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Lesson No.

2.1 : International Capital Movements
2.2 : Multinational Corporations
2.3 : The Transfer Problem and Foreign Aid
2.7 : International Liquidity

NOTE:

2.4 : International Monetary System
Bretton Woods System and Its Breakdown)
2.5 : International Monetary Fund (IMF)
2.6 : International Bank for Reconstruction and Development (IBRD), ADB, IFC and IDA

(For Chapter 2.4,2.5,2.6 students can read chapter no 10,11,12 & 13 of Section B of Money and Banking)

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International Capital Movements

2.1.1 Introduction

In the adjustment of BOP disequilibrium, the international capital movements, or flows have a vital importance. The transfer of capital resources from the developed to the developing countries can make a qualitative change in the structure of the economies of the latter while at the same time providing profitable outlets for the surplus financial resources of the former. In the adjustment of BOP disequilibrium, the international capital movements, or flows have
a vital importance.

The international trade and the movements of productive resources such as labour, capital and technology, are substitutes for *one* another. A relatively capital-abundant country, like the United State scan export either capital-intensive commodities or export capital itself. The conditions of capital-scarce countries require them to either import capital-intensive goods or procure the desired flow of capital from abroad. It is necessary to distinguish the international capital movements from the payments for imports. The capital movements may either be meant for financing the deficits in the BOP or for bringing about a net increase in productive capacity in the economy. In the latter situation, the international capital movements can be treated as a factor of production. If the sufficient inflow of capital fails to take place from abroad, the productive activity is likely to be adversely, affected. It must be recognised that only *real* capital movements are

significant from the point of view of the allocation of resources. It means the countries depending on the inflow of foreign capital to maintain and/or to raise the level of economic activity, should have capital inflow of the magnitude which can more than offset the domestic price movements.

2.1.2 Objectives of the lesson

The present chapter attempts to deal with different issues connected with the international capital flows.

2.1.3Meaning and Classification of Movements

International exchange transactions are not only confined to commodities, but include international movement of capital funds as well. International capital movements, however, should not be identified with the payments for imports. Capital flows internationally as a factor of production for the sake of suitable investments and as aids to the less developed countries. Indeed, international investment has played a significant role in the economic upliftment of many countries in the last few decades.

Classification of International Capital Movements

International capital movements may be classified as follows:

(i) Home and foreign capital;
(ii) Government and private capital;
(iii) Foreign Aids;
(iv) Short-term and long-term capital; and
(v) Foreign direct investment (FDI)

(i) Home and Foreign Capital

On the balance of payments of a country an explicit distinction is made between home capital and foreign capital. Home capital refers to investments made abroad by the residents of the countryconcerned, while foreign capital refers to the investments made by foreigners in this country. Thus, the former implies outflow of capital and the latter implies inflow of capital funds in the balance of payments account of the country under consideration. Apparently, the net investment position of the country can be known by the algebraic difference between the debits and credits of both types of capital investments.

(ii) Government and Private Capital

When in investing capital abroad, the investor (whether government or private body) keenly participates in organisational matters, it is referred to as direct investment. For instance, direct ownership and organisation of a foreign factory, mines, sales agency, *etc.,* are cases of direct investment. If, however,

the investor has only a sort of property interest in investing the capital funds in buying equities, bonds, securities or depositing with commercial banks abroad or so, it is referred to as portfolio investment. Under portfolio investment, the investor does not migrate with his capital and his basic interest remains in the earning of interest or dividends abroad or to make speculative gains in buying foreign bonds, equities and securities. While, under direct investment of capital, investor's migration is also very frequent. Usually, borrowing countries prefer portfolio investment while lending countries prefer direct investment because it entails management rights and control. Further in an inflationary situation, the real value of fixed interest earnings of portfolio investment deteriorates while money value of real property in direct investments increases.

(iii) Foreign Aids

Foreign aids refer to transfer payments which are unilateral gifts for aid. The receiving country has no obligation whatsoever, to repay the grants made by the donor country. Usually, developed countries give such aids to developing countries for their development planning. The aid may sometimes be given for military purposes also. Generally, aids are given for a specific use and it must be fulfilled by the recipient country.

(iv) Short-term and Long-term Capital

A short-term capital is embodied in a credit instrument which is redeemable within a year. For example, chequable bank deposits in a bank abroad is a short-term capital. Similarly, foreign bonds which mature within a year also constitute short-term capital. Short-term capital movements are usually speculative in nature.

Long-term capital, however, refers to such credit instruments which have a maturity period of more than one year or no maturity at all but consist a title to ownership, such as share of stock and other equities or a deed to property. Long-term capital flow is perpetual and stable over a period of time.

Foreign Investment: Foreign Investment has two dimensions:

(i) Portfolio Investment
(ii) Direct Investment

Portfolio Investment: It refers to short term and long term investment devoid of any managerial control. It refers to pure financial investment.

It implies primarily an international movement of capital. Interest Rate differentiation remain the factor in determining the flow of port folio

investment as direction or capital mobility,

(v) Foreign Direct Investment (FDI)
It refers to long-term real business investment of a firm abroad. It involves transfer of capital with the extension of a business enterprise from its home country into a foreign host country. The flow of FDI is least determined by the interest rate differentials.

Portfolio investment (PI) refers to an investment in securities without participation in the management or operations of a firm. Under the investors have no control over decision making.

Foreign direct investment is the investment combined with some degrees of ownership and management.

In comparison to FDI,PI has certain advantages such as:

- A relatively low transactions cost
- Lesser investment
- Greater probability for diversification of investment.

There are investment constraints such as:

- Unfavourable tax rates and taxation laws (which may result into double taxation, over taxation, bureaucratic red tape)
- Foreign exchange controls *(e.g.,* ban on purchase of securities by foreigners or purchase in foreign markets)
- Government regulations over the capital markets *(e.g.,* ceilings on the maximum number of securities purchased by foreign investors).

From a country's view point, there are inflows and outflows of investments. Inflow of investments means that foreigners are investing in the country. Outflow implies that the country's nationals are investing into the foreign country. Thus, outflow of FDI means the flow of FDI out of the country. Inflow of FDI obviously means the flow of FDI into the country.

The flow of FDI is observed as the amount of FDI over a period of time, usually a year.The stock of FDI is measured as the total accumulated value or foreign owned assets at a given point of time.

2.1.4. Factors Governing International Capital Movements
The following factors affect international capital movement:

1. The Rate of Interest

As Ohlinputs, the differences in the rate of interest between countries serve as the most important stimulus to export and import of capital. Capital will flow from low-return yielding country to the high-income yielding country, because a country which has a low rate of interest apparently finds it profitable to export capital to the country in which the interest rates are high.

2. Speculation

Speculation may also determine the short-term capital flow between countries. Speculation may pertain to either expected change in the interest rate or anticipation of change in the rate of exchange. When people expect rate of interest to rise at home in the future, they would like to take advantage of the consequent lower bond price then, but presently they will invest abroad in short-term securities. Thus, when a country expects a rise in interest rate in future it will experience an outflow of capital for the present. Contrarily, when a country anticipates a fall in the rate of interest in future, it pays foreigners to buy bonds and securities at their current low price and sell them later on at a high price. Eventually, it will experience an inflow of capital.[2]

Similarly, if a devaluation of a country's currency *(i.e.,* fall in its exchange rate) is expected, residents of the country will tend to hold foreign balances by converting their currency into foreign assets — bonds and securities; in the same manner, non-residents of the country also may withdraw their investments in the short-term securities of their country by selling them and taking back their capital. As such, an anticipated devaluation leads to capital flight abroad. Similarly, if revaluation, *i.e.,* a rise in the exchange rate of a country's currency, is expected the inflow of capital will get momentum.

3. Bank Rate

Since bank rate has a link with market rates of interest, the central bank can use the bank rate as means of including short-term capital flows. The raising of bank rate, thus, may stimulate an inflow of capital or prevent the flight of capital abroad.

4. Marginal Efficiency of Capital

For investing abroad entrepreneurs may compare the marginal efficiency of capital against the rate of interest between different countries and in different areas of investment. Thus, the country which has a marginal efficiency of capital will attract an inflow of capital. Likewise, a particular field of long-term investment will be chosen where the expected rate of returns

is higher than that of alternative investments abroad.

5.Political Climate
Apart from good prospects for foreign capital, if a country has political stability and internal and external peace, so that, economic and social progress is maintained, it will experience a better inflow of long-term direct investment than otherwise.

6. Government's Policy
If the government is bent upon nationalisation and expansion of public sector and adopts a hostile attitude towards foreign capital, private foreign capital will not move into such a country. On the other hand, if government adopts an encouraging policy in respect of foreign capital, it may induce inflow of foreign capital.

7. Economic Climate
Overall healthy economic position of the country, such as development of infrastructure of the economy, growth of financial institutions, availability of trained and skilled labour and other production facilities will play a significant role in attracting inflow of capital from abroad. Similarly, certain unexploited fields of exporting industries like plantations, mine's, *etc.*, also provide a good attraction to foreign investors.

8. Tariff Policy
A high protective duty may prevent foreigners' export to such country, so it will be profitable for the foreigner to start production in the protected country to compete with domestic producers. A direct foreign investment is thereby attracted.

9. Exchange Control Policy
A country resorting to severe exchange control will put au; omatic restriction on the outflow of capital abroad.

10. Business Conditions
Capital will tend to flow from a country experiencing depression into a country which is in prosperity.

2.1.5 The Role of International Capital Movements

In traditional economics, capital movements were treated merely as international balancing items in a country's balance of trade. It was held that, a creditor country having a surplus in its current account in order to balance

out its total payments account will invest or lend capital to deficit or debtor countries. Apparently, debtor countries with deficit in current account will bonow from the surplus countries in order to even out their balance of payments. Consequent upon foreign capital movements, thus, a credit in current account of a surplus country, there will be a corresponding lender position or its capital account, while to a deficit country there will be a corresponding borrower position on its capital account.

Modern economists, however, are of the view that capital movements are much more than merely balancing items. In reality, all international capital movements are not dependent upon the balance of payments deficit and surpluses. A significant portion of capital flow may also be independent of the balance of trade position which, in fact, is based on the judgements, financial decisions and discretions of lenders and borrowers in the international money markets. Where a country has a surplus in its current account, there will be an outflow of capital funds to deficit countries, hence, its holdings of short-term capital and its foreign and banking reserves will be depleted, while a deficit country will find an improvement in these holdings on account of the inflow of capital.

Again, if a country has invested its capital abroad, it receives income in the form of interest, dividends, *etc.,* which can be profitably used to finance its current deficits, which thus, help in balancing its balance of payments account.

Traditionally the capital movements were considered important as they assisted in the maintenance of BOP equilibrium. A country, having a BOP surplus will invest or lend capital abroad and thereby offset the payments surplus. On the opposite, given a BOP deficit, it could borrow capital from abroad and remove-the deficit. In other words, the capital movements had the specific role in balancing the international payments and receipts. In the context of LDC's like India, the international capital flows or *foreign aid* have much vital role to play. The international capital assistance may be in the form of private and public foreign investments, loans from foreign nationals, business and financial institutions,
central banks, governments and international economic institutions such as International Monetary Fund (IMF), International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC), International Development Association (IDA) and several other agencies. The capital transfers may also be in the form of private or inter-governmental unilateral assistance and technology transfer.

2.1.5.1 Benefits of International Capital Flows or Foreign Aid

The major benefits or advantages of capital transfer from the advanced to the LDC's are as follows:

(i) *Increase in the rates of saving and investment:* The under-development in poor country is fundamentally caused by their capital-deficiency or low rates of saving and investment. In India, for instance, the rate of saving was just about 5 percent on the eve of independence. The rate of gross investment too hoverel around the same rate. With such low rates of saving and investment, the country could not expect, given a rapidly growing population and making allowance for depreciation, to grow at a rate more than 2 to 2.5 percent per annum. Over the last four decades of planning, the rates of saving and investment could, however, be stepped upto more than 20 percent per annum and the rate of growth averaged at 3.5 percent per annum. To a largeextent the credit for it must go to the substantial flow of foreign capital since the inception ofplanning in the country.

(ii) *Technological change*: The LDC's are characterised by the technological backwardness manifested by low productivity of labour and capital due to abundance of unskilled labour and obsolete capital equipments. The technical barrier does not permit them to make the optimum use of all available and potential productive resources. The inflow of capital from advanced countries, apart from removing the capital deficiencies, brings in advanced technology and skills, organisationalexpertise and market management helps in training of domestic skills, establishment of infrastructure for scientific and technical research and creation of new varieties of products. The capital movements, thus, contribute in filling up the technological gaps in the developing countries.

(iii) *Creation of economic and social overheads*: The growth process in the LDC's remains hindered on account of the absence of economic and social overheads that include means of transport and communications, irrigation and power, educational, training and research institutions and health services. The creation of economic overheads calls for heavy investment of capital. It is generally beyond the capacity of LDC's to create the basic infra-structure. In case of India and several other developing countries, the foreign capital and technical assistance have played a key role in this sphere.

(iv) *Development of heavy and basic industries: The* industrial transformation of LDC's requires the development of heavy and basic

industries such as steel heavy electricals, machine tools, heavy engineering, od-refining, fertilisers, heavy chemicals, mining, transport and defence equipment industries. The creation of such an industrial base can greatly stimulate the future industrial expansion in these countries. But all these industries have high capital-intensity and a long gestation period It is only through a substantial inflow of foreign capital that the developing countries can hope to develop the structure of heavy and basic industries.

(v) *Undertaking of initial risk:* In the early stages of development, the investment in LDC's involves enormous risk on account of absence of infra-structure, unskilled labour and small extent of market. The indigenous investors shy away from investment and enterprise. The foreign investors or entrepreneurs, however, venture to bear unspecified risks and set up enterprises in different sectors of the economy.

(vi) *Check upon inflationary pressures:* The economies of the LDC's have a very high inflationary potential. The strong inflationary pressures in these countries result from excessive demand, rigidity in the structure of production, deficit financing and priority to projects having longer gestation period. In the conditions of severe inflationary strains, these countries can rapidly expand production of consumer goods through the import of machinery, equipments and even tum-key projects. The commodity assistance such as food grams import from the USA made by India during 1950's and 1960's under Pl. 480, too can contribute in a great measure in relieving the inflationary pressures.

(vii) *Creation of employment opportunities*: As the foreigns capital builds up infra-structure, assists in the setting up of heavy, basic and key industries, taps the sources of raw materials, opens up new markets, there is substantial expansion of employment opportunities in the developing countries. The modernisation of agriculture through the introduction of new farm machinery and chemical fertilisers with the help of foreign capital releases surplus manpower from that sector. The reduced pressure of population on agriculture brings about an increase in farm productivity. The expansion of manufacturing industry through foreign capital absorbs a large part of surplus labour displaced from agriculture.

(viii) *Removal of BOP deficit:* The LDC's are frequently faced with chronic BOP deficit In these countries, the capacity to export is limited. The exports are either almost stagnant or declining. There is secular deterioration in terms of trade due to falling international prices of primary products. These countries, at the same time, have a strong propensity to import. They have to make large scale imports of foodgrains, edible oils, industrial

raw materials, spares, capital goods, defence material etc. The foreign exchange component of development programmes is invariably large. They are obliged to make provision for debt servicing. In such conditions, they are faced with mounting BOP difficulties. A large inflow of foreign aid can take care of payments for imports and; servicing of external debts and BOP deficit can be removed.

(ix) *Beneficial for labour:* As the foreign capital causes industrial expansion, increased demand for labour ensures an increase in the real wages of the workers. The expanded production and creation of new varieties lower the product prices and effect a qualitative improvement in the standard of living of workers. As there is inflow of foreign capital and advanced techniques, there is creation of skills and scientific management which go a long way in not only ensuring better standards of production but also accelerating the entire process of growth.

(x) *Modern value system:* The flow of foreign capital and enterprise to the traditional societies of less developed countries starts infusing in them hard work, scientific temper, modernisation of outlook, greater innovativeness and increased self-reliance. These changes in value system pave the way for an uninterrupted process of growth.

It has also been maintained that unrestricted international capital movements tend to equalise the rates of interest and profits between countries. As a matter of fact, discrepancies in the rate of interest induce international flow of capital. When there are no checks on the movements, capital tends to flow from a capital-surplus nation to capital-deficit nation on account of high yields in the latter. Eventually, interest rates in the capital-exporting country will be enhanced, while in the capital-importing country it will decline. A condition of equilibrium in the international flow of capital exists when interest rates and profit yields in different countries are equalised. In practice, however," there are always some restrictions on an impediment to the free movement of capital which prevent such complete equilibrium to emerge. Moreover, apart from the rate of return on investment, many other factors such as risks involved, industrial and general economic policy of the foreign government, political relations between countries, international treaties and agreements on trade and commerce, etc., influence the investment decisions on foreign capital.

Indeed, capital movement, especially direct investment and foreign aid, plays an important role in the economic development of backward countries. External assistance is an important source of capital formation and finance resource for planning of project in a capital-deficit poor country.

2.1.5.2 Effects of International Capital Flows

Apart from the effects of international capital flows on output and welfare, there can be

(i) *Effect on employment of labour*: If it is assumed that the two factors of production-labour and capital were fully employed earlier, The investing country though, on the whole, gains from foreign investments, there is a redistribution of domestic income into labour to capital. In the host country, there is a gain from capital flows in the form of redistribution of income from capital to labour. If there is a less than full employment situation in the investing country, the transfer of capital is likely to depress the level of employment.

(ii) *Effect on balance of payments* : The international capital movements affect the BOP of both the investing and host countries. The year in which transfer of capital is made, the BOP deficit appears for the investing country. On the other hand, there is an improvement in the BOP for the host country in that year. However, the initial capital transfer and spending abroad by the investing country result in increased exports of capital goods, spares and other products. There is also subsequent flow of profits to the investing country after a lapse of five to ten years on an average. But in the long run there can also be possibility of replacement of exports and imports of the investing country. That makes the long-run effect of capital transfer for investing country as uncertain while its short-run or immediate effect is negative for it. As regards the host country, the effect of capital transfer on BOP is positive.

(iii) *Effect on taxes* : The effect of transfer of capital may arise for both investing and host countries from different rates of taxation and foreign earnings in the different countries. If the tax rate in investing country is 50 per cent and in host country is 40 percent, the firms in the former will undertake investment in the latter or reroute foreign sales through subsidiaries in order to pay lower tax rates. If the foreign earnings as repatriated by the firms of the investing country to the country of origin, the investing country will collect a tax of only 10 percent (because the most countries have the agreements to avoid double taxation). So the transfer of capital can cause a shrinkage of tax base and decline in the amount of tax collected. There is an expansion of tax base arid rise in tax collection, on the opposite, in the host country.

(iv) *Effect on terms of trade* : The capital transfer can affect the terms of trade through effects on output and the volume of trade. There is likelihood of terms of trade turning in favourof the investing country and

against the host country.

(v) *Effect on technological lead:* Prior to the international capital transfer, the technological gap between the investing and the host countries might be quite wide. But the transfer of technical knowhow brings about a narrowing down of the technological lead that the investing countries earlier had over the host countries.

(vi) *Effect on host country's control over the economy: The* large scale capital transfers and expansion in the activities of the host countries usually place some constraints on their ability to/Conduct and control their own economic policies.

2.1.6 Conclusion

Traditionally the capital movements were considered important as they assisted in the maintenance of BOP equilibrium. A country, having a BOP surplus will invest or lend capital abroad and thereby offset the payments surplus. On the opposite, given a BOP deficit, it could borrow capital from abroad and remove-the deficit. In other words, the capital movements had the specific role in balancing the international payments and receipts. In the context of LDC's like India, the international capital flows or *foreign aid* have much vital role to play. The international capital assistance may be in the form of private and public foreign investments, loans from foreign nationals, business and financial institutions. To sum up the foreign capital makes an immense contribution in the development process in the poor countries. It helps in the modernisation of agriculture, exploration and optimum utilisation of productive resources, in the creation of basic infrastructure, industralisation, in the expansion of markets, in overtaking risk of pioneering, in maximisation of employment, in moderating inflationary pressures, in the removal of BOP deficit, in technological development and in the creation of new skills, talents and modern outlook. The foreign assistance is, therefore, capable of complete transformation of the socio-economic structure in the developing countries.

9.7Short answer type Questions

1. Explain the meaning of international capital movements.
2. What are the classifications of international capital movements?
3. Make a distinction between short-term and long-term capital flows.
4. Distinguish between foreign direct investment and portfolio investment.
5. What are the benefits of international capital movements?

2.1.8 Long answer type Questions

1. What is meant by international capital movements? What are their classifications?
2. Explain the meaning of international capital flows. Distinguish between short-term and long-term capital flows.
3. What are the factors that influence international capital movements?
4. Discuss the role of international capital flows (or aid) in the LDC's.
5. Analyse the effects of international capital flows upon the investing and host countries.

2.1.9 Selected Readings

1. Kindelberger, C.P.: *International Economics*
2. Todaro, M.P.: *Economic Development in the Third World*
3. Grubel, H.G. : *international Economics*
4. Sodersten, B. : *International Economics*
5. Friedrich, K. : *International Economics*
6. Snider, D.A. : *Introduction to International Economics*
7. Salvatore, D. : International Economics

LESSON NO. 2.2 Author: Dr. Manisha

Multinational Corporations

2.2.1 Introduction

An important development in the post-war period is that of the spread of multinational corporations, (MNCs) as the vehicle of foreign direct investments. These are also called as Transnational Corporations (TNC's). MNC is one that acts as an organisation, maximising one overall objective for all its units and one which has the whole world (or parts of it) as its area of operation. Its subsidiaries or branches spread over in different countries with single headquarter in the country of origin to co-ordinate the activities of all its branches. The genesis of MNCs lies in transnational trading in early days conducted by the Greek, Phoenician and Mesopotamian merchants. After the fall of the Roman Empire, trade between nations become difficult. When Europe and the Middle East steeped in feudalism resulting in wars between feudal lords and church prohibited trade with Muslim States. Later on, merchants/traders of Italy established trade who were considered the fore runners of the multinational firms. The cities of Genoa, Venice, Florence and Pica became the supply depots of traders. Active transnational operations flourished with the development of banks and money lending agencies.

Multinationals in the form of trading companies started in the seventeenth

and eighteenth centuries. The Hudson Bay Company, the East India Company, the French Levant Company were the major transnational companies established in those days.

During the nineteenth century, huge foreign investment flowed from the Western Europe to the underdeveloped countries or Asia, Africa and America. England was the leading exporter of capital, followed by France, the Netherlands and Germany.

The chief characteristics of multinational corporations (MNC's) are they operate on a large scale having assets or sales in billions of dollars. *They* operate internationally through a central office in the country of origin. *They* have an oligopolistic structure and deal in differentiated products. They try to bring about a collective transfer of resources like machinery, equipments, technological know-how, materials, finance and managerial services.

During the last few decades, MNC's have assumed a dominant position in international production, trade, investment and technologjcal transfer.

2.2.2 Objectives of the lesson

In this lesson we will study about MNCs, features of MNCs, role of MNCs, benefits and adverse effects of MNCs.

2.2.3 Meaning and definitions of MNCs

In fact, the rise of MNCs has beers the most remarkable phenomenon of the post-war era. The MNCs are the product of industrial evaluation, advancement of technology and speedy growth of transport and telecommunication system the world over during the post-war period.

Meaning of Multinational Corporations

MNCs refer to enterprises which own/control production activities outside their base/ home country.

MNCs are usually superior/better than to their more local rivals at creating, collecting and cross-fertilising knowledge.

MNCs usually possess:

- A larger pool of management talent
- A wider range of skills
- A better understanding of consumer behaviours/market trends
- Technological requirements and competitors more
- A greater perspective of overall business environment and emerging

dynamic changes

Definitions of MNCs

The term "multinational corporation" is variedly defined. In a broad sense, multinational corporations refers to a corporate giant business firm having extended its productive activity in many nations besides its home country. David E. Liliental. Considering a wider parameter, defines the MNCs as "corporations which have their hor.ie in one country but operate and live under the laws and customs of other countries as well." For brevity, MNC refers to the business enterprise operating in more than one nation.

In a report of the International Labour Organisation (ILO), it is observed that, "the essential of the MNC lies in the fact that its managerial headquarters are located in one country (home country), while the enterprise carries out operations in a number of the other countries (host countries)."

It follows that even the firms participating in foreign trade or international economic relations simply by exporting or by licensing technology are not regarded as MNCs. To qualify to be a MNC, the firm must carry on production activity by its actual investment in several countries.

In India, the Foreign Exchange Regulation Act, 1973 (FERA) provides a specific definition of multinational corporation as follows:

"A corporation incorporated in a foreign country or territory shall be deemed to be multinational corporation if such corporation' (a) is a subsidiary or a branch or has place of business in two or more countries or territories, (b) carries on business or otherwise operations in two or more countries or territories."

A "multinational corporation" is also referred to as an international, transactional or global corporation. Actually, for an enlarging business firm, multinational is a beginning step, as it gradually becomes transnational and then turns into a global corporation. For, transnational corporation represents a stage wherein, the ownership and control of the concerned organisation crosses the national boundaries. The transnational corporation develops into a global corporator: when it has capacity to allocate production across countries and the company can equalise the cost of capital across the nations to an extent. A global corporation aims at market maximisation arid profit-maximisation rather than welfare maximisation.

2.2.4 Features of MNCs

The following are the main features of MNCs:

1. MNCs have managerial headquarters in home countries, while they carry out operations in a number of other (host) countries.
2. A large part of capital assets of the parent company is owned by the citizens of the company's home country.
3. The absolute majority of the members of the Board of Directors are citizens of the home country.
4. Decisions on new investment and the local objectives are taken by die parent company.
5. MNCs are predominantly large-sized and exercise a great degree of economic dominance.
6. MNCs control production activity with large foreign direct investment in more than one developed and developing countries.
7. MNCs are oligopolistic in character. It is sustained by modern technologies, management skill, product differentiation and enormous advertising.
8. MNCs are not just participants in export trade without foreign investments.

2.2.5 Classifications of MNCs

MNCs can be classified on the basis of several criteria, such as function, control, investment,origin, turnover, products, etc.

On the basis of functional criterion, the MNCs are broadly grouped into:

1. Service MNCs;

A service MNCs is defined as a transnational company which derives more than 50 per cent of its revenues from services, Service MNCs are found in areas such as banking, insurance, finance, transport, tourism, etc.

2. Manufacturing MNCs:

A manufacturing MNCs is one which derives at least 50 per cent of its revenue from manufacturing activity. A large number of MNCs has entered into the manufacturing sector. Out of the top 200 MNCs, 118 firms are manufacturing MNCs. They produce a variety of goods. For example, Parr/ and Cadbury Fry produce Chocolates Colgate and Palmolive produce soaps and detergents. Ponds—cosmetic goods.

3. Trading MNCs:

A trading MNCs is the one which *derives*revenue from trading activity.

These are the oldest form of multinational about 60 per cent of the world's export trade. Tatas, Liptons, are trading MNCs.

10.6 Benefits of MNCs

(a) *Capital requirements:* The MNC's have abundance of surplus capital resources which become available for the industrial and commercial development of the poor countries. The MNC's become important conduits through which transfer of capital takesplace from the capital-abundant to the capital-scarce countries.

(b) *Undertaking of risk* : There is risk inherent in the development process especially in LDC's in the initial stages of their development. The shortage"of"capi5lrSall extent of the market, absence of enterprising groups and undeveloped infra-structure signify a high degree of risk in different fields such as mining oil exploration, transport, capital goods, industries etc. The MNC's undertake this risk and remove a major barrier in the development of the LDC's.

(c) *Transfer of superior technology:* The LDC's are characterised by obsolete and inefficient techniques of production. They lack resources for research and development of better and more efficient techniques. The MNC's attempt to bridge the widening technological gap between the advanced and the LDC's through the transfer of advanced technical know-how, sophisticated manufacturing processes and improved skills.

(d) *Development of markets:* The growth process in LDC's remains inhibited on account of the small size of market. The MNC's have made a unique contribution in enlarging the market for the products manufactured in the LDC's through concerted advertising and global network of sales organisation. They undertake market research and adopt novel and highly efficient methods of marketing.

(e) *Development of human resources :*The MNC's want to make use of cheap labour available in LDC's. They provide training to different categories of workers in advanced techniques. In this way they make a highly useful contribution in the creation of skills. This brings about the development of human resources in these countries and raises their productive capacities. It is on account of this contribution of MNC's that they are sometimes called as carriers of knowledge and experience.

(f) *Fuller utilisation of natural resources :*The LDC's have abundance of natural resources such as lands, minerals and water resources. These countries remain undeveloped because they fail to exploit them efficiently and utilise them economically.

(g) *Creation of infra-structure :*The development process in the LDC's remains inhibitedon account of under-development of economic and social overheads or basic infra-structure which includes means of transport and communications, means of irrigation and power, education and training and health services. The MNCs assist in the creation of economic and social overheads and stimulate growth process in the developing countries.

(h) *Creation of industrial linkages :*The industrial structure in any country is highly integrated. The different industries have forward or backward linkages with other industries. If some linked industries remain undeveloped, the whole process of industrialisation can remain blocked. The MNC's sometimes help create those missing links in industrial chain. The creation of those linked industries greatly accelerates'the process of industrial expansion.

(i) *Creation of employment opportunities:* The expanding activities of MNC's in industrial and commercial spheres leads to the creation of job opportunities for different categories of workers and there is greater use of available manpower in the LDC's.

(j) *Favourable impact on balance of payments :*Many MNC's establish manufacturing units in the LDC's not only for "catering"to the needs of the host country but also for producing goods and services for exports. They are capable of expanding exports of the host countries to a large extent as they have a global marketing, organisation. The earning of large amounts of foreign exchange helps in improving the balance of payments position in the developing countries.

(k) *In fact, the MNC's ensure the transfer of a 'package of resources' to the LDC's and effectively pave the way for their rapid economic transformation.*

2.2.7. Role of MNCs in Developing Countries

1. MNCs due to their wide network of productive activity equalise the cost of production in the global market.
2. Entry of MNCs in the host country makes its market more competitive and break the domestic monopolies.
3. MNCs accelerate the growth process in the host country through rapid industrialisation and allied activities.
4. The growth of MNCs creates a positive impact on the business environment in the host country.
5. MNCs are regarded as agents of modernisation and rapid growth.
6. MNCs are the vehicles for peace in the world. They help in developing cordial political relations among the countries of the world.

7. MNCs bring ideas and help in exchange of cultural values.
8. MNCs through their positive attitude and efforts work for the establishment of social welfare institutions and improvement of health facilities in the host countries.
9. Growth of MNCs help in improving the balance of payment status of the host country.
10. The MNCs integrate national and international markets. Their growth in these days has remarkably influenced economic, industrial, social environment and business conditions.

In short, through basically seeking maximisation of profits by using all types of resources and strategies of the global economy, eventually globalisation has become the main focus of their business. In this way, it has become a main propelling force behind the expansion of world economy at large.

2.2.8 MNCs and Developing Countries

Today, invitation to MNCs is an unavoidable need of every developing country. The MNCs have played a significant role in the development of countries such as Germany, Japan and the USA. The MNCs are now interested in capturing the markets of populous countries like India, China, etc. The developing countries are also interested in the entry of MNCs with their open door policies.

According to the World Investment Report 1992, during 1985-90, MNCs' average growth of expansion was 34 per cent. In 1990, foreign direct investment flows to the developing countries increased by US dollars 32 billion. Over sixty per cent of this was attracted by the Asian region. The Report shows that, the foreign direct investment through MNCs has become the principal source of foreign capital for most of the developing countries in recent years.

The recent growth pattern of MNCs also show an increasing concentration of their investment activities in developing countries. However, the MNCs are not interested in all the developing countries. The inflow of foreign funds through MNCs in India is showing an upward trend in recent years.

1991 onwards, the Government of India has taken several steps to attract foreign investments and entry of the MNCs, such as:

1. Abolition of industrial licensing.
2. Removal of restriction on investment under the MRTP Act.

3. Liberalisation of policy and procedure for transfer of technology, import of capital goods, etc.
4. Existing companies are allowed to raise foreign equity up to 51 per cent.
5. Provisions of the FERA have been relaxed. As a result, companies with more than 40 per cent foreign equity can operate like any other Indian company.
6. Foreign companies are permitted to use their trade marks in domestic markets.

During the nineties, there has been increasing trends of foreign investments in India. The Government approved 666 foreign collaborations in 1990.

This number has become more than double to 1520 by 1992. Presently, the USA is the largest investor in India, followed by Switzerland, Japan and the UK. Foreign investment has largely been concentrated in sectors such as fuel and oil refineries, power, chemicals and electrical equipmentsand electronics.

2.2.9 Drawbacks of Multinational Corporations

Critics have pointed out several drawbacks of multination corporations, such as:

1. **Drain of Resources for Profit Maximisation:** The basic objective of a MNC is profit-maximisation through exploitation of host country's resources. It is least concerned with developmental areas, growth and equity of the poor host country,
2. **Strain of Scarce Foreign Exchange Reserves**: These days MNCs belonging to the developed countries are usually making huge investments in the developing countries for the benefit of their home country. Thus, they transfer a huge amount of the country's foreign exchange reserves by way of royalties, fees, dividends, etc., to their home countries. And, these may turn out to be much more than this initial investments.
3. **Minimum Transfer of Technology:** it has been observed that the MNCs generally do not transfer their advanced technology to the host county. They carry out their research and development in the home country only. Further, technology supplied by the MNCs to LDCs is capital-intensive and import-oriented which may not suit the real need of these countries. Moreover, they are most obsolete.
4. **Insignificant Employment Potential:** The MNCs mostly operate in

capital-intensive industries. Owing to their labour-saving technology approach, employment generation out of theirinvestment is not very significant in a LDC. Moreover, they are not very enthusiastic in employing local nationals on high cadre of technical and managerial posts.

5. **Interference in States' Sovereignty:** There are possibilities of interference by the home governments of the MNCs in the host countries' policy matters and international economic-political relations through the influence of the MNCs. The MNCs may misuse their financial clout on the host governments in shaping their policies to the advantage of the MNCs. They may also play their power game in getting a political party of their own choice elected to the government.
6. **Influence on Culture:** MNCs bring their cultural norms and attitudes in the host country and may cause destruction of its original culture in various ways.
7. **Ill-effects of Advertisements:** The MNCs spend large amount on competitive advertisements which in effect may lead to high prices of the products, manipulation of demand, wastages of economic resources, demonstration effect to change the living styles of natives, etc.
8. **High Profit-orientation:** MNCs minimise their overall costs of production through economies of scale. They take advantage of national and international market imperfections to maximise their profits. Thus, they do not lower the prices due to economy and continue to charge high prices to earn more profits and exploit consumers.
9. **Unfavourable Effect on BoP of** the Host Country: The MNCs by remittances of profits draw upon the foreign exchange reserves of the host country. This may add to the problem of BOP deficit which the country might be facing.
10. **Monopoly Growth:** The MNCs may create their monopolies in the markets and eliminate local competitors.
11. **Depletion of Nonrenewable Resources:** The MNCs exploit the host country's nonrenewable natural resources to their advantage. This results in the depletion of non-renewable scarce resources in the host country.
12. **Evasion of** Taxes: The MNCs may manipulate their accounts to evade local taxes.
13. **Economic Threat:** The MNCs realising the host country's dependency on their investments may exert their force to make the country to

accept their terms and conditions. They may even give threat of disinvestment. For instance, when the Government of India asked the IBM to reduce its equity share to 40 per cent, the company decided to withdraw its branch from India.

2.2.10 Conclusion

The MNC's have become a very powerful force in the world economy during the last few decades. They have exercised a revolutionary effect on international economic system in general and industrial organisation in particular. It has been truly regarded as a remarkable economic phenomenon of the twentieth century. We assessed here the role of MNC's from the point of view of the LDC's. The benefits of these organisations and adverse effects of MNCs.

2.2.11 Short answer type Questions

1. Explain the meaning of Multinational Corporations (MNCs). What are their features ?
2. Discuss the role of MNC's for the less developed countries.
3. What objections are raised against MNCs ?
4. Discuss the benefits of MNCs.

2.2.12 Long answer type Questions

1. Explain the meaning and features of Multinational Corporations. Discuss their role in the developing countries.
2. The MNC's have been the agents of exploitation—Examine this statement.
3. Explain the adverse effects of MNC's. How can their activities be regulated ?

2.2.13 Selected Readings

1. Kindelberger, C.P.: International Economics
2. Todaro, M.P.: Economic Development in the Third World
3. Grubel, H.G. : international Economics
4. Sodersten, B. : International Economics
5. Friedrich, K. : International Economics
6. Snider, D.A. : Introduction to International Economics
7. Salvatore, D. : International Economics

LESSON NO. 2.3 Author: Dr. Manisha

The Transfer Problem and Foreign Aid

2.3.1 Introduction

For international trade capital is required, as we all know that main problem of underdeveloped country is scarcity of capital and the rate of formation of capital is also very slow. So all the underdeveloped countries as well as developing countries require capital for expansion of trade. In the chapters of capital movements and multinational corporations we have discussed the role of foreign capital, its benefits and adverse effects as well. Transfer problem arises many a times as it arose after the first world war, when Germany was to pay war reparations to France. Another instance of this problem became available in the wake of steep rise in petroleum prices in 1970's.

2.3.2 Objectives of the lesson

In this lesson we will discuss transfer problem, foreign aid, benefits of foreign aid and adverse effects of foreign aid.

2.3.3 The Transfer Problem

The long term capital movement, to be successful, must involve a transfer of real resources (gbods etc.) from the investing or lending country to the host or borrowing country. If country A is to invest $ 100 million in country B, it must release domestic real resources or goods worth $ 100 million and export them to the host country B. It enables the transfer of capital in the actual sense. The essence of transfer problem is that the international

transfer of financial resources from the investing country must be accompanied *i.e.,* by the transfer of real resources of an equivalent value.

The transfer problem arose after the First World War, when Germany was to pay war reparations to France. Another instance of this problem became available in the wake of steep rise in petroleum prices in 1970's. The petroleum exporting countries such as Saudi Arabia, Libya and Kuwait failed to spend their increased earnings on larger imports from the oil-importing countries. As they tried to reduce their import surplus, that set in deflationary tendencies. So at the heart of 1970 oil crisis was the problem of transfer.

Similarly, the huge foreign investments in the United States resulted in that country joining the ranks of debtor country in 1985. At the same time, there were record trade deficits of the United States by which the transfer of real resources had been effected.

To examine the transfer problem, it is assumed that the investing and host countries operate under a fixed exchange system and there is a state of full employment in both the countries. It is further supposed that the investing country makes the financial transfer out of idle balances and this amount makes addition to idle balances in the host country. Since expenditure in neither of the countries is affected, there is no transfer of real resources.

In order to enable the transfer of resources to take place, there should be an increase in taxes in the investing country. In this way, its spending can be reduced. Alternatively, there should be tax reduction in the host country with the object of raising expenditure. As the expenditure is reduced in the investing country, it will induce a decline in imports. On the contrary, a rise in expenditure in the host country can cause an increase in imports. If the balance of trade equilibrium is assumed in the beginning, the changes in expenditure and resultant changes in imports can cause a trade surplus in the investing country and trade deficit in the host country. The existence of trade imbalance in the two countries signifies the transfer of real resources.

Whether the transfer of financial resources is adjusted completely or incompletely with the transfer of real resources is conditioned by the magnitudes of marginal propensities to import *(m)* in the two countries.

(i) If the sum of marginal propensities to import in the two countries A and B is equal to unity $[(m_A + w_B) = 1]$, there is a *complete adjustment* and the financial transfer is fully matched with the real transfer.

(ii) I f the sum of marginal propensities to import in the two countries is less than unity f(/«A + m_B) <1], there is *incomplete* adjustment and transfer of real resources falls short of the transfer of financial resources.

(iii) If the sum of marginal propensities to import in the two countries is more than unity [(m_A+ /w_B) > 1], there is over-complete *adjustment* and transfer of real resources exceeds the transfer of financial resources.

If the trade balance in the investing country deteriorates instead of improving, the adjustment between financial and real transfer can be said to be *perverse.* Such a situation signifies that the transfer of real resources takes place from the host country to the investing country instead of the opposite.

2.3.4 Foreign Aid

Foreign aids refer to transfer payments which are unilateral gifts for aid. The receiving country has no obligation whatsoever, to repay the grants made by the donor country. Usually, developed countries give such aids to developing countries for their development planning. The aid may sometimes be given for military purposes also. Generally, aids are given for a specific use and it must be fulfilled by the recipient country.

2.3.4.1 TIED AND UNTIED FOREIGN AID

An important aspect of aid debate is tied *versus* united aid. The foreign aid may be tied to a source, project or commodity. Sometimes the foreign assistance is tied to both project and source. The untied aid is a general-purpose aid and the recipient country has the discretion to use the aid according to its own priorities. Such an aid is also sometimes called as the non-project aid or the programme aid.

Tied Aid : The tied aid or project aid has been defined by A. Carline as "assistance whose disbursement is tied to capital investment in a separable productive activity."[4] The entire assistance rendered by erstwhile Soviet Union to India was of this nature. The assistance provided by **the** U.S. government to various countries under P.L. 480 too was tied aid. The aid from Exim Bank. Britain, Germany, Japan and host of other countries to India and other LDC's is mainly of this type. The U.S. aid programme requires that the recipient country should spend the aid on U.S goods and services. It means the U.S. aid to other countries is tied to the U.S. exports. A deviation from this rule can result in the discontinuance of U.S. assistance programme to country. In case of erstwhile Socialist block East European countries, a different practice of aid was followed. They tied the

aid flow to other countries to the overall trade arrangement or package. The countries like Germany followed still another practice of financing only those commodities and/or projects in case of which the donor country possessed a distinct advantage.

When the aid is tied to a specified source, it is estimated that the cost of the project to the recipient country rises by more than 30 percent. This happens because the recipient country is restrained from buying project requirements at the competitive world prices. The cost of aid procurement gets further escalated, if the aid is tied simultaneously to source as well as project. Sometimes the donors countries insist that the commodities to be supplied by way of aid should be carried to the ports of the recipient countries by the ships belonging to the donor countries. Such a stipulation can further erode the tied foreign assistance in real terms. The tied aid can result in a distortion in the allocation of investment resources in the donor countries. The development programme becomes biased towards such projects as have a high component of special import content under the conditions of tied aid. The aid tied to source limits also the choice of technology in the assisted projects. The recipient countries are forced to adopt highly capital-intensive techniques that may be clearly unsuited in the conditions of labour-surplus countries.

The assistance tied to specific project has a number of *advantages :*
Firstly, the financing of a specified project by a foreign advanced country provides an assurance that the project is sound and economically viable. ***Secondly,*** the availability of external capital specifically for some project allows the recipient country an opportunity to make use of the indigenous capital for some other projects for which foreign assistance cannot be arranged. ***Thirdly,*** the choice of projects in certain circumstances is left to the recipient countries. ***Fourthly,*** when the foreign assistance is tied to a particular project, the recipient countries can also avail of the technical advice of the donor country about design, implementation etc. ***Fifthly,*** the tied project aid provides extensive publicity to the aid programme of the donor countries. ***Sixthly,*** the project-linked aid ensures the most efficient utilisation of the foreign assistance. ***Seventhly,*** the information related to aid programme and working of the economy of the recipient country becomes available to the donor countries. The scientific and technical assessment based upon such information provides opportunity to the recipient countries to formulate more efficient and pragmatic economic policies and programmes. ***Eighthly,*** when the aid is tied to both project and source, the capital inflow is expected to have a less adverse effect upon the BOP position

of the recipient country.

The tied project aid suffers from certain ***defects. Firstly,*** the tied aid does not conform to the Pareto optimality as the recipient country is unable to secure machinery, equipments and materials needed for the given project at the competitive world prices. ***Secondly,*** it is likely that projects selected by the donor countries occupy a low-priority in the recipient countries. Some other projects, having a much higher priority in the development programme of the recipient country, may remain starved of funds. Thus tied aid can lead to a serious distortion of priorities in the recipient country. ***Thirdly,*** the tied aid generally involves heavy cost. The donor countries insist upon all procurements for the given project through aid to be made only from the suppliers of donor country. These imports are invariably made at prices higher than those in some other countries. The condition of carrying imports through the ships of donor countries escalates further the real cost. ***Fourthly,*** the projects selected by donor countries may be bound by agreement to make the subsequent maintenance imports also from the donor country. It will put an additional strain upon the former. ***Fifthly,*** the tied foreign aid may force a country to adopt capital-intensive projects. The choice of such projects for investment cannot generate sufficient employment opportunities for workers. Thus tied aid may worsen the unemployment situation ina labour-surplus country. *Sixthly,* tied aid sometimes thrusts upon the LDC's an obsolete technology in the form of turnkey projects. ***Seventhly,*** in the case of tied loans, the donor countries sometimes insist upon the detailed supervision of formulation and execution of project. There may also be differences in the interpretation of certain clauses in the agreement.

As a result there may be bureaucratic wranglings and tensions in economic and political relations between the two countries.

The recipient countries can reap the benefits of tied aid, if certain ***precautions*** are taken. *First,* the choice of project should remain with the recipient country. ***Second,*** there should be the maximum utilisation of the domestic resources. ***Third,*** the import-content should be within reasonable limits. ***Fourth,*** the choice of technology should be left with the recipient country. ***Fifth,*** the price differential in case of the importable goods from the donor country and other countries should be the least possible. If the above conditions are fulfilled, the tied aid can definitely go a long way in the industrial expansion of the developing countries.

Untied Aid

The untied aid is often preferred by the developing countries because that enables them to utilise aid in accordance with their plan priorities. They have a greater degree of freedom in pursuing their development programme related to infrastructure, agriculture, industry and other sectors. The real cost of untied assistance is much less than that of the tied aid because the recipient country can make purchases of all its requirements at the competitive prices from the world market. The recipient country has the freedom to select the technology which is the most appropriate for it and which is consistent with its resource-endowments. Unlike tied aid, the untied aid is not likely to supplant the domestic capital and enterprise. There can be no fear of an obsolete technology being thrust upon the aid-receiving country. There is also little possibility of bureucratic wrangling over the matters concerning formulation and execution of projects and interpretation of the clauses of agreement.

H.W. Singer, while explaining the reason for greater preference for untied aid by the developing countries remarked, "Plan aid seems to be more popular among the receiving countries than project aid. This would be expected to be considered as an advantage of plan aid, since it may spur the receiving country to greater efforts in order to get the aid, apart from smoothing relations between the aid-giver and the aid-receiver, which is presumably also an objective of aid. It may be said that aid tied to specific projects is an inducement for receiving countries to think of development in terms of concrete projects.

Development is, of course, much more than that, and in fact many expenditures classified as current or as consumption are much more developmental than expenditures classified as "projects" or capital expenditure. From this latter point of view, plan aid and even more annual budget aid, is clearly preferable if the donor agrees with the recipient on developmental policies and priorities.

The greatest drawback in the untied aid is that the foreign loans are used in wasteful way such as sending of delegations to foreign countries, purchase of non-essential goods and services from abroad and the setting up of projects as have low priorities. Many often the non-project assistance is employed to make short term BOP adjustments or for the servicing of outstanding foreign loans. In such eventualities, this type of aid makes no net addition to the productive potential of the recipient country. Most of the LDC's including India have failed to expend the foreign aid in a judicious

manner. Unless extra care is taken in the utilisation of such assistance, the untied loans are not expected to make the desired impact upon the development process in the LDC's.

2.3.5 Benefits of Foreign Aid

The major benefits or advantages of foreign aid mainly the capital transfer from the advanced to the LDC's are as follows:

(i) *Increase in the rates of saving and investment:* The under-development in poor country is fundamentally caused by their capital-deficiency or low rates of saving and investment. In India, for instance, the rate of saving was just about 5 percent on the eve of independence. The rate of gross investment too hoverel around the same rate. With such low rates of saving and investment, the country could not expect, given a rapidly growing population and making allowance for depreciation, to grow at a rate more than 2 to 2.5 percent per annum. Over the last four decades of planning, the rates of saving and investment could, however, be stepped upto more than 20 percent per annum and the rate of growth averaged at 3.5 percent per annum. To a large extent the credit for it must go to the substantial flow of foreign capital since the inception of planning in the country.

(ii) *Technological change*: The LDC's are characterised by the technological backwardness manifested by low productivity of labour and capital due to abundance of unskilled labour and obsolete capital equipments. The technical barrier does not permit them to make the optimum use of all available and potential productive resources. The inflow of capital from advanced countries, apart from removing the capital deficiencies, brings in advanced technology and skills, organisational expertise and market management helps in training of domestic skills, establishment of infrastructure for scientific and technical research and creation of new varieties of products. The capital movements, thus, contribute in filling up the technological gaps in the developing countries.

(iii) *Creation of economic and social overheads*: The growth process in the LDC's remains hindered on account of the absence of economic and social overheads that include means of transport and communications, irrigation and power, educational, training and research institutions and health services. The creation of economic overheads calls for heavy investment of capital. It is generally beyond the capacity of LDC's to create the basic infra-structure. In case of India and several other developing countries, the foreign capital and

technical assistance have played a key role in this sphere.

(iv) *Development of heavy and basic industries :*The industrial transformation of LDC's requires the development of heavy and basic industries such as steel heavy electricals, machine tools, heavy engineering, od-refining, fertilisers, heavy chemicals, mining, transport and defence equipment industries. The creation of such an industrial base can greatly stimulate the future industrial expansion in these countries. But all these industries have high capital-intensity and a long gestation period It is only through a substantial inflow of foreign capital that the developing countries can hope to develop the structure of heavy and basic industries.

(v) *Undertaking of initial risk:* In the early stages of development, the investment in LDC's involves enormous risk on account of absence of infra-structure, unskilled labour and small extent of market. The indigenous investors shy away from investment and enterprise. The foreign investors or entrepreneurs, however, venture to bear unspecified risks and set up enterprises in different sectors of the economy.

(vi) Check upon *inflationary pressures: The* economies of the LDC's have a very high inflationary potential. The strong inflationary pressures in these countries result from excessive demand, rigidity in the structure of production, deficit financing and priority to projects having longer gestation period. In the conditions of severe inflationary strains, these countries can rapidly expand production of consumer goods through the import of machinery, equipments and even tum-key projects. The commodity assistance such as foodgrams import from the USA made by India during 1950's and 1960's under Pi. 480, too can contribute in a great measure in relieving the inflationary pressures.

(vii) *Creation of employment opportunities* : As the foreign capital builds up infra-structure, assists in the setting up of heavy, basic and key industries, taps the sources of raw materials, opens up new markets, there is substantial expansion of employment opportunities in the developing countries. The modernisation of agriculture through the introduction of new farm machinery and chemical fertilisers with the help of foreign capital releases surplus manpower from that sector. The reduced pressure of population on agriculture brings about an increase in farm productivity. The expansion of manufacturing industry through foreign capital absorbs a large part of surplus labour displaced from agriculture.

(viii) *Removal of BOP deficit:* The LDC's are frequently faced with chronic BOP deficit Inthese countries; the capacity to export is limited. The exports are either almost stagnant or declining. There is secular deterioration

in terms of trade due to falling international prices of primary products. These countries, at the same time, have a strong propensity to import. They have to make large scale imports of foodgrains, edible oils, industrial raw materials, spares, capital goods, defence material etc. The foreign exchange component of development programmes is invariably large. They are obliged to make provision for debt servicing. In such conditions, they are faced with mounting BOP difficulties. A large inflow of foreign aid can take care of payments for imports and; servicing of external debts and BOP deficit can be removed.

(ix) *Beneficial for labour:* As the foreign capital causes industrial expansion, increased demand for labour ensures an increase in the real wages of the workers. The expanded production and creation of new varieties lower the product prices and effect a qualitative improvement in the standard of living of workers. As there is inflow of foreign capital and advanced techniques, there is creation of skills and scientific management which go a long way in not only ensuring better standards of production but also accelerating the entire process of growth.

(x) *Modern value system: The* flow of foreign capital and enterprise to the traditional societies of less developed countries starts infusing in them hard work, scientific temper, modernisation of outlook, greater innovativeness and increased self-reliance. These changes in value system pave the way for an uninterrupted process of growth.

It has also been maintained that unrestricted international capital movements tend to equalise the rates of interest and profits between countries. As a matter of fact, discrepancies in the rate of interest induce international flow of capital. When there are no checks on the movements, capital tends to flow from a capital-surplus nation to capital-deficit nation on account of high yields in the latter. Eventually, interest rates in the capital-exporting country will be enhanced, while in the capital-importing country it will decline. A condition of equilibrium in the international flow of capital exists when interest rates and profit yields in different countries are equalised. In practice, however," there are always some restrictions on an impediment to the free movement of capital which prevent such complete equilibrium to emerge. Moreover, apart from the rate of return on investment, many other factors such as risks involved, industrial and general economic policy of the foreign government, political relations between countries, international treaties and agreements on trade and commerce, etc., influence the investment decisions on foreign capital.

Indeed, capital movement, especially direct investment and foreign aid,

plays an important role in the economic development of backward countries. External assistance is an important source of capital formation and finance resource for planning of project in a capital-deficit poor country.

It is true that the reliance on foreign capital has its grave risks and dangers. But at the same time, its benefits to the development process in LDC's cannot be over-looked. The efforts should be made so that the foreign capital does not have adverse repercussions upon the developing countries. The LDC's should take precaution that the unnecessary economic and political strings to the inflow of aid are not accepted. The care should also be taken that the aid is used according to the accepted plan priority and dissipation of aid in non-priority areas is scrupulously avoided.

2.3.6 AMOUNT OF FOREIGN AID AND DEVELOPMENT

There is no denying the fact that the foreign aid in the form of commodities, services, capital and technology contributes greatly in accelerating the development process in the poor countries. The latter definitely want that there should be maximum flow of capital from the advanced countries. The pertinent point in this connection, is how the amount or quantum of foreign aid that actually becomes available to a developing country, gets determined. The main factors influencing the quantum of aid flow to a poor country are as follows :

(i) ***Availability of investible funds*** : The quantum of aid flow to poor countries is limited by the availability of capital resources to be invested with the developed countries. Unless the latter have surplus exportable capital to the tune of 15 to 20 billion dollars annually, the foreign capital needs of the former cannot be met. Except the United States, Germany, Japan and a few members of the OPEC, other advanced countries do not have sufficient exportable capital.

(ii) ***Absorption capacity of the recipient country*** :There is a significant aid flow to some developing countries while others experience only a trickle coming in. It is not as much a matter connected with the availability of investible funds as it is the capacity to absorb of the recipient countries. J.H. Adler suggested that the structure of the economic system along with the utilisation of its existing capacity determine the absorptive capacity of a country.[8] In other words, the absorption capacity is connected with the scale to which a country can plan and execute the development projects and programmes, given the economic, social, political and institutional constraints. The Fourth

Annual Report of the IBRD recorded, "The principal limitation upon Bank financing in the development field has not been lack of money but lack of well-prepared and well-planned projects ready for immediate execution. The projects must not only be built, to be "absorbed", they must be "productive". Kindelberger pointed out that the capacity to absorb capital is determined by different bottlenecks such as administrative capacity, skilled labour needed in fixed proportions and the engineering to formulate the project proposals".[9] In the conditions of LDC's, the capital absorptive capacity is very low on account of such factors as lack of complementary resources, lack of economic and social overheads, lack of trained personnel, lack of geographical and occupational mobility, lack of efficient entrepreneurship and administrative structure, undeveloped institutional structure and small extent of domestic market. On account of all these constraints, the marginal productivity of capital remains low and the extent of risk larger. These bottlenecks prevent the proper use of the foreign aid for the execution and completion of development projects. As the LDC's become able to overcome these bottlenecks, their capacity to absorb foreign capital increases. It becomes possible for them to complete the projects well in time. The delay in the utilisation of assistance authorised by the individual countries and international agencies gets reduced and the tempo and magnitude of aid utilisation gathers momentum. According to B. Higgins, the absorption capacity of a country is reflected by such factors as the unutilised capacity, scope for improving technology, domestic complementary investible resources, well-formulated development plan, capable administrative set up, strong, stable and popular government, a flexible society, a high level of literacy and an effective system of education and a modern, scientific, technology-minded and development-minded public. If these factors exist in a country, it is supposed to have a high absorptive capacity of external capital and the magnitude of capital inflow from abroad can be accordingly determined.

(iii) ***Adequacy of domestic, human and natural resources*** : If a country does not have adequate availability of natural and human resources, it cannot make an effective and efficientuse of investible funds borrowed from abroad. Such a country will face serious impediment in a large inflow of foreign capital.

(iv) ***Capacity to repay*** **:** A critical factor influencing the magnitude of foreign aid is the repaying capacity of the borrowing country. The burden of debt servicing has a prohibitive effect upon the flow of funds to the LDC's. The repaying capacity of the borrowing country is

conditioned by the magnitude of the gross national product, capacity to export and replace imports, domestic taxable capacity, the proportion of borrowing employed in self-liquidating projects, the rate of interest on borrowings, the period of loan and BOP position of the recipient country. In the words of R. Nurkse, "Over time, the only determinant of the capacity to repay is the loan's contribution to productivity of the economy as a whole, and the capacities of the system to skim off the necessary portion of that productivity in taxes or pricing, and reallocate resources so as to transfer debt service abroad. The requirement for payment is that the fiscal system raises the necessary funds, and the *transformation* occurs to shift resources into export-increasing or import-decreasing lines." If there is a steady and increasing flow of loans over a long period on soft terms, not only the repayment of loans will be easy but the borrowing country will also enjoy greater confidence of the lending countries. As a result the availability of aid will increase progressively. In order to maintain a satisfactory level of repaying capacity, the borrowing country should seek foreign loans mostly for productive purposes; these should be tied to self-liquidating projects; and the financing of social overheads, such as education, training, research, public health and community developmment, should be done preferably through foreign grants.

(v) ***Domestic will and effort*** **:** Last but not the least, the domestic will and effort of the people in the less developed countries to generate more saving through reducing consumption and step up the rate of domestic investment and output. The determination to overcome all the bottlenecks in growth on the part of the people of these country can induce the foreign capitalists to provide aid in a large measure.

All these factors taken together, determine whether a country will succeed in absorbing a large flow of capital from abroad or not. It is, therefore, important for the LDC's to create such conditions in which the foreign countries consider it mutually beneficial to permit a capital movement to the developing countries on a substantial scale.

2.3.7 Conclusion

It is true that the reliance on foreign capital has its grave risks and dangers. But at the same time, its benefits to the development process in LDC's cannot be over-looked. The efforts should be made so that the foreign capital does not have adverse repercussions upon the developing countries. The LDC's should take precaution that the unnecessary economic and political strings to the inflow of aid are not accepted. The

care should also be taken that the aid is used according to the accepted plan priority and dissipation of aid in non-priority areas is scrupulously avoided.

2.3.8 Short answer type questions

1. Point out the dangers of capital flows or foreign aid.
2. Make a distinction between tied and untied aid.
3. What are the factors that influence the quantum of foreign aid?
4. *W*hat is transfer problem?

2.3.9 Long answer type questions

1. Explain the benefits and dangers of foreign aid.
2. Discuss the role of international capital flows (or aid) in the LDC's.
3. Make a clear distinction between tied and untied foreign aid.
4. Make an assessment of tied versus untied aid from the viewpoint of a developing country.
5. Foreign aid or trade—which of the two do you prefer for the development of a poor country?

2.3.10 Suggested Books

1. Kindelberger, C.P.: *International Economics*
2. Todaro, M.P.: *Economic Development in the Third World*
3. Grubel, H.G. : *international Economics*
4. Sodersten, B. : *International Economics*
5. Friedrich, K. : *International Economics*
6. Snider, D.A. : *Introduction to International Economics*
7. Salvatore, D. : International Economics

LESSON NO. 15

International Liquidity

The late Jacobson said, "By liquidity, I understand the supply of credit in national currencies as needed to finance and provide the means of payment for trade and production. "International liquidity consists essentially of the resources available to national monetary authorities to finance potential balance of payments deficit. It may consist in the possession of assets like gold, foreign exchange, and in the ability to borrow internationally. Thus, in its international setting, liquidity includes all those assets including SDR's, which are generally acceptable without loss of value for settling international debts. It may include the following:

Gold stocks with Central Banks and with the IMF, foreign exchange reserves of countries, drawing rights of member countries with IMF, credit arrangement between countries, country's capacity to borrow in the money markets of another country, accumulation facilities (these arise when a foreign country accepts payment of debts in debtor's currency like sterling balance accumulated during World War II, Euro Dollar, SDRs etc.

Problem of International Liquidity

There is no agreement among the economists about the true nature of the problem of international liquidity. Some economists feel that the problem is quantitative and is of the inadequacy of the means of international payments. Others feel that the problem is qualitative in nature and pertains to the form and composition of international reserves for liquidity purposes. There are others who present the problem of international liquidity in a different way—they clain that the problem is more of confidence. It arises due to lack of adjustment on account of fixed exchange rates (as had been the case under Bretton Woods System till 1976).

According to them, the problem is one of adjustment. It may be true that a part of the problem of international liquidity (that is

providing the means of international payments) may be that of confidence and adjustment. But it is mainly the problem of inadequacy of reserves to cope with the expanding requirements of international trade. It has been found that the growth in the liquidity has not kept pace with the growth in the world trade. During the sixties and the seventies, the world trade almost doubled in a decade but the world reserves increased by hardly 25 percent to 30 percent in a decade and even this increase was unevenly distributed not only amongst developed countries but also between developed and underdeveloped countries, thereby, causing a serious shortage of international liquidity. The average annual increase in world trade in the decade 1960-70 was 8% to 10% while the annual average percentage change in reserves was hardly 3% between 1960-70. International monetary arrangement, based on gold or gold exchange standard or dollar and sterling as international reserves, could no longer inspire confidence and provide for increased quantum of international liquidity on account of expanding world trade. Apart from this, the most baffling has been the problem as to the form the new international reserve assets should take. Opinions differed in the past amongst leading countries as to the true nature and form of the new international reserve asset.

Problem of Adequacy :

It is rather difficult to determine as to what will constitute the adequate level of international liquidity under the dynamic conditions of expanding world trade and growth in developing economies. It is said that the quantum of international money needed by the world depends on the size of international trade, that is, more trade will require more money to finance it. But this is not true because trade is not financed normally by reserves. International reserves finance not the volume of international trade but the balance of payment deficits. The amount or the quantity of international reserves needed, therefore, varies with the size of the swings in the balance of payments. It may, therefore, be said that in a sense, the aggregate needs on international liquidity are in one way related to factors like world trade, capital movements and imbalance in balance of payment. But their adequacy is also affected by psychological attitudes towards what is minimum or desired levels or natural reserves by reserved movements and by the use of available credit facilities.

Because other influencing factors cannot be quantified, growth in imports seems to be the most relevant indicator of the need for reserves. According to Triffin, "The ratio of gross reserves to annual imports is the first and admittedly rough approach to the appraisal of reserves adequacy." But it is not easy to determine the correct ratio of gross reserves to annual imports. It will thus be seen that the factors, which determine the adequacy of international liquidity, are, in practice, not precisely measurable. It is not simply a matter of arithmetical relationship. Broadly speaking, the question of adequacy of liquidity, national and international, is a matter of judgement, depending on the economic circumstances prevailing in a country, on the time and on the purpose for which the reserves are to be used. We may conclude that a country will regard its liquidity or reserves as adequate when, in its opinion, the level of liquidity or reserves are sufficient to meet unforeseen deficits in its balance of payment without adopting restrictive policy affecting economic growth and international trade.

Importance :

The importance of international liquidity lies in providing means by which disequilibrium in the BOPs of different countries participating in international trade is settled. As such, it helps in the smooth flow of international trade by facilitating the availability of international means of payment. It must be understood that these means of reserves are used to finance deficit in the BOPs. These reserves are not used to finance the inflows or outflows of trade. Changes in the balance of payments to temporary deficits and surplus must be met by transfers of gold, convertible currencies or international borrowing facilities. All these go to constitute international liquidity. The greater the stock of these items of international liquidity held by any country and by countries in the aggregate, the less will be the need for changes in exchange rates. In a world, in which there are considerable fluctuations in economic activities, accompanied by a growth demand for stability the importance of international liquidity reserves lies in serving as a buffer, giving each country some leeway for the regulation of its national income and employment and providing it with a means to soften the impact of economy fluctuations arising on account of international trade and transactions. A greater world holding of international liquidity

reserves becomes necessary to maintain stable exchange rates over the whole business cycle than to meet any seasonal or short run fluctuations. It is in this sense that adequacy or otherwise of foreign liquid reserves is an important determinant of the levels of world trade and economic activity. If there are enough or sufficient international liquid reserves, specially with those countries which are likely to incur deficits, there will be less worry or panic for adjustment. On the other hand, if there is too little international liquidity in the world, deficit countries will have no or little time to adjust and they will be forced to impose restrictions on trade and capital movements. As a result, the world growth is turning the terms of trade in an unfavourable manner for developing economies. Easy access to international liquidity reserves makes it possible for the swings in the balance of payments to be financed, otherwise, the world trade may be strangled for want of international liquidity. It implies not only sufficient quantity but the right composition and distribution of international liquidity reserves.

International monetary system based on IMF or Bretton Woods system had been the chief source and mechanism by which international liquidity had been provided in the past. It was one of the main objectives of the IMF. The Fund, since its inception, had been trying hard to cope with the problem of international liquidity, in various ways, that is, by increasing quantity, by changing the composition and by ensuring equitable distribution of the available sources. The fund managed the various forms and means of providing international liquidity like gold, foreign exchange, quotas and other borrowing facilities and credit arrangements. There is no disagreement amongst the economists that the IMF must somehow be so reformed as to augment international liquidity. In fact, the IMF continues to hold a commanding position on two fronts, exchange stability and international liquidity. Its attempts and achievements in fostering the growth of international liquidity have, no doubt, been impressive but a bigger and more important rule lies ahead in making need based allocation of quotas and SDRs.

Exchange Rate Adjustment

Exchange rate adjustment is an important method of coping with the problems (shortage or otherwise) of international liquidity. The pertinent fact still remains that adjustment must

occur, failing which any kind of monetary or reserve arrangement will collapse. Concentration on liquidity problem and its solution through satisfaction with the ways the adjustment mechanism is working. Quite apart from the quantity or reserves, an adjustment mechanism between different economies is also essential. An arrangement of sufficient reserves but fixed exchange rates could not be enough because it meant a persistent imbalance between a weak and a strong currency. Under IMF system countries were allowed to adjust their exchange rate upto 10 percent without consulting the Fund and if a country could prove that it had a fundamental disequilibrium in the BOPs, it was allowed to depreciate its currency by more than 10 percent. But the circumstances during the sixties and the seventies rendered the Bretton Woods system of par value and fixed exchange rates entirely useless. Experts like Machlup, Mundell, Bernstein, Triffin, Harberler, Friedman and Meade supported the case for flexible and freely floating rates to overcome the problem of international liquidity through exchange rate adjustments. The IMF system of fixed exchange rates broke under the stresses and strains of an unbalanced development of the world economy, especially during the seventies in disorderly movements of short-term capitial.

As a result, there had to be a transition of the present system of floating and flexible exchange rates, which was fairly swift. As the picture emerged, 31 currencies were floating while 86 currencies used some peg or the other; 55 were pegged to the U.S. dollar, 13 to the French Franc, 4 to the pound sterling, and 3 to other currencies. Some countries peg their currencies to a composite of the currencies of their main trading partners. Under the **'Jamaica Plan'** of March/June 1976, gold stands dethroned. The Jamaica Plan, no doubt, provided a freedom of choice but not a freedom of behaviour. The new Articles of the Fund establish a set of obligation, both for the members and for the Fund's regulatory role as regards exchange rates, by exercising firm surveillance over member's policies and actions regarding exchange rates. Under this surveillance the Fund will see the countries pursue orderly exchange arrangement and a stable system of exchange rates, and must avoid manipulating exchange rates to prevent effective BOPs adjustment or to gain an unfair competitive advantage. The Fund will be able to recommend

exchange arrangements that are in conformity with the development of international monetary system.

Under the Jamaica Plan, the Fund has also tried to increase the overall international liquidity by supplementing and increasing the supply of conditional liquidity in various ways; (a) by increasing quotas, (b) by introduction of new credit facilities over and above the regular credit traches, (c) by creating a new international reserve asset called the SDRs.

(a) IMF Quotas and International Liquidity

Each member of the Fund is assigned a quota. The subscription of each member is equal to its quota.

Whenever international liquidity is to be increased, the usual way is to increase the Fund's total resources by increasing quotas generally. Quotas once fixed can be changed or adjusted according to variations in circumstances. The IMF has reviewed the quotas of its members from time to time. Until now the quotas were expressed in terms of gold or hard currencies but after the Jamaica Plan, quotas would be expressed in SDRs. In March, 1976 Fund's Governors voted for the 6th revision resulting in a substantial increase in Fund Quotas. This expanded the resources of the Fund by about one third, from SDR 29.2 billion to SDR 39 billion thereby giving a fillip to international liquidity. India's quota also increased from 940 million SDR's though in terms of overall IMF reserves, India's quote stands reduced from 3.22 percent to 2.93 percent. This may appear strange but India and other non-oil producing countries (rich and poor) had agreed for a cut in percentage in order to enable the new rich oil producing countries to benefit from percentage increase in accordance with their newly acquired wealth. The sixth revision increased the Fund's resources by 33.6 per cent. The increase in USA's quota was nearly 25 percent, U.K's by 4 percent. France's by 28 percent, Italy's 24 percent, Japan's by 38 percent and India's by 22 percent. But one unsatisfactory feature of distribution of quotas and of international liquidity based on such distribution is the lack of equity and uniformity amongst members. This revision did not make the distribution of international liquidity in any way better in the past. Hence, the problem of unequal distribution of international liquidity still remains.

(b) The Trust Fund and Credit Arrangements:

International liquidity has been augmented by what is called IMF reserve position, also called' IMF Tranche Positions'. These have been an important element of international liquidity. These reserve positions have been increasing over the years. A member's IMF position in the Fund represents the amount that a member, facing balance of payment deficit may draw essentially automatically under the Fund's gold tranche. In other words, these reserves of gold and credit tranche position in the IMF refer to the short-term financial assistance to its members to meet balance of payments deficits. Under gold tranche, a member could draw on the Fund without any question being asked. It represented unconditional liquidity. After it, a member could draw from the first or subsequent credit tranches, if the countries made reasonable efforts to solve their problems by setting right the deficit. However, requests for drawing beyond the first subscription was 25 percent of the quota, it represented the gold tranche, and each credit tranche was equivalent to one fourth of the quota. The Fund also provided liberal credit facilities, allowed frequent waivers, stand by agreements, and general arrangements to borrow all with a view to meeting the increased requirements of international liquidity.

Under the Jamaica Plan supply of liquidity has been increased by the Fund also by the creation of new facilities. Before the Jamaica Plan of 1976, there was the compensatory financing facility in 1963, the buffer stock financing facility in 1969, the Extended Fund facility in 1974 and the Trust Fund facility in 1976, created out of the profits of gold sales by the IMF. Besides, fund also provided a temporary oil facility, which was in operation in 1974 and 1975.

(c) SDRs and Jamaica Plan 1976

A number of confrontations took place between US and other countries regarding the amount and magnitude of the creation of SDRs; till they finally agreed to create $9.5 billions (about Rs. 7125 crores) worth new money (paper gold) between 1970 and 1972 alongwith increase in quotas worth $6 million to $ 7 million to solve the problems of international liquidity. In this way, for the first time, a supplement of existing unconditional liquidity came into being by a deliberate decision of the international community itself rather than through an erratic accumulation of

gold and reserve currencies. By March 31, 1973 out of 125 members of the IMF, 113 were participants in the SDR scheme. During the course of its working, many limitations came to the surface. For example, their quantity and the rate of growth were found to be inadequate. Their nature and scope and use were found limited because they were available for meeting the balance of payments difficulties only. IMF had to play an active role and direct designation. The distribution was found to be unjust. Developed countries felt that their creation gave undue advantage to developing economies and additional liquidity created by them was the main cause of global inflation. Major disagreement amongst members of IMF prevented the activation of the scheme for second basic period and this gave a setback to the whole scheme. Developed countries argued that existing reserves were in excess of needs and as such they had not been interested in the creation of more SDRs. The Fund allocated 4032.7 million SDRs on January 1, 1979 to 137 members. India would receive SDRs 120 million each year in the terms of its quota in the fund.

However, under the Jamaica or Kingston Plan, SDRs occupy a significant place. Numerous changes have been made in the Articles of the Fund in March 1976 at Jamaica dealing with special drawing rights. As such the present international monetary system may rightly be described as 'SDR' standard as against gold standard or gold exchange standard or the dollar standard of Bretton Woods System. SDR as the Fund's unit of account will be increasingly used in international transactions. As such the reformed system envisaged under the above reforms at Jamaica is an internationally managed system. Participants will have full freedom to enter into transaction in SDRs without being subject to some of the requirements in the present articles. The possible uses of SDRs operations and transactions have been expanded. The Fund will also be empowered to permit more public (though not non-official) entitles to hold SDRs. Lord Keynes, in his proposal for an International Clearing Union, wrote of the need to establish “an instrument of international currency having a general acceptability between nations." The amendment of the Articles of the Fund at Jamaica continues the process of establishing the SDR as such and members are required to collaborate with the Fund in pursuit of the objective of making the SDR, the principal reserve asset of international monetary system.

Its link with gold has been given up. Gold is no more in the picture and stands dethroned. In order to make SDR an effective international asset, there will be both immediate changes in the characteristics of the assests and possibilities for further development. Immediately; there will be far greater freedom for members to engage in transactions by agreement in SDRs and much wider possibilities for transfer of SDRs to and from the Fund itself. Official entitles will hold more SDRs and engage in broader range of transactions than at present. Provisions have also been made in the above plan for the Fund to permit new forms of operations in SDRs, for example loans or grants, thus, helping to bring the characteristics of SDRs closer to those of traditional reserve assets.

IInd Amendment to Fund's Article 1978

The second Amendment to the Fund's Article of Agreement came into effect on April 1978. It generated important changes in the fund's activities including surveillance over members, exchange arrangements, changes in the role of gold and wider uses of the SDR, as well as important innovations in the Fund's operations and transactions. In addition, the Fund's resources were enhanced in 1978, when its Board of Governors adopted two major resolutions, one of which enables members to raise their quotas in the fund from the present equivalent of SDR's 39 billion to SDR's 58.6 billion as a result of the completion of the Seventh General Review of Quotas; the other provide for the allocation of SDR Department in the three years 1979-81. In addition, the Fund Executive Board made further changes in the basket of currencies that determines the value of the SDR and established a method for its adjustments. Moreover, virtually all of the quota increases that were proposed in February 1976 under the Sixth General Review of Quotas came into effect in 1978 as a result of the completion of Seventh General Review of Quotas in 1978.

Other steps to improve the SDRs are in hand. SDRs can now be exchanged freely among the participants against currency and such voluntary transfers have already taken place on a large scale. In addition, the interest rate on the SDR will be increased and it will be possible to use SDRs to settle obligations without changing them first into currencies to lend SDRs, and to pledge them as security for a loan by another central bank or

Government. Further improvements are high on the agenda. They include forward operations in the SDRs and swap of SDRs and enlarging the number of official institutions that may deal in SDRs. The last point is potentiality of great significance for enlarging the volume of SDR denominated financing in the private markets, since many of the institutions unlike in the Fund, have direct links with the private market. Once such institution holds SDRs in their books, they are likely to increase their SDR denominated liabilities by developing transactions in the private markets.