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Lesson No.

LESSON NO. 2.1 **AUTHOR : DR. GOVIND KHANNA**

INTERNATIONAL TRADE AND THEORY OF COMPARATIVE COSTS

One of the main drawbacks of the Ricardian comparative cost theory was that it was based on the labour theory of value which stated that the price of a good was equal to the amount of labour time going into the production of the good. Gottfried Haberler gave new life to the comparative cost theory by restating the theory in terms of opportunity costs in 1933. The opportunity cost of a good is the amount of a second good that must be given up in order to release just enough factors of production or resources to be able to produce one additional unit of the first good. For example, supposing that the resources required to produce one unit of good X are equivalent to the resources required to produce two units of good Y. Then, the opportunity cost of one unit of good X is two units of good Y. Haberler made use of opportunity cost curve to express the opportunity cost of one good in term of the other. The opportunity cost curve can be called as the 'transformation curve' or 'production possibility curve'. According to the opportunity cost theory, a country with a lower opportunity cost for a good has a comparative advantage in that good and a comparative disadvantage in other good.

Haberler makes the following assumptions for his theory.

1. There are only two countries.
2. There are only two commodities in both the countries.
3. There are only two factors of production such as labour and capital.
4. There is perfect competition in both the factor and good markets.
5. Price of each good equals its marginal cost.
6. Price of each factor equals its marginal productivity.
7. Supply of each factor is fixed.
8. In each country, there is full employment.
9. No change in technology.
10. Factors are not mobile between two countries. But within countries, factors are totally mobile.
11. There is free and unrestricted trade between the two countries

On the basis of above assumptions, production possibility curve indicates the different combinations of two commodities that a country can produce with the

1. Cannan Edition, 1937, pp. 423

given factor endowments and technology. The slope of production possibility curve or opportunity cost curve is determined by marginal rate of transformation (MRT). MRT is a rate at which marginal unit of good X is substituted for certain units of good Y.

$$MRT = -\frac{\Delta x}{\Delta y}$$

The opportunity cost curve may be a straight line, convex to the origin or concave to the origin, depending on whether MRT between X and Y goods is constant, increasing or decreasing respectively.

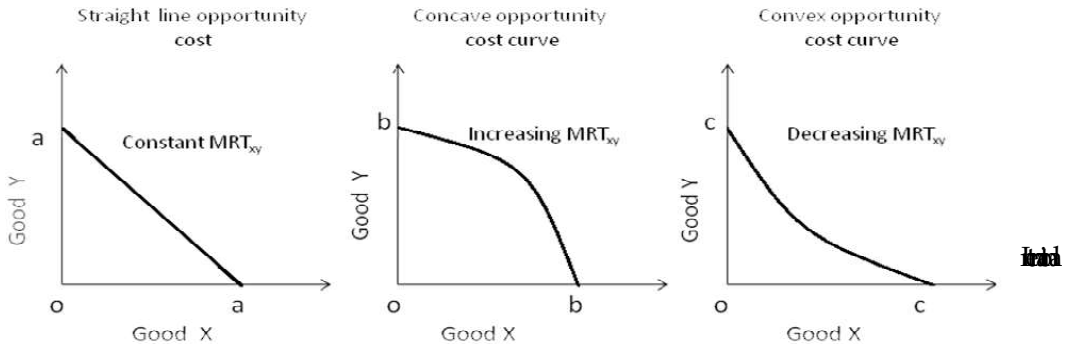


Figure 1

trade between two countries can be analysed under various types of production possibility curves or opportunity cost curves.

a) Constant opportunity cost and international trade

When MRT between X and Y goods remains constant then opportunity cost curve will be a falling straight line. If the slopes of opportunity cost curves in two countries are the same, so that the opportunity cost curves are parallel to each other (as shown in Figure 2), no trade can be possible. It is because of the fact that in such cases the cost ratios of two goods in both the countries are equal.

1. Robert Heller : International Trade—Theory and Expirical Evidence, p. 36

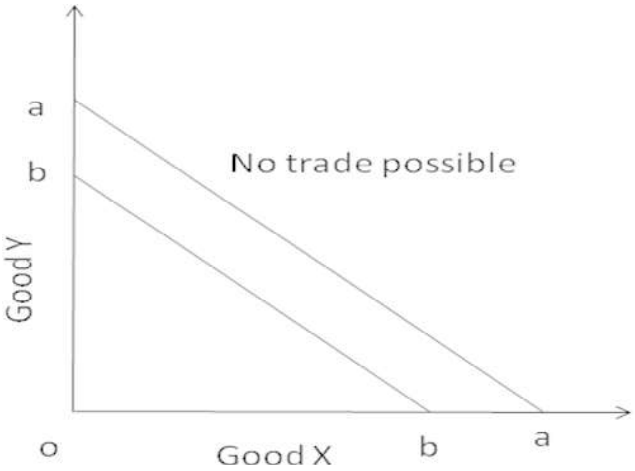


Figure 2

The trade is possible only when the slopes of the opportunity cost curves are different.

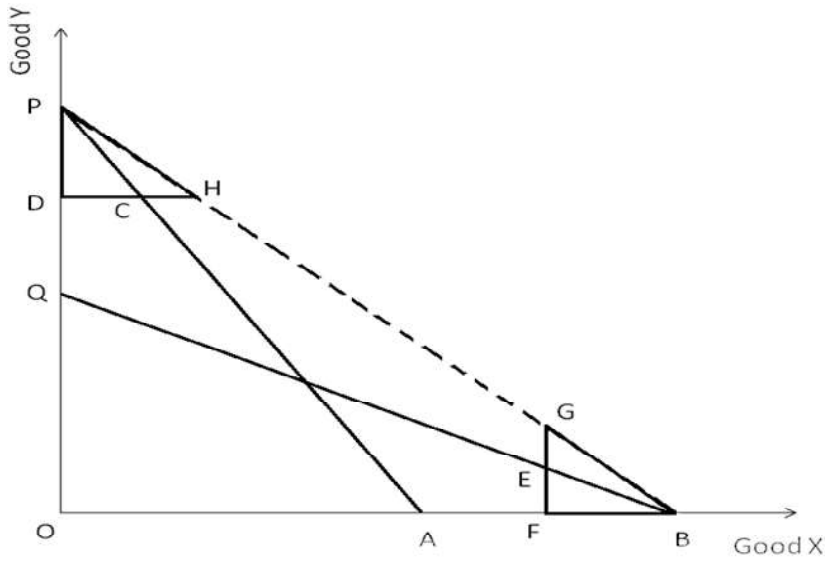


Figure 3

1. The theory of International Trade.

In Figure, PA and QB are the opportunity cost curves of country A and country B respectively. Under the situation of autarky, if county A produce and consume at point C at its opportunity cost curve, i.e, PA line then it will have DO qunatity of good Y and DC qunatity of good X. However, if county B produce and consume at point E at its opportunity cost curve, ie., QB line then it will have FO qunatity of good X and EF qunatity of good Y. However, the relatively greater steepness of PA line shows that country A has a comparative adventage in the production of good Y, whereas the relatively greater flatter of QB line reveals that country B has comparative advantage of good X. Therefore, country A will specialise in the production of good Y and country B will specialise in the production of good X. If country A produce only good Y then it can produce maximum OP quantity of good Y at its opportunity cost line PA. Similarly, country B can produce maximum OB quantity of good X if country B produce only good X at its opportunity cost line QB. Both countries will exchange goods in the ratio indicated by the dotted international commodity-price line PB.

A

Suppose country A want to consume both comodities at point H. At this point, the country A will export PD quantity of good Y and import DH quantity of good X. After international trade, country A can consume more quantity of good X, ie., CH (=DH-DC). Similarly if country B want to consume both commodities at point G then it will export BF quantity of good X and import FG quantity of good Y. Therefore, the gain from trade for country B will be GE (=GF-EF) quantity of good Y.

b) Increasing opportunity cost and international trade

If MRT between X and Y goods goes on increasing, then opportunity cost curve or production possibility curve will be convex to the origin. In Figure 4, AA represents the production possibility curve of country A and BB in Figure 5, is the production possibility curve of country B. The comparison of the shape of the production possibility curves of both countries makes it clear that opportunity cost of good X, in terms of good Y, is lower in country A and higher in country B. In other words, country A is better suited for the production of good X and country B for the production of good Y.

In the case of country A, under the absence of international trade the country is in equilibrium at E, where the production possibility curve AA tangents to the country' indifference curve, i.e, II curve. At this point, country A is producing and consuming OX quantity of good X and OY quantity of good Y. The slope of the production possibility curve AA at point E is donated by P_aP_a line. Similarly, country B will be in equilibrium at E_1 under the absence of international trade as shown in Figure 5 where the production possibility curve BB tangents to the country' indifference curve, i.e, I_1I_1 curve. At this point, country B is producing

and consuming OX_1 quantity of good X and OY_1 quantity of good Y. The slope of the production possibility curve BB at point E_1 is donated by P_bP_b line. The slope of P_aP_a line is relatively flatter than that of P_bP_b line. This indicates that good X is cheaper in country A and good Y is in country B.

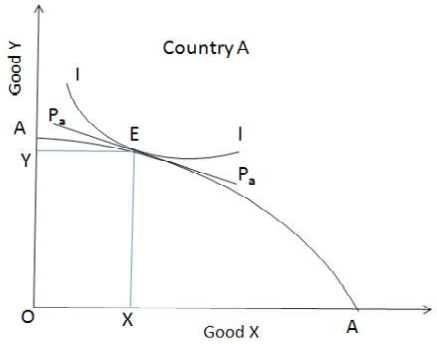


Figure 4

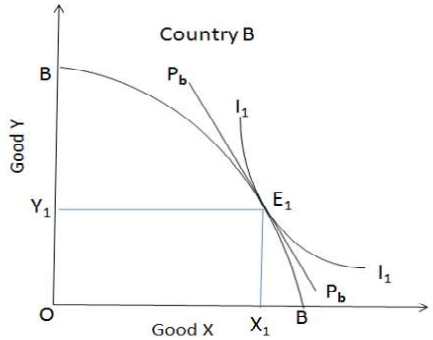


Figure 5

If both the countries enter into trade with each other, the international price ratio is most likely to be somewhere in between the pre-trade ratios in both the countries. In other words, the international price line would neither be as flat as price line P_aP_a of country A, nor be steep as the price line P_bP_b in country B. The slope of the international price line would be somewhere in between the price lines of both the countries. In Figure 6 and Figure 7, P_iP_i represents a possible international price line. If P_iP_i represents international price line, country A will produce at point N where its production possibility curve AA tangents to international price line P_iP_i. At this point it will produce more quantity of good X at the cost of good Y. Country A will expand the output of good X by MN by contracting the output of good Y by EM. If country A wishes to maintain consumption of good X at the old level of OX, it can now export MN quantity of good X and get in exchange ME_2 quantity of good Y. Hence, the gain from trade to country A is equivalent to EE_2 of good Y. the country A is now able to be at a higher equilibrium point E_2 on its indifference curve I_2I_2. In the absence of trade, this point cannot be reached by country A as it is beyond its production possibility curve.

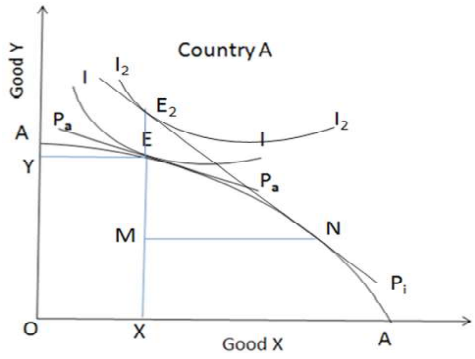


Figure 6

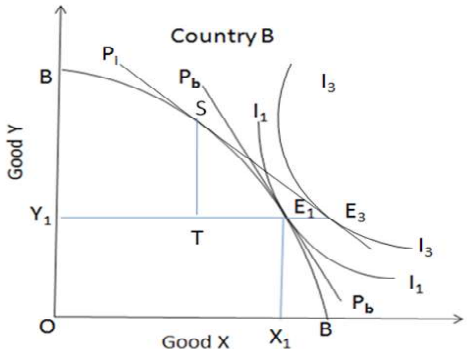


Figure 7

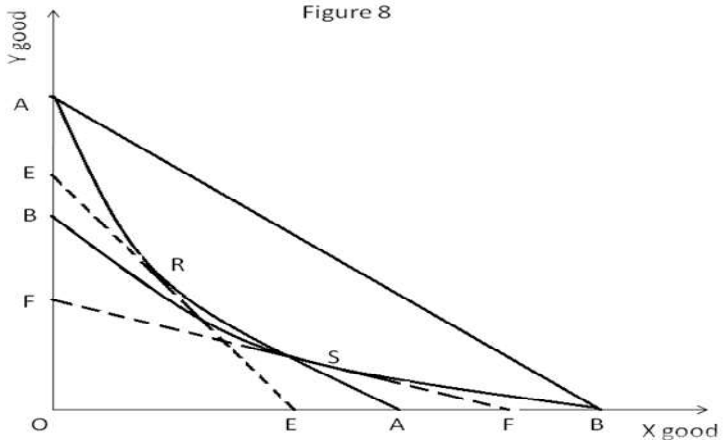
Similarly, under trade, country B would expand production of good Y by TS by contracting good X output by TE_1. If it would like to maintain pre-trade level of consumption of good Y, it can export TS quantity of good Y and obtain TE_3 quantity of good X and attain equilibrium at point E_3 which cannot be reached under the absence of international trade. The gain to country B will be equivalent to E_1E_3 of good X.

In the above analysis, it is assumed that the country A would wish to maintain the pre-trade level of consumption of good X and the country B the pre-trade consumption of good Y. But the real situation may be different. Consumption of these commodities by the respective countries may be less or more than under the absence of international trade so that community welfare could be maximized.

c) Decreasing opportunity cost and international trade

If MRT between X and Y goods goes on decreasing, then opportunity cost curve or production possibility curve will be concave to the origin.

Figure 8



In Figure, AA and BB are the production possibility curves for country A and country B respectively. In the situation of autarky, production equilibrium of country A is determined at R point, where its domestic price line EE tangents to its production possibility curve AA. Similarly, the production equilibrium of country B is at S point. Under the situation of international trade, the international price ratio is depicted by AB line. The relatively greater steepness of EE line to international price line AB shows that country A will specialize in the production of good Y. On the other hand, the relatively grater steepness of international price line AB than FF line indicates that country B will specialize in the production of good X. In other words, country A will export good Y and import good X; whereas country B will export good X and import good Y. The equilibrium point for both the countries, determined by tangency between community indifference curve and international price line will lie somewhere on AB line. Such point will indicate a higher level of satisfaction than either at R or S, signifying the gain from trade to the both countries.

Critical Appraisal

The critical appraisal of Haberler's opportunity cost theory can be discussed under two heads namely

1. Superiority over comparative cost theory, and
2. Criticisms.

1. Superiority over Comparative Cost Theory

Haberler's opportunity cost theory is regarded as superior to the comparative cost theory of international trade formulated by the classical economists like Adam Smith and David Ricardo. The arguments put for the superiority are summarized below:

a. **Dispenses with the Unrealistic Assumption of Labour Theory of Value:** The classical theory is based on the unrealistic assumption of labour theory of value. But Haberler's opportunity cost theory dispenses with such unrealistic assumption and is more realistic.

b. **Analyses the Pre-trade and Post-trade situations Completely:** The opportunity cost theory analyses pre-trade and post-trade situations under constant, increasing and decreasing opportunity costs, whereas the comparative cost theory is based on the constant cost of production within the country with comparative advantage and disadvantage between the two countries. Hence, Haberler's opportunity cost theory is considered to be more realistic over the classical theory.

c. **Highlights the Importance of Factor Substitution:** The opportunity cost theory highlights the importance of factor substitution in trade theory. It is vital in the production process especially for a growing economy.

d. **Facilitates the Easy Measurement of Opportunity Cost:** The opportunity cost can be measured easily.

e. **Explains the time, reason etc. about Trade:** The opportunity cost theory explains why trade takes place or when it should take place, showing how the gains shared between the countries etc.

f. **Explain about the Complete Specialization:** It explains when complete specialization is possible and when it is not possible etc.

2. Criticisms

Haberler's opportunity cost theory is also not free from criticisms. It has been vehemently criticized by Jacob Viner in his ¯Studies in the Theory of International Trade (1937) . Some of the important criticisms are listed below:

a. **Inferior as a Tool of Welfare Evaluation:** Jacob Viner says that opportunity cost approach is inferior as a tool of welfare analysis when compared to classical real cost approach. Further he says that the doctrine of opportunity cost fails to measure real costs in the form of Sacrifices or Disutilities.

b. **Fails to consider Changes in Factor Supplies:** Viner further criticizes that the production possibility curve or opportunity cost theory do not consider changes in the factor supplies.

c. **Fails to consider Preferences for Leisure against Income:** Viner also criticizes the opportunity costs theory on the ground that the production possibility curve does not take into account the preference for leisure against income.

Unrealistic Assumptions: Haberler's opportunity cost theory is based on many assumptions like two countries, two commodities, two factors, perfect competition, perfect factor market, full employment, no technical change etc. All these assumptions are unrealistic because they do not hold in the real world.

Though the Mercantilists, an early school of Economists, were the first to advocate a series of measures to regulate international trade, it was Adam Smith who provided the basic principles which influenced thinking on the subject for a long time. His method was to apply the benefits of specialisation to the international economy on the assumption that international trade was no different from internal trade of a country, if trade barriers were done away with. He wrote in "Wealth of Nations"[1], "It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. All of them find it in their interest to employ their whole industry in a way in which they have some advantage over their neighbours and to purchase with a part of it whatever else they have occasion for. What is prudence in the conduct of every private family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy of them with some part of the produce of our country employed in a way we have some advantage."

Adam Smith thus argued that relative advantage resulting from absolute differences in costs are the basis for international trade. But it was Ricardo who formulated the Law of comparative costs, which postulated that international trade would be possible even where absolute advantage did not exist. Ricardo's theory has been considerably refined and developed by later economists like Senior, Mill and Taussig.

To take a simple example :

Commodity	**Labour costs of output**	
	Country A	**Country B**
Wheat (Kgs.)	10	8
Cloth (Meters)	20	10

According to Adam Smith's theory, trade could have taken place only if one country produced more of one commodity per unit of labour input than of the other commodity in which the second country was more productive. However, in our example, country A can produce more of wheat as well as cloth per unit of labour than country B. The comparative cost theorists show that even in such a situation trade would take place. For though, A has an absolute cost advantage in both, its comparative advantage is greater in cloth than in wheat. Similarly, B is better placed in the production of wheat (relative to A) than in the production of cloth. Thus, 20 metres of cloth would buy 16 kgs. of wheat against only 10 Kgs. in A; while B could obtain 16 metres of cloth by exporting 8 Kgs. of wheat against only 10 in its domestic market. Thus, both sides can make a profit and trade will go on as long as relative production of wheat drops to 5 kgs. per unit of labour in B or alternatively, it rises to 16 Kgs. in A. We can restate our findings as follows :

"A country will tend to export the commodity whose relative cost or comparative cost of production is lower than it is in the other country. No international trade will occur if there are no differences in relative production costs between countries."[1]

Implicit in the above discussion is the Labour Theory of Value and hence the argument that prices equal labour costs. The labour theory of value is not generally accepted as valid because labour is neither homogenous nor the sole factor of production. Labour market consist of numerous qualitatively different sub-groups known as "non-competing groups." Even if labour were indeed homogenous and commended a single wage rate in a perfectly competitive market, there remains the more fundamental objection that labour is not the only factor of production. Goods are produced by various combinations of land, labour and capital, which may affect both productivity and profitability and, therefore, the structure of trade. Assumptions of labour theory of value also ignore money cost differences resulting from productivity differences. Nor does it take into account the causes underlying wage differences which may not always reflect real labour costs. Other economists have criticised the comparative cost theory for ignoring transport costs which can also effect the pattern and direction of trade. Equally valid criticism has been advanced against the implicit assumptions of constant costs and constant returns to scale.

We can conceive of trade taking place until a situation is reached when the ratio of the cost of producing the two commodities at home equals

this ratio abroad. At this point trade will come to a stop for want of further gain from it. Obviously, the greater the disparity in cost ratios between the two countries, the larger is the volume of profitable trade.

It is not within the scope of this lesson to discuss the determinants and the role of international prices and foreign exchange rates. But it may be noted, in passing, that the rate of exchange between two national currencies serves to convert relative cost differences into prices and hence may be significant to the direction and volume of trade predicted by the law of comparative costs.

The foreign account explains the classical theory of comparative costs as formulated by Ricardo and refined by Taussig. However, the theory has been analysed further and as a result modified and extended. Its modern versions reject the labour theory of value and restate it in terms of opportunity costs. This was first done by G. Harberler in 1933.[1]

Since every country has a given factor supply and given technology, at least in the short period, therefore, some of the possible alternative commodities, which could have been produced, will have to be foregone. Thus, there is an opportunity cost represented by the next best combination of commodities which may have been produced but for the scarcity of the resources. For simplicity of exposition, we assume, as Haberler did that there are only two factors of production, viz., capital and labour which can be used to produce wheat and/or cloth. The economic problem is to decide which of the two, or what combination of the two commodities to produce, because with a given factor supply, a country's production possibilities are necessarily limited. The greater the quantity of wheat that is produced, the less cloth will be manufactured and vice versa.

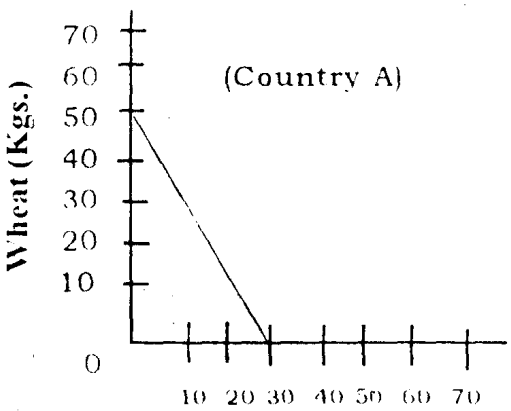


Fig. 1 (a)

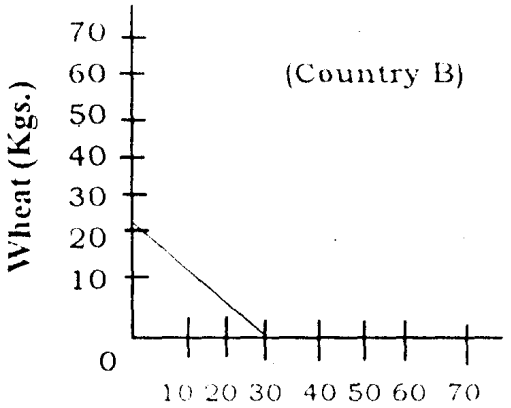
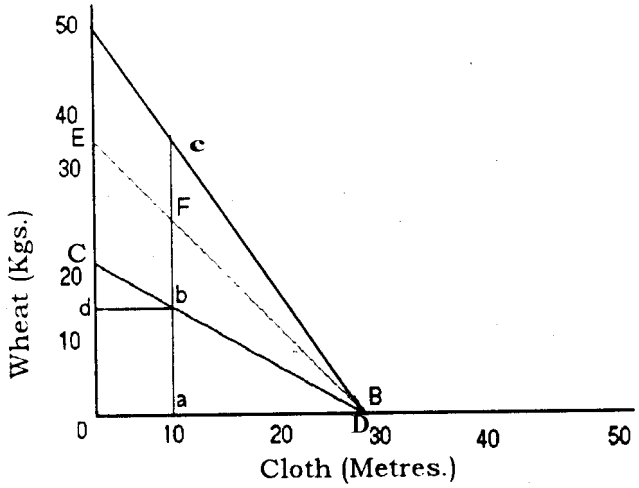


Fig. 1 (b)

In figures 1 (a) and (b), we have drawn hypothetical linear production frontier (or possibility) curves for countries A and B. These diagrams show that with given resources and optimum efficiency country A could produce either 50 Kgs. of wheat or 0 Metres of cloth or a combination of the two commodities indicated by the line AB, which shows the marginal rate of substitution (transformation) between the two commodities. Similarly, Combination of the two indicated by the curve CD for country B. Since the curves are linear, opportunity costs and so the rate of substitution (transformation) is constant. Therefore, 1 Kg. of wheat would exchange for 0.6 Metres of cloth in country A and 1.5 Metres of cloth in country B. It is apparent that A has comparative advantage in the production of wheat while B is relatively more efficient in the production of cloth and both the countries will gain if a specializes in wheat and B in cloth production. This can be illustrated with the help of the following figure which is derived from figure 1 (a) and (b).

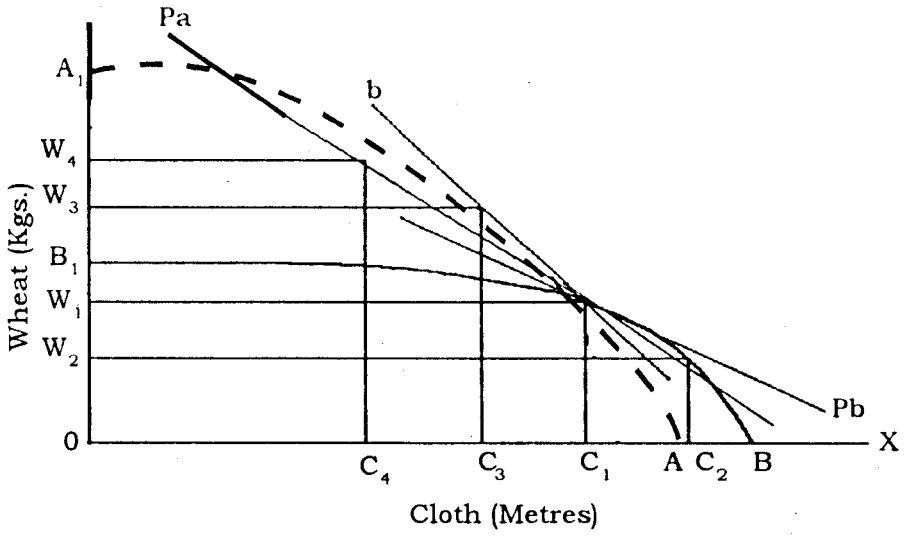


The initial consumption level in country B is at point b on the BC linear function which gives it Oa of cloth and Od of wheat. As trade between A and B begins the former will specialize in wheat production and latter in cloth. So B manufactures OB amount of cloth, of which it consumes Oa at home and exports B a to A in return for ac amount of wheat. Thus it adds bc to the previous level of wheat consumption which was ab, without any reduction in consumption of cloth. So B is a net gainer, but A is neither well off nor worse off. It simply moves from point P (not shown here) on A. B curve to point C representing a different combination of wheat and cloth than before, without loss or gain because the movement is along the same linear constant opportunity cost curve. This example, however, can be easily reversed to show the gains in favour of A. But international transactions are seldom based on the sided gain, and it often happens that as trade takes place between two products at the two domestic rations, represented by the line BE in our diagram. In this case, the two countries share the gains under the new terms of trade, the gain to B will be measured by bF and that of A by Fc.

Thus, to generalize from the above discussion of comparative (opportunity) costs, trade results from different production functions and/or commodity exchange ratios between different countries. It leads to

specialization by each country in the production of commodities in which it has a comparative (opportunity) cost advantage, and as a result of it, the combined production of all the commodities grows, enabling each country to consume more of it than before trade began. The ratio in which goods are exchanged between countries is known as "terms of trade" and in the present case they may be described without the intervention of money. The limit to the commodity terms of trade are set by the domestic exchange ratios prevailing in the two countries and the actuals are determined by the force of the internal demand. The terms of trade are relevant not merely for determining the quantity and pattern of trade between different countries but also between sectors within the same economy, e.g. between the agricultural and industrial sectors. The terms of trade between sectors within an economy determine relative costs, required level of consumption and the magnitude of import and export trade that can take place. Thus "internal terms of trade determine the "external" terms of trade and the environment in which trade takes place."

It may be noted that we have drawn a straight line curve because we have assumed constant (opportunity) costs. However, there is no reason that they must always be constant. If we have increased (opportunity) costs, the curve would be convex to the origin. It will be concave to the origin, if the costs are decreasing.



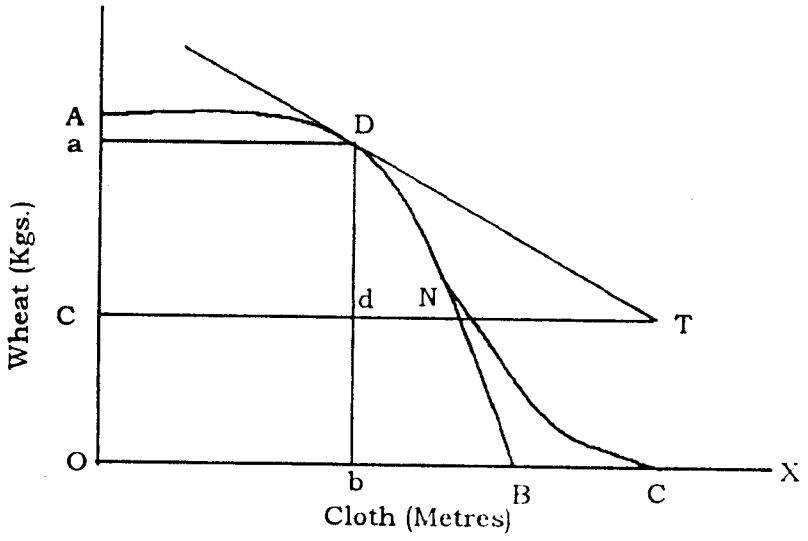
In the foregoing figure, we display the production possibilities and gains from specialization based on increasing opportunity costs. The two curves A, and B, have different slopes because with identical marginal rates of substitution (transformation) no trade would be possible. The slopes of the tangents Pa and Pb represent the domestic terms of trade between the two commodities in the two countries before the trade opens. Country A produces OW_3 amount of wheat and OC_3 of cloth. B produces OW_1 of wheat and OC_1 of cloth. It is evident that A has comparative advantage in wheat and B in cloth production, and it will be mutually advantageous for them to specialize accordingly.

International prices are determined by the interaction of demand and supply in the same manner as domestic prices are. Thus the line PP-tangential to the production possibilities (substitution) curves of both the countries indicates the equilibrium points at which trade between them would stablize. It shows that B can profitably decrease its output of wheat from OW_1 to OW_2, and increase its output of cloth from OC_1 to OC_2. Keeping its domestic consumption of cloth constant and equal to OC_4. It can now export C_4C_2 amount of cloth of A, in return for W_2W_4 equivalent of wheat imports from that country. On the other hand, A will increase its output to wheat from OW_3 to OW_4 by reducing its output of cloth OC_3 to OC_4. But its total consumption of cloth will increase to OC_2 (i.e. OC_4 domestic output $+C_4$ C_2 imports from B). Likewise, in B the consumption of wheat, will rise to OW_4 i.e., OW_4 (domestic output) + W_2 W_4 (imports from A). Thus both the countries are able to obtain and consume more of cloth or wheat, as the case may be, than they could obtain before trade began. But at the same time both had to reduce their consumption of other commodity-A had to reduce consumption of wheat from OW_3 to OW_2 and B of cloth from OC_1 to OC_4. It is, therfore, a moot point whether the two countries are better off on the whole, or not. The answer to this question would be that, if the gain from increased consumption of one commodity at a price lower than what would have prevailed in the absence of trade, outweigh the loss from reduced consumption of the other commodity whose comparative costs of production were higher than country as a whole gains from trade. Thus the final verdict involves careful weighting to benefits and costs.

So far we have assumed implicity, the absence of transport costs as a factor in determining comparative (opportunity) costs. We may now relax this assumption and consider the impact of transport costs (or to give it another

name-economic distance) on the international trade flows. We may define transport costs as the difference between the value of the product ex-factory, and its value at the point of delivery to the buyer consumer. The first impact of transport costs is to raise the import (FOB) price of the commodities traded. As a result, there will be a decline in consumption levels of the imported commodities in the trading countries, which in turn will bring about a shift in production pattern. Now the countries concerned will have to reduce their degree of specialization and the volume of trade between them will be reduced. The transport costs would modify the structure of their economies because they reduce the differences in comparative opportunity costs and thereby reduce the gains expected from international trade. Finally, transport costs do not effect the pattern of trade, except in cases, where they are so high as to completely nullify comparative advantages before absorption of transportation costs.

However, this loss of gain can be countered, if we consider the possibilities of decreasing (opportunity) costs-instead of constant and/or increasing (opportunity) costs, which we have considered till now. To analyse the implication of decreasing (opportunity) cost, we again assume zero transport costs for the sake of simplicity. Transportation costs can be introduced into the analysis, *mutatis mutandis,* as indicated in the preceding paragraph.



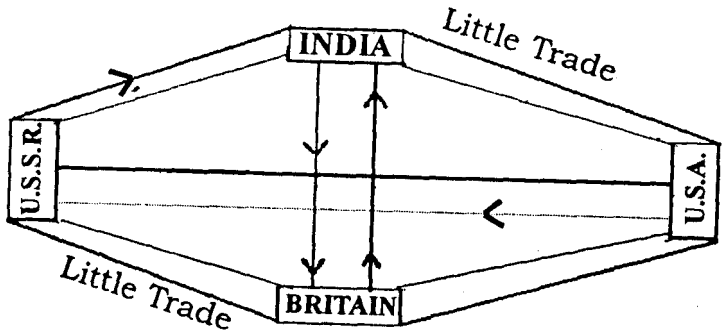
In the above figure, the ANC curve shows the transformation from increasing to decreasing opportunity cost. While wheat production is characterised by increasing opportunity costs throughout the stretch of ANB curve, cloth production is not if it is expanded beyond the critical point N at which the curve becomes convex to the origin. The country will then gain significant economies of scale which will alter the commodity terms of trade. The tangent represents the existing terms of trade giving Oa output of wheat and Ob output of cloth. Export of wheat equals to dD and import of cloth dT, while consumption level is given by T which lies outside the marginal substitution (transformation) curve. But as output moves beyond N towards C, less and less of wheat would have to be sacrificed for each marginal increase in cloth output, which is now subject of decreasing costs. Thus there will be a rapid shift in production. Even if complete specialization does not take place, the country will gain by extending production of those commodities in which possibilities of economies of scale exist.

Now we must extend our analysis to cover multilateral trade. So far we have analysed the theory of comparative costs on a bilateral basis with commodities. No doubt it is often bilateral but not always so. India's trading arrangements with Communist block countries are under bilateral trade treaties, but that with other countries are generally on a multilateral basis and so is most of international trade around the world. As such we must now lift our analysis out of the two country straight jacket and extend it to explain multilateral trade.

However, this does not mean that we can simultaneously take into account all the countries of the world with whom a country may have trade relations in the numerous commodities which it may be manufacturing. For them by permutation and combination, the number of possible outcomes will be infinite and it would be practically impossible to find out the precise direction of world commodity trade, especially for the fact that comparative costs themselves are constantly changing due to economic and non-economic factors. We will, therefore, limit ourselves to a group of four major countries which we known have substantial trade relations, viz., India, Britain, USSR and USA. By comparing the domestic pre-trade price-ratios (terms of trade) for any groups of commodities, a ranking in order of comparative advantages can be derived. The following table gives a hypothetical ranking in respect of commodities X and Y on the basis of assumed price rations :

Country	Commodities & Ranking	
	X	Y
Britain	1	4
USSR	2	3
India	3	2
USA	4	1

On the basis of above ranking, it can be seen that the pattern of trade expected would be something like the following diagram :



The foregoing table and diagram give an idea of the multilateral trade between four countries. It is possible to analyse the most probable commodity composition of any single country's trade with another country by similar ranking of the various commodities in terms of comparative costs. Thus, a general approximation can be made regarding the direction and commodity composition of trade among countries. But more remains to be known. No mention has yet been made of the factor endowments which affect comparative cost difference. To this we shall turn in the next lesson.

contrary to Heckscher Ohlin theory. But it ignores differences in production methods between the two countries.

Thus, though Heckscher-Ohlin theory explains why trade takes place, it is not accepted by modern economists as a full or complete explanation of the emerging pattern of trade in manufactured commodities between countries with similar economic structures. S.B. Linder has addressed himself to this problem. Explanation of trade pattern from comparative cost theories down to factor endowment theories have concentrated on the

analysis of supply side. They have virtually ignored the implications of demand for international trade. If a country has a buoyant home market for a certain commodity it guarantees a substantial demand which enables production to expand with resulting economics of scale, and the possibility of a surplus over domestic consumption emerging for export. Since economies with similar structure and more specifically, similar income levels tend also to be competitive, they offer better prospects for export performance than dissimilar economies. Hence according to Linder, two specific conditions must be fulfilled for trade between two countries to grow. First, the economies of scale in the domestic economies should be such as to enable costs of production to be reduced so that product becomes competitive abroad, and secondly, general economic conditions in foreign markets must be similar to those in domestic market.

In a somewhat different manner Kravis argues that determinant of the pattern of trade is the elasticity of supply within the trading countries. But he also argues that in the real world today, the volume and direction of the trade depends more on tariffs and foreign exchange and the nature of intervention by the state which regulate foreign trade and influence the terms of trade, rather than factor endowments and factor intensities.

LESSON NO. 2.2 **AUTHOR : DR. GOVIND KHANNA**

MODERN THEORY OF INTERNATIONAL TRADE

In the preceding lessons we have discussed the comparative cost basis of trade between countries. No mention was made therein of factor endowments which affect comparative cost differences. The theory sought to explain how comparative cost differences made trade mutually advantageous to the trading partners but did not offer any hypothesis as to how the pre-trade cost ratios differ between countries. The modern theory, on the other hand, goes behind these pre-trade cost ratios and seeks to predict the pattern to trade on the basis of the characteristics of pre-trade equilibria. Thus, modern theory (Heckscher-Ohlin) begins where the neo-classical (opportunity cost) theory of comparative advantage leaves off.

In 1919 Eli Heckscher published a paper on, "The Effects of Foreign Trade on the Distribution of Income"[1] in which he explained how factor endowments affect comparative cost differences. Unlike the classical theory, which make these differences dependent on the productivity of only one factor viz. labour, Heckscher's theory, which has been subsequently developed considerably by Bertil, Ohlin takes a multiplicity of factors into account. It makes the possibilities and pattern of trade department on these quantitative differences and the degrees of intensity with which the factors of production are used. However, Ohlin is of the view that even if two countries are equally endowed, profitable trade may still be possible between them, because differences and the degrees of intensity with which the factors of production are used. However, Ohlin is of the view that even if two countries are equally endowed, profitable trade may still be possible between them, because differences in demand patterns could give rise to differences in prices of the products.[2]

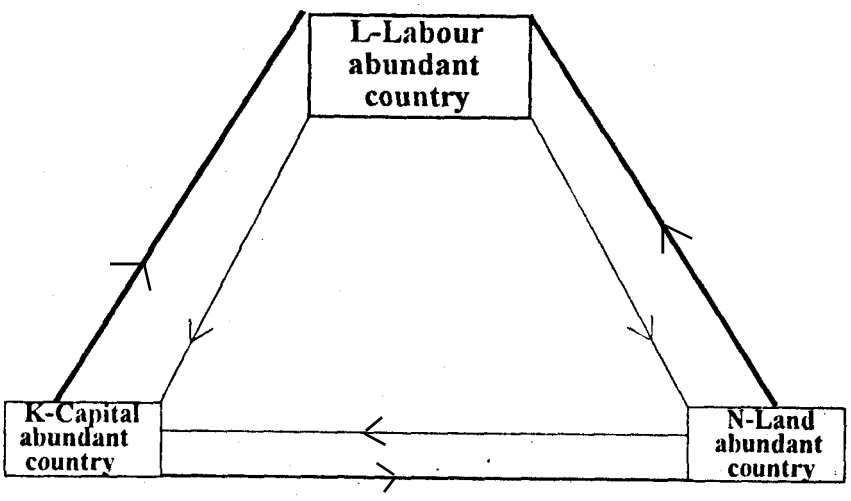
Differences in demand can be due to different patterns of income distribution, or the organisation of production activity as well as other institutional factors. A distinction, must, therefore, be made between physical abundance of a factor and its cheapness. The latter depends upon a balance between demand and supply, in which the former, when it outweigh the latter, can make the balance of comparative advantage against the abundant factor and

1. Ekonomiks Tidsknift vol. XXI (Ap. 497-912) 1919 - Reprinted in Reading in "The Theory of International Trade" Edition.
2. Inter-regional and International Trade (Harvard University Press), 1935.

in favour of the relatively scarce one. Also, where factor-substitution at the margin is possible, change in relative factor prices, e.g., a rise in wage rates may convert the labour intensive goods into capital intensive ones.

Furthermore, factor endowments may themselves be affected by inter-regional and international trade. Thus, there is a two way interaction between trade and economic structure of a country and also the distribution of income which effects the pattern of demand. Heckscher was of the view that free trade tends to equalize relative return of factors of production.

On the face of it, the theory seems to be quite reasonable and pragmatic. It suggests that countries which have an abundance of a factor (e.g. labour) should specialize in the production of those products in which labour intensive technology may be more efficient, because abundance would make wage rates and wage costs lower and thus give it a comparative advantage in labour intensive products. It can then export these products and import capital intensive product from those countries which have an abundance of capital relative to labour. Similarly, it could import land intensive products from those countries which have an abundance of land relative to labour or capital. Thus each country will end to specialize in the products which utilize the factor of which it has an abundant supply, and a pattern of trade will emerge such as the one suggested by the following diagram :-



As shown in the above figure, labour-intensive commodities are exported from country L to K and N, and capital-intensive commodities flow into country L and N from country K. Similarly, country N exports land-intensive commodities to the other two countries. However, as these transactions take place, the economies of the two countries are gradually changed. As L exports “Labour

intensive" commodities, more and more 'surplus' labour is absorbed and gradually, real wages rise till what was once an abundant resource becomes scarce. If real wages rise to the same level as in country K, the initial advantage completely disappears. Secondly, as the country L imports "Capital intensive" goods their scarcity is reduced and with growing abundance, their prices begin to fall. The two processes may go on till the difference between two countries is bridged. Reciprocal change may take place in the country K, where "Capital intensive" commodity will become less abundant with consequent rise in prices and "Labour intensive" commodity may become relatively more abundant with consequent decline in prices.

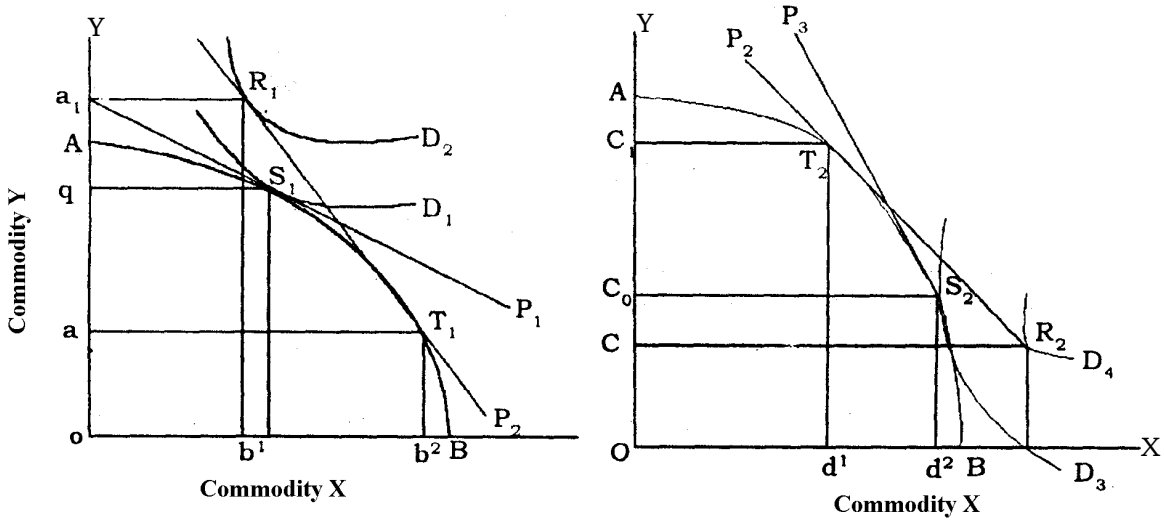
Thus, trade between the two countries tends to equalize both factors and commodity prices and it does so by bringing about corresponding changes in economic structure which tends to make their economies similar inspite of dissimilar factor endowment. From this, one should not jump to the conclusion that if only international trade is freed from all restrictions, as the classicals wanted, there would come a complete equalization of factor and commodity prices throughout the world. Such a conclusion would be unwarranted. Heckscher and Ohlin do not imply complete equalisation, which is impossible in the real world due to many products, changing techniques and production functions, differing character of people, geographical factors etc. As such, all that can be said is that international trade tends to equalize prices, other things remaining the same.

Another significant aspect of international trade highlighted by Heckscher-Ohlin's factor endowment approach to international trade is in respect of distribution of incomes, which results in shifts in production. International trade leads to specialization by each country in one of the specific type of goods, such as capital intensive or labour intensive. As a result, there is transference of resources and changes in capital/labour ratios in the production of both commodities in both the countries. If factor prices reflect the marginal productivities of factors, then in the capital abundant country real wages will tend to fall and will tend to be redistributed in favour of capital and against the working classes. The impact in labour abundant country will be the opposite. In either case regulation of international trade with a view to regulate distribution of income would be justified. But we shall postpone this question to a later lesson dealing with commercial policy.

A treatment of international economics shall be incomplete until we deal with the demand side also, because it is the interaction between demand and supply which determines the equilibrium of the economy. This can be demonstrated with the help of the following diagrams, refering to two countries, which we assume, have identical factor endowments, technologies, production

functions and therfore, identical production possibility (substitution/ transformation) curves. But tastes and preferences and, therefore, demand curves (Community indifference curves) are different.

AB curves represents the identical production possibilities of the countries. Pre-trade price ratios (terms of trade) are represented by tangentical lines P_1 (Country A) and P_3 (Country B) which have different shapes. The difference is not due to supply functions, but demand functions which are represented by the curves D_1 (Country A) and D_3 (Country B). These provide the basis for gains from trade. As trade begins price ratios (terms of trade) change and equalize along P_2 curve. In country A production and consumption are given by the coordinates of point S_1 in the pre-trade period. But as price ratios change to P_2 line, production shifts to the coordinates of point T_1 with consumption rising to point R_1 on the higher indifference curve D_2. The country will be importing a a_1 equivalent from country B and exporting b^1b^2 of the commodity.



Similarly, in country B, with price ratios shifting from P_3 to P_2 line, production of the two commodities will shift from the coordinates of S_2 to those of point T_2 and consumption will advance to point R_2 on the indifference curve D_4. The country B will now import d^1d^2 amount of commodity X and export c_0c_1 amount of commodity Y.

Thus the structure of production and consumption are simultaneously transformed as a result of differences in consumer preferences, and both countries gain in economic welfare resulting from specialization, improvements in economic efficiency and increased consumption.

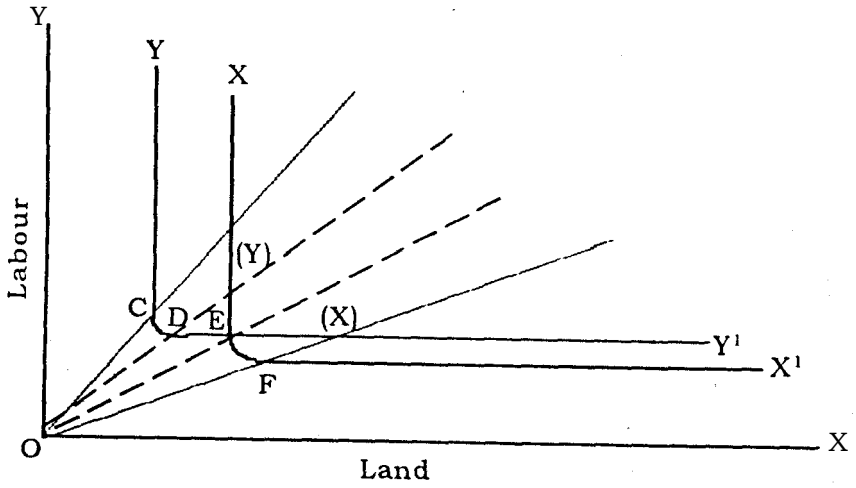
The above is a simplified version of the modern theory propounded by

Heckscher and Ohlin. Now we take a critical look at its assumptions and postulates.

Firstly, tastes are largely similar between countries and, therefore, demand factors are homogeneous and identical. Thus community indifferences, become possible and differences in pre-trade price ratios are then attributed to differences, in production possibilities frontiers of the countries involved in trade. At the same time production possibilities frontiers become a function of its factor endowments and the production functions of the various commodities which are assumed to be linear homogenous since the production function are further postulated to identical in the two countries. Therefore, any differences in the shape of production possibilities frontiers can be due only to differences in factor endowments.

With a single technique of production for commodity X, and a single technique for commodity Y, the two commodities can always be classified unambiguously into labour-intensive or land-intensive relative to the one or the other commodity. The only exception to this rule would be the case where the expansion paths of the two commodities coalesces over the entire range. But this would then become akin to a single commodity case from our point of view, and, therefore, outside the purview of the present discussion.

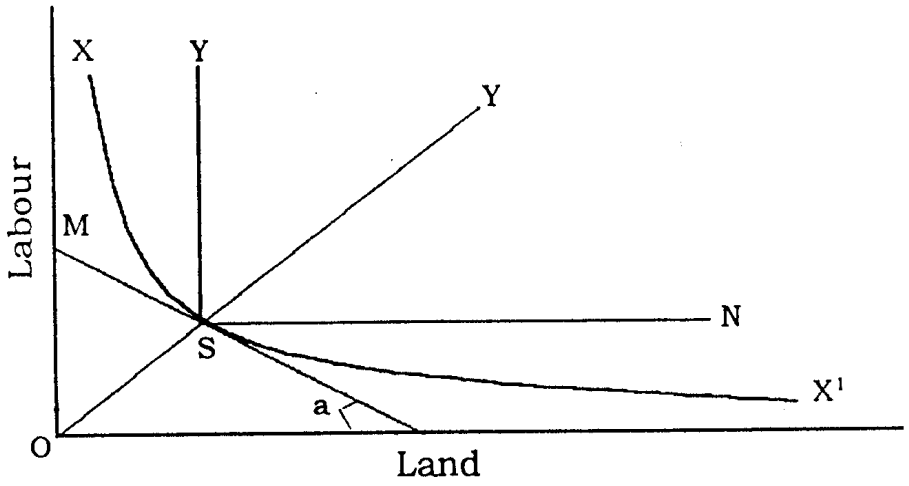
However, usually more than one technique of production is known to exist for each commodity. In such cases, it is not always possible to unambiguously classify two commodities in terms of factor intensity. Sometime it is and sometimes it is not.



In the above diagram, the two techniques of producing commodity X are given by the co-ordinates of E and F on XX^1 isoquant curve. Similarly, the coordinates of C and D on the isoquant curve YY^1 give the two techniques for

producing the commodity Y. If we assume that technique E and F can be combined (without any interaction between them) to produce one unit of X and similarly, techniques C and D can be combined to produce one unit of Y, then it is obvious that one unit of X can be produced by any combination of land and labour which is between the EF segment of the isoquant XX^1. Similarly, for the CD segment of the YY^1 isoquant. Thus, it is apparent from their above figure that commodity Y is labour-intensive relative to X and that commodity X is land-intensive relative to Y. This follows from the fact that the shaded areas X and Y do not overlap. However, such unambiguous classification would not have been possible if the shaded area X and Y overlapped, each wholly or partially. In that case, the conclusion would depend on the selection of the optimum expansion paths of the two commodities. The selection of the optimum expansion path depends upon factor price ratio and the marginal rate of substitution of labour for land. If both industries pay the same factor prices, the optimum expansion path would correspond to the identical marginal rates of substitution of labour for land. But since factor prices are not given to begin with, it is not possible to decide which commodity is labour-intensive and which is land-intensive. Hence, commodity Y is defined to be labour-intensive relative to another commodity X if commodity Y uses more of labour per unit of land than commodity X for all factor price ratios.

Unfortunately, there exist particular parts of isoquants for which commodities X and Y cannot be unambiguously ranked in terms of factor intensity and Heckscher-Ohlin requirements cannot be met.



The diagram alongside represents a case where Heckscher-Ohlin

condition cannot be met. The isoquant of commodity Y is L shaped while that of X is smooth. They touch at only one point S through which the line OS, which defines the expansion path of commodity Y passes. But X expansion path is not so uniquely defined. It depends on the factor-price ratios. When the factor-price ratio is the slope of x at point S, then X's expansion path coalesces with that of Y. However, for any factor-price ratio lower than x, such as at point N (on XX' curve, X's expansion path is flatter than Y's. This makes Y labour-intensive relative to X. On the other hand any factor price ratio higher than x (such as point M on XX') will make X labour intensive relative to Y. Therefore, in this particular case, an unequal classification of commodities by factor intensity is possible. In such cases, known as factor-reversal, Heckscher-Ohlin theorem becomes very difficult to follow since it is based on the implicit assumption that commodities can indeed be classified a priori, in terms of factor intensity. When this implicit assumption is not met, the structure of trade need not coincide with the pattern implicit in Heckscher-Ohlin theorem.

Similarly, when the ranking of commodities is contradictory between countries, the logic of Heckscher-Ohlin theorem breaks down because it is impossible for both countries, to export the commodity which uses more intensively their abundant factor.

Heckscher-Ohlin theory has been empirically tested by Prof. W.W. Leontief. But we will be surprised to see the conclusion that "American participation in the international division of labour is based on its specialisation in labour-intensive rather than capital intensive lines of production. In other words, this country resorts to foreign trade in order to economize its capital and dispose of its surplus labour, rather than vice-versa. This has come to be known as 'Leontief Paradox'.

Leontief sought to explain it in terms of superior effectiveness of the American worker as compared to foreign workers. W. Vanek thought that though U.S. is capital abundant, it may not be effective in terms of production because of the relative scarcity of cooperate natural resources. R. Robinson on the other hand, sought to explore it from the demand side and felt that at high levels of income, the consumption of capital intensive goods may be so high that a country may have to import it. While W.P. Travis argued that factor endowment cannot be the basis of determining trade-patterns is a tariff-ridden world. But as Ellsworth argued production functions are not identical as between different countries, especially those at different levels of economic and technological development, as Ohlin assured. Thus the basic assumption of the theory, is rarely fulfilled in the real world.

It may be appropriate to mention here, that an Indian economist Dr. Raghunath Bhardwaj has tested Heckscher Ohlin theory with reference to

Indian trade. He found that India's export to the USA are of capital intensive goods while its imports from USA are labour intensive. This may seem to be contrary to Heckscher Ohlin theory. But it ignores differences in production methods between the two countries.

Thus, though Heckscher-Ohlin theory explains why trade takes place, it is not accepted by modern economists as a full or complete explanation of the emerging pattern of trade in manufactured commodities between countries with similar economic structures. S.B. Linder has addressed himself to this problem. Explanation of trade pattern from comparative cost theories down to factor endowment theories have concentrated on the analysis of supply side. They have virtually ignored the implications of demand for international trade. If a country has a buoyant home market for a certain commodity it guarantees a substantial demand which enables production to expand with resulting economics of scale, and the possibility of a surplus over domestic consumption emerging for export. Since economies with similar structure and more specifically, similar income levels tend also to be competitive, they offer better prospects for export performance than dissimilar economies. Hence according to Linder, two specific conditions must be fulfilled for trade between two countries to grow. First, the economies of scale in the domestic economies should be such as to enable costs of production to be reduced so that product becomes competitive abroad, and secondly, general economic conditions in foreign markets must be similar to those in domestic market.

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Terms of Trade and Principle of Reciprocal Demand

1 Introduction

The terms of trade refer to the rate at which the goods of one country exchange for the goods of another country. It is a measure of the purchasing power of exports of a country in terms of its imports, and is expressed as the relation between export prices and imports prices of its goods. When the export prices of a country rise relatively to its import prices, its terms of trade are said to have improved. The country gains from trade because it can have a larger quantity of imports in exchange for a given quantity of exports. On the other hand, when its import prices rise relatively to its export prices, its terms of trade are same when a country is in trade there are many types of terms of trade which are as follows:

2.1 COMMODITY TERMS OF TRADE

The commodity or net barter terms of trade is the ratio between the prices of a country's export goods and import goods. Symbolically, it can be expressed as T = Px/P_m, where T, stands for the commodity terms of trade, P for price, the subscript x for exports and m for imports.

To measure changes in the commodity terms of trade over a period, the ratio of the change in export prices to the change in import prices is taken.

$$T_c = \frac{Px_1}{Px_0} \Big/ \frac{Pm_1}{Pm_0}$$

where the subscripts 0 and 1 indicate the base and current periods. Taking 1991 as the base year and expressing India's both export prices and import prices as 100, if we find that by the end of 2001 its index of export prices had fallen to 90 and the index of import prices had risen to 110. The terms of trade had changed as follows:

$$T_c = \frac{90}{100} \Big/ \frac{110}{100} = 81.82$$

It implies that India's terms of trade declined by about 18 per cent in 2001 as compared with 1991, thereby showing the worsening of its terms of trade.

If the index of export prices had risen to 180 and that of import prices to 150, then the terms of trade would be 120. This implies an improvement in the terms of trade by 20 per cent in 2001 over 1991.

This concept has been used by economists to measure the gain from international trade.

Despite its use as a device for measuring the direction of movement of the gains from trade, this concept has important limitations.

Usual problems associated with index number in terms of coverage, base year and method of calculation arise. The commodity terms of trade are based on the index numbers of export and import prices. But they do not take into account changes taking place in the quality and composition of goods entering into trade between two countries. Another serious difficulty in the commodity terms of trade is that it simply shows changes in export and import prices and not how such prices change. The concept of the commodity terms of trade throws no light on the "capacity to import" of a country. Suppose there is a fall in the commodity terms of trade of India. It means that a given quantity of Indian exports will buy a smaller quantity of imports than before. Along with this trend, the volume of Indian exports also rises, may be as a consequence of the fall in the prices of exports. The commodity terms of trade also ignore a change in the productive efficiency of a country.

2.2 GROSS BARTER TERMS OF TRADE

The gross barter terms of trade is the ratio between the quantities of a country's imports and exports. Symbolically, $Tg = Qm/Ox$ where Tg stands for the gross terms of trade, Qm for quantities of imports and Qx for quantities of

exports. The higher the ratio between quantities of imports and exports, the better the gross terms of traded.

To measure changes in the gross barter terms of trade over a period, the index numbers of the quantities of imports and exports in the base period and the end period are related to each other.

$$Tg = \frac{Qm_1}{Qm_0} \Big/ \frac{Qx_1}{Qx_0}$$

Taking 1991 as the base year and expressing India's both quantities of imports and exports as 100, if we find that the index of quantity imports had risen to 160 and that of quantity exports to 120 in 2001, then the gross barter terms of trade had changed as follows:

$$Tg = \frac{160}{100} \Big/ \frac{120}{100} = 133.33$$

It implies that there was an improvement in the gross barter terms of trade of India by 33 per cent in 2001 as compared with 1991.

If the quantity import index had risen by 130 and that of quantity exports by 180, then the gross barter terms of trade would be 72.22. This implies deterioration in the terms of trade by 18 per cent in 2001 over 1991.

The concept of gross barter terms of trade has been criticised for lumping together all types of goods and capital payments and receipts as one category in the index numbers of exports and imports. There are no units applying equal to rice and to steel, or to export (or import) of capital and the payment (or receipt) of a grant. It is, therefore, not possible to distinguish between the various types of transactions which are lumped together in the index.

2.3 INCOME TERMS OF TRADE

Dorrance has improved upon the concept of the net barter terms of trade by formulating the concept of *income terms of trade.* This index takes into account the volume of exports of a country and its export and import prices (the net barter terms of trade). It shows a country's changing import capacity in relation to changes in its exports. Thus the income terms of trade is the net barter terms of trade of a country multiplied by its export volume index. It can be expressed as on the next page :

$$Ty = Tc.Qx = \frac{PxQx}{Pm} = \frac{\text{Index of export prices} \times \text{Export quality}}{\text{Index of import prices}}$$

$$\left(\because Tc = \frac{Px}{Pm}\right)$$

Where, *Ty* is the income terms of trade, *Tc* the commodity terms of trade and *Qx* the export volume index.

A rise in the index of income terms of trade implies that a country can import more goods in exchange for its exports. A country's income terms of trade may improve but its commodity terms of trade may deteriorate. Taking the import prices to be constant, if export prices fall there will be an increase in the sales and value of exports. Thus while the income terms of trade might have improved, the commodity terms of trade might have deteriorated. The income terms of trade is called the capacity to import. In the long-run, the total value of exports of a country must equal its total value of imports, i.e. *PxQx=PmQm* or *Px.Qx/Pm=Qm.* Thus *PxQmlPm* determines *Qm* which is the total volume that a country can import. The capacity to import of a country may increase if other things remain the same the price of exports *(Px)* rises, or the price of imports *(Pm)* falls, or the volume of its exports *(Qx)* rises. Thus the concept of the income terms of trade is of much practical value for developing countries having low capacity to import.

But the index of income terms of trade fails to measure precisely the gain or loss from international trade. When the capacity to import of a country increases, it simply means that it is also exporting more than before. In fact, exports include the real resources of a country which can be used domestically to improve the living standards of its people. Moreover, the income terms of trade index is related to the export-based capacity to import and not to the total capacity to import of a country which also includes its foreign exchange receipts. For example, if the income terms of trade index of a country has deterierated but its foreign exchange receipts have risen, its capacity to import has actually increased, even though the index shows deterioration.

2.4 SINGLE FACTORAL TERMS OF TRADE

The concept of commodity terms of trade does not take account of productivity changes in export industries. Professor Viner has developed the concept of single factoral terms of trade which allows changes in the domestic export sector. It is calculated by multiplying the commodity terms of trade index by an index of productivity changes in domestic export industries. It can be expressed as:

$$Ts = Tc.Fx = \frac{Px.Fx}{Pm} \qquad \left(\because Tc = \frac{Px}{Pm}\right)$$

where *Ts* is the single factoral terms of trade, *Tc* is the commodity terms of trade, and *Fx* is the productivity index of export industries.

It shows that a country's factoral terms of trade improve as productivity improves in its export industries. If the productivity of a country's export industries increases, its factoral terms of trade may improve even though its commodity terms of trade may deteriorate. For example, the prices of its exports may fall relatively to its import prices as a result of increase in the productivity of the export industries of a country. The commodity terms of trade will deteriorate but its factoral terms of trade will show an improvement.

This index is not free from certain limitations. It is difficult to obtain the necessary data to compute a productivity index. Further, the single factoral terms of trade do not take into account the potential domestic cost of production of import industries in the other country. To overcome this weakness, Viner formulated the double factoral terms of trade.

2.5 DOUBLE FACTORAL TERMS OF TRADE

The double factoral terms of trade take into account productivity changes both in the domestic export sector and the foreign export sector producing the country's imports. The index measuring the double factoral terms of trade can be expressed as

$$Td = Tc.\frac{Fx}{Fm} = \frac{Px}{Pm}.\frac{Fx}{Fm} \qquad \left(\because Tc = \frac{Px}{Pm}\right)$$

where *Td* is the double factoral terms of trade, *Px/Pm* is the commodity terms of trade, *Fx* is the export productivity index, and *Fm* is the import productivity index.

It helps in measuring the change in the rate of exchange of a country as a result of the change in the productive efficiency of domestic factors, manufacturing exports and that of foreign factors manufacutirng imports for that country. A rise in the index of double factoral terms of trade of a country means that the productive efficiency of the factors producing exports has increased relatively to the factors producing imports in the other country.

In practice, however, it is possible to calculate an index of double factoral terms of trade of a country. But it has not been possible to construct a double factoral terms of trade index of any country because it involves

measuring and comparing productivity changes in the import industries of the other country with that of the domestic export industries

2.6 REAL COST TERMS OF TRADE

This index is calculated by multiplying the single factoral terms of trade with the reciprocal of an index of the amount of disutility per unit of productive resources used in producing export commodities. It can be expressed as:

$$Tr = Ts.Rx = \frac{Px}{Pm} Fx.Rx \qquad \left(\because Ts = \frac{Px}{Pm}.Fx\right)$$

where *Tr* is the real cost terms of trade, *Ts* is the single factoral terms of trade and *Rx* is the index of the amount of disutility per unit of productive resources used in producing export commodities.

A favourable real cost terms of trade index shows that the amount of imports received is greater in terms of the real cost involved in producing export commodities. But this index fails to measure the real cost involved in the form of goods produced for export which could be used for domestic consumption to pay for imports.

2.7 UTILITY TERMS OF TRADE

The utility terms of trade index measures "changes in the disutility of producing a unit of exports and changes in the relative satisfactions yielded by imports, and the domestic products foregone as the result of export production." In other words, it is an index of the relative utility of imports and domestic commodities foregone to produce exports. The utility terms of trade index is calculated by multiplying the real cost terms of trade index with an index of the relative average utility of imports and of domestic commodities foregone.

$$u = \frac{Um_1}{Ua_1} \Big/ \frac{Um_0}{Ua_0}$$

where u is the index of relative utility of imports and domestically foregone commodities. Thus the utility terms of trade index can be expressed as:

$$Tu = Tr.u = \frac{Px}{Pm}.Fx.Rx.u$$

Since the real terms of trade index and utility terms of trade index involve the measurement of disutility in terms of pain, irksomeness and sacrifice, they are elusive concepts. As a matter of fact, it is not possible to measure disutility (for utility) in concrete terms.

Hence like the single and double factoral terms of trade concepts, the concepts of real and utility terms of trade are of little practical use. They are only of academic interest. That is why the concepts of the commodity terms of trade and of income terms of trade have been used in measuring the gains from international trade in developed as well as developing countries.

3 FACTORS AFFECTING TERMS OF TRADE

The terms of trade of a country are influenced by a number of factors which are discussed as under:

1. Reciprocal Demand

The terms of trade of a country depend upon reciprocal demand, i.e. "the strength and elasticity of each country's demand for the other country's product". This also relates to the determination of the equilibrium terms of trade.

Suppose there are two countries, India and Bangladesh, which produce linen and cloth respectively. If India's demand for Bangladesh's cloth becomes inelastic, the price of cloth rises more than the price of linen, the commodity terms of trade will move against India and in favour of Bangladesh. On the other hand, if Bangladesh's demand for India's linen becomes more intense, the price of linen will rise more than the price of cloth, and the commodity terms of trade will move in favour of India and against Bangladesh.

2. Changes in Factor Endowments

Changes in factor endowments of a country affect its terms of trade. Changes in factory endowments may increase exports or reduce them. With tastes remaining unchanged, they may lead to changes in the terms of trade.

3. Change in Technology

Technological changes also affect the terms of trade of a country. The effect of technological change on terms of trade is favourable for the country which has improved its product technically.

4. Changes in Tastes

Changes in tastes of the people of a country also influence its terms of trade with another country. Suppose Bangladesh's tastes shift from India's linen to its own cloth. In this situation, Bangladesh would export' less cloth to India and its demand for India's linen would also fall. Thus Bangladesh's terms of trade would improve. On the contrary, a change in Bangladesh's taste for India's linen would increase its demand and hence the terms of trade would deteriorate for Bangladesh.

5. Economic Growth

Economic growth is another important factor which affects the terms of trade. The raising of a country's national product or income over time is called economic growth. Given the tastes and technology in a country, an increase in its productive capacity may affect favourably or adversely in terms of trade.

6. Tariff

An import tariff improves the terms of trade of the imposing country and for other country it will be unfavourable.

7. Devaluation

Devaluation raises the domestic price of imports and reduces the foreign price of exports of a country devaluing its currency in relation to the currency of another country. The commodity terms of trade will deteriorate only when export prices fall more than import prices in terms of domestic currency. In reality, the elasticities of demand and supply for exports and imports of a devaluing country determine deterioration or improvement in its terms of trade. If both the foreign demand for exports and home demand for imports are highly elastic and supplies both to home exports and foreign imports are highly inelastic to price movements, devaluation leads to an improvement in the commodity terms of trade.

4. Theory of Reciprocal Demand

Ricardo expounded the theory of comparative advantage without explaining the ratios at which commodities would exchange for one another. It was J.S. Mill who discussed the latter problem in detail in terms of his theory of reciprocal demand. The term 'reciprocal demand' introduced by Mill to explain the determination of the equilibrium terms of trade. It is used to indicate a country's demand for one commodity in terms of the quantities of the other commodity it is prepared to give up in exchange. It is reciprocal demand that determines the terms of trade which, in turn, determine the relative share of each country. Equilibrium would be established at that ratio of exchange between the two commodities at which quantities demanded by each country of the commodity which it imports from the other, should be exactly sufficient to pay for one another.

To explain his theory of reciprocal demand, Mill first restated the Ricardian theory of comparative costs. "Instead of taking as given the output of each commodity in two countries, with the labour costs different, he assumed a given amount of labour in each country, but differring outputs. Thus his formulation ran in terms of comparative advantage, or comparative effectiveness of labour, as contrasted with Ricardo's comparative labour cost."

Assumptions

Mill's theory of reciprocal demand is based on the following assumptions:

1. There are two countries, say, Bangladesh and India.
2. There are two commodities, say, linen and cloth.
3. Both the commodities are produced under the law of constant returns.
4. There are no transport costs.
5. The needs of the two countries are similar.
6. There is perfect competition.

7. There is full employment.
8. There is free trade between the two countries.
9. The principle of comparative costs is applicable in trade relations between the two countries.

Explanation of the Theory

Given these assumptions, Mill's theory of reciprocal demand can be explained with this example:

Suppose India can produce 10 units of linen or 10 units of cloth within one man-year and Bangladesh can produce 6 units of linen or 8 units of cloth with the same input of labour-time. This is because India has *an* absolute advantage in the production of both linen and cloth, while Bangladesh has the least comparative disadvantage in the production of cloth. This can be seen from their domestic exchange ratios and international exchange ratios.

Before trade, the domestic cost ratio of linen and cloth in India is 1:1 and in Bangladesh 3:4. If they were to enter into trade, India's advantage over Bangladesh in the production of linen is 5:3 (or 10:6), and in the production of cloth 5:4 (or 10:8). Since 5/3 is greater than 5/4, India possesses greater comparative advantage in the production of linen. Thus it is in India's interest to export linen to Bangladesh in exchange for cloth. Similarly, Bangladesh's position in the production of linen is 3/5 (or 6/10) and in the production of cloth is 4/5 (or 8/10). Since 4/5 is greater than 3/5, it is in the interest of Bangladesh to export cloth to India in exchange for linen.

Mill's theory of reciprocal demand relates to the possible terms of trade at which the two commodities will exchange for each other between the two countries. The terms of trade refer to 'the barter terms of trade' between the two countries, *i.e.,* the ratio of the quantity of imports for a given quantity of export of a country. And "the limits to the possible barter terms of trade (the international exchange ratio) are set by the domestic exchange ratios established by the relative efficiency of labour in each country."

In India 2 inputs of labour-time produce 10 units of linen and 10 units of cloth, while in Bangladesh the same labour produces 6 units of linen and 8 units of cloth. The domestic exchange ratio between linen and cloth in India is 1:1 and 1:1.33 in Bangladesh. Thus the limits of possible terms of trade are 1 linen: 1 cloth in India and 1 linen : 1.33 cloth in Bangladesh. Thus the terms of trade between the two countries will be between 1 linen or 1 cloth or 1.33 cloth.

But the actual ratio will depend upon reciprocal demand, i.e. "the strength and elasticity of each country's demand for the other country's product." If India's demand for Bangladesh's cloth is more intense (inelasic), then the terms of trade will be nearer 1:1. India will be prepared to exchange one unit of linen with one unit of cloth of Bangladesh. The terms of trade will

move against it and in favour of Bangladesh. Consequently, India's gain from trade will be less than that of Bangladesh. On the other hand, if India's demand for Bangladesh's cloth is less intense (more elastic), then the terms of trade will be nearer 1:1.33. India will be prepared to exchange its one unit of linen with 1.33 units of cloth of Bangladesh. The terms of trade will move in favour of India and against Bangladesh. Consequently, India's gain from trade will be greater than that of Bangladesh.

Mill's theory of reciprocal demand is explained diagrammatically in terms Marshall's offer curves.

In fig. 13.1, Bangladesh producing only cloth is taken on the horizontal axis and India producing only linen is taken on vertical axis. The curve OE is Bangladesh's offer curve. It shows how many units of cloth Bangladesh will give up for a given quantity of linen. Similarly, OG is the offer curve of India which shows how many units of Linen India is prepared to give up in exchange for a given quantity of cloth. The point T where the two offer curves OE and OG intersect is the equilibrium point at which OC of cloth is exchanged by Bangladesh of OL of linen of India. The rate at which cloth is exchanged for linen is equivalent to the slope of the ray OT.

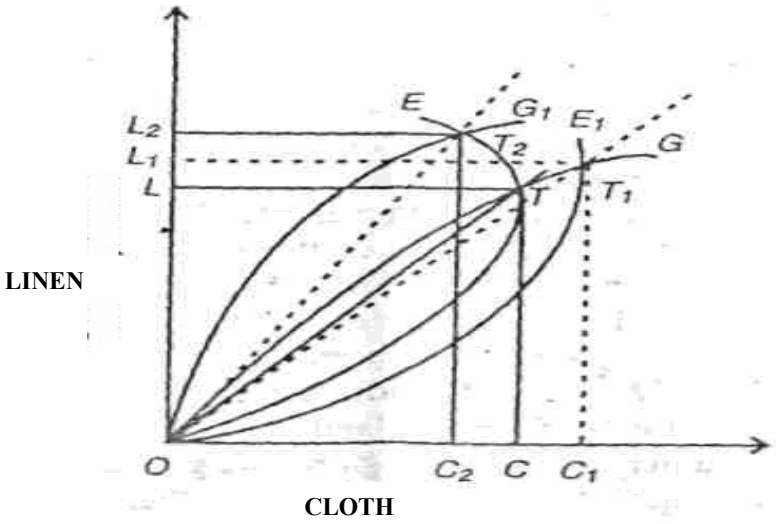

Figure 2.1

A change in the demand on the part of one country for the product of the other country brings about a change in the shape of its offer curve. Suppose Bangladesh's demand for India's linen increases. Bangladesh might now be prepared to exchange more cloth for India's linen. Consequently, Bangladesh's offer curve shifts to the right as OE_1 which intersects India's offer curve OG at T_1. Now Bangladesh trades OC_1 units of cloth for OL_1 units of linen. The terms of

trade, as shown by the slope of the OT_1 indicate that they have deteriorated for Bangladesh and improved for India. This is evident from the fact that Bangladesh trades CC_1 units of cloth for LL_1 units of linen. CC_l is greater than LL_1

Similarly, if India's demand for Bangladesh's cloth increases, India's offer curve shifts to the left as OG_1 which intersects Bangladesh's offer curve OE at T_2. Now India exchanges OL_2 units of linen for OC_2 units of cloth. The terms of trade, as shown by the slope of the OT_2, indicate that they have deteriorated for India and improved for Bangladesh.This is clear from the fact that India exchanges LL_2 more linen for CC_2 less cloth, *i.e.* $LL_2 > CC_2$

But the actual terms of trade will depend upon the elasticity of demand of the offer curve of each country. The more elastic the offer curve of a country, the more unfavourable will be terms of trade for it in relation to the other country. On the contrary, the more inelastic is its offer curve, the more favourable will be its terms of trade in relation to the other country.

Its Criticisms

Mill's theory of Reciprocal Demand is based on almost the same unrealistic assumptions that were adopted by Ricardo in his doctrine of comparative advantage. Thus the theory suffers from similar weaknesses. Besides, there are some additional criticisms made by Viner, Graham, and others.

1. Mill's theory of reciprocal demand does take into account the domestic demand for the product. As pointed out by Viner, each country would export its product only after satisfying its home demand. Thus the demand curve for India would not be below the line *Og* until the domestic demand was satisfied, and the same applies to Bangladesh.
2. According to Graham, Mill's analysis is valid only if the two countries are of equal size and the two commodities are of equal consumption value. In the absence of these two assumptions, if one country is small and the other large, the small country gains the most on both counts: *First,* if it produced a high-value commodity, it will adopt the cost ratios of its big partner; and *Second,* the two trading countries being of unequal size, the terms of trade will be fixed at or near the comparative costs of the large country.
3. Mill's theory is based on the unrealistic assumption of two-countries and two-commodities. Graham, therefore, favours several commodities, several countries and complex trade.
4. Graham further criticises Mill for emphasising demand and neglecting supply in determining international values. According io him, the application of the reciprocal demand makes it appear that demand alone is of interest. He maintains that production costs (supply) are also of paramount importance in international trade. He thus attacked the Law of Reciprocal

Demand "as appropriate only to trade in antiques and old masters."

5. Another weakness of Mill's analysis of reciprocal demand is that it makes no allowance for fluctuations in incomes in the two trading countries which are bound to influence the terms of trade between them.

6. Further, the theory is based on barter of trade and relative price ratios. Thus it 'neglects all stickiness of prices and wages, all transitional inflationary and overvaluation gaps, and all balance of payments problems'. No wonder, the theory is abstract and unrealistic. Graham, therefore, regards the theory "in its essence fallacious and should be discarded."

7. Mill's theory is based on such unrealistic assumptions as two countries, two commodities, law of constant returns, lack of transport costs, full employment, perfect competition, etc. These make the theory unrealistic.

Conclusion:

But there is little basis in the criticisms made by Graham which appear to be flimsy. As pointed out by Viner, "The terms of trade can be directly influenced by reciprocal demands and by nothing else. The reciprocal demands, in turn, are ultimately determined by the cost conditions together with the basic utility functions." The real fault in Mill's analysis is that it overemphasizes the basic utility functions and neglects the production costs.

5 Short Answer Type Questions

1. Examine critically the various concepts of terms of trade.
2. Distinguish between Gross Barter Terms of Trade and Barter Terms of Trade or Income Terms of Trade and Net Barter Terms of Trade.
3. Discuss the factors which determine the terms of trade.

6. Long Answer Type Questions

1. Name different kinds of terms of trade. Which of these concepts is most helpful in indicating 'gains from trade'? And why?
2. Analyse the nature and significance of the principle of reciprocal demand in the theory of comparative costs.
3. Critically discuss Mill's theory of reciprocal demand in the theory of comparative costs.

7 Suggested Books

1. International Economics: Bo Soderston
2. International Economics: Kindelberger
3. International Economics: Sadama Singh and Vaish.

Lesson No. 2.4 **Author : Dr. Manisha Sharma**

WORLD TRADE ORGANIZATION (WTO)

1 Introduction

The birth of World Trade Organisation (WTO) on January 1, 1995 holds a great promise for the entire world economy in respect of international trade. This World Trade Organisation will administer the new global trade rules estal lishing the rule of law in international Trade, which amounted to nearly five trillion dollars goods and services. The latest issue of GATAVTO News (January, 1995) observed that the new global trade rules were achieved after seven years of negotiations among more than 120 countries and through the WTO agreements and market access commitments, world income is expected to rise by over 500 billion dollar annually by the year 2005 and annual global trade growth will be as much as a quarter higher by the same year than it would have been otherwise.

2 Objectives of lesson

In this lesson we will discuss WTO and its impact on Indian economy.

3 Role of World Trade Organisation (WTO)

The World Trade Organisation (WTO) is playing an important role for administering the new global trade rules in the following manner:

(1) The WTO administers, through various councils and committees, the 28 agreements contained in the final act of the Uruguay Round, plus a number of plurilateral agreements, including one government procurement.

(2) WTO also oversees the implementation of the significant tariff cuts (averaging 40 per cent) and reduction of non-tariff measures agreed to in the trade

negotiations.

(3) WTO is a watchdog of international trade, regularly examining the trade regimes of individual members. In its various bodies, members flag proposed or draft measures by others that can cause trade conflicts. Members are also required to notify in detail various trade measures and statistics, which are maintained by the WTO in a large data base.

(4) WTO provides several conciliation mechanisms for finding an amicable solution to trade conflicts that can arise among members.

(5) trade disputes that cannot be solved through bilateral talks are adjudicated under the WTO Dispute Settlement Court. Panels of independent experts are established to examine disputes in the light of WTO rules and provide rulings. This tougher streamlined procedure ensures equal treatment for all trading partners and encourages members to live upto their obligations.

(6) WTO is a management consultant for world trade. Its economists keep a close watch on the pulse of the global economy and provide studies on the main trade issues of the day. The secretariat assists developing countries in the implementation of Uruguay Round results through a newly established development division and strengthened technical co-operation and training division.

(7) WTO will be a forum where countries continuously negotiate exchange of trade barriers all over the world. And the WTO already has a substantial agenda for further negotiations in many areas.

It can be expected that the WTO is different from and an improvement upon GATT, on the ground that firstly, the WTO will be more global in its membership than the GATT. Its perspective membership is already around 150 countries and territories, with many others considering accession. Secondly, the WTO has a far wider scope than its predecessor, bringing into the multi-lateral trading system for the first time, commercial activities like trade in services, the exchange of ideas in the context of intellectual property protection and investment.

4 Impact of WTO on Various Aspects of Indian Economy

India, being a founder member of the WTO, has been following the WTO decisions, but as a consequence, certain effects on the Indian economy have become evident.

WTO and Indian Industry

WTO has been urging India to lower import duties, remove controls on consumer goods imports, reduce quantitative restrictions, etc. Under the Uruguay Round Agreement, India offered to reduce tariffs on capital goods, components, intermediate goods and industrial raw materials to 40% in case our tariffs were above that percentage; to 25% in case our tariffs were between 25 to 40 per cent and to bind the tariff ceiling at 25

per cent in case our tariffs were below that percentage. This reduction in tariffs was to be achieved by the year ending 2000.

Since India scrupulously followed the agreement, the tariffs have been reduced year after year to conform with the WTO provisions. As the protection afforded by import duties gradually disappeared, Indian industry had to face increasing competition from foreign goods. Confederation of Indian Industry (CII), the apex body expressed its disapproval against duty-free status of capital goods sector. As a result, CII estimated that indigenous capital goods industry on a conservative estimate lost orders worth Rs. 5,000 crores from foreign countries.

Not only the entire manufacturing industry is faced with a crisis, even machine tools industry, gensets and boiler producers are put at a serious disadvantage. Consequently, imports of finished products are displacing indigenously produced products. As a result, many industrial units are being closed and cheap imports have become an important cause of recession in Indian industry. India was maintaining quantitative restrictions in the form of quotas, import and export licences on 2,700 agricultural commodities, textile and industrial products. United States along with Australia, New Zealand, Switzerland, European Economic Community and Canada complained to the WTO Dispute Settlement Machinery that these QRS were inconsistent with WTO norms. The dispute settlement panel gave its verdict against India. India went in appeal, but the WTO panel on 23rd August 1999 rejected India's appeal against QRs.

As a result, although India could continue QRs till March 2003, the process was hastened and QRS on all items were removed. This has opened the floodgates for foreign consumer goods to enter the Indian market, thereby seriously damaging Indian industry.

WTO and SSI Units

WTO agreements do not discriminate on the basis of size of industries or enterprises. In the WTO regime, reservations may have to be withdrawn, preferential purchase and other support measures may not be available and thus SSIs have to compete not only with the large units within the country, but also with cheap imported products. SSIs are thus losing their markets to cheap imported products. Consequently, a very large number of SSI units are becoming sick or have closed down. Thus, the ° SSI sector which accounts for 40 per cent of manufacturing output, 50 per cent of employment and over 33 per cent of exports is in jeopardy. Next to agriculture, this sector- is the principal source of employment accommodating 18 million persons. The rule of survival of the fittest is being applied to this sector and in their game, only a few able ones will be able to survive. Dumping of Chinese goods has seriously affected SSI sector. The real difficultly with the SSI sector is that it does not have adequate resources to prepare the case for anti-dumping duties in view of the prohibitive costs of anti-dumping investigation. The SSIs cannot collect detailed information on individual products required by the antidumping directorate to establish a complete case.

Consequently, small industries continue to suffer due to such dumping policy.

Not only that, the entry of multinationals in ordinary consumer goods like ice cream, agarbatti manufacture, food processing, mineral water etc. is also adversely affecting the SSI sector since these were the traditional areas of this sector. In soft drinks, the entry of powerful Coca Cola and Pepsi have eliminated practically all small units engaged in the manufacture of aerated water. MNCs are not interested in hi-tech products. Rather they prefer low technology, quick profit yielding and large volume products with regular demand throughout the year. In the name of consumer interests, MNCs continue to swallow SSIs and eliminate them from the market.

WTO and Agriculture

WTO Agreement on Agriculture stipulated that developed countries would reduce their subsidies by 20 per cent in six years and developing countries by 13 per cent in 10 years. But as facts stand today, developed countries tried to circumvent this agreement by providing Green Box and Blue Box subsidies to support agriculture.

Green Box Subsidies include amounts spent on Government services such as research, disease control, infrastructure and food security. They also include payments made directly to farmers that do not stimulate production, such as certain forms of direct income support assistance to help farmers restructure agriculture, and direct payments under environmental and regular assistance programmes. This definition is very wide and includes all types of Government subsidies.

Blue Box Subsidies are certain direct payments made to farmers where the farmers are to limit production, certain government assistance programmes to encourage agriculture and rural development in developing countries, and other support on a small scale when compared with the total value of the products supported 15 per cent or less in the case of developed countries and 10 per cent or less for developing countries.

India's agricultural imports were of the order of US $ 1.86 billion in 2000-01, but they increased to $ 2.29 billion in 2001 -02. If the surge continues, then the interests of Indian farmers would be seriously affected. **Economic Survey (2002-03)** makes a forthright statement: "India has considerable flexibility to counter flooding of the Indian market by cheap agriculture imports through the imposition of tariffs (bound rates) under WTO. WTO permissible tariff rates are reasonably high: 112 per cent for nuts, 150 per cent for sugar and coffee, 100 per cent for tea and cotton, 70 to 100 per cent for foodgrains, 45 to 300 per cent for edible oils and 40 to 50 per cent for fruits. Countervailing duties can also be imposed to counter questionable subsidies given to agriculture products by the exporting countries apart from having the option of acting under safeguard provisions to counter the surge of imports. In budget 2001 -02, import duties were raised for many agri products such as tea, coffee, pulses and edible oils. In 2002-03 budget, the import duties were raised for pulses (from 5 to 10 per cent, tea and coffee (from 70 to 100 per cent), natural rubber, pepper, cardamom and clove (from 35 to 70

per cent)." (pp. 174-75) So far India has followed the Agreement on Agriculture very honestly, but honest implementation should not be treated as a sign of weakness. In case, the US and OECD countries persist in their nefarious game of protective tariffs, quotas and subsidies for their farmers, India and other developing countries may be left with no choice but to retaliate. But this would mean the start of a process which may result in the decline of globalisation world over.

However, this does not mean that at the domestic level, India has no action to take to improve its agriculture. In fact, the reform process is guilty of neglecting agriculture. In agricultural infrastructure, the most important is irrigation. The reform process emphasized the role of the private sector in promoting irrigation. But the experience of the Ninth Plan as documented in the Tenth Plan reveals that the private sector invested in irrigation technologies which were mainly extractive such as tube wells. But these investments are not sustainable unless appropriate investments are made in rain-water harvesting and recharging of ground water resources. However, data as provided by CSO reveals that in gross capital formation in agriculture, the share of the public sector declined from 33 per cent in 1994-95 to merely 23.5 per cent in 2000-01. In absolute terms, public sector investment declined from Rs. 4,947 crores in 1994-95 (measured at 1993-94 prices) to just Rs. 3,919 crores in 2000-01. Although private sector investment improved, but it did not fulfill the functions of rain water harvesting and recharging of ground water resources.

In boosting agri exports, some success has been achieved, but agri-exports which reached $ 6,004 million in 2000-01, declined to $ 5,871 million in 2001-02.

Another important area which needs attention is to make agricultural credit available at lower rates of interest. There is no doubt that the total flow of institutional credit to agriculture which was of the order of Rs. 31,956 crores in 1997-98 has more than doubled to Rs. 82,000 crores in 2002-03. This is really heartening, but the rate of interest charged on loans ranges between 14-18 per cent. This implies that the benefit of declining rates of interest has not been passed on agricultural borrowers. On account of the efforts of former Agriculture Minister Mr. Rajnath Singh, the Finance Ministry agreed to reduce interest on farm loans upto Rs. 50,000 to 9 per cent. This step, though in the right direction, is still inadequate, moreso, in view of the fact interest on housing loans has been reduced to 8.5 to 10 per cent, it is imperative on the part of the Government to bring down interest rates on all agricultural loans— short-term, medium-term and long-term. Accepting the need to reduce interest rate on agricultural loans, Former Prime Minister Atal Behari Vajpayee on 27th July 2003 announced: "Crop loans below Rs. 50,000 will be charged nine per cent interest and banks are being asked to charge the rate of interest below the PLRs for agricultural loans.

5 WTO and India's Gain as a Founder Member

In a country like India, the benefits accruing from being a founder member of

World Trade Organisation (WTO) are immense. At present, only just five per cent of our tariff lines remain bound. With the finalisation of the Uruguay Round, about 68 per cent of India's tariff lines covering basically raw materials, components and capital goods, but excluding consumer goods, petroleum, fertilisers and some non-ferrous metals would have been bound.

The Government is of the view that it is in the long term interest of India to have low duties on raw materials, components and capital goods since they satisfy the production needs of the economy.

Regarding the threat arising out of TRIPs, the Commerce Minister, Pranab Mukherjee is on record saying that exclusive marketing rights to be provided for patent holders would in no way dilute the national interest in such crucial areas as agriculture, drugs and pharmaceuticals as enough safeguards had been built into the system to.take care of the concern voiced by developing countries including India.

India now stands to gain immensely from the membership of WTO. At the time the question of this country joining the WTO was broadly under consideration, the opposition political parties strongly opposed our joining the World body. The fears expressed by the opposition parties regarding adverse effects of membership on farmers and the agricultural sector, prices of foodgrains due to withdrawal of food subsidies which would become obligatory under the terms of membership of that body and life savings drugs require us to enact have all proved almost groundless. India being a founder country has already started to assert itself in the meetings of WTO council.

Although a great deal of misinformation has been spread throughout the country on the otherwise beneficial aspects of the multi-lateral treaty, but it is to be seen how far these safeguards built into the system by the Government are sufficient enough to take care the interest of the masses as well as the country as a whole. But the ultimate impact of the Uruguay Round and the formation of WTO would depend on gains in productivity in various sectors resulting from realisation of economies of scale, technology transfer and increased trade and investment.

Moreover, India is also facing a serious threat from the attempt of the developed countries to introduce social and environmental clauses in multilateral trading system and thereby imposing countervailing duty on imports from India and other developing countries. These type of proposals have shocked the experts of the developing countries because it will deprive the developing countries of their only competitive advantage arising out of cheap and abundant labour force.

Gains for India

The Commerce and Industry Minister who represented India at the Doha WTO Conference succeeded in sending a strong message that India can no longer be ridden roughshod over by the developed countries, more especially US and the European

Union. The biggest gain was that WTO chairman declared that negotiations on Singapore issues-investment, competition, labour standards and environment would be held only after an "explicit concensus" was reached at the Fifth Ministerial. Such a concensus may not be easy to emerge even in 2003, keeping in view the reservations expressed by the developing nations at the Doha Conference.

Another major gain was that instead of opening discussion on new issues, it was agreed under pressure from India and other developing countries that it would be more advisable to undertake an exercise on a more complete implementation of Uruguay Round recommendations. This would involve review of bottlenecks and constraints arising out of the roadblocks in the way of fulfillment of their obligations by the developed countries. This would be particularly directed towards the US, Japan and countries of the European Union to open markets to products in which the developing countries enjoyed a comparative advantage.

The anti-dumping laws of the US were another painful thorn in the flesh of countries like India in respect of steel and other allied items of manufacture. This was taken up strongly by India and other member countries. The pressure built on US was so strong that the US was forced to promise a toning down of its policies and legislation pertaining to anti-dumping laws.

Growth of E-commerce and WTO Declaration

The growth in e-commerce has added a new dimension to trade policy which countries have to take account of by formulating rules to keep abreast of the fast growing technological developments. The WTO General Council agreed on the comprehensive working definition of electronic commerce as "the production, distribution, marketing, sale or delivery of goods and services by electronic means". Electronic transactions involve three stages namely searching, ordering/making payment, and delivery of products. Electronic delivery of goods is by far the most challenging aspect from a policy perspective as such trade is compounding rapidly without any global regulatory framework and hardly any national or international legislation.

In recognition of the growing importance of electronic commerce in international trade, the Second Ministerial Declaration of the WTO at Geneva adopted a declaration on global electronic commerce on May 20, 1998, which directed the WTO General Council to establish a comprehensive work programme to examine all trade related issues arising from electronic commerce. The work programme includes issues like characterisation of electronic transmission as goods or services or something else: market access involving the method of application of customs duties to electronic transmission; classification of digitized products under the existing Harmonized System (HS) of trade classification; rules of origin; standardisation; development dimensions involving the effect on revenue and fiscal positions of developing countries

in future ; etc. The 1998 declaration also included a so-called moratorium stating that "members will continue their current practice of not imposing customs tariffs on electronic transmission". The work programme was adopted by the WTO General Council on September 25, 1998.

6 Fourth WTO Ministerial Conference and the Doha Declaration and India's Role

In the fourth Ministerial Conference at Doha, India played a proactive role in the deliberations. India preferred a genuine resolution of implementation related concerns, increased market access in agriculture, sufficient flexibility and clarity under TRIPs for public health policies and strongly opposed the introduction of non-trade issues like labour in the agenda. It was able to ensure adoption of an agenda that emphasised not only trade but also the developmental goals and priorities of developing countries.

It is the insistence of India that forced the WTO to amend its draft resolution at the eleventh hour even by extending the scheduled time to suit the interests of developing nations status, particularly, on the issues related to foreign investment, competition policies and environment. The conference primarily focussed its discussion on the related issues pertaining to global recession. Accordingly, the Declaration was also made— "We are determined particularly in the light of global economic slow-down, to maintain the process of reform and liberalisation of trade policies, thus ensuring that ,the system plays its full part in promoting recovery, growth and development.

As per the WTO norms, the member nations, out of its obligations, cannot discriminate against one another's goods and companies without showing any valid and justified reasons. But due to the violation of rules, most of the developing nations have failed to reap any benefits of WTO. It is a matter of happiness that in Doha, under the able leadership of India, the developing nations have been to able redress their grievances that they have fared much badly than they should have under globalisation and now the system should be changed to such an extent so that they should realise a greater share of benefits. Now the agreement so reached does not. give any immediate relief to the developing nations but the agreement ommits that the WTO members to negotiate reductions in tariff, especially on products of export interest to developing countries and the higher level of tariffs applied on goods such as textiles on which the developing countries have much better competitive strength. Moreover, under the active pressure of developing countries, the Doha Conference and its declaration also agreed to include anti-dumping on the WTO agenda.

The mandated negotiations as per Article 20 of the Agreement on Agriculture commenced in 2000. Considering its importance, India has submitted its comprehensive proposals in the areas of Domestic Support, Market Access, Export Competition and Food Security. The proposals keep in view the objectives of protecting India's food and livelihood security concerns by having freedom for taking all domestic policy measures for poverty alleviation, rural development and rural employment as

also to create opportunities for expansion of agricultural exports by securing meaningful market access in developed countries. India, with a view to garner support of other developing countries, also co-sponsored two proposals with other countries : one on market access and another on export credit for agricultural products. It is quite true that due to higher rate of export subsidies provided by EU, the agricultural prices in the developed countries have been kept at lower level deliberately thereby depriving the Third World countries to get the benefits from its agricultural exports. However, the issue was temporarily resolved by accommodating a clause in the declaration that the negotiations in this issue would be held "without prejudging" the outcome.

Under TRIPs, India has been seeking greater flexibility and clarity in the interpretation of the Agreement on TRIPs in order to ensure affordable access to essential medicines and life saving drugs, in keeping with the public health concerns of developing countries. India, the African group of countries, Barbados, Bolivia, Brazil, Dominican Republic, Philippines, Peru, Sri Lanka, Thailand and Venezuela jointly submitted a paper on TRIPs and Public Health to the TRIPs Council in which India, along with other co-sponsors had demanded that the WTO should ensure that TRIPs Agreement does not undermine the right of the WTO members to formulate their own public health policies and adopt measures for providing affordable access to medicines. Finally, the Doha declaration affirms that the TRIPs Agreement can and should be interpreted and implemented in a manner supportive of WTO members right to protect public health and, in particular, to promote access to medicines for all.

7 Conlusion

A survey of the globalisation policies followed in India reveals that the promised benefits of globalisation in the form of sharp increase in GDP, exports, foreign direct investment, reduction of poverty, deceleration of unemployment could not be realised by India during the 1990s. Globalisation has adversely affected Indian industry, it has enabled the developed countries to pusrrtheir exports to India at a much faster rate, but did not facilitate the process of access to international markets; small scale industry has suffered due to the policy of dumping practised by developed countries, more especially in consumer goods. The most distressing part of the story is the double standards practised by the developed countries which manifest in the form of unfair agreement on textiles; a policy marked by a bias in favour of the farmers of developed countries as against the poor farmers in India. Developed countries brought forth spurious environmental and social issues to prevent the exports from India of such commodities in which the country possessed comparative advantage.

8 Short answer type questions

1. Write a short note on WTO?
2. What are blue box subsidies?

3. What are green box subsidies?
4. Write a short note on Doha meeting

9 Long answer type questions

1. What is the impact of WTO and Indian economy?
2. Explain the role of WTO.

10 Recommended books

Datt and Sundaram	:	Indian Economy
P.K. Dhar	:	Indian Economy
Mishra and Puri	:	Indian Economy
A. N. Aggarwal	:	Indian Economy

LESSON NO. : 2.5 **DR. MANISHA**

SOUTH ASIAN ASSOCIATION OF REGIONAL COOPERATION (SAARC): Origin and growth of India's trade with SAARC

1 Introduction

The modern industrial system rests upon such techniques that can be employed economically only if the production takes place on a very large scale. This requires expanding markets on the one hand and increasing purchasing power on the other. For the fuller exploitation of the production potential of the modern techniques, certain countries having small internal geographical markets, have attempted to organise themselves into regional groupings. This is also called economic integration. The economic integration in the broadest sense means the unification of distinct economies into a single larger economy. SAARC is one such type of economic integration. This association was formed by the South Asian countries including India, Bangladesh, Pakistan, Nepal, Bhutan, Sri Lanka and Maldives in December, 1985.

2 Objectives of the lesson

In this lesson we will discuss about SAARC, its objectives, organisation, achievements and problems.

3 Objectives and Principles of SAARC

The SAARC has placed before it the basic goal of rapid economic and social

development of the countries of the region through the optimum utilisation of the collective material and human resources.

Objectives: The objectives of the Association, as specified in the Article I of the Charter of the SAARC are as under:

(1) Promotion of the welfare of the people of South Asia and improvement in the quality of their life.

(2) Acceleration of economic growth, social progress and cultural development in the region and provision for all individuals the opportunity to live in dignity and to realise their full potentials.

(3) Promotion and strengthening of collective self-reliance among the countries of South Asia.

(4) Making of contribution to mutual trust, understanding and appreciation of each other's problems.

(5) Promotion of active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields.

(6) Strengthening of co-operation with other developing countries.

(7) Strengthening of co-operation among themselves in international forums on the matters of common interest

(8) Promotion of co-operation with intranational and regional organisations with similar aims and purposes.

Principles: The Article II of the SAARC Charter has spelled out the following principles:-

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

(ii) The co-operation among the members of the Association shall not be substitute for bilateral and multilateral co-operation but shall be complementary to them.

(iii) The co-operation among the member nations shall not be inconsistent with bilateral and multilateral obligations.

4 Organisation of SAARC

The organisation of SAARC is comprised of the Summit, SAARC Secretariat, Council of Ministers, Standing Committee, Programming Committee and Technical Committees.

The summit is the highest policy making authority of the Association constituted by the heads of all the member countries. The summit called as the council meets almost every year in member countries on a rotational basis. If even one of the head of member state can not attend the meeting, it is not possible to hold the meeting of the council.

The SAARC Secretariat, co-ordinates and monitors the execution of the activities of SAARC, services the meetings and serves as the channel of communication between SAARC and other international organisations. It was set up at Kathmandu (Nepal) on

January 16, 1987. The, SAARC secretariat is headed by the Secretary-General, who is appointed by the Council of Ministers upon nomination by a member state on the principle of rotation in the alphabetical order for a fixed period of 3 years. Apart from the Secretary General, the secretariat includes also seven Directors, one from each state and the general services staff : The directors are appointed by the Secretary General upon nomination by member states for a period of three years. The term of the directors can be extended, in special circumstances by another three years by The Secretary General, in consultation with the concerned member states.

Nepal bore the initial cost of the establishment of the Secretariat. The recurring expenditures on SAARC are shared among the member countries. India contributes 32 percent of the total expenditure followed by Pakistan that contributes 25 percent of it. Bangladesh, Nepal and Sri Lanka each accounts for 11 percent and Bhutan and Maldives each accounts for 5 percent of it.

There is also the Council of Ministers which is constituted by the Foreign Ministers of all the member states of SAARC. The council of ministers is entrusted with the responsibilities to formulate policies, to review progress, to decide on further areas of co-operation, to establish additional mechanisms as deemed necessary and to decide on other matters of general interest of the Association. The meeting of the Council of Ministers in held twice a year. It may have an extra-ordinary session, if all the members states agree to do so.

The SAARC organisation, in addition, includes a Standing Committee, a Programme Committee and Technical Committees. The Standing Committee is constituted by the foreign secretaries of the member states. Its responsibilities are to monitor and co-ordinate programmes, to work out modalities of their financing, to determine intersectoral priorities, and to mobilise regional and external co-operation. This committee normally meets twice a year and submits its report to the Council of Ministers. The standing committee can institute action committees for the implementation of projects, comprised of more than two member countries. All the member countries may not have the representation on it.

In order to assist the standing committee, there is a Programme Committee comprised of senior officials. It is an adhoc body and meets prior to the sessions of the standing committee. It is entrusted with the tasks of the scrutiny of budget of the secretariat, to finalise the annual schedule of its activities, to deliberate upon any other matters assigned by the standing committee, to consider the reports of the technical committees and SAARC Regional Centres and to submit its comments to the standing committee. There are at present 12 Technical Committees related to agriculture, rural development, environment, health, population activities, transport, communications, science and technology, tourism etc. These committees include the representatives of all member states. They prepare programmes and projects in their respective areas. They monitor and execute the activities in their fields and submit

reports to the standing committee through the Programming Committee. There is rotation of chairmanship of every technical committee among the member countries in the alphabetical order every two years.

Self check exercise

Q1. What are the main objectives of SAARC?

Q2. Explain the organisation of SAARC.

Q3. Discuss the important features of SAARC.

5 South Asian Preferential Trading Arrangement (SAPTA)

At the Eighth Summit of SAARC held in New Delhi in May 1995, the member countries unanimously endorsed an agreement known as South Asian Preferential Trading Arrangement (SAPTA). The ministerial committee recommended that member countries should complete the process of ratification of SAPTA by November 8, 1995. India ratified it on September 22, 1995. After its ratification by all the member countries, SAPTA became operational on December 7, 1995, the tenth anniversary of the formation of SAARC.

Features of SAPTA: The main features of SAPTA are as follows:

(i) Objectives: The main objectives of SAPTA include the promotion of sustenance of intra-regional trade and economic co-operation among the SAARC nation through the extension of tariff and other concessions.

(ii) Basic Principles: The basic principles of the arrangement are enshrined in the Article 3 of the Agreement. According to this Article, all member states of SAARC will secure benefits equitably on the basis of reciprocity and mutuality of advantages. In this regard, the respective levels of economic and industrial development, pattern of their external trade, tariff and trade policies and system will, however, be taken into consideration. The negotiations related to SAPTA shall be carried forward step of step, improved and extended gradually in successive stages. There will be a periodical review of the agreement. The special needs of the least developed member countries will be taken into consideration and accordingly preferential treatment will be given to them.

(iii) Scope: The member countries will provide mutual concessions on all products, raw materials, semi-processed and processed and manufactures. There shall be trade liberalisation by preferential arrangements concerning tariffs, para-tariffs and direct trade measures. The trade negotiations of different types for the liberalisation of trade on preferential terms will be undertaken on product by product basis, across the board tariff reductions, sectoral basis of preferences, direct trade measures.

(iv) Special Preferential Treatment for the Least Developed States: SAPTA provides, apart from other provisions, for certain special preferential treatment for, the least developed members of the Association. These include:

(a) By assisting them to enlarge their export potential through technical assistance, setting up of industrial and agricultural projects linked to

co-operative financing and buy-back arrangements.

(b) By establishing the manufacturing and other facilities in the least developed member states for meeting their intra-regional demand under co-operative arrangements.

(c) By the formulation of export-promotion policies, creation of training facilities in die fields of trade and extending support to export marketing through export credit insurance, access to market information etc.

(d) By the removal of non-tariff and para-tariff barriers and the provision of duty free access, exclusive tariff preferences or deeper tariff preferences for export products.

(e) By the negotiation of long term contracts for the achievement of reasonable levels of sustainable exports.

(f) By extending special consideration of exports in the application of safeguard measures from the least developed member countries.

(g) By the adoption of greater flexibility towards the introduction and continuance of trade restrictions under critical circumstances by the least developed member nations.

(v) Balance of Payments and Safeguards: The arrangement permits any member country, faced with serious economic problems including balance of payments difficulties, to suspend provisionally the concessions allowed to import goods. In this regard, SAPTA allows the member countries some safeguard measures. First, if a product, imported from another member country on concessional terms in such a manner or in such quantities, that causes serious injury to importing member country, then the latter may suspend provisionally that concession. Second, to enable a member country to adopt balance of payments and safeguard measures, the SAPTA Agreement stipulates the provisions for information, consultation and dispute settlement.

(vi) Unconditional Extension of Negotiated Concessions: Except the concessions permitted to the least developed countries, all other concessions agreed upon under SAPTA, shall be extended to all the member nations unconditionally.

(vii) Committee of Participants: SAPTA makes provision for a committee of participants including representatives from the member countries. The committee ensures that the benefits of trade expansion arising from SAPTA agreement accrue equitably to all the member countries. The meeting of the committee takes place once a year for the review of the progress in the implementation of the Agreement.

(viii) Non-application of the Agreement: In case the preferences have already been granted or are to be granted by one state to some other member states, and to third countries through bilateral plurilateral and multilateral trade agreements and similar arrangements, the previsions of this Agreement shall not apply to the member states.

(ix) **Modification and Withdrawal of Concessions:** Any member country that has extended concessions, may notify the Committee on Economic Co-operation (CEC) of its intention to modify or withdraw the concession after a period of three years. For this, the given country will enter into consultations and negotiations with another concerned country, and if necessary, negotiate for appropriate compensation. In case the agreement is reached within six months, the affected member state may be asked by the CEC to modify or withdraw the concessions. But in the event of a country leaving SAPTA, the other member shall be free to withdraw all the concessions extended to it.

(x) **Withdrawal from SAPTA:** Any member country of the SAARC may withdraw from SAPTA by giving six month's prior notice to the SAARC secretariat and also informing other member states.

Self check exercise

Q4. What is full form of SAPTA?

Q5. Discuss the main features of SAPTA.

6 Indo-SAARC Trade Relations

The SAARC, despite several attempts to encourage regional trade under the regulation of SAARC and the SAPTA, has not taken an effective shape as a regional trade body because of political problems between Pakistan and India hampering regional interests. Despite official declarations to transform the SAPTA into an FTA in this region by 2001, the idea seems unrealistic. India has had problems with FTAs for its neighbours do not want free trade with a giant neighbour they do not trust or like. Hence, multilateralism will remain India's only choice. During the 10 years before SAARC (1975-1985), India's exports increased from US$ 160 million in 1975 to US $ 315 million in 1984 registering a compound growth rate of 7.8 percent. During the 10 years after SAARC inception, India's exports increased from US $ 277 million in 1986 to US $ 1532 million in 1995, i.e. from eight percent to 30 percent constituting an additional growth of 22 percent. So, the SAARC has encouraged India's exports to its member countries. Since 1991, liberalization too has increased India's exports to SAARC countries. From US $ 622 million in 1991, the exports have touched a peak level of US $ 2005 million in the year 2000, upping the decadal growth from five percent during the 1980-90 liberalisation to nine percent. Similarly, India's exports to the world during the pre- and post- liberalisation periods have witnessed an upward trend. On the other hand, India's import from the SAARC countries is quite low. It was just US $ 56 million in 1975 and rose to only US $ 105 million in 1984 and further to only US $ 182 in 1995. The immediate reform period has shown a decline in India's imports from the SAARC registering a low level of US $ 96 in the year 1993 and later picking up only to US $ 363 million in 2000. They have grown at a constant rate of 7 percent before and after liberalisation. This shows that India is not a good importer for its neighbouring countries. While the turnover of India's trade with SAARC members was US $ 382 million in 1985,

it increased to US $ 1714 million in 1995 and further to US $2368 million in 2000. So, the increase in India's trade with SAARC members outclasses the rise in its trade globally, from US $ 24594 million in 1985 to only US $ 94018 million in 2000.

Before liberalization India exported mostly to Pakistan followed by Bangladesh and Maldives. But after the liberalization Nepal and Maldives became the major export destinations. The growth rate of exports to Pakistan had fallen considerably until the substantial boost of 2005. The tremendous decline in the previous years may be attributed to the tensions between the two nations. But the growth in India's export to the entire bloc has increased from 8.61 percent before liberalization to 12.43 percent after, showing an increase of 3.82 percent. The growth rate of India's imports from all the SAARC nations has been negative before and after liberalisation. Nepal is a major exporter of Indian products with a high growth rate of about 27.5 percent followed by Sri Lanka (15.4 percent) and Bangladesh (14.7 percent). Though the volume of trade with the bloc has increased, India does not have a good trading partner within the bloc. Except Nepal, all other nations have registered a very low growth rate. Overall, the growth of India's exports and imports show a growing trade imbalance between India and its neighbouring South Asian countries.

Steps towards formal economic cooperation were made with the signing of the SAPTA in 1993. SAPTA did not achieve much in increasing intra-regional trade either. Intra-SAARC trade, as a percentage of South Asia's world trade, increased from 2.42 percent ($1.59billion) in 1990 to 4.56 percent ($6.53 billion) in 2001 and marginally to 4.7 percent by 2003, mostly attributed to rapid liberalisation under bilateral trade agreements and WTO regimes, rather than to SAPTA. The SAPTA failure is also reflected in the skewed pattern of trade in the region. Since India has not fully integrated into South Asia, this purely regional agreement did not expand trade much and failed to address high transport and transaction costs. The idea of a SAFTA was mooted in 2002, and culminated into an agreement in January 2004. The SAFTA agreement is expected to come into force from January 1, 2006 on completion of all formalities. (New date is now July1). SAFTA lists additional measures not included in the SAPTA such as harmonization of standards, reciprocal recognition of tests and accreditation of testing laboratories, simplification and harmonization of customs clearance, import licensing, registration and banking procedures; removal of barriers to intra-SAARC investment etc.

An expansion of intra-regional trade by 1.6 times the current level as proposed by SAFTA is not possible in the absence of concomitant moves towards investment and trade liberalization. If this arrangement is to be successful, the political tensions will have to be kept at bay and India's role as a leader would have to be enhanced, as Roy (2004) points out that India needs to take the lead in greater regional integration since it accounts for 80 percent of the total South Asia GDP.

BIMSTEC (Bangladesh-India-Myanmar-Sri Lanka-Thailand Economic Co-operation)

This agreement includes Bangladesh, India, Sri Lanka, Thailand, Myanmar,

Bhutan and Thailand. The idea of this regional cooperation was first mooted by Bangladesh, India, Sri Lanka and Thailand at a meeting in Bangkok in June 1997. The aim, purpose and principles are contained in Bangkok Declaration of June 6, 1997 on the establishment of the Bangladesh-India-Sri Lanka-Thailand Economic Cooperation (BISTEC).

At a special ministerial meeting convened in Bangkok on 22 December 1997 the Union of Myanmar was admitted to the grouping renaming it as BIMST-EC (Bangladesh-India-Myanmar-Sri Lanka-Thailand Economic Co-operation). This is known as Declaration of 22 December 1997. A ministerial meeting in February 2004 welcomed Bhutan and Nepal as new members.

The inter-regional grouping will serve as a bridge between the five SAARC countries and two ASEAN countries. BIMSTEC will have a greater potential to increase the trade among member countries by taking advantage of their geographical location in the region of the Bay of Bengal and the eastern coast of the Indian Ocean. Discussions have already been held on building a Trans-Asia Highway linking the five countries and also setting up a BIMSTEC Airline connecting the capitals and important cities of the member countries.

Held in Bangkok on 7 August 1998, the first BIMSTEC economic and trade ministers' meeting termed as the Retreat, decided that BIMST-EC would initially begin cooperation efforts in six areas. It was agreed that each country would play a lead role in planning and implementing programmes in each of the areas. The sectors and lead countries at the inception were:

Trade & Investment Bangladesh
Technology India
Transportation and Communication Thailand
Energy Myanmar
Tourism Sri Lanka
Fisheries Sri Lanka

Recognising that sub-regional cooperation can progress only in inter-governmental cooperation and coordination, and that the private sector is an engine of growth for enhancing interaction between government bodies and the private sector representatives of the five BIMST-EC countries, the BIMST-EC Economic Forum was conceptualized at a meeting in Dhaka in 1999. The BIMST-EC Economic Forum is a representative group of both the public and private sectors, formed to discuss ways for achieving the objectives of BIMST-EC and making recommendations for the ministerial meetings each year.

BIMSTEC covers a population of approximately 1.3 billion and the trade value between Thailand and other countries in the group exceeded US$3 billion in 2003. The forum is unique as the only link between South Asia and Southeast Asia, bridging South Asia's Look East policy with Thailand's Look West policy. BIMSTEC can also be considered as a mechanism to promote opportunities for trade, investment and tourism

between Thailand and South Asia.

BIMSTEC's objectives stretch from creation of economic and social prosperity based on equality, to enhancement of mutual benefits in economic, social and technological aspects. They also involve intra-regional assistance in training, research and development as well as beneficial cooperation in agriculture, industry, expansion of trade and investment, improvement in communication and transport, for improving living standards and cooperation with other international organisations. India's trade with the BIMSTEC countries rose by eight percent in dollar terms and six percent in rupee terms to reach more than $6.6 billion during 2004-05, according to the findings of the PHD Chambers of Commerce and Industry.

Reflecting good performance of India's "New Age Sector", drugs and pharmaceuticals, there has been appreciable increase in the country's exports of such products to the BIMSTEC countries. The growing thaw in Indo-Myanmar relations has increased pharma exports to Myanmar by over 36 percent. Export of pharmaceutical products to Bangladesh that stood at $50 million registered a 19 percent growth. While India's exports to these countries have grown faster, imports have remained almost stagnant. Having proved its information technology worth to the world with aggregate software and services exports of over $ 22 billion, Indian software industry is making steady inroads into the BIMSTEC countries. Though starting from a very low base, Indian software exports to Sri-Lanka stood at $1.2 million. Similar trends have also been observed for Bangladesh, Thailand, and Nepal.

Member countries should work towards greater air transport liberalization, short-sea shipping, and trilateral highway linkages among India, Myanmar and Thailand and between Bangladesh, Myanmar and Thailand, including linkages with other BIMSTEC countries. Implementation of transport linkages and physical connectivity among the member countries would generate huge benefits and expedite the trading process.

7 Appraisal of the SAARC:

SAARC is the trade organisation which is being structured by some very poor countries of the world primarily directed to accelerate the economic and social development of the South Asia. Four of the member countries of SAARC-Bangladesh, Bhutan, Maldives and Nepal are included in the least developed countries. Bhutan and Nepal are land-locked countries. They can have access to the world market through the ports of India and Bangladesh. The aggregate of exports of India to other SAARC countries were of the volume of Rs. 6100.98 crore, while its imports from these countries were of the magnitude of Rs. 1409.22 crore in 1999. The intra-regional trade of these countries is only 3.4 percent of the total trade of SAARC nations. It is clear that there is much potential for expanding the intra-regional trade among these countries.

According to Centre for Global Trade Development (CGTD) Report, the South Asian Preferential Trading Arrangement will give access to a consumer base of over 425 million people in the middle class bracket and permit the accelerated expansion of

the growing points of the economies of all the countries in the region. With imports of India as 8 percent of her GDP, 34 percent in Sri Lanka and 17 percent in Pakistan, Bangladesh and Nepal, the intra-regional trade-creation and trade-diversion effects will certainly unfold great prospects for the development of the entire region. It is expected that the combined average growth rate of 7 percent per annum would be realised.

8 Achievements of SAARC

Although SAARC has remained besieged with serious political problems since its inceptions yet it could register some achievements that are as under:

(i) **Removal of trade restrictions:** The member countries have undertaken some steps in the direction of reducing quantitative restrictions on imports from one another and granted some measure of concessions on trade. From August 1998, India removed quantitative restrictions' off about 2300 items of import from member countries. Upto August, 2003, India had permitted concessions to Pakistan on about 370 items. Pakistan, by that time, had allowed concessions on import of about 340 items to India. The free-trade agreements have been negotiated by India with Bhutan, Nepal and Sri Lanka.

(ii) **Institution of Technical Committees :** In order to promote co-operation among the member countries in the fields of agriculture, rural development, environment, health, communications, science and technology, transport, tourism, education and culture, the technical committees for economic co-operation have been instituted.

(iii) **Poverty-Alleviation Programme:** SAARC has adopted the strategy of social mobilisation, decentralised agricultural development, small labour-intensive industries and human development. The priority has been given to the right to work and extension of primary education for the poor. SAARC has created a three-tier mechanism for exchange of information among member countries on poverty alleviation programme. In this connection, it has received co-operation from IBRD, UNDP and ESCAP.

(iv) **SAARC Funds:** In order to render financial assistance to the member countries, SAARC has instituted two funds-South Asian Development Fund (SADF) and SAARC, Japan Special Fund (SJSF). The SADF has three windows-window for identification of development project, window for institutional and human resource development and window for social and infrastructural development

(v) **SAARC Food Security:** The SAARC has set up die SAARC Food Security Board for making a periodic review of the food situation in the region. A reserve of 2.42 lakh tonnes of foodgrains has been created to tide over any emergency in the member states.

(vi) **SAARC Chamber of Commerce and Industry:** A SAARC Chamber of Commerce and Industry (SCCI) has been instituted with its headquarters in Karachi It has the aim to promote trade and interaction of chambers of commerce and

industry of seven member countries, to organise trade fairs and to negotiate with other trade organisations for the expansion of intra-regional trade. The SCCI has played an important role in the formation of SAPTA and promoting economic and trade co-operation in the region.

(vii) **SAARC Agricultural Information Centre (SAIC) :** It was established in 1998 and acts as a central information institution on agriculture-related activities like forestry, fishery, rice, potato, live-stock etc. It assists in the exchange of information among the seven member countries also about R & D activities. The information about research and experiments related to agriculture is published by SAIC and distributed among the member nations.

(viii) **Agreements with International Organisations:** For facilitating the social and economic development of SAARC countries, the memorandum of understanding have been signed with various international organisations including UNCTAD, UNDP, UNDCP, ESCAP, ITU and Asia Pacific Telecommunity (APT) etc.

(ix) **Formation of South Asian Growth Quadrangle (SAGQ) :** In early 2000, India, Bhutan, Nepal and Bangladesh formed the South Asian Growth Quadrangle with the aim of the development of Nepal, Bhutan, Bangladesh and Eastern India and the basin of the rivers Ganga, Meghna and Brahmaputra. The countries of this area will co-operate in the fields of multi-nodal transport and telecommunications, effective use of tourism, protection from environmental hazards and increase in trade and investments.

(x) **Bilateral Free Trade Agreements:** In order to move towards the creation of South Asian Free Trade Area (SAFTA), some of the countries of the region have forged the bilateral free trade area agreements. A major development in this regard has been the signing of the agreement between India and Sri Lanka on December 28,1998. Under this agreement, India shall permit the import of 1000 items on zero duty from Sri Lanka and the latter shall permit the duty free import of 900 items. Similar agreements have also been forged by India also with Bhutan and Nepal.

Self check exercise

Q6. Make a critical appraisal of SAARC.

Q7. What are the achievements of SAARC?

9 **Problems:** Although SAARC has attempted to move forward over the years, yet it has been faced with very serious problems and so far it has not been able to play its assigned role. These problems are as under

(i) **Political, ethnic and religions disputes:** The major barrier to the co-operation among the member countries of SAARC has been long-drawn political, ethnic and religions disputes among the member countries. Pakistan has been insisting over the years that co-operation in trade and other matters of social and economic development can not be possible unless India hands over its state of

Jammu & Kashmir to it.

(ii) **Lack of complementarity:** The member countries of SAARC mostly produce same type of products. The successful integration requires dissimilarity in production rather than similarity. Lack of complementarity in the economies of these countries is having restrictive effect upon the co-operation among them.

(iii) **Preference to trade with hard currency areas:** Some of the member countries of SAARC prefer to enlarge their exports to hard currency areas. As a result, the promotion of intra-regional trade among the SAARC countries has remained generally neglected. .

(iv) **Deficit in Balance of payments:** The countries of SAARC including India are faced with the problem of persistent BOP deficit and consequent shortage of foreign exchange. They generally have an inclination to restrict imports and impose tariff and other restrictions rather then abolishing them.

(v) **Competition among themselves:** There is competition among some of the member countries in the export of certain products in the international market. For instance, India and Sri Lanka compete in respect of tea. India and Pakistan do so in respect of textiles and clothing. There is competition between India and Bangladesh in respect of Jute. Such a state of affairs tends to discourage co-operation among them.

(vi) **Infra-structural inadequacies:** There is a lack of proper development of transport, communications, institutional arrangements as well as payment and clearing arrangements in the region. That is a major impediment in the expansion of intra-regional trade among the member countries.

(vii) **Big brother complex:** In view of large geographical area and natural, financial, technical and manpower resources, the countries like Pakistan and Bangladesh look at India as big brother who will over-swamp their markets with her products. India is conscious of such complex among the member countries of SAARC and has been constrained from extending fuller co-operation in the economic and social development of other countries of the region.

(viii) **Low intra-regional investment:** The member countries of SAARC look to the West and international lending agencies for capital resources and are afraid of seeking investments from India due to irrational reasons. The intra-regional investment is only one percent of total investment in the region. In contrast, 43 percent of ASEAN investment and 64 percent of EU investment is intra-regional. The increase in intra-regional investment by the investors of the member countries will certainly enhance greater co-operation among member countries of SAARC in the diverse areas.

(ix) **Bilateral preferential arrangements:** Some member countries of SAARC have entered into bilateral agreements with one another for extending trade concessions. In some cases, these concessions are even more than those assured

under SAPTA. Consequently, there is no added attraction for member countries to await indefinitely the outcome of SAPTA.

(x) Product by Product Approach: The lack of progress in SAARC negotiations so far has been on account of the product by product approach of the member countries in the matter of granting trade concessions. Some of the products included in the lists for trade concessions are actually not traded among the member countries. The move towards the creation of South Asian Free Trade Area (SAFTA) can make headway only if the countries adopt a more wide sector-based rather than product-based approach in the extension of trade concessions.

(xi) Transport problems: Even though there is technical committee on transport, created by the member countries, yet the transport facilities are still less developed. The transit duties are also quite high. It is a major impediment in the creation of SAFTA.

(xii) Trade barriers: Despite the protracted trade negotiations among the member countries, there are still high tariffs on several commodities. Pakistan and Bangladesh impose VAT on all imported goods. All the member countries continue to levy non-tariff barriers such as quantitative restrictions, restrictive licenses etc. Pakistan has not yet granted Most Favoured Nation (MFN) status to India, despite the fact that it is obligatory to do so under the WTO Agreement by the year 2005. Unless the countries become willing to dismantle the trade barriers, the avowed goal of creating SAFTA will remain a mirage.

Self check exercise

Q8. What are the problems in growth of SAARC?

Q9. What are the problems in the economic integration of the LDC's?

10 Summary

In this lesson we have discussed the SOUTH ASIAN ASSOCIATION OF REGIONAL COOPERATION (SAARC) , its objectives and principles, organisation of SAARC. It is a sort of economic integration for the fullest exploitation of the production potential of the modern techniques. South Asian countries have tried to organise themselves into regional grouping. These countries are India, Bangladesh, Pakistan, Nepal, Bhutan, Sri Lanka and Maldives and they have formed this association in December, 1985. No doubt, that with this type of integration market is always expanded and countries can make full utilisation of resources but some problems are always faced by the concerned countries.

11 Glossary

Bilateral	:	Two-sided - when trade is going on in two countries
Free trade area	:	when there is no restriction in trade.
Self reliant	:	self -sufficiency.
Negotiation	:	arbitration

12 Short answer type questions

Q1. What is full form of SAARC?

Q2. Why there is a need of economic integration?

Q3. What are the objectives of SAARC?

Q4. Write a note on organisation of SAARC.

Q5. Discuss the problems of SAARC.

13 Long answer type questions

Q1. Discuss the main features of SAPTA.

Q2. What are the achievements of SAARC?

Q3. Critically evaluate the SAARC.

14 Suggested Readings

International Economics : B. Sodersten

International Economics : Sadama Singh and Vaish

International Economics : D. Salvatore

LESSON NO. 2.6 **AUTHOR : DR. H. G. P. SRIVASTAVA**

BALANCE OF PAYMENTS

Meaning and Significance

The balance of payments of a country is a statement showing the various payments to and from the country in a given period, generally a year. All transactions in a year which give rise to claims by residents of the country on foreigners and claims by foreigners on citizen of the country are comprised in balance of payments. Therefore, the balance of payments may be defined in a statistical sense as an itemised account of transactions involving receipts from foreigners on the one hand, and payments to foreigners, on the other. Since the former relate to the international income of a country, they are called "Credits" and since the latter to international payments, they are called "Debits".

According to the rules of double-entry book keeping, a nation's receipts and payments for any given period must be exactly equal. Hence in a way, the balance of payments will always be in equilibrium. In an open economy, however, total receipts may differ from total payments. The positive difference is termed as surplus and the negative difference is termed as deficit in the balance of international payments of a country.

A country's balance of payments serves as its economic barometer. There are, however, many things which are only partially explained by it. A surplus or a favourable balance of payments position is not always a sign of the economic prosperity of a country nor is adverseness or unfavourable balance of payments position always an indicator of a country's economic insolvency. A balance of payments deficit is not, in itself, proof, of the competitive inability of a country in foreign markets. A detailed analysis of the causes and prospects will be necessary to determine the magnitude of alarm. The longer a deficit continues, however, the more it would seem to point to some fundamental deficiencies. Likewise, a favourable balance of payments position need not always make the government of the country feel complacent. It can happen that a debtor and economically backward nation at the time of receiving foreign loans might have surplus in its balance of payments.

Generally speaking, the balance of payments exhibit various aspects of a country's international economic position. In the case of an underdeveloped country, the balance of payments will reveal the degree of dependence of the country's economic development on the financial assistance given by the industrially advanced capital lending countries. The balance of payments help in analysing or appraising a nation's short-term international economic prospects,

evaluating the extent of its international solvency and determining the appropriateness of the foreign exchange rate of the money unit of a national currency. Comparison of a pair of balance of payments covering a given period shows changes in the country's trading position, that is, in the relative movements of exports and imports. The information so obtained could clearly be significant for the determination of trade and commercial policies. The effect of such changes on employment and production will also be of value to monetary and fiscal policy.

Distinction between Balance of Trade and Balance of Payments

The term 'Balance of Trade' and 'Balance of Payments' are often interchangeably used leading to confusion. A country's exports and imports comprise many items both visible and invisible. Invisible items refer to the services like shipping, banking and insurance services for which payments are made and received by a country in the sphere of international trade. The merchandise imports of a country are constituted by the value of goods purchased by the nationals and government of the country from those of other countries in a given period. These have to be paid for and necessitate remittance from the country to various other countries. The country is debtor to this extent. The exports are the value of goods sold by its nationals to other country and has to receive payments for them from aboard. The country is creditor on this account. The net amounts the country has to pay and receive in a given period from its balance of trade. Balance of trade is, therefore, the difference between merchandise exports and imports of a country.

The balance of payments has a wider connotation and it comprise the total debits and credits due to all items on account of which a country makes payments to rest of the world and receives payments from rest of the world. In this way, the balance of payments includes both the visible and invisible items. The balance of trade is only a part of the balance of payments. There is no doubt that it is major part but its significance is limited. We can very well imagine a situation in which a country's balance of trade is favourable yet its balance of payments may show deficit and vice versa. Seen in historical perspective, England's balance of trade was for long unfavourable but her balance of payments used to be favourable because on account of exports of visible services and interest earnings on her foreign investments she used to receive payments more from the rest of the world than she had to pay the rest of the world on account of imports of visible goods.

Components of Balance of Payments

The emphasis in classical ecomomics was on the export and import and on the whole, little attention was paid to capital movements. In part the explanation lies in the classical assumption that capital does not move across national boundaries or is transferred only with hesitation. Today the position has changed. It is a rule of book keeping to charge, or debit, the owner of an account for everything he gets and to credit him for everything he gives up. Therefore, the

debits and credits can be conveniently linked with payments and receipts. Since a country's exports or the services i.e. shipping, banking or insurance companies rendered to others are the items it gives up, they are entered in the balance of payments as credits. One could equally say that these items give rise to receipts, when this term is used in connection with the balance of payments. Similarly, since a country's imports or services rendered to its residents by foreigners are what the country acquires, they are entered as debits. These items also give rise to payments on the part of the country concerned and the term payments is used in this sense is a balance of payments.

As an illustration, we give below the Balance of Payments of Country X:

TABLE I—BALANCE OF PAYMENTS OF COUNTRY X

Debits		*Credits*	
	Current Account		
Merchandise imports	Rs. 1800	Merchandise exports	Rs. 2300
Services	Rs. 300	Services	Rs. 200
Donation : Official	Rs. 100		
	Rs. 2200		Rs. 2500
	Capital Account		
Short-term		Short-term	
Capital (Private)	Rs. 500	Capital (Official)	Rs. 450
Long-term capital	Rs. 500	Gold exports	Rs. 250
	Rs. 3200		Rs. 3200

It will be seen from the table I, that the most important way in which a country can acquire foreign currency is by exporting merchandise. This comes to Rs. 2300. The value of merchandise imports is Rs. 1800/-. These two items relate to Country X's visible trade and the difference i.e. 500/- indicates the balance of trade. If a country exports more goods than it imports, it is said to have a favourable balance or surplus in its balance of trade. Here country X's balance of trade is favourable. The next item in order of importance relates to services rendered to foreigners during the period in question or to the services received by the citizen of the country. In the former case it gives rise to receipts whereas in the latter it entails payments. Shipping services are significant under this heading because both exports and imports of merchandise have to incur costs of transportation. Other types of earnings under this heading are interest and dividends which

citizens of the country earn on investments abroad. Such payments are regarded as payments made by foreigners for current services which they derive from capital in question. Investment income is included in the current account since it is associated with a service; the use of one's capital. It gives rise to the payments for the country which has borrowed or in which foreigners own income-earning property; it is a source of receipts to a lending or investing country. Tourism constitutes another example and income earned from X this source comes under the same heading. Other payments falling under this heading are those for banking and insurance services which are necessary components of modern trade and commerce. The item of services in table-I figures both on the credit and debit side, it is 300/- on the debit side Rs. 200/- on the credit side.

Donations differ from ordinary business transactions, such as are included in the current accounts, in that they do not reflect an exchange of goods or services for money. They involve no quid pro quo. A person or government transfers commodities or services or money to some other persons or government and receives nothing in exchange. The category of donations in a nation's balance of payments includes a wide variety of transactions : military aid, economic aid, technical assistance, etc. Frequently, the term "unilateral transfers" is applied to these transactions to indicate their one sided character. In table I, the value of donations shown on the debit side comes to Rs. 100.

Even though the country X had a surplus in its balance of trade, this might be offset by items on other accounts. Country X has a deficit of Rs. 100 in its balance of services and a deficit in its balance of unilateral transactions to the extent of Rs. 100. When we take into account these heads, we arrive at the balance of current account, which is large concept than the balance of trade. This is because it takes into account the balance of trade, the balance of services and the balance of donations or unilateral transfers. The balance of current account need not be equal but can show a surplus or a deficit. In table I, Country X has a surplus in its balance of current account to the tune of Rs. 300.

The balance of current account is a very valuable concept because it reveals the flow aspect of a country's international transactions. We could say that all the goods and services produced within the country during the time period in question and exported are entered on the credit side of the balance of current account and all the goods and services imported and consumed with in the country during the same period are entered on the debit side of the balance of current account. Thus it can be observed that all the international transactions entering a country's system of national accounting should be listed on the country's balance of current account. It is therefore clear that all items of a flow nature find a place in the balance of current account whereas all those items which exhibit changes in stock are entered in the balance of capital account.

Reverting back to Table I, we find that since country X's receipts from the export items exceed payments for imports items and donations, X is said to have surplus on current account. The difference between a country's exports and imports, including broadly all current account items, in its international investment i.e. X's surplus on current account, is the basis for an improvement in its capital position vis a vis the rest of the world.

The surplus or the deficit has to be settled. If a country has a surplus on the balance of current account, the country has spent less in abroad during the period than it has earned. A way to settle this is by a transaction on the capital account. The country can increase its stocks to an amount equal to the surplus on the balance of current account. This can be done, for example, by lending aboard, i.e. by buying a loan instrument to the value of Rs. 300 abroad, by purchasing assets or by increasing its reserves of foreign currency.

Balance of Payment Concept

Three fundamentally different ideas are simultaneously called by the same name. For the sake of clearer understanding, it is necessary to distinguish each one of them from the other two. What is indiscriminately termed as the balance of payments may refer to one of the following balance :

1. The Market Balance

The market balance of payment is a model of given situation in the foreign exchange market, characterised by the effective demand and supply of foreign exchange at given exchange rate, and at alternative, hypothetical rates. This is an exante concept for use in the analysis of the foreign exchange market, with major emphasis on the effects which changes in the exchange rate might have upon the amounts of exchange effectively demanded and supplied.

The dollar deficit in a country's market balance of payments may be tentatively defined as an excess of dollar amount effectively demanded at the given exchange rate by would be purchasers (who are not restricted by specially adopted or discretionary government control measures) over the dollar amounts supplied at the exchange rate by would-be sellers (who are not motivated by a desire to support the exchange rate.)

The market supply is by no means confined to transactions on income account, i.e. to the proceeds from sales of exported goods and services (and certain donations). It includes all those transactions on capital account (and donations) which are not the result of deliberate efforts to satisfy the effective demand. Long term capital imports i.e. direct investment by foreigners and the proceeds from the sale of securities to foreigners, are unquestionable components of such a balance of payments. Every supply and demand analysis has several time aspects. It pictures a situation prevailing at a particular time and expected to last for a

definite period of time, it deals with quantities offered or demanded per unit of time, and it expresses the variability of those quantities in response to changes in the price with a certain time interval allowed for the adjustment. The significance of time aspect is great, particularly in relation to policy decisions. For instance, if excess demand for foreign exchange is expected soon to give way to excess supply; the problem of the dollar shortage is surely quite different from what it would be if no change was expected in the foreseeable future.

It makes no sense to recast the market balance of payments for a future period into which the present market conditions can hardly continue, unless, we believe that we know the future market conditions. Thus , the market balance of payments refers to a given exchange rate under given conditions of supply and demand.

2. The Programme Balance

The programme balance of payments is a statement of sources and uses of foreign funds, expected or planned over a future period of one or more years based upon the nation's capital and consumption requirements and on a programme of meeting an excess of requirements over resources by recourse to foreign finance expected or sought. This also is an exante concept, not for analysis but for use in planning, forecasting, or negotiating with major emphasis not on what is effectively demanded but on what is felt to be desirable with reference to some expected norm. A dollar deficit in a country's programme balance of payments may be defined as an excess of dollar amounts needed or desired for some specified purposes (assumed to be important with reference to some accepted standards) over the dollar amounts expected to become available from regular sources.

The existing foreign exchange rate is not as essential for the programme balance as it is for the market balance of payments. The amounts of dollar effectively demanded and supplied will vary if the price of dollars changes, but the amounts of the dollar needed or desired for certain national purpose may be entirely independent of the price of the dollar. Further it is in the assumptions about the level of incomes that the difference between market balance and programme balance of payments is most striking. An increase in money and real income will be most striking. An increase in money and real income will most likely increase a dollar deficit in the market balance. But decrease, a dollar deficit in the programme balance. In the market, the dollar-gap will be widened at a given exchange rate because people can buy much more and thus more goods will be imported and fewer goods made available for exports. In the programme, the dollar gap will be narrowed because people produce more, thus fewer goods need be imported and more goods may be made available for exports.

Generally, policy measures are undertaken to deal with deficit in the balance of payments; but, in a sense one should really not speak of policies "dealing" with a deficit in a programme balance of payments. This is not a deficit which first "exists" and than is "dealt with". Instead, it is a deficit which is

programmed when there is a possibility of financing it. There is no sense in drawing up a programme balance with a dollar deficit.

3. The Accounting Balance of Payments

The accounting balance of payments is a record of all transactions, real and financial, which have taken place over a past period of one or more years between the country's residents and the residents of other Countries, the record being kept in the form of double-entry book keeping with each credit (debit) entry balanced by an offsetting debit (credit) entry. This is an ex post concept based on statistical information and estimates for use chiefly in the description of past developments, and perhaps also in the appraisal of the present position of one nation in relation to others. Although every body agrees that the accounting balance of payments necessarily balances, many choose to present it as showing a surplus or deficit in some meaningful sense.

Thus a dollar deficit in a country's accounting balance of payments may be defined as an excess of dollar amounts entered on the debit side of certain accounts in the annual record of its international transactions over the dollar amounts entered on the credit side of the same accounts, the accounts being selected from the foll, necessarily balancing statement in order to throw light upon problems connected with market or programme balances of payments. The apparent puzzle of a balance in the accounting sense, and also of a deficit, leads us to the realm of equilibrium and disequilibrium in the balance of payments.

The concepts of balance of current account and the balance of capital account are of a great significance. The former shows the flow aspect of country's international transactions whereas the latter lists all items expressing changes in stocks. The balance of current account which includes the merchandise exports, and imports, services and donations need not be in equilibrium. It may show a deficit or a surplus and, therefore, a transaction on capital account has to take place in order to cover the difference. The movement of capital plays an important role in settling the differences and the movement of capital itself is dependent on a broader economic perspective. Thus, the different concepts of balance of payments are designed to serve different objectives.

LESSON NO. 2.7 **AUTHOR : DR. H. G. P. SRIVASTAVA**

FOREIGN EXCHANGE

Economic stability, international as well as domestic, presupposes stability in the value of money as one of the essential requirements. Foreign exchange covers all the means and methods by which the claims expressed in terms of one currency are converted into another currency and the rate at which exchanges take place. The money of a country circulates freely as medium of exchange and measure of value only in that country but it cannot be used in a foreign country. A mechanism of foreign exchange is, therefore, necessary for making payments possible between countries. The term foreign exchange comprises the methods by which the currency of one country is exchanged for that of another, the causes which make such exchanges necessary, the forms in which such exchanges are conducted and the rates at which the exchanges are effected.

Demand and Supply

The forces of demand and supply determine the market price of a commodity and exactly the same conditions apply in the case of the price of a currency i.e. the exchange market. When there is an increase in the demand for a foreign currency without a change in its supply, its price in terms of the domestic currency rises. If at any time, there is a rush on the banks, in the home country dealing on foreign exchange for the purpose of a foreign currency, say, dollars, the banks find their balances in the U.S.A. getting depleted and they try to meet the situation by selling dollars at a higher price. If, on the other hand, the banks find that their dollar balances are larger than usual and there is not much demand for that currency, the balance between demand and supply is restored by lowering the price of dollars in terms of domestic currency. Thus the demand for and supply of a currency in the exchange market of a country determines its price in terms of the domestic currency.

What are the factors influencing the demand for and supply of foreign exchange? The demand for and supply of foreign exchange is in the final analysis nothing else than the demand for and supply of foreign goods and services; the former is derived from the latter. The supply of foreign exchange results from the "Credit" items in the balance of payments, while the demand for foreign exchange results from "debits". Therefore, to know what constitutes credit and debits is to

know the sources of the demand and supply of foreign exchange, as shown in the following list :

Supply (Credits)	**Demand (Debits)**
1. Commodity exports	1. Commodity imports
2. Services rendered to foreigners (e.g. shipping and freight)	2. Services rendered by foreigners.
3. Travel expenditure by foreigners	3. Travel expenditure by nationals abroad
4. Interest and dividends on foreign securities owned here.	4. Interest and dividend on domestic securities owned by foreigners.
5. Remittances and charitable contributions by foreigners.	5. Remittances and charitable contributions by residents.
6. Government expenditures by foreign nations.	6. Government expenditures by home Government.
7. Imports of long-terms capital (i.e. exports of stocks and bonds to home country by foreigners, foreign direct investments here and foreign loans to home country).	7. Exports of long-terms capital (i.e. import of foreign stock and bonds, domestic country making direct investments aboard, and loans to foreigners)
8. Imports of short-terms capital (i.e. increase of foreign owned bank balances in the home country).	8. Export of short-terms capital (i.e. increase of domestic bank balances abroad).
9. Gold Exports	9. Gold imports.

It is a recognised practice to put 1, 2, 3, 4, 5 and 6 on both sides in the category of current transactions, 7 and 8 in capital movements and 9 in gold movements. Of all the items, exports and imports have predominant position; it is usually the single largest source of the demand for and supply of foreign exchange. We must, however, remember that the quantitative significance of any one item differs from country to country. If a country has a deficit in its current account as a result of an excess of visible and invisible imports over similar exports, it must experience an adverse balance of payments in the sense that it is paying off the debts by drawing on its foreign exchange reserves, by exporting gold, or by borrowing on short term from creditor countries-in short, by giving foreigners' claims on its currency. Conversely a favourable balance of payments, means that a surplus country (on current account) must be accumulating claims on foreign currencies. It is not difficult, therefore, to explain the relation between the balance of payments and the exchange rate.

Since an increase in a country's claims on another country's currency means an increase in the supply of that currency on the first country's foreign exchange market, the domestic price of that currency tends to decrease, thus appreciating the external value of the creditor country's currency. When the

creditor country's currency appreciates in value such a country becomes a dear market in which to buy and eventually exports decline. This is likely to wipe out a favourable balance of payments, cheaper the domestic currency relative to other currencies and thereby restore equilibrium. A deficit country, on the other hand, is likely to have a weak exchange-rate position since an increase in foreign claims on its currency means an increase in the demand for foreign exchange relative to supply to cause a decline in the external value of its currency. It is now clear that change in the demand for and the supply of a foreign currency occurs because of variations in the payments which the nationals of the country have to make and to receive from foreigners.

Exchange Rate and Foreign Exchange Market

The rate of exchange between two countries is the price in the home currency for one unit of the money of foreign country payable in that country, or more simply the price of the money of one country expressed in the money of the other. It is generally quoted in two ways :

1. One unit of the foreign currency to so many units of the domestic currency,
   or
2. A certain number of units of foreign currency to one unit of the domestic currency or for instance, we can say

   £ 1 = Rs. 15 or Re. 1 = £ $\frac{1}{15}$ = i.e. Re. 1 = 1 $. 4 d

The market for a commodity comprises the buyer and sellers of that commodity. Similarly, the buyers and sellers of foreign currency, in the form of credit instruments, constitute the foreign exchange market. There are various institutions operating in the foreign exchange market whose primary business is to deal in foreign exchange e.g. banks, discount houses, exchange brokers, etc. While there are others who enter the market in subsidiary capacity e.g. traders in merchandise or buyers and sellers of foreign securities.

We have to remember that prior to World War-II, foreign exchange markets functioned freely but the situation has changed thereafter because most of the countries have introduced wide-ranging exchange controls measures. At present, the authorities fix exchange rates, consciously allocate the foreign currency available to importers, require exporters to sell their foreign exchange earnings to specified dealers and regulate borrowing and lending. The foreign exchange markets as they existed in pre-World War-II times, do not function today.

Methods of Fixation of Rate of Exchange

The external value of money or the domestic price of foreign currencies on the foreign exchange market is determined diversely under different monetary

standards and the way in which it is determined affects domestic and international economic welfare differently. It is, therefore, necessary to examine both the theoretical basis and the practical implications of various international currency systems. There are three typical monetary standards, namely, (a) the gold standard, (b) the paper standard and (c) the mixed standard, the International Monetary Fund'.

(a) Mint Par of Exchange

It seems useful to begin with a definition of gold standard. A country is said to be on the gold standard (i) When its monetary authority is committed to a policy of buying and selling gold at a fixed price in unlimited amounts. (ii) When the purchasing power of a Unit of its currency is kept equal to the purchasing power of a given weight of gold and (iii) when the external value of its currency is fixed through the medium of gold. Practically all major trading nations were on gold in the above sense before 1931 and gold served as a principal international means of payment and as an important reserve of international liquidity.

The gold standard enables exchange rates between currencies to be stable. The normal rate of the par of exchange then depends on the gold values of currencies. Since gold has the same value in all gold standard countries, the rate based on it tend to remain unchanged. There are small fluctuations on either side but these take place within narrow and well-defined limits because of the possibility of people making remittances in gold.

The method of ascertaining the rate of exchange by comparing the metallic contents of the currencies of different countries is called the Mint Par Theory of exchange. A simple example will make it clear. Suppose we want to find out rate of exchange between England and America-assuming both of them to be on the gold standard. We know that the weight of the British Sovereign is equal to 113.0016 grains of fine gold. The weight of the American golden eagle (which is equal to $ 10) is equal to 232.2 grains of fine gold. The weight of one dollar comes to 23.22 grains of fine gold.

Therefore £ 1 = $\frac{113.0016}{23.22}$ = $ 4.8665. Hence the London-New York or Sterling-Dollar Mint Par of Exchange is £ 1 = $ 4.8665.

By similar comparisons, the Mint Pars between two countries using the same metal their standards of value can be calculated but it must be understood that any Mint Par is merely a theoretical measurement of the value of one standard coin in terms of another standard coin. It takes no account of practical variations in the weight or fineness of actual coins due to wear and tear and is purely arbitrary basis of comparison. It is a theoretical rate of exchange based on the laws of the two countries which prescribe the weight of fine gold contained in the respective coins.

Even when gold is available, the traders prefer to settle their debits through exchange bills purchased from bankers. If the bills drawn on a particular country

are exactly equal to the bills drawn by this country upon foreigners, there is no difficulty. The debits are offset by credits such a condition, however, seldom exists. In actual practice, sometimes a country imports more than what it exports and sometimes its exports largely exceed its imports, so that the price of the bills of exchange varies in accordance with their supply and demand. Let us take an example to show how it all happens. X in New York has sold a consignment of steel to Y in London. Before it is detached from New York the steel becomes represented by a bill of London 'X' draws a bill of exchange on 'Y' for the amount, that is, he instructs 'Y' to pay a definite sum at a definite time. It may be according to the terms of bargain, payable 'at sight' or in the three months time. This bill of exchange and the bill of lading are sold by 'X' to a New York banker who sends them to his London Agent from whom 'Y' obtains 'the bill' of lading enabling him to get the steel by accepting or by actually paying the bill. The New York banker thus has at his disposal credit in London.

Now suppose another businessman 'Z' in U.S.A. owes money to somebody in England. He goes to New York Banker (who has credit in London) and wants a draft payable in London. The banker knows very well that if his client did not get the bill he shall have to ship the required amount of gold and incur the cost of transportation and insurance into the bargain, that in addition to spending $4.866 for every, £ 1 he will have to spend .024 cents per sovereign. He therefore, quotes for his bill any price between $ 4.866 and 4.89 (4.866+ .024). He cannot demand a price higher than $ 4.89 for every £ 1) because otherwise 'Z', the American debtor, will think it worthwhile to undergo the risk and expense of shipping gold. The highest point to which the price of bills can go is called the Upper Special Point of the Gold Export Point. The actual rate of exchange will be different from mint par but it will vary between $ 4.866 and 4.89 depending on the supply and demand of bills. When the demand for the bills of exchange is less than their supply, their prices fall. The lowest price to which it can fall is determined by deducting the cost of commission, insurance and freight from the mint par and is called the Lower Special Point or the Gold Import Point. Thus the rate of exchange cannot fall below $ 4.842 (4,866-.024) for every pound. It will be clear that the rate of exchange between two countries on the gold standard is determined by the Mint Par and the rate thus determined fluctuates between the upper and lower specie points depending upon the extent of mutual indebtedness measured by the supply and demand of bills.

(b) The Purchasing Power Parity Theory

Suppose there are two countries on gold standard and one unit of the currency of one is equal to one of that of the other or the par rate of exchange is unity. If both of them resort to inconvertible paper money and the former doubles the quantity of currency in circulation while the latter quadruples it, the price level in the former will be half of that of the latter. The rate of exchange, therefore

will be 1:2 in accordance with their price levels. The rate of exchange obtained by comparing price-levels of two countries is called the purchasing power parity.

The essence of this theory is that we judge the value of a foreign currency to us by its command over goods and services. Purchasing Power is indicated by the general level of prices so that if prices in a foreign country are higher compared with our own the money of that country will not go very far and we, therefore, expect to get more of its money in exchange for our own. In other words, the value of the unit of one currency in terms of another is, in the long run, determined by the relative values of the two currencies indicated by their respective purchasing powers over goods and services.

Gustav Cassel, J. M. Keynes and others used the purchasing power parity theory after World War-I to show that the fall in the external value of some European currencies was largely the result of the post-war inflation in Europe. The theory is also useful in demonstrating the consequences of a possible discrepancy between the internal and external purchasing power of a national currency. The concept of over-valuation and under-valuation are based on purchasing power parities. There are a number of limitations of the purchasing power parity theory:

Firstly, we know that the calculation of the purchasing power parity depends upon index numbers of prices. Since index numbers are merely indications of average rise or fall in prices, the rate of exchange calculated by means of purchasing power parity theory frequently deviates from the existing rate of exchange.

Secondly, the theory suffers from its failure to take into consideration the elasticities of reciprocal demand. By the elasticity of reciprocal demand is meant by responsiveness of one country's demand for another country's exports with respect to price or income. As far as the price elasticity of demand for exports, the price change which is relevant here might be considered to be due to exchange depreciation or appreciation, not to general price movements. With international price movement remaining constant, whether the external value of a national currency will change depends, on the responsiveness of the foreign demand for a nation's total exports to a slight change in that nations export prices in terms of foreign currencies. Needless to say, in the longer period the elasticities of the reciprocal demand can change significantly as a consequence of change in international consumer tastes.

Thirdly, although Keynes concentrates on short-term speculative capital movements, long term capital movements may have an equally important effect on exchange rates. Short-term speculative capital movements, otherwise known as "capital flight", may arise from a desire to make a profit or avoid a loss on exchange fluctuation as in the case of "hot money", or from a desire for safety and security as in the case of "refugee capital". The new exchange rate resulting from capital movements has nothing whatsoever to do with general price movements of changes in purchasing power parities.

(c) Pegged Rate of Exchange

The International Monetary Fund is substitute for the old gold standard and an alternative to both a system of completely free exchange rates and a system of extreme exchange control. It is a mixed standard embodying within itself some features of the gold standard and the paper standard.

The Fund requires that the par value of a member-country's currency be expressed in terms of gold as a common denominator or in terms of U.S. dollar of the weight and fineness in effect on July 1, 1944. We must bear in mind that this requirement is for accounting purpose, not for the purpose of maintaining stable exchange rates as under the gold standard. If, for example, the dollar sterling exchange rate is fixed at $ 4.08= £1 as an expression of the relative gold weights of the dollar (0.889 gram) and the pound (3.581 grams), as was initially set by Fund, it by no means precludes the possibility that the rate may be altered as domestic and international conditions necessarily change.

In order to facilitate multilateral trade among member countries the Fund bars “competitive exchange alterations” and requires each member country to "maintain orderly exchange arrangements with other members". In other words, the Fund thereby hopes to avoid the disadvantage of a laissez-faire exchange rate policy as well as the disadvantage of unalterable exchange rates, in short, to achieve managed exchange stability. To implement this exchange arrangement, the Fund provides for a 10 percent adjustment upwards or downward, in the external value of a member-country's currency without prior approval of the Fund and for a more than 10 percent adjustment with the Fund's consent all for the express purpose of correcting a serious disequilibrium in a member country's balance of payments. This is an important concession to exchange flexibility which is impossible under either the gold standard or the paper standard. Under gold standard, exchange flexibility of any kind is out of the question, while under the paper standard, exchange flexibility is in the habit of degenerating into disorderly, discriminatory competitive exchange depreciation.

The international monetary system has been under a serious strain since August 1971. The official price of gold was raised by U.S.A. from $ 35 to $ 38 per fine ounce i.e. 8.57 recent. This meant a devaluation of the dollar in gold by 7.89 percent. The dollar, however, continued to remain inconvertible. The exchange parities of many other currencies were realigned and their values in the dollar were revised upwards. Another important change that was effected was an increase in the range of exchange fluctuations from 10 percent to 2.25 percent on either side of the parities. The exchange could, thus fluctuate within a span of 4.5 percent instead of 2 percent as before. This will give greater scope to the balance of payments to change without causing any serious concern to the Fund authorities to do anything about it. Exchange rates will, thus, have greater flexibility without losing any of their stability.

LESSON NO. 2.8 **AUTHOR : DR. M. L. SHARMA**

INTERNATIONAL MONETARY FUND (IMF)

The collapse of gold exchange standard in the 1930s, competitive exchange depreciation, exchange restrictions, wide fluctuation in the exchange rates, discriminating trade policies and general uncertainty about the medium of international exchange were some of the factors responsible for economic instability and decline in world trade in the post world war period. The lack of co-operation in matters of trade and payments was the main problem in the field of international economic policy. The international community was, therefore, in search of a substitute for the gold standard, and an alternative to both a system of completely free exchange control. It was also considered desirable to evolve an international monetary system which could reconcile the autonomy of internal economy with the discipline of international mechanism of payments. A conference was, therefore, organised in 1944 under the auspices of the United Nations at Bretton Woods in U.S.A. The conference was attended by the representatives of 44 countries. Many experts contributed to the Bretton Woods Agreement but the major influence was exerted by Lord Keynes and Harry Dexter White. The final agreement, however, was based on the plan propounded by Harry Dexter White, under secretary of the U.S. Treasury. As a result of the Bretton Woods Agreement, the International Monetary Fund (IMF) was set up in 1945.

Objectives of IMF

The International Monetary Fund started functioning on the Ist of March, 1947, with the following objectives :

(1) To promote international monetary co-operation amongst the various member countries.

(2) To facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion of high levels of employment and real income.

(3) To promote exchange stability to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(4) To assist in the establishment of multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(5) To give confidence to the members by coming to their timely rescue by giving them short period monetary resources to help them tide over the temporary maladjustments in their balance of payments without resorting to measure destructive to national or international prosperity.

(6) To shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

The above mentioned objectives, as embodied in the Articles of Agreement clearly indicate the obligations of the International Monetary Fund. These objectives indicate that they shall be required to regulate monetary relationship among member countries in accordance with the 'Code of good conduct' and also to provide finance to members facing balance of payments deficit.

Organisation of IMF

The total membership of IMF was only 40 at the time of its inception on March 1, 1947. In September, 1966 the IMF had a total membership of 135. Now the memebership is of 181 countries. The Capital resources of the IMF consists of the total of the quotas allotted to member countries. The quota of a member country is based upon its importance as measured by the value of her foreign trade, gross national product, gold and foreign exchange reserves and certain other related factors. Each member country is required to contribute its quota both in terms of gold as well as in its national currency. Each member has to pay its quota in gold either 20 percent of the quota or 10 percent of its entire gold and dollar holding, whichever is less. The aggregate of quota amounted to $ 7.5 billion on Ist March, 1946. In September, 1976 the aggregate quotas are counted to $ 43 billion. Since one unit of SDR is now held equivalent to $ 1.08571, therefore, the aggregate quota of $ 43 billion amounts to SDR 39 billion.

The IMF has also appointed certain Central banks as its gold depositories where members can deposit gold to the credit of IMF. The gold and the national currencies deposited with the IMF are the properties of the IMF. The IMF utilizes its gold holdings to acquire Dollars and other currencies for its operations. The IMF holds two kinds of accounts with the Reserve Bank of India's A/C No. 1 and A/C No. 2. The A/C No. 1 is the major account in which the portion of India's IMF quota subscription and other payments in rupees are credited and through which all the major transactions with the IMF involving purchase of foreign currencies (sale of rupees) are routed. For day-to-day use, the IMF maintains A/C No. 2 with the Reserve Bank of India. This is a very small current account. Deposit in A/C No. 2 produces the impact on the supply of money in India.

There are two bodies to run, the management of the IMF-(1) The Board of Governors, and (2) The Board of Directors. Every-member country appoints one Governor and one alternate Governor. The alternate Governor participates in the meeting in the absence of the Governor. The Board of Governors formulates the general policy of the IMF. Thus, the Board of Governor is a decision-making body of IMF. There are 21 members in the Board of Directors. The Board of Directors has to carry out the day-to-day working of the IMF. The chief executive of the IMF is the Managing Director. The head office of the IMF is at present located at Washington.

Functions and Working of the IMF

The following are the main functions of IMF :

(1) Determination of Exchange Rates : The very first article of the IMF agreement stipulates that one of the functions of the IMF is to promote exchange stability. The IMF adopted the 'par value' system of determining the exchange rates for member countries. Under the 'par value' system each member country is required to define the value of its currency in terms of weight of gold as a common denominator or in items of the United States dollar of the weight and fineness in effect on July 1, 1944 which was $ 35=one ounce of gold of 0.995 fineness. The initial par value of the Indian rupee, established with the IMF on December 18, 1946 was 0.268601 gram of fine gold or 30.2250 U.S. cents. In other words, the exchange rate determined in the terms of par value was Rs. 3.30=1.00. When all the member countries express the values of their currencies in gold or Dollars, it becomes easier for the IMF to fix the foreign exchange rate of the concerned countries.

(2) Management of Exchange Stability : In order to facilitate multilateral trade among member-countries, the IMF bars "competitive exchange alteration" and requires each member-country to "maintain orderly exchange arrangements with other members". It does not mean that the IMF favours a fixed exchange rate system. As a matter of practice and principle, the IMF is against the floating exchange rate policy. The IMF believes in the merits of stable exchange rate policy. In order to achieve the goal of exchange stability, the IMF provides for a 10 percent adjustment, upward or downward in the external value of a member-country's currency without its prior approval, and for a more than 10 percent adjustment with its prior consent. It must, however be pointed out that the adjustment in the external value of the currency is permitted only for correcting a fundamental disequilibrium in a member-country's balance of payments. The downward adjustment in the external value of the Indian rupee was made when the rupee was devalued on September 18, 1949 and again when the rupee was devalued again on June 6, 1966. Thus, the IMF seeks to manage the stability of exchange rate. It must, however, be pointed out that from December 18, 1975 the IMF has allowed' the fluctuation in the exchange rate of member's currency within a wider margin of 2.25 percent in place of old margin of 1 percent, in either direction of the parity relationship.

(3) Establishment of a multilateral system of payments and elimination of Foreign Exchange restrictions : Article I (IV) of the IMF agreement indicates that IMF shall operate assist in the establishment of multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade. In order that this objective may be achieved, Article VIII provides that no member-country may, without the approval of the IMF, impose restrictions on the making of payments or transfers for current international transactions or engage in discriminatory

currency arrangements or multiple currency practices. It is also stipulated that the monetary authority of each member country shall convert any balances which another member-country's monetary authority has acquired from or needs for current transactions, into gold or into currency of that member-country. In short, all the member-countries shall abolish restrictions upon current payments, avoid discriminatory currency practices and promote convertibilities of foreign held balances, would ensure that a member country would be free to use payments surplus with any other member-country to pay for its deficit with a third country. As a result, multilateral system of payments will be established and trade volume will be increased.

(4) Lendings to members to cover up deficits in Balance of Payments : The IMF's resources consist of a common pool of gold and currencies, which in turn consist of an aggregate "quotas" paid in or payable by its member-countries. The IMF lends to a member country which is in need of a short-term credit to settle current deficit in its balance of payments. The deficit country "borrows", the necessary fund in exchange for its IOUs It implies that a deficit country buys the needed foreign exchange from the IMF with its own currency. If the short-term credit thus acquired helps the deficit country to overcome its adverse balance of payments, the country is required to 'repurchase' its own currency in exchange for gold or 'convertible currencies'. As a result, the IMF is protected against quick depletion of its scarce currencies (e.g. dollar resources.) It must, however, be pointed out that a member-country can buy foreign exchange from the IMF upto an amount equal to 25 percent of its quota in any given year. However, the currency of a member-country with the IMF at any time should not exceed 200 percent of its quota. Let us suppose, as an example, that the quota of member country is $ 100 million comprising $ 25 million in gold and $ 75 million in its own national currency. If this country wishes to obtain some foreign currency from the IMF, it can not secure foreign currency of the value greater than $ 122 million. The IMF charges rate of interest which varies between 0.5 and 2.5 percent. It also levies service charges to the extent of 0.75 percent on its loans. These drawings of the member-countries from the IMF are conditional.

(5) Dealing with the problem of 'Scarcity of Currencies' : The currency of a member-country is said to be 'scarce' if its supply is less than, its demand. If a country sells its goods to other countries but does not buy from them, then the other countries are not able to acquire the currency of the former. As a result the currency of the export-surplus country becomes scarce in relation to demand. Dollar for most of the times, has been a scarce currency. The IMF can deal with the problem of dollar scarcity in two ways, namely, (a) by increasing its supply of dollars through purchase of dollars with its gold, and (b) by declaring the dollar to be a 'scarce currency'. If the IMF's gold assets are enough to buy all the dollar needed by deficit members, then it will not have to ration its scarce dollar holdings among the dollar-

needing members. Fundamentally, however, it is more important to correct a sustained disequilibrium between those members whose currencies are 'scarce' and those whose currencies are not scarce, because that is what gives rise to a general scarcity of the former's currencies. This suggests that the burden of responsibility should not rest on the shoulders of deficit countries alone.

(6) The Special Drawing Rights : Under the original articles of the IMF, it had powers to lend sums to member countries. But this lending was conditional, and it was repayable. The unprecedented growth in international trade in the post war era has posed a serious problem of international liquidity. The introduction of special drawing rights (SDRs) by the IMF was an important step in improving international liquidity. The plan for SDRs was approved in September, 1967 and was introduced in 1969. The essence of these Special Drawing Rights (SDRs) is that they create a new international reserve assets. They can be used unconditionally by the participating countries, and they are not packed by any assets.

Unlike existing IMF, drawing rights, SDRs are not created by countries contribution of gold and currency to the IMF and once drawn they do not have to be paid back to the Fund. The peculiarity of the new drawing rights is that they would not be treated as borrowing as the existing claims on IMF are. The SDRs are sometimes nicknamed 'paper Gold'. They could be used as gold in as much as they would be the ultimate resource for purchasing other currencies. They are not pieces of paper like bank notes or Treasury Bills. They are simply entries in a special account kept by the IMF. The SDRs are allocated to each member country in exchange for usable foreign exchange in proportion to its IMF quota. They can only be transferred to another member country for usable foreign exchange. It means they can not be spent directly on goods and services. In short, SDR is an international medium of exchange and store of value.

By the end of 1976, 121 members were participants in the SDRs. The allocations of SDRs were made at the beginning of 1970, 1971, 1972. The total SDRs allocated during this period amounted to SDR 9.3 billion. On 4th January, 1979 the IMF decided to make a fresh allocation of total of SDR 12 billion. India was entitled to receive SDR 3.6 billion out of the total SDR 12 billion.

(7) Expert Advice to the Member Countries : Along with financial help, the IMF also grants technical assistance to the member-countries. The experts and specialists of the IMF render valuable help to the member-countries in solving their complicated economic and monetary problems. In fact, the under-developed countries have been helped in the formulation of their monetary, and exchange policies. Thus, the IMF helps the member-countries to stabilize their economies.

IMF and Under-developed Countries

The stable exchange rate system was set up in the Bretton Wood System. The developing countries have been favouring stable exchange rate system because it

is in the interest of such countries. These countries face often adverse balances of payments problem. The stable exchange rate system with the support of international liquidity is better arrangement because they are in a better position to pursue the development programmes under such an international monetary system. In 1976, under-developed countries had deficits in their balance of payments of the order of $ 3.2 billion, whereas in 1973 the deficits were of the tune of $ 10 billion. The developing economies, therefore, want an adequate supply of international liquidity to meet the adverse balance of payment. The total SDRs, created and allocated from 1970 and 1972 stood at $ 3 billion. The under-developed countries were allocated SDRs to the tune of $ 1.9 billion out of the total SDRs of $ 9.3 billion. Thus, the allocations of SDRs to under-developed countries had been much less as compared to their requirements.

The adverse balance of payments position of under-developed countries has also been affected further by rise in oil prices. In order to meet the situation created by rise in oil prices and its consequent effect on balance of payments, the IMF created an 'Oil Facility Arrangement'. The total contribution to the 'Oil Facility' has been SDRs 6.5 billion. Share of developing countries in the borrowing out of the capacity worked to be only 37 percent. Though the 'Oil Facility' of 1975 gave some relief to the under-developed countries yet the scheme has not benefitted much owing to insignificant amount of facility. These countries had to drop some of the projects envisaged under the development plans.

The world economic development in 1971 was characterised by the realignment of major currencies. Currency floats became the order of the day. It led to the demise of the 'Par Value' system enshrined under IMF agreement. It must however, be pointed out that most of the under-developed countries did not make resort to floating currency system. They have been supporting the case for a fixed exchange rate system because of the relative absence of uncertainty about exchange rate under this system. In short, the IMF has not succeeded in safeguarding the interests of under-developed countries. The deficits in balance of payments, adverse terms of trade, rising bill of oil imports, uncertainty of the inflow of aid, availability of SDRs and fluctuations in the exchange rates suggest that the IMF should evolve suitable policies to suit the interests of developing economies.

Critical Appraisal of the Policies of IMF, with special reference to Triffin Plan

Robert Triffin predicted the breakdown of the international monetary system evolved at the Bretton Woods. His prediction recorded in his classic book 'Gold and the Dollar Crisis' proved true with the advent of 1990s.

The International Monetary System under the auspices of the IMF has been making reliance in a major national currency—the United States dollar. This is clear from the fact that the dollar was chosen as a common denominator in terms of which all exchange rates were in fact defined and readjusted from time to time.

The dollar was regarded as the main component of international reserve accumulation by all countries other than the United States. As a result, the dollar came to be used as the main instrument for central bank interventions in the exchange markets and for the settlement of balance of payments surpluses and deficits. But at the same time gold formed the basis of the monetary system institutionalised in the form of the IMF because of the convertibility of dollar into gold. This meant in practice, that the growth of international reserves becomes more and more by product of the United States balance of payments deficits. As a result, the deficits in the balance of payments of the United States make its indebtedness to foreign central banks (dollar balance). The United States was required to convert the dollar balance of foreign central Banks into gold.

This system worked reasonably well as long as the deficits in the balance of payments of the United States did not exceed the normal needs for growth of world reserves. The accumulation of dollar balances by foreign central banks over 1950-1969 was of the order of $ 14.5 billion. As a matter of fact, 95 percent of the overall deficits of the United States balance of payments were financed by the acceptance of American IOU's as international reserves by other countries. In 1971, the position was such that the world having acquired dollar balance for more than the American gold reserves finally lost its confidence in the dollar as the principal reserve currency. This forced U.S.A to abrogate convertibility of dollar into gold on August 15, 1971. The countries having surplus balance of payments have to adopt the floating rate system because of the inflationary implications of rising dollar balance with them. In short, the inconvertibility of the dollar and the generalised adoption of floating rate in the basic contravention of the Bretton Woods agreement were the manifestations of the total breakdown of the international monetary system institutionalised in the form of the IMF. Gold has been dethroned from its position of constitutional head of the international monetary system. Thus we see comes true Triffin's prediction : “Man-made credit reserves will continue to displace and will eventually replace gold reserves just as man-made credit money has long replaced gold money in even every national monetary system, the world over”. He has criticised the use of gold as a component of international liquidity on the ground that for a long time the monetary stock of gold has been rising more slowly than the volume of world trade. It is significant to point out than even though the IMF evolved in 1969, SDRs as an international liquidity, the fixation of its value in terms of gold proved ineffective. In accordance with the recommendations made by the C-20 (The Committee of Twenty), the SDRs was delinked from gold in July 1974.

Triffin has given a proposal for reform of the international monetary system. He has advocated the centralization of reserves and establishment of an international reserve-creating institution. He suggests to adopt the model of

domestic monetary system and establish some form of an international reserve creating institution to perform tasks to those of domestic central banks.

A new international monetary system was born on January 8, 1976 as a result of the conference of the C-20. The Old, Bretton Woods monetary system had collapsed on December 18, 1971, when the dollar was devalued. Thus basic features of the new monetary system are as follows: Firstly, the new monetary system has now given legal recognition to the floating of currencies in the foreign exchange market of the world. Secondly, the new monetary system instituted a Special Trust Fund with the sale proceeds of gold stock of the IMF. This fund was intended to be utilized to help the developing countries to meet chronic imbalance in their balance of payments. However, the assistance from this fund shall be given only to those developing countries whose per capita income was less than $ 360. Thirdly, the quotas of the member countries in the capital resources of the IMF had been increased by 33 percent under the new system. Fourthly, the paper gold i.e. SDRs has been declared as the principal reserve asset of the international monetary system.

The above discussion clearly brings out that the IMF succeeded in achieving such objectives like exchange rate stability, convertibility of a new currency and multilateral payments system. But it could work satisfactorily only in the first two decades of its existence. The reliance on one national currency dollar and convertibility of dollar into gold, enshrined under the IMF agreement, brought a halt and ultimately collapse of the Bretton Woods system in the beginning of 1970s. Triffin has always been against the introduction of gold in the edifice of international monetary system. Fortunately in the amended 1976 international monetary system the yellow metal has been dethroned from its position of the basis of the international monetary system.

LESSON NO. 2.9 **AUTHOR : DR. I. A. QUREISHI**

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (IBRD)

Introduction

The International Bank for Reconstruction and Development, better known as the World Bank, established at the same time as the International Monetary Fund, to tackle the problem of international investment. Since the IMF was designed to provide temporary assistance in correcting balance of payments difficulties, an institution was also needed to assist long-term investment purpose. Thus, IBRD was founded in 1944 and began its operation in 1946 for promoting long-term investment loans on reasonable terms. The Second World War had given a severe blow to global trade by disrupting the world economies. The economy of England was completely destroyed while Germany had been totally ruined. France and other countries had also suffered on a large scale. Economic reconstruction was the immediate need of war-torn Europe. Besides, the task of re-building the war-shattered economies of European countries. Another problem which required urgent attention was the problem of vast economic inequalities between the developed and developing countries. The entire continents of Asia, Africa and Latin America were immersed in increasing poverty. The widening gap in the living standards of the rich and poor nations breeded social unrest and political upheavals which had the potential of originating the flames of war, once again. It was realised that the only way to ensure lasting world peace was by eradicating poverty in the underdeveloped economies through economic development of these countries. To solve this problem, the Bretton Woods Conference decided to establish the International Bank for Reconstruction and Development.

Functions

IBRD is an inter-governmental institution, corporate in form, the capital stock of which is entirely owned by its members.

The main functions of the Bank are :

(i) to assist in reconstruction and development of the economies of its member governments by facilitating investment of capital for productive purpose;

(ii) to promote foreign private investment by guarantees or through participation in loans and other investment by private investors;

(iii) where private capital is not available on reasonable terms, to make loans for productive purpose out of its own resources, or out of the funds borrowed by it; and

(iv) to promote the long-term balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging

international investment for the development of the productive resources of member countries.

A little reflection will reveal that the objectives of the IMF and IBRD are complimentary. Both aim at increasing the level of national income and standard of living of the member nations. Both serve as lending institutions, the IMF for short-term and the IBRD for long-term capital. Both aim at promoting the balanced growth of international trade.

Organisation of the Bank

Any country is eligible for membership of the Bank if he subscribes to the Charter of the Bank. The Bank has a Board of Governors, Executive Directors, a President and other staff. All powers of the Bank are vested in the Board of Governors consisting of one governor and one alternate appointed for five years by each member. Each governor has the voting power which is in proportion, to the financial contribution of the government which it represents. The voting power of the big shareholders outweigh the voting power of the smaller ones. The U.S.A. has 25.66 percent of total votes while the U.K. has 10.31 percent. The Board of Governors meet once a year. This annual meeting is an important occasion for informal exchange of views at high level on major international financial and monetary issues.

The initial authorised capital of the world bank was 10 billion; subscribed by its members in accordance with their economic growth. The United States of America is the largest subscriber, followed by the United Kingdom; India is the fifth-largest subscriber. Each country's quota is divided into three parts :

(i) Two percent of the subscription is payable in gold or U.S. dollars and is freely available for lending;

(ii) 18 percent of the subscription is payable in member's own currency and is available for lending with the consent of the member whose currency is involved; and

(iii) The remaining 80 percent of the subscription is not payable for lending but is subject to call as and when required to meet the Bank's obligations.

The subscribed capital of the bank is increased as a result of the enhancement of its sources in the form of increases in member's subscription and also due to the increase in membership. The principal purpose of increasing World Bank's capital resources is to increase its ability to lend for financing projects for economic development.

Aims

The fundamental aims and objectives of the Bank are :

(i) To provide a catalyst by which production may be generally stimulated and private investment encouraged;

(ii) To encourage necessary action by the member governments to ensure that the Bank's loans will actually prove productive; and

(iii) To initiate development plans and to see to it that the Bank's resources are used wisely from the standpoint of the world.

The World Bank is more than the usual type of lending institution. Its concern is primarily to ensure that its loans make the greatest possible contribution to increasing the production, raising the living standards and opening opportunities for further investment in the borrowing member country. Recently, the scope of Bank's assistance to the members has been considerably widened. In its early years, most of the Bank's leading was for "hardware" projects which simply added to the physical assets of the economy like dams; roads and power plants. Now Bank is also lending for "software", like education, population planning, urbanisation, water supply and sewerage.

Granting of Loans

In the granting of loans and their administration, there are four stages involved. The first stage may be characterised as exploratoty discussion and preliminary investigation. At this stage, there are discussions between a Mission sent by the Bank and the prospective borrower about the latter's ability to repay the loan.

If the Mission is satisfied with preliminary investigation then the second stage of investigation of the specific project starts. The Mission investigates the specific project in its technical, financial and administrative aspects whether the project plans have been properly drawn, whether the required local capital would be entrusted to capital management, etc.

If the second stage of technical investigation is satisfactory, the third stage of negotiation of the terms of loans starts. This involves determination of the part of total investment to be provided by the Bank; the interest rate, the period of the loan and securing of several assurances and guarantees for safeguarding the interests of Bank.

The final stage is that of the administration of the loan which is a special feature of the Bank loans. The Bank representatives visit the borrowing country and check the end use to which the funds are put, in order to determine that this use conforms to the loans agreement.

Guiding Principles of the Bank

In its lending operation, the Bank is guided by certain guidelines which have been formulated on the basis of the Articles of Agreement.

In the first instance, the Bank should assess properly repayment prospects of the loans. For this, it should consider the availability of natural resources and existing productive plant capacity to exploit the resources and operate the plant and the country's past debt record.

Secondly, the Bank should lend only for specific projects which are economically and technically sound and of high priority natures.

Thirdly, it is the Bank's policy to maintain continuing relations with borrowers so as to check the progress of the projects and to keep in touch with financial and economic development in the borrowing country.

The rate of interest charged by the Bank is based on the rate which it would itself have to pay to borrow money at the time the loan is made plus one percent commission charge which is allocated to a special reserve. Since July 1976, a new lending formula provides for a positive spread 0.5 percent between the Bank's own borrowing cost and the interest charged on its loans granted after that date. Accordingly, in July 1976, the interest rate on Bank loans was fixed at 8.9 percent. The interest rate was gradually reduced to 8.2 percent.

The bank has advanced loans for specific development projects in the field of agriculture, electric power, transport, telecommunication, industry, population, planning, water supply, project preparation, urban development and education. The Bank has lent to current borrowers a cumulative total amount of 51,51,692 million (upto 20 June, 1979), for financing various development projects, the main beneficiaries were the developing countries. During the nine year period (1971-79) the Bank lent a total of 3,019.2 million to the 'core' less development countries with annual per capita income below $ 296. Bank's loans are long-term loans granted on the conventional rate of interest for projects of economic priority.

An intermediate financing facility was created in 1975-76 to enable the Bank to provide development assistance on terms intermediate between those of the Bank and IDA. The total amount of loans advanced by this 'Third Window' amounted to $ 600.4 million by the end of fiscal year, 1979.

A majority of IBRD's loans have gone to developing countries for development projects. These loans were meant for the creation and development of infrastructure projects in the developing countries in Africa, Asia and Western Hemisphere. More than 30 percent of the total loans assistance has been given for the development of electric power projects. About 22 percent of the total amount had been utilised for providing transportation and telecommunication facilities. About 22 percent of the total cumulative loan amount has financed the development of agriculture and rural development projects. Rest of the loan assistance has been given for the development of education, project preparation and technical assistance, population planning, water supply and sewerage. Region wise, about 7 percent of the total amount has been given to South Asia and about 30 percent to Europe, Middle East and North Africa, about 20 percent has gone to East Asia and Pacific region countries. Africa claimed about 13 percent while, Latin America and Caribbean territories have shared about 30 percent of the total loan assistance provided by the Bank.

The substantial growth in the lending activities of the Bank would not have been possible without a corresponding expansion in its resources. The paid in capital of the bank during the past 35 years has risen to more than four fold. Besides the increase in its capital resources, the Bank has also borrowed funds on a mass scale by successfully floating loans in the international financial markets. Investors or about hundred countries hold the security of the Bank which has been established in the

money markets of Belgium, Canada, Germany, Italy, Netherlands, Switzerland, U.K. and U.S.A. and thirteen pertroleum exporting countries including Saudi Arabia.

World Bank and India

In addition to the conventional loans which it has made available for development projects, the Bank has made sincere efforts to secure outside assistance from developed countries for under-developed countries. The Bank has taken the lead in organising and coordination mechanism for a number of developing countries which receive assistance from several bilateral and multilateral sources. It has helped in the establishment of International development Association from which under-developed countries can borrow in hard currencies without being worried to repay in the same currencies. Another contribution of the World Bank was the amendment to the charter of International Finance Corporation to enable it to provide equity to private industrial undertakings in underdeveloped countries. These developments have helped the developing countries to effectively implement their development plans. The Bank's lending to least-developed among the developing countries increased from the low annual average of 204.2 million during 1974-75 to 550 million in 1978-79. Moreover, lending has been in favour of agriculture and rural development transportation and industrial sectors where development is vital for the development of member countries. India is a founder member of the Bank and holds a permanent seat on the Bank's Board of executive directors. In view of the achievements, the role of the Bank has been commendable. The proof of its popularity is the rapid increase in its membership. The bank has sent several missions to India to assess country's development programmes and also for field surveys of various projects. The Bank has appointed a resident representative in New Delhi who remains in close contact with the government of India in regard to the country's development plans and the projects.

India is the largest single borrower of the Bank. In the thirty year period (1949-79) the Bank has lent 26456 million in 57 loans. Of this loan assistance, over 50 percent was given for the improvement of transportation. Power claimed about 20 percent of the total loan assistance. Industry's share came to about 29 percent of the total loan assistance given by the bank of India.

India has gained from assistance given to it by the Bank. It was due to its concerted efforts that a consortium of twelve lending western countries known as 'Aid India Club' comprising of the U.K., U.S.A., West Germany, Japan, France, Canada, Italy, Sweden, Austria, Belgium, Netherlands and Holland was formed.

But, much more significant is the involvement of the Bank in India's development programmes. The proof of the massive assistance of 5,472 million which she received from the members of the consortium for development programmes during the Third Five Year Plan and the non project aid of $ 3,700 million would never have been made available without the support of the Bank.

Apart from providing the massive assistance, the Bank also paid the foreign exchange amounting to $ 862,000 for improving the transport of coal in India. In 1965 the Bank helped in financing a survey of transport in the eastern region in order to enable the Government to formulate a transport investment programme for the Fourth and Fifth Five Year Plans (1966-76).

The Bank also gave a loan of $ 39 million in 1971 and 1972 to the Punjab Agricultural Project to boost farm production. Projects financed with the help of the Bank have strengthened the Indian economy.

The International Development Association affiliate of the Bank had also lent a total of 6750.2 million in 12 soft credits for various development projects upto June 30, 1970. This shows that the World Bank Group has granted massive loan and credit assistance of more than 9 million to India for the planned economic development of the country's economy.

Critical Appraisal

The 'modus operandi' of the Bank has been criticised in various grounds. Firstly, it is alleged that the Bank charges a very high rate of interest on its loans even when the loans given by it are guaranteed by government of the borrowing member countries and there is no risk of loss of capital. There is truth in it because the latest loans that India has received from the Bank bear interest of over 8 percent. The Bank must remember that it was created to be an active instrument in the establishment of lasting international economic peace by making it possible for the economically weaker nations to become stronger by mobilising their resources. This purpose of the Bank can be fulfilled only when the rate of interest charged by it is low enough for all countries to enable them to take loans from the Bank more frequently.

Secondly, the Bank's insistence on the repaying capacity of a borrowing country before granting the loan is faulty. The repaying capacity follows rather than proceeds the utilisation of the loan. It is created as the projects financed by loans materialise. Trying to estimate repaying capacity before granting the loans betrays lack of judgement on the part of the Bank.

Thirdly, the Bank is non-political and non-partisan financial institution. It is expected to treat all members equally, being enjoined not to discriminate against some and in favour of others in the granting of loans. However, in practice loans have not been given purely on economic considerations. It is only recently that the economically backward countries of Asia and Africa have caught the eyes of the Bank and even now these areas are not getting the attention they need. The Third World countries taken together have the largest population and unexploited economic resources. On the contrary, Europe and Western Hemisphere are small of both from population and area consideration and even then they have received huge amounts or loans. All this cannot be explained on economic consideration alone.

Fourthly, the Bank is still far from playing an effective role in reshaping the

economic structures of member countries, because the amount of financial help given by it falls far short of the vast requirements of resources needed for accelerating the process of economic development.

Inspite of these shortcomings, evaluating the Bank's role we should not forget the limitations within which the Bank works. The Bank is largely instrumental in quickening the tempo of economic development projects, it has financed a large number of them which have proved quite successful. In future, the Bank will be in a stronger position to render financial assistance to the member countries with its increased capital resources and the active co-operation of its affiliates.....International Development Association and International Finance Corporation.

BOOKS SUGGESTED

1. A.E.A. : *Readings in the Theory of International Trade.*
2. C.P. Kingleberger : *International Economics.*
3. C.S. Barla, H.S. Aggarwal : *International Economics.*
4. B.O. Sodersten : *International Economics.*
5. Vaish and Sudama Singh : *International Economics.*

LONG ANSWER TYPE QUESTIONS

1. What do you mean by balance of payments ? Briefly discuss the measures adopted to correct adverse balance of payments with reference to India.
2. "The balance of payments is always balanced". How then do we talk about a surplus or a deficit in the balance of payments of a country?
3. Critically examine the various theories for the determination of the rate of foreign exchange.
4. Discuss the various factors that bring about fluctuations in the rate of foreign exchange.
5. Explain the functions of the IMF. How far the IMF has succeeded in achieving its objectives ?
6. What is SDRs ? How for the IMF has succeeded in dealing with the problem of international liquidity through SDR's ?
7. Discuss the role of IMF in the context of developing countries.
8. What are the features of new international monetary system ? How far the new monetary system has accommodated the ideas to Triffin Plan ?

SHORT ANSWER TYPE QUESTIONS

1. Why did the International Monetary System of Bretton Woods breakdown in 1970-71 ?
2. What do you mean by SDR's ?
3. What do you mean by Mint Par of Exchange ?
4. Differentiate between Balance of Payments and Balance of Trade.

Type Setting By :
Computer Lab, Dept. of Distance Education, Punjabi University, Patiala.