing Countries:

Before the Kennedy Round (1964-67) developing countries gained very little from the GATT except that they could use quantitative restrictions to correct disequilibrium in Balance of Payments and benefitted from tariff reduction by developed countries. But the principle of reciprocity for trade concessions went against the developing countries because they were unable to provide equivalent benefits to the developed countries. For instance, tariffs on total manufactured imports by developed countries averaged 11% but were 17% on those from developing countries. Moreover GATT did not take any initiate on trade barriers on agricultural and tropical producers of developing countries.

The concept of **'special and preferential'** treatment for developing countries was formally introduced into the General Agreement in 1957. Under it, negotiations would take into account the needs of Less Developed Countries (LDCs)for a more flexible use of tariff protection to assist their economic development and the special needs of the countries to maintain tariffs for revenue purposes. On the recommendations of the Heberler Report, the GATT started an action programme in 1958 which recommended that developed countries should reduce taxation and trade barriers on industrial and primary products of developing countries.

In 1963, the contracting parties agreed on a more flexible attitude towards LDCs. Accordingly, tariffs on tropical products like tea and timber were reduced or eliminated by developed countries.

In 1965, a new portfolio on trade and development was incorporated into the General Agreement dealing with the principle of non-reciprocity for developing countries. It states that, the developed contracting parties do not expect reciprocity or commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade less developed contracting parties. It further adds that the less developed contracting parties should not be expected in the course of trade negotiations to make contributions which are inconsistent with their individual development of financial and trade needs, taking into consideration part trade development.

The Kennedy Round (1964-67) bestowed some benefits to developing countries when 37 developed countries reduced tariffs on manufactured goods.

In 1970, the Generalized System of Preferences (GSP) was introduced which permitted developed countries to grant unilateral tariff preferences to developing countries. In June 1971, the GATT waived the MFN (Most Favoured Nations) Treatment obligation for developed countries for a period of 10 years to the extent needed to grant preferential treatment under the GSP which has been extended further.

However, it was in the Tokyo Round (1973-79) that a number of agreements on subsidies and countervailing duties covering agricultural, fisheries and forestry products; on customs valuation, on government procurement, on technical barriers to trade on import licensing, on dairy products, on penile meat and on civil aircraft.

Moreover, GATT rules also ban export subsidies and manufactured products by developed countries. On the other hand, they also export subsidies for economic development and industrialization by developing countries.

However trade textiles and clothing has been subjected to special restriction for nearly 4 decades by developed countries outside the GATT rules.

In 1974, the first Multi-Fibre Arrangement (MFA-I) was negotiated between the developed and developing countries for 4 years. It was renewed in 1978 (MFA-II) and in 1982 (MFA-III). In 1986 for 5 years, it was renewed (MFA-IV). It contains the right of the developed importing country to cut imports of specific products from developing countries. For the first time, a return to GATT rules is written into the MFA.

Despite special and preferential treatment for developing countries provided in GATT rules, they are being discriminated under the 'escape clause' and safe guard rules of the GATT.

Criticism of GATT:

1. From the beginning of the GATT, agriculture was treated as a special case. Almost, every developed country follows this policy which is inconsistent with GATT rules. But trade liberalisation for agricultural products has been much less than for manufacturers.
2. Developed countries have removed the majority of tariff barriers; rather they have devised new trade restriction. (i.e.) 'Low cost Suppliers', etc., which are outside the GATT rules. They are applied against developing and state trading countries and Japan.
3. The GATT's role is being undermined by concluding bilateral discriminatory and restrictive arrangements outside the GATT rules.
4. The increasing use of subsidized has been another important factor in side tracking the GATT.
5. The 'safeguard rules' of the GATT allow the contracting parties to grant protection in case of need
6. The GATT rules which permit the formation of customs union and free trade areas have been disforced and abused.
7. The GATT being a mandatory body does not possess any mechanism to get its rules implemented by contracting parties.

Despite these criticisms, 123 countries operate under the GATT rules while the remaining countries of the world benefit from them under the umbrella of MFN rules.

Suggestions for reform:

In November 1983, the Director General of the GATT appointed an independent group on the international trading system. In March 1985, the group issued a report entitled'Trade policies for better future, proposals for action'.

Its **15 principal recommendations** are:

1. Open formulation and monitoring of trade policy and action
2. Clearer and fairer rules for agriculture and trade with no special treatment for particular countries or commodities

3. A time table and procedures to bring into conformity with that rules in all countries, also measures which are inconsistent with the GATT.
4. Trade in textiles and clothing should be subject to ordinary GATT rules
5. Rules on subsidies need to be revised
6. Improvement and vigorous application of GATT codes governing non-tariff distributions of trade
7. Clarified rules permitting customs, unions and free trade areas
8. Regular oversight and actions by the GATT secretariat which should collect and publish information
9. Limitations on applications of emergency for particular industry should continue to be non-discrimination
10. Greater integration of developing countries into the trading system with all rights and responsibility
11. Expansion of trade in services
12. GATT's dispute settlement procedures should be reinforced by permanent roster of non-governmental experts
13. A new round of GATT negotiations should be launched to strengthen the multilateral Trading system and further open world markets
14. Establishment of a permanent ministerial level body of GATT to ensure high level attention to trade issue
15. A satisfactory resolution of the world debt problem, adequate flows of development finance, better international co-ordination of macro economic policies and greater consistency between trade and financial policies.

United Nations Conference on Trade and Development (UNCTAD)

The **United Nations Conference on Trade and Development** (**UNCTAD**) was established in 1964 as a permanent intergovernmental body. It is the principal organ of the United NationsGeneral Assembly dealing with trade, investment, and development issues.

The organization's goals are to "maximize the trade, investment and development opportunities of developing countries and assist them in their efforts to integrate into the world economy on an equitable basis." The creation of the conference was based on concerns of developing countries over the international market, multi-national corporations, and great disparity between developed nations and developing nations.

In the 1970s and 1980s, UNCTAD was closely associated with the idea of a New International Economic Order (NIEO).

The United Nations Conference on Trade and Development was established in 1964 to provide a forum where the developing countries could discuss the problems relating to their economic development. UNCTAD grew from the view that existing institutions like GATT (now replaced by the World Trade Organization, WTO), the International Monetary Fund (IMF), and World Bank were not properly organized to handle the particular problems of developing countries.

Membership

As of October 2012, 194 states are UNCTAD members. UNCTAD members are divided into four lists, the division being based on United Nations Regional Groups with six members unassigned: Armenia, Kiribati, Nauru, South Sudan, Tajikistan and Tuvalu. List A consists mostly of countries in the African and Asia-Pacific Groups of the UN. List B consists of countries of the Western European and Others Group. List C consists of countries of the Group of Latin American and Caribbean States (GRULAC). List D consists of countries of the Eastern European Group.

The lists, originally defined in 19th General Assembly resolution 1995 serve to balance geographical distribution of member states' representation on the Trade Development Board and other UNCTAD structures. The lists are similar to those of UNIDO, an UN specialized agency.

List A (100 members): India, **List B** (31 members), **List C** (33 members) and **List D** (24 members):

Objectives:

The objectives of UNCTAD are

(a) To reduce and eventually eliminate the trade gap between the developed and developing Countries, and

(b) To accelerate the rate of economic growth of the developing world.

Functions:

The main Functions of the UNCTAD are:

(i) To promote international trade between developed and developing countries with a view to accelerate economic development.

(ii) To formulate principles and policies on international trade and related problems of economic development.

(iii) To make proposals for putting its principles and policies into effect, (iv) To negotiate trade agreements.

(iv) To review and facilitate the coordination of activities of the other U.N. institutions in the field of international trade.

(v) To function as a centre for a harmonious trade and related documents in development policies of governments.

Activities:

The important activities of UNCTAD include

(a) Research and support of negotiations for commodity agreements;

*(b)*Technical elaboration of new trade schemes; and

(c) Various promotional activities designed to help developing countries in the areas of trade and capital flows.

The UNCTAD Conference – held every four years:

- UNCTAD I in Geneva, 1964
- UNCTADII in New Delhi, 1968
- UNCTAD III in Santiago, 1972
- UNCTAD IV in Nairobi, 1976 and Manila, 1979
- UNCTAD VI in Belgrade, 1983
- UNCTAD VIII in Cartagena, Colombia on 8–25 February 1992
- UNCTAD IX in Midrand, South Africa on 27 April – 11 May 1996
- UNCTAD X in Bangkok, Thailand on 12–19 February 2000
- UNCTAD XI in São Paulo, Brazil on 13–18 June 2004
- UNCTAD XII in Accra, Ghana on 21–25 April 2008
- UNCTAD XIII in Doha, Qatar on 21–26 April 2012

UNCTAD I 1964 GENEVA:

- To adopt a new international division of labour and make the external sector conductive to the developing countries.
- To improve invisible trade of developing countries through development of shipping, tourism, etc. Each developed countries contributes 1% of their income to the developing countries.

UNCTAD II 1968 NEW DELHI:

- To reappraise the economic situation and its implanting the recommendation of UNCTAD I

- ❖ Problems and measures of economic integration and trade and development among developing countries
- ❖ Special measures for economic and social upliftment of the last developed among the developing nations.

UNCTAD III 1972 SANTIAGO:

- ❖ Changes in shipping freight (i.e. 1/3 of total deficit in the balance of payment of L.D.C's was due to high shipping freights.
- ❖ Promotion to world trade new structure of world shipping in which the merchant marine of developing countries play an increasing and substantial role.

UNCTAD IV 1976 NAIROBI:

- ❖ Helping the poor countries by the developed countries
- ❖ Some kind of taxes may be disposed by the advanced nations to raise funds.

UNCTAD V 1979 MANILA:

- ❖ 150 member countries were participated in this conference.
- ❖ No concrete resolutions were passed but having some future consideration on monetary reforms.

UNCTAD VI 1983 BELGRADE:

- ❖ Attainment of new international economic order
- ❖ Monetary issues such as adequacy of fund resources, conditionality etc were discussed.
- ❖ Developed countries insisted on Liberalizations of trade policies by the developing nations

UNCTAD VII 1987 GENEVA:

- ❖ The developed countries express their desire to provide debt relief to the poor countries.

UNCTAD VIII 1992 COLOMBIA:

- ❖ 170 member countries agreed on board features of revitalising UNCTAD and to make it more effective in dealing with development related issues.
- ❖ It has agreed to create Trade and Development Board (TDB).

- ❖ Establishment of five ad hoc (created for a particular purpose only) group to support the committee & TDB

UNCTAD IX 1996 MIDRAND:

- ❖ Met at Midrand in South Africa in 1996 in which it discussed issues pertaining to WTO, sustainable development and debt relief to developing nations.

UNCTAD X 2000 BANGKOK (THAILAND):

- ❖ The effective integration of all countries in the international trading system
- ❖ Improving supply capabilities
- ❖ Overcoming the debt problem
- ❖ Strengthening the commitment to social development; ensuring women´s political, economic and social participation
- ❖ Generating adequate financial flows for development
- ❖ Undertaking institutional reforms; reducing financial volatility
- ❖ Focusing on central problems of acute poverty and growing inequality within and among nations
- ❖ Supporting knowledge-based development as a necessary element for effective participation of developing countries in the world economy

UNCTAD XI 2004 SAU PAULO, BRAZIL:

- ❖ The effective integration of all countries in the international trading system
- ❖ Improving supply capabilities; overcoming the debt problem
- ❖ Strengthening the commitment to social development
- ❖ Ensuring women´s political, economic and social participation
- ❖ Generating adequate financial flows for development
- ❖ Undertaking institutional reforms; reducing financial volatility
- ❖ Focusing on central problems of acute poverty and growing inequality within and among nations

UNCTAD XII 2008 ACCRA, GHANA:

- ❖ Food prices increases Diversification and value added Increasing the level of investment in technology and infrastructure Equitable distribution of rents:

- ❖ Harnessing development gains from windfall incomes Human resource development: Ensuring a stable macroeconomic framework Food safety and health standards Food safety and health standard
- ❖ The Secretary-General of UNCTAD is Dr.Mukhisa Kituyi (Kenya), who took office on 1 September 2013.

In performing its functions, the secretariat works together with member Governments and interacts with organizations of the United Nations system and regional commissions, as well as with governmental institutions, non-governmental organizations, the private sector, including trade and industry associations, research institutes and universities worldwide

Currently, UNCTAD has 194 member states and is headquartered in Geneva, Switzerland. UNCTAD has 400 staff members. It is a member of the United Nations Development Group. There are non-governmental organizations participating in the activities of UNCTAD.

ACHIEVEMENTS:

The most significant achievements included.

a) The agreement on Generalized System of Preferences (GSP) 1971

b) The setting up of the Global System of Trade Preferences among developing Countries (1989)

c) Negotiation of International Commodity Agreements

d) The establishment of transparent market mechanisms in the form of intergovernmental commodity expert and study groups, involving consumers and producers

e) The negotiation of the Common Fund for Commodities (1989)

f) The adoption of the resolution on the retroactive adjustment of terms of Official Development Assistance debt of low-income developing countries

g) The establishment of guidelines for international action in the area of debt rescheduling (1980)

h) The Programme of Action for Least Developed Countries for the 1990s and

i) The negotiation of convention in the area of maritime transport

Although for many limitations of UNCTAD could not fulfill all expectations but it has tried and still trying with its limited resources to do its work. For the cause of the developing countries the role of UNCTAD should be strengthen. To make it more dynamic and effective **some measures** should be taken like as follows:

a) The Third World countries should minimize their differences and have to sacrifice their own interest for the sake of other developing countries. It will be easier for UNCTAD to work in a co-operative atmosphere than of conflict.

b) UNCTAD should give emphasis those issues in which it possesses considerable expertise. Here the proposal is not to alter its earlier position, but to focus more strongly on specific matters which are covered little if at all by other organizations. In trade field UNCTAD should give importance on consensus building. As UNCTAD provides a universal forum for policy analysis, so for consensus on trade policy issue it can help to prepare ground for later negotiations within WTO. UNCTAD and WTO should co-operate with each other in the field of international trade. It is encouraging that two organizations have already started their co-operation. As the main functions of WTO are the implementation and negotiation of contractual trading rules and discipline, there is considerable scope for complementarily between WTO and UNCTAD.The policy analysis and consensus building functions of UNCTAD can make essential contribution to the intergovernmental consideration of trade issues to the point where they can be fruitfully negotiated in WTO.

c) In post cold war economic environment, the need for collective action by the Third World countries to meet the evolving challenges is more important than ever. UNCTAD is the only body in the UN which has some scope to deal with global economic issues from a development perspective. UNCTAD should be equipped for that purpose.

d) UNCTAD's monitoring and analytical capacities should be increased sufficiently.

e) Its efficiency in the area of foreign investment, technology transfer, competition policy regarding Multinational Corporation should be strengthening.

f) UNCTAD should prepare its answer for Third World country regarding liberalization and regional groupings.

UNCTAD is the only organization in the world which gives the impression of being trade and development in an integrated way which is very important.

World Trade Organization (WTO)

World Trade Organization (WTO)

The **World Trade Organization** (**WTO**) is an organization that intends to supervise and liberalizeinternational trade. The organization officially commenced on January 1, 1995 under the Marrakech Agreement, replacing the General Agreement on Tariffs and Trade (GATT), which commenced in 1948. The organization deals with regulation of trade between participating countries; it provides a framework for negotiating and formalizing trade agreements, and a dispute resolution process aimed at enforcing participants' adherence to WTO agreements, which are signed by representatives of member governments and ratified by their parliaments. Most of the issues that the WTO focuses on derive from previous trade negotiations; especially from the Uruguay Round (1986–1994).The organization is attempting to complete negotiations on the Doha Development Round, which was launched in 2001 with an explicit focus on addressing the needs of developing countries. As of June 2012, the future of the Doha Round remains uncertain: the work programme lists 21 subjects in which the original deadline of 1 January 2005 was missed, and the round is still incomplete. The conflict between free trade on industrial goods and services but retention of protectionism on farm subsidies to domestic agricultural sector (requested by developed countries) and the substantiation of the international liberalization of fair trade on agricultural products (requested by developing countries) remain the major obstacles. These points of contention have hindered any progress to launch new WTO negotiations beyond the Doha Development Round. As a result of this impasse, there have been an increasing number of bilateral free trade agreements signed. As of July 2012, there are various negotiation groups in the WTO system for the current agricultural trade negotiation which is in the condition of stalemate.

Structure or Organisation of WTO:

WTO is headed by the Ministerial Conference composed of representatives of all the members who meet at least once every two years. It carries out its functions of the WTO and takes actions necessary to this effect. It takes decisions on all matters under any of the Multilateral Trade Agreements. The Ministerial conference is the supreme authority of the WTO.

There is a General Council composed of representatives of all the members to oversee the operation of the WTO Agreement and ministerial decisions on a regular basis. There is the Council for trade in Goods, the Council for Trade in Services and the Council for Trade-related Aspects of Intellectual Property Rights (TRIPS)which operate under the General Council.The Secretariat of the WTO is headed by the Director General. The Ministerial Conference appoints the Director General and sets out his powers, duties, and conditions of service and terms of office. The Director of General appoints the members of staff of the secretariat and determines their duties and conditions of service. The Director General presents to the committee on budget, finance and administration, the annual budget estimates and financial statement of the WTO.

Objectives of WTO:

Important objectives of WTO are mentioned below:

(i) to implement the new world trade system as visualized in the Agreement;

(ii) to promote World Trade in a manner that benefits every country;

(iii) to ensure that developing countries secure a better balance in the sharing of the advantages resulting from the expansion of international trade corresponding to their developmental needs;

(iv) to demolish all hurdles to an open world trading system and usher in international economic renaissance because the world trade is an effective instrument to foster economic growth;

(v) to enhance competitiveness among all trading partners so as to benefit consumers and help in global integration;

(vi) to increase the level of production and productivity with a view to ensuring level of employment in the world;

(vii) to expand and utilize world resources to the best;

(viii) to improve the level of living for the global population and speed up economic development of the member nations.

Functions of WTO:

The former GATT was not really an organisation; it was merely a legal arrangement. On the other hand, the WTO is a new international organisation set up as a permanent body. It is designed to play the role of a watchdog in the spheres of trade in goods, trade in services, foreign investment, intellectual property rights, etc. Article III has set out the following five functions of WTO;

(i) The WTO shall facilitate the implementation, administration and operation and further the objectives of this Agreement and of the Multilateral Trade Agreements, and shall also provide the frame work for the implementation, administration and operation of the plurilateral Trade Agreements.

(ii) The WTO shall provide the forum for negotiations among its members concerning their multilateral trade relations in matters dealt with under the Agreement in the Annexes to this Agreement.

(iii) The WTO shall administer the Understanding on Rules and Procedures Governing the Settlement of Disputes.

(iv) The WTO shall administer Trade Policy Review Mechanism.

(v) With a view to achieving greater coherence in global economic policy making, the WTO shall cooperate, as appropriate, with the international Monetary Fund (IMF) and with the International Bank for Reconstruction and Development (IBRD) and its affiliated agencies.

Principles of the trading system:

The WTO establishes a framework for trade policies; it does not define or specify outcomes. That is, it is concerned with setting the rules of the trade policy games.

Five principles are of particular importance in understanding both the pre-1994 GATT and the WTO:

1. **Non-discrimination**. It has two major components: the most favoured nation (MFN) rule, and the national treatment policy. Both are embedded in the main WTO rules on goods, services, and intellectual property, but their precise scope and nature differ across these areas. The MFN rule requires that a WTO member must apply the same conditions on all trade with other WTO members, i.e. a WTO member has to grant the most favorable conditions under which it allows trade in a certain product type to all other WTO members."Grant someone a special favour and you have to do the same for all other WTO members." National treatment means that imported goods should be treated no less favorably than domestically produced goods (at least after the foreign goods have entered the market) and was introduced to tackle non-tariff barriers to trade (e.g. technical standards, security standards et al. discriminating against imported goods).
2. **Reciprocity**. It reflects both a desire to limit the scope of free-riding that may arise because of the MFN rule, and a desire to obtain better access to foreign markets. A related point is that for a nation to negotiate, it is necessary that the gain from doing so be greater than the gain available from unilateral liberalization; reciprocal concessions intend to ensure that such gains will materialize.
3. **Binding and enforceable commitments**. The tariff commitments made by WTO members in a multilateral trade negotiation and on accession are enumerated in a schedule (list) of concessions. These schedules establish "ceiling bindings": a country can change its bindings, but only after negotiating with its trading partners, which could mean compensating them for loss of trade. If satisfaction is not obtained, the complaining country may invoke the WTO dispute settlement procedures.

4. **Transparency**. The WTO members are required to publish their trade regulations, to maintain institutions allowing for the review of administrative decisions affecting trade, to respond to requests for information by other members, and to notify changes in trade policies to the WTO. These internal transparency requirements are supplemented and facilitated by periodic country-specific reports (trade policy reviews) through the Trade Policy Review Mechanism (TPRM). The WTO system tries also to improve predictability and stability, discouraging the use of quotas and other measures used to set limits on quantities of imports.
5. **Safety valves**. In specific circumstances, governments are able to restrict trade. The WTO's agreements permit members to take measures to protect not only the environment but also public health, animal health and plant health.

Agreements:

The WTO oversees about 60 different agreements which have the status of international legal texts. Member countries must sign and ratify all WTO agreements on accession. A discussion of some of the most important agreements follows. The Agreement on Agriculture came into effect with the establishment of the WTO at the beginning of 1995. The AoA has three central concepts, or "pillars": domestic support, market access and export subsidies. The General Agreement on Trade in Services was created to extend the multilateral trading system to service sector, in the same way as the General Agreement on Tariffs and Trade (GATT) provided such a system for merchandise trade. The agreement entered into force in January 1995. The Agreement on Trade-Related Aspects of Intellectual Property Rights sets down minimum standards for many forms of intellectual property (IP) regulation. It was negotiated at the end of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in 1994.

The Agreement on the Application of Sanitary and Phytosanitary Measures—also known as the SPS Agreement—was negotiated during the Uruguay Round of GATT, and entered into force with the establishment of the WTO at the beginning of 1995. Under the SPS agreement, the WTO sets constraints on members' policies relating to food safety (bacterial contaminants, pesticides, inspection and labeling) as well as animal and plant health (imported pests and diseases). The Agreement on Technical Barriers to Trade is an international treaty of the World Trade Organization. It was negotiated during the Uruguay Round of the General Agreement on

Tariffs and Trade, and entered into force with the establishment of the WTO at the end of 1994. The object ensures that technical negotiations and standards, as well as testing and certification procedures, do not create unnecessary obstacles to trade". The Agreement on Customs Valuation, formally known as the Agreement on Implementation of Article VII of GATT, prescribes methods of customs valuation that Members are to follow. Chiefly, it adopts the "transaction value" approach. In December 2013, the biggest agreement within the WTO was signed and known as the Bali Package