MODULE I

1

INTERNAL AND INTERNATIONAL TRADE

Unit Structure

1.0 OBJECTIVES

International economics plays a very important role in the world economy. International economics helps in economic, social and political development of the country. In this lesson of International Economics, we are going to study in terms of international trade. The objectives of this lesson are as follows:

- To study the concept and importance of international economics.
- To study the difference between interregional or internal and international trade.
- To study the scope of international trade.

1.1 MEANING OF INTERNATIONAL TRADE

International trade means trade between the two or more countries. International trade involves different currencies of different countries and is regulated by laws, rules and regulations of the concerned countries. Thus, International trade is more complex.

According to Wasserman and Haltman, “International trade consists of transaction between residents of different countries”.

According to Anatol Marad, “International trade is a trade between nations”.

According to Eugeworth, “International trade means trade between nations”.

International trade is in principle not different from domestic trade as the motivation and the behaviour of parties involved in a trade do not change fundamentally regardless of whether trade is across a border or not. The main difference is that international trade is typically more costly than domestic trade.

1.2 SCOPE OF INTERNATIONAL TRADE

1. Export and Import of Goods:

International trade involves the import and export of goods. It is also called invisible trade.

2. Export and Import of Services:

This is also known as invisible trade. Invisible trade includes tourism, transportation, telecommunications, banking, warehousing, distribution, and advertising.

3. Licenses and Franchises:

A license is a contractual arrangement whereby one company (the licensee) grants access to its patent, copyright, trademark or technology to another foreign company (the licensee) at a rate called a royalty. Pepsi and Coca-Cola are produced and sold worldwide under a license system. A franchise is similar to a license, but a term used in the context of the provision of services. For example, McDonald's operates fast-food restaurants worldwide through its franchise system.

4. Foreign Investment:

It involves investing funds abroad in return for financial gains. There are two types of foreign investment.

(A) Foreign Direct Investment (FDI):

Investing in foreign assets such as plant and machinery for the purpose of manufacturing and marketing goods and services abroad.

(b) Portfolio Investments-

Liability to invest in shares of a foreign company or to earn income by way of dividends or interest.

1.3 IMPORTANCE OF INTERNATIONAL TRADE

International trade has become very important in modern economy. Even a country like England has achieved its development through international trade. It is clear that international trade is the foundation of modern economic development. An important reason for the industrial progress made by the advanced countries like America, France, Germany, Japan etc. can be found in the trade policy adopted by them. Therefore, classical economists consider international trade as an engine of economic development and not merely a means of increasing production.

The importance of the study of International Trade can be explained as follows.

1) The optimal use of the natural resources of a country:

The international trade between two or more nations helps all of them to make the best possible use of their natural resources. Every country can focus on the production of goods and services using these resources and sell them to other nations to earn foreign exchange and shore up their economy. It also helps to avoid the wastage of crucial resources and use them to improve the overall economic standing of the country.

2) The availability of different types of goods and services:

One of the major benefits of international trade is that it enables a country to obtain goods and services that it is unable to make on their own due to lack of resources or higher costs of production. They can get these goods from outside the country at relatively lower costs.

3) The specialisation in the production of certain goods and services:

Some nations are endowed with certain advantages like natural resources, workforce, technology and capital. These resources allow them to engage in the production of certain kinds of goods and services at relatively cheaper costs and sell it to other nations who need them. They can engage in large scale production to cater to the needs of home domestic as consumption as well as serve the international markets. They can also dispose of goods and services which they possess in large quantities to other countries and improve their foreign exchange reserves in return.

4) The stability in prices of products and services:

It is one of the major benefits of international trade. It helps to iron out the benefits and put a stop to the wild fluctuations that can arise due to the non-availability of these products.

5) The exchange of technical expertise:

International Trade allows countries with a lack of knowledge in terms of production, manufacturing and technology to access it from other nations. Underdeveloped countries can take the help of the developed ones to establish and develop industries apart from increasing their economic prosperity.

6) Improve efficiencies in terms of production and distribution of goods and services:

Countries can take advantage of international trade to increase their scale of production and make it more efficient to cater to the demands of other nations. They can also focus on producing better quality products and services while minimising the overall costs.

7) The development of transport and communication:

International trade between nations can flourish only if the means of transport and communications are robust and highly efficient. Or else, it will lead to bottlenecks that can hamper the viability of the transactions. International trade often acts as an incentive for nations to improve their transportation and communication with other countries to facilitate the continuous exchange of goods and services.

8) Improved relations:

International trade between nations also leads to a greater scope of communication between the two nations. It enables the exchange of knowledge and ideas as well. This can foster greater cooperation and understanding and act as a cornerstone for developing more cordial relations between the two countries.

Conclusion:

The benefits of International Trade far outweigh the risks, and it also leads to greater economic prosperity for the economies involved. The size of the world economy has jumped manifold in the past decade, and it is a result of the increased volume and value of the exchange of goods and services between nations.

1.4 DIFFERENCE BETWEEN INTERNAL AND INTERNATIONAL TRADE

Trade means exchange of goods. What difference, then, does it make to the theory of trade whether these goods are made in the same country or in different countries?

Why is a separate theory of international trade needed? Well, domestic and foreign trade are really one and the same.

They both imply exchange of goods between persons. They both aim at achieving increased production through division of labour.

There are, however, a number of things which make a difference between foreign trade and domestic trade and necessitate a separate theory of interna-tional trade.

(i) Immobility of Factors of Production:

Labour and capital do not move freely from one country to another as they do within the same country. “Man”, declared Adam Smith, “is, of all forms of luggage, the most difficult to transport”. Much more so when a foreign frontier has to be crossed. Hence differences in the cost of production cannot be removed by moving men and money, the result is the movement of goods.

On the contrary, between regions within the same political boundaries, people distribute themselves more or less according to opportunities. Real wages and standard of living tend to seek a common level, though they are not wholly uniform. As between nations, however, these differences continue to persist for wages and check population movements. Capital also does not move freely from- one country to another. Capital is notoriously shy.

(ii) Different Currencies:

Every country has a different currency. India has the rupee and the U.S.A. has the dollar, Germany the mark, Italy the lira, Spain the peso, Japan the yen, and so on. Hence, buying and selling between nations give rise to complications absent in internal trade.

(iii) Restrictions on Trade:

The trade between different countries is not free. Very often there are restrictions imposed by custom duties, exchange restric-tions, fixed quotas or other tariff barriers. For example, our country has imposed heavy duties on import of motor cars, wines and liquors and other luxury goods.

(iv) Ignorance:

The knowledge of other countries cannot be as exact and full as of one's own country. Differences in culture, language and religion stand in the way of free communication between different countries. On the other hand, within the borders of a country, labour and capital freely move about. These factors, too, make internal trade different from international trade.

(v) Transport and Insurance Costs:

Then costs of transport and insurance also check- free international trade. The greater the distance between the two countries, the greater are these costs. Wars increase them still more.

Thus, comparative immobility of labour and capital, restric-tions on trade, transport and other costs, ignorance, and differences in language, customs, laws and currency systems make international trade different from domestic trade and necessitate a separate theory of international trade.

1.5 SUMMARY

In this chapter the meaning of international trade and various definitions of international trade are given. Also, the scope of international trade is elaborated and the importance of international trade and international economics is also highlighted. We have also studied the meaning of interregional and international trade and the difference between these two trades. This shows that international trade is necessary and beneficial for every nation.

1.6 QUESTIONS

Q.1 What is international economics? Explain the importance of international economics?

Q.2 What are the salient features of international trade?

Q.3 Explain the difference between international trade and international trade?

Q.4 Explain the characteristics of international economics.

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2

THEORIES OF INTERNATIONAL TRADE

Unit Structure

2.0 OBJECTIVES

- To understand Adam Smith's theory of international trade and its importance.
- To study Ricardo's theory of comparative cost advantage.
- To understand Heckscher-Ohlin theory.
- Studying Leontief's Paradox and Krugman's model.

2.1 INTRODUCTION TO THEORIES OF INTERNATIONAL TRADE

Trade whether internal or external or international and economic development are closely related to each other. There is a complementary relationship between trade and economic development. Trade leads to increase in the volume of trade. The increase in the volume of trade facilities economic development of the participating countries. The economic development in its own term facilities trade. Trade comes into being when countries produce surplus goods over and above their domestic demand or requirement. When surpluses are exchanged against surpluses trade comes into being. When trade remains within the geographical or political boundary of the country it is called as domestic trade and when trade or exchange crosses the geographical or political boundary of the county it gets referred to as international or global trade.

As per the comparative costs theory of international trade propounded by David Ricardo international trade benefits all the trading partners which can be referred to as gains from international trade. The gains from international trade spring up to the trading partners due to division of labour i.e. specialization, reallocation of factors of production, optimum expectation of resources, saving of the cost of production etc. Instead of producing all the goods domestically it is better to produce only those goods in which it has got comparative superiority. If it does so it can produce the goods more cheaply. If all the trading countries follow the same tactics them the people of these trading countries enjoy consumer's surplus as they get the goods from foreign countries at a low price as compare to domestic price. All these things are illustrated with help of international trade theories.

Theories of International trade:

There are two very important theories of international trade viz.

1) Classical Theory of International Trade.

2) Modern Theory of International Trade

There are two versions to the classical theory of International Trade viz.

i) The Theory of Absolute Cost Differences.

ii) The Theory of Comparative Cost Differences.

2.2 ADAM SMITH'S THEORY OF INTERNATIONAL TRADE

The Theory of absolute cost advantages was propounded by Adam Smith. It was he who advocated free trade i.e. laissez faire par excellence. It was a reaction against mercantilism. The mercantilist propounded the theory of protection i.e. one way trade only. The gospel of the theory of protection i.e. one way trade of the mercantilists was, "Only export, Don't import". This gospel was meant for strengthening of the national economy. As a reaction. against mercantilism Adam Smith advocated free trade. As per the principle of free trade there should be no obstacles between the exchange of goods from one country to another. It benefits all the trading countries. The country doesn't make any difference between the domestic goods and the foreign goods. Adam Smith was the champion of division of labour i.e. specialization. Instead of producing all the goods the country should specialize in the commodity in which it has absolute cost advantage. The international division of labour leads to reallocation of resources which leads to increase in the volume of trade. Each country specialises in the production of a commodity in which it is best suited which leads to enrichment of both the trading countries.

Illustration:

The above stated points can be illustrate with the help of a numerical hypothetical example.

Adam Smith presented a two countries, two commodities and one factor model of international trade.

Commodities	Country A	Country B
1) Wheat	25 tonnes	15 tonnes
2) Cloth	15 metres	25 metres

The table highlights the following points:

1) There are two countries viz. country A and country B participating in the international trade.

2) There are two commodities taking part in the international trade viz. wheat and cloth.

3) Assumption of labour theory of value. According to labour theory of value labour is homogenous. The cost of production is expressed in terms of labour cost.

4) With the help of one unit of labour country A produces 25 tonnes of wheat and 15 metres of cloth domestically while country B produces 15 tonnes of wheat and 25 metres of cloth.

5) The comparison of domestic production figures show that country A has got an absolute superiority over country B in the production of wheat because it produces 25 tonnes of wheat while country B produces 15 tonnes of wheat with the help of given unit of labour. Conversely country B has got an absolute superiority over country A in the production of cloth because country B produces 25 metres of cloth while country A produces 15 metres of cloth with the help of a given unit of labour.

6) Under this scenario country A will be called upon to specialise in the production of wheat while country B will be called upon to specialise in the production of cloth.

7) The specialization or division of labour will bring about reallocation of factors of production such that country A will withdraw factors of production i.e. labour from the production of cloth and will employ on the production of wheat. Conversely country B will withdraw factors of production i.e. labour from the production of wheat which will be employed in the production of cloth.

8) The reallocation of resources will lead to double the production. Now country A will produce 50 tonnes of wheat while county B will be is a position to produce 50 metres of cloths. In this way surpluses will be created which will lead to exchange of surpluses leading to an emergence of international trade.

9) It leads to increase in the total volume of trade. Before international trade the total volume of trade was of the order of 40+40= 80 units. After international trade the total volume of trade will be of the order of 50+ 50 = 100 units i.e. there is an excess of 20 units over 80 units.

However it is found that the absolute cost advantage theory is highly unrealistic, hypothetical and narrow is scope. Prof. Higgins divided the world in to categories viz. the DCs and the LDCs i.e. the Developed countries and the less developed countries on the basis of per capita income. The per capita income of the DCs is very high as compared to the LDCs. The DC's can experience an absolute superiority while the LDCs can't. Thereby Adam Smith has narrowed down the scope of his theory which encompasses only DC's in its fold and the LDCs are relegated to the background. The LDCs partly produce the goods and partly import form the DCs.

The drawbacks of the absolute cost difference theory leads us to study another classical theory of international trade namely comparative costs theory of international trade propounded by David Ricardo.

2.3 RICARDIAN THEORY OF COMPARATIVE COST DIFFERENCE

The comparative costs theory of international trade was propounded by David Ricardo in his book." Principles of political Economy" which was published in the year 1817. His international trade theory was based upon his labour theory of value. According to this theory the value of the commodity is determined by its labour cost. The goods are exchanged on the basis of the relative amount of labour embodied in them. As per the labour value theory there is a tendency of wages equalling to the prices of goods.

Ricardo's labour theory of value assumes the following things:

1) `Labour is the only productive factor of production

2) `Total cost means labour cost.

3) `Labour is homogenous.

4) `There is a perfect mobility of labour.

5) `Perfectly competitive labour market.

Assumptions of his comparative cost theory of international trade:

1) Two countries, two commodities and one factor model of international trade.

2) Cost of production is the labour cost because labour is the only productive factor of production.

3) Prices of goods are determined on the basis of labour cost embodied in them.

4) Perfect competition.

5) Perfect mobility of labour domestically but immobility of labour internationally.

6) Constant returns to scale.

7) Existence of full employment.

8) Free trade

9) Division of labour i.e. specialization.

10) No transport cost.

To illustrate the comparative costs theory of international trade let us take a numerical hypothetical model of international trade as was taken by David Ricardo himself in his book "The principles of political Economy" published in the year 1817.

The basis of international trade is the comparative cost difference. Different countries specialise in the production of goods on the basis of comparative costs advantage. All the world counties are not endowed with similar natural bounties i.e. nature makes a difference between countries as regards natural bounties. Therefore different countries of the globe are called upon to specialise in the commodities in which they have got a comparative cost advantage such that these countries can produce the goods comparatively at a cheaper rate. If all the world countries follow this they stand to benefit thereby in terms of division of labour i.e. specialization reallocation and optimum exploitation of resources, savings of the cost of production etc.

Countries	**Commodities**		**Domestic Exchange Rate**
	Wine	**Cloth**	
1) Portugal	80	90	1W : 0.89 C
2) England	120	100	1W : 1.2 C
Cost Ratios	0.67	0.90	

The above table tells us that Portugal produces one unit of wine with the help of 80 hours of labour and one unit of cloth with 90 hours of labour. While England produces one unit of wine with 120 hours of labor and one unit of cloth with the help of 100 hours of labour. From this scenario it is clear that Portugal has got absolute superiority over England in the matter of production of both the commodities viz. wine and cloth become it can produce both wine and cloth at an absolutely lower cost as compare to England. Conversely England has got an absolute disadvantage in the matter of production of both the commodities viz, wine and cloth as the cost of Production of both the commodities is very high as compare to the cost of production of both wine and cloth in Portugal.

Under this scenario if we would like to know the comparative cost advantage we will have to compare the ratios of cost of production of both the commodities in both the countries (i.e. wine in both the countries and cloth in both the countries). The table shows that the cost ratio of wine in Portugal comes to 80/120 = 0.67

While the cost ratio of cloth in Portugal comes to 90/100 = 0.90 If we compare these two ratios we find that 0.67 is less than 0.90. It tells us that though Portugal has got absolute superity or absolute cost advantage over England in both the commodities viz. wine and cloth its superiority is greater in wine than in cloth. It means that Portugal has got comparative cot advantage in the production of wine. Conversely take the case of England. England has got absolute cost disadvantage over Portugal in the production of both the commodities viz. wine and cloth because it produces both the commodity at an extremely higher cost as compare to cost of production of wine and cloth in Portugal. However the disadvantage of England is comparatively less in cloth than in wine.

120/80 = 1.5; 100/90 = 1.1

1.1 < 1.5

In a situation of this type Portugal will be called upon to specialise in wine manufacture. It will undertake reallocation of resources i.e. it will withdraw labour from cloth manufacture and will employ it in wine manufacture to create surpluses. Conversely England will be called upon to specialise in cloth manufacture. It will bring about reallocation of resources by withdrawing labour from wine manufacture and will employ it in cloth manufacture to create surplus. International trade will come into existence by exchanging surpluses i.e. Portugal will export wine to England and will import cloth from England. Conversely England will export cloth to Portugal and will import wine from Portugal.

Any exchange ratio between 0.89 and 1.2 will benefit both the countries viz. Portugal and England. It is advantageous to Portugal to export wine to England where 1 unit of wine commands 1.2 units of cloth such that be exporting wine to England she gets more than 0.89 units of cloth i.e. 1.2 units of cloth from England against 1 units of wine. It is advantageous to England to export cloth to Portugal where 1 unit of wine is exchanged at 0.89 units of cloth. It means for one unit of wine it has to give less than 1.2 units of cloth (i.e. 0.89 units of cloth) If 1:1 exchange rate gets established when the international trace takes pace Portugal gains because she gets 1 unit of cloth against 80 hours of labour. In the absence of international trade it would have got it for 90 hours. Thus it saves 10 hours of labour. It also implies that Portugal gets 0.11 units of extra cloth from England. Conversely England also benefits from international trade. It gets 1 unit of wine for 100 hours of labour which would have cost for 120 hours of labours in the absence of international trade. It means that England saves 20 hours of labour. It also implies that England gets 0.17 units of wine more.

Critical Evaluation:

i) David Ricardo has assumed full employment. But full employment is a myth. It is an ideal goal which all the world countries cherish. But this goal is hardly realised specially by the underdeveloped countries. The underdeveloped countries suffer from unemployment, underemployment and disguised unemployment.

ii) He has assumed free trade i.e. laissez faire. Free trade or laissez faire entails cut throat competition. In underdeveloped countries there is a vast ocean of infant industries which can't survive under conditions of free trade i.e. they can't stand on their own legs. These infant industries need protection. Thus the assumption of free trade instead of spreading mutual gain will lead to making the poor country poorer.

iii) Secondly the underdeveloped countries are primarily primary producing countries. These countries rely on the export of food stuffs and raw materials for which the foreign demand is elastic while they rely heavily on import of machinery, technology, spare parts etc for which their demand is inelastic. In a situation of this type international gain will spring upto the DC's while the LDC's will sustain losses.

iv) He has assumed fixity of the factors of production which therefore involve reallocation of factors of production. The developing economics are under taking planned economic development wherein resource go on fluctuating. Planning entails more resources.

When there is a dearth or pancity of resources how can there be reallocation of resources. As a matter of fact the LDC's have to generate more resources.

v) He has assumed constant returns to scale. As a matter of fact in the actual life there can be either increasing returns to scale or decreasing returns to scale. Most of the underdeveloped countries are agricultural countries and the DC's are industrially advanced countries. The DC's experience increasing returns to scale while the LDC's experience decreasing returns to scale.

vi) David Ricardo has assumed a perfect mobility of labour domestically and immobility of labour internationally. Perfect competition is also a myth. Underdeveloped countries suffer form market imperfections, ignorance, personal attachment, transport bottlenecks, production bottlenecks, power failures, strikes personal likes and dislikes due to which domestic mobility gets hampered.

vii) The LDC's constantly suffer from disequilibrium in their balance of payments hence they have to switchover to tariffs, import quotas import licensing etc.

2.4 HECKSCHER-OHLIN THEORY

The modern theory of international trade was propounded by Swedish economist Bertil Ohlin is his book "Inter- regional and international trade published in 1933. The modern theory of international trade is also known by various names which are as follows:

1) It is known as "General Equilibrium Theory of international trade". It is because general equilibrium rules are applied in case of international trade. When in the market twin market forces viz. total demand and total supply are in equilibrium the equilibrium price gets established in the market.

ii) It is also known as "Factor proportions Theory" It is because different countries are endowed with different factors of production. Some countries have a Surplus of some factors and scarcity of some factors. For example if there are two countries viz. Australia and England. Australia has got land in abundance than capital. Conversely England has got an abundance of capital over land. In a situation of this type Australia will specialize in the production of wool which will call for the employment more land and less capital conversely England will specialize in the production of machinery which will call for an employment of more capital and less land which gets referred to a factor proportion.

iii) It is also called as "Heckschar Ohlin theorem". It is because before ohlin it was Heckscher who enunciated the mutual interdependence theory of international trade. Lateron it was Bertil Ohlin who developed, refined and renovated the mutual interdependence theory of international trade. It is become of joint endeavour of two viz. Heckscher and ohlin that led to an emergence of international trade theory hence the modern theory of international trade gets referred to as "Heckscher Ohlin theorem.

iv) The modern theory of international trade is also called as "mutual interdependence theory". It is because the sole basis of the emergence of international trade is the difference is the price of the final goods. There is a mutual interdependence between the price of the final goods and the price of the factors of production PG = f (DG and SG)

PG stands for price of goods.

F stands for functional relationship.

DG stands for demand for goods.

SG stands for supply of goods.

i.e. the price of a commodity depends upon the demand for and supply of a commodity.

PG= f (PF)

i.e. The price of a commodity i.e. goods depends upon factor price.

PF = f(DF and PF)

i.e. Factor price depends upon the demand for and supply of factors of production.

v) It is also known as monetary theory of international trade. It is because of an application of a foreign exchange rate to the phenomenon of international trade.

Bertil Ohlin says "International trade is nothing but a special case of inter-regional trade". It is because of which the single market theory get applied to multi market trade.

As a matter of fact instead of criticizing the comparative cost theory of David Ricardo,

Bertil Ohlin supports his theory and says the following:

i) "The comparative cost theory is applicable to all trades whether internal i.e. inter-regional or international. As a matter of fact David Ricardo had limited the scope of his comparative cost theory by applying it only to international trade".

ii) "The immobility of labour is not an exclusive feature of intentional trade. It is also applicable in interregional trade i.e. domestically also labour is immobile because of regionality, likes an dislikes, taste and preferences, etc. Therefore we find that wages and interest rates are different in different provinces of India. Therefore Bertil Ohlin said, "The immobility of factors of production is a matter of degree and not of kind". Hence he said "There is no need for a separate theory of international trade. International trade is a special case of inter-regional trade".

He picks up a double model system i.e.. two countries, two commodities and two factors model to illustrate the above points which is as follows:-

The two countries are Australia and England. The two commodities are wool and machinery and the factors are land and capital. In Austria there is an abundance or surplus of land in relation to capital which is scarce while in England capital is in abundance while there is a scarcity of land. In a situation of this type Australia specializes in the production of wool which needs more land and less capital while England specializes in the manufacture of machinery which requires more capital and less land. Australia produce wool cheaply i.e. at an extremely low cost of production because of which the price of wool will be extremely low in Australia. Conversely England produce machinery at an extremely low cost of production because of which the price of machinery will be extremely low in England. In a situation of this type Australia exports wool to England and imports machinery from England. England exports machinery to Australia and imports wool from Australia. Bertil Ohlin has indirectly made the land mobile from Australia to England just like a playback singing. (The singer is at the back of an actor/actress who money the ups.) When Australia exports wool to England indirectly it has exported land to England.

It is already pointed out that Berlil Ohlin’s theory is also called as monetary theory of international trade because of an application of an element of foreign exchange rate in the realm of international trade. The application of foreign exchange rate transforms comparative costs into absolute cost. But the very important point to be remembered is that foreign exchange rate is not the basis of international trade.

There are two countries viz. India and USA both the countries have got different monetary units. India has got rupee while USA has got dollar as their currencies. Suppose of the foreign exchange rate between dollar and rupee is 1 $ = Rs. 40.

Commodities	India (Rs.)	U.S.A ($)	Conversion of dollar into rs.
A	10	0.5	20
B	20	1.0	40
C	70	1.5	60
D	90	2.0	80

Before conversion of American dollar into Indian rupees we can't make out as to what is what? When we convert dollar into rupees the picture becomes clear. From the above table it is clear that commodities A and B are cheaper in India while commodities C and D are cheaper in U.S.A. in a situation of this type India will be called upon to specialize in the production of commodities. A and B and export A and B to USA while USA will be called upon to specialize in commodities C and D and export these two commodities to India.

2.5 LEOTIEF’S PARADOX

One of the attractions of the HO theory is that it provides us with set of fairly simple and readily testable predictions. One of the first attempts made to test the theory was made by a Russian-born economist, Wassily Leontieff (b.1906) in 1954. Using the 1947 input-output tables for the United States, he sought to test the proposition that the US had a comparative advantage in capital-intensive goods and therefore traded these goods for imported labour-intensive products. Leontieff measured the factor intensity of U.S. exports and *import replacements* using the input-output tables. The reason for taking import replacements (U.S. produced goods that are substitutes for goods imported) rather than imports was that information about factor intensities could not be obtained for all the products which the US imported or for all the countries from whom she imported. If the factor intensities for these products are the same in other countries, the use of import replacements need pose no major problems. Interestingly, Leontieff's results showed that U.S. imports were more capital-intensive than U.S. exports, the exact opposite of what the theory predicted (Leontieff, 1954)!

The *Leontieff Paradox,* as it came to be known, seemed to prove that the HO theory was wrong. Subsequently, a variety of explanations were put forward for Leontieff's results.

1. One possible explanation was that the year chosen. 1947, was not very representative given that trading patterns may still have been - distorted by the ending of the Second World War. However, attempts to carry out the same test for later years reproduced the same result and thus appear to refute the explanation (Leontieff, 1956).

2. A second explanation focused on the use of import replacements rather than imports. If products imported by the US were produced by different methods in other countries to those adopted in the US, factor intensities will differ and the use of import replacements as *a* proxy for imports will render the, theory invalid. Specifically, it is possible, given the scarcity of labour in the US, that goods that are produced by labour-intensive methods abroad, are produced by capital intensive methods in the US. This is known as *factor-intensity reversal* (Ellsworth, 1954) The important question is: to what extent does factor-intensity reversal occur in reality) and is it of sufficient importance to render the HO theory invalid? If factor-intensity reversal is a common occurrence then the HO assumption that all countries face identical production functions for the same good is not valid and the theory breaks down. Empirical research his established that factor-intensity reversal does, indeed, take place (Minhas 1963). However, it appears that, in most cases, it is not **sufficient** to account for the result obtained by Leontieff. (See Leontieff 1964, Moroaey, 1967, Bhagwati, 1969.)

3. A third explanation is that the assumption of identical consumer preferences is invalid. Specifically, it was argued **that,** in 1947, on account of their higher per capita income; U.S. consumers had a greater preference for capital-intensive goods. Higher quality consumer goods are generally more capital-intensive than lower quality ones (see Houthakker, 1957).

4. The explanation preferred by Leontieff was that U.S. labour Was superior to that of other countries. Quite arbitrarily, he gave a figure of three to one as the difference between the efficiency of U.S. labour and that of- other countries. In that case, labour could not be described as relatively scarce and the fact that U.S. exports were more labour-intensive than U.S. imports was hardly surprising. The main problem with this argument is that it is by no means apparent why this hold be true of labor alone. There is every reason to suppose that U.S. capital was also more productive than that of other countries, in which case the capital-labour ratio would be unaffected and the presumption that labour was relatively scarce would still hold. No empirical evidence has been forthcoming to contradict this.

5. A further explanation has emphasised the failure of Leontieff to distinguish human from physical capital. Human capital finds its

embodiment in the skills and education of a country's labour force. If allowance is made for this, it would be the case that U.S. exports are more capital-intensive than Leontieff found. In a later work, Leontieff himself found that the average level of skill of the labour force in the U.S. was higher in the export than the import replacements sector (Leontieff, 1956). Subsequently, Kenen (1965) has shown that, once human capital is included, the Leontieff Paradox is reversed but only just. On the other hand, using a different method of estimating human capital, Baldwin (1971) found that, while the inclusion of human capital was sufficient to weaken the Paradox, it was' not enough to reverse it. In fact, since physical and human capital are hardly perfectly substitutes, it is more appropriate to treat human capital as a separate factor of production. Since human capital and not capital in aggregate is most probably the United States' most abundant factor of production, the right test to perform is to measure the relative human capital intensity of U.S. exports.

6. The next explanation concerns natural resources that are moitted as a factor from the model used by Leontieff. The HO model becomes more complex if a third factor of production is introduced. Attention was drawn to the fact that, on account of her rapid industrialisation, the US had become relatively deficient in natural resources such that much of what she imported consisted of resource-intensive goods. The possibility, therefore, existed that natural resources and not labour were her relatively most scarce factor. Therefore, the US had become an exporter of both capital- and labour-intensive goods in exchange for resource-intensive goods. In a later study, Leontieff excluded certain resource imports which were noncompetitive with U.S. production (i.e. they could not be produced anywhere in the US) and found that the original Paradox disappeared. Work by Vanek (1963) confirmed that U.S. imports were more resource-intensive than her exports. He also found some evidence that capital and natural resources were complementary in U.S. imports but not in U.S. exports. If so, this would impart a capital-intensive bias to U.S. imports.

2.6 SUMMARY

- The main purpose of this chapter is to point out the basis of international trade.
- International trade and economic development are complementary to each other.
- There are two main theories of international trade viz.

a) Classical theory of international trade.

i) There are two version to the classical theory of international trade viz.

i) The Absolute cost difference theory of Adam Smith.

ii) The comparative cost difference theory of David Rilcardo

b) The modern theory of intentional trade of Bertil Ohlin.

- The Absolute cost difference theory limits the scope of international trade.
- The comparative cost advantage theory widens the scope of international trade by involving DCs and LDCs in to the realm of international trade.
- The modern theory of international trade supplements the comparative costs theory of international trade.
- The modern theory of international trade is a monetary theory of international trade because of an application of an element of foreign exchange rate in the relm of international trade.
- The foreign exchange rate doesn't facilitate the international trade but merely transforms the comparative advantage into absolute advantage i.e. it is merely an indicator of the cheapness and costliness of the commodities.

2.7 QUESTIONS

1) Explain absolute advantage theory of International Trade.
2) Explain Ricardo's theory of comparative cost variance.
3) Explain Heckscher-Ohlin theory.
4) Explain the Leontief paradox.

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MODULE II

3

TERMS OF TRADE

Unit Structure

3.0 OBJECTIVES

- To know the concepts of terms of trade.
- To understand the various types of terms of trade.
- To study the limitations of terms of trade.

3.1 INTRODUCTION

The study of terms of trade began with classical trade theory to measure the benefits of international trade. The concept of terms of trade is very important in trade theory. On the basis of terms of trade, the favorability (advantage) or disadvantage of two countries in international trade is calculated. In Ricardo's analysis, the comparative advantage theory of international trade states that the comparative advantage of production expenditure in the domestic economy is the main factor that determines the advantage of international trade. But Ricardo did not analyse how the benefits of international trade would accrue to which country or how they would be distributed. The lacunae in Ricardo's theory were later covered by John Stuart Mill. Through his theory of reciprocal demand, he showed how international terms of trade depend on the elasticity of demand of consumers in one country for goods in another country. Thus, J. S. Mill showed that the demand side, completely ignored by Ricardo, is an important determinant of the international terms of trade. While doing so, the supply side was neglected. This aspect was presented by Alfred Marshall in his book "Money, Credit and Commerce" written in the year 1923 with the help of offer curve technique. Alfred Marshall made the point that the terms of trade of a country depend as much on supply as on demand. How important is the elasticity of supply over the elasticity of demand in determining the terms of trade? To demonstrate this, he developed the technique of the offer curve.

3.2 CONCEPTS OF TERMS OF TRADE

Terms of trade is the rate at which one country's goods are exchange with another country's goods. It determines the prices of the goods traded in foreign market. It expresses relationship between export prices and import prices of a country. When a country's export prices are more than its import prices, then it is favourable to the country. Since its export prices are more than export prices it can obtain more quantity of imports. So there is a gain for the country. A country's terms of trade said to be unfavourable when its export prices are less than its import prices i.e. it can obtain a small quantity of imports with its export prices or has to pay more import prices.

3.2.1 Net Barter Terms of Trade:

It is also called as Commodity Terms of Trade. It is used to understand the overall view of the changes in the country's trading in a better way. It is calculated as a ratio between a country's import and export prices i.e.as the percentage ratio of the export unit value indexes to the import unit value indexes, measured relative to the base year. It is mathematically represented as,

$T0 = Px / Pm$

$T0 \rightarrow$ Commodity terms of trade

$P \rightarrow$ Prices and x and m $\rightarrow$ exports and imports

3.2.2 Gross Barter Terms of Trade:

Gross Barter Terms of Trade is the ratio of total physical quantity of import to total physical quantity of export of a given country. In symbolic terms:

$TG = Qm / Qx$

$TG \rightarrow$ Gross barter terms of trade

$Qm \rightarrow$ Total physical quantity of imports

$Qx \rightarrow$ Total physical quantity of exports

A higher value of TG indicate that the given country can import more units of goods and services from abroad for the given units of exports.

3.2.3 Income Terms of Trade:

Income Terms of Trade is defined as- commodity TOT multiplied by quantity of export. Symbolically, income terms of trade can be written as:

$Ty = (Px / Pm)\ Qx$ or $Px \times Qx / Pm$

Ty → Income terms of trade

Px → Price of exports

Qx → Volume of exports

Pm → Price of imports

Income Terms of Trade can increase through an increase in export prices i.e. when there is rise in exports, and a decrease in import prices. It is therefore used to measure a country's capacity to import.

Other Types of Terms of Trade:

Single factor Terms of Trade:

Single factor Terms of Trade is found by multiplying Net Barter Terms of Trade with productivity index of domestic export sector. Symbolically, Single factor Terms of Trade can be written as:

$Ts = (Px / Pm)\ Zx$

Ts → Income terms of trade

Px → Price of exports

Pm → Price of imports

Zx → Productivity index of domestic export sector

It is the net barter terms of trade corrected for changes in the productivity of export goods.

Double Factorial Terms of Trade:

Double Factorial Terms of Trade is calculated by multiplying Net Barter Terms of Trade with the ratio of factor productivity of domestic industry and foreign export industry. Symbolically, Double Factorial Terms of Trade can be written as:

$TD = TC\ (Zx / Zm)$

TD → Double Factorial Terms of Trade

TC → Net Barter Terms of Trade / Commodity Terms of Trade

Zx → Productivity index in the domestic export sector

Zm → Import productivity index / Productivity index in the foreign country's export sector

It expresses the change in the productivity of both the domestic export industry and the export industries of the foreign countries selected.

Real Cost Terms of Trade:

In case of an increase in export production drives resources are taken away from the other sectors of the economy to the export sector. In other words, some common resources can be used by the export sector and also the other sectors of the economy. But since these resources are used to increase production of export the same cannot be used in other sectors of the economy. Since these resources are sacrificed by the other sectors to increase the export production, it involves some amount of disutility or sacrifice. The amount of resources allocated elsewhere or utility cost per unit of resources employed in the production of export goods is considered to be the real cost terms of trade or the opportunity of exporting a good into the exports production.

Real Cost Terms of Trade is measured by multiplying the single factor Term of Trade by the index of the amount of disutility. It is mathematically represented as:

$Tr = Ts \times Rx$

$Tr \rightarrow$ Real Cost Terms of Trade

$Ts \rightarrow$ Single factor Terms of Trade

$Rx \rightarrow$ disutility or real cost in producing export goods

Utility Terms of Trade:

Utility Terms of Trade measures the changes in the disutility or dissatisfaction of producing a unit of exports. It also measures the changes in the satisfactions arising imports and the indigenous products wasted to produce those exports. In other words, it calculated the changes in the Real cost ToT in terms of the utilities wasted.

It is therefore calculated by multiplying the real cost terms of trade index with an index of the relative average utility of imports and of domestic commodities foregone. It is mathematically represented as:

$Tu = Tr \times U$

$Tu \rightarrow$ Utility Terms of Trade

$Tr \rightarrow$ Real cost terms of trade index

$U \rightarrow$ Index of relative utility of imports and domestically foregone commodities

Limitations of Terms of Trade:

1. Problem of Index Numbers:

All types of terms of uses index number to measure the variations in the prices of goods and services in different countries at different time. Many time it becomes difficult to associate with the index numbers in terms of its coverage, base year, and method of calculation.

2. Change in Quality of Product:

All types of terms of trade are based on the index numbers of export and import prices of goods and services in participating countries. It fails to take into consideration the changes taking place in the quality and composition of goods entering trade between these countries. Generally, terms of trade index show changes in the relative prices of goods exported and imported in the base year. So, it fails to consider large changes in the quality of goods that are taking place in the world, as also new goods that are constantly entering in international trade.

3. Problem of Selection of Period:

Terms of trade compare the changes in prices during a certain period between the trading countries. The problem is about the selecting of this period. In case of selected period, if it is too short then no meaningful change may be found between the base and the present time. If the period is too long then there may be structural changes could have been taken place in the trading countries and therefore export and import commodity content could not be compared.

4. Neglect of Import Capacity of a country:

The concept of terms of trade throws neglected capacity to import of a participating country. In case of low terms of trade in India, with a given quantity of Indian exports a smaller quantity of imports than before is possible. If India's export rises, may be due to fall in the prices of exports then it may lead to either increase of import capacity or it may remain unchanged.

5. Not Helpful in Balance of Payment Disequilibrium:

The concept of terms of trade is applicable only if the balance of payments of a country includes export and imports of goods and services. If the balance of payments includes unilateral payments or unrequired exports and or/imports, such as gifts, remittances from and to the other country leading to disequilibrium in the balance of payments, then the concept of terms of trade is not helpful in measuring the gains from trade.

6. Ignores distribution of Gains from Trade between countries:

The concept of terms of trade fails to explain the distribution of gains from trade between participating countries such as developed and developing country. If the export price index of a developing country rises more than its import price index, it means an improvement in its terms of trade. But if there is an equivalent rise in profits of foreign investments, there may not be any gain from trade.

3.3 SUMMARY

Terms of trade is the rate at which one country's goods are exchange with another country's goods. It determines the prices of the goods traded in foreign market. It expresses relationship between export prices and import prices of a country.

3.4 QUESTIONS

1) Discuss the various types of terms of trade.

2) Discuss the limitations of terms of trade.

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4

BALANCE OF TRADE (BOT) AND BALANCE OF PAYMENT (BOP)

Unit Structure

4.0 OBJECTIVES

- To understand the concept of balance of trade and balance of payments.
- To study the difference between balance of trade (BoT) and balance of payments (BoP).
- To study the theory of purchasing power parity.
- To understand the reciprocal demand theory.
- To understand how trade is profitable.
- To study the Marshall – Edgeworth offer curve.
- To study the case for or against free trade.
- To understand the protection policy.

4.1 BALANCE OF TRADE (BOT)

Trade balance is also known as the balance of trade (BoT) which indicates the distinction between the monetary value of a country's imports and exports in a given time period.

Balance of trade (BoT) is the visible current account of balance of payment (BoP).

Formula,

Trade balance calculates by below formula.

Trade Balance = Value of Exports of Goods – Value of Imports of Goods

In the case of trade balance there are two possibilities as below-

1. Positive trade balance/ Trade Surplus
2. Negative trade balance/ Trade Deficit

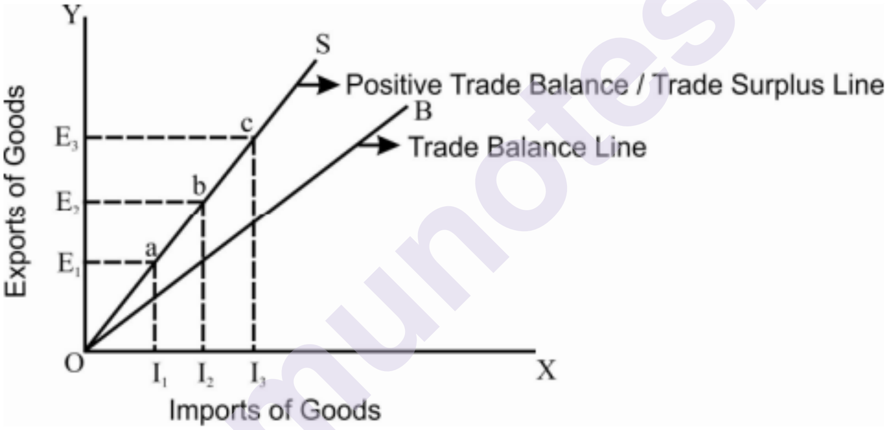
1) Positive trade balance/ Trade surplus:

When the value of trade balance comes positive, it means export value is greater than import value, it is called as trade surplus.

Trade surplus = value of export > value of import

The positive trade balance or trade surplus has been explained in detail by below diagram-

Figure No. 4.1 : Positive trade balance/ Trade surplus



Above diagram shows the trade surplus. In this diagram, on the X axis imports of goods have been shown and Y axis, exports of goods. OS curve is a trade surplus curve and OB is a trade balance curve. OS curve is a right of OB curve which shows positive trade balance on which every point (a, b & c) shows that exports of goods is greater than imports of goods.

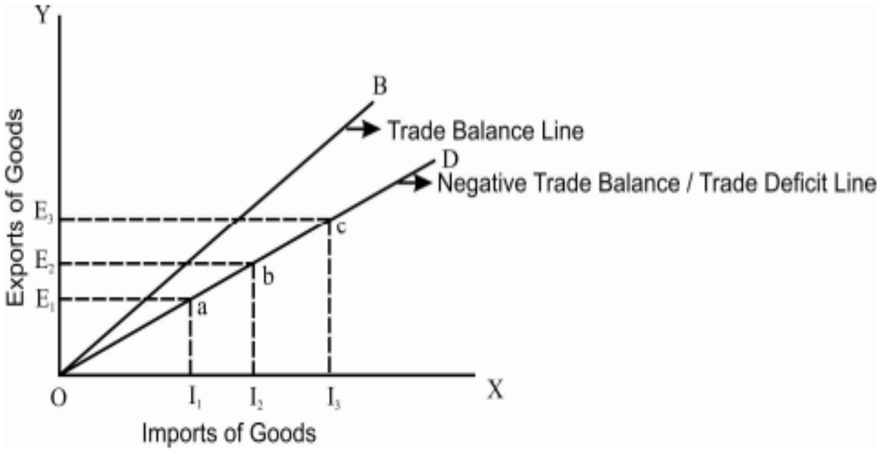
2) Negative Trade Balance/ Trade Deficit:

When the value of trade balance comes negative means export value is less than import value, it is called as trade deficit.

Trade deficit = value of export < value of import

The negative trade balance or trade deficit has been shown in detail by below diagram.

Figure No. 4.2 : Negative Trade Balance/ Trade Deficit



Above diagram indicates that the trade deficit. In this diagram, on the X axis imports of goods have been shown and Y axis; exports of goods have been mentioned. OD curve is a trade deficit curve and OB is a trade balance curve. OD curve is a left of OB curve which shows negative trade balance on which every point (a, b & c) indicates that import of goods is greater than export of goods (export of goods is less than import of goods).

4.2 BALANCE OF PAYMENTS (BOP)

4.2.1 Meaning of Balance of Payments (BOP):

The balance of payments (BOP) of a country is a systematic record of all economic transactions between the residents of a country and the rest of the world. The balance of payments is a consolidated account of the receipts and payments from and to other countries arising out of all economic transactions during the year.

In the words of C. B. Kindleberger; "The balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting and the residents of the foreign countries during a given period of time."

The International Monetary Fund defines BOP as a "statistical statement that subsequently summarises, for a specific time period, the economic transactions of an economy with the rest of the world."

4.2.2 Features of Balance of Payment Account:

(i) It is a systematic record of all economic transactions between residents of one country and rest of the world.

(ii) It includes all transactions in goods (visible items), services (invisible) and capital during a period of time.

(iii) It is constructed on double entry system of accounting. Thus, every international transaction will result in credit entry and debit entry of equal size.

(iv) All economic transactions that are carried out with the rest of world are either credited or debited.

(v) In accounting sense total debit will always be equal to total credits, i.e., balance of payments will always be in equilibrium. But in economic sense, if receipts are larger than payments, there is surplus in BOP. Similarly, if payments are larger than receipts, there is deficit in BOP.

4.2.3 Structure of BOP Accounts:

According to the broad nature of the transactions concerned, the BOP of a country is divided into four parts: (i) the current account, (ii) the capital account, (iii) errors and omissions and (iv) official reserve account.

Structure of Balance of Payment:

1.	Current Account	
	a) Balance of Trade	Export of Goods Import of Goods
	b) Invisible Trade	Export of services Import of services
	c) Other Flows	Investment Income Unilateral Transfers
2.	Capital Account	Long Term Capital Transaction Short Term Capital Transaction
3.	Errors and Omissions	
4.	Official Reserve Account	

1. The Current account:

The current account of BOP includes all transaction arising from trade in goods and services, from income accruing to capital by one country and invested in another and from unilateral transfers, both private and official.

The current account is divided in three parts:

a) The first of these is called Balance of trade or visible account or merchandise account. This account records imports and exports of physical goods. The balance of visible exports and visible imports is called balance of visible trade or balance of merchandise trade.

b) The second part of the account is called the invisibles account since it records all exports and imports of services. The balance of these transactions is called balance of invisible trade. It includes freights and fares of ships and planes, insurance and banking charges, foreign tours and education abroad, transactions out of interest and dividends on foreigners' investment, and so on.

c) Investment income consists of interest, profit and dividends on bonus and credits. Unilateral Transfer include grants, gifts, pension, etc.

2. The Capital account:

The capital account shows transactions relating to the international movement of ownership of financial assets. It refers to cross-border movements in foreign assets like shares, property, or direct acquisitions of companies' bank loans, governments securities, etc. In other words, capital account records export and import of capital from and to foreign countries.

The capital account is divided into two main parts one is the short term and another is the long-term movements of capital. A short-term capital is one which matures in one year or less, such as bank accounts. A long-term capital is one whose maturity period is longer than a year, such as long term bonds or physical capital.

Long term capital account is, again of two categories: direct investment and portfolio investment. Direct investment refers to expenditure on fixed capital formation, while portfolio investment refers to the acquisition of financial assets like bonds, shares, etc.

3. Errors and omissions:

Since BOP always balances in theory, all debits must be offset by all credits and vice versa. In practice, rarely it happens particularly because statistics are incomplete as well as imperfect. That is why errors and omissions are considered so that BOP accounts are kept in balance.

4. The official reserve account:

The total of 1,2 3 and 4 comprises the overall balance. The category of official reserve account covers the net amount of transactions by government. This account covers purchases and sales of reserve assets (such as gold, convertible foreign exchange and special drawing rights) by the central monetary authority.

4.2.4 BOP can be summarized as:

Current account balance + Capital account balance + Reserve balance = Balance of Payments.

The equilibrium in BOP or Basic Balance:

Overall, the BOP accounts will always balance inaccounting sense. They must balance as any flows of foreign exchange on payment sideshould match flow of foreign exchange on receipt side. This is so because under double entry book keeping system, the credit and debit transactions are equal to each other.

Disequilibrium in BOP:

Though the balance of payment always balances in accounting sense, in reality, the BOP will be in disequilibrium due to difference in current and capital account. A disequilibrium in the balance of payment means a condition of Surplus or deficit.

A Surplus in the BOP occurs when Total Receipts exceeds Total Payments. Thus, BOP= CREDIT>DEBIT.

A Deficit in the BOP occurs when Total Payments exceeds Total Receipts. Thus, BOP= CREDIT<DEBIT.

Autonomous and Accommodating Movement: There are two types of transaction in Balance of payment. Autonomous and Accommodating. Autonomous transactions are those which takes place irrespective of the transactions in other items of the BOP. All transaction in the current and capital accounts are autonomous transactions since they are independent of other transaction in the BOP and are influenced by income and profit consideration. The transaction like export and import of goods and services, Foreign Direct Investment are included in this. Accommodating transaction on the other hand are dependent on other transaction in BOP. They are undertaken to offset the deficit or surplus in the capital or current account. They take place when disequilibrium occurs in the autonomous transactions. The deficit or surplus has to be balanced with the help of accommodating flow. They are in the form of loan or foreign aid from foreign country. They are utilized to balance the deficit or surplus in the BOP and maintain the overall equilibrium of BOP.

4.2.5 Types of Disequilibrium In Balance of Payments:

Main types of disequilibrium in the balance of payments are:

i. Short-run Disequilibrium

ii. Long-run Disequilibrium

iii. Cyclical Disequilibrium

iv. Structural Disequilibrium

i. Short run Disequilibrium:

It is a disequilibrium that prevails for a year or more. They occur due to a sudden change in demand for foreign goods and services. Domestic problems like natural calamities of financial crisis may result in increase in imports or decline in exports. Such imbalances are temporary in nature, and they can be corrected through short term borrowings or other adjustments in the capital account.

ii. Long-run Disequilibrium:

The long-term disequilibrium thus refers to a deep- rooted, persistent deficit or surplus in the balance of payments of a country. It is secular disequilibrium emerging on account of the chronologically accumulated short-term disequilibria — deficits or surpluses. A long-term deficit in the balance of payments of a country tends to deplete its foreign exchange reserves and the country may also not be able to raise any more loans from foreigners during such a period of persistent deficits. In short, true disequilibrium is a long-term phenomenon. It is caused by persistent deep-rooted dynamic changes which slowly take place in the economy over a long period of time. It is caused by changes in dynamic factors such as capital formation, population growth, technological advancement, innovations, etc.

A newly developing economy, for instance, in its initial stages of growth needs huge investment exceeding its savings. In view of its low capital formation, it has also to import a large amount of its capital requirements from foreign countries and its imports thus tend to exceed its exports. These become a chronic phenomenon. And in the absence of a sufficient inflow of foreign capital in such countries, a secular deficit balance of payments may result.

iii. Cyclical Disequilibrium:

It occurs on account of trade cycles. Depending upon the different phases of trade cycles like prosperity and depression, demand and other forces vary, causing changes in the terms of trade as well as growth of trade and accordingly a surplus or deficit will result in the balance of payments. Cyclical disequilibrium in the balance of payments may occur because:

a) Trade cycles follow different paths and patterns in different countries. There are no identical timings and periodicity of occurrence of cycles in different countries.

b) Income elasticities of demand for imports in different countries are not identical.

C) Price elasticities of demand for imports differ in different countries.

In short, cyclical fluctuations cause disequilibrium in the balance of payments because of cyclical changes in income, employment, output and price variables. When prices rise during prosperity and fall during a depression, a country which has a highly elastic demand for imports experiences a decline in the value of imports and if it continues its exports further, it will show a surplus in the balance of payments. Since deficit and surplus alternatively take place during the depression and prosperity phase of a cycle, the balance of payments equilibrium is automatically set forth over the complete cycle.

iv. Structural Disequilibrium:

It emerges on account of structural changes occurring in domestic economy or abroad which may alter the demand or supply relations of exports or imports or both. Suppose the foreign demand for India's jute products declines because of some substitutes, then the resources employed by India in the production of jute goods will have to be shifted to some other commodities of export. If this is not easily possible, India's exports may decline whereas with imports remaining the same, disequilibrium in the balance of payments will arise. Similarly, if the supply condition of export items is changed, i.e., supply is reduced due to crop failure in prime commodities or shortage of raw materials or labour strikes, etc. in the case of manufactured goods, then also exports may decline to that extent and structural disequilibrium in the balance of payments will arise. Moreover, a shift in demand occurs with the changes in tastes, fashions, habits, income, economic progress, etc. Propensity to import may change as a result. Demand for some imported goods may increase, while that for certain goods may decline leading to a structural change.

4.2.6 Causes of Disequilibrium In Balance of Payment:

Disequilibrium in the balance of payment is the result of imbalance between receipts and payments in current and capital account of the BOP. Disequilibrium in a country's balance of payments position may arise either for a short period or for a long period. Any disequilibrium in the balance of payments arises owing to a large number of causes or factors operating simultaneously. Types of disequilibrium differ from country to country, while the different kinds of disequilibrium and their causes in the same country will differ at different times.

Following are the important causes for disequilibrium in the balance of payments of a country:

1. Trade Cycles:

Cyclical fluctuations generally produce cyclical disequilibrium. Recession or inflation in any of the developed countries can have impact on the rest of the world. The cyclical fluctuations in income, demand, production is transmitted from one country to another. This affects the export of the country causing deficit in the balance of payment.

2. Huge Developmental and Investment Programmes:

Huge development and investment programmes in the developing economies are the root causes of the disequilibrium in the balance of payments of these countries. Their propensity to import goes on increasing for want of capital for rapid industrialisation; while exports may not be boosted up to that extent as these is the primary producing countries.

Moreover, their exports of primary commodities may decline as newly created domestic industries may require them. Thus, there will be structural changes in the balance of payments and structural disequilibrium will result.

3. Changing Export Demand:

Improvement in domestic production of essential food grains, raw materials, substitute goods, etc. in advanced countries has reduced their need for import from the primary goods producing underdeveloped countries. Thus, export demand has considerably changed, resulting in structural disequilibrium in these countries.

Similarly, advanced countries also suffer from fall in exports earnings as a result of loss of their markets in developing countries owing to the tendency of these nations for self-reliance and their ways and means of curtailing their imports. But disequilibrium (deficit) in balance of payments seems to be more persistent in the underdeveloped or developing nations than in the advanced rich nations.

4. Population Growth:

High population growth in underdeveloped countries adversely affects their balance of payments position. It is easy to see that an increase in population increases the needs of these countries for imports of essential goods and decreases the capacity to export.

5. Huge External Borrowings:

Another reason for a surplus or deficit in the balance of payments arises out of international borrowing and investment. A country may tend to have an adverse balance of payments when it borrows heavily from another country, while the lending country will tend to have a favourable balance and the receiving country will have a deficit balance of payments.

6. Inflation:

Owing to rapid economic development, the resulting income and price effects will adversely affect the balance of payments position of a developing country. With rising income, the marginal propensity to import is high in these countries. This causes their demand for imported goods to rise.

Since marginal propensity to consume is also high in these countries, people's demand for domestic goods also will rise, and hence less may be available for export. Moreover, a huge investment in heavy industries in the developing countries may have an inflationary impact, as the output of these industries will not be forthcoming immediately, whereas money income will have been already expanded. Thus, there will be an excess of monetary demand for goods and services in general which will push up the price levels. A rise in the comparative price level certainly encourages imports and discourages exports, resulting in a deficit balance of payments.

7. Demonstration Effect:

Demonstration effect is another most important factor causing deficit in the balance of payments of a country — especially of an underdeveloped country. When people of underdeveloped nations are influenced by advanced countries through economicor social relations, there will be demonstration effect on the consumption pattern of these people and they will desire to adopt western pattern of consumption so that their propensity to import increases, whereas their export earnings may remain the same or may even decline with the increase in income, thus causing an adverse balance of payments for the country.

8. Reciprocal Demands:

Since intensity of reciprocal demand for products of different countries differs, terms of trade of a country may be set differently with different countries under multi-trade transactions which may lead to disequilibrium in a way.

9. Globalization:

In the recent years, Globalization has led to increase in movement of goods and services and foreign investment. The competitive environment created due to globalization has led to disequilibrium in balance of payment of some countries.

4.2.7 Measures to Correct Disequilibrium In Balance of Payment:

1) Expenditure reducing polices:

The important way to reduce imports and thereby reduce deficit in balance of payments is to adopt monetary and fiscal policies that try to reduce aggregate demand in the economy. The fall in aggregate demand in the economy works to reduce imports and help in solving the balance of payments problem.

The two important instruments of reducing aggregate demand are the use of:

(1) Tight monetary policy and

(2) Concretionary fiscal policy.

Tight Monetary Policy:

Tight monetary is used to check aggregate demand by raising the cost of bank credit and restricting the availability of credit. For this bank rate is raised by the Central Bank of the country which leads to higher lending rates charged by the commercial banks. This discourages businessmen to borrow for investment and consumers to borrow for buying durable consumers goods. This therefore leads to the reduction in investment and consumption expenditure. Besides, availability of credit to lend for investment and consumption purposes is reduced by raising the cash reserve ratio (CRR) of the banks and undertaking of open market operations (selling Government securities in the open market) by the Central Bank of the country. This also tends to lower aggregate demand which will helps in reducing imports.

Contractionary Fiscal Policy:

Fiscal policy is also an important means of reducing aggregate demand. An increase in direct taxes such as income tax will reduce aggregate demand. A part of reduction in expenditure may lead to decrease in imports. Increase in indirect taxes such as excise duties and sales tax will also cause reduction in demand. The other fiscal policy measure is to reduce Government expenditure, especially unproductive expenditure. The cut in Government expenditure will not only reduce expenditure directly but also indirectly through the operation of multiplier. It may be noted that if tight monetary and contractionary fiscal policies succeed in lowing aggregate expenditure which causes reduction in prices or lowering the rate of inflation, they will work in two ways to improve the balance of payments. First, fall in domestic prices will induce people to buy domestic products rather than imported goods. Second, lower domestic prices will stimulate exports. Fall in imports and rise in exports will help in reducing deficit in balance of payments. However, it may be emphasized again that the method of reducing expenditure through contractionary monetary and fiscal policies is not without limitations. If reduction in aggregate demand lowers investment, this will adversely affect economic growth. Thus, correction in balance of payments may be achieved at the expense of economic growth.

2) Expenditure – Switching Policies: Devaluation:

Another method which used for correcting disequilibrium imbalance of payments is the use of expenditure-switching policies. Expenditure switching policies work through changes in relative prices or through exchange rates. Prices of imports are increased by making domestically produced goods relatively cheaper. Expenditure switching policies may lower the prices of exports which will encourage exports of a country. In this way by changing relative prices, expenditure-switching policies help in correcting disequilibrium in balance of payments. The important form of expenditure switching policy is the reduction in foreign exchange rate of the national currency, namely, devaluation. By devaluation we mean reducing the value or exchange rate of a domestic currency with respect to other foreign currencies. Devaluation takes place when a country is under fixed exchange rate system and occasionally decides to lower the exchange rate of its currency to improve its balance of payments. On the other hand, in the present flexible exchange rate system, its exchange rate as determined by demand for and supply of currencies. Fall in the value of a currency with respect to foreign currencies as determined by demand and supply conditions is described as depreciation. As a result of reduction in the exchange rate of a currency with respect to foreign currencies, the prices of goods to be exported fall, whereas prices of imports go up. This encourages exports and discourages imports. With exports so stimulated and imports discouraged, the deficit in the balance of payments will tend to be reduced.

Marshall Lerner Condition:

According to the Marshall Lerner condition, that whether devaluation or depreciation will lead to the rise in export earnings and reduction in import expenditure depends on the price elasticity of foreign demand for exports and domestic demand for imports. Marshall and Lerner condition states that devaluation will succeed in improving the balance of payments if sum of price elasticity of exports and price elasticity of imports is greater than one. Thus, according to Marshall-Lerner Condition, devaluation improves balance of payments if

$ex + em > 1$

where ex stands for price elasticity of exports

em stands for price elasticity of imports

If in case of a country $ex + em < 1$, the devaluation will adversely affect balance of payments position instead of improving it. If $e\ x + e\ m = 1$, devaluation will leave the disequilibrium in the balance of payments unchanged.

3) Direct Measures:

The countries may also adopt direct measures which will help to restrict imports or promote exports to bring equilibrium in the Balance of payment.

a) Tariffs:

Tariffs are duties (taxes) imposed on imports. When tariffs are imposed, the prices of imports would increase to the extent of tariff. The increased prices will reduce the demand for imported goods and at the same time induce domestic producers to produce more of import substitutes.

b) Quotas:

Under the quota system, the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting import through the quota system, the deficit is reduced and the balance of payments position is improved.

c) Export promotion:

Exports may be encouraged by reducing export duties and lowering the interest rate on credit used for financing exports. Exports are also encouraged by granting subsidies to manufacturers and exporters. Besides, on export earnings lower income tax can be levied to provide incentives to the exporters to produce and export more goods and services. By imposing lower excise duties, prices of exports can be reduced to make them competitive in the world markets.

d) Exchange Control:

Under it, all the exporters are ordered to surrender their foreign exchange to the central bank of a country, and it is then rationed out among the licensed importers. No one else is allowed to import goods without a license. The balance of payments is thus rectified by keeping the imports within limits.

4.3 DIFFERENCE BETWEEN BALANCE OF TRADE (BOT) AND BALANCE OF PAYMENTS (BOP)

1) Definition

- Balance of Trade or BoT is a financial statement that takes into account a country's imports and exports of goods with the rest of the world.
- Balance of Transaction or BoP is a financial statement that records all financial transactions of a country with the rest of the world.

2) What does it handle?

- Trade balance deals with the net gain or loss of a country from imports and exports of goods.
- Current account deals with proper accounting of transactions done by the nation.

3) Fundamental differences

- Balance of Trade (BoT) is the difference between exports and imports of goods.
- Balance of Transaction (BoP) is the difference between inflow and outflow of foreign exchange.

4) What kind of transactions are involved

- Commodity related transactions are included in BoT.
- Transactions related to transfer, goods and services are included in BoP.

5) Is capital transfer involved?

- Trade balance does not include capital transfer.
- Transactions include capital transfers.

6) What is its net effect?

- The net effect of BoT can be positive, negative or zero.
- The net effect of BoP is always zero.

4.4 PURCHASING POWER PARITY THEORY

4.4.1 Introduction to Purchasing power parity:

This theory has been restated by the Swedish economist Gustav Cassel in 1916, exactly in the years following the First World War, when the exchange rates are free to fluctuate the rate of exchange between two currencies in the long run will be determined by their respective purchasing powers. According to him:

"The rate of exchange between two currencies must stand essentially on the quotient of the internal purchasing powers of these currencies."

Thus, according to the purchasing power parity theory, the exchange rate between one currency and another is in equilibrium when their domestic purchasing powers at the rate of exchange are equivalent. E.g. if in India 40 Rs are spent for purchasing 1 kg of apples and in America for the same kg of apples if one dollar is needed to spend, then it is clear that the purchasing power of both currencies is different in their respective nations. In order to make equivalent these currencies with each others units purchasing power will be 1$ = 40Rs.

Once the equilibrium is established, the market forces will operate to restore the equilibrium if there are some deviations. E.g if the exchange rate changes to 1$ = 42Rs when the purchasing power of these currencies remain stable, dollar holder will convert dollars into rupees because, by doing so, they save Rs. 2 when they purchase a commodity worth $ 1. A change in the purchasing power of currencies will be reflected in their exchange rates. For this purpose the price index is made. It is the parity (equality of the purchasing powers of the currencies which determines the exchange rate.

If there is a change in prices (purchasing power of the currencies), the new equilibrium rate of exchange can be found out by the following formula; ER = Er x Pd/Pf

Where,

ER = Equilibrium exchange rate

Er = Exchange rate in the reference period

Pd = Domestic price index

Pf = Foreign country's price index

Two versions of PPP:

1. Absolute Version:

Under this version, the exchange rate between the currencies of two nations is established at the point where their purchasing power is equal. It reflects their domestic purchasing power too. It is calculated as

Rate of exchange = PI / PA

Where,

PI = Prices of certain goods in India

PA = Prices of same goods in another country, say USA.

Thing to note is that, the changes in internal price level cause changes in the exchange rate. if inflation is India, then the purchasing power of rupee in terms of dollars would decline. It is not easy to measure the value of money in absolute terms.

2. Relative version:

In this method the changes in the purchasing power can be measured by the changes in the indices of domestic prices of the countries concerned. Hence the changes in the equilibrium rate can be measured by the ration of the price indices of the respective countries. in this new equilibrium rate of exchange can be calculated by multiplying the base period of rate exchange by the relative changes in the price levels in the two countries with the help of index numbers.

4.4.2 Evaluation of PPP theory:

- It is based on the unrealistic assumption that international trade is free from all barriers.
- This theory does not explain the demand for supply of foreign exchange. While in the free economy the rate is determined by the forces of demand and supply of foreign exchange.
- The quality of goods and services may vary from country to country, so comparison of prices without regard to the quality is unrealistic.
- Cost of transport is ignored in this theory.
- It also ignores the impact of international capital movement which affects on the foreign exchange market.
- The price index number includes the price of all commodities and services, including those which are not internationally traded and hence the rate of exchange calculated on the basis of these price indices cannot be realistic.
- It does not consider the significance of the elasticity‘s of reciprocal demand.
- This theory is good in long run and lacks its significance in short run.

Check your progress:

1) What is PPP theory?

4.5 LAW OF RECIPROCAL DEMAND

4.5.1 Introduction:

The idea of Reciprocal demand was presented by John Stuart Mill in1873 and then it was further developed by Alfred Marshall. Reciprocal demand means the relative strength and elasticity of demand of the two trading countries for each other's product in terms of their own product. The theory advocated that the actual price at which trade takes place between two countries depends on the trading countries interacting demands. It works similarly as the demand and supply of goods and services in any other market. If demand does not equal to supply in the international market, the international price will change until it becomes equal. Thus, equalization of terms of trade depends on the demand and supply conditions for goods and services in the international market. So the equilibrium terms of trade is determined by the equation of reciprocal demand. A stable ratio of exchange is therefore determined by the equilibrium value of imports and exports of each country.

Theory of reciprocal demand is based on the following assumptions-

(i) Full employment conditions – it assumed that all the resources are fully employed.

(ii) Perfect competition – exists in the international market.

(iii) Free foreign trade – it assumed no restrictions are imposed on foreign trade.

(iv) Free mobility of factors – all the factors of production are mobile.

(v) Applicability of the theory of comparative cost – the trade between the two countries is based on the theory of comparative cost i.e. production based on specialization.

(vi) Two country, two commodity model – it assumed for simplicity that the trade takes place between two countries and related to two commodities.

4.5.2 Changes in Demand and Supply Conditions:

The theory of reciprocal demand analysed the impact of changes in supply and demand conditions on the terms of trade.

A. Changes in Supply Conditions:

Supply conditions changes due to several causes such as cost-reducing improvements in technology which bring changes in terms of trade. For e.g. an improvement in the textile industry in England increases the productivity due to which cloth will be cheaper in terms of India's wheat i.e. the same amount of wheat is exchanged for more cloth. It thus makes the terms of trade in favour of India's importer of cloth in exchange for wheat.

B. Changes in Demand Conditions:

The extent to which the barter terms of trade change depend on the increased production in exporting country. It also depends on the importing country's elasticity of demand for imports in terms of its exports. In our example suppose,

(i) If elasticity of demand for England's cloth in terms of India's own wheat is more elastic (e1), then the barter terms of trade will change in favour of India. It can be more than the fall in price of cloth in terms of wheat.

(ii) In case of unitary elastic demand (e = 1), the barter terms of trade turn in favour of India which is equal to the fall in the price of cloth in terms of wheat.

(iii) If elasticity of India's demand for cloth in terms of wheat is less elastic (e 1), then the barter terms of trade will change in favour of India less than the fall in the price of cloth in terms of wheat.

4.5.3 Criticism of the Mill's Theory of Reciprocal Demand:

The theory of reciprocal demand has been criticised on the following grounds:

(i) The very first point of criticism is that the theory is based on unrealistic assumptions such as perfect competition and full employment.

(ii) In reality, actual trade is not restricted to two country, two commodity model but between many countries and many commodities.

(iii) Mill theory concentrates on the aspect of elasticity of demand, and thus neglected the impact of elasticity of supply. According to the modem economists, terms of trade (ToT) are generally influenced by elasticity of demand for exports and imports, elasticity of supply of exports, and imports.

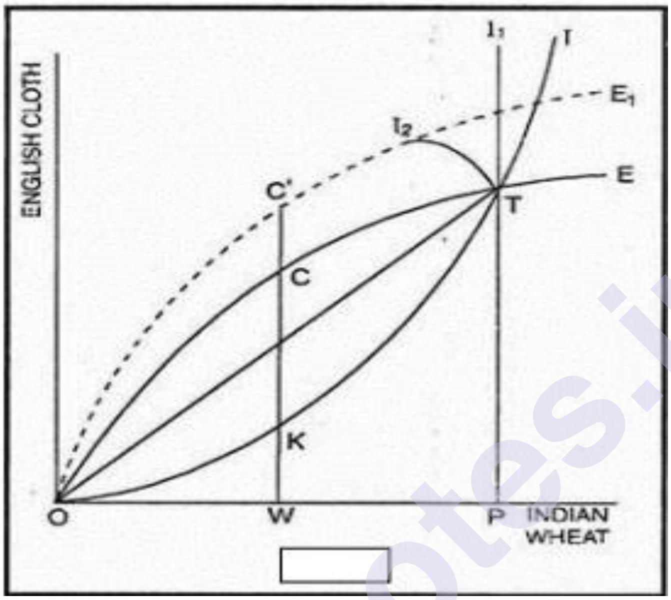
(iv) Graham has criticised the reciprocal demand aspect of Mill's theory by stating that it has exaggerated the role of reciprocal demand and neglected the comparative cost conditions in determining the terms of trade.

4.6 MARSHALL – EDGEWORTH OFFER CURVES

The offer curves approach is a geometrical technique which uses graphical representation to determine the equilibrium terms of trade. This technique is developed by Marshall. Offer curve is a demand curve which shows the demand for one commodity in terms of the supply of another commodity. Generally, it is the demand for import of one commodity in terms of the supply of export of another commodity.

Let us assume that India and England, these two countries are trading partners. India produces only wheat and England only cloth. In the following diagram, India's offer curve is presented as OI. It indicates India's demand for cloth in terms of wheat. It represents the quantities of wheat which India is willing to offer in exchange for England's cloth. India is willing to offer less and less amount of wheat in exchange for more and more quantity of cloth. It is seen in the figure that for KW quantity of cloth India is willing to offer OW quantity of wheat.

Figure No. 4.3



England's offer curve is represented as OE in the diagram which represents the quantity of cloth England is willing to offer in exchange of India's wheat. As it is seen in the diagram England is willing to offer CW quantity of cloth for OW quantity of wheat to India. T is the equilibrium point where OIand OE i.e. offer curves of India and England respectively intersect. The reciprocal demand at this point is equal thereby TP quantity of England's cloth is exchanged for OP quantity of India's wheat. Line OT represents terms of trade (ToT) line between two countries.

Effect of Change in Supply:

Due to improvement in technology if cost of producing cloth in England reduces then offer curve of England will shift to the left and OE1 is England's new offer curve. With this shift now England is willing to offer C1 W cloth for OW wheat, i.e. more cloth by C1 C for same quantity of OW wheat. The terms of trade (ToT) change is in favour of India as a result of this improvement.

Effect of Change in Demand:

The extent of change in terms of trade is also depend upon the slope of India's offer curve. India's offer curve slopes positively after point T. Thus TI represents India's more elastic demand for cloth in terms of wheat. It makes the terms of trade in favour of India more than the fall in cloth's price in terms of wheat.

Suppose India's offer curve becomes a vertical straight line after point T (i.e., TI1), then it shows unitary elastic demand for cloth in terms of wheat and the terms of trade (ToT) will change in favour of India equal to the fall in cloth price in terms of wheat. And if India's offer curve slopes backward then after point T (i.e., TI2), the terms of trade (ToT) will change in favour of India more than the fall in price of doth relative to wheat.

4.7 GAINS FROM TRADE

International trade brings out several benefits to the trading countries. As put forth in the comparative cost doctrine, if countries produce on the basis of their specialization, then each country will make optimum use of their resources by adding into their total output and income.

(a) Optimum use of natural resources:

Natural resources are scarce and having several uses. If we don't use them optimally then they will exhaust soon and there won't be maximum production. Therefore, a prudent and careful use of the resources is essential. International Trade makes the optimum use of these scarce resources possible due to the comparative cost advantage in practice. When a country produces a commodity at a lower cost than other countries, it means it is using the existing resources carefully to produce more. In this way international trade helps each country to make optimum use of its natural resources. Each country can concentrate on production of those goods for which its resources are best suited so that wastage of resources will be avoided.

(b) Availability of all types of goods:

Due to scarcity of resources, it is not possible for the countries to produce all types of goods in required quantities at a lower price. But international trade made it possible to avail all types of goods by importing from the other countries.

(c) Specialisation:

International trade leads to specialisation. So, it encourages production of different goods in different countries on the basis of their specialisation. Goods can be produced at a comparatively low cost due to advantages of division of labour.

(d) Advantages of large-scale production:

In the absence of international trade countries used to produce for domestic consumption in limited quantity. In international trade countries produce goods not only for domestic consumption but also for export purpose i.e. to meet the demand of foreign consumers at large. It therefore increases their total production where goods are produced in large scale.

So the benefits of large scale production are enjoyed by all the participatory countries in international trade.

(e) Establishment of new industries and technology transfer:

In international trade countries are encouraged to establish new industries with imported machinery, equipment and technical know-how from the industrially advanced countries. This helps in the rapid economic development of the underdeveloped and developing countries.

(f) Increase in efficiency:

In international market, participating countries attempt to produce better quality goods at minimum possible cost due to stiff competition between the countries. It leads to increase in overall efficiency and benefits to the consumers.

(g) Development of transport and communication facilities:

With the establishment of new industries and increase in large scale production, transportation and communication facilities also developed rapidly due to international trade.

(h) International co-operation and understanding:

For successful international trade, cooperation and understanding between people of different countries is required. Interaction and exchange of ideas on regular basis leads to cordial relations between participant countries. It is beneficial to maintain international peace.

4.8 CASE FOR AND AGAINST FREE TRADE

The dictionary definition of free trade states it as a policy of allowing people of one country to buy and sell from other countries without restrictions. This idea originated with the influential British economist, philosopher, and author of The Wealth of Nations, Adam Smith. He inspired the writings of great economists such as David Ricardo, Karl Marx, Thomas Malthus, and others. According to Smith, specialization and trade is the best solution to create a flourishing American economy. William H. Peterson, holder of the Lundy Chair of Business Philosophy at Campbell University, agrees with Smith's philosophy.

Free Trade refers to the Trade between countries without any restriction or discrimination. In other words when the citizen of one country are free, either to import or export or to do both, with the citizens of the country, then the trade is termed as free. In more precise words, Free Trade is the restriction less trade among the nations. Thus in a free trade no differentiation is made between the national or foreign industries. No policy exists to favour the national industries and shock the foreign industries.

Adam Smith defined Free Trade as the, "of commercial policy which drawn no distinction between domestic and foreign commodities and therefore neither imposes additions burden on the latter, for grants any special favours to the farmers. "The definition does not however mean that under the 'Free Trade banner' various duties and levies will disappear. But it means that the duty is to be levied only to raise the revenue and not with any other purpose like the protection of the interests of the domestic enterprises.

In the free trade the countries take part because they get the comparative advantage by doing so. If the countries are not disturbed in this context them the trade may become of durable in character. To quote Cairns, "If nations only engage in trade when advantage arises from doing so any interference in their free action in trading can only have the effect of debarring them from an advantage.

Adam Smith Supported the Free Trade, he wrote, if a foreign country can supply us with a commodity cheaper than we out selves can produce, better buy it from them with the some part of the produce of our own industry employed in a way in which we have some advantage. Whether the advantage which one country has over another be natural or acquired is in this respect of no consequence. As long as one country has those advantages and the other wants them, it will always be more advantageous for the latter rather to buy of the former than to make. "

a) Defence Industry on Exception. However, Adam Smith suggested that the Defence Industry should be an exception to the doctrine. He considered defence to be more important than opulence'.

b) International Trade as an Extension of the Division of Labour. Adam Smith believed that with the expansion of national industries, division of labour becomes more and more extensive. Free participation in the international trade in the field for the expansion of the division of labour. Free trade also encourages specialisation which is loomed by the division of labour. Adam Smith wrote, "Individuals find it for their interest to employ their industry in a way in which they have some advantage over their neighbours."

c) Best Suited. Adam Smith explained that the free trade is the best suited to the instinct of the individual. It facilitates every country to produce and sell the commodities in which it has specialisation. Free trade enables the countries to produce the commodity in which they can have comparative advantage.

d) It is interesting to note Adam Smith's following words, emphasizing the need for the free trade between the countries:

"In a country which has neither foreign commerce nor any of the finer manufactures, great proprietor, having nothing for which he can exchange the greater part of the produce of his lands which is over and above the maintenance of the cultivators, consumes the whole in rustic hospitality at home. If this surplus produce is sufficient to maintain a hundred or a thousand men, he can make use of it in no other way than by maintaining a hundred or a thousand men. He is at all times, therefore, surrounded with a multitude of retainers and dependants who having no equivalent to give in return or their maintenance, but being fed entirely by his country, must obey him, for the same reason that soldiers must obey the prince who pays them. Before the extension of commerce and manufacture in Europe, the hospitality of the rich and the great, from the sovereign down to the smallest baron, exceeded everything which in the present times we can easily form a nation of West minister hall was the dining room of William Rufus and might frequently, perhaps not be too large for his company. It was reckoned a piece of magnificence in Thomas Becket that he strewed the floor of his hall with clean hay or rushes in the season, in order that the knights and squares who could not get seats might not spoil their fine clothes when they sat down on the floor to eat their dinner. The great Earl of Warwick is said to have entertained every day his different manors thirty thousand people, and though the number here may have been exaggerated, it must however, have been very great to admit of such exaggeration. A hospitality nearly of the same kind was exercised not many years ago in many different parts of the highlands of Scotland. It seems to be common in all nations to whom commerce and manufactures are little known. I have seen says an Arabian chief dine in the streets of a town where he had come to sell his cattle and invite all passengers, even common beggars, to sit down with him and partake of his banquet."

Case For Free Trade:

(i) In Free Trade no vested interests are created. All are equal, thus no industry can claim any special right. No differentiation is adopted in the governmental policies, which removes any feeling of favouritism.

(ii) Free Trade attracts foreign capital. Foreign capital keeps the national producers alive to their duty and to fight in the competition with them. There are improvements due to tough competition.

(iii) In Free Trade policy the industrialists need not bribe the legislators for their protection. The corruption on this front is reduced to the minimum level.

(iv) Free Trade removes any chances of Monopolistic tendencies. No temptation emerges in the heart of the home- producers because of the foreign producers. Thus 'Monopoly-profit earning"' tendency is also removed.

(v) Free Trade provides maximum protection to the interests of the consumers.

(vi) Free Trade leads to fair distribution of wealth. The centralizing tendencies are removed.

(vii) Free Trade promotes the division and specialization at international level. It nourishes the feelings of co-operation among the producers of different countries.

(viii) Free Trade removes the feeling of hatred or every against other nations. It helps in establishing international amity.

Case Against Free Trade:

(i) Free Trade harms the new or infant industries. Due to absence of protection from the government, new industries find it very difficult to emerge and compete with the existing industries.

(ii) Free Trade discourages the cottage and small scale industries, since they find it difficult to compete with the large foreign producers.

(iii) According to J.S.Mill, a new industry must be given protection till it develops. But in the absence of protection it is not possible.

(iv) Free Trade does not help in the diversification of industry.

(v) Free Trade also establishes the domination of the foreign capital and producers.

(vi) Under Free Trade government cannot create employment opportunities. It is also harmful for the economic development of the country.

(vii) Free Trade results into misuse of economic resources. Unless there is protection, national resources cannot be conserved in the national interest.

(viii) Free Trade also hampers the development of ordinance and defence industry. Sometimes; "Guns are better than butter, "and "defence is better than opulence."

(ix) Free Trade nullifies the revenue collection from certain industries. In Free Trade, revenue cannot be collected according to the needs of the government.

(x) Free Trade also does not provide any special place tokey industries. The development of key-industries is also of basic importance to the sound economic development.

(xi) Free Trade hampers the feelings of patriotism of using home-made commodities.

(xii) Free Trade does not make any special provision for the self-sufficiency.

(xiii) Free Trade encourages unfair competition arising due to dumping depreciated exchange, etc.

Check Your Progress:

1. Define Free trade.

4.9 PROTECTION POLICY

Restrictive Trade Policy was advocated, first of all, by the Mercantilists. Mercantilists expounded that restriction is the only answer to the adverse balance of payments. Their policy of restriction was only for the imports and exports. This theory did not say much about the protection of the home industries.

The meaning of the term 'protection' refers to a set of policies framed to encourage the home, industries, it is the protection of the home on industries so that they may prosper rapidly, protectionism involves following steps:

a. Concessional rates for the home-industries in the case of levies, duties, etc.

b. Higher rate on levies and duties for the foreign producers.

c. Availability of necessary resources to the home industries.

d. Reservation of national resources for the home industries.

e. Discouraging the consumption of the products of the foreign producers.

f. Creation of credit marketing facilities and award of tax concessions to the home industries.

Thus in simple terms protection means 'step-motherly behaviour' with the foreign producers. Pelgrave defines Protection as, "The need for maintaining economic independence the danger of invasion of foreign goods and tribute paid to foreign producers from whom goods are purchased such are well known protectionist place which show by their form that they have originated in a time of international conflict. "It is in the interest of every citizen of the state to allot favour to home made goods and home industries. To the local citizens he promotion of national industries and economic interest seem a duty nearly as imperative as the defence of the national territory against invasion.

The protectionism is more affected by the political ideal than the economic interest. Protectionism helps in building the national industries which avoid any kind of foreign interference. A country which is economically dependent on foreign products cannot be an independent country in its political life. Diplomacy, at international level is bound to affect the national integrity, protectionism helps in diversifying the resources, building of key industries and providing the national colour to the economy. To quote Pelgrave again, "The advantages of diversified industry of husbanding national resources, or of maintaining certain industries that would disappear under free trade are not believed to mainly economic.

Advantages of Protection:

Following arguments have been placed forward in favour of Protectionism. They all support the establishment of Protection as the accepted trade policy by the nations; these arguments are:

a. The infant Industry Argument.

b. Diversification of Industry Argument.

c. The Employment Argument.

d. Conservation of National Resources.

e. The Defence Argument.

f. Key Industry Argument.

g. Patriotism Argument.

h. Self-Sufficiency Argument.

i. The Revenue Argument

j. Fair Economic Life Argument.

1. The Infant Industry Argument:

The staunch supporter was J. S. Mill. According to him only the infant industry argument is sound for adopting Protectionism in Theory and Practice of International Trade. To quote Mill: "A - protective duty continued for a reasonable time; might sometimes by the best convenient mode in which a nation can tax itself for the support of such an experiment (introducing new industries). But it is essential that protection should be confined to cases in which there is good ground of assurance that the industry which it fosters, will after a time be able to dispense with it."

This argument has received wide acceptance. In spite of its criticisms this has been accepted by many countries like USA, UK and India.

2. Diversification of Industry Argument:

This argument was favoured by many German and American Economists: Frederich List, a German Economist also favoured this argument. For the rapid development of the economy a country must have varied sources of income, production when there is employment. Balanced growth is only possible when there is diversification of Industry and resources. If a country depends on a few industries then it is dangerous for her stability and independency. Diversification of resources provide ample opportunity to the labourers to. move from one place to another. Diversification also helps in creation of new industries, which in consequent creates new employment opportunities.

This argument has been criticised on the ground that it removes the specialising tendencies and the importance of the principle of comparative costs which are established for the specialisation of a country in the production of certain commodities.

3. The Employment Argument:

Protection provides ample opportunity for the industrial expansion. In the absence of protection the home industry can not expand. This may create unemployment in the economy. A burning example is the decay of cottage industry especially the Indian handicrafts; in the 19th century which threw artisans and workers into the 'mire' of poverty.

4. Conservation of National Resources Argument:

National resources are the costliest assets of a country. In Free Trade, the export of natural resources may occur which is not fruitful for the exporting country. American economists Carey and Hatten also argument against the export of agricultural commodities from America; since it exhausted the natural quality of the soil. Similar voice was raised by the British economist Javons, who voted against the export of coal from the British coal fields. Ruthless exhaustion of resources may make the economy crippled after a period of time.

5. The Defence Argument:

The feeling of protection from external aggression is essential for the peaceful development of the industries. Adam Smith has once remarked": Defence is better than opulence ". The Military strength of an economy is prior to its development. An active encouragement to defence industries is a must according to this view. For defence even an uneconomic distribution of resources is not objectionable.

This argument has been criticised by the advocates of Free Trade on the ground that it is more a political argument than being an economic one in its essence.

6. Key Industry Argument:

Development of key Industries is highly essential for providing stability and basic function to the economic growth. Without their development it is like jumping into dark. Protection is must for the safe development of the key industries.

7. Patriotism Argument:

It is the national duty of every citizen to respect home industries by using and having goods manufactured by the home industries. A step to develop own industries through protection is essential. Dependence on the foreign producers keeps one away from being nationalist.

8. Self-Sufficiency Argument:

This is one of the basic arguments voiced in the favour of Protectionism. A country must try to become self-sufficient in all the fields especially in the field of basic requirements. Protection is a policy for developing the home industries which could help the economy in becoming self-sufficient.

9. The Revenue Argument:

Protection has been a good policy for revenue purposes, the imposition of protective import duties bring handsome revenue. India has been receiving a large amount of money since such duties were imposed. Here it is suggested that the revenue must be moderate and not burdensome.

10. Fair Economic Life Argument:

Protection is necessary to check unfair cut-throat competition. It helps in bringing the atmosphere healthier.

Disadvantages of Protectionism:

Theory of protectionism has been criticised by the supporters of the principle of Free-Trade. The criticism of the theory of Protectionism has been based on the following arguments:

a. Protection creates laziness among the home-industries. In the absence of foreign competition they do not fight hard to introduce innovations to the old pattern of production. Thus it creates lethargic atmosphere.

b. Protection creates vested interests. Industries, which are granted protection, starts claiming it as their right in the future. The infants try to remain infants to use motherly protection.

c. Thus utilise the special grant of Protection, industrialists start bribing the legislators. This was quite frequent in USA when the Principle of Protection was newly applied there.

d. Monopolies are often created under the cover of Protection. It is dangerous for the consumers.

e. There originates two-dimensional industrial policy and management. One for the Protected and other for the 'Unprotected class' of industries. This harms the interests of consumers as well as unprotected class of industries.

f. Protection leads to the centralisation of wealth and wide disparity in the income level of the people.

g. International transactions become difficult and callous.

h. Protection acts against the division of labour at the international level.

In spite of these criticisms, the theory of Protection is far better than the theory of Free Trade; especially where we come to the practical points of view. Protectionism is the only principle for the poor and developing countries including our own big Indian Republic.

While there will always be necessary adjustments to new and changing circumstances, free trade between nations ultimately benefits all who participate. Protectionism can only lead us down a road of impoverishment and international commercial tensions. To paraphrase the great 18th-century, free-market thinker, David Hume, when he criticized the protectionists of his time: Not only as a man, but as an American, I pray for the flourishing commerce of Germany, France, England and even Japan. Why? Because America's prosperity and economic future are dependent upon the economic prosperity of all of those with whom it trades in the international division of labour.

4.10 SUMMARY

In short, only if the protection policy is followed carefully will its results be good in the long run. It is not easy to choose between these diametrically opposed policies. However it is not impossible. It is certainly possible to adopt a flexible policy keeping in mind the needs of the economy.

4.11 QUESTIONS

1) Explain the causes and solutions of imbalance in balance of payments (BoP).
2) Explain the difference between balance of trade and balance of payments.
3) Explain the purchasing power parity theory.
4) Explain the theory of reciprocal demand.
5) Explain Marshall – Edgeworth offer curve
6) Explain the case for or against free trade.
8) Write a note on ‘Protection Policy'.

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MODULE III

5

FOREIGN EXCHANGE MARKET AND EXCHANGE RATE DETERMINATION

Unit Structure

5.0 OBJECTIVES

Relations between different countries are linked through international trade. Each country has its own currency. Therefore, while doing business in different countries, currency also has to be exchanged. Currencies of different countries are used in international trade. Foreign exchange rate has gained importance in settling the exchange transactions between two countries. So in this chapter we are going to study everything related to foreign exchange market and foreign exchange rate.

The objectives of this lesson are as follows:

1. To study the meaning and functions of foreign exchange market.
2. To study the nature and components of foreign exchange market.
3. To study exchange rate determination.
4. To study the factors affecting the foreign exchange rate.

5.1 MEANING OF FOREIGN EXCHANGE MARKET

International trade is a trade which takes place between two or more countries of the world. It involves exports and imports of goods and services which in turn involves receipts and payments unlike the primitive economy the exchange of goods and services is no longer carried out directly on barter basis. Nowadays every country of the world is a politically sovereign country having independent currency of its own which is a legal tender in its territory. This currency doesn‘t act as legal tender money outside its boundary. The same thing happens in case of other countries of the globe. Thus different countries of the globe have got different currencies which circulate as legal tender money in the respective country viz Rupee in India, Pound Sterling in England, U S Dollar in USA, Franc in France, Roubles in Russia etc. Therefore whenever a country buys or sells goods and services from or to another country the residents of the two countries have to exchange their currencies. Thus the problem of foreign exchange arises. The importing country, while making payment to exporting country has to convert its currency in to the exporting country‘s currency or in to the internationally acceptable currencies like US Dollar or Pound Sterling. This type of conversion or transfer is facilitated by the foreign exchange market.

Country for making payments to other countries. It includes all claims upon foreign currencies. It is a mechanism to the international payments through which payments are made between two counties having different currency systems. This mechanism converts domestic currencies to foreign currencies. It is the international payment mechanism. Foreign exchange includes foreign currency, foreign cheques and foreign drafts.

Foreign exchange market is the place where currencies are bought and sold. Institutions like the Treasury, Central Bank, Foreign exchange banks etc. involved in the purchase and sale of foreign exchange currencies constitute the foreign exchange market. The transactions in the foreign exchange market viz. buying and selling foreign currency take at a rate, which is called **‘Exchange rate’.** This market is not any physical place but a network of communication system connecting the whole complex of institutions including banks, specialized foreign exchange dealers and official government agencies through which the currency of one country can be exchanged for that of another (converted into another).

5.2 FUNCTIONS OF FOREIGN EXCHANGE MARKET

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

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

1] Transfer Function:

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

2] Credit Function:

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

3] Hedging Function:

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

5.3 DETERMINATION OF EXCHANGE RATE

Domestic trade involves no question of foreign exchange and hence no question of foreign exchange rate because trade remains within the geographical/political boundary of a country and the trade is facilitated through the medium of national currency only. Unlike the domestic trade the international trade involves the participation of two or more than two countries and hence two or more than two currencies come to the forefront. Therefore there arises the problem of foreign exchange rate.

Concept:

The foreign exchange rate is defined as the rate at which the currencies of two countries get exchanged against each other. It is the price of one country‘s currency in terms of another country‘s currency. For example in U. S. A. Dollar is the domestic currency while in India Rupee is the domestic currency. When international trade takes place between these two countries it leads to payments and receipts. So as to facilitate payments and receipts between these two countries we have to correct one country‘s currency in terms of another country‘s currency which is effected through the medium of foreign exchange rate. If 1 $ = Rs. 45. This foreign exchange rate gets established then it expresses the price of one U.S. dollar in terms of Indian Rupees. i.e. one U.S. Dollar is equal to 45 Indian Rupees.

Since exchange rate is the price of foreign exchange, it is determined by the demand for and supply of foreign exchange. The following are the various sources of demand and supply of foreign exchange:

1. Demand for Foreign Exchange:

A country would demand foreign exchange for the following purposes:

a. **Merchandise Imports:** A country requires foreign exchange to pay for its imports. These are a major source of demand for foreign exchange.

b. **Import of Services (invisible imports):** A country requires foreign exchange in order to pay for the transport, insurance and banking services that the residents obtained from other countries. Debt servicing and amortization are also important sources of demand for foreign exchange.

c. **Unilateral Receipts:** Residents, organisations and government may receive gifts, donations and grants from other countries.

d. **Export of Capital:** When residents, institutions and government invest abroad, they will demand foreign exchange. Since a fall in the exchange rate increases the demand, the **demand, the demand curve is downward sloping.**

2. Supply of Foreign Exchange:

A country obtains foreign exchange from the following sources:

a. **Merchandise Exports:**

When country exports its produce to other countries, it will obtain foreign exchange.

b. **Exports of Invisibles:**

Countries obtain foreign exchange when they provide transport, insurance and banking services to other countries. Remittances, interest received on previous loans to other countries are also an important source of supply of foreign exchange.

c. **Unilateral Payments:**

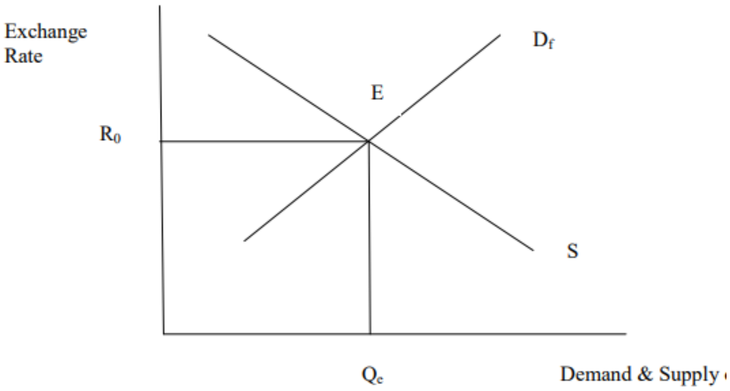
These are gifts, transfers, and grants from individuals, organisations and governments to residents, organisations and governments in other countries.

d. **Imports of Capital:**

These are borrowings and transfer of reserves from one country to another. As the price of foreign exchange falls, the supply of foreign exchange increases, thus the supply curve is upward sloping.

The market exchange rate is determined by the interaction between the demand and supply of foreign exchange. The following diagram explains the determination of the exchange rate.

Figure 5.1



Exchange Rate R0 Demand & Supply of Foreign Exchange Qe S Df E 150 In the above diagram, we showed the demand (Df) and supply (Sf) of foreign exchange. At point E, the demand and supply are equal and Re is the equilibrium exchange rate.

5.4 FACTORS INFLUENCING FOREIGN EXCHANGE RATE

1. Trade Movements:

Changes in imports and exports will cause a change in the rate of exchange. If import exceeds exports, the demand for foreign currency rises and rate of exchange will be unfavorable to the country favourable balance of payments will raise the exchange value of the currency and vice- versa.

2. Price Trends:

Prices trends in the domestic economy may bring abut fluctuations in exchange rate e.g. inflation will result in rising prices causing falling exports. Therefore changes in price within the nation brings effect on the exchange rates too. Because price fluctuations directly affects the purchasing power of the consumers for goods and services.

3. Capital Movements:

Export and import of capital will bring about fluctuations in the rate of exchange. The import of capital will result in increased demand for the currency of that country in the foreign exchange market and the exchange value of that currency will rise and vice-versa.

4. Banking operations:

Bank are the major dealers of foreign exchange, the operations of the bank regarding the changes in the bank rate, transfer of funds, accepting foreign bills of exchange, arbitrage etc. affect the demand and hence influence the exchange rates.

5. Political conditions:

Political stability will invite foreign capital and the rate of exchange will move favorably to the country. Political instability will cause a flight of capital resulting in an unfavorable exchange rate for the county.

6. Monetary policy:

An expansionary or contractionary monetary policy may result in inflation or deflation bringing about changes in the internal and external value of money. Tariff policy may also bring about fluctuations in exchange rate.

Check Your Progress:

1. Why do exchange rate fluctuate?

5.5 SUMMARY

This chapter explains the meaning of foreign exchange market, various functions of foreign exchange market, as well as the determination of exchange rate on the basis of diagrams. Also the meaning of foreign exchange rate and the factors affecting the foreign exchange rate are mentioned in detail.

5.6 QUESTIONS

1) Explain the functions of foreign exchange market by explaining the meaning of foreign exchange market.

2) Explain the determination of exchange rate with the help of diagram.

3) Explain the Factors Affecting Foreign Exchange Rate.

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6

FOREIGN EXCHANGE MARKET: RELATED TERMS

Unit Structure

6.0 OBJECTIVES

- The objectives of this unit are as follows –
- To know about the concept managed flexibility.
- To study about the SWAP market.
- To understand the components of foreign exchange reserve.
- To know the difference between the foreign aid and foreign trade.
- To study the foreign direct investment.
- To know about the multi-national corporations.

6.1 INTRODUCTION

A foreign exchange market facilitates the monetary transactions of foreign trade. It is a part and parcel of international money market. A foreign exchange market can‘t be designated by any geographical area or location. A foreign exchange market can be defined as a mechanism through which foreign currency can be bought and sold. It comprises of the buyers and sellers of foreign exchange and the intermediaries through which the buyers and sellers of foreign exchange are brought to-gether. They deal with each other through telecommunication network viz. telephones, mobiles, telexes, and electronic systems. With the advent of advanced technology like Renters Money 2000 – 2 it is possible to access the trader in any corner of the world within a few seconds. The deal can be done through electronic devices which allow bid and offer rates to be matched through central computers.

Participants in the Foreign Exchange Markets:

The main participants or players in the foreign exchange markets are as follows:

1) Customers:

The customers who participate in the foreign exchange markets mainly comprise of the importers and exporters. They participate in the foreign exchange market by availing of the bank services. The importer has to make payments to the exporting country in the exporting country's currency hence he utilizes the services of bank to convert its local currency into exporting country's currency. The exporter also would like to avail of the services of bank to convert the receipt of foreign currency into local or domestic currency.

2) Commercial Banks:

Commercial banks facilitate the conversion of one country's currency into another country's currency. The commercial banks are supposed to be the most active players in the foreign exchange market. These banks have a wide network of branches or the correspondent banks all over the world because of which they can transact the foreign exchange business smoothly, fastly and efficiently. The importers and exporters belong to different countries. These banks act as intermediaries between the importers and exporters. They buy foreign exchange from the exporter and sell it to the importers.

Commercial banks being the active players in the foreign exchange market achieve the following objectives:-

i) Profitability:

Foreign exchange business is a profitable activity. The commercial banks buy the foreign exchange from the exporting country at a lower rate and sell the same to the needy importing country at a higher rate. The difference between these two rates leads to accruing of profit to the commercial banks.

ii) Risk bearing:

The foreign exchange business entails risk which arises out of fluctuations in the foreign exchange rate. This risk is shouldered by the foreign exchange banks by entering into a contract with the party concerned. It gets referred to as forward dealing.

iii) Better service:

Commercial banks render better service to the customers by offering competitive foreign exchange rates.

In India in order to indulge into foreign exchange business the commercial banks have to obtain license from the Reserve Bank of India under section 6 of Foreign Exchange Regulation Act (FERA), 1973.

3) Central Banks:

The central banks are the main players in the foreign exchange market. It is one of the functions of the central banks of the world countries to maintain the external value of the domestic currency. There are two main types of foreign exchange rate systems viz.

a) fixed exchange rate system and

b) floating or fluctuating exchange rate system.

Under fixed exchange rate system the central bank has to maintain the parity under floating exchange rate system the central bank as a monetary and foreign exchange authority of the country has to intervene in to the foreign exchange market to buy and sel the foreign exchange depending upon the situation. When the demand for foreign exchange is more then it releases its foreign exchange reserves and sells foreign exchange. Conversely when the supply of foreign exchange happens to be more it buys foreign exchange from the market. Thus it tries to maintain the external value of the domestic currency.

4) Bill Brokers:

Bill brokers are the intermediaries who act as liaison between the buyers and sellers of foreign exchange. Their function is to bring both the parties together to settle the foreign exchange traction. For performing this function they get their commission known as brokerage.

5) Discount Houses:

The discount houses are the specialized houses specializing in the business of discounting the foreign bill of exchange. The discount houses discount the foreign bill of exchange put forwarded by an exporter and finances him before the maturity of the foreign bill of exchange at a discount. They retain the foreign bill of exchange till maturity and recover the full value of the foreign bill of exchange. The London discount houses are the glaring example of specialized discount houses in the London International money market.

6) Acceptable Houses:

The Acceptance Houses are the financially well to do firms which have earned name and fame in the foreign exchange world. When an importer who is a drawer receives the foreign bill of exchange from the drawer of the foreign exchange will be acknowledges the responsibility of involving payment of the said foreign exchange bill. He being an armature he would like to put the weight of the acceptance house once that foreign bill of exchange. The acceptance house lends its name and acknowledges the responsibility to make the payment of the foreign exchange bill to the payee on behalf of the drawee. The New York Acceptance Houses are the world f* acceptance houses which is the special feature of the New York International Money Market.

6.2 MANAGED FLEXIBILITY

Managed flexibility means the system of controlled flexibility to foreign exchange rate. The system of managed flexibility is a golden mean, a via media between the two extreme situations of foreign exchange rate systems viz.

i) the fixed exchange rate system and

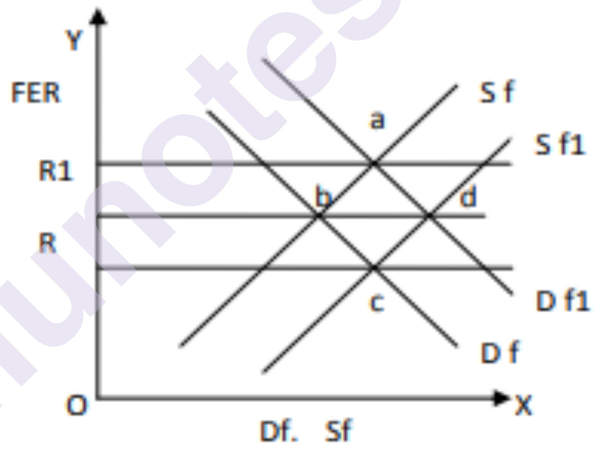
ii) the flexible exchange rate system.

As a matter of fact the system of managed flexibility emerged out of the drawbacks of both the foreign exchange rate systems.

In the managed flexibility the Govt. is called upon to play a very important role of intervening in the foreign exchange market. The central bank of the country being the monetary and foreign exchange authority of the country intervenes into the foreign exchange market.

As per the managed flexibility the foreign exchange rate is allowed to fluctuate but within limit. Hence it is also called as controlled flexibility.

Figure 6.1



OR is the equilibrium foreign exchange rate. When the foreign exchange rate fluctuates around the equilibrium foreign exchange rate then the central bank intervenes into the foreign exchange market. When the demand for foreign exchange rises the central bank releases its foreign exchange reserve and sells the foreign exchange in to the market to tide over the increased demand for foreign exchange. Conversely when the supply of foreign exchange rises it buys the foreign exchange from the market. Thus the central bank keeps the fluctuations in the foreign exchange rate within limit.

The managed flexibility can be of three types.

i) Adjustable Peg System

ii) Crawling Peg System

iii) Managed floating.

The adjustable Peg System believes in the fixed rate of exchange up to a certain point-beyond which it doesn‘t stick to it and hence switches over to adjustable Peg System. So long as a country possessed adequate foreign exchange reserves it sticks to fixed exchange rate. Afterwards a country may resort to devaluation of the currency by lowering down the foreign exchange value of the domestic currency. In short it recommends a little flexibility in the midst of stability of exchange rate. Thus this system possesses the duel characteristics of stability and flexibility.

In the Crawling Peg System on and after adjustment is made in the fixed exchange rate system due to changes in the market conditions of demand and supply. But it recommends only mild devaluation and not extreme devaluation.

A system of managed floating believes in Governmental intervention for a quick and reasonable adjustment in the foreign exchange rate.

Check Your Progress:

1. What is managed flexibility?

6.3 SWAP MARKET

The swap operations are undertaken by the commercial banks in the foreign exchange market. The term swap means simultaneous sale of spot currency or the purchase of the spot currency for the forward sale of the same currency. The simultaneous sale or purchase of spot currency for forward delivery, are technically known as swaps. The swap mean double deal. The spot currency is swapped against forward.

6.4 COMPONENTS OF FOREIGN EXCHANGE RESERVES

Just as an individual has to be in a position to pay his debts. in order to pay the debts a person must have his own income. In the same way every nation has to pay for the imports of goods and services. To settle the international obligation a nation must have adequate foreign exchange reserves. In order to accumulate foreign exchange reserves a nation must earn foreign exchange by exporting goods and services. The reserves are generally hold in the form of gold, Dollar, Pound Sterling and other strong or reserve carries of the world plus other international financial assets, S.D. Rs. etc.

There is a linkage between the growth of international trade and the growth of foreign exchange reserves. With the growth of international trade foreign exchange reserve also grows. When the demand for foreign exchange reserve matches with the supply of foreign exchange reserves then there will be no problem of foreign exchange reserve. The problem of foreign exchange reserve crops up when the demand for foreign exchange reserves exceeds the supply of foreign exchange reserves.

Concept:

The term foreign exchange reserves is associated with the system of international payments of a country. It is a part and parcel of International liquidity.

There is a difference between the term international liquidity and the term foreign exchange reserves. The term international liquidity is a broad term which encompasses foreign exchange reserves while foreign exchange reserves is a very narrow term in the realm of meeting the balance of payments deficit and settling other international obligation. It is a part and parcel of international liquidity. International Liquidity refers to generally accepted means of international payments available to a country for the settlement of international transactions. This International Liquidity comprises of two elements viz.

i) Owned reserves and

ii) Borrowing facilities

Of these two elements the foreign exchange reserves constitute the first one i.e. owned reserves. Hence it forms as only one fragment of International Liquidity.

International reserves of a country comprise of

i) Official holdings of gold

ii) foreign exchanges like U.S. Dollar Pound Sterling and other strong or reserve currencies of the world countries.

iii) Special Drawing Rights (SDRs)

iv) Reserve Position in IMF.

Note:- The international reserves do not include private holdings of gold, private holdings of foreign exchange and private holdings of international financing assets.

6.5 FOREIGN DIRECT INVESTMENT (FDI)

6.5.1 Meaning of FDI:

A Foreign Direct Investment (FDI) is an investment made by a firm or individual in one country into business interests located in another country. With FDI, foreign companies are directly involved with day-today operations in the other country. FDIs, apart from being involved in capital investment, also include the provisions of management or technology. The key feature of FDI is that it establishes either effective control of or at leasta substantial influence over the decision-making of the foreign business. The FDI can be made in various ways, including the opening of a subsidiary or associate company in a foreign country or ensuring a merger or joint venture with a foreign company.

6.5.2 Types of FDI:

- FDI can be categorised into horizontal, vertical or conglomerate.
- A horizontal direct investment happens when an investor sets up the same type of business operation in a foreign country as it operates in its home country.
- A vertical investment is one in which different, but related business activities from the investor's main business is established or acquired in a foreign country. For instance, when a manufacturing company acquires an interest in a foreign company that supplies parts or raw materials required for the manufacturing its finished goods, it is called vertical investment.
- A conglomerate type of FDI is the one where a company or an individual makes foreign investment in a business that is unrelated to its existing business in its home country.
- Since this type of investment involves entering a new industry where the investor has no experience, it often takes the form of a joint venture with a foreign company already operating in the country.

6.5.3 Advantages and disadvantages of FDI:

What are the advantages of FDI?

i) Increase in production:

Allowing FDI inflow ensures an increase in investment in key areas such as infrastructure development, which may lead to increase in capital goods production. For instance, investment in power generation can generate more electric power, which would enable the growth of more industries.

ii) Increase in capital inflow:

FDI promotes more capital inflow into the countries, especially in key sectors like infrastructure .It can address the shortage of capital and materials, which can rapidly enhance the growth of the country.

iii) Increase in employment opportunities:

FDIs in developing countries have enhanced the service sectors. This increased the employment opportunities within these countries, leading to an increase in economic growth. Educated unemployment has also been reduced by the FDIs as they can absorb some of the workforces.

iv) Strengthening of financial services:

FDIs can enhance financial services of a country by not only entering its banking industry but also by extending other activities like merchant banking, portfolio investment etc.It has also helped the capital market within the country.

v) Exchange rate stability:

RBI has been maintaining the exchange rate in the country through its exchange control measures. However, the constant and continuous supply of foreign exchange is vital for the continuation of exchange rate stability. FDI inflow plays a crucial role in this aspect by helping RBI to have comfortable foreign exchange reserve position of more than 1 billion dollars.

vii) Economic development:

FDIs, in the past, have played a crucial role in developing backward areas by starting industries. This resulted in many of these areas becoming industrial centres, with improvement in the standard of living of the people in these areas.

viii) Efficient use of natural resources:

The natural resources in the country can be used efficiently by the FDI, which may otherwise have been unutilised.

ix) Improved knowledge and technology:

One of the crucial benefits received by the host countries through the FDIs is access to new technologies and expertise from foreign companies. This can result in enhancement of the country's growth potential.

x) Maintenance of Balance of Payments:

FDI growth can help maintain the Balance of Payments. It can also maintain the value of countries' currencies.

What are the Disadvantages of FDI?

- Foreign ownership of strategically important sectors cannot favour the countries.
- Foreign investors might strip the business of its value.
- They could sell unprofitable portions of the company to the local, less sophisticated investors.
- They can use the company's collaterals to get low-cost, local loans.
- Instead of reinvesting it, they lend the funds back tothe parent company.

- The MNCs, through FDIs, can get controlling rights within the foreign countries.
- FDI can also be a convenient way to bypass local environmental laws.
- Developing countries are tempted to reduce environmental regulations to attract FDI inflows.
- FDI does not always benefit host countries as it enables foreign multinationals to gain from ownership of raw materials and even exploit labour force by not distributing its wealth to the backward society.
- MNCs are often criticised for their poor working conditions in foreign countries.
- The entry of large firms can often displace local businesses and may drive them out, as these small companies cannot compete.

6.5.4 FDI policy in India:

New Industrial policy 1991:

The Government introduced automatic approval upto 51% of foreign in 34 priority sectors. Government had the authority to raise FDI limit to 100% without prior approval of Parliament.

There were 2 ways to get FDI approval in India .

Automatic Route:

Under the Automatic Route, the non-resident investor or the Indian company does not require any approval from Government of India for the investment.

Government Route:

Under the Government Route, prior to investment, approval from the Government of India is required. Proposals for foreign direct investment under Government route, are considered by respective Administrative Ministry/ Department.

FDI policy 2017: On August 28, 2017 , DIPP announced the revised FDI policy. The following initiatives were taken.

- Abolition of FIPB and establishment of Foreign Investment Facilitation portal.
- Different departments were appointed to look into sector specific investments .
- DIPP issued Standard operating Procedures with detailed procedures, the timelines and list of competent authorities for government approval.

- Start-ups could issue equity or equity linked debt instruments to foreign venture capital investors.

Trends of FDI in India

- The Measures taken by the Government on the fronts of FDI policy reforms, investment facilitation and ease of doing business have resulted in increased FDI inflows into the country as India has attracted total FDI inflow of US$ 72.12 billion during April to January, 2021.
- It is the highest ever for the first ten months of a financial year and 15% higher as compared to the first ten months of 2019-20 (US$ 62.72 billion).
- The trends show that the FDI equity inflow grew by 28% in the first ten months of F.Y. 2020-21 (US$ 54.18 billion) compared to the year ago period (US$ 42.34 billion).
- In terms of top investor countries, 'Singapore' is at the apex with 30.28% of the total FDI Equity inflow followed by U.S.A (24.28%) and UAE (7.31%) for the first ten months of the current financial year 2020-21.
- Japan has been leading the list of investor countries to invest in India with 29.09% of the total FDI Equity inflows during January, 2021, followed by Singapore (25.46%) and the U.S.A. (12.06%).
- The Computer Software & Hardware has emerged as the top sector during the first ten months of F.Y. 2020-21 with 45.81% of the total FDI Equity inflow followed by Construction (Infrastructure) Activities (13.37%) and Services Sector (7.80%) respectively.
- As per the trends shown during the month of January, 2021, the consultancy services emerged as the top sector with 21.80% of the total FDI Equity inflow followed by Computer Software & Hardware (15.96%) and Service Sector (13.64%).
- These trends in India's Foreign Direct Investment are an endorsement of its status as a preferred investment destination amongst global investors.

6.6 MNCS

6.6.1 Meaning of Multinational Companies (MNCs):

A multinational company is one which is incorporated in one country (called the home country); but whose operations extend beyond the home country and which carries on business in other countries (called the host countries) in addition to the home country.

Features of Multinational Corporations (MNCs):

(i) Huge Assets and Turnover:

Because of operations on a global basis, MNCs have huge physical and financial assets. This also results in huge turnover (sales) of MNCs. In fact, in terms of assets and turnover, many MNCs are bigger than national economies of several countries.

(ii) International Operations Through a Network of Branches:

MNCs have production and marketing operations in several countries; operating through a network of branches, subsidiaries and affiliates in hostcountries.

(iii) Unity of Control:

MNCs are characterized by unity of control. MNCs control business activities of their branches in foreign countries through head office located in the home country. Managements of branches operate within the policy framework of the parent corporation.

(iv) Advanced and Sophisticated Technology:

Generally, a MNC has at its command advanced and sophisticated technology. It employs capital intensive technology in manufacturing and marketing.

(v) Professional Management:

A MNC employs professionally trained managers to handle huge funds, advanced technology and international business operations.

(vi) Better Quality of Products:

A MNC has to compete on the world level. It, therefore, has to pay special attention to the quality of its products.

6.6.2 Advantages and Limitations of MNCs:

Advantages of MNCs

(i) Employment Generation:

MNCs create large scale employment opportunities in host countries. This is a big advantage of MNCs for countries; where there is a lot of unemployment.

(ii) Automatic Inflow of Foreign Capital:

MNCs bring in much needed capital for the rapid development of developing countries. In fact, with the entry of MNCs, inflow of foreign capital is automatic. As a result of the entry of MNCs, India e.g. has attracted foreign investment with several million dollars.

(iii) Proper Use of Idle Resources:

Because of their advanced technical knowledge, MNCs are in a position to properly utilise idle physical and human resources of the host country. This results in an increase in the National Income of the host country.

(iv) Improvement in Balance of Payment Position:

MNCs help the host countries to increase their exports. As such, they help the host country to improve upon its Balance of Payment position.

(vi) Technical Development:

MNCs carry the advantages of technical development In fact, MNCs are a vehicle for transference of technical development from one country to another.

(vii) Managerial Development:

MNCs employ latest management techniques. People employed by MNCs do a lot of research in management. In a way, they help to professionalize management along latest lines of management theory and practice. This leads to managerial development in host countries.

(viii) End of Local Monopolies:

The entry of MNCs leads to competition in the host countries. Local monopolies of host countries either start improving their products or reduce their prices. MNCs compel domestic companies to improve their efficiency and quality.

(ix) Improvement in Standard of Living:

By providing super quality products and services, MNCs help to improve the standard of living of people of host countries.

(x) Promotion of international brotherhood and culture:

MNCs integrate economies of various nations with the world economy. Through their international dealings, MNCs promote international brotherhood and culture; and pave way for world peace and prosperity.

Limitations of MNCs:

(i) Danger for Domestic Industries:

MNCs, because of their vast economic power, pose a danger to domestic industries; which are still in the process of development. Domestic industries cannot face challenges posed by MNCs. Many domestic industries have to wind up, as a result of threat from MNCs. Thus MNCs give a setback to the economic growth of host countries.

(ii) Repatriation of Profits:

MNCs earn huge profits. Repatriation of profits by MNCs adversely affects the foreign exchange reserves of the host country; which means that a large amount of foreign exchange goes out of the host country.

(iii) No Benefit to Poor People:

MNCs produce only those things, which are used by the rich. Therefore, poor people of host countries do not get, generally, any benefit, out of MNCs.

(iv) Danger to Independence:

Initially MNCs help the Government of the host country, in a number of ways; and then gradually start interfering in the political affairs of the host country. There is, then, an implicit danger to the independence of the host country, in the long-run.

(v) Disregard of the National Interests of the Host Country:

MNCs invest in most profitable sectors; and disregard the national goals and priorities of the host country. They do not care for the development of backward regions; and never care to solve chronic problems of the host country like unemployment and poverty.

(vi) Careless Exploitation of Natural Resources:

MNCs tend to use the natural resources of the host country carelessly. They cause rapid depletion of some of the non-renewable natural resources of the host country. In this way, MNCs cause a permanent damage to the economic development of the host country.

(vii) Exploitation of People, in a Systematic Manner:

MNCs join hands with big business houses of host country and emerge as powerful monopolies. This leads to concentration of economic power only in a few hands. Gradually these monopolies make it their birth right to exploit poor people and enrich themselves at the cost of the poor working class.

6.7 QUESTIONS

1) Explain the concept of managed flexibility with diagram.
2) Write a detailed note on swap market.
3) Explain the components of foreign exchange reserves. .
4) Write a note on Foreign Direct Investment (FDI).
5) Explain the merits and demerits of multinational companies.

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MODULE IV

7

INTERNATIONAL ECONOMIC INSTITUTIONS

Unit Structure

7.0 OBJECTIVES

- To understand the role and functions of International Monetary Fund.
- To study the role and functions of the World Bank.
- To review the objectives, functions and agreements of the World Trade Organization.

7.1 INTRODUCTION

From the early 19th century till the past First World War period most of the industrialized countries of the world followed gold standard. Under gold standard each country following gold standard expressed its currency in terms of gold. In 1900 for example the dollar was equal to 1/20lh ounce of gold and the Pound sterling was equal to 5/20th ounce of gold. Hence 1£=S5. Secondly the countries also agreed to convert its paper currency in the gold on demand. Thirdly there was no restriction on the shipment of gold from one country to another. The gold standard provided for an automatic corrector of balance of payments disequilibrium. If the country imported goods more than its exports then gold flowed out.

Conversely when a country exported goods more than its imports gold flowed in. Many supply in the country also depended on the receipt and payment of gold. In case receipt of gold money supply expanded in the country conversely in case of payment of gold money supply contracted in the country. The increase in money supply led to increase in prices. While the contraction in money supply led to fall in the price level. Until the outbreak of First World War (1914) the gold standard worked remarkably well and the stability in the exchange rate was maintained. Gold standard countries were very eager to abide by the golden rule of gold standard to expand money and credit. When it coming in and to contract the volume of money and credit when gold is going out. The gold standard was, shattered in the first week of first world war (1914-1918). The conversion of paper currency notes in the gold was prohibited and the import and export of gold was stopped. After the First World War the international gold standard was restored line due to the following reasons:

i) There was a natural wish to return to normalcy

ii) People wished to go back to pre-war conditions

iii) Post war inflation

However, after a decade the international gold standard once again was abandoned by majority of the world countries due to 1930's great depression. Great Britain suspended international gold standard in 1931 followed by majority of the countries of the world including U.S.A.

The breakdown of the international gold standard created a vacuum in the field of international trade. All the countries of the world realised the need for international economic co-operation. The breakdown of international gold standard created a chaos in the field of foreign exchange rates. In order to take the advantage of increase in exports each country deliberately switched over to competitive devaluation. Each country tried to prosper at the cost of the other. They followed, "beggar thy neighbour policy." Competitive devaluation, exchange controls, import quota, tariffs 73, export regulations and bilateral pacts were the order of the day. Thus the volume of international trade declined to a considerable extent. Due to uncertainly, international investment suffered a lot.

It was realised that mutual agreements between world countries having international economic relation would solve the problem of international monetary disorder. International monetary Co-operation became the need of the hour. It was impossible to revive the international gold standard, a new system had to we devised which would provide sufficient flexibility through international assistance without disturbing the internal economies. Different nations put forwarded different plans to solve the problem of international trade and monetary disorder, in 1943 the United States Treasury published a proposal for the establishment of an International stabilization Fund of the United and Associated Nations. Great Britain also proposed the establishment of an International clearing union. The American proposal was known as "white plan" while the British proposal was known as, "Keynes plan". The author of "white plan" was Mr. White while the author of "Keynes plan" was Lord J.M. Keynes. In 1944 a joint plan in the shape of" Joint statement by Experts on the Establishment of International Monetary Fund of the United and Associated Nation" emerged which become the basis for the United Nations monetary and Financial conference. Which was held at Bretton woods, New Hampshire from July 1 to July 22, 1944. The purpose of the Bretton woods conference was to devise means for assuring a system of international trade and payments consistent with the dual objections of high world productivity and trade and domestic income and employment with economic stability. At the meeting it was decided that an 'International Monetary Fund (IMF)' be organised for the smooth settlement of international payments.

7.2 INTERNATIONAL MONETARY FUND (IMF)

The IMF was organised in 1946 and it commenced its operation in March 1947. The International monetary system introduced at Bretton woods rested on two pillars viz. the maintenance of stable exchange rates and a multilateral credit mechanism institutionalized in he IMF and supervised by it. The International Monetary System that existed from 1947 to 1971 in generally known as the par value system or pegged exchange rate system. Under this system each member country of IMF is required to define the value of its currency in terms of gold or U.S. dollar and to maintain (to peg) the market value of its currency within ± of the defined par value. The value of US dollar was set at 1/ 35 of an ounce of gold and the limited states promised that all US dollars in the hands of central banks would be redeemed in gold, up on demand at the fixed price of $ 35 per ounce of gold. Every country defined its currency in items of gold or dollar. The dollar was not merely as good as gold, but it was better than gold because dollar reserves earned interest while gold did not. The exchange rate between two currencies would not remain constant for-ever. It would change under following conditions:

i) A member shall not propose to change except to correct the fundamental disequilibrium in the balance of payments and it shall act only after consultation with IMF.

ii) The fund will not object to change not exceeding 10% of the initial par value.

iii) It a change in proposed exceeding 10% but not exceeding 20% of the initial par value. The IMF may agree or object but must declare its attitude within 72 hours.

iv) If the proposed change is longer than 20% the Fund may concur or object without limit of time.

v) The Fund must agree "if it is satisfied that the change is necessary to correct fundamental disequilibrium in the balance of payments.

Concept And Meaning Of Imf:

The international monetary fund is a landmark in the history of international monetary Co-operation. It is an international Financial Institution. The abbreviation IMF stands for International Monetary Fund. The International Monetary Fund (IMF) is an organization of countries that seeks to promote international monetary co-operation. It facilitates the expansion of international trade. Thus, it contributes towards increased employment and improved economic conditions in all member countries. Membership of IMF is open to-every country of the world that controls its foreign relations and is able and prepared to fulfill the obligations of membership. Membership of IMF is a pre - requisite for membership in the IBRD i.e. the World Bank. There is a close relationship between the IMF and the IBRD. The Fund is a specialized agency within the United Nation system, it cooperates with the UN on matters of mutual interest.

The IMF can be designated as a central bank of central Banks of the world countries because it collects the resources and maintains the reservoir of nation's currencies just like that of the central bank of a country which collects cash reserves of the commercial banks of the country. However, there is a difference in the functioning of the central bank of the respective countries and IMF. The central banks of the world countries can control the volume of money and credit through the monetary policy while IMF can't control the volume of money and credit of any member country.

7.2.1 Role of International Monetary Fund (Imf):

Since the onset of the global economic crisis in 2007, The IMF introduced several changes in its lending reforms, policy of lending aid to poor countries, governance reforms, conditionality's of getting funds etc. which are as follows:

1) Governance Reform:

On December 15, 2010, the Board of Governors approved far-reaching governance reforms under the 14th General Review of Quotas. The package includes a doubling of quotas, which will result in more than a 6 percentage point shift in quota share to dynamic emerging market and developing countries while protecting the voting shares of the poorest member countries. The reform will also lead to a more representative, fully-elected Executive Board. Changes in Conditionality of Fund: The conditionality of IMF are no longer set in quantitative targets such as reducing fiscal expenditure, or contracting the supply of credit to bring aggregate demand in balance with the aggregate supply. The conditionality's are now set in qualitative targets such as structural reforms, passing of new legislations such as bankruptcy codes, reform of tax administration and removing rigidities that hold back growth.

2) Credit line for strong performers:

The Flexible Credit Line (FCL), introduced in April 2009 and further enhanced in August 2010, is a lending tool for countries with very strong fundamentals that provides large and upfront access to IMF resources, as a form of insurance for crisis prevention. There are no policy conditions to be met once a country has been approved for the credit line. Colombia, Mexico, and Poland have been provided combined access of over $100 billion under the FCL (no drawings have been made under these arrangements). FCL use has lead to lower borrowing costs and increased room for policy scheme. Structural performance criteria have been discontinued for all IMF loans, including for programs with low-income countries. Structural reforms will continue to be part of IMFsupported programs, but have become more focused on areas critical to a country's recovery.

3) Social Safety Net Programs:

The IMF is promoting measures to increase spending on, and improve the targeting of, social safety net programs that can mitigate the impact of the crisis on the most vulnerable in society.

4) Reforms in the Lending Framework of the IMF:

To provide better support to countries during the global economic crisis, the IMF beefed up its lending capacity and approved a major overhaul of how it lends money by offering higher amounts and tailoring loan terms to countries' varying strengths and circumstances.

5) Policies for Low Income Countries:

In response to the global financial crisis, the IMF undertook policy reforms toward lowincome countries. As a result, IMF programs are now more flexible and modified to the individual needs of low-income countries, with streamlined conditionality, higher concessions and more emphasis on safeguarding social spending.

6) Availability of Resources:

Resources available to low-income countries through the Poverty Reduction and Growth Trust over the period 2009–2014 were boosted to $17 billion, consistent with the call by G-20 leaders in April 2009 of doubling the IMF's concessional lending capacity and providing $6 billion additional concessional financing over the next two to three years. The IMF's concessional lending to low-income countries amounted to $3.8 billion in 2009, an increase of about four times the historical levels. In 2010 and 2011, concessional lending reached $1.8 billion and $1.9 billion respectively.

7) Establishment of a Post-Catastrophe Debt Relief (PCDR) Trust:

This allows the IMF to join international debt relief efforts for very poor countries that are hit by the most catastrophic of natural disasters. PCDR-financed debt relief amounted to $268 million in 2010.

8) Efforts against Global Crisis:

As a key part of efforts to overcome the global financial crisis, the Group of Twenty industrialized and emerging market economies (G-20) agreed in April 2009 to increase borrowed resources available to the IMF (complementing its quota resources) by up to $500 billion (which tripled the total pre-crisis lending resources of about $250 billion) to support growth in emerging market and developing countries. In April 2010, the Executive Board adopted a proposal on an expanded and more flexible New Arrangements to Borrow (NAB), by which the NAB was expanded to about SDR 367.5 billion (about $560 billion), with the addition of 13 new participating countries and institutions, including a number of emerging market countries that made significant contributions to this large expansion. On November 15, 2011, the National Bank of Poland joined the NAB as a new participant, bringing the total to about SDR 370 billion (about $570 billion) and the number of new participants to 14 (once all new participants have joined). In addition to increasing the Fund‘s own lending capacity, in 2009, the membership agreed to make a general allocation of SDRs equivalent to $250 billion, resulting in a near ten-fold increase in SDRs. This represents a significant increase in own reserves for many countries, including low-income countries.

9) Sharpening of IMF Analysis and Policy Advice:

To try and prevent future crises, the IMF is working closely with governments and other international institutions. Risk analysis has been enhanced, including by taking a crosscountry perspective, and early warning exercises are being carried out jointly with the Financial Stability Board. Analyses on linkages between the real economy, the financial sector, and external stability are being strengthened. Work has also been done on mapping and understanding the implication of rising financial and trade interconnectedness for surveillance and for lending to strengthen the global financial safety net.

7.2.2 Functions Of International Monetary Fund (Imf):

The fundamental objective of the IMF was the avoidance of competitive devaluation and exchange control. Basically there are three general objectives of IMF viz.

i) The elimination or reduction of existing exchange controls.

ii) The establishment of maintenance of currency convertibility with stable exchange rates.

iii) The establishment of multilateral trade and payments.

Objectives As per the Article 1 of the IMF Agreement are as follows:

- To promote international monetary co-operation through a permanent institution which provides machinery for consultation and collaboration on international monetary problems.

- To facilitate the expansion of balanced growth of international trade and to contribute thereby to the promotion and maintenance of high level of employment and real income and to the development of the productive resources of all member countries as the primary objective of economic policy.

- To promote exchange stability to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.

- To assist in the establishment of a multilateral system of payments is respect of current transactions between member countries and in the elimination foreign exchange restrictions which hamper the growth of world trade.

- To lend confidence to members by making the Fund resources available to them under adequate safeguards, thus providing them with opportunity to correct mal adjustments in the balance of payments without resorting to measures destructive to national and international prosperity.

- In accordance with the above to shorten the duration and lessen the degree of disequilibrium in the balance of payments of the member countries.

Functions of IMF:

To fulfill the above objectives, the IMF performs the following functions:

1. The IMF operates in such a way as to fulfil its objectives as laid down in the Bretton Woods Articles of Agreements. It is the IMFs duty to to see that these provisions are observed by member countries. Some of the provisions of the original Articles such as relating to exchange rates have become obsolete due to international monetary events. Accordingly IMF has amended its Articles of Agreement to make appropriate adjustment.

2. The fund gives short-term loans to its members, so that they may correct their temporary balance of payments disequilibrium.

3. The fund is regarded as _the guardian of good conduct‘ in the sphere of balance of payments. It aims at reducing tariff and other trade restrictions by the member countries. Article VII of the Charter provides that no member shall ,without the approval of the fund, imposes restrictions on the making of payments or engage in discriminatory currency arrangement or multiple currency practices. It

is the functions of the IMF to have surveillance of the policies being adopted by the member countries.

4. The fund also renders technical advice to its members on monetary and fiscal policies.

5. It conducts research studies and publishes them in IMF staff papers, Finance and Development, etc.

6. It provides technical experts to member countries having balance of payment difficulties and other problems.

7. It also conducts short training courses on fiscal, monetary and balance of payments for personnel from member nations through its Central Banking Services Development, the Fiscal Affairs Department, the Bureau of Statistics and the IMF institute.

Thus the Fund performs Financial, Supervisory and Controlling functions.

7.3 WORLD BANK

World Bank is a bank established by 148 countries of the world to provide financial assistance to developing countries for their development. This World Bank is also known as International Bank for Reconstruction and Development (IBRD). The office of this bank is in Washington. Development funds are given to underdeveloped and third world countries through this bank. It provides loans and technical assistance. Economic policies are important in international politics. Therefore, developed countries resort to the World Bank to exert their influence on underdeveloped countries. Also, various conditions are imposed on them while giving loans.

The following international organizations are included under the World Bank.

1. International Bank for Reconstruction and Development (IBRD)

2. International Development Association (IDA)

3. International Financial Corporation (IFC)

4. Multilateral Investment Guarantee Agency (MIGA)

5. International Centre for Settlement of Investment Disputes (ICSID)

The World Bank is referred to as the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). Today the World Bank has 185 members.

7.3.1 Role Of World Bank:

The main objective of the establishment of the World Bank is to help underdeveloped countries to achieve economic development, reduce poverty, stimulate economic growth through investment. The following role of the World Bank as a development agency is important.

1. Economic & Social Development:

The World Bank is very useful as a financial source. The World Bank plays an important role in reducing the problem of poverty and raising the standard of living in order to achieve sustainable and equitable growth in underdeveloped countries.

Underdeveloped countries have always faced capital problems, so the World Bank has been trying to encourage foreign investment. The role of the World Bank in bringing about the economic and social development of underdeveloped countries is important because it provides all possible help or cooperation to develop basic and infrastructural facilities in underdeveloped or developing countries.

2. Efforts to reduce the problem of poverty (Poverty Reduction):

Most of the underdeveloped and developing countries are facing the chronic problem of economic and social poverty. The World Bank provides important support facilities to solve the problem of poverty in underdeveloped countries. It provides capital to raise the income of the lower and middle class people in such countries. Provides access to capital for economic, social, financial, monetary and fiscal policies for sustainable economic development. Poverty alleviation in underdeveloped countries is one of the main objectives of the World Bank.

3. Supports debt relief:

Since the 1980s, the World Bank has focused and actively supported debt relief as a solution to the international debt problem. The World Bank and the International Monetary Fund (IMF) have launched the Heavily Indebted Poor Countries (HIPC) since its inception. During 2002-2026, debtor countries will get relief from external debt problems. Such is the expectation of HIPC.

4. Achievements of Millennium Development Goal's - MDG's:

Today, the World Bank is focusing on the goals of happy-prosperous development. 189 nations have signed up to this goal. It generally consists of eight (8) major goals or objectives.

1. Poverty alleviation
2. Universal Primary Education
3. Equality and Women Empowerment
4. Reduce Child Mortality
5. Health improvement (Improve material health)
6. Malaria, H. I V./ Control of (AIDS).

7. Ensuring sustainable environment

8. Development of Global Partnerships for Development

The World Bank aims to meet or achieve the Sustainable Development Goals by 2010. For this, the World Bank has sought further for the overall development of underdeveloped countries.

A. Access to universal primary education.

b. H. i. Combating H.I.V. and AIDS.

c. Funding of health programmes.

d. Conservation of Biodiversity

5. Fight Against Corruption:

Corruption is a growing problem in underdeveloped or developing countries. The World Bank is playing an important role in fighting corruption.

6. Assistance to conflict countries:

The World Bank is supporting 39 struggling countries. The World Bank has implemented activities to provide education and training facilities to these countries to stay away from conflict or war.

In short, the World Bank is playing a role for the economic, social, cultural and political development of the underdeveloped countries, but new challenges have arisen regarding the development of the developing countries in the future. It is important that the World Bank's program plans, activities are for the economic development of the country (sustainable) for poverty alleviation and human development.

Check your progress.

1. Briefly study the role of World Bank.

7.3.2 Functions of World Bank :

- The World Bank helps war-torn countries by providing loans for reconstruction.

- They provide a wealth of experience and the financial resources of the World Bank help poor countries to promote economic development, reduce poverty and achieve better living standards.

- They help developing countries by providing development loans.
- The World Bank lends to various governments for irrigation, agriculture, water supply, health and education.
- Encourages foreign investment in other institutions by guaranteeing loans.
- The World Bank also provides economic, financial and technical advice to member countries on all projects.

Thus, by introducing various economic reforms, we are promoting the development of industries in developing countries.

7.4 WORLD TRADE ORGANIZATION (WTO)

Setting up of World Trade Organisation (WTO) in 1995, has been the greatest event to occur, in recent times in international trade relations. The purpose of WTO is to remove restrictions in international trade. It is designed to play the role of a watch dog in the spheres of trade in goods, trade in services, foreign investment, intellectual property rights etc.

In the new era of globalization where the world economy is undergoing significant changes, there is a need to study the impact of the WTO on the Indian economy. We also need to review and examine the challenges that the Indian economy will now be facing in the area of trade as a result of the WTO agreements. Thus the setting up of WTO has thrown up number of opportunities and challenges.

Formation of Wto : Gatt To Wto:

After the world war II, many countries got down together to work on ways and means to promote international trade. The result was the signing of the General Agreement on Tarrifs and Trade (GATT) by 23 countries in 1947. India was one of the founder members of GATT. Over the years the membership of GATT has increased to 143 countries. GATT was primarily concerned with the promotion of international trade through tariff reductions, doing away with non discriminatory practices among trading partners, and evolving rules to counter protectionism.

GATT provided for reduction in tariffs and trade restrictions in a phased manner over a period of time. In all, Eight Rounds of Multilateral Trade Negotiations were held under the auspices of GATT. The Eight Round was held in Uruguay, in 1986 and in known as _Uruguay Round' This Round took more than Eight years of complex negotiations. The final act was signed in April 1994 by the member nations of GATT and this paved the way for the setting up of WTO. The WTO agreement was singed by 104 member nations GATT and it came into force from January 1, 1995. Thus, WTO was set up on January 1, 1995. The former GATT was not really an organization. It was merely a legal arrangement on the other hand, the WTO is a new international organization set up as a permanent body and is designed to play the role of a watch dog in the spheres of trade in goods, trade in services, foreign investment, intellectual property rights etc. India is one of the founder-member of WTO. China and Taiwan entered the world trade body towards the end of 2001. The present membership of WTO is 149 countries.

Organization:

In WTO framework Ministerial Conference is the highest decision making body, which has to meet at least once in two years. Following Ministerial Conferences have been held; so far viz. Singapore (9 – 13 December 1996), Geneva (18 – 20 May, 1998), Seattle (30 Nov. – 3 Dec., 1999) ; Doha (9 – 14 Nov. 2001); Cancun (10 – 14 Sept. 2003); Hong Kong (13 – 18 Dec. 2005). The seventh WTO Ministerial meeting was held in Geneva from Nov 30 – Dec. 3, 2009. In addition to the Ministerial Conference there is a General Council again Consisting of representatives of all the members. It itself meets as the Disputes Settlements Body (DSB) and the trade policy review committee. There are three separate councils under General Council : Council for Trade in Goods; Council for trade in services, council for Trade Related Aspects of Intellectual Property Rights.

7.4.1 Objectives of World Trade Organization (Wto):

The main advantages of WTO can be stated as follows.

i) Removal of tariff and non-tariff barriers to trade.

ii) Abolition of discriminatory policies in international trade relations. In relation to the trade sector, raising the standard of living of the people in the country, increasing the employment level, increasing the real income, increasing the effective demand, increasing the production, increasing the trade in goods and services.

iv) Maximize use of global resources while promoting sustainable development and economic growth.

v) To increase the trade of developing countries by keeping a positive attitude towards their economic development.

vi) Coordination and promotion of trade under multilateral agreements.

vii) Coordinating trade policies for transformational strategies and sustainable development.

7.4.2 Functions of World Trade Organization (Wto):

i) WTO is expected to promote international trade, for this it must provided necessary administrative frame work.

ii) WTO should provide forum for negotiations among its members.

iii) WTO should formulate rules of the trade and proper mechanism for the settlement of disputes.

iv) WTO should take periodical review of its trade policy.

v) WTO should work in co-operation with the IMF and the world bank.

vi) It administers the 29 Agreements contained in the final act of the Uruguay Round of World trade.

vii) It oversees implementation of tariff cuts and reduction of non tariff measures agreed to in the negotiations.

viii) It assists developing countries in implementing Uruguay agreements through a Developments Division.

7.4.3 Agreements of World Trade Organization (Wto):

The World Trade Organisation (WTO) was set up in 1995 as the watchdog for ensuring the free flow of trade among nations. India is one of the founder members of the WTO and played a vital role in the multilateral trade negotiations. Initially, the WTO was to confine itself to the regulation of trade in goods. As these negotiations known as Uruguay Round progressed, the developed countries succeeded in bringing in a number of issues that are not directly related to trade in goods under the gamut of the WTO. Important among these are the Trade Related Aspects of Intellectual Property Rights (TRIPs), Trade Related Investment Measures (TRIMs) and the General Agreement on Trade in Services (GATS). These three agreements are since considered to be more detrimental to the national interests of the developing countries than the tariff and non-tariff barriers that these countries had to face. The benefits of lowered tariff rates were more than offset by these agreements. We shall examine them in detail.

The main WTO agreements can be divided into the following categories.

7.4.3.1 Trips:

Intellectual property is considered as the corner stone for the progress of developed countries. It refers to the creation and use of knowledge. In simple terms, it refers to the protection that is accorded to the creators of knowledge. Under the TRIPs Agreement, it is proposed that Member countries should grant protection to the patents obtained by individuals and organisations from the other member countries. Thus, a firm can claim a patent in the USA and this protection is accorded to it in all the member countries of the WTO. An important aspect of the new regime proposed under the TRIPs agreement is that a patent is a product patent. That is protection is given to entire product. Apart from patents, the protection is given in the form of 'exclusive market rights' also. Under this, a firm can obtain license as the sole supplier of a designated product in a particular market/country. No other firm would be allowed to enter in to this market. It is argued that these protections would encourage innovation and technological progress. However, over the years, a number of issues emerged that showed the iniquitous nature of this agreement. We shall now examine some of them.

1. Protection of the intellectual property goes against the spirit of free trade. Most of the patents are claimed by the multi-national corporations (MNCs) operating from the USA and Europe. In case of pharmaceutical sector, the prices of medicines with patents and exclusive market rights, the prices are much higher than in countries with no such protection. This causes the exploitation of the consumer. It is interesting to note that the USA has been a vocal supporter of these measures. When some countries like South Africa and Brazil proposed to waive off the protection on some of the life saving drugs for HIV/AIDS treatment, the US opposed it claiming the 'national emergency' clause cannot be invoked by a member country. However, in wake of the terrorist attacks on the USA, the anthrax medicines were required on a large scale. Novartis Company had the exclusive market rights for this product in the USA. When it was found that the medicines provided by Novartis are three to four times higher than those supplied by companies in the developing countries like India, the US proposed to waive the protection accorded to Novartis. Thus, the USA, who champions the cause of free trade, is more opportunistic than the others are. The Supreme Courts of Brazil, South Africa and others, that the national government alone has the authority to declare a situation as a national emergency and no international agreement can absolve a country of this right have ruled it.

2. The introduction of product patents led to a situation where the domestic pharmaceutical industries have to face a survival problem. The production of generic drugs has been an important source of innovation that contributed to lower prices and expansion of firms. The introduction of product patents in India in 2005 created a number of problems.

3. The patent regime, created a situation where traditional knowledge also could be exploited by profit-seeking MNCs. In case of many Latin American countries, this has happened. In case of India, the introduction of a particular variety of rice, termed as "Texamati" created a furore. Similarly, attempts to seek patents on turmeric and neem products also demonstrated the dangers of the TRIPs agreements.

4. The TRIPS agreement provides for protection of traditional knowledge from being patented. This includes plant varieties also. The country has to declare a list of such items that are termed as 'traditional'. In many developing countries, including India, precious little is being done in this direction and thus, the MNCs can easily claim protection on them.

5. Patenting of plant varieties will lead to serious problems in the developing countries. Providing seeds at reasonable prices is a task of all the national governments. If patents are granted to the profit-driven MNCs on plants, the farmers would be left with nothing for survival. An undeniable right of the farmers has been to use the produce of a

year as seeds for the next. It is observed that in case of certain seeds supplied by the MNCs, this is not possible. In other words, the farmer cannot use his produce as seeds and has to return to the same MNC each year for seeds.

6. The patenting of microorganisms is a further cause of concern. These are used extensively in agriculture, pharmaceuticals and biotechnology. In the coming years, these technologies would hold the key for increased production and efficiency. Once the MNCs obtain the protection, these benefits would be denied to a vast majority of population in the developing countries.

7. Most importantly, the developing countries are helpless victims of the new global trade regime imposed by the developed countries at the behest of the MNCs, which provide funds to these governments. The WTO provides for a dispute settlement mechanism. Experience however, shows that in many cases, the developing countries are forced to suffer the losses than to challenge the will of the advanced countries.

Thus, it is reasonable to conclude that the TRIPs agreement conferred undue advantages to the rich nations at the cost of the developing countries.

Check Your Progress:

1. What are the main provisions of the TRIPs?

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7.4.3.2 Trims:

The Agreement on Trade Related Investment Measures (TRIMs) relates to the restrictions on foreign investment, domestic regulations of industrial activity and the incentives accorded to the domestic industries. 'The national treatment clause' allows for non-discrimination between a domestic and a foreign firm in access to the markets in a member country. On the face of it, this agreement looks innocuous. However, the actual implications have disastrous consequences. Let us now examine them in detail.

1. An important provision for the development of domestic industries has been the local content requirements. Under this provision, each foreign firm when enters into a country is required to obtain a certain percentage of its value added from the domestic suppliers. This arrangement was historically used by all the present day developed countries, including the USA. However, under the new WTO regime, this benefit is denied to the developing countries. All the local content

requirements are declared as invalid. This has adversely effected the development of industrial sector in the developing countries, including India.

2. Providing subsidised capital for industries of national importance has also been an important measure at promoting economic development. However, the TRIMs do not allow such provisions. In one case, the EU approached the WTO Dispute Settlement Board seeking to revoke the interest subsidies to iron and steel industry in India. Since India did not have a balance of payments problem, the DSB ruled that India should stop these subsidies.

3. The TRIMs do not allow the host country to select the industries in which it would like to attract foreign capital. Thus, under this regime, only profit seeking capital would be flowing into the developing countries. The increase in investments by many luxury foreign brands in India after 1991 is an indication of the adverse consequences of TRIMs. The EU countries have been demanding the liberalisation of wine/liquor investments in India. Profits, rather than public welfare are the guiding force of capitalist investment.

Check Your Progress:

1. What is TRIMs?

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7.4.3.3 GATS:

According to the IMF, trade in services refer to 'economic output of intangible commodities that may be produced, transferred and consumed at the same time.' There are three important components of trade in services:

a. Transport: This covers all transport services provided by residents of one economy for those of other and involve transport of passengers, goods and so on. Insurance freight is not included here.

b. Travel: This covers goods and services acquired form an economy by travellers in that economy for their own use during visits of less than one-year duration for business and personal purposes. This includes meals, lodging, and transport.

c. Other commercial services: These include activities like insurance and financial services, international telecommunications, and postal and courier services, computer data, news related service transactions between residents and non-residents, construction services, royalties and license fees, miscellaneous business, professional and technical services, and personal, cultural, and recreational services.

The GATS encompasses all that is traded under the four modes of service transactions carried out among different countries: i) cross-border trade (Mode 1); ii) consumption abroad (Mode 2); iii) Commercial presence (Mode 3); and iv) movement of natural persons (Mode 4). It proposes to bring in more transparency in the trade of these services and to provide a level-playing field for all members.

Indian commitments at the GATS cover 33 activities like business services; communications; construction work for civil engineering; financial services; health-related and social services; tourism among others. These commitments have sectoral variations in terms of free access to Foreign Service providers. It also committed on market access and national treatment clauses on sectoral restrictions in services. India did not undertake any commitments in services relating to distribution, education, environment, recreation, culture and sports; transport; and other services. It has made specific MFN exemptions and further reserves the right to liberalise to some WTO members in the areas of communications, recreational and transport services. Further India is a member of the 43 country Information Technology Agreement (ITA) covering computers, telecommunication equipment, semiconductors, manufacturing equipment for semiconductors, software and scientific equipment. As a part of its commitments under GATS, India adopted zero tariff on 217 information technology related tariff lines.

The significance of GATS can be understood when one observes that studies pointed out that the inefficient service sector raises the manufacturing costs substantially for the industrial sector. In case of India, it is estimated that in electrical machinery, steel and ferrous alloys, fertilizers and woollen textiles, the inefficient services are responsible for manufacturing costs being higher by 25 percent and above.

India undertook gradual liberalisation of the FDI norms in many services in light of these commitments. Since it has substantial presence in the software sector, it needs to undertake some reciprocal liberalisation.

However, it is pointed out that India opted for its short-term interests at the Hong Kong Ministerial and thus gained at the cost of its leadership of the Third World Countries.

The US stand on H1B visas also is a case of inability to bargain for the advantage of the country. In many cases, India failed to ascertain its advantages and adopted a rather cautious stand on the liberalisation of services.

Check Your Progress:

1. What do you understand by GATS?

7.4.3.4 AOA:

This provides a frame work for the long term reform of agricultural trade and domestic policies over the years to come, with the objective of introducing increased market orientation in agricultural trade. It provides for commitments in the area of market access, domestic support and export competition. The members have to transform their non-tariff barriers like quotas into equivalent tariff measures. The tariffs resulting form this transformation, as well as other tariffs on agricultural products, are to be reduced on an average by 36 percent in the case of developed countries and 24 percent in the case of developing countries. The least developed countries were not required to make any commitment for reduction.

7.5 SUMMARY

WTO was set up in 1995 with the aim of removing restrictions or barrier from international trade. It is designed to play the role of a watchdog in the sphere of trade in goods, trade in service, foreign investment, intellectual property rights, etc. The government of India has made commitments to WTO in the following fields (i) tariff lines (ii) quantitative restrictions (iii) TRIPS (iv) TRIMS and (v) General Agreements on Trade in services (GATS). The benefits that India might derive from WTO are (i) when world trade expands, India‘s trade will also increase (ii) Phasing out of Multiple Fabric Agreement by 2005 will benefit India as the export of textiles and clothing will increases (iii) Prospects for agricultural exports will increase (iv) Multilateral rules and disciplines will create a more favourable environment for trade. At the same time India will have to make some homework at domestic level to reap the benefits of these arrangements, such as developments of infrastructure, making exports more competitive improve labour laws check environmental degradation etc.

7.6 QUESTIONS

1. Discuss the objectives and functions of WTO.
2. Bring out the impact of WTO on Indian Economy.
3. Explain the WTO Agreements with respect is the following:

(a) TRIPs (b) TRIMs (c) GATS

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8

ECONOMIC INTEGRATION

Unit Structure

8.0 OBJECTIVES

- To know the meaning, objectives and forms of economic integration.
- To know about the ASEAN, EU, NAFTA and SAARC.
- To understand the concepts Cartels & Trade Blocs.

8.1 INTRODUCTION

To know economic integration it is desirable to know economic liberalization. Economic liberalization is a process whereby structural reforms are initiated in the economy. Economic liberalization involves the following major changes:-

i) Changes in the outlook

ii) Technological up gradation

iii) Changes in trade, fiscal, monetary, price and industrial policies

iv) Opening the economy for foreign investment

v) Delicensing and enhancing export incentives.

Economic liberalization attempts to remove restrictions and make an economy global in its approach. Economic liberalization and globalization go hand in hand. Economic liberalization facilitates global integration of open economies.

After Second World War, countries of the world followed the policy of protection so as to rehabilitate the war shattered economies. But it led to adoption of a retaliatory policy on the part of other countries of the world. It is called as the policy of tit for tat which led to the lowering down of the volume of trade, lowering down of competitiveness, efficiency, income and employment. Hence all these things triggered off the wave for speedy liberalization by reducing tariff barriers. It paved the way for economic integration among the countries of the region and also among the countries of the world. When economic integration takes place among the regional economic integration. On the other hand when economic integration takes place among the countries of the world it gets referred to as multilateral economic integration. E.U, NAFTA, ASEAN, OPEC, SAARC are some of the glaring examples of regional economic examples while GATT which later on got merged into WTO are the glaring examples of multilateral economic integration. A very important point to be noted in connection with economic integration is that economic integration entails some extent of political integration too if not full political integration.

Concept:

The Term economic integration has been interpreted in different ways. Some authors even include social and political integration in economic integration.

As per some authors the mere existence of trade relations between two or more independent national economies signifies economic integration.

As per some authors economic integration is a type of an arrangement which leads to removal of artificial trade barriers for example tariffs between two or more independent economies.

Economic integration is a general term which covers several kinds of arrangements by means of which two or more independent economies agree to come closer economically. By economically integrating themselves in the form of a union they would like to discriminate against goods produced by countries of the rest of the world lying outside the economic union.

As per Timbergen ―economic integration is the creation of most desirable structure of international economy removing artificial barriers to the optimum operation and introducing deliberately all desirable elements of coordination or unification.

While defining the term economic integration he draws a distinction between two types of economic integration viz. positive and negative economic integration. Positive economic integration refers to bring about reforms in the existing institutional arrangement, checking out the neo policy to correct the market imperfections. On the other hand the negative economic integration refers to removal of artificial barriers like tariffs on the movement of goods among the member countries of the group.

Mr. Balasa defines economic integration as, —a process and as a state of affairs. As a process it encompasses measures designed to abolish discrimination between economic units belonging to different national states; viewed as a state of affairs, it can be represented by the absence of various forms of discrimination between national economies.

While interpreting the term —economic integration he draws a distinction between economic integration and economic co-operation. The nature of the difference is both quantitative and qualitative. Co-operation entails action leading to lessen the severity of discrimination while economic integration is a process which leads to adoption of measures which can be used for the suppression of some form of discrimination. For example G.A.T.T. or W.T.O. are the examples of cooperation. It is an agreement between the member countries of the world about the trade policies to be pursued in order to intensity the volume of trade among the member countries of the world while removal of trade barriers the tariffs and other non-tariff barrier is an example of economic integration.

The integration of economies resulted in the formation of various group of nations for mutual cooperation in trade and service areas. They are termed as “Trade Blocs”. Number of trade blocs have been formed worldwide region- wise. In this chapter we are concentrating on the evaluation and functions of few blocs like NAFTA, EU, OPEC and SAARC. The large scale and production is the outcome of such blocs and it is the step towards good cooperation among the neighbouring countries.

8.2 OBJECTIVES OF ECONOMIC INTEGRATION

Economic integration or grouping are the formation of groups of friendly nations for mutual benefits. Countries of specific region form their group to enjoy common advantage of trade among themselves. Such integration is known as **Trading Blocs**. Such grouping of nations started after the second world war. Number of such blocs are active today at global level. Both positive and negative advantages have been observed of such blocs. One side they have increased trade and other side they also have created imbalance in the world economy. It is because they have common objectives for the member nations and for the non-members they have discriminating restrictions. Some the important economic groupings or trade blocs are **EU, LAFTA, NAFTA, SAARC, ASEAN, OPEC, APEC etc.**

Objectives:

1. To eliminate or reduce trade barriers among the member countries of the bloc to encourage free trade.

2. To promote growth and development of the all the members being from the same region with mutual cooperation.

3. To provide assistance to each other in case of emergencies or any other socio-economic problems occurred.

4. To bargain collectively with the non-members with unity against the trade barriers and.

5. To make factor of production mobile within the group so that labour, capital , and technology can be transferred easily within the member countries.

6. To strengthen economic, social, political and cultural relations among the members.

7. To make bloc strong and known through collective efforts including mass production, large marketing of goods and free movement of capital and labour.

8.3 FORMS OF ECONOMIC INTEGRATION

There are as many as five major types or forms of economic integration which are as follows:-

i) A group of countries making preferential Trading Agreements.

ii) F.T.A i.e. Free Trade Area.

iii) C. U. i.e. Customs Union.

iv) C. M. i.e. Common Market

v) E. U. i.e. Economic Union

i) A group of countries making Preferential Trading agreements:

In this type of economic integration a group of countries come together and make tentative or temporary preferential trading agreements among themselves to give preferential treatment to each other‘s goods. This is a loose type of economic integration because this type of integration remains temporary. The member countries of this group reduce tariffs on imports of goods from each other while there is no change in the original tariff policy followed by each member country of the group trading with rest of the countries of the world which are not the members of the group. For example common-wealth Preferential System of 1932. Great Britain and the member countries of commonwealth established among themselves a system of trade which was referred to as commonwealth Preference System. As per this system the commonwealth countries reduced tariffs among themselves but allowed their high tariff rates to continue on the imports from rest of the world countries.

ii) F.T.A. i.e. Free Trade Area:

As per the title a group of countries forming a free trade area bring about a free trade between them by removing all the trading restrictions. They completely remove all tariffs on imports of goods from the member countries. However, each member country of the free trade area retains its autonomy in levying tariffs on the imports from non member countries of the world. The European Free Trade Area (EFTA) is a burning example of Free Trade Area.

iii) C. U. i.e. Customs Union:

A customs Union is a free trade area plus a common policy of tariffs adopted by the member countries in dealing with the imports from the non member countries of the world. A burning example of customs union is E. C. ie the European Community. It was formed in 1958 by signing the treaty of Rome in 1957. By July 1, 1958 a customs union was established among the original six members of the European Economic Community viz Belgium, France, Federal Republic of Germany, Italy, Luxembourg and Netherlands.

iv) Common Market:

A common market is a step higher than the customs union. A common market is a customs union plus free movement of factors of production viz labor and capital within the common market area or region. A common market retains the two common character features of a customs union viz. i) free trade among member countries by removing tariffs internally and ii) the member countries follow the common tariff policy in dealing with non member countries of the world.

A glaring example of common market is European Economic Community which is also called as European Common Market which was established in Jan. 1958 by signing the treaty of Rome in 1957. It had original six members viz Belgium, France, Federal Republic of Germany, Italy, Luxembourg and Netherlands.

The treaty of Rome required every member to.

i) Eliminate tariffs, quotas and other barriers on intra-community trade.

ii) Devise a common internal tariff on their imports from countries belonging to rest of the world.

iii) Allow free movement of factors of production within the EEC.

iv) Harmonies their taxation and monetary policies and social security policies and

v) Adopt a common policy on agriculture, transport and competition in industry.

The EEC was expanded in 1973 with the inclusion of United Kingdom, Denmark and Ireland. Greece joined the EEC in 1981. Spain and Portugal joined the EEC on 1st January 1986. Austria, Finland and Sweden joined the EEC afterwards and as such the membership of EEC became 15.

The common market is an advanced stage of customs union. It provides a free market for goods belonging to all the member countries. It facilitates the mobility of factors of production among the members of the community. It means factors of production viz labour, capital and enterprise can switch on to any member country to EEC which they can find most profitable due to which efficiency and productivity increase.

v) E. U i.e. Economic Union:

The Economic Union is still an advanced stage of economic integration. The Economic Union is a common market plus harmonization of national economic policies viz monetary and fiscal policies.

An economic union can be defined as an economic integration which leads to monetary union. The member of the economic union chalk out common rules embodying things like taxation, economic legislation foreign trade, agriculture, transport balance of payments, fiscal and monetary policies, social and economic welfare etc.

The glaring example of economic union is E. U. ie European Union viz Benelux ie Belgium, Netherlands and Luxembourg.

vi) ECM or EEC i.e. European common market or European Economic Community:

An economic union is a case of absolute economic integration. It means it is a complete economic integration of group of countries.

Check Your Progress:

1. What do you understand by Economic Integration?

2. Give the reasons of popularity of Economic Integration.

3. What are the different types of Economic Integration?

8.4 CARTELS

An international cartel is formed by producers in the same line of production in two or more countries, agreeing to regulate production and sales for monopolistic ends. Haberler defines international cartels more precisely as "A union of producers in a given branch of industry, of as many countries as possible, into an organisation to exercise a single planned control over production and price and possibly to divide markets between the different producing countries."

Concept of Cartel:

Business Agreement whether formal or informal that serve to limit or suppress competition are referred to as cartel. Cartels originally developed to suppress competitions from abroad.

Formal or informal agreements among business enterprises engaged in the same trade but located in different countries to limit competition to regulate markets and restrict trade are known as international cartels.

Thus international cartels are a sort of monopoly combines to eliminate competition in the foreign markets. Cartel members usually form an organised association through explicit agreements which would ensure them higher profits than would be possible otherwise.

Conditions conducive to International Cartels:

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

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

Indeed, the scope of cartels is wide enough covering metals and minerals, and manufactured goods like chemicals, dyestuffs, pharmaceutical products and electrical goods. The main inducing factor behind the formation of cartels is the fear of cut-throat competition and desire for monopoly control. Further, when productive capacity is found to exceed current demand, international cartels have been formed as an attempt to share a diminished market. Professor Krause points out the following important objects of cartels:

1) To achieve control over prices Cartels resort to price-fixing above .competition price and reap high monopoly profits.

2) To impair the quality of product. When cartels are formed, buyers will have no safeguards against low quality, since hardly an opportunity is made available to the buyers to choose between different varieties.

3) To make allocation of trade territories and thereby to acquire and maintain a monopolistic position by each cartel member in their respective allocatedmarkets.

4) To restrict supply, assigning quotas to each cartel member.

5) To deliberately retard technological change until the existing plants and productive facilities have been fully depreciated.

Merits of cartels:

1) Due to business combines, large-scale output is made possible, so goods may be sold at cheaper rates through cartels.

2) Cartels tend to eliminate wasteful competition also.

3) Cartels can solve the problem of excess capacity.

Drawbacks of cartels:

1) They tend to reduce international trade on account of restricted output and high price policy.

2) International cartels may also mean under-utilization of the world‘s resources and manpower, in view of lack of competition and the system of production quotas followed by the cartel members.

Since international cartels are not governed by impartial international machinery in favor of the consumer‘s interest in general, it is utmost desirable that cartels must be prevented by all means. For breaking up the cartels, it is necessary to adopt unilateral action through anti-thrust measures by a country, coordinated with such international actions.

8.5 TRADE BLOCS

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

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

(i) E. U. i.e. ECONOMIC UNION

(ii) NAFTA i.e. NORTH AMERICAN FREE TRADE AGREEMENT

(iii) APEC i.e. ASIA-PACIFIC ECONOMIC CO-OPERATION

(iv) ASEAN i.e. ASSOCIATION OF SOUTH EAST ASIAN NATIONS

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

8.6 ASEAN

ASEAN stands for Association of South East Asian Nations. The origin of ASEAN goes back to ASA. ASA stands for Association of Southeast Asia. It was proposed by Mr. Tunku Abdul Rahman, the Prime Minister of Malaya in 1959. The member countries of ASA fought among themselves due to political and territorial disputes as a result of which ASA couldn‘t last long. On 8th August 1967 a declaration was signed by Five south East Asian countries viz. Indonesia, Malaysia, Philippines, Singapore, Thailand as per which the Association of South East Asian Nations (ASEAN) was formed to accelerate the economic growth of the member countries with the spirit of equality and partnership. Brunei and Vietnam joined ASEAN in 1984 and 1995 respectively. Burma and Laos joined ASEAN in 1997. United States of America supported the establishment of ASEAN. The establishment of ASEAN shows a move towards globalization.

ASEAN nations area of land and the population are larger than European union comprising of 15 nations. The outstanding feature of the economic growth strategy of ASEAN is FDI i.e. Foreign Direct Investment. Foreign trade in the life blood of ASEAN. The economic prosperity and the economic integration of ASEAN depend upon two important factors viz. controlling inflation and sustained high growth rate. As regards natural resources ASEAN is a treasure island. The aim of ASEAN is to become a Free Trade Area by reducing tariffs among the ASEAN. Inspite of tremendous political, economic and cultural diversity the ASEAN countries are becoming integrated.

8.7 EUROPEAN UNION (EU)

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

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

E.C. which stands for European Community

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

The immediate objective behind the establishment of EEC was to set up a custom union. A custom union is one which removes the tariff barriers within the regional trading block and follows a common tariff policy in trading with the non-member countries. Later on the custom union was transformed into a common market in which not only goods and services but also factors of production like labour, capital, enterprise are free to move within the regional trading block. Later on the EEC as a common Market got transformed into economic Union which led to harmonization of laws, social policy, economic, monetary, fiscal policies, international trade policies etc.

The following are the provisions of the treaty of Rome:

Article 2

i) The community shall have a common market

ii) A harmonious development of economic activities within the region.

iii) Balanced expansion of the region increase in stability, increase in the standard of living of the people of the region and the closer relationship between the countries belonging to the region.

Article 3

i) Elimination of custom duties and qualitative restrictions on the import and export of goods

ii) The establishment of common commercial policy towards other countries (non member countries)

iii) The abolition of all obstacles to freedom of movement for persons, services and capital.

iv) The adoption of common policy of Agriculture.

v) The adoption of common policy of transportation.

vi) To ensure that competition in the common market is not distorted.

vii) To coordinate the economic policies of the members of the region and disequilibrium in the balance of payments should be corrected.

viii) The laws of the member countries of the region should be adjusted as required for the proper functioning of the Common Market.

ix) Improvement in employment opportunities and raising of the standard of living.

x) The establishment of European Investment Bank to facilitate the economic expansion of the EEC through creation of fresh resources.

xi) To promote economic and social development of the member countries of EEC.

The membership of the EEC is open to all the European countries. It rose from the original Six to Nine in 1973 when Denmark, Ireland and United Kingdom joined the community. In 1981 the membership of EEC rose to ten when Greece joined the community. Portugal and Spain joined the community in 1986 and the membership of the EEC rose to twelve. In 1995 three more countries viz. Austria, Sweden and Finland joined the EEC and thus the total membership of the community rose to fifteen.

In 1992 a Treaty of Maastricht was signed which strengthen the process of integration by creating a common currency w. e. f. Jan. 1999. It led to making the price system and the exchange rate system more stabilized.

The Economic Union has built up an institutional system which is unique in the world. Following are some of the most important institutions:-

i) The Council of European Union:

It is a main decision making body of The Economic Union. It is a cluster of ministers from each member country of the union.

ii) European Parliament:

It is a cluster of elected members from each member country. It supervises the European Commission. It also shares the legislature and budgetary powers with the council of the E.U.

iii) European Commission:

It is a conglomeration of the commissioners nominated by the member countries of the E.U. It is the main administrative body of E.U. which is responsible for day to day administration of E.U.

iv) Court of Justice:

It is the highest legal authority of E. U. Each country nominates one judge to the court of Justice of E.U.

v) European Central Bank:

It is a central monetary authority of E. U. It issues Euro notes and coins. It is a foreign exchange authority of E.U.

vi) Court of Auditors:

It‘s main function as a court of Auditors is to cheque EU‘s revenue and expenditure.

vii) Economic and Social Committee:

It is an authority on economic and social policy of E.U.

viii) European Committee of Regions:

The portfolio of this committee is to maintain the rules, regulations and identities to the respective regions. It is composed of representatives from all the states of the region.

ix) European Investment Bank:

It is the financial Institution of E.U.

x) European Ombudsman:

It is an official appointed by E.U. to investigate people‘s complaints against public organizations.

The European Union is not against globalization. It‘s exports and investments are of very high order. The European Union contributes 1/4th of the total worlds exports which accounts for about 15% of its GDP. As much as 40% of the foreign direct investment (FDI) of the developed countries goes to the European Union

8.8 NAFTA

NAFTA stands for NORTH AMERICAN FREE TRADE AGREEMENT. NAFTA is an extension of CUSTA i.e. the Canada United states Trade Agreement. Though United States of America supported the move to form the regional trading groups like EEC but it was suspicious about its working. Therefore in 1965 the united states of America and Canada entered into bilateral trade agreement to eliminate tariffs on automobiles and auto-parts. In 1985 both the countries decided to integrate their economies generally by reducing trade barriers like tariffs gradually over a period of ten years. In 1989, USA and Canada formed a Free Trade Area and hence along with goods trade in services among them was also liberalized. It was also decided that other internal problems like subsidies, dumping and other trade policy should be settled peacefully and friendly. However they couldn‘t set up customs union as it was difficult to have a common tariff policy with rest of the world countries or with non member countries. Canada joined hands with America in forming Free Trade Union because it faced with the disadvantageous situation due to following of the policy of protection on the part of U.S.A. The United States of America also wanted to see that Mexico also should join the agreement and ultimately in December 1992, the three countries signed the agreement leading to the formation of the North American Free Trade Agreement (NAFTA). The operation of NAFTA commenced from January 1994.

As per the provision of NAFTA all tariffs and quotas on manufactured and agricultural goods are to be eliminated within 5 to 15 years. It is called as a transitional period. Restrictions on direct foreign investment (DFI) between the NAFTA members will be lifted. The Intellectual Property Rights (IPRs) are to be protected in the member countries i.e. in the NAFTA viz. U.S.A. Canada and Mexico. It is expected that Chile and other Latin American countries may join NAFTA in future. It was decided that trade in financial services will be liberalized by 2000.

Check Your Progress:

1. What do you mean by Regional trade blocks?

2. Explain the working of European Union.

3. What do you understand by NAFTA?

8.9 SOUTH ASIAN ASSOCIATION FOR REGIONAL CO-OPERATION (SAARC)

The abbreviation, SAARC stands for The South Asian Association for Regional cooperation. The move to have an economic regional block among south Asian countries started taking shape from 1980. The first summit of seven south Asian countries viz. India, Pakistan, Bangladesh, Nepal, Shri Lanka, Bhutan and Maldives took place at Dhaka in December 1985 and the SAARC came into existence. The idea behind the formation of SAARC was to have fearless tensionless progress and prosperity in the South Asian Association for Regional cooperation regional group countries. The SAARC emerged out of the problems faced by South Asian countries. The SAARC has got over 1/5th of world‘s population. It has only 3.3% of world‘s total land area. It has a major share of total world‘s poor population. These countries can be branded as a low per capital income countries. India is the largest SAARC country having 2/3rd of SAARC population while Maldives is the smallest island having population of only 3 lakhs.

Following are some of the most pressing problems faced by SAARC countries:

i) The very first problem faced by the SAARC countries is the Border dispute problem, political problem and the religious problem.

ii) The economies of all the seven member countries of SAARC are more or less similar. Dissimilar economies call for economic integration.

iii) Neglect of intra-regional trade. Their exports are channelised towards hard currency area.

iv) Most of the SAARC member countries are exporting almost the same types of products. For example India and Shri Lanka export tea.

v) The economic strength of the member countries of SAARC is different so is the case with economic development. Hence benefits accrue more to the relative economically stronger countries than the relative economically poor countries was the feeling developed amongst the SAARC countries.

vi) The main hurdle in the way of intra-regional trade is the scarcity of foreign exchange.

vii) These countries also face number of inadequacies like transportation, communication etc.

The main objectives of SAARC:

Following are the main objectives of SAARC as per Article 1 (One) of the charter of

SAARC:-

i) To promote the welfare of the people of South Asia and to improve their standard of life.

ii) To accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realize their full potentials.

iii) To promote and strengthen collective self-reliance among the member countries of SAARC.

iv) To contribute to mutual trust, understanding and appreciation of each others problems.

v) To promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields.

vi) To strengthen cooperation among themselves on matters of common interest.

vii) To strengthen cooperation among other developing countries.

viii) To co-operate with international and regional organizations with similar aims and purposes.

Principles:

Following are the principles laid down as per Article II of the charter of the SAARC:-

i) Co-operation within the framework of the Association shall be based on respect for the principles of sovereign equality, territorial integrity, political independence, non-interference in the internal affairs of other countries and mutual benefit.

ii) Such co-operation shall not be a substitute for bilateral and multilateral co-operation but shall be complementary.

iii) Such cooperation shall not be inconsistent with bilateral and multilateral obligations.

The SAARC countries started with cooperation in non-economic areas like sports, arts, culture etc. Later on they switched over to the following area: Agriculture, Rural development, Telecommunication, Science of technology, Health Transport, Post etc.

In 1991 6th SAARC Summit was held at Colombo in which the idea of Preferential Trading Arrangement popularly known as SAPTA was piloted. On 11th April, 1993 7th SAAR Summit was held at Dhaka. The basic principles of are as follows:-

i) Overall mutual advantages.

ii) Step by step extension of preferential trade arrangements.

iii) Inclusion of all types of products – raw, semi finished and finished

iv) Special and favorable treatment to LDCs ie Less Developed Countries.

The SAARC Preferential Trading Arrangement (SAPTA) is to play a very important role in stepping up the intra-regional trade. All the SAARC countries have been implementing the proposal of reduction in tariffs and they have also undertaken economic policy reforms.

SAARC Preferential Trading Agreement (SAPTA):

SAPTA came into operation from December 7, 1995. It heralds a new chapter of economic co-operation among the original seven member countries of SAARC-India, Pakistan, Bangladesh, Sri Lanka, Nepal, Bhutan and Maldives, Afghanistan became its eighth member in early 2007. It also concretise the first step towards creation of a trade bloc in the South Asian Region.

Under the SAPTA mechanism, the SAARC countries have identified 226 items for exchange on tariff concessions ranging from 10 per cent to 100 per cent. India has agreed to extend tariff concessions on 106 items, while Bangladesh has agreed to offer tariff concession on 12 items, Maldives on 17, Nepal 14, Pakistan 35, Sri Lanka 31 and Bhutan 11. Out of 106 items offered by India for tariff concessions, 62 items would be for the least developed countries in the SAARC.

SAPTA to SAFTA: SAPTA has paved way for the setting up of the South Asia Free Trade Area(SAFTA), which came into force from July 1, 2006. The developing countries have been given a span of seven years, and the least developed countries have been provided a span of ten years for its full implementation.

The South Asian developed countries are well endowed with labour and natural resources. Growing openness among themselves would lead to higher production and expansion of labour-intensive exports, thus increasing employment, increased wages and thereby helping in reducing poverty .

Role of India:

India plays a dominant role in SAARC because of its commanding position in SAARC. Demographically India is the most popular country among the SAARC countries. It possess the largest land area and economically also it commands relatively a better position. Though India itself suffers from several problems still there is a scope for India to play its dominant role in SAARC from both the sides ie from the side of rendering helping hand to member countries of SAARC to tide over their problems and from the side of demanding help from the member countries of SAARC in terms of piloting the scheme of joint ventures specially in the fields of Co-operation, Agriculture, industry, energy, transport, tourism, business, communication, widening of markets etc. The second SAARC summit was held in India at Bangalore in 1986.

8.10 SUMMARY

- Economic integration means group of nations from the similar regions agreed for mutual trade and development.
- It is also known as Trading Blocs
- It is advantageous for the growth and development of all member nations agreed with each other on many issues.
- Economic integration among the world economies varies in degree. They are FTA, CU,CM and ECU.

- Only EU has been successful in achieving highest degree of economic forms or types.
- NAFTA is expected to eliminate all tariffs Non-Barriers among USA, Canada and Mexico. It is the leading bloc and has large dealings and contribution in world trade.
- European Union has been the most successful bloc. It has maximum members dealing in free trade. It has its own common currency being used by all the members for promoting quick and fast trade.
- SAARC is the developing bloc. Its members are all the developing nations and it is the world's consuming bloc having maximum population. It is the poorest bloc having number of socio-economic turmoil's.
- SAPTA has been trying to assist the poorest nations of SAARC for trade development.
- ASEAN countries have close cohesiveness, share their economic and human resources and achieve synergy in the development of agricultural sector, industrial sector and service sector.

8.11 QUESTIONS

1. What is Economic Integration and what are its objectives?
2. Explain the forms/ Types/ Degrees of Economic Integration?
3. Write a note on –

a) Cartels

b) Trade Blocs

c) ASEAN

d) European Union (EU)

e) NAFTA

f) SAARC

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Question Paper Pattern (For IDOL Students Only)
TYBA SEM VI (Economics) – for all Six papers

Time: Three Hours **Total Marks: 100 Marks**

Please Check whether you have got the right question paper.

N.B. 1) All questions are compulsory. Attempt Sub question (A) or (B) of Question no. 5
2) Figures to the right indicate marks.
3) Draw neat diagrams wherever necessary.

Q1. Answer any TWO questions of the following. **20**
Mar

a.
b.
c.

Q2. Answer any TWO questions of the following. **20**

a.
b.
c.

Q3. Answer any TWO questions of the following. **20**

a.
b.
c.

Q4. Answer any TWO questions of the following. **20**

a.
b.
c.

Q5. (A) Write short notes on any TWO of the following. **20**

a.
b.
c.
d.

OR

(B) Multiple choice questions, select an appropriate option (20 MCQs) **20**