BANKING: FINANCE OF FOREIGN TRADE & INTERNATIONAL BANKING

(DCM28)

(MCOM)

ACHARYA NAGARJUNA UNIVERSITY

CENTRE FOR DISTANCE EDUCATION

NAGARJUNA NAGAR,

GUNTUR

ANDHRA PRADESH

Lesson - 1

FOREIGN TRADE - AN INTRODUCTION

OBJECTIVES :

After going through this lesson you should be able to :

* understand the need and nature of foreign trade
* identify the diffirence between internal trade and international trade.
* know the commercial concepts of international trade

STRUCTURE

1.1. INTRODUCTION

Trade is generally mean the buying and selling of goods. Formerly trade took place in barter system. Trade is one of the two main divisions of commerce; the other including aids to trade such as transport, banking and insurance. Trade that takes place with in the country is called as internal trade. It can also be called as domestic or inter-regional trade. Where as, trade between different countries is known as international trade or foreign trade. It is an important indicator of economic development. Classical and neo-classical economists treated that foreign trade can be a propelling force of economic development. It is an engine of economic development.

1.2. NEED FOR TRADE WITH FOREIGN COUNTRIES

Countries trade with one another for several reasons. All countries cannot produce all things equally well. Firstly, some nations possess certain natural resources, chemical deposis excess of their own requirement, where as, the other possess less and they possess other natural resources in excess compared to others. Secondly, climatic conditions of different nations are different, which play a larger part of natural products. Hence nations will produce excess of the commodities, which have climatic advantage and trade with other countries. Thirdly, despite efficient production, some times it may happen that the home production must be supplemented with imports. Further, trade is takes place when it is to the economic advantage of the nations concerned to specialize in particular activities. For the above reasons, the trade will takes place between the nations.

1.3. DISTINCTION BETWEEN INTERNAL TRADE AND INTERNATIONAL TRADE

There is lot of debate regarding the distinction between internal trade and international trade. Classical econimists such as Adam Smith, David Ricardo opined that the features of internal trade are different from that of international trade. But economists like Bertil Ohlin, Haberler etc., are argued that it is neither possible nor essential to draw dintiction between internal trade and international trade. Ohlil strongly opined that there is no basic difference between national or international trade. However, when compared to domestic trade, international trade has certain distinguishing features. The salient features of International trade are as follows:

i) International Immobility of Factors of production

Factors of production are mobile with in the country. But they are immobile between countries. Various laws and restrictions of the countries are responsible for this immobility. So, cost of production and prices in one country is different from another country. But within the country they are mobile.

ii) Independent Monetary System

Every country has its own currencies. International trade needs exchange of one country's currency with another country's currency during the course of trade at the agreed rate. Exchanging one country's currency with another country's currency is known as exchange rate. Hence, there is a need to study the factors that determine value of each country's monetary unit as well as the facts relating to divergence practices relating to exchange rate. Whereas this problem cannot arise in internal trade.

iii) Different political Boundaries

Every country has its own Politicial Boundries. International trade between countries has their politicial boundries, which carries administrative protection policies with controls and restrictions such as customs duties, quotas, exchange rate politics etc. Rules, laws and policies relating to trade, commerce, industry etc., are uniform with in the country but differ between different political boundaries.

iv) Heavy Transport Costs

International trade takes place between greater geographical distances which inturn increase transport costs. So transport costs are main input in international trade. These costs are less within the nation.

v) Terms of Trade

Sharing of gains from trade (Terms of Trade) is an important issue of international trade. Terms of trade can be often called as physical exchange of goods and services for each other countries. On national point of view, fovourable terms of trade are an important factor.

vi). Linguistic, Cultural Differences

World market comprises of heterogeneous languages, cultures, preferences, customs, weights and measures etc. The buyer preferences in each country are different when compared to other countries. For example, Americans have left hand driven cars where as Indians have right hand driven cars. Hence, International market is heterogeneous, on the other hand, the national market is homogeneous.

vii) Education Effect

Foreign trade has an effect of education like install new wants and tastes, as goods flow between nations transforming technology, skills and entrepreneurship also takes place as they start flowing from one nation to another either because of bilateral agreements or due to cheap costs of production else where.

viii). Specific problems

International trade creates economic relations between countries, which leads to certain specific problems like international Liquidity, International monetary cooperation, evaluation of international organizations etc. These problems can never arise in internal trade.

The above discussion states that international trade has distinguishing features, as such a separate theory is needed for international trade. Hence separate trade theories were developed. Now we will know some commercial concepts of international trade which come across in future discussion.

1.4. COMMERCIAL CONCEPTS OF INTERNATIONAL TRADE

Some concepts of international trade are given below :

a) Export Trade

Selling the products of a country either in response to direct or division consignment abroad. Exports are of two kinds namely goods and services. Export of goods is known as visible trade items and services are known as invisible trade items.

b) Import Trade

Buying of foreign goods and services by a country either in responsce to direct orders or consignment.

c) Absolute Cost Advantage

Absolute cost advantage as developed by Adam Smith, is complete advantage in production of a good in one nation their produce of the same in another nation. This was basically calculated in terms of labour units used in manufacturing that particular good.

d) Comparative Cost Advantage

Comparative cost advantage theory was developed by Ricordo. According to him, each country will specialize in the production of those commodities in which it has greater comparative cost advantage or least comparative cost disadvantage.

e) Free Trade Policy

A trade policy of placing no restrictions on the movement of goods between countries is called as the policy of free trade. The free trade policy permits international flow of goods and services without any artificial impediments or it is necessarily a non- discriminatory trade policy. Hence there is no tariffs, quotas, exchange restrictions, taxes etc., in free trade policy.

f) Protection Trade Policy :

A policy of encouraging home industries by paying bounties to domestic producers or by imposing customs duties on foreign products is known as protection trade policy. It is also refer to any policy that raises the price of import substitutes and safe guards the interest of domestic producers against foreign competition.

g) Terms of Trade

Generally speaking, the terms of trade refer to the quantity of goods bought and sold and the price at which they are traded. But in the field of international trade, it refer to the rate at which a country's exports exchange for imports. This exchange naturally depends upon the relation between the prices of export goods and the prices of import goods.

h) Devaluation

Devaluation of a country's currency is meant by reducing the external value of a unit of currency expressed in terms of gold or Special Drawing Rights (SDRs) or foreign currency. Devaluation raises the domestic prices of imports and reduces the prices of exports. Generally, a country opt devaluation to improve balance of payments because due to devaluation exports become cheaper and imports become costlier.

i) Dumping

Dumping is an act of selling goods abroad at lower prices than at home. It is a discriminatory monopoly pricing in foreign trade i.e., charging different prices in the domestic and foreign markets. Haberler defines dumping as "the sale of a good abroad at a price which is lower than the selling price of the same good at the same time and in the same circumstances at home, taking account of differences in transport costs."

j) International Cartels

In general terms, an international cartel may be defined as an arrangement between producers or sellers of two or more countries for the purpose of regulating competition in the production and selling of international commodity. According to Haberlar " a union of producers in a given branch of industry, of as many countries as possible, into an organization to exercise a single planned control over production and price and possibly to divide markets berween the different producing countries.

k) Balance of Payments

Balance of payments of a country is a systematic record of all economic transactions within a given period between the residents of one country and the rest of the world. Balance of payments accounting of a country uses a double entry system of recording accounts. The balance of payments account is divided into two known as payments or debits and receipts or credits.

l) Foreign Exchange Market

Foreign exchange market is a part of money in financial countries. It is a place where foreign moneys are brought and sold. The buyers and sellers of claims on foreign money and the intermediaries together constitute a foreign exchange market. Thus, the foreign exchange market is the market for a national currency (foreign currency) any where in the world, as the financial centers of the world are united in a single market.

m) Foreign Exchange Rate

The rate at which one currency buys or exchanges with other currency is known as the rate of foreign exchange. Other words, foreign exchange rate between the currency units of two countries means the number of units of one national currency that are needed to buy one unit of other nationl currency. For example 36 Indian rupees exchange for one American dollar. Then the foreign exchange rate as stated as 1$ = Rs. 36.

n) International Gold Standard

It is an international monetary system where in all participating countries have legally defined their unit of account (Currency Unit) in terms of gold, established a mechanism where by their local currencies are kept equal in value to gold and to each other, fixed the external value of their currencies through the medium of gold and their monitory authorities are willing to buy and sell gold at a fixed price in unlimited amounts.

o) Special Drawing Rights

Special drawing rights (SDRs) can also be called as paper gold. SDRs were introduced at the International Monitory Fund (IMF) meeting in 1967. SDRs have the characteristics of international money. The unit of account of SDR is equal to the gold content of 0.888671 gram, i. e., the same value as 1 US dollar had in 1971.

p) International Liquidity

International liquidity is associated with international payments. These payments arise out of international trade in goods and services and also in connection with capital movements between one country to another. Liquidity in simple terms comprises of all reserves that are available to the monetary authorities of different countries for meeting their international disbursement.

q) Tariffs

Tariffs in a narrow sense refer a schedule of customs duties levied on the imports. In a broader sense tariff include all customs duties such as import duties, export duties and transit duties. Tariff is a kind of protectionist devise to curtail consumer freedom or to change customers preferences. Tariffs lead to reduction of international trade.

r) Quotas

Quotas are another protectionist measure like tariffs. Quotas are either import quotas or export quotas. Import quota implies a fixed quantity or value of commodity that has been allowed to be

imported in the country during a given period of time. Whereas, export quota means a fixed quantity or value of commodity that has been allowed to be exported from the country during a period of time.

s) Global Trading Environment

The global trading environment pertains to the general business conditions in which the world trade operates or the conditions thatt affect the exports and imports between economies in the world. The factors that effect global trade environment can be categarized into two, namely, economic factors such as economic systems, mutual economic dependence, WTO, regional economic groups etc and non- economic factors such as socio, economic, cultural, legal and political factors.

t) Foreign Exchange Crisis

It is a situation when a country's imports are much higher than the exports resulting in an adverse balance of payments.

u) Bilateral Trade Agreement

A trade agreement between two countries is called bilateral trade agreement. This type of agreement may be relating to quote or volume of certain exports or imports or relating to tariff rates. The purpose of this agreement to check balance of payments, to control inflationary trends etc.

v) Multilateral Trade Agreement

A trade agreement between more than two countries is called as multilateral trade agreement. This agreement may be about helping each other country during crisis such as adverse balance of payments.

w) Letter of Credit

These are letters of credit issued by banks to its depositors certifying their ability to repay credit in relation to their deposits and cash balances. The holders of these letters can borrow funds from any bank in any place or presentation of these letters.

1.5. SUMMARY

Trade takes place between different countries in the world is known as foreign trade. Foreign trade has certain distinguishing features such as immobility of factors of production, heterogeneous currencies etc. Countries which participate in international trade has definite advantages such as widening the size of market, monitoring the rural sector, improving high growth, inflow of foreign trade etc. Hence international trade is treated as engine of economic development. But unfavorable terms of trade, inflationary tendencies and demonstration effects will result unfavourable effects on the economy.

Trends in international trade have changed for the last three decades in the wake of liberalization, privatization and globalization. Today, as world has become a global village, it is inevitable for every country to open their economy. In these circumstances, foreign trade is a necessary require-

ment for all countries in the world for acceleration of economic development. It is also very difficult for a country to survive in isolation

1.6. KEY WORDS

Internal trade : Trade in between different regions of the country.

International or foreign trade : Trade in between different countries of the world.

1.7. SELF-ASSESSMENT QUESTIONS

1. What is meant by foreign trade? Explain the distinguishing features for international trade.
2. Define internal and international trade? Write the need of international trade.

1.8. FURTHER READINGS

1. B.O. Soderston : International Economics
2. G. Meir : Leading Issues in Economic Development
3. P. T. Ellsworth : International Economics
4. G. V. Haberler : Theory of International Trade

LESSON – 2: BALANCE OF TRADE & BALANCE OF PAYMENTS

2.0. OBJECTIVE

The objective of this lesson is to explain various aspects of the balance of payments of a country, the basic concepts of balance of trade and balance of payments, current and capital accounts, the difference between accounting balance and equilibrium and disequilibrium in balance of payments and the nature, causes and remedies for conditions of disequilibrium.

After reading the unit, you will be able to

. Distinguish between balance of payments and balance of trade,
. Explain the statement of balance of payments,
. Describe the concepts of equilibrium and disequilibrium in balance of payments, and
. analyze the methods of correcting disequilibrium in balance of payments.

STRUCTURE:

2.1. INTRODUCTION

In this lesson, we will learn the concepts relating to balance of payments. The statement of balance of payments is explained. You will also know how the disequilibrium in balance of payment be rectified. A nation's international Balance Of Payment (BOP) is a quantitative summary of a country's international financial transactions over a given period of time. It reveals various aspects of a country's international economic position. The international BOP of a country informs the government about the international financial position of the country. It also helps the government in taking decisions on monetary and fiscal policies on the one hand and on internal trade and payments issues on the other. The BOP also is used to determine the influence of foreign transactions on the level of national income. In the case of underdeveloped country, the BOP shows the extent of dependence of the country's economic development on the financial assistance given by the developed capital leading countries. In the case of advanced countries, the BOP can show the extent to which its citizens are living on their past exports.

However, the greatest importance of the study of international BOP lies in its serving as an indicator of the changing international economic position of a country. The BOP is the economic barometer which, if properly handled by economic analysis, can be used to appraise a nation's short-term international economic prospects, to evaluate the degree of its international solvency, and to determine the appropriateness of the exchange rate of country's currency. Many with other relevant factors, the trends in and position of the balance of international payments of a country significantly affect the economic policies of the government.

2.2. BALANCE OF TRADE

Balance of Trade refers to the total value of a country's exports of commodities and total value of that country's imports of commodities from other countries. Thus, balance of trade takes into account only those transactions arising out of the exports and imports. The export and import of commodities is seen by eye and hence they are called visible or visible transactions. The visible exports and imports are those, which are actually recorded at the ports. The balance of trade of a country reveals the relationship between the aggregate value of exports and aggregate value of imports during a year.

Balance of trade is a statement showing the value of exports and the value of imports. This shows the value of visible trade of a country with other countries during a year. Generally, one year is taken as the basis for the calculation of trade between countries. Sometimes, in a year the total value of imports of commodities of a country and the total value of imports of commodities by that country might be exactly equal. In this case, it said that balance of trade is in equilibrium. It is important to note that balance of trade is a rare phenomenon.

Suppose that a country exported commodities produced by it to three countries worth Rs.25.00 crs. In return, suppose, that country imported commodities from three countries worth Rs.25.00 crs. This means the value of exports (receipt) of a country is exactly equal to the value of its imports (payments) and thus receipts and payments are balanced with one another. This

occurs very rarely because the demand for exports and imports is influenced by a variety of factors such as population, tastes, changes in technology, multiple uses of the commodities etc.

During a year the total value of commodity exports of a country may exceed the total value of commodity imports of that country or the total value of imports may be less than the total value of its exports. In this case the balance of trade is said to be favourable to that country. Suppose that during a year, the total value of exports of a country is Rks.30.00 crs and that of imports is Rs.25.00 crs. In this case the balance of trade is (surplus) positive with Rks.5.00 crs. It is favourable balance of trade as this country earns a net of Rs.5.00 crs in trade with other countries.

During a year, the total value of imports of commodities by a country may exceed the total value of exports of commodities of that country or the total value of exports may be less than the total value of imports. In this case the balance of trade is said to be unfavorable to the country. Suppose that during a year, the total value of imports of a country is Rs.15.00 crs and that of exports is Rs.10.00 crs. In this case the balance of trade is (deficit) negative with Rs.5.00 crs. This is unfavorable balance of trade as this country loses an amount of Rs.5.00 crs. in trade with other countries.

In this comprehensive system of international trade the balance of trade of a country need not balance every year. In other words, the total value of commodity exports and the total value of commodity imports during a year need not be equal to one another. If the aggregate value of imports of a country exceeds the aggregate value of its exports in one year the balance of trade becomes unfavorable. However, this may not cause grave concern because there are various means of making payments for excess value of imports. This relates to the mechanism of balance of trade adjustment.

2.3 BALANCE OF PAYMENTS

In International trade, many countries export commodities (visible items) and sell services such as shipping, tourism, technical services etc (invisible items) and thereby earn revenues or receipts. On the other hand, many countries import commodities (visible items) and purchase services (invisible items) and thereby incur expenditure 9payments). Balance of payments include the receipts for a country from visible and invisible exports and the payments by a country for the visible and invisible imports. The balance of payments is a wider and more comprehensive concept than the balance of trade. Balance of payments includes visible exports and imports and also non-commodity items that give rise to receipts and payments.

According to KindleBerger balance of payments of a country is “a systematic record of all economic transactions between the residents of the reporting country and the residents of foreign countries”. The IMF balance of payments Manual describes that “the balance of payments is a statistical statement for a given period showing transactions in good and services and income between an economy and the rest of the world, changes of ownership and other changes in the country’s monetary gold, special drawing rights and claims on and liabilities to the rest of the world, and un-required transfers and counter-part entries that are needed to balance, in the accounting sense, any entries for the foregoing transactions and changes which

are no mutually offsetting". According to reserve Bank of India "the balance of payments of payments of a country is a systematic record of all economic transactions between the residents of a country and the rest of the world. It presents classified record of all receipts on account of goods exports, services rendered and capital received by residents and payments made by them on account of goods imported and services received from the capital transferred to non-residents or foreigners".

An economic transaction is an exchange of value in which there is a transfer of title of an economic good or rendering of service from residents of one country to residents of another. Generally, economic transaction involves a payment and receipt of money in exchange for the economic good, services or asset. The purpose of maintaining the records of payments is to enable the Government to know the international position of the country and the help in reaching decisions on monetary and fiscal policies on one hand and payments and trade policy on the other.

There are three approaches to balance of payments and the nature of balance of payments is multifold a) The Resource approach – It relates to the statistics of trade which measure the resource flows between the countries. In fact, it is a record of goods and services b) Foreign exchange budget approach – It relates to the additional information on other payments and receipts. This is intended to assure monetary authorities that the country could go on buying foreign goods and meeting payments in foreign currency when they become due c) National Income approach – This is used to measure the influence of foreign transactions on national income.

The balance of payments may be defined as a systematic record of all economic transactions, which take place during a given period between residents – individuals, institutions and government bodies – of a country and those of the rest of the world. It is common knowledge that the residents of a country buy goods and services from other countries. They may visit foreign countries as tourists or students and they may use foreign insurance, banking or transport services for various purposes. All these transactions in steal payments to foreigners. In the same way, the residents of a country may sell good and services to foreign residents. They may offer them insurance, banking and transport services. Residents of foreign countries may visit this country for various purposes. Residents of foreign countries may visit this country for various purposes. In the case of all these transactions, the residents receive payments from the rest of the world. Economic transactions would result in payments or receipts of money. A record of all such payments and receipts between a country and the rest of the world during a given period is called balance of payments. Table-1 presents Balance of Payments statement of country 'X'. Balance of Payments statement of country. Payments to foreigners are debit items and receipts from them are credit items.

Table-1

Balance of Payments Statement of country 'X'

Current Account			
Credits (+)	Rs. Crores	Debits	Rs. Crores
1. Exports of merchandise	1000	4. Imports of merchandise	1500
2. Exports of services		5. Imports of services	
a) Insurance & Banking	100	a) Insurance & Banking	20

b) Transport services	50	b) Transport services	20
c) Tourism	30	c) Tourism	10
d) Interest on loans, etc. Dividend	100	d) Interest on loans; and dividend	40
3. Unrequired receipts: Gifts, etc.	20	6. Unrequired payments: Gifts etc.	10
Total	+ 1300	Total	- 1600
Current Account Balance	-300		
Capital Account			
7. Long term & short term loans	300	9. Long term and short term loans	50
8. Decrease in gold & foreign exchange reserves	100	10. Increase in gold and foreign reserves	50
Total	+ 400	Total	- 100
Capital Account Balance =	- 300		
Total balance	+ 700		- 1700

Depending on the nature of transactions, it is possible to classify them into different types. First, the relation of exports to imports of merchandise (i.e., goods) is described as the balance of trade. It is a record of payments and receipts on account of imports and exports of goods. Since one can actually see the movement of goods from one country to the other, it is called visible trade or commodity trade. Items 1 and 4 represent these transactions. Secondly, buying foreign services like those of banking, insurance, shipping, etc., or selling our banking, insurance and shipping services to foreigners are recorded in 'invisible trade or balance'. Payment of interest on loans taken from foreign residents and divided on shares owned by foreign investors is included in the invisible balance. Similarly, receipts of interest on loans to foreigners and dividends on foreign shares are a part of this account. Though we do not see the movement of goods between countries, we can observe payments and receipts on account of these transactions. They are, therefore, called invisible items of trade. Items 2 and 5 give the details of such transactions.

Unrequited receipts refer to gifts and donations received from the rest of the world. Any sale or transfer of goods or services does not earn these receipts. They are one sided or unilateral transactions. Compare them with exports where payments are received because of sale of goods or services. Similarly, a country may give gifts or donate funds to foreign countries for some reasons or other. For example, several countries are giving free gifts of food grains and medicines to victims of famine in Ethiopia. They are called unrequited payments. Items 3 and 6 represent such receipts and payments.

Items 7 & 9 in Table 1 refer to long-term and short-term loans. When a country receives these loans, they are shown as a credit item, though a loan involves liabilities. It is to be understood that a country sells or exports its bonds (promissory note) to foreigners for receiving the loan amount. A country that advances the loan is importing a foreign country's bond (promissory note) for which it is paying money. Such transactions are shown as debit items.

Changes in official gold and foreign exchange reserves have a special significance. If a country loses gold or foreign exchange reserves, it is understood that it is exporting them. It is shown as a credit item. Similarly, if it receives gold or foreign exchange reserves from other countries, it is understood that it is importing them. Therefore it is shown as a debit item. In Table 1, items 8 and 10 represent such transactions.

2.3.1 Meaning and Definition of BOP

In simple terms, the balance of international payments usually referred to as the BOP which is a systematic and summary record of a country's economic and financial transactions with the rest of the world over a period of time. The IMF publication BOP Manual describes the concept as follows:

The BOP is a statistical statement for a given period, showing transactions in goods and services and income between an economy and the rest of the world changes in ownership and other changes in that country's monetary gold. Special Drawing Rights (SDRs) claims on and liabilities to the rest of the world unrequited transfers counter part entries that are needed to balance in the accounting sense any entries for the foregoing transactions and changes, which are not mutually off setting.

Generally we treat balance of trade and balance of payments as synonyms. But there is difference between the two concepts. Balance of trade takes into account only those transactions arising out of the exports and imports of the visible items. It does not consider the exchange of invisible items such as the services rendered by shipping, insurance and banking etc. BOP takes into account the exchange of both visible and invisible items. Hence, the BOP represents a better picture of a country's economic and financial transactions with the rest of the world than the balance of trade. The transactions that fall under BOP are recorded in standard double entry bookkeeping, under which each international transaction undertaken by the country will result in a credit entry and debit entry of equal size. As international transactions are recorded in double entry book keeping, the BOP must always balance i.e. the total amount of debits must equal the total amount of credits. Some times, the balance item errors and omissions must be added to balance the BOP. A detailed examination of the constituent items in BOP would make the meaning and measurement of disequilibrium clear.

2.3.2 Constituent Items and Different Accounts in BOP

The balance of payments and the accounts statement of a country, are generally maintained in the form of a balance sheet with the help of double entry book keeping principle. The format of the BOP given below shows the important transactions that enter into it.

Table-2: Hypothetical example of balance of payments

Credits/Receipts		Debits/Payments	
TRADE FOR CURRENT ACCOUNT			
(1) Visible exports (export of goods)	850	(6) Visible Imports (import of goods)	970
(2) Invisible exports (export of services)	140	(7) Invisible Imports (imports of services)	110
TRANSFER OR CAPITAL ACCOUNT			
(3) Unrequited receipts (gifts, indemnities etc., received from foreigners)	70	(8) Unrequited payments (gifts, indemnities etc., paid to foreigners)	40
(4) Capital receipts (loans from capital repayment by or sale of assets to foeigner	140	(9) Capital payments (Loans to capital repayments to purchase assets from foreigners)	80
(5) Errors and Omissions		(10) Errors and Omissions	
Total	1200	Total	1200

Broadly, the items in the BOP are vertically classified into credit and debits and horizontally divided into trade/current and transfer/capital items. Any item in the credit side gives monetary claim to the residents of the reporting country over the residents of other countries. On the other hand, debit transactions give services transfer.

Capital account items include capital flows and unilateral transfers. Usually current account covers transactions such as exports and imports of goods and services which relate to the current year's national income. In other words, such payments or receipts do not create any future claims over foreigners nor cancel the existing claims. As against this capital account covers transactions which create or cancel claims over foreigners . When a country borrows from other countries, it has to pay interest on the loan every year and repay the loan after some years. It means some countries give loans to others, it buys claims over others. It is customary to treat capital account transactions compensatory or adjustment transactions. It may be observed that the table presents BOP accounts in the double entry book keeping form and now let us discuss the different items in the BOP in detail.

Item I consists of the reporting country's receipts from the exports of goods and item 5 shows the country's payment for imports of goods. Item 2 indicates receipts of the reporting country, from exports of current services of foreigners during the reference period, for the services like insurance & banking, transport services, tourism, interest loan etc. and dividend. Similarly, item 6 contains payments made by the reporting country for similar services rendered to them by foreigners. The difference between items 1 and 5 is known as the balance of visible trade, while the difference between items 2 and 6 is termed as the balance of invisible trade. The difference between the value of goods and services sold to foreigners by residents of the

reporting country and the value of goods and services purchased from foreigners by them is termed as balance of trade. These transactions are also considered as current account transactions because these give rise to or use up national income.

The transfer items or capital account items consists of short term and long term capital transactions. In this account item 3 represents unrequited receipts. They are payments from some persons or body from other countries to persons or body in the reporting country for which no present or future quid proquo is demanded. Gifts, indemnities etc., constitute such unilateral transfers. These may be gifts from persons of native country residing abroad and they send money to their Kith and kin which need not be repaid. Other governments may send gifts on charity, which again need not be paid back. Payments of similar kind from the reporting country are enumerated under item 7 as unrequited payments. As they are insignificant items, they may be mentioned in capital account or in current account.

Item 4 contains capital receipts, which take different forms. Receipts from long term claims like equity claims and debit claims, sales from short term claims against deposits. Similarly, payments towards purchase of long term equity deposits and others and purchase of gold from other countries are considered as item No.8 and items 5 and 10 of errors and omissions some times also capital payments. The last called unrecorded transactions arise from the possibility that certain transactions may escape identification. For example, payments or receipts arising largely from unrecorded movements of short-term claims may be listed under unrecorded transactions.

2.4. EQUILIBRIUM AND DISREQUILIBRIUM IN THE BOP

The country under reference is exporting goods worth Rs.850 crores and importing goods valued Rs.970 crores. The deficit in the balance of visible trade is or the order of 120 crores. But this does not measure disequilibrium in BOP, Part of the deficit is financed by a surplus of Rs.30 crores in the balance of invisible trade. The deficit in balance of trade ultimately is of Rs.9 Crores. Even this does not measure disequilibrium. Turning to transfer balance, it shows a surplus of Rs.30 crores on account of unrequited transfers. Further, on account of capital flows, a surplus of Rs.60 crores exists. Thereby surplus in balance of transfers is Rs.90 crores, the total receipts equal the payments. The deficit in trade balance is exactly met out of surplus in transfer balance. Similarly any deficit in transfer balance may be met by a surplus in trade balance.

Balance of payments is said to be balanced if the total amount of debits equals the total amount of credits. In the case of double-entry system, it is always balanced. But if the sense is maintained on a single entry system, then the total amount of debits may differ to total amount of credits. It is also possible that some errors in the evaluation of exports and imports may occur. It adds a balancing item to the BOP of a country, entitled errors and omissions. Here the fact should be noticed that the BOP always balances in an accounting sense does not mean that a country never faces BOP difficulties. It is far from the reality. In real and actual sense the BOP of countries are always in disequilibrium.

2.5. CAUSES OF DISEQUILIBRIUM

In the light of the foregoing discussion on the nature of disequilibrium, we can describe briefly the main causes of disequilibrium. First, seasonal or cyclical fluctuations may cause changes in imports and exports and thereby cause disequilibrium. Secondly, there may be changes in demand for a country's exports due to changes in tastes and preferences or techniques of production in foreign countries. There may be competition from other countries for our exports. Thirdly, a country might increase its imports for the purpose of economic development and thus cause deficit in its balance of payments. Fourthly, inflation and excessive expenditure by the government may also lead to decline in exports and increase in imports thereby widening the gap between them. Increasing prices would attract foreign goods i.e., lead to higher imports. Similarly, higher expenditure may step up the demand for imports.

When a country suffers from a deficit in balance of payments it has to pay for the deficit either by selling gold or use past savings of foreign exchange or borrow from other countries. Any of these policies cannot be used for long. There is a limit to the amount of gold or foreign exchange reserves, which it can have in its possession. When it losses these reserves it will become bankrupt and lose prestige in the world market. Similarly, there is a limit to the amount of loans, which it can raise and bear the burden of interest and repayment. Therefore, it is natural that some corrective measures are adopted.

2.6. DIFFERENT KINDS OF DISEQUILIBRIUM

Broadly speaking, the main kinds of disequilibrium in the BOP are cyclical, secular structural, actual or potential, short term and long term and fundamental. Cyclical disequilibrium takes place due to the occurrence of trade cycles. To know that the rate of growth of income and output is not fixed. Over a long period, changes in income have been characterized by short-term boom and depressions. Cyclical disequilibrium occurs either because the patterns of business cycles in different countries follow different path or because income elasticities of demand for imports in different countries are different.

Secular disequilibrium in the BOP arises from changes in an economy as it moves from one stage of growth to another or due to the economic development of a country. A number of factors such as capital formation, technological change, growth of population, growth of markets and changes in resources etc may cause it.

Similarly structural disequilibrium at the goods level occurs when a change in demand or supply of exports or imports alters a previously existing equilibrium or when a change occurs in the basic circumstances under which income is earned or spend abroad, in both cases without the requisite parallel changes elsewhere in the economy. Therefore, we can say that it arises from structural changes in the demand and or supply conditions of exports and / or imports the deficit in the BOP may be actual or potential. Actual deficit is measured by the extent of accommodating finance required to meet the deficit. There are no restrictions imposed. Potential deficit is measured by the amount of accommodating finance, which could have been necessarily to be provided without the use of controls. Such controls range from depreciation of

the exchange rate, imposition of import restrictions, following of suitable internal policies. Further, time element is important in measuring disequilibrium in balance of payments.

The deficit may be of short run or long run nature. Some times, any deficit may be met by inflow of short-term funds attracted by interest rate differentials. If circumstances that attracted capital are temporary, the capital may outflow, and the deficit would appear. Hence, any deficit may have to be viewed with reference to their variations over a long period to eliminate random and seasonal fluctuations. It is this deficit which is of serious nature, which deserves the attention of any government to be equilibrated. When disequilibrium in the BOP continued for a long time and there is no expectation now or in the future, that the new factors revealed in the BOP are likely to disappear, it is defined as a case of fundamental or permanent disequilibrium. Actually, most of the non-oil developing countries, including India are facing the problem of fundamental or permanent disequilibrium in their balance of payment accounts.

2.7. EQUILIBRIUM, DISEQUILIBRIUM AND ADJUSTMENT

2.7.1 Accounting Equilibrium

Since the balance of payments is constructed on the basis of double-entry book-keeping, credit is always equal to debit. If debit on current account is greater than the credit, funds flow into the country that are recorded on the credit side of the capital account and the excess of debit is wiped out. Thus the concept of balance of payments is based on the concept of accounting equilibrium, that is

Current account + Capital account = 0

The accounting balance is an expost concept. It describes what has actually happened over a specific past period. Accounting disequilibrium occur when the two sides of the autonomous flows differ in size but in such cases, accommodating flows bring the balance of payments back into equilibrium.

2.7.2 Disequilibrium and the Focus of Adjustment

In the economic sense, balance of payments equilibrium occurs when a surplus or deficit is eliminated from the balance of payments. But normally, such equilibrium is not found. Rather, it is the disequilibrium in the balance of payments that is a normal phenomenon.

Though several external economic variables influence the balance of payments and give rise to disequilibrium, domestic economic variables like national output and national spending, money supply, exchange rate, and interest rate are more significant causative factors.

If national income exceeds national spending, the excess amount (saving) will be invested abroad, resulting in capital account deficit. Conversely, excess of national spending over national income causes borrowings from abroad that would push the capital account into a surplus. Disparity in national income and national spending influences the capital account via the current account also. If national output exceeds national spending, the difference manifests itself in export causing current account surplus. The surplus is invested abroad, which means a capital

account deficit. The excess of national spending over national output leads to import. Deficit appears on the current account. The country borrows to meet the current account deficit and the borrowing results in a capital account surplus.

Increase in money supply raises the price level; exports turn uncompetitive and fall in export earnings leads to a deficit in the current account. Similarly, the higher prices of domestic goods make the price of imported commodities competitive as a result of which imports rise and a deficit appears in the current account. If the currency of a country depreciates, exports become competitive and export earning improves. On the other hand, imports become costlier. If, as a result, imports are restricted, the trade account balance will improve but if imports are not restrained, a deficit will appear on the trade account. In fact, the net effect depends upon how price-elastic is the demand for export and import.

Any increase in domestic interest rate causes capital inflow in search of higher returns and the capital account turns surplus. The reverse is the case when the interest rate falls. However, disequilibrium becomes a cause for concern when it is associated with the current account because it represents a shift in real income; and also because adjustments on this account are not very easy. In fact, it is the balance of trade account that is largely responsible for the disequilibrium. If the balance of trade is surplus, its correction is not difficult; the surplus amount is used either for meeting the deficit on invisible trade account or may be invested abroad but if the balance of trade is in the deficit zone and if the deficit is too large to be covered by the invisible trade surplus, a current account deficit will occur. Its correction is not easy, in so far as the autonomous and accommodating capital flows are not so smooth. Again, if deficit on current account continues to persist, the official reserves will be eroded. If the country borrows large amounts to meet the deficit, it may fall into a vicious debt-trap. This is why adjustment measures are primarily directed at correcting disequilibrium in the trade account.

2.8 SUMMARY

All types of balance of payments disequilibria are not harmful to the health of an economy However, any type of disequilibrium (surplus or deficit) in the balance of payments when it continuous for a long time is under sizable because of its disastrous effects on the country's economy and orderly world trade. Between the surplus and deficit balance of payments, deficit balance of payments is said to be harmful to the country. Hence, it is to be corrected by encouraging exports and discouraging imports.

There are various measures that are used to correct balance of payments deficit. They are categorized in automatic measures and deliberate measures. Automatic measures may be applied in countries under gold standard or under paper currency standard disequilibrium in balance of payments in corrected through the inflow and outflow of gold. In countries under paper standard deficit in balance of payments of payments is corrected automatically through fluctuations in the exchange rate of its currency. These measures may not be effective in the short-run and may not effectively deal with the fundamental and serious balance of payments deficit.

Deliberate measures refer to the conscious efforts made by the government to control the forces that cause disequilibrium in balance of payments. They are classified into monetary

measures, trade measures and other measures. Monetary measures relate to the contraction of money supply, devaluation and exchange control. Some economists do not favour these measures as the successes of these methods depend upon unchanged exchange rate, the elasticity of demand for exports and imports.

2.9 MODEL QUESTIONS

1. Examine the difference between Balance of Trade and Balance of Payments
2. Write about the constituent items and different accounts in BOP
3. Analyse the Equilibrium and Disequilibrium in the BOP
4. Elucidate the different methods of adjusting Disequilibrium in the BOP

2.10. REFERENCES

1. Alexander, S.S. (1959), Effectkls of devaluation: A simplified synthesis of elasticity and absorption approaches, American Economic Review.
2. Connolly, M. (1978), The monetary approach to an open economy: The fundamental theory, in Putnam, B.H. et.al., (Eds.), The Monetary Approach to International Adjustment, New York, Praeger.
3. Lerner, A.P. (1944), The Economics of Control, New York, The Macmillan Co., Chaps. 28-29.
4. Metzler, L. (1968), The process of international adjustment under the conditions of full employment: A Keynesian view, in Caves, R. et.al. (Eds.), Readings in International Economics, Homewood (Illinois), Richard D. Irwin.
5. Mundell, R.A. (1968), International Economics, New York, Macmillan.

Lesson - 3

FOREIGN TRADE AND ROLE OF RBI

OBJECTIVES

After reading this Lesson, you should be able to understand the :

* Origin of Reserve Bank of India
* Functions of RBI
* Organizational Structure and Management of the RBI
* RBI and Export Finance

STRUCTURE :

3.1 INTRODUCTION

The apex financial institution for every sovereign independent state is known as Central Bank. It plays vital role in executing economic policies of the government in the Country. Broadly, the functions of the Central Banks of different countries are similar. But they are different from one country to other in their structure and organization. The Central Bank of India is Reserve Bank of India.

3.2 ORIGIN OF RBI

A series of attempts were made to establish a Central Bank in India. At first time, Warren Hastings felt the need of Central Bank in 1733 and recommended to establish a General Banks in Bengal and Bihar to execute the functions of a Central Bank. In the year 1913, the report of the Chamberlin Commission raised to issue of founding of a Central Bank in the year 1921. The Imperial Bank was set up by amalgamation of three presidency banks known as Bank of Bombay, Bank of Calcutta and Bank of Madras. Afterwords with the pursuance of the recommendations of Hilton -

Young Commission (1926) a bill was introduced to establish Reserve Bank of India but was dropped on constitutional grounds. In 1931, the Central Banking Enquiry Commission made a strong recommendation for immediate establishment of a Reserve Bank. The question of starting a Central Bank in the country again received serious attention with the publication of a White Paper on Indian Constitutional reforms eventually. A fresh bill was introduced in Legislative Assembly on September 8, 1933, and was passed and received assent of the Governor - General on March 6, 1934 and ultimately became the Reserve Bank of India Act 1934. In accordance to this Act, Reserve Bank of India was Constituted and inaugurated in April 1935 with a share capital of 5 crores.

The main objectives of the Reserve Bank of India are to :

i. Regulate the financial policies and development banking through out the country.

ii. Remain free from political influence and be in successful operations for maintaining financial stability an d credit.

iii. Discharge purely central banking function in Indian money market.

iv. Assist the planned process of development of Indian Economy.

v. Aims at the promotion of modernization and monitory integration of the economy filling in the 'credit gaps'.

3.3 ORGANISATIONAL STRUCTURE AND MANAGEMENT OF THE RESERVE BANK OF INDIA

The Reserve Bank of India is a corporate body. The Ministry of Finance, however, owns the Bank by directive right. The Bank has special powers and obligations for serving the national interest. As per the Reserve Bank of India Act, the organizational structure of the Reserve Bank comprises of : (i) Central Bank, and (ii) Local Boards.

3.3.1 Central Board

The Central Board of Directors is the leading governing body of the Bank. It is entrusted with the responsibility of general superintendence and direction of the affairs and business of the Reserve Bank.

The Central Board of Directors consists of 20 members as follows:

(i) One Governor and not more than four Deputy Governors appointed by the Central Government. They are whole time officers of the bank. Their term of office does not exceed 5 years. They are eligible for reappointment.

(ii) Four Directors nominated by the Central Government, one from each of the Local Boards. Their term of office is related to their membership of the Local Boards.

(iii) Ten Directors nominated by the Central Government. They are experts from the fields of business, industry, finance and cooperation. They hold office for four years. The retiring Directors, however, may be renominated.

(iv) One government official (the Secretary, Ministry of Finance) is usually nominated by the Central Government. His term of office depends on the pleasure of the Central Government.

The Governor is the Chairman of the Central Board. In his absence, he nominates a Deputy Governor as a Chairman. The Deputy Governors and the Government' s official nominee have no right to vote at the meetings of the Board.

3.3.2 Local Boards

The Reserve Bank of India has been divided into four regions: the Western, the Eastern, the Northern and the Southern regions. For each of these regions, there is a Local Board with headquarters in Bombay, Calcutta, New Delhi and Chennai.

Each Local Board consists of five members appointed by the Central Government for four years. They represent territorial and economic interests and the interests of co-operative and indigenous banks in their respective areas. In each Local Board, a chairman is elected from amongst their members. Managers in-charge of the Reserve Bank's offices in Bombay, Calcutta, Madras and New Delhi are ex-officio Secretaries of the respective Local Boards at these places.

The Local Boards carry out the functions of advising the Central Board of Directors on such matters of local importance as may be generally or specifically referred to them or performing such duties which may be assigned to them. Generally, a Local Board deals with the management of regional commercial transactions.

To carry out its functions / operations smoothly and efficiently, the Reserve Bank of India has various departments such as:

Banking Department, Issue Department, Department of Currency Management, Department of Expenditure and Budgetary Control, Department of Government and Bank Accounts, Exchange Control Department, Department of Banking Operations and Development, Industrial Credit Department, Agricultural Credit Department, Rural Planning and Credit Department, Department of Non-Banking Companies, Credit Planning Cell, Department of Economics Anlysis and Policy, Department of Statistical Analysis and Computer Services, Legal Department, Inspection Department, Department of Administration and Personnel, Premises Department, Management Services Department, Reserve Bank of India Service Board, Central Records and Documentation Centre, Secretary's Department, and Training Esablishments.

3.4 FUNCTIONS OF RBI

The Reserve Bank of India performs all the typical functions of a good Central Bank. Besides these it discharges variety of developmental and promotional functions since adopting five year plans in India.

Its major functions may be stated as follows:

a) Issuing currency notes,i.e., to act as a currency authority.

b) Serving as banker to the Government.

c) Acting as banker's bank and supervisor.

d) Monetary regulation and management.

e) Exchange management and control.

f) Collection of data and their publication.

g) Miscellaneous developmental and promotional functions and activities.

Various functions of the Reserve Bank of India are briefly discussed in this chapter. However, the main discussion of this chapter is on export finance.

3.4.1 RBI as Currency Issuing Authority :

The Reserve Bank has the sole right to issue currency notes, except one rupee notes which are issued by the Ministry of Finance. The RBI follows a minimum reserve system into the note issue. Initially, it used to keep 40 percent of gold reserves in its total assets. But, since 1957, it has maintained only Rs.200 crores of gold and foreign exchange reserves, which gold reserves should be of the value of Rs.115 crores. As such, India has adopted the "managed paper currency standard".

The Bank has established 14 offices of the Issue Department for the discharge of its currency functions. At all the other centres of country, the currency requirements are met by the Bank through currency chests. Currency chests are maintained by the bank with the branches of the SBI group, Government Treasures and Sub-Treasures, and public sector banks.

3.4.2 RBI as a Banker to Government :

The Reserve Bank of India acts as a banker to the Central Government as well as the Stae Governments. It is its obligatory function as a Central Bank. It provides a full range of banking services to these Governments, such as:

(i) Maintaining and operating of deposit accounts of the Central and the State Governments.

(ii) Receipts and collection of payments to the Central and State Governments.

(iii) Making payments on behalf of the Central and State Governments.

(iv) Transfer of funds and remittance facilities to the Central and the State Governments.

(v) Managing the public debt and the issue of new loans and treasury bills of the Central Government.

(vi) Providing ways and means advances to the Central and the State Governments to bridge the interval between expenditure and flow of receipts of revenue. Such advances are to be repaid by the Government within three months from the date of borrowel.

(vii) Advising the Central and State Governments in financial matters, such as, the quantum, timing and terms of issue of new loans. For ensuring the success of Government loan operations, the RBI plays an active role in the gilt-edged market.

(viii) The bank also advice to the Government on policies concerning banking and financial issues, planning as well as resources aspects of formulation of the country's Five Year Plans, such as financing pattern, mobilization of resources, institutional arrangements regarding banking and credit matters. The Government also seeks Bank's advice on policies regarding international finance, foreign trade and foreign exchange of the country.

(ix) The Reserve Bank represents the Government of India as member of the International Monetary Fund and the World Bank.

3.4.3 RBI as a Bankers' Bank and Supervisor :

The Reserve Bank of India serves as a banker to the scheduled commercial banks in India. All the scheduled commercial banks keep their accounts with the Reserve Bank. According to the Banking Companies' Act of 1949, originally, each scheduled bank had to maintain with the Reserve Bank of India a balance as cash reserves equal to 5 percent of its demand liabilities and 2 percent of its time liabilities. The Act, amended in 1962, specifies that 3 percent of the total liabilities should be kept as reserve requirement.

The Reserve Bank of India serves as a clearing agent for commercial banks. It provides clearing and remittance facilities to the scheduled commercial banks at centres where it has offices or branches. The Reserve Bank of India also serves as 'a lender of last resort by rediscounting eligible bills of exchange of commercial banks during the period of credit stringency. The Bank can, however, deny rediscounting facility to any bank without assigning any reason therefore. In recent years, however, to contain inflationary pressures and to check heavy borrowings by commercial banks, the Reserve Bank with its tight and discretionary lending policy has been operating as a lender of "regular resort" rather than of "last resort".

Apart from being the banker's bank, the Reserve Bank is also entrusted with the responsibility of supervision of commercial banks.

Under the Reserve Bank of India Act and the Banking Regulation Act, 1949, the Reserve Bank of India has been vested with a wide range of powers of supervision and control over commercial and co-operative banks. The various aspects of the supervisory/regulatory functions exercised by the Reserve Bank may be briefly mentioned as under :

Licensing of Banks, Approval of Capital, Reserves and Liquid Assets of Banks, Branch Licensing Policy, Inspection of Banks, Control Over management, Control Over Methods, Audit, Credit Information Service, Control Over Amalgamation and Liquidation, Deposit Insurance, and Training and Banking Education.

3.4.4 Monetary Regulation and Management :

Reserve Bank formulates implements and monitors the monetary policy with an objective to maintain price stability and ensuring adequate flow of credit to productive sectors. In order to formulate and administer monetary policy, RBI has various credit controlling instruments which ultimately reflect the level of demand goods and services. Credit controlling measures of RBI are two kinds namely quantitative and qualitative credit. The controlling instruments are bank rate, open market operations and variable reserve ratio.

3.4.5 Exchange Management and Control :

Under section 40 of the Reserve Bank of India Act, it is obligatory for the Bank to maintain the external value of the rupee. The Reserve Bank of India is the custodian of the conutry's foreign exchange reserves. It has authority to enter into foreign exchange transactions both on its own and on behalf of the Government. It is obligatory for the Bank to sell and buy currencies of all the member countries of the International Monetary Fund to ensure smooth and orderly exchange arrangements and to promote a stable system of exchange rates. In India, exchange control was introduced under the Defence of India Rules in September, 1939. It was, however, statutorily laid down by the Foreign Exchange Regulation Act of 1947. This has been again stipulated by the Foreign Exchange Regulation Act, 1973.

3.4.6 Collection of the Data and their Publication :

The RBI collects and compiles the statistical information relating to banking and other financial sectors of the economy. Out of various publications of the RBI two are relatively more important. One is RBI Bulletin, a monthly publication and the ohter is The Report on Currency and Finance, an annual publication of RBI.

3.4.7 Miscellaneous Developmental and Promotional Functions :

The Reserve Bank of India performs a number of developmental and promotional functions. Apart from credit regulation, the Reserve Bank effectively channelises credit, especially to priority sectors, such as agriculture, exports, transport operations, and small scale industries. It makes institutional arrangements for rural and industrial finance. For instance, special agricultural credit cells have been set-up by the Bank. The Industrial Development Bank of Inida has been set-up to solve the allied problems of industries. The Bank also assists the Government in its economic planning. The Bank's credit planning is devised and co-ordinated with the five year plans of the country.

With the object of providing security to depositors with the banks, and there by promotion the growth of banking in the country, the Reserve Bank of India took initiative to set-up the Deposit Insurance Corporation of India in 1962. The Reserve Bank of India appoints ad-hoc committees/ expert groups, from time to time, to enquire into specific money/banking problems and make recommendations to solve them.

3.5 RBI AND EXPORT FINANCE :

Presently, a slogan for the developing economies is export promotion, including India. India is very particular on expanding its exports. The Government of India has devised liberal policies,

offering a number of concessions to the exporting industries. Growth of exports needs liberal and adequate export credit.

The Reserve Bank of India has undertaken a number of measures for increasing bank lending to the export sector. In a nutshell, we may state them as under :

3.5.1 Refinance Facilities to Banks against Export Credit

For promoting export financing by the banks, the RBI has introduced certain export credit schemes. The Export Bills Credit Scheme and the Pre-shipment Credit Scheme are the two important schemes in this context.

Export Bills Credit Scheme : The Bill Market Scheme of 1958 was extended by the RBI to include export bills in its rediscounting facilities to the banks, so that banks can provide credit to exporters on a more liberal basis. For widening the range of collateral borrowing of banks from the RBI, the scheme was introduced in 1963. All scheduled banks which are authorized dealers in foreign exchange are eligible for credit facilities under this scheme. Under the scheme, the banks could now borrow from the RBI against export bills.

Pre-shipment Credit Scheme : This scheme was introduced in 1969. Under this scheme, the RBI extends refinancing facilities to include pre-shipment finance given by banks to exporters. The new scheme does away with the need for banks to convert the demand promissory notes covering their pre-shipment advances into promissory notes for the purpose of lodging with the RBI as well essential under the Bill Market Schemes.

Bill Market Scheme : The Reserve Bank of India introduced a scheme of Bill Market, a market in commercial bills, in January 1952. Under the scheme, bills arising out of bonafide trade or commercial transactions, and bearing two good signatures (one of these being that of an official of a scheduled bank) were considered as eligible bills for being rediscounted by the Reserve Bank as the lender of last resort. Advances against such bills were made to the commercial banks by the Reserve Bank at 1/2% less than the prevailing Bank Rate. Moreover, the Reserve Bank also agreed to share 50% of the stamp duty paid by the banks while converting their advances into bills of usance. Initially, the scheme was confined to internal bills, but in 1963, it was extended to export bills of as well. This scheme enjoyed wide popularity. Nevertheless, it failed to develop a genuine bill market in the country, because it was basically meant to proved short-term accommodation to the commercial banks only. Moreover, it did not contain any positive aspect for stimulating a bill market.

Thus, in order to develop a sound bill market, the Reserve Bank introduced a New Bill Market Scheme in November 1970. Under the new scheme, genuine trade bills (bills which evidence sales and/or dispatch of goods) were to be rediscounted by the Reserve Bank.

3.5.2 Concessional Rates of Interest for Export Credit :

Concessional interest rates have been stipulated by the Reserve Bank for providing export credit to the commercial banks. In order to provide export credit at a cheaper rate, the RBI also prescribed ceilings on the rates of interest charged by banks on their lendings to exporters.

In 1968, the Export Credit (Interest Subsidy) Scheme was introduced by the Government of India for granting a subsidy of 1.5 percent to the banks giving export credit at concessional rates. The Schemes is administered by the RBI on behalf of the Government. Other measures include :

i) Non-applicability of CAS to sanction of credit facilities by way of post-shipment credit;

ii) Adopting a flexible approach by the banks in giving credit to exporters.

iii) The exception from application of penal rates of interest.

3.5.3 Assistance to the EXIM Bank :

In January 1982, the RBI has been instrumental in the establishment of the Export-Import (EXIM) Bank, as a statutory corporation wholly owned by the Central Government. The EXIM Bank is to provide financial assistance to exporters and importers. The RBI is empowered to grant loans and advances to the EXIM Bank, under certain conditions, such as issue of lands and debentures. EXIM Bank provides loans to Indian companies for various forms such as direct financial assistance to exporters, technology and consultancy services, overseas investment financing for equity participation by an Indian Company in joint ventures abroad and pre-shipment used in case of export contract for capital goods.

It provides loans to foreign governments, companies and financial institutions under a) overseas buyers credit schemes, lines of credit to foreign governments and relending facility to banks overseas. In addition, this bank provides loans to commercial banks in India include export bills rediscounting scheme and refinance of export credit.

3.5.4 Recognizing / Treating Export as a Priority Sector :

In the credit policy of the Bank, export is recognized as one of the priority sectors and the public sector banks have been asked to give preferential treatment to the export sector in their credit deployment.

3.5.5. Refinance Facility to Various Institutions :

In 1964, the Export Credit and Guarantee Corporation (ECGC) was set-up by the government of India. It provides guarantees to banks for granting liberal credit to exporters. The RBI is, however, not involved directly in the management of ECGC, but it provides refinance facilities to the banks through the ECFC.

3.6 RBI EXPORT PACKAGE MEASURES

In order to promote International Trade, the following package was announced by the RBI.

a) Reduction in the rate of interest on pre-shipment and post-shipment credit from 11% to 9%. This facility will be continued upto 31st March 1999.

b) Government to pay interest if duty drawback or refund of terminal excise dues is delayed by two months.

c) Manufacturers - exporters with record of specified export performance and above one year of unblemished export record to be given legal undertaking facility instead of bank guarantees for duty-free import of raw materials.

d) A Single annual 'mother bond' to replace a plethora of bonds to Excise and Customs Bond officers by exporters for fulfillment of diverse obligations.

e) Tax holiday for EOU/EPZs units extended from five to ten years.

f) EOUs to be permitted sub-contracting facility in domestic tariff area.

g) Private software technology parks permitted to avail of the export promotion capital goods scheme.

h) Export through courier will be permitted from the EPZs.

i) Bio-technology and small-scale engineering industry to be specified will also be entitled for zero EPCG scheme under 1 crore threshold limit.

j) Special package for hardware electronics to be announced shortly.

k) Duty on mobile cooling and other cold chain equipment to be reduced to help export of processed foods, horticultural and floricultural products.

l) With all these measures, government hopes to achieve an export growth of 20% this year.

m) RBI has reduced refinance rate for export credit from 9 percent to 7 percent. The revised rate will be valid upto March 31, 1999.

3.7 SUMMARY

The apex financial institution which acts as a Central Bank of India is known as Reserve Bank of India. The major functions of RBI are issue of currency, serving as banker to the Government, acting as banker's bank and supervisor, monetary regulation and management, exchange management and control, collection of data and their publication and miscellaneous development and promotional functions and activities. As per the RBI Act, the organizational structure of the RBI comprises: (i) Central Bank and (ii) Local Boards.

In order to encourage international trade, the RBI provides export finance. The RBI indirectly assists for export sector in the form of refinance facilities to Banks agaisnt export credit, Concessional rates of interest for export credit ; Recognizing treating export as priority, and Refinance facility to various institutions such as ECGC etc. The RBI announces export package measures from time to time encouraging international trade.

3.8 KEY WORDS

Money Market : It is a market of short term loans

Bill Market : The bill market comprises dealings in short term bills of exchange, including hundis of indigenous bankers.

3.9 SELF-ASSESSMENT QUESTIONS

1. Write origin, organizational structure and management of RBI
2. Explain the role of RBI in International Trade of India.
3. Write the functions of the RBI
4. RBI and Export Finance

3.10 FURTHER READINGS

B. Rama Rao, - Evolution of Central Banking in India

Y. Venugopal Reddy, - Monetary and Financial Sector Reforms

Vijay Joshi and I.M.D. Little - India's Economic Reforms 1991-2001.

D.M.Mithani & E. Gordon - Banking, Theory and Practice.

Lesson - 4

FOREIGN TRADE AND ROLE OF BANKS

OBJECTIVES :

After studying this lesson you will be able to :

* know the areas where finance is required
* understand the modes of payment in International Trade
* identify the various Modes of Trade financing
* role of export import Bank of India, Export Credit and Guarantee Corporation and Small Scale Industries Development bank.

STRUCTURE

4.1 INTRODUCTION

Foreign trade treats as engine of economic development, which require finance. Basing on the availability of finance, exporter exports more and importer imports more. So finance facility encourages foreign trade activities. The importers do borrow from banks but exporters are major beneficiary. Commercial banks provides adequate financing facilities at cheaper rate to foreign trade. Reserve bank of India (RBI) and Exports Credit Guarantee Corporation of India (ECGCI) encourage financing of international trade by commercial banks. Reserve Bank of India provide refinance facilities to commercial banks. Export Credit Guarantee Corporation of India covers the risks of the commercial banks in financing foreign trade.

4.2. NEED OF FINANCE

The areas where finance is essentially needed are Procuring raw materials and components and manufacturing the product. Refinance facilities so as to get the proceeds of exports bills at the

time of negotiation of export documents, soon after shipping the goods.

1. Availability of funds until the exports benefits are realized.
2. Refinance facilities for long term credits offered for the export of products.

4.3. MODES OF PAYMENT :

Modes of payment vary from on transaction to another. What would be the mode in a particular transaction depends upon the bargaining power and creditworthiness of the exporter and importer and upon the requirements of the exchange control. 1. Cash in advance, 2. Payment under consignment sale, 3. Drafts, 4. Letter of credit, 5. Open account.

Various modes of payment in international trade are discussed bellow :

a) Cash in Advance

When cash is paid in advance by the importer to the exporter, that is prior to the shipment of the goods or before the arrival of the goods, the exporter does not need money to finance the receivables. Moreover, this mode negates any risk concerning payment to be borne by the exporter. But is not a very common mode. It is normally adopted when the importing country is facing political instability, causing obstruction in transfer of funds. It is also common where the goods are specifically designed and manufactured to order from abroad. In India, facilities of advance remittances are allowed in specific cases.

b) Payment under Consignment Sale

When exporter on consignment ships the goods, the title of the goods remains to lie with the exporter even after the importer receives the goods. The importer remits money only after it sells the goods. This means that the exporter's capital is tied untill goods are finally sold. In such cases, if importer defaults, it is difficult for the exporter to collect money. This is why consignment sale is found normally between related companies. In India, it is more frequently found in the export of traditional goods.

c) Draft

A draft is an instrument through which an exporter instructs the importer or its agent to pay a specified amount of money at a specified time. It is also known as will of exchange. In this case, the exporter, who initiates the draft, is known as the maker, originator or drawer. The importer, on the other hand, is known as the drawee. The amount mentioned in the draft may not necessarily be paid to the drawer. Sometimes it is paid to its agent, normally the bank. In this case, the drawer is not the payee; rather the payee is the bank.

A draft is normally a negotiable instrument if it is properly drawn. Properly drawn draft means that it should.

i) be in writing and signed by the drawer.

ii) incorporate an unconditional promise or order to pay a specified amount of money.

iii) be payable either at sight or at a specified time, and be payable to order or to bearer. (When it is payable to order, the payment is made to the person specified. When it is a bearer one, the amount can be paid to any person presenting the draft).

d) Letter of Credit :

A letter of credit is a letter of payment authority issued by the buyer's bank at the best of the buyer in favour of the exporter, and stipulates certain conditions, the performance of which fulfils the contractual obligations of the exporter and entitles him to receive payment. The letter of credit is routed through a bank in the exporter's country referred to as the negotiating bank.

The technical definition of a letter of credit is found in the 'Uniform Customs and Practices for Documentary Credits', where it is defined as "any arrangement, however named or described, whereby a bank (the issuing bank), acting on the request and in accordance with the instructions of the customer (the applicant for the credit), is to make payment to or to the order of the third party (beneficiary) or is to pay, accept or negotiate bill of exchange (drafts) drawn by he beneficiary, or authorizes such payments to be made or such drafts to be paid, accepted by another bank against stipulated documents provided that the terms and conditions of the credit are complied with".

Payment methods through a documentary letter of credit have a number of advantages. These are :

i) Once the exporter fulfils all the conditions of credit and presents the documents for negotiation to his bankers in his own country, he receives his payment as per the terms of the letter of credit and is entitles to receive full payment for the exports he has made.

ii) Once the letter of credit is established, the exporter may be reasonably sure that all the import trade regulations of the buyer have been complied with and that the transfer of funds against payment would not normally pose a problem from the exchange control authorities.

iii) Where the letter of credit is a confirmed and without recourse one, the liability of the exporter ceases, once he has presented the negotiable set of documents and adhered to all the conditions of the L/C.

iv) A letter of credit in India is an important document, for a commercial bank advances pre-shipment finance, such as packing credit, against the letter of credit.

Parties to a letter of Credit :

From the above definition of L/C, it is clear that there are a number of parties thereto. There are :

i) A Customer : It is on his account and his request and according to his instruction that the L/C is opened. Usually, he is an importer of goods from a foreign country. He is also known as a opener or accountee.

ii) Bank. The bank which opens (or issue or writes) the L/C at the request of the customer is known as the issuing bank. The issuing bank is granting the facility of opening the L/C to

the customer for importing goods from abroad. Therefore, this bank is also known as importer's Bank. From the definition of L/C given above, it is clear that the bank undertakes to perform a number of functions.

iii) Third party. The person in whose favour the L/C is opened is the third party who is an exporter in a foreign country. He is also known as beneficiary as it is he who derives the benefit of the L/C.

iv) Another bank. Which may be a branch office of the issuing bank or agent or correspondent or the beneficiary's own banker if the paying banker has not been named in the letter of credit. This bank is situated in the exporter's country and is also known as "paying" or "negotiating" bank.

In this connection, another term, 'notifying or advising' bank is also used. When the issuing banker opens a L/C then it informs the beneficiary of such a facility through its branch or some correspondent bank in the beneficiary's country by a letter or cable or telex. This bank or correspondent in the exporter's country is known as the advising or notifying bank.

The following stages must be gone through in the L/C transaction.

i) The importer requests his bank to open a L/C in favour of his exporter with whom he has already concluded a contract for the purchase of goods. This request is to be made by the importer in the form of application.

ii) The issuing banker after on sidering the application of the importer, opens its L/C in favour of the exporter.

iii) The advising bank (in the exporter's country) receives the credit from the issuing bank and after satisfying itself about the authenticity of the credit, it forwards the credit to the beneficiary (i.e., the exporter).

iv) The exporter (on receipt of the credit from the advising bank), checks it to ensure that it conforms to the terms of the sale contract. In case, there is any shortfall, he will ask the importer to get necessary modification in the credit. It is only then he proceeds to effect shipment of goods.

v) The exporter will ship the goods, prepare the documents and draw his bill, for the price of the good, under L/C, for obtaining payment from the negotiating bank.

vi) The negotiating bank, after receiving the bill and documents from the exporter, will check them with terms of the L/C and if in order, negotiate the bill and pay him.

vii) The issuing bank, after receiving the bill and documents from the negotiating bank, will check them and if found in order, reimburse, or if reimbursement has been obtained already, confirm it to the negotiating bank. The issuing bank shall present the bill for acceptance/payment to the importer.

viii) The importer receives the bill of exchange, checks the shipping documents and then accepts/pays the bill. On acceptance/payment, he gets the shipping documents, covering the goods imported by him.

Types of Letters of Credit

i) Commercial Letter of Credit

The transaction of L/C explained above is a commercial L/C. These days, it is a very common method for financing foreign trade as number of advantages accrues to both importer and exporter there from.

ii) Traveler's Letter of Credit.

A bank also issues traveler's L/C for the convenience of the person who want to travel within the country or abroad.

Types of Commercial Letter of Credit. Banks have devised different types of L/Cs to meet the requirements of their customers. Some of them are explained below.

a) Clean/Documentary L/C.

Where a bank undertakes to accept the bill of exchange drawn in accordance with the L/C without keeping documents of title to the goods as security, the letter is called 'open' or 'clean' letter of credit Such L/C is issued usually on behalf of a party of the highest standing as the issuing bank does not get possession of the documents which are sent direct to the importer.

b) Revocable/Irrevocable L/C.

A letter of credit may be 'revocable' or 'irrevocable'. A revocable L/C may be modified or cancelled by the issuing bank without notice to the beneficiary. It was, however, held in Cape Asbestos Company Limited. Vs. Lloyds Bank Ltd., 1921, that in the case of revocable L/C, though the bank was not under any legal obligation to notify the exporter before revoking, the practice of bankers in the usual course of business is to give such notice.

A revocable letter of credit is practically useless from the point of view of the exporter. It may be noted that in the case of a revocable L/C the terms of issue will be given by the issuing banker in the L/C. itself. For example, if the following clause is there, it will be a revocable L/C. "The issuing bank reserves the right to cancel the L/C at any time and the bank will be under no obligation to give a notice of cancellation to the beneficiary". However, there may be inserted clause that bills negotiated prior to the receipts of notice of cancellation shall be honoured.

c) Confirmed/Unconfirmed L/C.

A confirmed L/C is one under which an intermediary bank has accepted a direct obligation to the beneficiary to honour his bills drawn in accordance with the terms of credit. The opening of a confirmed L/C "constitutes a bargain between the banker and the sender of goods, which imposes on the banker an absolute obligation to pay irrespective of any dispute which there may be between the parties on the question whether the goods are up to contract or not. A vendor of goods selling against a confirmed letter of credit is selling under the assurance that nothing will prevent him from receiving the price (Mlalas & Another Trading as Hanzeh Malas & Sons) vs. British Imex Industries Ltd. 1956. Such a confirmation is added at the request of the opening banker. In case the intermediary banker merely advises the credit without confirming it, the credit would be unconfirmed.

d) Fixed L/C and Revolving L/C

A L/C opened for a specific (total) amount up to which one or more bills may be drawn by the beneficiary is termed as fixed L/C. Here the period of currency of L/C is specified. The L/C remains effective untill the specified amout is exhausted within the specified period, unless renewed. A L/C opened for a total amount up to which bills drawn may remain outstanding at a time is known as revolving L/C. Thus, the amount of a revolving letter of credit remains constant during the period of its validity. Whenever a bill drawn there under is paid, the credit is automatically available for the full amount immediately or as soon as the advice of payment of the bill is received. Thus revolving L/C is automatic and does not need renewal within the specified period of time.

e) "With/Without recourse" to Drawer L/C.

A L/C opened with a clause that the banker as its holder can have recourse to the drawer in case of default of the importer to accept/pay the bill of exchange, then it is known as L/C "with recourse". In this case, the exporter as the drawer shall be called upon to reimburse the drawee bank. Thus the exporter undertakes a liability in the case of a default of the importer. On the other hand, in a L/C, where exporter cannot be called upon to reimburse the bank, when a default is made by the importer in accepting or paying the bill then, it is known as L/C "without recourse".

b) Transferable and non-transferable L/C.

A transferable L/C confers on the beneficiary the right to give instructions to the negotiating bank to make the credit available in whole or in part to one or more third parties. The third party is known as a second beneficiary. A transferable L/C is very useful when the beneficiary is a broker, commission agent or an intermediary only and he has to procure goods from some other party (parties). These third parties are actual shippers and are known as second beneficiaries. In such situation, the beneficiary may request the importer to arrange for a transferable L/C. In this way, the beneficiary will be able to transfer his right to draw bill of someone else.

Article 46 of Uniform Customs and Practices for Documentary Credit provides for the following rules as regards transferable L/C.

i) A transferable L/C can be transferred once only.

ii) The credit represented by L/C is divisible. Fractions can be transferred separately in favour of different persons provided partial shipments are not prohibited and the aggregate of all fractions does not exceed the total amount of L/C.

iii) The transfer can be done only on the terms and conditions specified in the L/C.

iv) The first beneficiary can transfer the right under the L/C to a second beneficiary in the same country. However, transfer to a second beneficiary to another country can be done if so provide in the L/C.

On the other hand, if no right is given to the beneficiary to transfer credit to another person, the L/C is known as non-transferable. However, the beneficiary to such a L/C may request a bank to open

a new L/C in favour of some other person on the security of L/C issued in his favour. Such a L/C is called "Bank to Bank L/C".

iii) Opening a letter of credit.

The following is the usual procedure followed in the opening of a L/C.

The importer has to make a request to a bank which is engaged in financing of foreign trade to open the L/C in favour of the exporter. This request must be made atleast one month before the actual date of shipment, as opening of L/C takes sometime. The application form is prescribed format. The opening bank will scrutinize the application.

The bank may open a L/C at the request of a person without any security. But here the bank must be sure about the reputation of the party and should have dealings with him for quite sometime. But the usual practice of the banks is to ask the opener to deposit with the bank cash or securities before the L/C is opened. In such a situation the bank has to decide about the margin depending upon the credit - worthiness of the opener.

The bank asks the importer to take an insurance policy know as Marine Insurance Policy on C.I.F. value of the goods plus some percentage (usually 10%) to cover profits. The policy is to be in the joint names of the bank and the importer. The International Chamber of Commerce has formulated a set of guiding principles for the governance of the letters of credit. These are designated as Uniform Customs and Practices for Documentary Credits and are prevalent in almost all parts of the world including India.

4.4. METHODS OF TRADE FINANCE

Finance for foreign trade may be required for exporters and importers. The importers do borrow from the banks but major beneficiaries are exporters. Banks are important source of foreign trade. The following are various forms of credit :

i) Pre-shipment finance or packaging credit. Which is provided before the goods are shipped.

ii) Post-shipment Finance. Which is provided after the goods are shipped.

iii) Medium Term Credit

iv) Credit under duty draw-back scheme.

Each of the above forms of credit for international trade are discussed bellow :

a) Pre-shipment Finance.

Short term Finance assistance before loading the goods and service is known as Pre-shipment Finance. It can also be called as packaging credit. Packaging Credit is a pre-shipment short term finance obtained by exporters through their bankers. It is a loan granted to exporters with a view to finance the manufacturing activity exclusively in relation to specific export order or contracts. It is provided to the exporter for procuring raw material, processing, and packing of goods aimed some other processes till the goods are really shipped. This Credit is usually granted for a period not exceeding 180 days and is liquidated by negotiation or purchase of the export bills covering the particular shipments for which the credit was granted. If it exceeds 180 days, interest rate goes higher.

Kinds of Packaging Credit.

Packaging Credit or pre-shipment finance may be either secured packaging credit or unsecured packaging credit. Secured Packaging Credit : Packaging Credit may be secured by the following ways.

i) Pledge :

Pledge is a form of packaging in which the bank retains the possession of the goods to be exported. The necessary shipping documents are delivered to bank as and when the goods are shipped. The bank, then negotiates purchases the export documentary bill and the amount payable to the exporter on negotiation or purchase of the bill is adjusted towards the packaging credit.

ii) Hypothecation

Hypothecation is a form in which the goods remain with the borrower and he executes a deed of hypothecation in favours of the bank. The borrower himself arranges for the shipment of goods. The entire set of shipping documents is delivered to the bank for negotiation / purchase where upon the credit granted is liquidated.

iii) Export Trust Receipts

In this form, the borrower executes a stamped export trust receipt in favour of the bank. The goods remain in the possession of the borrower but the borrower declares that he holds them in trust for the bank. Periodical stock statements are to be submitted by the borrower. Like pledge and hypothecation, the advance is liquidated by negotiation or purchase of export bills covering the shipment of goods. This facility is, however, granted only to most reliable and honest customers.

iv) Anticipatory Letter of Credit

An anticipatory letter of credit means bank makes the payment in anticipation of the exporter shipping the goods and submitting the relative documents under the credit, at a later date under an anticipatory letter of credit bank may either immediately make the full or part payment or the payment may be made from time to time as per the terms agreed upon and contained in the letter of credit.

b) Post-shipment Finance :

An exporter, who has loaded the goods for shipment to a foreign national, may seek financial assistance from a bank, against bills drawn on the foreign importer. The bills are drawn either on Documents Against Payments Against Acceptance (D/A) basis or Documents Against Payment (D/P) basis, that is, the bank is given the delivery of documents of the title (Bill of Lading) which he delivers to the importer or his agent only on acceptance or payment of the bill/bills of exchange. The banker should advance against such export bills only to the parties of trusted credit as there is every chance of the importer refusing to accept the bills or pay against them. To ensure payment, the banker should insist that the exporter secures a letter of credit from the banker in the importer's country.

Further, the banker should take a letter of pledge, covering the documents of title to the goods shipped. In case, the money is not received from the importer and then subsequently the exporter also fails to pay, the banker has some tangible security to fall back upon.

c) Medium - term credit

There are certain categories of export, such as engineering items, capital goods and project export, in case of which short-term finance does not meet the desired objective. It is because the importers normally withhold a part of the cost of goods/services towards guarantee of performance. Such withholding generally crosses the six-month mark and so the short - term finance is hardly of any use in these cases. It thus necessitates medium-term credit.

Broadly speaking, there are two types of medium-term credit. One is known as supplier credit, while the other is known as buyer credit. For supplier credit, the exporter provides deferred- payment terms to the importer. This means that the importer makes payment for the imports in installments. And to meet the working capital requirements on account of deffered payment, the exporter borrows from the bank. The supplier credit is provided by the bank either at the pre-shipment stage or at the post-shipment stage, or at both the stages.

Besides extending credit to the exporter, the bank executes a performance guarantee on behalf of the exporter. The exporter too gives an undertaking to the bank to repay the debt. But this undertaking has no concern with the amount the importer has to pay to the exporter. Thus in such a situation, if the importer refuses to pay, the exporter will have to face the credit risk. Again, the bank lends to the exporter in local currency, while the exporter gets the export proceeds in foreign currency. This means that the exporter may have to face the risk on account of changes in exchange rate. Fortunately, in India, Export Credit and Guarantee Corporation covers the exchange risk.

In the case of buyer credit, the exporter gets the export proceeds immediately, but the buyer or importer gets the deferred-term facilities from the exporter's bank. In other words, the importer makes the payment for import out of its borrowing from the exporter's bank. The bank's credit is repaid in installments. The buyer's credit is extended both at pre-shipment and the post-shipment stages. At the pre-shipment stage, such credit normally takes the form of opening of re-clause L/C by the importer authorizing the exporter's bank to extend pre-shipment finance. At the post-shipment stage, credit extended by the exporter's bank is used by the importer for making payment for import. However, in such cases, the importer's bank guarantees the repayment of loan by the importer. Buyer credit is different from the supplier credit. In the former, it is not the exporter but the exporter's bank that has to face the credit risk if the importer refuses to pay. In India, the banks need taking permission from the Reserve Bank of India if they like to extend buyer credit to the importers abroad.

d) Advances under duty drawback scheme

The duty drawback scheme provides that the duty paid by the exporter on the imported inputs or the excise duty paid on the goods produced for export are repaid to the exporter on the completion of the export. Since the exporter's cash is locked up during the period between the payment of duty and the completion of export, the exporter is given a cash advance by the banks for this period. Such an advance is given a cash advance by the banks for this period. Such an advance is given both at the pre-shipment stage. It is represented by additional amount of credit over and above the FOB value of

the goods. It is because the credit upto the FOB value is purely the pre-shipment or packing credit. If the bank grants additional amount over and above the FOB value, it is nothing but an advance against the duty drawback. At the post-shipment stage, it is extended by the bank when an exporter makes a claim with the bank. The period of such advance is three months. It is the exporter's bank that gets the duty drawback from the government on behalf of the exporter. When it gets the amount, it adjusts the advance with this amount. There is no interest charged on such an advance.

4.5. EXPORT-IMPORT BANK OF INDIA

The Export-Import Bank of India (EXIM Bank) is a public sector financial institution, established on January 1, 1982. It has taken over the various export financing functions of the Industrial Development Bank of India. It was established by an Act of Parliament for the purpose of financing, facilitating and promoting foreign trade of India. It is the principal financial institution for coordinating the working of institutions engaged in financing export and import. The EXIM Bank Act also empowers the bank to finance export of consultancy and related services, finance export-oriented industries and provide international merchant banking services.

Lending Pogrammes : The main focus of EXIM Bank operation is on export credits for medium-term and long-term exports. Whenever a buyer of exported goods and services from India, is allowed to defer payment, an export credit arises. Deferred export credit is available for the sale of Indian machinery, manufactured equipment and related services.

Capital goods eligible for export credit have been identified. It is divided into group A which is eligible for term credit beyond 12 years, and group B which is eligible for credit up to a maximum of 2 years. Such credit given may be in the form of supplier's credit or buyer's credit. Supplier's credit arises when an Indian exporter extends credit to the overseas buyer and finances himself through EXIM Bank. The bank extends credit directly to the buyer.

EXIM Bank operates three broad programmes of financing. These are - Loans, Rediscounting and Guarantees. The Lending and Rediscounting programmes are divided into nine categories as indicated below :

(a) **Provide financial assistance to exporters** - This enables the Indian exporter to extend term credit to an importer overseas for the purchase of Indian capital goods. The exports include equipment, machinery and related services, projects exports, turnkey projects, construction projects etc. Export of this nature arises when an Indian company contracts supply agreements for the supply of equipments and services or a project export agreement involving the setting up of a textile mill, sugar plant etc.

(b) **Technology and consultancy services** - Indian companies borrow funds from EXIM bank and provide deferred credit to overseas buyers of Indian technology or consultancy services.

(c) **Overseas investment financing** - The bank provides financing where an Indian company establishes a joint venture overseas, and requires funds towards equity participation.

(d) **Pre-shipment credit** - This loan of credit is available for companies that have won an export contract for capital goods and are seeking finance to produce the goods which entails a production period exceeding six months.

(e) **Overseas buyer's credit -** This is offered directly to foreign importers for the import of Indian capital goods and relative services with repayment terms spread over a period of years.

(f) **Lines of credit to foreign governments -** Lines of credit are offered to foreign government and foreign financial institutions. Such lines provide long-term finance for import of Indian capital goods, and related services, Annexure - IV gives full details of such schemes.

(g) **Re-lending facility to banks overseas -** This facility to overseas banks is made available to enable them to provide term financ to importers for import of Indian capital goods. The overseas bank will facilitate the foreign buyer, the EXIM Bank, and supplier to avail of these facilities.

(h) **Export bills re-discounting -** This lending programme is available to commercial banks in India who are authorized to deal in foreign exchange. Scuh banks can rediscount their short-term usance export bills with the EXIM Bank. Exim Bank provides funds under this programme for a period 90 days.

(i) **Refinance of Export credit -** Under this programme, the commercial banks in India, who are authorized to deal in foreign exchange, can obtain from EXIM Bank 100% refinance of term loans extended for export of Indian capital goods. This credit is limited up to Rs.1 crore. For contract above Rs.1 crore, commercial banks can obtain financing participation under EXIM Bank's other Programmes.

GUARANTEES

The guarantee programme is available in the case of construction and turnkey contracts. Construction contract involves eration, civil works and commissioning. In a turnkey contract, say for setting up of a textile mill, supply of equpment accounts for the major value of the contract. In such contracts an Indian exporter usually requires bid bond, advance payment guarantee, performance guarantee, guarantee for retention money and guarantee for borrowings abroad, EXIM Bank participates with commercial banks in India in the issue of guarantees.

ADVISORY SERVICES

Through its International Merchant Banking Division, Exim Bank offers the following Advisory services :

(a) Advise small-scale manufactures on export markets and product areas;

(b) Work closely with Indian Companies in designing financing packages for joint ventures in third countries;

(c) Advise Indian companies executing contract abroad on sources of favourable overseas financing;

(d) Provide access to Euro-financing sources and global credit sources of Indian companies engaged in exports;

(e) Advise on exchange control practices globally;

(f) Advise on design of packages for export-oriented industries in India.

4.6 SMALL SCALE INDUSTRIES DEVELOPMENT BANK (SIDBI)

SIDBI has been established by an act of parliament for pormotion, financing and development of industries in the small-scale sector. It came in to being in 1990. It is a wholly owned subsidiary of the Industrial Development Bank of India (IDBI).

It provides refinance facilities to either scheduled banks or state financial corporations which lend to small scale sector in areas such as equipment purchase, term finance for operation etc. In terms of exports made by the small scale sector, it can get packing credit and post-shipment credit through their own branches, and SIDBI would refinance these loans given by the banks. Even after the export, the small scale unit can seek the help of the bank for discounting the bills, and SIDBI in turn will rediscount the bills that were earlier discounted by the scheduled bank.

4.7. ECGC - EXPORT CREDIT & GUARANTEE CORPORATION (ECGC)

Export transactions by their method and operations involved, carry substantial risks which are both commercial and political in nature. This is expecially so in regard to the financing of export transactions. Even the Scheduled banks, which are authorized to extend easy financial terms for export endeavours are not equipped to take care of these risks. Nor are the exporters in a position to bear the risks attending export transactions. The need thus defnitely exists for a specialized agency, which would take upon itself the responsibility of insulating both the exporter and the financial institutions from these risks.

To provide these specialized services, the Government of India has established the ECGC, which is under administrative control of the Ministry of commerce. By issuing suitable policies, it insures exporters against the attendant risks of export operations. Besides, it is also provides financial guarantees to banks and exporters for exports against deferred credit payment terms. The covers issued by ECGC could be divided broadly into four groups;

(a) Standard Policies issued to exporters to protect them against payment risks involved in exports on short-term credit;

(b) Specific Policies designed to protect Indian firms against payment risk involved in a) exports on deferred terms of payment, b) services rendered to foreign parties, and c) construction works and turnkey projects undertaken abroad;

(c) Financial guarantees issued to banks in India to protect them from risks of loss involved in their extending financial support to exporters at the post-shipment as well as pre-shipment stages.

(d) Special schemes, viz. Transfer Guarantee meant to protect banks which add confirmation to Letters of Credit opened by foreign banks, Insurance cover for Buyers Credit, Lines of Credit, Overseas Investment Insurance and Exchange Fluctuation Risk Insurance.

(A) STANDARD POLICIES

ECGC has designed four types of standard policies to provide cover for shipments made on short-term credit.

(i) Shipments (Comprehensive Risks) Policy - to cover both commercial and political risks from the date of shipment.

(ii) Shipments (Political Risks) Policy - to cover only political risks from the date of shipment.

(iii) Contracts (Comprehensive Risks) Policy - to cover both commercial and political risks from date of contract.

The Shipments (Comprehensive Risks) Policy is the one ideally suited to cover risks in respect of goods exported on short-term credit. This policy covers both political and commercial risks from the date of shipment. Risk of pre-shipment losses due to frustration of export constracts is nil or very low since goods expored on short-term credit are raw materials, primary goods, consumer goods or consumer durables which can be resold easily.

Contract policies, which cover risks from the date of contract, are issued only in special cases when goods to be exported are manufactured to the non-standard specifications of a buyer.

Shipments to associate or to agents and those against letters of credit can be covered for only political risks by suitable endorsements to the Shipments Comprehensive Risks Policy. Premium is charged on such shipments at lower rates.

1. Risks covered : The risks covered under the Standard Policies are :

(i) Commercial Risks

The Commercial risks covered under this policy are (a) Insolvency of the buyer; (b) buyer's protracted default to pay for goods accepted by him; (c) buyer's failure to accept goods subject to certain conditions.

(ii) Political Risks

Political risks covers in these policies are :

(a) imposition of restrictions on remittances by the government in the buyer's country or any government action which may block or delay payment to the exporter;

(b) war, revolution or civil disturbances in the buyer's country;

(c) new import licensing restrictions or cancellation of a valid import license restrictions in India (under contracts policy);

(d) cancellation of export license or imposition of new export licensing occasioned by interruption or diversion of voyage which cannot be recovered from the buyer;

(e) payment of additional handling, transport or insurance charges occasioned by interruption or diversion of voyage which cannot be recovered from the buyer;

(f) any other cause of loss occurring outside India, not normally insured by commercial insurers, and beyond the control of the exporter and / or the buyer.

2. Risks not covered : The risks that are not covered in these policies are :

(a) commercial disputes raised by the buyer, unless the exporter obtains a decree from a competent court of law in the buyer's country in his favour;

(b) causes inherent in the nature of the goods;

(c) buyer's failure to obtain necessary import to exchange authorization from authorities in his country.

(d) insolvency or default of any agent or the exporter of the collection bank;

(e) loss or damage to goods which can be covered by commercial insures;

(f) exchange fluctuation.

(B) SPECIFIC POLICIES

The Standard Policy is a whole turnover policy designed to provide a continuing insurance for the regular flow of an exporter's shipments of raw materials, consumer goods and consumer durables for which the credit period does not exceed 180 days. Contracts for export of capital goods or turnkey project or construction works or rendering services abroad are not of a repetitive nature. Such transactions are therefore, insured by ECGC on case basis under specific policies.

All contracts for export on deferred payment terms exceeding Rs.1 crore in value and all contracts for trunkey projects and construction works abroad require prior clearance of the Working Group consisting of representatives from Reserve Bank of India, EXIM Bank and ECGC. Applications for this purpose are to be sent to EXIM Bank through the exporter's bank. An 'in principal' clearance by the working group enables the exporters to get necessary facilities from the institutions concerned.

(C) SPECIFIC POLICY FOR SUPPLY CONTRACTS

Specific Policy for supply contracts may take any of the following four forms;

(i) Specific Shipments (Comprehensive Risks) Policy to cover both commercial and political risks at the post-shipment stage;

(ii) Specific Shipments (Political Risks) Policy to cover only political risks at the post-shipment stage in cases where the buyer is an overseas Government, or payments are guaranteed by a Government or by banks, or are made to associates;

(iii) Specific Contracts (Comprehensive Risks) Policy;

(iv) Specific Contracts (Political Risks) Policy.

Contracts Policy provides cover from the date of contract. Losses that may be sustained by an exporter at the pre-shipment stage due to frustration of contract are covered under this policy in addition to the cover provided by the Shipments Policy.

(D) ECGC's SPECIAL POLICIES

Besides the risks covered under standard policies, an exporter sometimes needs coverage of risks of other types connected with various export transactions. To suit the various needs of the exporters, the ECGC has devised the following special Policies :

(a) **Construction Works Policy :** A contract for construction work comprises not only the supply of the material required but also the provision of services as well as the execution of civil engineering works connected with the completion of the contract. The ECGC's construction works policy provides cover for all payments that fall due to the contractor under this contract.

(b) **Policy for Consignment Exports :** The ECGC also covers exports made on consignment basis. A Specil endorsement for the purpose may have to be obtained by the exporter on the standard specific shipment policy. The cover obtained would provide for political risks from the date of shipment and commercial risks from the date of sale of overseas stock to the buyer, subject to the terms and conditions of policy.

(c) **Services Policy :** A service policy of the ECGC is designed to protect Indian exporters against the risk of non-payment for services rendered to foreign parties. Under this policy, technical and professional services are covered. The services policies are availed of for the coverage of the political and commercial risks.

(d) **Manufacturer's Credit Insurance Policies :** The necessity of this insurance cover arises when a manufacturer exports his goods through an exporter or an export house. Exporters normally obtain credit from the manufacturer while they offer credit to the buyer. Under the manufacturer's credit insurance policy, the manufacturer is protected against deault of insolvency on the part of the exporter. The extent of coverage is 80% of the manufacturer's loss.

(e) **Exporter's Credit Insurance Policy :** Sometimes exporters offer credit to a manufacturer for the procuring and manufacturing of export goods. The ECGC's Exporter's Credit Insurance Policy covers losses arising out of default or insolvency on the part of the manufacturer. The extent or coverage is 50% of the total loss to the exporter.

(f) **Market Development Policies :** Often an exporter has to undertake detailed market surveys to assess market potential and devise strategies for marketing a product. Besides, several publicity measures are aslo undertaken for the development of the overseas market. If such expenses are not recovered in terms of the prospects revealed by the survey, the ECGC shares the loss with the exporter on 50:50 basis, provided that the surveys are undertaken by an approved and independent agency.

FINANCIAL GUARANTEES

In view of the peculiar nature of, and the risks connected with export financing, the ECGC has designed a number of financial guarantees, which help scheduled banks to extend credit to exporters.

Some of the important guarantees offered by the ECGC are : (a) Packing credit guarantee, (b) Post-shipment export credit guarantee, (c) Export finance guarantee, (d) Export production finance guarantee, (e) Export performance guarantee, and (f) Transfer guarantee;

METHODS OF PAYMENT IN EXPORTS

TERMS OF PAYMENT IN EXPORT

The following are the usual payment terms in any export transaction :

(a) Payment by documentary credit

(b) Advance payment.

(c) Cash against documents (CAD)

(d) Documents on acceptance (DA)

(e) Consignment basis.

(a) Payment by Documentary Credit : Export orders or contracts normally stipulate that the buyer should open a letter of credit in favour of the exporter. Once the goods are shipped, the exporter presents the negotiable documents against the letter of credit and receives payment. A letter of credit is an authority for payment for the exporter provided he does not violate any of its clauses. Payment by a letter of credit (L/C) is not only one of the most secure methods of payment but also the most widely followed in international marketing.

4.8. SUMMARY

International Trade treats as engine of economics development. Trade deals require finance. Various kinds of finance from banks and other sources are discussed in this chapter. Broadly, different forms of credit are : 1. Pre-shipment credit. 2. Post-shipment credit. 3. Medium-term credit. 4. Credit under duty draw-back schem.

Payments in international trade are made through different modes such as 1. Cash in advance, 2. Payment under consignment sale, 3. Drafts, 4. Letter of credit and 5. Open Account.

In India, the Export-Import Bank of India is the apex body in respect of financing of foreign trade SIDBI provide refiance facilities. The loans such as packaging credit and post shipment credit given by the banks. The Government of India has established Export Credit Guarantee Corporation, which is under the control of Ministry of Commerce. It insumes exporters against the attendant risks of export operations. It also provides financial guarantee to banks and exporters for exports against deffered credit payment terms. Commercial banks and other institutions provide major contribution for financing foreign trade. Credit is an important input for expansion of international trade and it very essential in the phase of globalization.

4.9. KEY WORDS

Cash in Advance : Cash is paid in advance by the importer to the exporter.

4.10 SELF -ASSESSMENT QUESTIONS

1. What are various financial assistances provide for foreign trade?
2. What are the different variants of L/C? How does an L/C operate?
3. Explain the different modes payment in international trade.
4. Write a note on the EXIM Bank of India.
5. What are the functions of Export Credit and Guarantee Corporation?
6. What is L/C ? Is it useful for the traders?
7. SIDBI.
8. Guarantee Programme of EXIM Bank.
9. Forfeiting.

4.11 FURTHER READINGS

1) Vyuptakesh Sharan : International Financial Management 2003.
2) Banks, The Economics and Policies of Counter-Trade, 1983.
3) Financing International trade, M.L. Jhingan.

LESSON – 5. INTERNATIONAL FINANCIAL SETTLEMENTS

5.0. OBJECTIVE:

The object of this lesson is to develop linkages between the domestic economic and financial system and international financial system and to provide theoretical and analytical inputs necessary for a student of international financial system. The corporate executives have before them the corporate goals for implementing the management function, finance function or marketing function. All these functions are inter-related and connected with the international financial system. After going through this lesson you will be able to know about:

* Nature of International Financial System
* Marco view of Foreign flows
* Components of International Financial System
* Institutions in International System
* Channels for International flow of funds and settlements

STRUCTURE:

5.9 Reference Books

5.1. INTRODUCTION:

The mutual interactions between foreign sectors of various countries lead to the emergence of the international financial system. The foreign sectors are the cementing blocks of the international financial system and institutions operating in the international financial system are closely connected with the foreign sectors of the various economies. In this lesson an attempt has been made to trace back the operations in the international finance system from the international level to the national level through various financial institutions and banks and at the national level, from these institutions to the corporate units and the company executives.

When a multinational enterprise finalises its foreign investment project, it needs to select a particular source, or a mix of sources of funds to finance the investment project. Here it may be noted that a multinational enterprise positions itself on a better footing than a domestic firm as far as the procurement of funds is concerned. A domestic firm gets funds normally from domestic sources. It does get funds from the international financial market too but it is not as easy as in case of multinational enterprise. The latter can use the parent company's funds for its foreign investment project. It can also get funds from the host country financial market, but more importantly, it tries to get funds from the international financial market. It selects a particular source or a mix of sources or a particular type or types of funds that suits its corporate objectives.

When one discusses the sources of funds in the international financial market, the discussion takes into account both, the supply aspect and the demand aspect. It embraces, on one hand, the official and non-official sources of funds and the changing profile of the international financial market over past few decades; and on the other, the selection of the sources of funds by the multinational firms depending on the fulfillment of the corporate objectives. In this chapter, therefore, let us discuss the channels for the flow of funds, the structural changes that have taken place in the international financial market over the past few decades and the criteria for the selection of a particular source or type of funds.

5.2. INTERNATIONAL FINANCIAL SYSTEM:

There are various facets of the international financial system (IFS) which are analysed in depth in the book. To start with, an important aspect of international financial system is international trade, which accounts for the largest chunk of international commercial and financial relations and payments. Thus, a part of the treatment of this lesson is on the theory and practice of international trade followed by a discussion on Balance of Payments and related aspects of international economic relations. Another aspect is the institutions and organizations in it under which banks, national and international financial institutions have all found a place in this lesson.

The sub-markets in the financial system such as in foreign currency, corresponding to short term flow of funds as between countries' investments in foreign money markets and in foreign claims, etc., are reflected in financial flows as between countries through the flows of money payments and receipts. Thus, both international trade and international currency and

exchange markets are closely connected and are dealt with. Yet another aspect of the international financial system is the role of term lending and foreign aid in the flows of trade as between countries, corresponding to long term flows as between countries. It is in this context that foreign trade and aid are discussed as important components of the international financial system as short-term and long-term wings of the operations of the IFS.

5.2.1 Relevance to Management

As this lesson is intended for students and corporate executives, we should set out in the beginning itself the relevance of international finance to their day-to-day work. Domestic finance and international finance are next-door neighbors – both complementary and competitive – viewed either as sources or uses of funds. Firstly, in a fast-growing world economy and world markets, it would be naïve for a corporate executive to confine himself to the domestic markets and domestic finance alone. The days of national autarky have gone by and we are in a world of interdependence. With a fast growing network of transport and communications, the world is getting closer and a finance executive can hardly ignore the forces operating on him from the international plane as much as from the domestic plane. Secondly, as the operations and systems in domestic and international finance are different, the factors influencing them need to be studied separately. Thirdly, in a world of competition and survival of the fittest, the managerial function involves choosing the right input mix both from home and abroad and the right output mix suitable for home and foreign markets and expose oneself to the winds of competition both at national and international levels. These aspects are clearly noticed in India, with the opening up of the economy since July 1991 through Economic and Financial Reforms.

It is to be conceded that the impact of the foreign sector on the activities of the corporate executive is more keenly felt in some lines more than in others. Such lines are in exportable goods and services, shipping, airways, tourism etc. if the corporate entity belongs to the sector of multinational companies, foreign-owned companies, subsidiaries or branches of foreign companies etc., international forces are relatively more important. At any rate, any management executive can ill-afford to be blind to the international economic and financial scene even if he is not directly involved in it as these forces operate on him in the modern world.

5.2.2 Finance Settlement Function

The objective of the finance function of a manager may be set out in different ways. He may aim at optimizing the value of his assets or minimizing the worth of his liabilities. Put in differently, he may maximize his gross profits or net profits or aim at optimizing the market value of his company's shares. Looked at from any angle, the management basically aims at economy, efficiency and productivity leading to greater profitability. For this purpose, he concentrates on the efficient management of cash and credit so far as the financial aspects is concerned. But more importantly, he has to consider the production function of which cash and credit are inputs. The manager has to take into account the international forces in the preparation of plans and budgets for resource inflows and outflows and in input and output markets. In the raising of funds and use of such funds, the costs of alternative uses and sources have to be considered both at home and abroad.

In terms of the real sector or the financial sector, he has to observe the criteria of efficiency and productivity etc., in the input market and output market and in allocation of physical resources or financial resources. In the input and output markets as well as in financial markets, both domestic and foreign forces have to be reckoned with.

5.2.3 Input Market

In the input market, physical and financial inputs are fed into the productive system. Physical inputs relate to physical capital equipment, plant and machinery, raw materials, spare parts and intermediate (semi-finished) products, etc. They may come from domestic or foreign markets. Financial inputs relate to moneys spent on wages for labour or cash kept for current liabilities or contingencies. Such inputs can be secured both from domestic markets and foreign markets. As such, a cost calculus has to be made for the right mix of inputs and the right sources of supply of such inputs so as to mimeses the costs for a given product mix. It is possible that some raw materials or spares are more cheaply available abroad than at home and due to free access to such markets the manager may plan for a mix of inputs at the least cost, subject to the technical feasibilities in the production process. The markets, both domestic and foreign , have to be assessed for these inputs in terms of costs and prices and alternative sources of supply explored. This is an area in international economics and finance. In the supply of financial inputs for production purposes one has to take into account the need for cash and credit and the relative proportions of each both from home and abroad and to assess their relative costs. Marginal costing of cash and credit is part of the wider subject of cash management. The cash component as an input in the production function is part of the subject of production management, while the overall management of all funds – is in the domain of financial management.

In a subsidiary or branch of a foreign company, foreign sources play a more important role even in financial inputs. Such exercises relating to financial inputs have to be made after an assessment of cash inflows and outflows, both on current and capital accounts. On the capital account, sources and uses of funds for investment also become an important pre-requisite for planning for credit. These will be discusses below under sources and uses of funds.

5.2.4 Output Market

In the output market, the sale of final and intermediate products can be made both in domestic and foreign markets. International marketing and international finance are closely interlinked and flows of finance follow the flows of trade. Marketing is an important pre-requisite for trade. International trade and international finance are close complements. The costs of production and selling costs and the available margins both on domestic sales and foreign sales have to be considered. Here again, it is assumed that there is a free market abroad or trading is possible subject to satisfying all the requirements of the government policy in this regard. A cost calculus has to be made for planning for the right mix of sales at home and abroad. For an assessment of the demand prospects abroad, we need to know the alternative sources of supply in such markets, costs and prices of such alternative sources, transport and selling costs etc., which are the subject of international economics and finance. In India due to

premium put on export sales by government policy the cost calculus has to take into account this aspect also.

5.2.5 Sources and Uses

At the micro level of a company, an analysis of the sources of funds reveals that broadly there are three categories of sources: (i) Savings of the company which are its retained earnings, (ii) External sources (domestic) from the capital and money markets such as banks, all-India or State-level financial institutions, government or the public, and (iii) Foreign sources, namely, institutions and persons abroad. The last category can in turn be specified as follows: (a) Credit from private parties, viz., trade credit, buyer's credit, etc., (b) Foreign government credit, viz., government to government line of credit, foreign aid or grants or loans, (c) Resources from international or inter-regional bodies such as IFC, IBRD, foreign banks or Euro-currency markets etc., and (d) Non-resident individuals and institutions.

The same analysis holds good at the sectoral and national level. In fact, the emergence of international financial markets can be traced to this sectoral interdependence, including the foreign sector and intra-national dependence. Basically, as no country is self-sufficient or autarkic but is dependent on other countries for something or the other, international economic and commercial relations emerge. These are referred to later in this chapter.

In a similar fashion, it would be appropriate to set out the pattern of use of funds of any company into various sectors of the economy, including the foreign sector. Dispensation of funds for current or capital expenditures in domestic markets and international markets can be separately set out. Such an analysis is particularly more relevant to multinational corporations and branches or subsidiaries of foreign companies in whose case foreign markets and foreign sources of supply play an important part. The head office or the holding company may spend a part of its funds in investment in the host country, make inward remittances for working capital or investment purposes and outward remittances for royalty and dividend, payments or technical fees.

5.3. MACRO VIEW OF FOREIGN FLOWS:

RBI Company Finance Studies throw light on the macro-view of Foreign inflows and outflows in the Corporate Sector. These are published in RBI Bulletins regularly. A large number of smaller companies contribute larger foreign exchange earnings to the country. It is true that both expenditure and earnings on foreign account are concentrated in a small number of large foreign controlled Indian companies and multi-national corporations, but they may not add much to the net accrual of foreign exchange. But a large number of small companies do not operate on such a large scale, but add substantially to our net accrual of foreign exchange.

International financial markets emerged out of the felt need to facilitate operations of nations arising out of the commercial and financial transactions with the rest of the world. This emergence can be attributed logically to: (a) Sectoral interdependence, and (b) National interdependence.

It would be apt to set out here the inter-relations between the micro-level operations of a finance manager with the macro-level working of the corporate sector and foreign sector. A finance manager is a micro unit in the corporate sector. The environment he faces is competition from other similar units in the corporate sector and as suppliers of inputs or as consumers of output. Besides, this corporate sector, in turn, is interlinked with all other sectors of the economy. The micro–level manager is thus faced with a total environment of the economy which includes foreign sector, and it is thus relevant to him to be familiar with the international financial system, which is the product of developments in the foreign sectors of all the world economies.

The corporate sector is a part of the total business sector having trading and manufacturing activities. The corporate sector is also connected with all sectors of the economy, namely, government sector, household sector and foreign sector either as suppliers of inputs or as consumers of output. Besides, all these domestic and foreign sectors are interconnected through the flow of funds and savings from one sector to the other. In each sector, there are both savers and investors. Only the household sector is a net saver in India. Besides, the household sector is a supplier of factors of production such as labor, management, enterprise etc. For sometime in the past, foreign sector was a net saver, as there was a net balance on current account of our balance of payments leading to the accretion to our foreign exchange reserves. We are running huge deficits in merchandise trade account for some time, which would offset any positive balance on the invisible trade account. This would mean a negative savings in the foreign sector leading to a loss of our foreign exchange reserves.

If there is a net inflow of funds from abroad either as foreign credits, grants etc., or borrowings from foreign governments, international bodies etc., there may be a positive balance in the balance of payments and foreign savings would accrue. The surplus savings in some sectors would flow into other sectors with deficit. In the corporate sector where investment is invariably more than their available savings, the units have to depend on other sectors to finance them. These savings may flow directly from the government sector or household sector or indirectly through financial institutions, banks and other agencies. It would thus be clear that the corporate sector is intricately connected with all other sectors of the economy either as suppliers of inputs of production or suppliers of factors of production, including land, labor, capital or enterprise of consumers of their products or services. They are also connected with other sectors of the economy through inflow or outflow of funds or savings or financial assets – moneys or near money assets or financial flows.

5.3.1 Sectoral Interdependence

Another aspect of interdependence of the various sectors of the economy is foreign private investment in the domestic economy or Indian investment abroad. This investment may take the form of – (i) Equity participation in Indian enterprises, (ii) Investment in bonds or debentures, (iii) Granting of loans or credits either on government to government basis or party to party basis in the private sector, (iv) Joint ventures in third countries and (v) Technical consultancy or know-how participation etc. Transfer of technology is also one of the aspects of the international commercial and financial relations, which is necessary for a sustained rate of growth at the lowest possible costs and the highest level of productivity.

All the inputs of the corporate sector come either from the household sector as labor, capital or enterprise or from Government sector as infrastructure, land, electricity, water etc., or from agriculture or industry (business sector) as raw materials, intermediate products, spares, parts etc. Particularly more relevant for our discussion is the contribution of foreign sector towards inputs of the corporate sector in the form of physical capital, plant, machinery, spares, raw materials, etc., or financial inputs in the form of short-term credits or investment in financial assets, etc.

Such interdependence between the corporate sector and other sectors is also noticed in the field of outputs. The main consumers of some products may in fact be the foreigners. Either in respect of consumer goods or capital goods, there is a good element of foreign demand, particularly from the less developed countries. In view of the vastness of our domestic markets, the executives of the corporate sector rarely explore the foreign markets, unless the products are export-oriented. With the projected expansion of the industry and limitations in the domestic markets, the future executives may have to think more in terms of foreign markets than of domestic markets. More recently, the government in the light of the prevailing balance of payments difficulties of the country and increasing export shortfalls is encouraging export-oriented industries and 100 per cent export units. Besides, the philosophy of the government is also veering round to the view of making our economy more competitive with a greater role allocated to the private sector. The cost consciousness and competitiveness has increased in the Indian enterprise. In such an environment, the role of foreign sector can be hardly overemphasized when the chill winds of competition and cost consciousness make the future executives of the corporate enterprise more alert and informed on both the domestic and external sectors. The foreign environment would be equally important and more challenging than the domestic markets due to the ever-changing scene of demand and supply forces, competition and cost price factors operating from all sides of the world. These may hopefully improve the efficiency of factors and lower the costs of production.

There is another reason why the foreign sector is more important to India; namely, the limits are already reached in the domestic markets and the scope for further expansion of markets lie abroad. Besides, there is the debt service burden, which we carry due to our reliance on foreign credits during the last few decades of our planning. This burden can be discharged by a continuous flow of goods and services outside the country leading to an export surplus for the nation.

In the output market, the domestic household sector has been the main consumer in India, followed by the government sector, which needs the output of the corporate sector both for capital formation and current consumption. Besides, the government with its contracting role in the economy has got less say in the affairs of the corporate sector today and is likely to become lesser in future due to their avowed policy of a greater role for the private sector in the years to come. The business sector comprising industry and agriculture continue to consume the products of the corporate sector as intermediates or raw materials for manufacture or further processing. These facts are brought out in any analysis of input-output matrix tables for the economy.

5.3.2 Intra-National Dependence

We have seen that national economy of a country is composed of a number of sectors, including the foreign sector and the interdependence of these sectors either as suppliers of savings or of factors of production, or of other inputs in the productive process or as consumers of their output leads to economic, commercial and financial transactions as between these sectors. It is such transactions between the domestic sectors and foreign sector that gives rise to the international financial system.

An extension of this principle of mutual interdependence to the case of national economy of one country depending upon that of others lends further support to our thesis that emergence of international financial markets is the result of such interdependence. Thus, no modern nation/state is self-sufficient nor is it closed to external forces from other nations and states. This dependence is the result of the expanding civilization and modern socio-economic systems. It is now well recognized that countries are interdependent in various degrees resulting in economic, commercial and financial transactions among them. Such interdependence is a necessary but not a sufficient condition for the emergence of international financial markets.

The interdependence of nations can be ascribed to the following factors:

(1) Differential factor endowments and natural endowments in different countries, leading to different production functions.
(2) Different stages of growth of industry, agriculture and other sectors in the economies of these countries.
(3) Differentials in technological advancement.
(4) Differences in habits tastes and consumer preferences, leading to different demand functions.
(5) Differences in standards of living and incomes, leading to flow of funds through grants, loans etc.

It would thus be seen that the origin and emergence of the international financial system can be traced to the sectoral and national interdependence which leads to international economic, commercial and financial relations as between countries. International trade, aid and financial flows account for the bulk of such transactions as between nations. The basic economic principles of efficiency, productivity and least cost optimization process necessitate the use of inputs both domestic and foreign and flow of goods and services across national borders, provided there are no barriers to such flows. The result is the exchange of goods and services involving payments and receipts as between countries and exchange of one currency for another and borrowing and lending of money or near money assets across borders. These transactions and trading in foreign currencies, foreign assets or liabilities and foreign claims constitute the international financial system.

5.4. COMPONENTS OF INTERNATIONAL FINANCIAL SYSTEM:

International financial system relates to the management of and trading in international money and monetary assets. These monetary assets are claims on foreign currency, foreign

deposits and investments and/or foreign assets. The claims may be denominated in various foreign currencies purchased and sold and involve exchange as between various currencies. Thus, these transactions give rise to: (i) Borrowing and lending operations in foreign currencies or trading in financial assets denominated in foreign currencies and (ii) A foreign exchange transaction involving an exchange of one currency for another. The first is called the foreign currency market and the second is the foreign exchange market.

5.4.1 Foreign Exchange Market

International economic and commercial relations between countries involve exchange of goods and services and payments for these exchanges. The payments lead to conversion of one currency into another. Each country has its own financial system and its own currency and financial assets. Exchanges between the money and financial assets of one country for money or financial assets of another country constitute international financial transactions. These transactions are put through the foreign exchange market. The demand for any currency as against its supply in such markets determines the exchange rate. These financial assets could be money or near-money assets, cheques, drafts, mail transfers and other negotiable instruments.

The difference between the domestic financial system and international financial system lies in the introduction of exchange of one currency for another or exchange of one instrument in one currency for another denominated in a different currency. In the process of such exchange, the transfer problem arises in the international markets, which relates to the problem of finding the proper source of supply to suit the demand for any foreign currency. This leads to an adjustment process in the balance of payments of the various countries which in turn depends upon the type of international monetary system in vogue. These will be dealt with in another chapter.

The basic principle involved is that economic and commercial transactions between one country and another are adjusted by the corresponding purchase and sale of financial assets, including money and near-money by one country for that of another country. The prices of goods and services of one country vis-à-vis the prices of the corresponding goods and services of another country will determine the purchasing power of each currency. Exchange rate is primarily a reflection of the purchasing power of the currency domestically.

Exchange rate fluctuations on a day-to-day basis will depend, however, upon the competitive forces of demand for and supply of any currency in these markets. In the short run and long run, exchange rates would depend upon the relative degrees of inflation in the domestic economies and changes in the purchasing power of currencies. Exchange standard and the international monetary system would facilitate such adjustment of exchange rates to changes in supply and demand and to changes in purchasing power parities. Speculative purchases and sales of currencies and hedge trading in these currencies would also take place daily and would depend upon their relative strengths in international markets, market confidence in those currencies and intrinsic strength of the domestic economies.

The International Monetary Fund was established to facilitate transactions as between the member-countries and impart an element of stability in the international monetary scene. Each

country can purchase and sell its currency from the International Monetary Fund for another currency of the member country to meet its requirements of international payments for goods and services.

5.4.2 International Currency Markets

As an adjunct to the exchange markets, there are international currency markets where internationally accepted currencies, namely, the so-called reserve currencies, are traded. These relate to the deposits of such currencies with international banks at an agreed rate of interest. The excess funds in these reserve currencies owned by countries, institutions and governments having surplus receipts over payments would be lent out to banks and other financial institutions for various durations at a rate of interest. The currencies are in demand for meeting the balance of payments deficits or for investment in fixed capital or for working capital purposes.

The other components of the international financial system are international capital markets and bonds markets. The international capital markets such as London, New York, Zurich etc., have lost much of their popularity due to national restrictions and scarcity of funds in those centers. Bond markets in these centers are still operating and international banks are arranging these issues on a selective basis. Now, Euro-currency and Euro-bond markets are the most popular international means of medium and long-term financing.

The relations between the foreign exchange market and international currency markets are not difficult to comprehend. The trade and other economic and commercial transactions involve receipts and payments as between countries. These will lead to exchange of one currency for others. The demand for and supply of each of the currencies against an alternative currency determines the rate at which two currencies are exchanged. This is called the exchange rate and the market is the foreign exchange market. In the process of such economic and commercial transactions, a country can be a net creditor or a debtor. If a country is a net creditor or has a positive trade surplus or receives more than it pays out, it has net foreign claims on others. Such claims are held in the form of deposits, balances, etc., abroad or investments in Treasury Bills, Government and Private securities etc. Such claims would lead to international currency holdings, which are generally held in convertible currencies, by the creditor countries for reasons of facilitating subsequent use and conversion for international payments. Any market representing the demand for and supply of such currencies is called the international currency market. While thus the foreign currency market refers to trading in external dollars or other currencies held abroad, foreign exchange market refers to the conversion of such dollars into other currencies. The obvious inter-relations between these two segments in the international financial system need no elaboration. The details of how they originate and the factors of supply and demand, etc., are discussed in a later chapter.

5.5. INSTITUTIONS IN INTERNATIONAL FINANCIAL SYSTEM:

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

(a) National banks and domestic financial institutions, which deal in foreign currencies and foreign credits.

(b) International brokers of repute.
(c) Regional or multi-national banks or corporations dealing in international markets and borrowing/lending in these markets.
(d) Regional Finance and Development Corporations and banks such as the Asian Development Bank, Commonwealth Finance Corporation, Latin American Development Bank, Bank for International Settlements, etc.
(e) International financial organizations like International Monetary Fund (IMF), International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC) and International Development Agency (IDA).

5.6. CHANNELS FOR INTERNATIONAL FLOW OF FUNDS AND SETTELMENTS:

The international financial market can be compartmentalized into two segments. One is the international money market, which is represented by the flow of short-term funds. International banks or the short-term securities come under this segment. On the other hand, the international capital market forms the other segment where medium and long-term funds flow.

Irrespective of such a distinction between the two segments, there are a number of agencies and instruments through which funds move to the resource-needy institutions or firms. The resource-providing agencies may be official or non-official. Among the official agencies, are the multilateral institutions, such as international development banks and regional development banks, and the bilateral agencies, such as the different governmental agencies? Multilateral or bilateral funds can be confessional or nonconcessional. The highly confessional funds or funds having a large grant element, are known as official development assistance.

The non-official channel comprises the borrowing and the lending streams such as the international banks on the one hand, and on the other, the securities market in which the Euro-equities and the debt instruments, such as international bonds, medium-term Euro-notes, short-term Euro-notes, and Euro-commercial papers are sold and purchased. It may be noted that the operation of the international financial market spreads beyond the lending and borrowing of funds or the sale and purchase of securities. Swap is also very common and it forms an integral part of international financial market. If a borrower needs a fixed-rate funds but has access to the floating-rate loan market, he can go in for an interest-rate swap in order to exchange the floating-rate loan for the fixed-rate loan. Similarly, if a borrower does not get loan in a particular currency, the loan can be swapped for obtaining the desired currency.

5.7. SUMMARY:

There are different channels for the international flow of funds. One channel is represented by the official agencies. These are either multilateral institutions like the international and regional development banks or bilateral, that is the different governmental agencies. Among the non-official agencies, the most important sources are the international banks. However, funds are raised also through the sale of international equity and short-term, medium-term and long-term debt securities.

There has been a distinct structural change in the international financial market over the decades. The establishment of the international and regional development banks and the participation of different governments in the international lending business changed the very shape of the international financial market. More importantly, the character of the international bank changed-from its traditional form to a more unregulated form. The banks did not remain confined to the lending business but they widened their functions to cover the off-balance sheet activities. Of late, the international securities market has become significant for raising funds.

A firm that has to raise funds for investment selects a particular channel or a mix of channels and a particular currency or a mix of currencies with a view to minimizing the cost of capital, and so it takes into account not only the interest rate but also the changes in the exchange rate that influence the effective cost of capital.

Apart from the interest rate and the exchange rate, the raising of funds takes into account also the capital structure norms as well as a proper balance between the short-term funds and the long-term funds. They also influence the cost of capital but in a different way. Moreover, the fund-raising firms have to abide by the rules and regulations and the necessary formalities. They too influence the fund-raising decisions.

5.8. MODEL QUESTIONS:

1. Distinguish between traditional international banks, Euro banks and off-shore banking centers.
2. Discuss the factors behind the emergence of Euro banks.
3. What do you mean by syndication of lending ?
4. Explain the various sources of international finance.
5. Give a brief account of the changing scenario of international financial market during the past four or five decades.
6. Explain the criteria followed while raising funds from international financial market.

5.9. REFERENCE BOOKS:

Bhatt, P.F. (1991), International Banking, New Delhi, Commonwealth Publishers.

Honeygold, D. (1989), International Financial Markets, New York, Woodhead-Faulkner,

IMF (1997), International Capital Markets, Washington, D.C.

Johnson, R.B. (1982), The Economics of the Euro Market: History, theory and policy, New York, St. Martin's Press.

Sekely, W.S. and J.M. Collins (1988), Cultural Influences on International Capital Structure, Journal of International Business Studies, XIX, 87-100.

Sharan, V. (1991), The World Bank Group and the SAARC Nations, New Delhi, Anmol Publishers.

Lesson – 6

Protection in Foreign Trade: Tariffs and Quotas

CONTENTS

6.0 AIMS AND OBJECTIVES

After studying this unit, you should be able to

- describe the disadvantages of free trade;
- analyse various economic and non-economic arguments for protection;
- evaluate the effects of tariffs and quotas on various economic variables;.
- make comparison between the effects of tariffs and quotas and their relative efficacy;

6.1 INTRODUCTION

The standard international trade theory argues that free trade is the first best policy. The argument rests on several convincing grounds. First, free trade results in efficient allocation of available resources across the trading nations and ensures Pareto Optimality. Pareto Optimality is a bliss situation where it is impossible to increase the production of any commodity without decreasing the production other commodities. Secondly, the world production of every commodity is maximized. Thirdly, countries can consume beyond the national production possibilities frontiers. Fourthly, through free international trade the consumers get larger basket of commodities to choose among. Fifthly, international commodity market will tend to be more competitive and the elements of monopoly and oligopoly will get dissolved. Lastly, international differences in the real rewards of factors of production get narrowed down and there will be a tendency towards the equalization of their prices across the trading nations. Nevertheless, there are equally convincing arguments against free trade also. Firstly, free trade ignores the balance of payments effects of free trade. Free trade may result in persistent deficit in balance of payments of a country if imports continuously outstrip exports. Secondly, as emphasized by Gunnar Myrdal, gains from free trade would more than be offset by unfavorable terms of trade (price of exports/price of imports) if a country specializes in the production of primary commodities. This is because price and income elasticity of demand for primary commodities are very low and hence their export prices relative to prices of manufactured commodities may

fall in the long run. Thirdly, free trade results in excessive specialization on a narrow range of commodities putting a country's economy at the mercy of external forces. Fourthly, comparative advantage enjoyed by a country in the production of a commodity is not some thing divine or god given. It may change over the years or it can be made to change by deliberate policy measures. Fifthly, free trade brings about unequal distribution of income among various factors of production in a country. The income distribution would shift in favour of the factors of production engaged in the production of export commodity and against those engaged in the production of import commodity. Lastly, the production and exports of certain commodities particularly primary commodities will have very little forward and backward linkages and hence countries that concentrate in the production of such commodities will never develop. In view of these limitations in free international trade some economists advocate protection in international trade. In this unit you will study the economic and non-economic arguments for protection, types of protection such as tariffs, quotas and subsidies and their effects on several economic variables.

6.2 ARGUMENTS FOR PROTECTION

It is a fact that free international trade is better than no trade from the point of view of both of world as whole and of each individual country. Yet in real world free trade is impeded by several protectionist measures such as tariffs, quotas, exchange controls etc. This is due to the fact that imports have negative sign in the aggregate demand function (Y=C+I+G+X-M) and hence capable of reducing it. Arguments for protection may be on economic grounds or non-economic grounds. Let as thoroughly analyze these arguments for protection.

6.2.1 ECONOMIC ARGUMENTS FOR PROTECTION

The desire to accelerate the pace of economic development of the less developed countries and to raise the standard of living of the masses gave renewed interest in the economic arguments for protection in the post-war literature.

6.2.1.1 Infant Industry Argument

Of all the arguments for protection, the infant industry argument commanded respect and weight both among the economists and among the policy makers. The policy advocates temporary tariffs on imported commodities. This enables the domestic industry to learn how to produce the goods at low enough costs so as to compete with the well-established foreign firms. The essence of the argument is that an industry in the initial stages of development cannot compete with the well-established foreign firms because it will have very high initial cost. Since the size of the firm is very small it cannot reap the internal economies of scale and hence the average cost of production would be very high. Since the number of such firms is also very limited in a developing country in the initial stages of development, the firms cannot also reap external economies of scale. Under such circumstances, the government should give protection to the infant industry by means of imposing tariff on the substitute import commodities, or by fixing quota limits on their physical imports into the country. Once the level of production increases and the firm is able to reap both internal and external economies of scale, the firm can be thrown open to the foreign competition. Thus the infant industry argument is dynamic in nature.

Alexander Hamilton put forward this argument for the first time in his Report on Manufactures in 1971. Based on the Report, United States first imposed tariffs to encourage the domestic production of textiles, non-ferrous metals, and other goods that are struggling hard to survive against the well-established British firms. The noted German Economist, Fredrich List has reapplied the argument to shield the nascent German industries in early 19th century. Japan also used this policy extensively in 1950s and 1960s in order to protect her steel, automobile and shipbuilding industries. It is argued that protection of infant industries will have long-term benefits such a development of skilled labour, learning new capabilities etc. Some times it is argued that if the protection of domestic industry against the onslaught of foreign industry is the objective of the infant industry argument, then this could be better realized by providing subsidies or by extending long-term interest free loans to the firms. This is because tariffs cannot be easily removed once it is levied. In view of continuous advancement of technology, new products are developed continuously and hence the case for infant industry argument will always be there. But alternative protection measures such as subsidies are subject to frequent budgetary review and hence they can be easily removed.

6.2.1.2 Industrial Diversification Argument:

Foreign trade on the basis of the Doctrine of Comparative Cost Difference leads to excessive specialisation on a narrow range of commodities. This is a dangerous situation both economically and politically. Economically there is a danger of serious economic dislocation in case of adverse circumstances that affect few industries on which the country is dependent. For instance, if a country depends heavily on export of prawns, then the entire economy will be in doldrums if there is a infectious disease that affects the prawn culture. If a country depends on export of agricultural commodities to a greater extent, then the economy will have to suffer a lot if there is a monsoon failure. Politically, in terms of war imports from a foreign country becomes very difficult and people will have to suffer hardships. In order to overcome all these problems, there is need to bring about harmonious and balanced growth of all industries and self-sufficiency by diversifying the industrial structure of the economy. This argument seems to have merit in these days of international tensions. Nevertheless, the argument is also criticised on the following grounds. Firstly, no country does possess all natural resources in order to become self-sufficiency. It has to depend on other countries for some products. Secondly, it underscores the very doctrine of the Doctrine of Comparative Advantage. Lastly, in the era of liberalisation, privatisation and globalisation, it is not possible to have complete isolation.

6.2.1.3 Dying Industry Argument

Another important argument put forward in favour of protection is the dying industry argument. It rests on the plea that the government should intervene and save the traditional industries from the onslaught of cutthroat foreign competition. There are certain traditional industries such as handlooms industry, power loom industry, whose whole livelihood is threatened by the cheap imported goods. Again there is dilemma over the issue that whether these should be allowed to take their own natural end or should they be protected through government intervention. The first best economic theory believes in the survival of fittest. The resources (including labour) used in the production of dying industries will have the next best opportunity to be employed. But in reality if they don't' find any such profitable avenues of employment and their earning power is

zero in other activities, then the whole society will stand lose. The government cannot be a silent spectator of this tragic situation and hence it has to interfere and see that the dying industries are saved through the imposition of either tariff or other means of protection. The U. S. government's bailout loans to Chrysler at the end of the 1970s are the best example of government helping the dying industry. In India also government of India reserved certain categories of products to be produced only by the small-scale industry.

6.2.1.4 Employment Generation Argument:

It is believed that protection of domestic industry by means of imposition of tariff leads to generation of additional employment and incomes for the domestic workers. This belief was more popular during the Great Depression of 1930s when there was wide spread cyclical unemployment. When a tariff is imposed, the imports fall and correspondingly the domestic production of imported commodity increases. This creates employment opportunities to the native people at the cost of foreign countries. In other words, after imposition of tariff the unemployment is exported away to foreign countries. This type of policy is known as 'beggar-my-neighbor policy'. It was believed that initial employment generation through protection leads to creation of additional employment both via multiplier and accelerator process. Consequently, the final increase in the employment will be several times more than the initial employment and incomes. The politicians have understood this concept pretty well and exploit this highly sensitive issue with a view to getting votes from the youth. There is no denying the fact that in India after the introduction of liberalization policies, many industries lay off their workers or down sized their employment levels. VRS has become a common policy in almost all public and private sector units in India. The policy of permanent employment is given up and the policy of contract labour has come into operation. It is, however, argued that this is a fallacious argument and focuses its attention very narrowly. It ignores the fact that the creation of new jobs or the preservation of existing jobs is done at a very high cost. If the protected commodity is used as input in other industries, then it will lead to high cost of production and reduction in employment in other industries. According to the World Development Report- 1987, each job preserved in the U.S. automobile industry cost American consumers between $40,000 and 108,500 a year or the equivalent of the wages of as many as six ordinary industrial workers.

6.2.1.5 Public Revenue Argument

Another important argument advocated in favour of protection is the public revenue argument. Many developing countries are not in a position to provide basic public goods like, drinking water, primary education, health, or control communicable diseases of their citizens due to lack of public revenue. Their people are languishing under abject poverty and malnutrition. Under such circumstances, the tariff revenue could be considered as an important source of public revenue. The tariff revenue could be raised with relatively low efforts and cost. Just to guard the ports with some customs officials and record the export, import transactions carried out at major ports. Tariffs are considered to be the double-edged knife as they yield revenue and also at the same time extend protection to the domestic industry. Secondly the burden of tariff revenue may partly fall on the foreigners, if the demand for imports is elastic. Thirdly if the demand for imports in most developing countries were relatively inelastic, the revenue collections would also show buoyancy. The share of customs duties in total tax revenue in many developing

countries is anywhere between one-quarter to three-fifth. This is equal to the level of tariff revenue realized in trade oriented developed countries like Canada. On the other hand, in many developed countries the share of tariff revenue forms about 2 per cent of total revenue. If the tariff revenue is efficiently used in the provision of essential public goods, then protection would not only benefit the tariff imposing country but the world as a whole also. If foreign trade is heavily taxed by corrupt and inefficient governments like those of Bokassa (In Central Africa), Louis IV in France, Marcos in Philippines then, several distortions would result in leading to fall in the public welfare.

6.2.1.6 Safeguard the labour interest Argument:

Protection is advocated especially in an advanced country to safeguard the interests of the labour. It is argued that in the absence of tariff there will be unhealthy competition between the countries having 'cheap labour' and 'dear labour'. The products from the developing countries where labour is cheap compete away the products of industrial countries where the labour cost is very high. In view of this in recent WTO negotiations labour standard in developing countries is insisted very much.

6.2.1.7 Forward and Backward Linkages Argument:

In order to achieve rapid development any country should have sound industrial base. To wards this end development of basic and key industries such as iron and steel cement, fertilizers, chemicals are necessary. These industries will have very high level of forward and backward linkages. Hence it is necessary to promote these industries even if they do not have comparative advantage in the country.

6.2.1.8 Existence of Social Benefits Argument:

The determination of comparative advantage is based on the estimation of private cost only. But in developing countries the social cost of producing certain goods particularly the manufactured commodities would be very high. But the social benefits from such activities will be very higher than the private benefits due to the existence of externalities (particularly the external economies). Hence such activities should be encouraged. For instance if social benefits from industry are higher than the private benefits, there is every need to encourage industrial activities in the country even by providing protection to the industry. This is because industrial sector will have more forward and backward linkages than the agricultural sector. In other words, as a result of development of industries particularly basic and heavy industries, there will be over all development in the economy.

6.2.1.9 Balance of Payments Argument:

Imposition of tariff is considered to be one of the effective methods of correcting or controlling deficit in the balance of payments of a country. It is considered to be a better alternative to devaluation of domestic currency. The success of devaluation depends upon several crucial assumptions, all of which are not met in the real world. This is particularly true in a developing country. More over, devaluation will have several side effects especially inflation. Hence it must be accompanied by other fiscal or monetary policies. Under these

circumstances, imposition of tariffs is considered to be the best alternative to keep balance of payments under control. However, it should be used only as a temporary measure. This is because it only suppresses the balance of payments dis-equilibrium situation rather than solving it.

6.2.1.10 Terms of Trade Argument:

Imposition of tariff leads to more favourable terms of trade for the tariff imposing country. The price of the imported commodity, on which tariff is imposed, rises in the domestic market. If the demand for the imported commodity is elastic, it will lead to fall in the demand for imports and consequently exports of the foreign country. In order to regain the lost market, the foreign producer may reduce the price of the imported commodity. This results in the improved terms of trade for the tariff imposing country.

6.2.1.11 Income Redistribution

One of the criticisms of the Classical and Neo-classical theories of Comparative advantage that advocated unlimited free trade is that free trade redistributes income in favour of factors of production engaged in export sector and against those engaged in the import competing industries. Besides, there are underprivileged caste or ethnic groups or regions that are bypassed by the development efforts in a country. These are politically highly sensitive issues that must be handled very carefully. The protagonists of the policy of protection advocate that the tariffs could effectively be used to redistribute income in favour of neglected sections of the society and thereby equity could be established in the country. Such a policy is advocated even though it may reduce the over all income and output of the country. A tariff has the capability of brining such redistribution of income in a country as is evident from the Stolper-Samuelson Theorem which states that imposition of tariff increases the real income of the factors of production engaged in the import competing sector of the economy.

6.2.1.12 Retaliation

Some times tariff is used as a retaliatory measure to counter the imposition of tariff by a foreign country. If a foreign country imposes tariff on the exports of the domestic goods, it will result in deteriorating terms of trade for the country. In order to overcome this situation, the country has to retaliate and impose tariff on the imports from the foreign country. This will improve the terms of trade of the domestic economy. Retaliation may take the form of imposing tariffs on imports originating from such countries or fixing quota limits on imports originating from such countries or taking the extreme step of banning imports from such countries. In all these cases the government of a country can play crucial and decisive role in regulating the international business and payments. The danger in such a policy is that it will result in fall in the volume of trade. The gains from the improved terms of trade may offset the losses on account of fall in the volume of trade.

6.2.1.13 Strategic Trade Policy

In many commodities, a few firms dominate world trade. For example the automobile industry is dominated by Hondas, the computer software industry is dominated by Microsoft company, Trade in industrial products are dominated by developed countries, trade in textile garments are controlled by the developing countries and so on. This is because the first movers will always be in the forefront and the lagging firms will always be lagging behind. Under such circumstances, keeping the national interests in view governments of the nations should design appropriate policy mix to counteract the aggressive trade policies of the dominant firms and to protect the domestic industry from foreign competition and dumping. In some cases the foreign firms may create barriers for the domestic firms even to enter the domestic market. For instance, when the Japanese automobile firms created barriers to domestic firms in U. S., the U. S. government designed strategic policy measures to counteract the strategies of the Japanese firms.

6.2.1.14 Conservation of Natural Resources Argument

Carely and Jevons have argued that protection is necessary to conserve the national natural resources. This argument is particularly true for countries, which export minerals and raw materials. Export of coal from England, according to Jevons need to be restricted by imposing export duties. Similar arguments hold true for exports of gold and diamonds from South Africa, manganese and mica from India. In recent years adverse environmental effects of indiscriminate of agricultural and manufactured exports are also realized and accordingly pollution abatement costs are also included in the export prices.

6.2.2 NON-ECONOMIC ARGUMENTS FOR PROTECTION

So far we have presented the economic arguments for protection. These economic arguments seek to promote economic welfare of the people. But economic welfare is not the sole goal of life. Non-economics objectives like political, social, and cultural are also important. Such non-economic argument may make it desirable to pursue activities that are not economically efficient. Adam Smith himself stated that national defence matters more than the national opulence.

6.2.2.1 National Security

From the national defence point of view, it is argued that each country should be self-sufficient as far as possible. It should avoid too much dependence on foreign countries even if such an action results in economic loss. No nation can prosper if its defence is weak. If a country depends on other countries for some essential commodities and war goods, it becomes politically weak and highly dangerous especially during war times. The protagonists of national security argument hold the view that in view of national security and sovereignty, the government should control certain industries like defence, aerospace, electronics, semiconductors, posts, railways etc. The production and/or the provision of these commodities/services should be in the hands of government or should be controlled by the government. No foreign firm should be entrusted with this task. Even in developed market economies like U. S. and Japan the government runs these activities. Even during the era of liberalization and globalization, the government of India

reserved eight strategic industries for exclusive public sector operations. Until recently no foreign firms were allowed in certain areas such as insurance and telecommunications.

6.2.2.2 National Pride

Nations feel pride from certain actions and activities, as do individuals. Winning a gold medal in Olympic is a pride to the nation. Winning Prudential World Cup is a pride to the nation concerned. In the same way feel pride in producing goods within the country, the so called the Gandhian concept of 'Swadesi'. The concept of Swadesi became the slogans of certain political parties in India. The concept of Swadesi implies domestic production of goods and prohibiting imports into the country. If this is the objective of protection, then imposition of tariff is not the only alternative available. There are several other methods such as subsides etc.

6.2.2.3 Preservation of Cultural Identity:

Some times protection is advocated in order to preserve the cultural identity of a country. It is argued that foreign goods invade the native identity and culture and spoil them. In order to preserve this protection is advocated.

Check Your Progress:

1. What do you mean by protection?
   _____
   _____
   _____
   _____
   _____
   _____
2. List out the economic and non-economic arguments for protection.
   _____
   _____
   _____
   _____
   _____
   _____

6.3 TARIFFS

Tariffs and quotas are the two chief methods of protection of domestic industry. Let us analyse the effects of these two instruments of commercial policy in a more detailed way. A tariff is a tax or duty levied on a commodity when it crosses a national boundary. The most common tariff is the import duty that is imposed on a imported commodity. Export duties that are generally imposed on the exports of rice, primary commodities such as coffee, coca etc., are less common. They are imposed to create scarcity in the world market and thereby to raise international price. In general, tariffs whether on imports or on exports can be imposed in three forms viz., an ad valorem duty, Specific Duty and Compound Duty. **The ad valorem duty** is imposed according to the value of the commodity. It is the fixed percentage of the value of the commodity

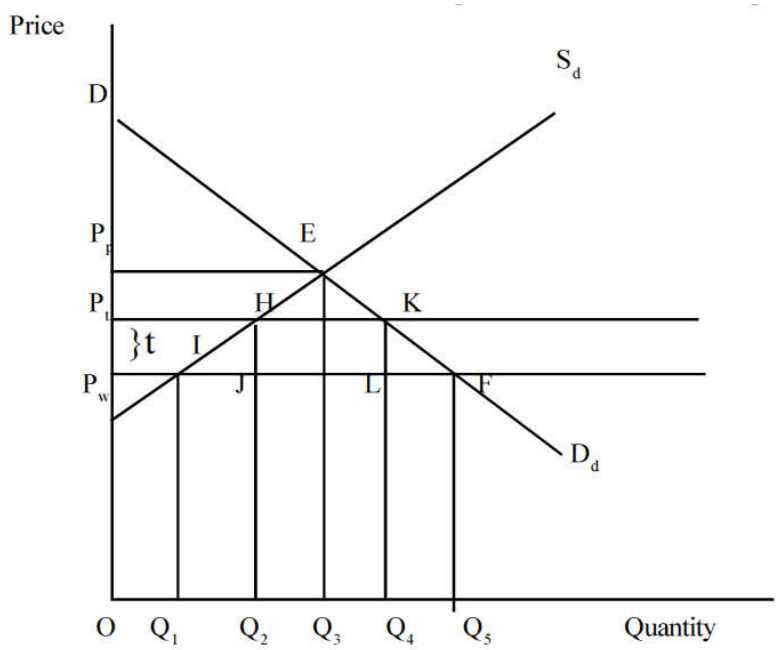
including or excluding the transport charges. For example, if the value of a Japanese car is Rs.2,50,000/- and if a duty of 10% is imposed, the importer has to pay Rs.25,000/- as ad valorem duty. A **Specific Duty** is a fixed sum of money imposed per unit of the commodity imported or exported. For instance, an Indian importer of Japanese car needs to pay Rs. 25,000/- as import duty per car. **Compound Duty** is the combination of ad valorem duty and specific duty. For instance, an Indian importer of Japanese cars needs to pay Rs. 15,000 plus 5% of the value of the car imported.

6.3.1 Effects of Tariff

The first and foremost effect of imposition of a tariff is the rise in the domestic price of the imported commodity to the full extent of level of tariff. As a result, the level of consumers' surplus enjoyed by the consumers falls. The imported commodity will become uncompetitive in the domestic market. The demand for imports falls and consequently consumption of imported commodity falls. It will also give incentive for the domestic producers of the imported commodity to expand their production levels. The domestic production increases and they can charge a higher level of price for the commodity there by the producers get more surpluses. Most importantly, the government gets tariff revenue on the reduced level of imports into the country. All these effects are illustrated in Diagram 14-1 where a partial equilibrium analysis of domestic and supply curves of an imported commodity say cloth is represented. In the diagram, D_d stands for domestic demand and D_d stands for domestic supply curve. P_w represents the world market price for cloth. It is perfectly elastic indicting the fact that any amount of the commodity can be purchased at the on going price of P_w. The domestic demand curve and the world market price intersect at point D. This gives the total amount of domestic demand or consumption of the commodity that is cloth at the world market price P_w. Thus the total demand is OQ_5, Out of this OQ_1 is produced domestically and the rest Q_1Q_5 is imported from abroad. Let us suppose that the country under question imposes a non-prohibitive tariff of 't'. This raises the domestic price of the imported commodity to P_t. If a higher level of tariff say P_p is imposed it will take the price to OP_p, where domestic demand and domestic supply would be equal and hence imports are completely prohibited. Such a tariff is known as prohibitive tariff. Let us consider the effects of the non-prohibitive tariff level of 't'.

As stated already, after imposition of tariff, the domestic price of imported commodity cloth increases from OP_w to OP_t. Consequently the domestic consumption falls from OQ_5 to OQ_4. Domestic production increase from OQ_1 to OQ_2. Imports of cloth into the country fall from Q_1Q_5 to Q_2 Q_4. The government gets tariff revenue equal to the area HJLK (Q_2 Q_4, the imports multiplied by the per unit tariff 't').

Diagram –6.1
Effects of Non-prohibitive Tariff: Partial Equilibrium Analysis



A tariff involves costs to the society and it is known as costs of protection. Let us examine this cost of protection in detail. We know that the area below the demand curve and the actual price line represents consumers' surplus. The imposition of tariff 't' and the consequent rise in the price of the imported commodity results in the fall of consumers' surplus from P_wDF to P_tDK, that is to the area equal to $P_w P_tKF$. This total fall in the consumers' surplus can be divided into different components as detailed below. Part of this consumers' surplus (HJLK) goes to government in the form of tariff revenue. Another part of the consumers' surplus equal to the area P_wP_tH goes to producers in the form of producers' surplus. This leaves the two triangles IJH and LFK unaccounted for and these two triangles together measure the cost of protection to the society as a whole. The first of these two triangles viz., IJH indicates the **Production Cost of Protection.** If the country had imported the quantity Q_1Q_2 instead of producing the same at home, its cost would have been only Q_1Q_2 JI and not Q_1Q_2 HI. In other words, the quantity Q_1Q is produced inefficiently with an additional cost of IJH in the domestic market. The economic argument is that if the country had used resources equal to Q_1Q_2 JI only in the export market it would have produced enough export goods so as to enable to buy Q_1Q_2 and it need not waste additional resources equal to the area IJH.

The second triangle LFK measures the **Consumption Cost of Protection. A** tariff will raise the price of the good in question in relation to other goods giving rise to distortions in consumption. The consumption falls from OQ_3 to OQ_4. It could be observed from the Diagram that the international price of the commodity is only OP_w where as the consumer has to pay a higher price of OP_t for the same unit OQ_4 after the imposition of tariff. The size of the consumption cost is measured in terms of the area of the triangle LFK. These two triangles are called **Dead Weight**

Costs of protection because the consumers have lost their consumers' surplus once for all and nobody benefited as in the case of other two areas.

6.3.1 Other Effects of Tariff

In the preceding partial equilibrium analysis it was assumed that the price of the commodity increased to the full amount of the tariff. When tariff is imposed the price of the imported commodity decreases in the domestic market leading to fall in domestic demand for the good and the consequent fall in the demand for imports. When the imports fall, the foreign exporter of the commodity would like to recapture at least the part of the lost market by decreasing the price of the export commodity. This means the fall in the price of the imported commodity in the tariff imposing country. This would improve their net barter terms of trade where the net barter terms of trade is defined as the ratio of export price index to import price index multiplied by 100. This effect is called the **Terms of Trade Effect**. The terms of trade of the tariff imposing country would always increase except in the limiting case where the foreign supply elasticity of the exporting country is infinitely large. When the foreign supply elasticity is very large, the foreign producers would easily shift their factors of production from the production of the commodity on which tariff is imposed to other commodities on which there are no tariffs. Thus there is no possibility for the improvement in the terms of trade of the tariff imposing country. On the contrary, when the foreign supply elasticity is relatively inelastic, there will be very large improvement in the terms of trade of the tariff imposing country. This is because the foreign producers would not be able to shift the factors of production from the production of tariff-ridden commodity to other commodities. There by they have to reduce the price of the commodity on which tariff is imposed resulting in very large improvement in the terms of trade of the tariff imposing country. Another important effect of imposition of tariff is shifts in the income distribution. As theorized by Stolper and Samuelson, imposition of tariff increases the real income of the factors of production engaged in the import-competing industries both in absolute and relative terms. In other words, as a result of imposition\ion of tariff income distribution shifts in favour of the factors of production employed in the import competing industries and away from the factors of production employed in the export industries. This is known as **'Income Redistribution Effect'** of tariff. The distortions introduced in production and consumption may result in inefficiency and thereby national income may fall in the tariff imposing country. This is known as **'Income Effect'** of tariffs. As a result of imposition of tariff a small county consumes inside the free trade consumption possibility frontier but outside the production possibility frontier. A tariff on imports clearly lowers national well-being and costs consumers more than it benefits producers and the government. Some times the foreign governments may retaliate to a tariff imposed by a country and they in turn impose tariff. This retaliation may improve the terms of trade of the retaliating country but it would result in fall in the volume of trade. The first country finding that its terms of trade once again deteriorated may again impose a tariff to improve its own terms of trade. This would improve the terms of trade for the country but may result in fall in the volume of trade. This retaliation and counter retaliation may continue until the trade extinct and the countries return to an autarkic situation where there will be no trade at all. This is called **'The Trade Effect'** of tariff.

Check Your Progress:
What is a tariff? What are different types of tariff?

_____
_____
_____
_____
_____
_____

What are the dead weight costs of protection? Why they are called so?

_____
_____
_____-
_____
_____
_____

6.4 QUOTAS

Another important and powerful weapon of protection in the hands of governments is an import quota. A quota is a limit on the total quantity of imports allowed into a country each year. In practice quotas may be fixed either in physical or monetary terms. The time period may also vary from country to country. Quotas have the following objectives: 1. to reduce the level of imports so as to protect the domestic industries, 2. to correct the balance of payments deficits and 3. to regulate imports in an effective manner, 4. to retaliate against the countries pursuing restrictive trade policies like imposition of tariff and quota, 5. to check speculative imports in anticipation of tariffs, 6. to maintain and stabilise domestic price level and 6. to expand domestic employment and economic activities. A quota is an emergency and effective devise in the hands of executives to control imports. Using some method of distribution, the government gives out a limited number of licenses to import the good legally and prohibits imports without a license. As long as the quantity of imports licensed through quota is less than the quantity the people want to import without quota, the quota will have the effect of not only cutting the quantity imported but also result in increase of domestic price of the imported commodity above the world market price. In this respect a quota is similar to the tariff. Many a time, an import quota is preferred to tariff for several reasons. Firstly, an import quota insures against foreign competition. If foreign products are more competitive, there may be further fall in the price of the imported commodity and hence both the quantity of imports and value of imports (if our import demand is elastic) will rise. On the other hand, if quota limit is fixed, even in the presence of extreme foreign competitiveness, our imports will not fall but only result in fall in the expenditure on imports. If imports do not fall as a result of imposition of tariff, it will complicate the official forecast of import demand and will have problems on the balance of payments front.

6.4.1 Types of Quota:

There are five major types of quotas, viz., 1) tariff or custom quota, 2) unilateral quota, 3) bilateral quota, 4) mixing quota and 5 import licensing. A **Tariff Quota** or C**ustom Quota** is a widely used method. Under this system, imports up to a specified quantity are allowed duty free or with moderate duty. Imports beyond this physical limit will attract a higher level of

tariff. Thus the tariff quota combines the features of tariff and quota. Under **Unilateral Quota** system, a country fixes an absolute limit on the importation of a commodity without any intimation to the trade partner countries. The quota so fixed may be either global or allocated to different countries or regions. Under the global quota, the goods may be imported from any country. But under allocated quota system the total quantity of imports is allocated among the trading partners. Under **Bilateral Quota** system, imports to different trading partners are allocated after having bilateral discussions with them. This system is less arbitrary and hence attracts less resistance from the exporting countries. Under **Mixing Quota** system, domestic producers who want to import imported components or raw materials, are required to utilise certain proportion of domestic raw materials along with the imported components to produce finished products. Actual users concept in India is the best example of mixing quota. This system helps the producers of domestic raw materials and also to save the scarce foreign exchange. Import Quota regulations are generally administered through import licenses. Under this system prospective importers are required to obtain a license from the concern authorities for importing any quantity within the specified quota. Import licenses are generally auctioned in the market. Some times they are distributed among the established importers based on their share in the total imports in the previous years.

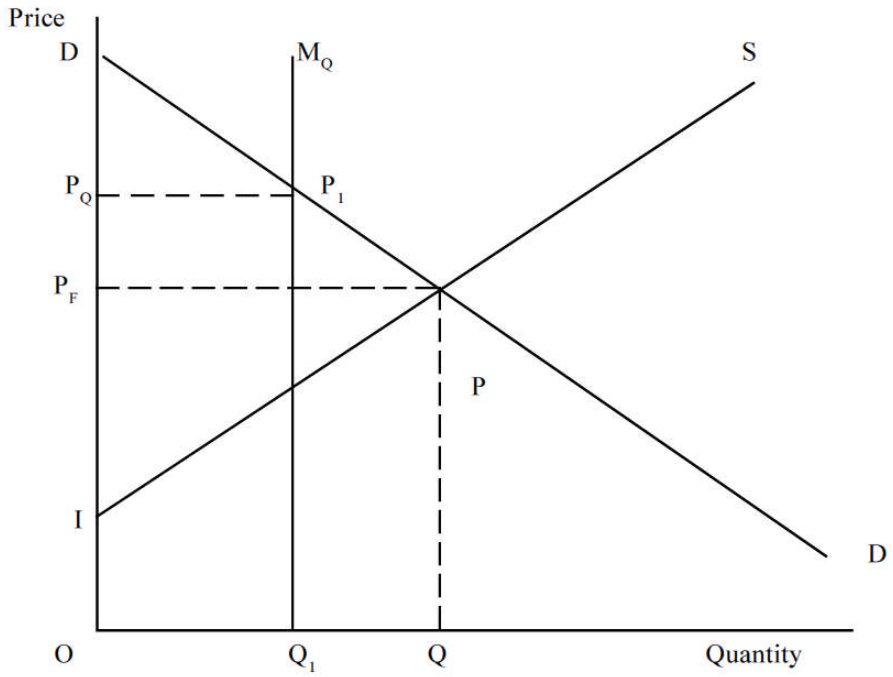
6.4.2 EFFECTS OF QUOTAS:

The effects of quotas are similar to the effects of tariffs. But the methods of tariff and quota are different. A tariff affects the price directly and quantity indirectly. Quota, on the other hand, affects the quantity directly and price indirectly. Both tariff and quota raise price and restrict imports. So they have similar effects on production, consumption, trade-balance, terms of trade, domestic prices, national income, redistribution of income, factor movements, economic growth and welfare. The equivalence of effects of tariff and quota critically depend on market conditions. That is whether there are perfect competition or monopoly elements.

6.4.2.1 Price Effect:

As noted already, a quota has an effect of raising the domestic price of the imported good so long as the quantity of imports allowed into the country is less than the quantity that people want to import without quota. The range of price rise in the case of tariff will be between the level of tariff and any reduction in the price of the good abroad. But the range of the price rise in the case of quota is very difficult to ascertain. The level of price rise due to quota depends upon several factors such as 1) the degree to which imports are restricted, 2) degree of elasticity of domestic and foreign supply curves and 3) degree of elasticity of domestic demand curve. The effect of quota on the price of the imported commodity can be explained in terms of Diagram 6.2.

Diagram 6.2
Effect of Quota on the Price of the Imported Commodity



In the Diagram domestic demand and supply curves are represented in a partial equilibrium framework. The free trade equilibrium price, OP and equilibrium quantities, OQ are given by the intersection of domestic demand and supply curves. If the importing country fixes a quota of OQ_1, then supply becomes inelastic from the point N. Given the demand curve, DD, the price rises to OP_Q. Thus the price under quota will be different from that under free trade situation.

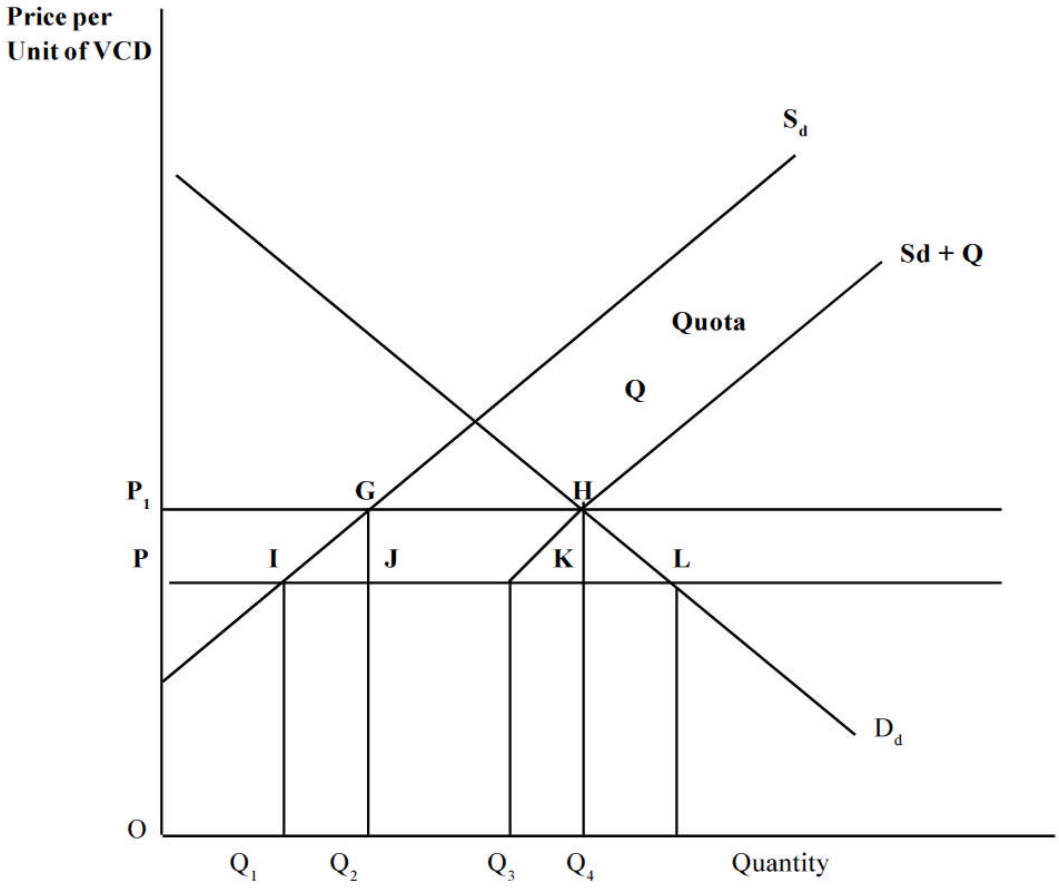
6.4.2.2 Production and Consumption Effects of Quota:

The effects of quota are similar to the effects of tariff when there is perfect competition in the domestic import competing industry. In order to illustrate this point, consider Diagram 6.3 In the Diagram D_d and S_d are the domestic demand and supply curves. Assume that OP is the world market price for the commodity, say VCD. At this price, OQ_1 is the domestic supply, OQ_4 is the domestic demand. Now let us assume that the country fixes a quota of 'Q'. Consequently, domestic buyers face the supply curve that is equal to the domestic supply, OQ plus fixed quota, 'Q'. Their inability to buy as much as they want at the world market price drives up the price of the commodity in the domestic market to OP_1. At this level of price, the welfare effects of tariffs and quotas are similar.

The domestic production increases from OQ_1 to OQ_2. The additional quantity is produced at a very high cost when they could have imported the same at a lower price. The production cost of protection equals to the area IJG. The consumption cost of protection as defined earlier equals to the area KLH. The consumer surplus equals to the area JKHG is redistributed from

consumers to who ever commands the import licenses. Therefore, the net loss to the society again equals to the areas IJG and KLH. In this respect the effects of tariffs and quotas are similar. A quota is worse than the tariff when quota creates monopoly power and when the import licenses are distributed inefficiently.

Diagram 6.3
Effects of Quota- Partial Equilibrium Analysis



6.4.3 DIFFERENCES BETWEEN TARIFFS AND QUOTAS:

There are major differences between tariffs and quotas in their effects. These are discussed in the following pages:

6.4.3.1 Scarcity Rent:

Quotas attach scarcity rent. If government charges fee for the distribution of licenses or auctions off licenses to quota holders, the government would get revenue. That revenue may be used to incur social welfare expenditure. In that respect a quota is similar to the tariff in its effects. On the other hand, if government distributes quotas freely, or in a haphazard manner, then the scarcity rent attached to quota will go to the importers or exporters depending on the market conditions. If the importers have a monopoly of trade and exporters are un-organised,

the importers will get the increased price or the scarcity rent. On the other hand, if exporters are organised and importers are not, the exporters will get the increased price. The terms of trade will go against the importing country.

:

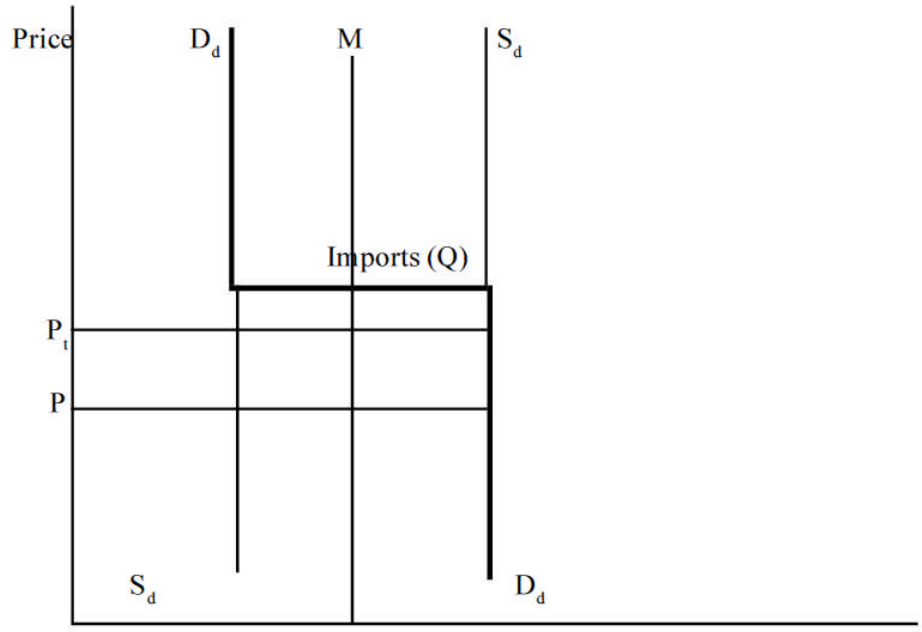
6.4.3.2 Terms of Trade Effect:

The terms-of-trade effect of tariffs is predictable. But the terms-of-trade effect of a quota is indeterminate. The imposition of quota may improve or deteriorate the terms of trade of the quota imposing country depending upon the elasticity of the offer (supply) curve of the partner country. If foreigners are well organised and their offer (supply) curve is less elastic, then the terms of trade of the quota imposing country may go against it.

6.4.3.3 Quotas are more effective than Tariffs:

Quotas are more effective than tariffs particularly when the domestic demand and supply curves for the imported good are inelastic as shown in the Diagram 6.4. In the Diagram D_d and S_d are the domestic demand and supply curves. It should be noted that the imports are the difference between domestic demand and domestic supply. When the domestic demand and supply curves are inelastic any amount of tariff will fail to reduce the quantity of imports which will stay at "Q" level. However, quotas will succeed to curtail imports at a level such as OM if necessary.

Diagram 6.4
Effectiveness of Quotas compared to Tariffs



6.4.3.4 Inelastic Supply Curve Abroad:

A country would find it difficult to limit imports through tariff if elasticity of supply of the goods abroad is less than unity. In that case there will be large improvement in the terms of trade. But the volume of imports will not fall. This will make difficult to protect the domestic import competing industry. Under such circumstances quotas are generally used to limit imports and to protect the domestic industry. Quotas were used in 1930s in France to limit agricultural imports as they face inelastic supply especially in the short run.

6.4.3.5 Effective Protection against Dumping:

If foreigners practice price discrimination and dump exports at prices lower than in the domestic market, use of tariff will not be useful. Quotas will help to restrict imports under such a circumstance.

6.4.1.6. Administrative Convenience:

From the administrative point of view quotas have a high flexibility. They are easy to impose, remove, change and administer. International attitude is more permissive on quotas than on tariffs, especially for emergency cases.

6.4.3.7 Potential Monopoly:

If tariffs were used to limit imports, the foreign goods would be freely permitted into the country at tariff inclusive price. Even the sole domestic producer would charge only international price plus tariff. If he attempt to charge more prices, he will lose additional sales to the importers. In other words, the domestic monopoly producer is still price taker. On the other hand, if quotas are used to limit imports, they will prohibit or curtail imports and raise the domestic price. The domestic producer is secured from foreign competition and there is a tendency for the development of monopoly. In other words, change of a tariff into quota without reducing the existing volume of imports may convert a potential monopoly into an actual one.

Check Your Progress:

What are different types of quota?

_____
_____
_____
_____
_____
_____

Why a quota is considered to be a better alternative than an equivalent amount of tariff?

_____
_____
_____
_____

6.5 LET US SUM UP:

Free trade according to the doctrine of Comparative Cost Difference is considered to be the first best policy. Yet the special problems of some countries particularly the developing ones make the free trade unsuitable and unsustainable policy. There are many convincing economic and non-economic arguments for protection, the most important being the Infant Industry argument. Tariffs and quotas are the two mostly widely used protective measures even though production subsidies are not uncommon. An import tariff creates several effects. Some are re-distributive and others are dead weight in nature. The most important dead weight losses are production cost of protection and consumption cost of protection where by distortions in production and consumption are created. A tariff also improves the terms of trade of the tariff imposing country except when the country faces perfectly elastic offer curve. Quotas are more effective method than the tariffs to restrict imports. The effects of quotas are similar to that of tariff. But under quota a sole domestic producer may become an actual monopoly.

6.6 KEY WORDS & CONCEPTS:

Tariffs : A tax on imports and exports levied and collected when goods cross the national boundaries.

Quotas : A limit on the absolute quantity of imports allowed in to the country.

Infant Industry Argument : Extending protection to the infant domestic industry until the domestic firm is sufficiently grown so as to reap the economies of scale.

The ad valorem duty : Levying tax according to the value of the product imported.

Specific Duty : A Specific Duty is a fixed sum of money imposed per unit of the commodity imported or exported.

Compound Duty : Compound Duty is the combination of ad valorem duty and specific duty.

Tariff Quota or Custom Quota : Under Tariff Quota or Custom Quota imports up to a specified quantity are allowed duty free or with moderate duty. Imports beyond this physical limit will attract a higher level of tariff.

Unilateral Quota : Under Unilateral Quota system, a country fixes an absolute limit on the importation of a commodity without any intimation to the trade partner countries.

Bilateral Quota : Under Bilateral Quota system, imports to different trading partners are allocated after having bilateral discussions with them

Mixing Quota : Under mixing quota system, domestic producers who want to import imported components or raw materials, are required to utilise certain proportion of domestic raw materials along with the imported components to produce finished products. Actual users concept in India is the best example of mixing quota.

6.7 BOOKS FOR FURTHER READING:

1. Soderstein, Bo & Geofray Reed (1995), *International Economics*, 3rd Edn., London: Macmillan.

Chacholiades, M. (1990), *International Economics*, Houndmills: McGraw Hills.

Mannur, H. G. (1983), *International Economics*, New Delhi: Vikas Publications.

Pugel, Thomas A. & Peter H Lindert, (2000**), *International Economics,*** New York: Irwin Mc Graw-Hill.

Mithani, D.M. (1999), ***International Economics,*** Mumbai: Himalaya Publishing House.

6.8 QUESTIONS AND EXERCISES:

Answer the Questions in about 15 lines.

1. What are arguments for protection?
2. What are the different types of tariff?
3. What are the different types of quotas?

Answer the Questions in about 30 lines.

1. Examine the economic and non-economic arguments for protection.
2. State and illustrate the Infant Industry argument for protection
3. Examine the effects of tariff using partial and general equilibrium analysis.
4. Compare and contrast the effects of tariffs and quotas.

******

Lesson No. 7

Types and Theories of Foreign Exchange Rates

7.0 AIMS AND OBJECTIVES

After reading this lesson you will be able

- to know the meaning of the concept of foreign exchange, foreign exchange market and foreign exchange rate;
- to explain the different types of exchange rates that are in vogue in international financial market;
- to describe the functions of the foreign exchange market in modern days;
- to appreciate how the foreign exchange rate is determined under gold standard and the Mint Parity theory of exchange rates;
- to understand the determination of exchange rates under the conditions of inconvertible paper currency standards or the Purchasing power parity theory;
- to analyse the determination of equilibrium exchange rates under free market conditions;
- to elucidate the current exchange rate system.

STRUCTURE

7.1 INTRODUCTION:

One of the distinguishing features of international business is involvement of different currencies. In the case of trade within a country, a single currency is involved. Whether a trader in Tamil Nadu has to pay a trader in Nagaland or Sikkim or Kashmir or Rajasthan, the same currency that is Rupee is involved. But, a trader in Rameswaram is to make a payment to a trader in the neighboring Jaffna in Sri Lanka, he cannot use Rupee. He has to convert the Indian rupee into Sri Lankan Rupee and settle the transactions. Thus the distinguishing feature of international trade is involvement of different currencies or more particularly the foreign exchange. What is foreign exchange? By foreign exchange we mean foreign currencies or

more commonly foreign money balances. It includes all monetary instruments, which will give residents of one country a financial claim on another country. Foreign exchange may also refer to the sale and purchase of foreign currencies. In a wider sense, foreign exchange refers to the whole exercise or mechanism by which two countries clear off their trade and balance payments. It relates to the Institutional structure that facilitates foreign payments, the mechanism followed to make international payments and the rate at which the currency of one country is converted into the currency of the other country. According to S.E. Thomas "foreign exchange is that branch of economics which seeks to determine the principles on which the peoples of the world settle their debts one to the other". Foreign exchange is a system whereby different nations clear of their international obligations. According to S.J. Chapman" the machinery whereby payments are effected in international trade is known as foreign exchange". In other words, foreign exchanges are a mechanism by which international indebtedness is settled between one country and another. A country's demand for and supply of foreign exchange provide the basis for the determination of exchange rate. What is foreign exchange rate? It is the rate of exchange or the rate at which the currency of one country is converted into the currency of any other country. Foreign exchange rate or simply exchange rate is the ratio between the values of two currencies. In other words, foreign exchange rate is the price of one unit of the foreign currency expressed in terms of domestic currency. For example if $1 = Rs.47/- or £1= Rs.76/-. Conversely we can also express the foreign exchange rate between rupee and dollar as Re. 1=$1/47 or Re.1 = $0.021 and the foreign exchange rate between rupee and pound sterling as Re.1=£1/76 or Re.1= or £ 0.013. Since it may create confusion, the foreign exchange rate is always expressed as the price of one unit of the foreign currency (dollar) expressed in terms of the domestic currency (rupee).

7.2 TYPES OF EXCHANGE RATES

There are as many exchange rates as there are currencies traded. Even in between two currencies, there may be different types of exchange rates. The following are the major types of foreign exchange rates that are in the literature of international business.

i). Spot rate and Forward rates of exchange;
ii). Buying and selling rates;
iii). Single and multiple rates of exchange;
iv). Fixed, flexible and floating rates of exchange;
v). Market rate and equilibrium rate of exchange.

7.2.1 Spot and Forward Rates of Exchange

The spot rate of exchange is quoted for the immediate delivery of foreign exchange. It is distinguished from the forward rate, which is quoted for the delivery of foreign exchange at a future date. The spot rate of exchange is also known as the cable rate. Forward rate refers to the rate at which a future contract for selling or buying is made. The forward rate may be quoted either at premium or at discount of the spot rate. Premium implies that the foreign currency is more expensive in future and has a higher price than the spot rate. Discount, on the other hand, implies that foreign currency is cheap and will be available at a lower rate than the spot rate in future. You will know more about the spot and forward deals for the purchase and sale of foreign currencies in Lesson –10.

7.2.2 Buying and Selling Rates of Exchange

When a government is under the regime of exchange controls, the government or the central bank of a country may fix different rates for buying and selling of foreign currencies. The buying

rate of exchange is slightly lower than the selling rate. The difference between the two rates will constitute the profit margin for the foreign exchange dealer. For instance as on December 24, 2003 the buying rate of US dollar was Rs.45.37 and the selling rate of the same was Rs. 45.68. Similarly the buying rate of Pound sterling was Rs.80.04 and the selling rate of the same was Rs.80.63. The difference of Rs.0.31 in the case of U.S. dollars and Rs.0.59 in the case of pound sterling constituted profit margin for the dealers in the foreign exchange.

7.2.3 Single Rate and Multiple Rates of Exchange

Generally the government of a country adopts a single rate vis-à-vis another country. But it may also have more than one rate depending on the circumstances. There may one rate for exports and another rate for imports. There may also be yet another rate for capital transactions. Some times different rates may be fixed for obtaining foreign exchange meant for imports of different types of goods such as essential goods, luxury goods, capital goods etc. From the point of view of economic efficiency, a single rate of exchange is preferred over multiple rates of exchange. The multiple rates of exchange are discriminatory and are not conducive to promote international monetary cooperation.

7.2.4 Fixed, Flexible and Floating Rates of Exchange

Fixed exchange rate refers to the rate, which is fixed in terms of gold or in terms of a foreign currency or in terms of a basket of currencies, which have fixed value in terms of gold. Flexible exchange rates refers to keeping the exchange rates fixed over a short period but allowing it change from time to time according to the changing conditions of demand for and supply of foreign exchange. Floating exchange rate is that which finds the natural price of the currency in accordance with the demand and supply conditions in relation to a foreign currency. The currency of a country freely fluctuates and finds its own level in the foreign exchange market. There may be absolute or free floating or managed floating in which the authorities concerned intervene to influence the demand and supply conditions.

7.2.5 Market Rate and Equilibrium Rate of Exchange

The market rate of exchange is a short-term rate of exchange that prevails in the market. It reflects the influence of forces of demand and supply for foreign exchange in free exchange market. But it has a tendency to fluctuate around normal rate called the equilibrium rate. The equilibrium rate, according to Ragnar Nurkse, is the rate that over a certain period maintains the balance of payments in equilibrium without any net change in the international currency reserves.

7.3 ROLE OF FOREIGN EXCHANGE OR FUNCTIONS OF FOREIGN EXCHANGE

Foreign Exchange market in a country performs several economically useful functions. It transfers the purchasing power from the residents of one country to that of another country who are involved in international business. In other words, the foreign exchange market acts as a clearing agent of international business transactions. Secondly, foreign exchange market provides credit for international business. This credit function is considered to be very important. Thirdly, foreign exchange market provides hedging facility to the exporters and importers in order to avoid the risk arising out of fluctuations in the foreign exchange rates. Fourthly, it is by means of exchange rates the domestic prices are transformed into the foreign

prices and vice versa. Fifthly, it greatly influences the flow of international investments and capital flows. Sixthly, the foreign exchange rates make the international comparison of costs and prices possible. Seventhly, it regulates the flow and direction of foreign trade. Lastly the changes in exchange rates bring about changes in the balance of payments as revealed by the Marshall-Lerner condition.

Check Your Progress:

Distinguish between Spot and Forward Rates of exchange.

_____
_____
_____
_____
_____
_____

What does that make the difference between the buying and selling rates of exchange?

_____
_____
_____
_____
_____
_____
_____

7.4 THEORIES OF FOREIGN EXCHANGE

Theories of foreign exchange rates explain how the foreign exchange rates of different currencies are determined. The method of determination of exchange rates largely depends on the nature of monetary system that prevails in a country. Under the gold standard, the exchange rates between the currencies of different countries are determined by the metallic equivalent of their respective currencies. The theory that explains the determination of exchange rates under the gold standard is known as the 'Mint Parity' Theory of Exchange. When the gold standard disappeared from the world due to some several reasons, many countries switched over to inconvertible paper currency standards. Under this monetary system, the purchasing power of each currency vis-à-vis other currencies determines the exchange rate between the currencies. This theory is known as purchasing power parity theory. Once the rate of exchange between any two currencies is determined the changes in their exchange rates are largely determined by the demand for and supply of foreign exchange rates. Accordingly, in this chapter we shall learn these three major theories of foreign exchange rates.

7.4.1 Mint Parity Theory of Exchange

In order to understand the mint parity theory of exchange, first we should know about the international gold standard and the working of gold standard. The gold standard emerged slowly in during the 19^{th} century. It was well established by 1870. The gold standard was at its peak level during the period from 1870 to 1914. The system collapsed in many countries of the world during the period 1914-25. Some countries like United Kingdom strived to revive it during 1825 but the system witnessed its final collapse during 1930. What is a gold standard? Under gold standard the currency unit of a country is expressed in terms of a specified weight of gold and the volume of the currency in the country is made dependent on the volume of gold reserves. The countries participating in the international gold standards have to observe certain golden rules of gold standard. These golden rules are as follows:

i) All the participating countries have to legally define the unit of account (currency) in terms of gold;

ii) They have to establish a mechanism whereby their local currencies are kept equal in value to gold and to each other;

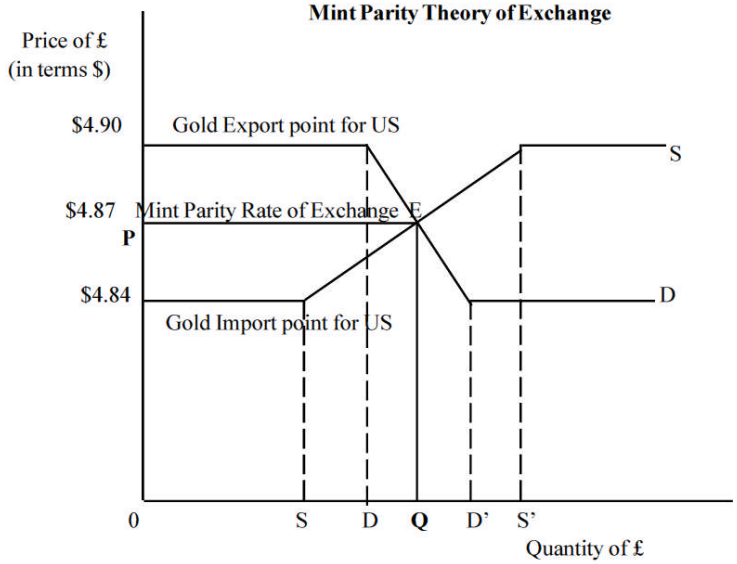
iii) The countries have to fix the exchange rates of their currencies through the medium of gold; and

iv) Their monetary authorities should be willing to buy and sell gold at fixed price in unlimited quantities.

What is Mint parity?

Under gold standard, a British gold sovereign or a Pound Sterling (£) contained 113.0016 grains of pure gold. The United States dollar in turn contained 23.22 grains of pure gold. As both the countries were under the gold standard, their currency units were tied to gold. It implies that £1=113.0016 = $1=23.22 or 113.0016 / 23.22 £1=$4.87. Thus a pound sterling is equal to 4.87 dollars. This exchange rate is known as Mint Parity exchange rate as the metallic equivalent of the respective currencies determined it. Under gold standard the mint parity rate of exchange would remain stable, or fixed forever. Hence, the gold standard was a system of fixed exchange rates. However, the dollar could fluctuate between an upper gold point of 4.90 and a lower gold point of 4.84. These upper and lower limits were determined by the cost of transporting a pound sterling equivalent of gold from New York to London. The Mint Parity theory of exchange is illustrated in terms of Diagram 7.1. In the Diagram the price of foreign exchange (£) in terms of domestic currency (i.e., U. S. dollar) is represented in the vertical axis. The quantity of foreign exchange (i.e., £) is represented in the horizontal axis. Point E provides the equilibrium or mint parity rate of exchange at £1=$4.87. This rate of exchange would remain fixed or constant forever. Even if the demand for foreign exchange (£) rises or falls this rate of exchange would be the fixed one. However, the rate of exchange could fluctuate from the lower gold point of £1=$4.84 to the upper gold point of £1=$4.90 depending upon the changes in the current demand and current supply conditions. However, the exchange rate could never rise beyond the upper gold point of £1=$4.90 and the lower gold point of £1=$4.84. If there is a persistent demand for £ at the upper gold point, instead of rise in the exchange rate, there will be outflow of gold from the United States and hence this point is known as gold export point for the United States. Similarly, if the exchange rate falls beyond the level of £1=$4.84, then there will be inflow of gold into the United States instead of further fall in the exchange rate. To illustrate these points let us assume a hypothetical situation. Assume that there is a persistent deficit in the balance of payments of the United States due to excess imports over exports.

Diagram –7.1
Mint Parity Theory of Exchange



This will lead to increase in the demand for foreign exchange (£) in United States and hence the price of foreign exchange (£) will increase in United States. This excess demand for foreign exchange over and above the supply would result in the increase of price for foreign exchange. That means the importers in the United States have to pay more dollars per unit of pound sterling. But they will not be inclined to pay more than $4.90 per unit of pound sterling. If they have to pay more than this, then they will buy gold from the Federal Reserve Bank of United States at the official price of one-pound sterling equivalent of gold (113.0016 grains) at $4.87 and transport the same to Britain with a transport cost of 3 cents. Thus the total cost of per unit of pound sterling would be only $4.90. In Britain the British Central Bank is committed to buy gold at the official price of $4.87 equivalent of gold (113.0016 grains) for one Pound Sterling. Thus the gold will be converted into pound sterling to pay for the exporters in the United Kingdom. Hence, rate of foreign exchange will not rise beyond £1=$4.90. Similarly, if in the United States the price of foreign exchange falls beyond the level of £1=$4.84, then the U. S. exporters would convert their sterling earnings into gold in Britain at the official price and transport the same to United States with a cost of 3 cents per pound sterling-equivalent of gold. The gold will be converted into U. S. dollars at the Federal Reserve Bank at the official price. Thus there will be no loss to the U. S. exporters. Hence, this point of £1=$4.84 is known as gold import point for the United States. As could be seen from the Diagram the supply curve of foreign exchange became perfectly elastic at the upper gold point or the gold export point. This means that any increase in demand for pound sterling beyond this level would not result in the rise in the price of pound sterling. Similarly, if the demand for pound sterling in United States falls beyond the level of £1=$4.84, there will be import of gold rather than further fall in the price of pound sterling. Thus the Mint Parity rate of Exchange is a fixed exchange rate.

The Mint parity theory presupposes the existence of gold standard and the strict observation of the golden rules of the gold standard by the participating countries of the gold standard. The gold standard and the related fixed exchange rate system necessitates the countries to sacrifice the internal stability for the sake of external stability or stability in the foreign exchange and balance of payments. Due to inflow and outflow of gold from the countries, the related economic variables like money supply, rate of interest, investment, production, income and price levels in the countries would get disrupted and hence the internal stability is to be sacrificed. This was not agreeable to the nationalistic conscious countries. This led to the break down of the gold standard in the world during early 1930s. Many countries went to the system of inconvertible paper currency standards.

7.4.2. PURCHASING POWER PARITY THEORY

As noted already, after the First World War many countries abandoned the unlimited buying and selling of gold at fixed price and adopted inconvertible paper currency standards. A question that arises in this connection is that under the system of inconvertible paper currency standard what determines the exchange rates between the currencies of different countries. The answer is that in the long run, the relative purchasing powers of the two currencies in terms of the amount of goods and services they purchase would determine the exchange rate between the two currencies. This theory is known as 'Purchasing Power Parity Theory of Foreign Exchange". Among the theories of foreign exchange rate, purchasing power parity theory is considered to be an important theory of foreign exchange. It was John Wheatley who first stated the purchasing power parity theory of foreign exchange in an abstract form in 1803. In 1810 William Blake formulated this abstract theory in a definite form. Later David Ricardo improved it. However, it was Gustav Cassel, the Swedish economist who developed the purchasing power parity theory in a systematic way in an article published in Economic Journal in 1918. Hence, the purchasing power theory is generally associated with Gustav Cassel. According to Gustav Cassel "the rate of exchange between two currencies must stand essentially on the quotient of the internal purchasing powers of these currencies". This rate of exchange determined on the basis of the relative price levels is said to be in conformity with the

purchasing power parity between the two currencies. According to G.D.H. Cole "The relative values of national currencies especially when they are not on gold standard, in the long run, are determined by their relative purchasing powers in terms of goods and services". The rate of exchange tends to rest at that point which expresses equality between the respective purchasing powers of the two currencies. In other word, according to the purchasing power parity theory, the rate of exchange between the currencies of the two countries should be in the same proportion as to the price levels in the two countries. This is called the purchasing power parity. This may be true in the long run. However, in the short run the rate of exchange between two countries can either be more or less than the purchasing power parity. It is believed that free international trade iron out the differences in the prices of traded goods across the countries and hence the price of the traded goods must be same in all countries if they are measured in a single currency. This led to the development of purchasing power parity theory of exchange rates. We know that the foreign prices are transformed into the domestic prices through exchange rate. That is

$$P_d = r_s * P_f \text{ or } \qquad r_s = P_d / P_f$$

Where P_d stands for domestic price, r_s refers to the spot rate of exchange and P_f denotes the price in foreign currency. Thus the exchange rate is the ratio of the domestic price to foreign price. The purchasing power parity theory assumed importance during the interwar period when the exchange rates were fluctuating widely. The theory was relegated to the background with the establishment of fixed exchange rates system under the supervision of IMF after the Second World War. When the floating exchange rates became the order of the day after 1973, the purchasing power parity theory once again gained importance.

7.4.2.1 Assumptions of the Purchasing Power Parity Theory

The purchasing power parity theory is based upon the following set of assumptions:

i. It assumes that there is a direct relationship between the purchasing power of currency units and exchange rate.

ii. It assumes that there is no difference between the prices of domestic goods and the prices of foreign goods.

iii. It assumes that the changes in the prices reflect the changes in foreign exchange rates.

iv. The changes in the prices encourage changes in the foreign exchange rates.

v. Changes in the foreign exchange rate influences the prices of different countries in different ways.

vi. International trade alone determines the demand for and supply of foreign exchange.

There are two versions of the purchasing power parity theory viz., absolute version and the relative version. The absolute version of the purchasing power parity theory explains the determination of ex change rates between two currencies at a particular point of time based on the purchasing powers of the two currencies. The relative version of the purchasing power parity theory explains the changes in the exchange rates between the two currencies over a period of time.

7.4.2.2 Absolute Version of the Theory of Purchasing Power Parity

The absolute version of the purchasing power parity theory can be illustrated with a simple example. For example, assume that a representative bundle of goods and services in India cost Rs.1000 in India whereas the same costs $20 in the United States. Then according to the purchasing power parity theory the exchange rate between rupee and dollar is Rs.1000/$20 = 50 or $1=Rs.50. This is the equilibrium rate of exchange under the purchasing power parity theory. Since the expenditure is the product of the quantity and the price, we may state the expenditure in each country as follows:

$P_I * Q\text{--}_I$ = Rs.1000 and $P_A * Q\text{--}_A$ = $20

Where P_I stands for unit price of the good in India, $Q\text{--}_I$ stands for quantity of goods purchased in India, P_A stands for unit price of the good in America and $Q\text{--}_A$ stands for the quantity of the good purchased in America. It should be noted that $Q\text{--}_I = Q\text{--}_A$ as the same quantity is purchased in both the countries. If the price level remains same in the two countries the purchasing powers of the currencies would also remain constant and hence, the rate of exchange between the two currencies would also remain constant. During the times of inflation, the purchasing power of paper currency declines, hence, purchasing power parity decreases leading to an increase in the exchange rate. On the other hand, during the times of deflation the purchasing power of paper currency increases. Hence, the purchasing power parity increases leading to a fall in the exchange rate. From this it is clear that exchange rate will not be stable, in countries under paper currency standards. The changes in the exchange rates of currencies are explained by the Relative version of the purchasing power parity theory.

7.4.2.3 Relative Version of the Theory of Purchasing Power Parity

The relative version of the purchasing power theory measures the changes or departures from the equilibrium rates of exchange. In other words, the relative version of the purchasing power parity theory states that how the exchange rate changes as a result of changes in the purchasing power of the currencies in the two countries. In fact, Gustav Cassel and others directed the purchasing power parity in early 1920s to show much the European countries have to change their national price levels in order to establish some desirable levels of foreign exchange rates when the First World War disrupted them. The purchasing power parity highlighted the mistake made by Britain in 1925 when it returned to the gold standard in the light of relatively higher levels of domestic inflation when compared to their trade parters. The new rate of exchange is the product of the old rate of exchange and the quotient of inflation in the two countries. That is,

$$R_1 = R_0 * \{[P_{I1} / P_{I0}] / P_{A1} / P_{A0}]\}$$

Where R_1 is the new rate of exchange between the two currencies, R_0 is the old rate of exchange, P_{I1} is the current year price in India, P_{I0} is the base year price in India, P_{A1} is the current year price in America and P_{A0} is the base year price in America. Now let us suppose that in the base year the price levels in India and America were the same that is 100. Now let us suppose that in India the price level rose from 100 to 300 whereas in America the same rose from 100 to 150. In other words, the inflation rate in India was the twice that in America. What would be the relative increase in the price level in India on the exchange rates? Substituting the values in the formula, we get

$$R_1 = R_0 * \{[P_{I1} / P_{I0}] / P_{A1} / P_{A0}]\}$$

$$= 50 * \{[300/100] / 150/100]\}$$

$$= 50 * 3/1.5$$

$$= 50 * 2$$

$$= 100$$

That is the price of foreign exchange has doubled from $1=50 to $1=100. Thus the double the inflation rate in India as compared to U.S. has resulted in the halving of the purchasing power of rupee and hence now India has to pay the twice the rupees to get one U. S. dollar. This means the depreciation of Rupee appreciation of dollar. Thus the purchasing power parity theory explains the effects of inflation on the rise in the exchange rates of the countries.

The empirical evidence obtained during the interwar period as well as during the post-1973 period broadly confirms the relationship between the changes in the purchasing power parity and the changes in the exchange rates. Over a long period from 1975 to 1998, a strong relationship was found for the purchasing power parity theory. The study made by Thomas A.Pugel, Peter H. Lindert incorporating the experiences of 20 developed countries, and 20 developing countries clearly supported the purchasing power parity theory.

7.4.2.4 Role of Money in the Determination of Purchasing Power Parity

The purchasing power parity theory reveals that at least in the long run exchange rates are intimately related to the levels of commodity prices in different countries. If it is so what determines the level of prices in national economies? No one would disagree with the answer that the money supply plays a crucial role in the determination of level of commodity prices and the changes in them. This implies that money supply in different countries through their links with price levels and inflation rates will have close association with the exchange rates of national currencies. According to Kindleberger and Lindert, analyzing the exchange rates without looking at national money supplies would be like playing **"Hamlet"** without the prince of Denmark. The quantity theory of money predicts that in equilibrium the supply of money will be equal to the demand for money, which is directly proportional to the value of the gross domestic product of the nation. The quantity theory equations for home country and the rest of the world becomes

$$M^S_h = K_h \times P_h \times Y_h$$

$$M^S_f = K_f \times P_f \times Y_f$$

Where M^S_h stands for money supply in the home county, K_h is the proportion of total output, which is kept in money form in home country, P_h is the price level in the home country and Y_h stands for GDP in the home country. The three variables on the right hand side relate to the money demand in the home market. Similarly, M^S_f stands for money supply in the rest of the world, K_f is the proportion of total output, which is kept in money form in the rest of the world, P_f is the price level in the rest of the world and Y_f stands for GDP in the rest of the world. The three variables on the right hand side ($K_f \times P_f \times Y_f$) relate to the money demand in the rest of the world. By taking the price variable to the left hand side in both the equations,

$$P_h = M^S_h / K_h \times Y_h$$

$$P_f = M^S_f / K_f \times Y_f$$

And finding the ratio of domestic prices to foreign prices and rearranging the variables, we get,

$$P_h / P_f = (M^S_h / M^S_f) \times (K_f / K_h) \times (Y_f / Y_h)$$

It should be noted that according to the purchasing power parity theory the spot rate of exchange is nothing but the ratio of domestic prices to foreign prices. That is $r_S = P_h / P_f$. Thus

$$r_S = P_h / P_f = (M^S_h / M^S_f) \times (K_f / K_h) \times (Y_f / Y_h)$$

The equation predicts that the domestic spot rate of exchange will depreciate (r_S will be up) if the domestic money supply relative to the foreign money supply (M^S_h / M^S_f) grows at a faster rate, or a fall in the preference for money holdings in domestic economy (K_f / K_h) or slower growth rate of output in the domestic economy (Y_f / Yh)

necessitating imports from abroad. We can also predict the percentage change in the exchange rates as a result of percentage change in these variables. Thus money supply plays an important role in the determination of price levels in the economy and there by the foreign exchange rates.

7.4.2.5 Criticisms of the Purchasing Power Parity Theory

The purchasing power parity theory has been criticized on several grounds. Firstly, it is argued that the measurement of the purchasing power of the currency units is very difficult because the construction of a good index number is very difficult. The same goods may not be included in the two counties for which the exchange rates are compared. Secondly, in many countries, apart from the purchasing power, exchange rates are influenced by the imposition of tariffs, quotas, and even exchange controls. Such measures break the direct and predictable relationship that exists between the purchasing power parity and the exchange rates. Thirdly, in many countries domestic prices change without affecting the exchange rates. This is because only internationally traded goods would affect the demand for and supply of foreign exchange and thereby the rates of foreign exchange. Commodities, which are not internationally traded, have no bearing on the exchange rates and hence their prices could fluctuate widely without influencing the foreign exchange rates. Fourthly, the theory predicts one-way causation between price levels and the foreign exchange rates. Some times the changes in the foreign exchange rates could also influence the domestic prices particularly in countries where the share of foreign trade is substantial. For instance, in predominantly open economics such as Japan and gulf countries depreciation of domestic currency will increase price of the imported goods substantially and if imports constitute for instance 50 % of GNP, they will increase the domestic prices by 50 %. Lastly, the theory ignores the changes in the demand for foreign exchange for invisible imports such as banking, insurance, shipping etc. Long-term investments, transfer of capital account interest, dividend payments and short-term speculative capital movements all will affect the exchange rates between currencies. In spite of these criticisms, the purchasing power parity is considered to be an important determinant of foreign exchange rates particularly during the period of fluctuating rates of foreign exchange.

Check Your Progress:

What is mint Parity?

_____
_____

What are the upper and lower gold points?

_____
_____
_____
_____
_____

What is the need for purchasing power parity theory of foreign exchange?

_____
_____
_____
_____

7.4.3. FREE MARKET THEORY OF FOREIGN EXCHANGE

In many market economies the rate of foreign exchange is determined in the foreign exchange market. Foreign exchange market consists of a number of banks, brokers, and dealers engaged in buying and selling of foreign

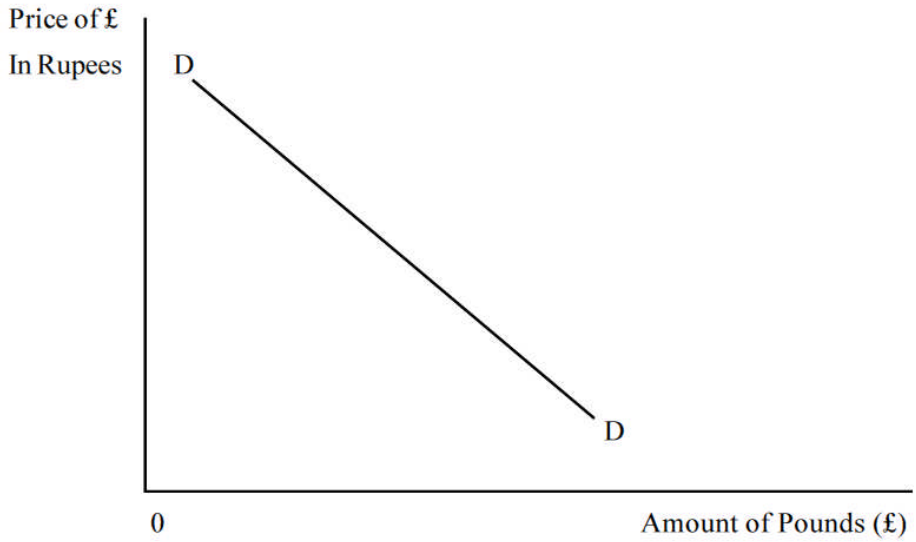
exchange. Occasionally the central banks of these countries also intervene in the transactions of foreign exchange market. However, in countries having strict controls on foreign exchange transactions, there is no foreign exchange market. Since, the days of controls and regulations are over, in many countries the forces of demand and supply determine foreign exchange rate. In these countries the Equilibrium exchange rate is determined at that level where the demand for foreign exchange is equal to the supply of foreign exchange. This rate of exchange is also called as normal rate of exchange or basic rate of exchange. This rate indicates the parity of exchange between the currencies.

7.4.3.1 DEMAND FOR FOREIGN EXCHANGE

To understand how the exchange rate between two currencies is determined and how the changes in the exchange rates come about, let us first derive the demand curve for foreign ex change. People in any country demand foreign currency for various reasons. Firstly, people may want to import goods from foreign countries. Secondly they may also want to invest in a foreign country or buy financial assets from foreign country. Or they may also want to pay back the loans that they have taken already. For all these transactions they need foreign exchange. The Indian demand curve for British Pounds, for instance, takes the usual negative slope as shown in Diagram 7.2.

Diagram –7.2

Indian Demand for British Pounds



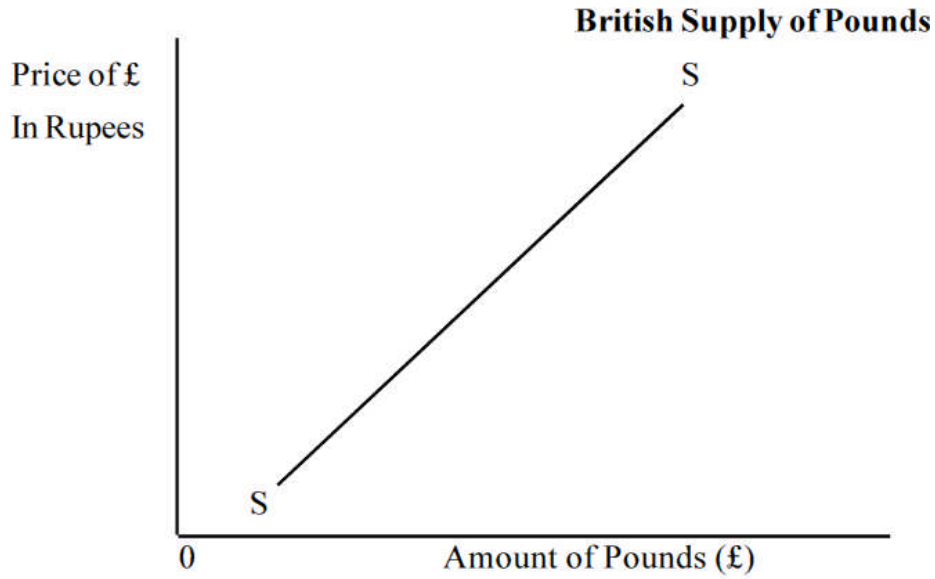
The negative slope of the demand curve for foreign exchange implies that higher the price of pound sterling, lower will be the demand for it and lower the price of the pound sterling, higher will be the demand for it. This is because when the price of pound is high more Indian rupees per unit of pound sterling have to be paid for acquiring. Hence, the demand for pound sterling would be lower. The elasticity of demand curve for pound sterling depends upon the nature of goods that are imported into the country. For instance, if India imports raw materials, essential goods, etc., the elasticity will below and if the country imports the non-essential and luxury goods, the demand curve for pound sterling will be very high. Similarly, if the country has got highly developed import competing industry producing substitute goods for imports, the elasticity will be very high other wise it will be very low. The time period also will determine the

elasticity of the demand curve. For instance, in the short-run the elasticity of demand for foreign exchange will be high and in the long run the elasticity will be low.

7.4.3.2 SUPPLY OF FOREIGN EXCHANGE

The supply of foreign exchange (pound sterling) depends upon the foreign demand for domestic goods and services. Assume that Britain imports sweaters from India. In that case British supply of pound sterling depends upon the price of sweaters in rupees in India, the exchange rate between rupees and pound sterling and finally the price of sweaters in terms of pound sterling in Britain.. The elasticity of demand for sweaters also influences the supply of pound sterling in Britain. When the price of pound sterling in terms of rupees rises, the demand for sweaters increases and consequently the supply of pound sterling also increases. This is given by the upward sloping supply curve of foreign exchange (pound sterling). The supply curve of British pounds is represented in Diagram 7.3. When the price of pound sterling in terms of rupees increases, the supply also increases because Indian rupee would become cheap and consequently the Indian goods will also be cheap. Hence there will be more demand for Indian goods (sweaters) and in the process of buying Indian goods more pound sterling will be supplied. Hence the supply curve for pound sterling is positively sloped. In general when the price of foreign currency appreciates there will be more supply of foreign currency

Diagram –7.3



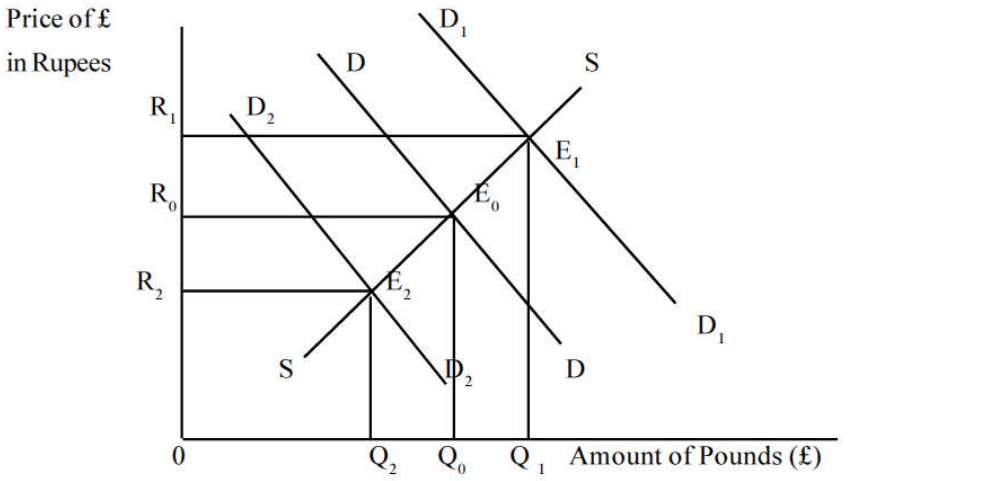
7.4.3.3 EQUILIBRIUM RATE OF FOREIGN EXCHANGE

The demand curve for foreign exchange shows how much pounds India demands at various possible exchange rates. If the relative price of pound is high (i.e., Indians have to pay more rupees per unit of pound), the demand for foreign exchange will be low. On the other hand, if the relative price of pound is low, larger is the demand for British pound. The supply curve of foreign exchange shows that how much pounds Britain is willing to supply at various levels of exchange rates. The British supply of pounds depends upon the price of her currency in the foreign exchange market. The higher the price of pound in the foreign exchange market, the cheaper will be the imports from abroad in Britain and hence more pounds will be supplied. The intersection of demand and supply curves will give us the equilibrium exchange rate. The

determination of equilibrium exchange rate assuming that there will be competitive conditions in the economy is explained in Diagram-7.4.

Diagram –7.4

Equilibrium Rate of Exchange between Rupee and Pound Sterling



ans import British goods to the value equal to $0Q_0$ amount of pounds and the British import Indian goods equal in value to the tune of $0Q_0$ units of pounds. The mutual trade between them is in balance. Hence, the demand for pound sterling will be equal to the supply of pound sterling. The rate of exchange R_0 that brings about equilibrium in their mutual trade and mutual demand for and supply of foreign exchange is known as equilibrium exchange rate.

7.4.3.4 BENEFITS OF MARKET CLEARING FOREIGN EXCHANGE RATES

There is an upward shift in the Indian demand curve for British pounds (increased demand for pound sterling) when there is deficit in India's balance of payments. There may be a number of reasons for deficit in the balance of payments like change in the tastes and preferences in favour of British goods, increase in the national income, increased demand for imports, decrease in exports, fall in capital remittances, increased flight of capital etc. What ever be the reason, the immediate effect will be depreciation of currency. This will lead to increased demand for foreign exchange and consequently, the exchange rate will increase from R_0 to R_1. At this new exchange rate Indians have to pay more rupees per unit of pound sterling implying that the value of Indian rupee has decreased vis-à-vis British pound. This situation is known as 'Depreciation of Rupee' or 'Appreciation of pound sterling'. Depreciation means fall in the relative value of the currency and appreciation means rise in the relative value of the currency. Appreciation of pound sterling implies that Britain has to pay fewer units of pound per unit of Indian rupee. When Indian rupee depreciates, Indian importers have to pay more in terms of domestic currency to get any one unit of foreign currency and hence this would discourage imports. Imports would fall. Conversely, when the Indian rupee depreciates, exporters will get more in terms of domestic currency for every unit of the foreign currency they earn. This will give incentive for the exporters to export more and hence exports would increase. Thus in the context of depreciation, on the one hand, imports would fall and exports would increase resulting in the fall in the deficit in the balance of payments of the country.

Analogously, a surplus in the balance of payments will lead to an excess supply of foreign currency. This will lead to down ward shift in the demand curve for foreign exchange and hence the exchange rate will fall from OR_0 to OR_2 resulting in the appreciation of the domestic currency viz., Indian rupee. This implies that the country has to pay less in terms of domestic currency per unit of foreign currency. As a result, the demand for imports will increase. The exporters will receive less in terms of home currency for any one unit of foreign currency earned from abroad. This may reduce the incentive for the exporters and fall in the exports. Thus in the context of surplus in the balance of payments and appreciation, imports would increase and exports would fall automatically leading to the establishment of new equilibrium exchange rates at which there will be equality between demand for and supply of foreign exchange. Thus the free play of market forces (demand for and supply of foreign exchange) in the foreign exchange market will automatically adjust both the deficit and surplus in the balance of payments and hence there will be equilibrium in the balance of payments always. The shifts in the supply curve for foreign exchange will bring about similar effects in the rates of foreign exchange. The shifts in the supply either upward or downward are not represented in the Diagram to keep the Diagram a simple as possible.

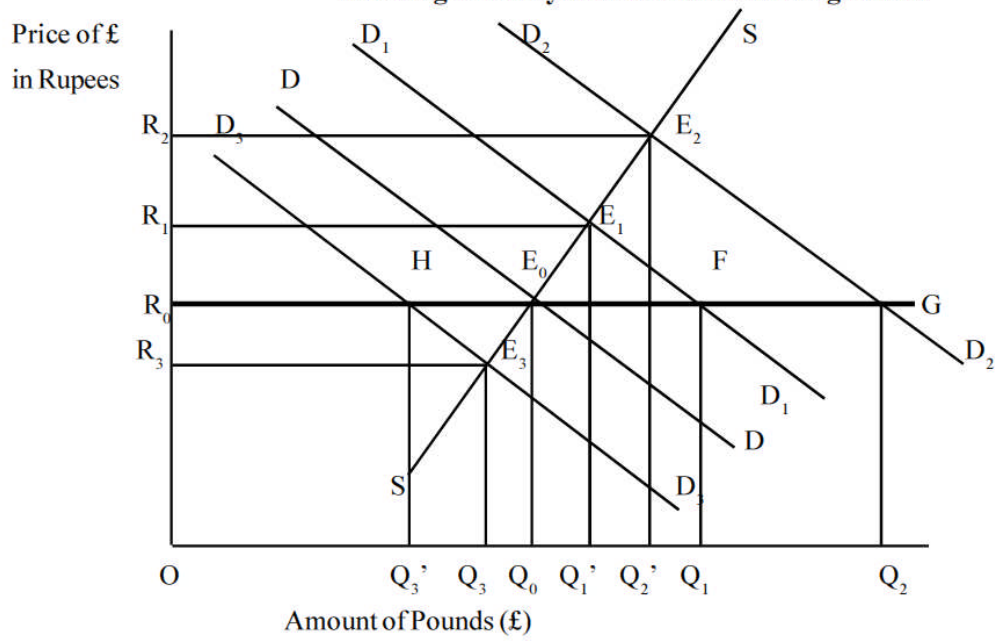
When the government or any authentic ogranisation like central bank intervene in the free play of market forces and set the foreign exchange rate at some particular level, it may result in either 'over valued currency' or 'under valued currency' both of which are undesirable from economic point of view. The over valued currency, that is the currency which has more artificial value than its true value as determined by the market forces, will discourage exports and encourage imports. Consequently exports will fall and imports will rise resulting in the deficit in the balance of payments. Conversely, the under valued currency, that is the currency which has less value than its true value as determined by the market forces, will discourage imports and encourage exports. Consequently exports will increase and imports will fall resulting in the surplus in the balance of payments. Surplus in the balance of payments will be as harmful as deficit in the balance of payments as the former will bring about inflationary tendencies in the economy.

7.4.4. FIXED VERSES FLEXIBLE EXCHANGE RATES

In economic and business circles there is a controversy over the issue of desirable system of exchange rates viz., fixed and flexible exchange rates. Historically the system of fixed exchange rates prevailed in the world during the era of gold standard from 1870 to 1914. The exchange rates fluctuated widely during the interwar period. Recognizing the benefits of the system of fixed exchange rates, the IMF established the fixed dollar exchange standard under the Bretton Woods system in 1944. The system worked fairly well and collapsed in 1971 and from 1973 onwards virtually the flexible or floating exchange rates system is in vogue. In view of the vivid experience in both the systems, several advantages and disadvantages of each system are well documented. We shall learn the advantages and disadvantages of these systems in the present section. The system of flexible exchange rates refers to the system where the currencies will freely fluctuate or float and find their own natural place in the market depending upon their strength. The demand for and supply theory of foreign exchange discussed in section 7.4.3 gives an idea about the working of the system of flexible exchange rates. Fixed exchange rate is the rate, which is fixed either in terms of gold or some key currency. This peg will remain fixed even if there is deficit or surplus in the balance of payments. In case of disequilibria, the government or the central bank intervene in the market and set the exchange rates at the fixed level. Consider Diagram –7.5.

Diagram –7.5

Working of the System of Fixed Exchange Rates



In the Diagram, the intersection of demand and supply curves for foreign exchange give the equilibrium rate of exchange OR_0. If this rate of exchange is to be maintained forever even when the demand for foreign exchange rises in the market, then there is a need for government intervention in the foreign exchange market. For instance, when the demand curve for foreign exchange shifts from DD to D_1D_1, there will be excess demand for foreign exchange at the existing rate of exchange. If the market forces freely operate, this excess demand will result in the establishment of a higher exchange rate at OR_1. But if the exchange rate is to be maintained at that particular level of OR_0, the government or the central bank has to supply the additional foreign exchange to the extent of Q_0 Q_1 at the low exchange rate of OR_0 when the market rate of exchange is well above it at OR_1. This will clear the market but the government has to bear the additional burden of supplying foreign exchange at low rates of exchange. Similarly, when the demand for foreign exchange shifts further to D_2D_2 , the government has to release additional foreign exchange from the reserves to the tune of Q_1 Q_2 at the subsidized rate of OR_0 when the actual market rate of exchange is at OR_2 . Thus there will be a heavy burden on the part of the government to maintain the system of fixed exchange rates. Similarly, when the demand for foreign exchange falls from DD to D_3D_3, there will be excess supply of foreign exchange at the existing level of foreign exchange rate OR_0. If the determination of exchange rate is left to the market forces, then a new equilibrium rate of exchange will be established at the lower level of OR_3. But if the government wants to peg the exchange rate at the original level of OR_0, the government has to buy the excess supply of foreign exchange in the market at the higher rate of OR_0. Thus again the burden falls on the government. In the light of the working of the systems of fixed and flexible exchange rates, let us now analyse their relative merits and demerits.

7.4.4.1 ADVANTAGES OF FLEXIBLE EXCHANGE RATES

There are several advantages of the system of flexible exchange rates, which make a strong case for it. Firstly, there will be an easy and automatic adjustment in the balance of payments under the system of flexible exchange rates. The simple market mechanism of demand and supply will establish equilibrium rate of exchange where the market for foreign exchange will be cleared. Secondly, there is no need of government intervention in foreign exchange market. It is not always possible for the government to set the exchange rates at the market clearing level. The possibilities of over valued and undervalued currencies are more under the system of fixed exchange rates. Both are undesirable for the economy as noted already. Thirdly, there is no need for building foreign exchange reserves, which is a great relief to any modern government. Fourthly, the system of flexible exchange rates would not necessarily lead to wide fluctuations in the exchange rates. The system would be stable so long as the underlying economic forces remain stable. Random fluctuations if any around the normal rate would be smoothened by the speculative forces. Fifthly, the same forces that under the system of fixed exchange rates give rise to deficit or surplus in the balance of payments would give rise to exchange rate depreciation or appreciation. The flexible exchange rate system ensures external equilibrium without affecting the internal equilibrium. Seventhly, the system gives more freedom to the government to leave the external sector to the market forces and concentrate more on the domestic sector to achieve full employment or price stability. Lastly there will be no need of any international monetary institutions like IMF to provide international liquidity to the countries, as there will be no problem of balance of payments.

7.4.4.2 DISADVANTAGES OF FLEXIBLE EXCHANGE RATES

The system of flexible exchange rates is not an unmixed blessing. There are several alleged disadvantages of the system some of which are real and some are unfounded. The first alleged demerit of the system of flexible exchange rates is that flexible exchange rates would create uncertainty and instability and that it would hamper foreign trade and investment. However, it is a mistake to argue that flexible exchange rates give rise to uncertainty. It is a mistake of confusing the symptom of difficulties with the difficulties themselves. The movement of exchange rates under the system of flexible exchange rates would only reflect the changes in the underlying economic factors and would therefore, gives exporters and importers correct signals to guide their behaviour. Under the system of flexible exchange rates, the exporters and the importers can protect themselves against changes in the rates of exchange by ‘hedging’ in a future market. The risk if any in the exchange rate changes will be borne by the speculators. It is not always correct to say that there uncertainty only in the system of flexible exchange rates. There will also be uncertainty of other kind in the system of fixed exchange rates viz., non-availability of foreign exchange. The second criticism against the system of flexible exchange rates is that flexible exchange rates lead to speculation and that speculation is destabilizing. This is because the speculators view the fall in the exchange rates as a sign for the further fall in them and hence they postpone the buying. Similarly the rise the exchange rate will be seen as a sign for further rise in the exchange rate and hence they buy more. Speculation will be destabilizing only if they sell the currency when the currency is low in price and buy when it is high. It follows that speculation is not destabilizing. However, there is some empirical evidence to support that the speculation is destabilizing. Analysing the international currency experience during the inter War period, Ragnar Nurkse found that speculation is destabilizing. S.C. Tsiang also found that exchange rates fluctuated more widely than that could be attributable to the real factors such as purchasing power parity. The third criticism is that flexible exchange rates lead to inflationary tendencies in the economy. Since most developing countries experience deficit in their balance of payments, deficit will lead to

depreciation of the national currencies and depreciation make imports more expensive. If imports constitute a substantial proportion of GNP it will lead to increase in the domestic price level and hence the inflation in the economy. However, the protagonists of the flexible exchange rates system argue that when the retaliation by the rest of the world is taken into account the rise in the exchange rate may not be to that extent and hence the inflation will not also be to that extent. Lastly it is argued that the system of flexible exchange rates may be suitable for developed countries which have export surplus and which can afford to scale down their imports. But developing countries do not have export surplus in most of the commodities and also in view of the requirements for development, they cannot afford to scale down their imports.

7.4.5. A NOTE ON THE CURRENT EXCHANGE RATES SYSTEM

Since the collapse of the Bretton Woods System in 1973, many countries of the world are following the policy of **"Controlled Floating"** or **"Managed Flexibility"** or **"adjustable peg"**. This policy lays down that the country should try to hold on to an exchange rate for as long as it can, that is until the foreign exchange reserves are at stake. Then it should devalue the currency to move to a higher peg. This rate should be continued as long as the country can, and then it should move to a new peg. The adjustable peg system is also known as the maximum devaluation method. This system believes in the merits of the fixed exchange rate system and only when it becomes impossible to manage it, the country moves to a new peg. Some countries use a variant of this policy known as **"Crawling Peg"** or **"Trotting Peg"** or **"Gliding Parity".** This system believes that sudden devaluation is bad, as it would upset the plans of the exporters, importers and investors. Hence, this system advocates regular and periodical adjustments in the exchange rates say once in a month or fortnightly, so that all the concerned will be in a preparedness to face the changes in the exchange rates. The exporters, importers and the investors will not feel the burden of adjustments once exchange rates are adjusted in small quantities. In India as we know the exchange rate between rupee and dollar used to around Rs.20/- before the last devaluation in 1991. Over the 13 year period the exchange rate more than doubled to reach around $1=Rs.47.50 in 2004. But the burden was not felt much by the economic units.

Check Your Progress:

What is depreciation?

_____

_____

What is appreciation?

_____

_____

What is adjustable peg system?

_____

_____

7.4.6. LET US SUM UP

In this chapter we have discussed the meaning of foreign exchange and foreign exchange rate. Foreign exchange includes all monetary instruments, which will give residents of one country a financial claim on another country. There are several types of exchange rates such as spot rate

and forward rate, buying and selling rates, single and multiple rates of exchange, fixed, flexible and floating rates of exchange and market rate and equilibrium rate of exchange. Foreign exchange market performs several functions including clearing of debt, hedging and provision of credit. There are three major theories of exchange rates viz., Mint parity theory, Purchasing power parity theory and Free Market theory. When the gold standard prevailed in the world, the exchange rates were determined by the mint parity or the metallic equivalence of their respective currencies. It was a system of fixed exchange rates. When gold standard disappeared and countries went to the system of inconvertible paper currency standards, the purchasing power of their respective currencies determined the exchange rates between the currencies. This theory is known a purchasing power parity theory. In determining the purchasing power of currencies, price level plays a crucial role and in determining the absolute price level in a country, the money supply plays an important role. Thus there is an intimate relationship between the exchange rates and national money supplies. The third theory is known as "Free Market Theory". Under this theory, the free play of demand for and supply of foreign exchange in the market will determine the equilibrium exchange rates of the currencies. Depending upon the excess demand and excess supply of foreign exchange, there will be depreciation or appreciation of domestic currency. Since the final break down of the Bretton Woods system in 1973, floating exchange rates are found in the world. Some countries occasionally intervene in the market to smooth out the fluctuations in the exchange rates. The monetary that prevails in the present day can be characterized as the system of managed flexibility or adjustable peg system.

7.4.7. KEY WORD AND CONCEPTS

Foreign Exchange : Foreign exchange refers to foreign currencies or more generally all those financial instruments that make claims on foreigners are known as foreign exchange.

Foreign Exchange market : The market where foreign currencies known as foreign exchange are traded is known as foreign exchange market.

Foreign Exchange Rate : The price of one unit of foreign currency expressed in terms of domestic currency is known as foreign exchange rate.

Spot Rate of Exchange : The rate of exchange quoted for the immediate delivery of foreign exchange is known as spot rate.

Forward Rate : The rate of exchange which is quoted for delivery of foreign exchange at a future date is known as forward rate.

Fixed, and Floating rates : The rate of exchange which is fixed either in terms of gold ore in terms of a key currency is known as fixed rate. The rate, which is obtained when the currencies freely float in the foreign exchange market and find their own natural price in the market, is known as floating rate.

Mint Parity Rate : The metallic equivalent of a currency is known as Mint Parity.

Upper Gold Point : The upper limit of foreign exchange rate which is determined by the cost of exporting gold from domestic country to foreign country is known as upper gold point.

Lower Gold Point : The lower limit of foreign exchange rate which is determined by the cost of importing gold from foreign country to domestic country is known as lower gold point.

Purchasing Power Parity : The ratio of purchasing powers of two currencies is known as purchasing power parity.

Adjustable Peg System : The revision of fixed exchange rate depending upon the availability of foreign exchange reserves is known as adjustable peg system or managed flexibility.

Crawling Peg : Frequent and periodical revision in the exchange rates in small quantities is known as crawling peg.

7.4.8. BOOKS FOR FURTHER READING

1. Ian H. Giddy (1997), ***Global Financial Markets***, New Delhi: A.I.T.B.S. Publishers & Distributors.
2. Thomas A. Pugal and Peter H. Lindert (2000), ***International Economics,*** New York: Irwin-McGraw Hill.
3. Bo Soderstein & Geoferry Reed (1998), ***International Economics***, New York: Macmillan.
4. Vaish, M. C. (1991), ***Money, Banking and International Trade***, New Delhi: Wiley Eastern Limited.

7.4.9. MODEL EXAMINATION QUESTIONS

1. Explain different concepts of exchange rates.
2. What are the functions of foreign exchange markets?
3. Examine the Mint Parity theory of foreign exchange.
4. Discuss the Purchasing power parity theory of foreign exchange.
5. Analyse the determination of exchange rates in free market economies.
6. Discuss the relative merits and demerits of the system of flexible exchange rates.

—000000OOO000000—

LESSON – 8

EXPORT CREDIT AND GUARNTEE CORPORATION AND EXCHANGE CONTROLS

8.0 AIMS AND OBJECTIVES

After studying this unit, you should be able to

- analyse the genesis and establishment of ECGC;
- assess the types of risks covered by ECGC;
- need for and types of exchange controls;
- objectives and methods of exchange controls;
- objectives and provisions of Foreign Exchange Regulation Act-1973;
- objectives and features of the new Foreign Exchange Management Act 1998.

STRUCTURE

8.1 INTRODUCTION

An exporter has to deal with a foreign buyer who is thousand of miles away. Often an exporter does not know about the foreign importer. The former may have very little information or no information about the latter. Hence, export transactions by their very nature involve risks of several types. Among the risks involved, commercial and political risks are considered to be the most important. The risks are very much there in the financing of export business. The scheduled commercial banks that finance export business also do not have enough mechanism to deal with the risks associated with export business. Even the exporters are not in a position to bear with it. There is, therefore, a great need to establish a specialized agency to cover such risks so that both the exporters and the financial agencies would feel secured. With a view to catering to these needs the Export Credit and Guarantee Corporation Committee in 1956 recommended the establishment of an Export Credit Insurance Scheme. Following these recommendations, the government of India as a first step set up an Export Risk Insurance Corporation (ERIC) as a fully owned government corporation. The authorized capital of the Corporation was Rs.5 cores and the paid up capital was Rs.50 lakhs. The government of India established Export Credit and Guarantee Corporation under the direct control of the Ministry of Commerce. The function of the ERIC was largely confined to the provision of insurance facility against certain commercial and political risks involved in export trade. During those days the exporters were mainly concentrated in the exports of consumer goods that needed credit for a period not exceeding 180 days. With the passage of time the export of capital goods emerged that required longer credit terms to cover the payment gaps and also working capital. These necessitated an improvement in the scope of services rendered by ERIC. Therefore the activities of ERIC were enlarged to enable to build a coordinating role to take up export functions, as well as to strengthen, and stimulate the activities of existing institutions in the field of export functions. Consequently, ERIC was transformed in to the Export Credit and Guarantee Corporation (ECGC) in 1964.

The ECGC is a company fully owned by the government of India. It is under the direct control of the Ministry of Commerce. The Board of Directors run the administration and they are taken from various fields such as government, industry, trade, banking and other related fields. ECGC provides such services to the exporters that are not generally available from the commercial insurance companies. It is run on commercial lines but at the same time it charges premium as low as possible. The main objective of ECGC is to make the exporters to be in a competitive position vis-à-vis his foreign rivals.

8.2 FUNCTIONS OF EXPORT CREDIT AND GUARANTEE CORPORATION

The Export Credit and Guarantee Corporation (ECGC) performs several functions ranging from insuring exporters against the attendant risks of export operations to providing financial guarantees to banks and exporters for exports against deferred credit payment terms.

The functions of undertaken by ECGC could be divided broadly into four groups;

I. **Standard Policies:** Issuing of Standard Policies to exporters to protect them against payment risks involved in exports on short-term credit;

II. Specific Policies: Covering Specific Policies designed to protect Indian firms against pay-ment risk involved in (a) exports on deferred terms of payment, (b) services rendered to foreign parties, and (c) construction works and turnkey projects undertaken abroad;

III. Supply Contracts: Providing Financial guarantees to banks in India to protect them from risks of loss involved in their extending financial support to exporters at the post-shipment as well as pre-shipment stages.

IV. Special Policies: Offering Special schemes, viz. Transfer Guarantee meant to protect banks, Letters of Credit opened by foreign banks, Insurance cover for Buyers Credit, Over-seas Investment Insurance and Exchange Fluctuation Risk Insur-ance.

Let us examine these policies in detail.

8.2.1 STANDARD POLICIES

ECGC has designed four types of standard policies to cover risks for shipments made on short-term credit.

(i) Shipments (Comprehensive Risks) Policy—to cover both com-mercial and political risks from the date of shipment,

(ii) Shipments (Political Risks) Policy—to cover only political risks from the date of shipment.

(iii) Specific Contracts (Comprehensive Risks) Policy—to cover both com-mercial and political risks from the date of contract,

(iv) Contracts (Political Risks) Policy—to cover only political risks from the date of contract.

The Shipments (Comprehensive Risks) Policy is ideally suited to cover risks when goods are exported on short-term credit. This policy covers both political and commercial risks from the date of shipment. This type of policy is taken when goods such as raw materials, primary goods, consumer goods or consumer durables are exported on credit basis. There will be very little or no risk of pre-shipment losses due to violation of export contracts of such products because these goods can be resold easily. Contract policies, which cover risks from the date of contract, are issued only in special cases when goods to be exported are manufactured to the non-standard specifications of a buyer.

The standard policies cover both commercial and political risks.

(i) Commercial Risks occur under the following conditions:

(a) When the buyer goes insolvent;

(b) Continued default of the buyer to pay for goods (within six months) as accepted by him;

(c) Buyer's failure to accept goods subject to certain conditions when such non-acceptance is not due to the actions of the exporter.

(ii) Political Risks may take the following forms:

(a) Imposition of restrictions on remittances by the government in the buyer's country or any government action which may block or delay payment to the exporter;

(b) War, revolution or civil disturbances in the buyer's country;
(c) New import licensing restrictions or cancellation of a valid import license in the buyer's country;
(d) Cancellation of export licence or imposition of new export licensing restrictions in India (under contracts policy);
(e) Imposition of additional handling, transport or insurance charges when there is interruption or diversion of voyage which cannot be recovered from the buyer;
(f) Any other cause of loss occurring outside India, not normally insured by commercial insurers, and beyond the control of the exporter and/or the buyer.

The following risks do not come under the purview of ECGC:

(a) Commercial disputes raised by the buyer, unless the exporter obtains a decree from a competent court of law in the buyer's country in his favour;
(b) Causes inherent in the nature of the goods;
(c) Buyer's failure to obtain necessary import or exchange au-thorisation from authorities in his country;
(d) Insolvency or default of any agent of the exporter or the collecting bank;
(e) Loss or damage to goods which can be covered by commer-cial insurers;
(f) Losses due to fluctuations in the exchange rates.

8.2.2 S PECIFIC POLICIES FOR CONSTRUCTION ACTIVITIES AND CAPITAL GOODS

The Standard Policy is intended to provide a continuing insurance for the regular flow of an exporter's shipments of goods such as raw materials, consumer goods and consumer durables. The credit period for such goods does not exceed 180 days. Export of capital goods or turnkey projects or construction works or rendering services abroad are not of a repetitive nature. These will also be exposed to similar risk if the service providers do not receive payments after rendering of the services. The contracts for such transactions are, therefore, insured by ECGC on a case-to-case basis under specific policies. All contracts for export on deferred payment terms exceeding one Crore rupees in value and all contracts for turnkey projects and construction works abroad require prior clearance of the Working Group. The representatives of the Group are taken from Reserve Bank of India, EXIM Bank and ECGC. Applications for this purpose are to be sent to EXIM Bank through the exporter's bank. An 'in principle' clearance at the Working Group enables the exporters to get necessary facilities from the institutions concerned. The service policies are also designed on the same lines of policies intended to cover risks involved in the exports of goods and these will be issued to cover specific activities. These Specific Policies designed for supply contracts may take the following two forms:

(a) Specific Service Contracts (Comprehensive Risks) Policy to cover both commercial and political risks in respect of the contracts made with the private parties abroad,

(b) Specific Contracts (Political Risks) Policy to cover risks emanating from contracts with the overseas governments or those in respect of which payments are guaranteed by the overseas governments.

The ECGC covers a wide range of services under this category such as technical and professional services, copyright fees, royalties, etc.

The Specific Service Contracts (Comprehensive Policy) covers the following risks:

(i) The insolvency of the buyer;

(ii) Continuous default in payments;

(iii) Restrictions on payments in the host country which may block or delay the payments;

(iv) War between India and the host country;

(v) Political upheaval or civil disturbance in the host country;

(vi) Stoppage of the execution of the project either due to the actions of the host government or the Indian government;

(vii) Loss due to any other reason occurring in India or abroad, which are beyond the control of the executing firm or the host firm.

Each policy covers 90 per cent of the losses suffered by the executing firm. The claim will be settled after four months from the due date of payments. The Service policy applies only where agreement is made to provide services. It will not apply to contracts where provision of contracts is a part of the agreement to supply a machinery or capital good. The premium amount is in proportion to the extent of risk involved and it may vary according to the nature of the service and from the country to country.

(i) Services Policy: A services policy of the ECGC is designed to protect Indian exporters against the risk of non-payment for services rendered to foreign parties. Under this policy, technical and professional services are covered. The services policies are obtained to cover both political and commercial risks.

(ii) Construction Works Policy: A contract for construction work comprises not only the supply of the material required but also the provision of services as well as the execution of civil engineering works connected with the completion of the contract. The ECGC's construction works policy provides cover for all payments that fall due to the contractor under this contract. The policy covers contracts entered into with various governments or contracts with other bodies where payments are guaranteed by an overseas government. In such contracts, supplies from third countries shall be limited to 15 per cent of the value of the total supplies. The policy is issued to cover the specific contract and it takes effect from the date of the contract. The risk coverage is usually comprehensive in nature. Cover can also be provided for the contractor's equipment— such as cranes, bulldozers and trucks used for construction—against risk like confiscation, by a suitable endorsement on the policy.

The construction policy contract covers all the risks of payments that fall due to the contractor

The Specific Service Contracts (Comprehensive Policy) covers the following risks:

a) Default of the government employers;

b) Delay in the transfer of payment to India;

c) War between India and the host country;

d) Civil war or disturbance in the host country;

e) Subsequent cancellation of licence for goods or materials used in the contract; and similar risks.

The ECGC pays 85 per cent of the loss after the expiry of four months after the due date of the payment or the event causing loss. Premium is to be paid at the outset on the estimated value of the contract. Loss of construction equipments such as cranes, bulldozers, trucks that are used in construction activities can be covered under the scheme.

(iii) Exports of Capital Goods: Just as construction or turnkey projects, the exports of capital goods or projects are not of repetitive nature like exports of consumer goods. Hence, these transactions are also insured by the ECGC on case-by-case basis. As in the case of standard policies, the risk cover can be provided from the date of contract or from the date of shipment of goods. Similarly the contactor can insure only against political risk or against the whole risk. Since the value of the contract would generally be higher, risk cover can be extended up to 95 per cent of the value with sufficient increase in the rates of premium. The proposals for such contracts are put forward well in advance because the ECGC has to study the credit worthiness of the buyer of the capital good, destination country, terms and conditions of the contract etc. The premium on the entire amount of the credit extended to the buyer will have to be paid immediately after the singing of the contract.

8.2.3 FINANCIAL GUARANTEES

In view of the peculiar nature of, and the risks connected with export financing, the ECGC has designed a number of financial guarantees, which help scheduled banks to extend credit to exporters. The credit guarantees offered by ECGC protect the banks from loss that arises due to their lending operations to the exporters. ECGC guarantees both pre-shipment and post-shipment credit operations. Such type of guarantees benefit both the bankers and the exporters. The following are the some of the important guarantees offered by the ECGC:

i. Packing credit guarantee.
ii. Post-shipment export credit guarantee;
iii. Export finance guarantee;
iv. Export production finance guarantee;
v. Export performance guarantee; and
vi. Transfer guarantee.

(i) Packing Credit Guarantee: An exporter requires finance to under-take the procurement of raw materials and the manufacture and pack-aging of the goods meant for export. Packing credit for this purpose is extended by commercial banks to exporters. The packing credit guarantee covers the advance by a bank to an exporter and protects it against the risk of loss due to insolvency or protracted default on the part of the exporter to whom advances have been extended. Specifically, ECGC protects the financing bank against (i) Non-delivery of shipping documents to the bank, (ii) Non-payment of the debt if shipments cannot be made. The ECGC indemnifies the financing bank up to 66.66 per cent of the loss in the first case and up to 75 per cent of the loss in the second case. The premium charges vary between 3 paise and 7.5 paise per Rs.100/- per month. In the case of a small-scale merchant exporter whose turnover does not exceed Rs.2 lakhs, the ECGC indemnifies the bank up to 90 per cent of the loss.

(ii) Post-shipment Export Credit Guarantee: Commercial banks extend post-shipment credit to exporters through purchase negotiations and discount of their export bills. Against this credit, the bank is eligible to obtain a cover from the ECGC, which protects it against defaults or insolvency on the part of the exporter. No doubt the standard policies and specific policies of the ECGC cover the exporter against the financial risks involved in these transactions. They do not, however, protect him against the losses sustained by him on account of his own fault, or against losses due to disputes between him and the buyer. To cover these risks and secure the advances made to an exporter against his own default or non-performance of the contract, the bank approaches the ECGC for a post-shipment credit guarantee. Normally, the bank is covered to the extent of 75 per cent of the loss. A premium of 5 paise per Rs.100/- per month is charged to the bank on such a credit guarantee executed by the ECGC.

(iii) Export Finance Guarantee: Reclamation of incentives, such as cash assistance and duty drawback may take some time after the completion of exports. Banks extend advances to exporters against these receivables to help them finance their export operations. Such advances may be given up to a maximum of 50 per cent f.o.b. value, or the actual amount of receivables, whichever is less. The ECGC's export finance guarantee scheme indemnifies the bank against losses incurred by it on its advances to exporters owing to their default or insolvency. The extent of coverage is 75 per cent of the losses incurred.

(iv) Export Production Finance Guarantee*:* Usually goods which are eligible for incentives, such as cash assistance and duty drawback, are sold in the export market at prices lower than the domestic prices. Only when the exporter realises his f.o.b. value from the buyer and incentives from the Government, he receives the full domestic value of the goods commensurate with the cost of production. Invariably, realisation of incentives takes time, as a result of which the exporters' finances are blocked. To help him in his finances, the ECGC has devised the export production finance guarantee, which enables finance for the manufac-turer/exporter up to 50 per cent over and above f.o.b. value at the pre-shipment and post-shipment stages. The guarantee is issued to financial banks to the extent of 66.66 per cent of any loss owing to insolvency on the part of the manufacturer-exporter or his protracted default.

(v) Export Performance Guarantee: An exporter who is negotiating exports on deferred terms of payment may need to arrange for bank guarantees for the following purposes:

(a) Bid Bond: The foreign buyer may require this when an exporter wants to quote for a tender. This is a guarantee certifying the genuine of the offer submitted by the buyer.

(b) Advance Payment Guarantee: After the exporter secures the bid, the buyer may pay the exporter a percentage of the value of the contract as an advance against the bank guarantee.

(c) Bank Guarantee for Performance of the Contract by the Exporter*:* The buyer will require this guarantee when the contract is awarded to the exporter.

(d) Bank Guarantee for Payment of Retention Money: In order to ensure the performance, the buyer may retain a percentage of the contract value as retention money and agree to release it to the exporter against a bank guarantee.

(e) Bank Guarantee for Loans of' Foreign Exchange: It may, in some cases, be necessary for an exporter to raise funds in foreign currency to finance his operations in connection with an export project. In these cases, the financing institutions abroad may need a bank guarantee to be furnished by the exporter. The exporter approaches the bank for these guarantees. To cover the risks involved in such transactions, the bank obtains a counter-guaran-tee from the ECGC under the letter's performance Guarantee Scheme. The bank may make the proposals for these guarantees to the ECGC, on the basis of which, ECGC counter guarantee will be given. The ECGC indemnifies the bank up to 66.66 per cent of the total loss in the case of bid bonds and 75 per cent of the loss in the case of other guarantees required by the exporter.

(f) Transfer Guarantee: An exporter always prefers to obtain a letter of credit confirmed by a reputed bank. Sometimes he may ask his own bank in India to confirm a foreign letter of credit. When this letter of credit is confirmed, the bank binds itself to honour the drafts drawn by the beneficiary if they are in accordance with the letter of credit. The confirming bank may run the risk of the foreign bank not reimbursing the Indian bank, especially in the event of certain political situations such as war, civil war, transfer delays, moratorium, etc. To protect these banks against these risks that might delay or prevent the transfer of funds to the banks in India, the ECGC has devised the Transfer Guarantee Scheme, which safeguards the banks in India. In other words, the Indian bank, which confirms the letter of credit, will not suffer any serious loss even if the foreign bank fails to reimburse it, since the ECGC guarantee protects it.

ECGC has, in the last few years, brought forward many progressive schemes and policies to encourage exports, and cover the risks of the exporters and the financial institutions. It is up to the exporters to make full use of these facilities. However, they should not forget the cardinal Principle of making their own comprehensive commercial evaluation of the buyer, his previous record and antecedents before they embark on credit or insurance cover.

8.2.4 ECGC's SPECIAL POLICIES

Apart from the risks covered under standard policies, an exporter some-times needs coverage of risks of other types connected with various export transactions. To suit the varied needs of the exporters, the ECGC has devised the following special policies:

(i) Policy for Consignment Exports: The ECGC also covers exports made on consignment basis. The exporter has to obtain a special endorsement for the purpose on the standard specific shipment policy. The cover obtained would provide for political risks from the date of shipment and commercial risks from the date of sale of overseas stock to the buyer, subject to the terms and conditions of policy.

(ii) Manufacturer's Credit Insurance Policies: Some times a manufacturer exports his goods through an exporter or an export house. Generally the exporter obtains credit from the manufacturer while they offer credit to the buyer. Under such circumstances the Manufacturer's credit insurance policy provides risk coverage to the manufacturer against default or insolvency on the part of the exporter. The extent of coverage will be up to 80 per cent of the manufacturer's loss.

(iii) Exporters' Credit Insurance Policy: Sometimes exporters offer credit to a manufacturer for the procuring and manufacturing of export goods. The ECGC's Exporter's Credit Insurance Policy covers losses arising out of defaulter insolvency on the part of the manufacturer. The extent of coverage will be up to 50 per cent of the total loss to the exporter.

(iv) Market Development Policies: Many a time, an exporter has to undertake detailed market surveys to assess market potential and devise strategies for marketing a product. Besides, several publicity measures are also undertaken for the development of the overseas market. If a survey reveals that such ex-penses are not possible to recover, the ECGC shares the loss with the exporter on a 50: 50 basis, provided that the surveys are undertaken by an approved and inde-pendent agency.

8.2.5 NEW FEATURES IN EXPORT FINANCE

(i) Dollar Denominated Credit for Exporters: There has been a persistent and genuine complaint from the export-ers that the interest rates in India are very high. This is reflected in the cost of the products, which makes us non-competitive in quite a few products. Even though government agrees in principle, it is not able to bring down the interest rates in India, due to the fact that such a move would increase the money supply, and result in inflation. However, to help exports ECGC has brought out a scheme of providing post-shipment credit to exporters in Dollars, at Dollar related interest which amount to 6.5 per cent. This has been extended to the packing credits as well. Under the scheme, the exporter quotes and gets an order from the buyer abroad the amount denominated in US Dollars. Based on this the exporter gets his pre-shipment or post-shipment credit in Dollars (the assumption here is that the exporter would convert it into rupees at the ruling exchange rate, and utilise the rupees for the production of (the product, in the case of a packing credit). As the product is exported, the exporter will obtain the proceeds in Dollars as per his original order received and the proceeds there from will be utilised to offset the credit. This is a good arrangement, and the only risk an exporter takes is that of the exchange fluctuation risk between the time he gets the credit from the bank and the realisation of the proceeds.

(ii) Forfeiting: This is a familiar mode of export transaction abroad, but has recently been introduced in India by Export-Import Bank of India. The word 'forfeit' is derived from the French word 'forfeit' which means the surrender of rights. Simply put, forfeiting is the non-recourse discounting of export receivables. In a forfeiting transaction, the exporter surrenders, without recourse to him, his rights to claim for payment on goods delivered to an importer, in return for immediate cash payment from a forfeiter. As a result, an exporter in India can convert a credit sale into a cash sale, with no recourse to the exporter or his banker.

Check Your Progress:

What are commercial risks?

_____
_____
_____
_____
_____
_____

What are political risks?

_____
_____
_____
_____
_____
_____

8.3 EXCHANGE CONTROLS

Regulation of export proceeds and restrictions on payments for both current and capital transactions are termed as exchange controls. In its extreme form, all foreign exchange proceeds resulting from country's economic transactions with the rest of the world are to be handed over to the country's monetary authority and all those who want to pay for the rest of the world in connection with any economic transaction must get the same from the country's monetary authority. In its less extreme form, there will be limits for certain type of transactions while there will be free access for certain other types of transactions. For example the government may permit use of foreign exchange for all imports of essential goods and services but may place restrictions on the use of foreign exchange for import of luxury consumer goods. In some cases all current account transactions can have free access to foreign exchange but the capital account transactions may be controlled. According to IMF about 100 countries in the present day world have fairly comprehensive exchange control methods imposed both on capital sand current account transactions. About 50 more countries use restrictions on capital account transactions. These countries face the persistent deficit in their balance of payments by relying upon fixed exchange rates through the imposition of controls and regulations on the foreign exchange transactions. Consequently they restrict the ability of their residents to buy foreign goods and services, or to travel abroad or to invest in foreign countries. The genesis of exchange controls can be traced back to the inter-war period when several countries imposed a wide range of controls on the foreign exchange transactions. The foreign exchange rates were fluctuating widely. Denmark was the first country to impose exchange controls to stabilize the exchange rate of its own currency. Several countries resorted to exchange controls even to solve domestic economic problems such as unemployment. The effects of exchange controls are similar to that of import quota. In a sense exchange controls are more powerful than import quotas as the former can be used to influence not only imports of goods and services but also foreign investments, tourism, and even foreign studies. The economic ill effects of exchange controls are as bad and in some cases even worse than the import quota and tariffs. Before we analyze the effects of exchange controls, let us understand the objectives of exchange controls.

8.3.1 OBJECTIVES OF EXCHANGE CONTROLS

The first objective of the exchange control is to exercise the monopoly power in all foreign exchange transactions. In many centrally controlled economies, exchange control was merely an extension of its arms to international sector. The second objective of exchange control is to set right the massive deficit in the balance of payments of a country. The country may not wish to take the futile chance of correcting the deficit in the balance of payments by leaving it to the correction by the automatic forces such as flexible exchange rates or domestic deflation. Under the highly disturbed conditions of international trade, exchange control would be the only alternative left to the countries to correct the deficit in the balance of payments. Thirdly many

countries resort to exchange control to avert the flight of capital from the country. Destabilizing and speculative movements of hot money may exert undue and unwanted pressure on the balance of payments of the country. Fourthly conservation of limited foreign exchange to use of import of essential goods or capital goods needed for economic development. During war times, the countries may want to import essential war materials and arsenals needed for the war. During the Second World War the main reason for exchange control was to preserve the foreign exchange to import war equipments. Fifthly, some countries may want to stabilize their exchange rates vis-à-vis their major trade partners so that their trade and payments could go smoothly and uninterruptedly. Sixthly yet another reason for exchange control could be to deliberately over value their currency so that the country could import essential raw materials at cheap rates or liquidate her external debt cheaply in terms of domestic currency. After the Second World War many Central European countries liquidated their debt with United States and England using this method. Seventhly, some countries resort to exchange controls to deliberately undervalue their currency so that they could give incentives to their exporters and discouragement to their importers. Lastly some countries may institute foreign exchange controls as a part of their national program of economic development with the objective of direct rationing of the scarce foreign exchange reserves.

8.3.2 DIRECT METHODS OF EXCHANGE CONTROLS

Broadly there are two methods of exchange controls viz., i) Direct Methods and ii) Indirect methods. The Direct methods may be used either to peg up or peg down exchange rates depending upon the prevailing economic conditions in the economy. Direct methods of exchange controls include a) Intervention to per up or peg down exchange rates, b) Exchange Restrictions including Blocking of foreign Accounts, c) Multiple exchange rates, d) Transfer Moratorium, e) Exchange Clearing Agreement, and f) Payment Agreements. The indirect methods of Exchange controls include export subsidies, import tariffs, changes in the rate of interest to influence the exchange rates. Let us first discuss the direct methods of exchange controls.

8.3.2.1 Intervention

The term ‘Intervention’ refers to the government’s intervention in the foreign exchange market either to hold up or hold down the foreign exchange rate of its currency. It may take the form of bulk buying and bulk selling of the currency in the foreign exchange market either by the government or government authorized agencies. This might be due the fact that the government may want to peg the exchange rate at some particular level. Pegging refers to the act of fixing the exchange value of the currency to a chosen rate of exchange called ‘pegging’. For instance, the British government pegged the pound sterling rate at 4.765 US dollars during 1914-18. New Zealand did the same during 1933. Pegging exchange rate at some particular level need not be objective of exchange control by a government. The government may intervene through the purchase and sale of home currency against the foreign currency in the foreign exchange market in order to support or depress the exchange value of home currency without evolving any fixed exchange rare for it. The ability of the government to control the exchange rate by intervention depends entirely on the foreign exchange reserves of the country. With a view to strengthening

the reserve position of the government, England, America and France established Exchange Stabilization Funds in 1932, 1934 and 1936.

8.3.2.2 Exchange Restrictions

An Exchange restriction is the policy where by the government reduces the supply of home currency in the foreign exchange market. There are three important features of exchange restrictions. Firstly, the government centralizes all trading in foreign exchange by itself or with its agents. Secondly, the people have to obtain the government's permission either to offer home currency for foreign currency or to sell foreign currency. Thirdly, nobody can make foreign exchange transactions without prior permission of the government or government agency. In 1931 Germany and Austria employed exchange restrictions more vigorously. The non-compliances of currency regulations were punishable under act with death punishment. In 1939 Britain ordered all its residents to surrender gold holdings and other foreign exchange reserves to the government at the official exchange rates. The residents had to sell all foreign currency holdings to Bank of England or its authorized agencies. There were different types of exchange restriction each differing only in degree and not in kind. Some countries such as Germany adopted the practice of blocking the accounts of creditor's countries. Many refugee Jews who migrated to London to escape Hitler's prosecution found themselves in a starving conditions even though they had millions of marks in their accounts in Germany. The Nazi government blocked these.

8.3.2.3 Multiple Exchange Rates

Fixing of different rates of exchange for different purposes is known as multiple exchange rates. Different exchange rates were fixed for imports and exports of different goods. Even for different categories of imports different rates of exchange are fixed. The objective of fixing the different rates for different purposes is to earn the maximum possible foreign exchange through exports and to conserve maximum possible foreign exchange by minimizing the use of foreign exchange for different purposes. Germany employed the multiple exchange rates for the first time. Later, Latin American counties of Chile, Argentina, Brazil, Peru, Ecuador and other countries followed suit. Until recently Argentina was successfully implementing a complex system of multiple exchange rates, as she was not the member of IMF. Use of exchange controls enables a country to abstain from quantitative restrictions and export and import licensing. Multiple exchange rates generally promote exports, discourage imports, and thereby bring about a favorable balance of payments for the country. In spite of these advantages, there are several demerits of the system. They introduce the complexity in the system of exchange rates. If adequate steps are not taken they may result in the emergence of inconsistent cross exchange rates and uncertainty. Multiple exchange rates obstruct the optimum utilization of country's productive resources. The scheduling of imports of essential foodstuffs at low exchange rates under the multiple exchange rates greatly hampered the development of Chile's agriculture. In short the system of multiple exchange rates is highly discriminatory.

8.3.2.4 Exchange Clearing Agreements

During the inter-war period when countries of the world adopted several restrictive trade practices, some countries made Exchange Clearing Agreements with their trade partners in order to boost their mutual trade. During this period many European countries were in serious deficit in their balance of payments in spite of adoption of several trade restrictive policies. When the foreign exchange reserves are totally exhausted, countries evolved some clearing arrangements with their trade partners that avoided the use of any foreign exchange reserves. Under this arrangements, the central bank in a country, say Country-X opens an account in the name of the Central bank of country-Y. In country-X there may be some persons who are creditors of county-B and certain other persons who are debtors to the country-Y. The debtors that is those who have imported from country-Y deposit with the central bank of country-X the sum of money due to them in home currency in discharge of their foreign debt obligations. Similarly, the creditors i.e., those who have exported goods to country-Y receive payments from the central bank of the country-X in their home currency. A similar operation will take place in country-Y. Germany and Switcher land made such exchange clearing agreements during 1929. Several European countries followed suit. An exchange clearing arrangement is not free from shortcomings. The payments to the exporters in a country are not effected immediately. The total value of each country's exports and imports may not be equal. Consequently, there may be deficit or surplus in the currency reserves with a particular country.

8.3.2.5 Payments Agreements

Exchange clearing agreements were suffering from two shortcomings viz., non payments to the creditors (exports) immediately after the payments by the debtors (importers) in a foreign country and non-equivalence of total value of exports and imports for a particular country. In view of these reasons, many countries entered with payments agreements. Under these agreements, both countries establish mutual credit facilities. So that delays in the payments are averted. There is no need of centralized payments arrangements as in exchange clearing agreements. Under the payments agreement, payments between the two parties concerned are made through special non-resident accounts opened for that purpose. Let us illustrate the system using payments agreements made between India and United States. Under the payments agreement Reserve Bank of India and other authorized banks keep "Indian Accounts" in dollars in United States. Conversely, the Federal Reserve Bank of America and other authorized banks keep "American Accounts" in Rupees in India. Under the terms of accord, the central banks of two countries undertake to buy each other's currency at an agreed exchange rate. A payment made by an American resident to Indian resident was effected either in American dollars through credit of Indian account maintained by Indian banks in America or in rupees through the debit of a American account kept by American bank in India. The opposite happens when an Indian made payments to American resident.

8.3.2.6 Moratorium on Transfers

Under transfer moratorium, payments to foreign creditors or exporters are suspended during the period of moratorium. By this a country temporarily suspends its balance of payments problem temporarily. The importers and exporters make payments in home currency and these are

deposited with certain authorized bank. On the expiry of the moratorium period during which the country sets rights its balance of payments problem, these deposits are released and equivalent foreign exchange is provided. During the inter war period many countries imposed moratorium on the foreign exchange payments.

8.3.3 INDIRECT METHODS OF EXCHANGE CONTROL

As noted already the indirect methods of exchange controls include import tariffs, import quotas, export subsidies, and changes in the rate of interest to influence the exchange rates. Let us now briefly discuss the indirect methods of exchange controls. Tariffs and quotas are the primary indirect instruments of exchange controls. Generally import tariffs and quotas are used as commercial instruments to restrict imports and to encourage the indigenous production of the imported commodity, conversation of precious foreign exchange earnings would some time take precedence over the commercial considerations. Similarly, if export subsidies are allowed with a specific view to conserve the foreign exchange earnings, then export subsides could also be considered as an indirect method of exchange control. When there are shortages in the foreign exchange earnings, the rate of interest may be raised so that there will be greater inflow of foreign capital from abroad. Correspondingly, the flight of capital from the country in face of low interest rates could also be averted. It is the short-term capital, which is more sensitive to interest rate changes in any country.

Check Your Progress:

What are the objectives of exchange controls?

_____
_____
_____
_____
_____
_____

Distinguish between direct and indirect methods of exchange controls.

_____
_____
_____
_____
_____
_____
_____

8.4 FOREIGN EXCHANGE REGULATION ACT-1973.

Regulation of foreign exchange refers to regulation of transactions relating to foreign exchange. As noted in section 8.3, the origin of control and regulation of foreign exchange in India also can be traced back to the interwar period. For a very long period India was confronted with adverse balance of payments position due to excess imports over exports. Finding in deplorable conditions of depleted gold and foreign exchange reserves, India imposed payment restrictions to

prevent massive capital flight and instill stability and confidence in the minds of exporters and importers in the country. For the first time India introduced foreign exchange controls in September 1939 under Defence of India Rules. Soon after Independence, the Government of India promulgated the Foreign Exchange Regulation Act in 1947 to regulate the operation of foreign exchange companies in India. The Act was amended and a comprehensive legislation was brought out in 1973. The comprehensive Foreign Exchange Regulation Act (FERA) came into force from 1st January 1974. The major objectives of FERA are

i) to conserve the precious foreign exchange reserves of India and
ii) to issue guideline to the foreign investors to divert their funds to the core sectors of the economy that employ sophisticated technology.

At the time of enactment of FERA, India possessed very limited foreign exchange reserves of less than one billion dollars. During this period almost all sectors of the economy were controlled and regulated by the government. Hence, there was no wonder in extending the government's hand to the foreign exchange sphere as well. Under FERA, all transactions in foreign exchange and all transactions with non-resident (whether in foreign exchange or in rupees) were absolutely prohibited except where specific relaxations were made. Similarly, the non-residents were also not permitted to have any foreign exchange transactions in India. However, the government of India issued separate guidelines to regulate the practical and day-to day transactions. These guidelines related to business of foreign firms and industries in India. For instance, the government of India stipulated that all branches and all foreign subsidiaries in India (except airlines and shipping companies) should have a minimum Indian equity participation of 26 per cent. Non-banking foreign branches and subsidiaries with foreign equity exceeding 40 per cent has to obtain permission to establish new undertakings, or to purchase shares in the existing companies, or to acquire wholly or partly any other company. These guidelines were revised substantially in 1976.

According to the revised guidelines, all branches of foreign companies operating in India should convert themselves into Indian companies with at least 60 per cent local equity participation. Further more, all subsidiaries of foreign companies should bring down the foreign equity share to 40 per cent or less. The 1976 guidelines provided three levels of foreign equity viz., 74 per cent, 51 per cent, and 40 per cent. Companies were allowed to retain foreign equity holdings above 40 per cent and up to 74 per cent on the condition that they wee engaged in (a) core goods industries, (ii) predominantly export oriented production, (iii) activities requiring sophisticated or specialized skills or (iv) tea plantations. If the turnover from any or all of these activities combined exceeded 74 per cent of total turnover of the company, it was entitled to retain the 74 per cent foreign equity level. Similarly, companies exporting more than 40 per cent of their own production or the equivalent of at least 60 per cent of their, total turnover, the companies can retain the 74 per cent equity level.

8.4 1 WORKING OF FOREIGN EXCHANGE REGULATION ACT-1973.

The implementation of the provisions of the FERA was not satisfactory. There were inordinate delays in enforcing certain provisions of the Act. Many companies have not implemented the directions of the government to dilute the foreign equity levels. Some even have not initiated the process of dilution. The government itself has given exemptions for a large number of

companies. A study undertaken by Martinussen revealed that out of 895 companies studied, 249 companies were exempted from the general rule of stipulating a maximum of 40 per cent non-resident interest, 132 companies were allowed to continue with more than 40 per cent equity, 116 with more than 51 per cent and up to 74 per cent of equity and one company was given permission to hold 100 per cent equity. According to Martinussen, three groups of companies did not comply with FERA regulations. They were (i) Tea plantation units, (ii) Drug manufacture and pharmaceutical units and (iii) Giant Multinational Corporations or their allied units. In view of importance of tea exports in Indian economy, tea plantations were exempted from the purview of FERA. Since India depended heavily on the imported drugs or drugs manufactured by the giant Multinational Corporations, the government of India abstained from applying the provisions of FERA to Drugs and Pharmaceutical companies. However, the giant MNCs have managed to get exemptions from the provisions of FERA in view of their mighty economic and political powers. To illustrate the case Martinussen, gives the example of Hindustan Lever Ltd. that managed to get concessions from the government for their toilet soaps on the pretext that they were the import substituting industry.

The 1973 FERA came under severe criticisms. The Act stipulates that whenever, a person was prosecuted or proceeded against for contravention of any provisions of the Act, the burden of proof that he had the requisite permission lies with him. This often led to unnecessary harassment of bona fide persons and companies with show cause notice and prosecution for alleged violations of FERA on narrow technical grounds. Nevertheless there are unscrupulous individuals and companies that manage to evade and avoid the provisions of FERA and get away scoot free.

In view of these reasons, when the government of India initiated far reaching economic reforms in 1991, the provisions of FERA also liberalized. The government of India announced major concessions to FERA companies in their order announced in November 1991 and in January 1992. On January 8, 1993, the government of India promulgated an ordinance to amend the provisions of FERA. The ordinance removed a large number of restrictions on companies including the removal of limit of 40 per cent equity, permission of Indian citizens to set up joint ventures abroad or to acquire immovable property abroad. Important concessions announced by the government of India through policy pronouncements in the above years are as follows:

i) Companies with foreign shareholding were allowed to increase foreign equity up to 51 per cent by remittances in foreign exchanges in specified high priority industries;
ii) Section 26 subsection 7, that required the FERA companies to get Reserve Bank's permission before raising working capital or accepting deposits was removed;
iii) The repulsion of Sections 28 and 29 enabled the FERA companies to use their trade marks in India and could carry on in India any activity of a trading, commercial or industrial in nature;
iv) The revoking of Section 31 allowed the FERA companies to deal in immovable property in India;
v) Section 27 which restricted Indian companies to set up joint ventures abroad and resident Indians associating themselves with or taking part in overseas concerns was scarped;
vi) Restrictions in regard to assets held in India by non-residents were removed;

vii) Indians were allowed to keep foreign exchange up to $500 or Rs.15, 000/-;
viii) Import and export in gold and silver was exempted from FERA implying that these commodities would now be governed by the EXIM policy;
ix) Section 17 which conferred powers on the government to regulate the use of imported gold and silver was removed;
x) Restrictions on the transfer of any security from a register in India to a register outside India were removed;
xi) Restrictions on the transfer of shares by a non-resident to another non-resident were also removed;
xii) The provision allowing government to acquire foreign securities for the purpose of strengthening the reserve position of the government has also been removed even though it was never used in practice;
xiii) Foreign nationals were exempted from obtaining prior permission under FERA before taking up employment in India;
xiv) A FERA provision that permitted the government to direct the FERA companies the payment to a certain special account was omitted.

The above list of concessions announced through different policy pronouncements clearly indicates that the FERA was redundant in the new era of liberalization and outlived its purpose. Hence, efforts were made to place FERA companies in par with Indian companies. Since the country has moved to full current account convertibility and there is opening up of foreign exchange markets and foreign transactions, as the then Finance Minister put it in his budget speech in June 1988, 'it is no longer appropriate to deify foreign exchange some thing special and maintain a burdensome and highly regulatory structure of this deity'. Consequently, the government of India brought out a new and liberalized law known as "Foreign Exchange Management Act" in 1999 and the Act was made effective from 1st June 2000.

8.5 FOREIGN EXCHANGE MANAGEMENT ACT-1999.

The government of India introduced the Foreign Exchange Management Bill in the Parliament on August 4, 1998. It was adopted by the Parliament in 1999 and it is known as the Foreign Exchange Management Act, 1999. In the new law the emphasis was more on management rather than the regulation of foreign exchange. The objective of the Act was to 'consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India'. Thus in contrast to FERA which aimed at conservation of foreign exchange and control of foreign exchange transactions directly or indirectly, the aim of FEMA is to facilitate and management of foreign exchange in order to promote functioning of the free foreign exchange markets. In other words, the approach of FEMA is radically different from that of FERA as the former aimed at facilitation rather than conservation, management rather than control.

8.5.1 SALIENT FEATURES OF FEMA

The FEMA contains several salient features formulated in tune with the emerging political and economic conditions in the world. The salient features of FEMA are discussed under the following six heads viz., i) Current and Capital account transactions, ii) Realization and

Repatriation of foreign exchange, iii) Contravention and penalties, iv) Adjudication and appeal, v) Enforcement and vi) Miscellaneous provisions.

1. **Current and Capital Account Transactions:** Section-5 and Section – 6 deal with current and capital account transactions. According to section –5, any person may sell or draw foreign exchange to or from an authorized person if such sale or drawl is a current account transaction. However, the Central government may, in public interest and in consultation with RBI may impose such reasonable restrictions for current account transactions as may be prescribed. Section –6 states that any person may sell or draw foreign exchange from an authorized person for a capital account transaction. The RBI in consultation with the government of India may specify the class of capital account transactions, which are permissible, the limit up to which the foreign exchange shall be admissible of such transactions. The RBI may prohibit, restrict or regulate the following:
   i) transfer or issue of any foreign security by a person resident in India; by a person resident outside India or by any branch, office or agency in India of a person outside India;
   ii) any borrowing or lending in foreign currency in whatever form or by whatever name called;
   iii) any borrowing or lending in rupees between a person resident in India and persons resident outside India;
   iv) deposits between persons resident in India and persons outside India;
   v) export, import or holding of currency or currency notes;
   vi) transfer of immovable property outside India other than a lease not exceeding five years by a person resident in India; Like wise acquisition or transfer of immovable property in India other than a lease not exceeding five years by a person outside India;
   vii) giving guarantee or surety in respect of any debt obligation or other liability incurred by a person resident outside India.

Subsection –4 of Section–6 provides that a person resident in India may hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India, if such currency, or security or property was acquired held or owned by such person when he was resident in India.

Subsection –5 of Section-6 applies to a person who reside outside India i.e., they may hold, own, transfer or invest in Indian currency, security or any immovable property situated in India if such currency or security or property was acquired or owned by such person when he was resident in India.

Under subsection 6, RBI may, by regulation, prohibit, restrict, or regulate establishment in India of a branch, office or other place of business bay a person resident outside India, for carrying on any activity relating to such branch office or other place of business.

Under FEMA (1998) every exporter of goods shall furnish to RBI a declaration containing true and correct, material particulars including the amount representing the full export value of the goods exported for the purpose ensuring the realization of the full export proceeds by such exporter without any delay. Further, every exporter of services shall furnish to RBI a declaration containing the true and correct material particulars in relation to payment for such services.

2. Realization and Repatriation of Foreign Exchange: Section-8 lays down that save as other wise provided in the Act, where any amount of foreign exchange is due or as occurred to any person resident in India such person shall take all responsible steps to realize and to repatriate to India such foreign exchange within such period and in such manner as may be specified by the Reserve Bank.

Section –9 refers to certain exemptions from realization and repatriation from in certain case of contravention and penalties.

(a) possession of foreign currency or foreign coins by any person up to certain limit as the Reserve Bank may specify;
(b) foreign currency accounts held or operated by such persons or class of persons and the limit up to which the Reserve Bank may specify;
(c) foreign exchange acquired or received before the 8th day of July 1947 or any income arising or occurring there on which is held outside India by any person in pursuance of permission granted by the Reserve Bank;
(d) foreign exchange held by a person resident in India up to such limit as the Reserve Bank may specify, if such foreign exchange was acquired by way of gift or inheritance from a person referred to in Class C including any income arising there from;
(e) foreign exchange acquired from employment, business, trade, vocation, services, honorarium or gifts, inheritance or any other legitimate means up to such limits as the Reserve Bank may specify; and
(f) such other receipts in foreign exchange as the Reserve Bank may specify.

3.Contravention and Penalties: Chapter – IV deals with the issue of contravention and penalties. Section 13 says that if any person contravenes any provision of FEMA, after adjudication he shall be liable to a penalty up to thrice the sum involved in such contravention where such amount is quantifiable or up to two lakh rupees where the amount is not quantifiable. If such contravention is continuing nature, further penalty, which may extend up to Rs.5000/- per every day after the first day during which the contravention continues may be imposed. Section 14 states that if the person concern fails to make the full payment of penalty imposed on him within a period of 90 days, he shall be liable to civil imprisonment.

4. Adjudication and Appeal: Chapter **–** V deals with the issue of adjudication and appeal. Section –16 states that the central government may appoint an adjudicating authority for holding an enquiry in the manner prescribed after giving the accused person a reasonable opportunity of being heard for the purpose of imposing any penalty. Section 17 provides for the appointment of one or more special Directors (Appeals) to hear appeals against the orders of the adjudicating authority under this Act. Section 18 states that the Central government shall, by notification, establish an Appellate Tribunal to be known as the Appellate Tribunal for Foreign Exchange to hear appeals against the orders of the adjudicating authorities and Special Director (Appeals) under this Act. The Appellate Tribunal shall consists of a chairperson and such number of members as the Central government may deem fit. Subsection-2 of Section 28 deals with the powers of the Appellate Tribunal and the Special Director (Appeals). It says that they shall have, for the purpose of discharging their functions under this Act, same powers as are vested in a civil court under the code of civil procedures, 1908.

5. Directorate of Enforcement: Chapter – VI deals with the establishment of the Directorate of Enforcement and its powers, etc. Sub-section-1 of section 36 states that Central government shall establish a Directorate of Enforcement with Director and such other officers or class of officers as it thinks fit that shall be called officers of enforcement for the purpose of this Act. Sub-section-3 of section 37 states that the Director of enforcement and other officers of Enforcement shall exercise similar powers which are conferred on Income tax authorities under the Income Tax Act 1961 (43) of 1961 and shall exercise such powers subject to such limitation laid down under the Act.

6. Miscellaneous Provisions: The last chapter, chapter –VII consisting of sections 39 to 49 deals with the miscellaneous issues. Sub-section-1 of Section 40 empowers the Central government in the public interest and by notification to suspend or relax the provisions of the Act in certain circumstances. Sub-section-3 provides that notification issued there under shall be laid before each house of Parliament. Section – 41 empowers the central government to give general or special directions to the RBI. Section 42 provides that where a company commits contravention of any of the provisions of this Act, the person responsible fort the conduct of its business shall be deemed to be the guilty of the contravention. Section 44 bars the prosecution of the legal proceedings against the officers of the central government or the Reserve Bank or any other person exercising any powers or discharging any functions or performing any duties under the provisions of this Act for anything done in good faith. Section 45 empowers the central government to remove the difficulties in giving effect to the provisions of the Act. Section 46 empowers the central government to frame the rules and section 47 empowers the RBI to make regulations to carry out the provisions of this Act and the rules made there under. Section 48 provides for lying before Parliament the rules and regulations made under this Act. Section 49 provides for repeal of the Foreign Exchange Regulation Act 1973 and for dissolution of the Appellate Board constituted under section 52 of the said Act. Sub-section-3 of this section states that notwithstanding any thing contained in any other law for time being in force, no court shall take cognizance of an offender under the repealed Act and no adjudicating officer shall take notice of any contravention under section 51 of the repealed Act after the expiry of the period of two years from the date of commencement of this Act. According to sub-section 4, subject to provisions of sub - section-3, all offences committed under the repealed Act shall continue to be governed by the provisions of the repealed Act as if that Act had not been repealed.

8.5.2 EVALUATION OF FEMA

The Foreign Exchange Regulation Act 1974 was promulgated at the time when India's foreign exchange position was not satisfactory requiring stringent controls over the use of foreign exchange. More over the international economic environment was one that characterized by controls and regulations on every front. Hence, FERA was more harsh and stringent. Under FERA all transactions involving foreign exchange and all transactions with non-residents in rupees or foreign currency were absolutely prohibited except where specific relaxations were made. Similarly, non-residents were also not permitted to have any dealings in India. Over the years the nature of the Indian economy has changed. The size of the economy and external sector in particular has grown up. The remittances from abroad and foreign exchange reserves have grown enormously. The private corporate sector has been complaining for long against what it termed as 'draconian' provisions of FERA which gave unbridled powers to the

Enforcement Directorate to arrest any person, search any premises, seize any document and start proceedings against any person for contravention of FERA or for preparations of contravention of FERA. The contravention of FERA was treated as criminal offence and the burden of proof lies on the guilty. In view of all these a new legislation dealing with foreign exchange transactions was found necessary. The result was the enactment of FEMA. As the name suggests the emphasis under FEMA has been 'exchange management' whereas the emphasis under FERA was 'exchange regulation' or 'exchange control'. Under FERA prior permission of RBI was necessary in respect of most of the transactions whereas under FEMA it is not necessary. FEMA has brought about a sea change in most of the transactions. FEMA is expected to facilitate external trade and payments and promote the orderly development and maintenance of foreign exchange market in India. In respect of current account transactions there are no restrictions except under section –5. Under section –5 the central government in consultation with the RBI is empowered to impose reasonable restrictions as an enabling provision to avert such grave crisis as witnessed in East Asia in 1997-98. Another major change under FEMA is that only monetary penalty will be imposed on the convicted and there is no punishment by way of imprisonment for contravention of any part of the provisions. Only the non-payment of the penalty will attract imprisonment under FEMA. Most of the goods can be imported under OGL reducing the license raj. Gold and silver can also be imported within limits. Rupee is made fully convertible on current account. It is not yet fully convertible under capital account. Since rupee is convertible under current account, all current incomes including rent, dividends, interest and salary are repatriable even though the principal amount is not repatriable. FEMA can be considered as a first step towards capital account convertibility. The critics feel that the government has decided to abandon even the bare responsibility of regulating the foreign capital in the country. This is deplorable when the international institutions under leadership of the developed countries push forward the multilateral investments regimes without any controls and regulations from the host countries.

Check Your Progress:

What are the salient features of FERA?

_____
_____
_____
_____
_____
_____

List out the special features of FEMA.

_____
_____
_____
_____
_____
_____

8.6. LET US SUM UP

In this chapter we have discussed about three interrelated topics relating to foreign exchange viz., functions and policies of Export Credit and Guarantee Corporation, meaning and objectives and methods of exchange controls and the much controversial Act viz., Foreign Exchange Regulation Act and its modified version Foreign Exchange Management Act. The Export Credit and Guarantee Corporation (ECGC) was set up in 1964. The ECGC is a company fully owned by the government of India. It is under the direct control of the Ministry of Commerce. ECGC provides such services to the exporters that are not generally available from the commercial insurance companies. ECGC has four types of standard policies that cover both commercial and political risks. ECGC administers some specific policies to deal with supply contracts for exports of capital goods, or turnkey projects or construction works which are not repetitive in nature. Apart from these, ECGC offers financial guarantees to cover packing, post shipment, export finance and export production finance guarantees. ECGC also provides dollar denominated credit at low rates of interest. Exchange control is another important method used in many developing countries to regulate or control precious foreign exchange reserves. These were widely used during the interwar period with varied objectives. There are broadly two methods of exchange controls viz., direct and indirect methods. Direct intervention in foreign exchange dealings, exchange restriction, multiple exchange rates, and exchange clearing agreements, payment agreements, and moratorium on foreign exchange transfers are some of the direct methods of exchange controls being used in different countries. In India Foreign Exchange Regulation Act (FERA) was enacted to enforce strict controls over all foreign exchange transactions in 1973. FERA made it possible to conserve foreign exchange and to prevent its misuse. But it failed to facilitate trade and to improve foreign exchange reserves in India. In this context, the government of India replaced FERA with a more liberal and consumer friendly Act known as Foreign Exchange Management Act (FERA) in 1998. After implementation of the Act, the foreign exchange reserves started to rise in India. With less than one billion dollars of foreign exchange reserves on the eve of the introduction of New Economic Reforms in July 1991, India has now (January 2004) accumulated foreign exchange reserves over $100 billion. This is indeed the remarkable achievement of the new liberalized economic policy being pursued in India.

8.7. KEY WORD AND CONCEPTS

Export Credit and Guarantee Corporation: ECGC is a company fully owned by the government of India. It offers several guarantees to the exporters to cover their commercial and political risks involved in their foreign trade transactions.

Commercial Risks: Risks faced by an exporter in his foreign trade such as insolvency of the foreign buyer, continuous default in the payments for goods and buyers' failure to accept the goods are termed as 'commercial risks'. The ECGC provides guarantee to the bankers against all these commercial risks.

Political Risks: Risks that arise in foreign trade to an exporter due to such incidents as imposition of restrictions on remittances by foreign governments, war, revolution, or civil disturbance, introduction of new import licences etc. are known as political risks.

Exchange Controls: Exchange control may be defined as the activities of government that influence the cost and availability of foreign exchange by imposing controls over the sale and purchase of foreign currencies.

Multiple Exchange Rates: Fixing of different rates of exchange for different purposes is known as multiple exchange rates. Different exchange rates are fixed for imports and exports of different goods. Even for different categories of imports different rates of exchange are fixed.

Exchange Clearing Agreement: When the foreign exchange reserves are totally exhausted, countries evolve some clearing arrangements with their trade partners that avoid the use of any foreign exchange reserves.

Foreign Exchange Regulation Act-1973: The comprehensive Foreign Exchange Regulation Act (FERA) enacted in India and came into force from 1st January 1974 is known as FERA. The objectives of FERA include, conservation of the precious foreign exchange reserves of India and issuing guideline to the foreign investors to divert their funds to the core sectors of the economy that employ sophisticated technology.

Foreign Ex change Management Act – 1998: The new Foreign Exchange Management Act passed in 1998 seeks to repeal FERA-1973 and consolidate and simplify the law relating to foreign exchange with a view to facilitating external trade and payments and for promoting orderly development and maintenance of foreign exchange market in India.

8.8. BOOKS FOR FURTHER READING

1. Ian H. Giddy (1997), ***Global Financial Markets***, New Delhi: A.I.T.B.S. Publishers & Distributors.
2. Balagopal, T.A.S.(1998), E***xport Marketing,*** Mumbai: Himalaya Publishing House.
3. Rajajee, M.S., Rasheed, I. A. and Narasimhan S. (1982), E***xport Marketing and Management***, New Delhi: S. Chand & Company Ltd.
4. Misra, S. K. and V. K. Puri (2002), ***Indian Economy,*** Mumbai: Himalaya Publishing House.
5. Subba Rao, P. (2001), ***International Business –Text and Cases***, Mumbai: Himalaya Publishing House.
6. Pandey, I. M. (2001), ***Financial Management***, New Delhi: Vikas Publishing House Pvt. Ltd.

8.9. MODEL EXAMINATION QUESTIONS

1. Explain functions and policies of ECGC.
2. Evaluate the objectives and working of ECGC.
3. What are the objectives of exchange controls?
4. Examine different methods of exchange controls.
5. Critically examine the working of FERA-1973.
6. What is FEMA? How is it an improvement over FERA?

—0O0—

9 : The Foreign Exchange Market

Objectives

The Objectives of this lesson are to:

- explain the structure of and the participants in the foreign exchange market
- familiarize the mechanics of trading and methods of quotation
- discuss foreign exchange transactions
- understand the major changes in the exchange rate regime in India.

Structure

9.1. Introduction

The foreign exchange market is the market in which currencies are bought and sold against each other.

If there were a single international currency, there would be no need for a foreign exchange market. The purpose of the foreign exchange market is to permit transfers of purchasing power denominated in one currency to another. For example, a Japanese firm exports automobiles to a U.S. dealer for dollars, and a U.S. seller sells machine tools to Japanese Company for Yen. Finally, the U.S. Company might be interested in receiving dollars, where as the Japanese manufacturer will want Yen.

The foreign exchange market is not a physical place. It is an electronically linked network of banks, foreign exchange brokers, and dealers whose function is to bring together buyers and sellers of foreign exchange. It is an over – the – counter market. It is not confined to our country but is dispersed throughout the leading financial centres of the World London, New York, Paris, Zurich, Amsterdam, Tokyo, Toronto, Milan, Frankfurt and other cities. The traders sit in the offices (foreign exchange dealing rooms) of major commercial banks around in world and communicate with each other through telephones, telexes, internet and other electronic means of communication.

The markets, geographically, span all the time zones from New Zealand to the west coast of the United States. Foreign exchange markets have become truly global in the sense that currency transactions require only a telephone call and take place round the clock. For instance, when commercial banks and their regular business day in San Francisco and Los Angels, they open in Singapore, Hong Kong, Sydney and Tokyo, and by the time the latter wind down their regular business day, banks open in London, Paris, Zurich, Frankfurt, and Milan. The market, therefore, functions 24hours enabling a trader to offset a position created on our

market using another market. If the market centres mentioned above, the major ones are London, New York and Tokyo. Other important centres are Zurich, Frankfurt, Hongkong and Singapore.

The trading of currencies takes place in foreign exchange markets whose primary function is to facilitate international trade. Knowledge of the structure and operation of these markets is essential for any fundamental understanding of international banking and trade. This chapter deals with the most important foreign exchange market – the interbank market – including the spot market (the market in which currencies are traded for immediate delivery), and the forward market (the market in which currencies are traded for future delivery). It also deals with the links between the spot and forward markets.

9.2. Foreign Market Structure And Participants

The participants can be identified in foreign exchange markets from ladder of transactions. The participants constitute the following markets:

Retail Market: At the base, or at the first level, tourists and travelers exchange one currency for another. The turnover and average transaction size are very small.

Wholesale Market: This is also referred to as *interbank market*. The participants at this second level are commercial banks, corporations and central banks. The average transaction size is very large. This chapter mainly highlights this market.

Among these participants, *primary price makers* make a two-way market to each other. In other words, they will quote a two-way price and be prepared to take either the buy or the sell side. This group includes commercial banks, big investment dealers and a few large companies.

In the retail market there are entities which make foreign exchange prices but do not make a two-way market. They are called *secondary price makers.* For example, restaurants, hotels and shops catering to tourists buy foreign currency in payment of bills.

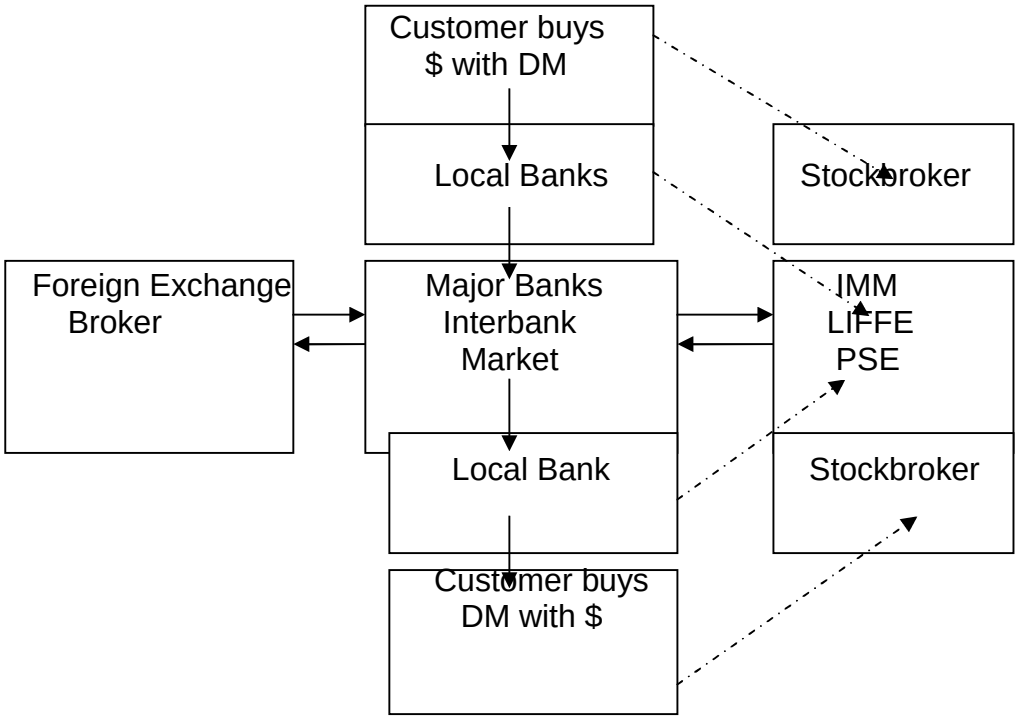
Brokers: At the third level, foreign currency brokers act as intermediaries between two market makers. By maintaining constant interaction with market makers, brokers tend to possess much useful information. It is to be noted that brokers do not buy or sell on their own account.

Central Bank: Finally, at the top is the nation's Central bank, which acts as a seller or buyer of last resort when the country's total foreign exchange earnings and expenditures are required. Central banks intervene in the market to smooth exchange rate fluctuations or to maintain target exchange rates.

Commercial and Central bank customers buy and sell foreign exchange through their banks. Generally, small banks and local offices of major banks will have a credit line with a large bank or with their home office. The customer deals with a local bank that in turn deals with its head office or a major bank.

Figure 9.1. explains various linkages between banks and their customers. The figure also exhibits the linkages with currency futures and options markets.

Figure 9.1. Structure of Foreign Exchange Markets.



Note: The international money market (IMM) Chicago trades foreign exchange futures and DM future options. The London International Financial Futures Exchange (LIFFE) trades foreign exchange futures. The Philadelphia Stock Exchange (PSE) trades foreign currency options.

9.3. Mechanics Of Trading

As discussed above, the main participating in the forex markets are the primary market makers. They deal with each other and with their clients, Central banks and sometimes with currency brokers.

The International Standards Organization (ISO) has developed three-letter codes for all the currencies which abbreviate the name of the country as well as currency. A complete list of ISO codes is given in Annexure 9.1. The codes for selected currencies are given in Table 9.1. The symbols “$” , “£” and “¥” are used to indicate the US dollar, the British Pound and the Japanese Yen respectively.

Table 9.1: The codes for selected currencies

DEM: Deutsche Mark	CHF: Swiss Franc
NLG: Dutch Guilder	BEF: Belgian Franc
FRF: French Franc	DKK: Danish Kroner
ESP: Spanish Peseta	ITL: Italian Lira
USD: US Dollar	AUD: Australian Dollar
CAD: Canadian Dollar	JPY: Japanese Yen
GBP: British Pound	IEP: Irish Pound
INR: Indian Rupee	SAR: Saudi Riyal

Note: In the three-letter ISO code, the first two letters refer to the country and the third to the currency.

Methods of quotation

Foreign exchange dealers quote two prices: the rate at which they are prepared to sell a currency and that at which they are prepared to buy. The difference between the bid rate and the offer is the dealer's spread, which is one of the potential sources of profit for dealers. The smaller rate is known as the bid rate and the higher is called in offer, or ask, rate.

Foreign exchange dealers quote two prices: the direct quote and the indirect quote. The direct quote gives the quotation in terms of the number of units of home currency necessary to buy one unit of foreign currency. The indirect quote gives the quotation in terms of the number of units of foreign currency bought with our unit of home currency.

Most of the trading takes place between market making games. Hence, it is a zero-sum game, i.e., gains made by our trader are reflected in losses made by another. But when central banks interfere, it is possible for banks to gain or loss as a group at the cost of the central bank. The practice in foreign exchange markets is that currencies are quoted against the U.S. dollar. If one bank asks another for its Deutschmark rate, that rate will be quoted against the U.S. dollar. If a company wants to buy or sell Yen against the Deutschmark, a cross rate will be worked out from the DEM/USD and JPY/USD quotation. The purpose for using a common currency for all quotations is to economize on the number of quotations. In money or capital markets, different rates of interest are charged to different borrowers. But in the wholesale foreign exchange market, such distinction is not made. Normally, the bid-ask spread is the transaction cost. Communications relate to international financial transactions are handled by a network called society for worldwide Interbank Financial TeleCommunication (SWIFT).

9.4. Foreign Exchange Transcations And Settlement Dates

Settlement of a transaction takes place by transfers of deposits between the two parties. *Settlement date* or the *Value date* is the day on which such transfers are affected. The concerned countries of the two currencies are called *settlement locations*. The locations of the two banks involved in the trade are *dealing locations*. Dealing locations need not be the same as settlement locations. For example, a Paris bank can sell deutschemarks against U.S. dollar

to a London bank. Settlement locations may be Frankfurt and New York. Dealing locations are Paris and London.

Foreign exchange transactions can be classified into spot and forward transactions, depending on the time elapsed between the transaction date and the settlement date. A third type called swaps are combination of a spot and a forward transaction.

Spot Contract

A spot foreign exchange deal is made for settlement in two working days' time. For example, in normal circumstances, a deal done on Tuesday is settled on Thursday (The value date or settlement date in the date of Thursday). If Thursday were a holiday in either the settlement countries, then the spot day would be Friday, assuming that both centres were open that day. In the case of a U.S. dollar/ Deutschmark deal done, for instance, in Tokyo, the occurrence of Japan bank holidays during the spot period is totally irrelevant. This is because all bank account transfers are made in the settlement country rather than the dealing centre.

The Mechanics of Spot Transactions*

The simplest way to explain the process of actually settling transactions in the spot market is to work through an example. Suppose a U.S. importer requires FFI million to pay his French supplier. After receiving and accepting a verbal quote from the trader of a U.S. bank, the importer will be asked to specify two accounts:

(1) The account is a U.S. bank that he wants debited for the equivalent dollar amount at the agreed exchange rate and
(2) The French supplier's account that is to be credited by FF 1 million.

Upon completion of the verbal agreement, the trader will forward a dealing slip containing the relevant information to the settlement section of her bank. That some day, a *contract note* – that includes the amount of the foreign currency, the dollar equivalent at the agreed rate, and confirmation of the payment instructions – will be sent to the importer. The settlement section will then cable the bank's correspondent (or branch) in Paris, requesting transfer of FF 1 million from its *nastro account* – that is, working balances maintained with the correspondent to facilitate delivery and receipt of currencies – to the account specified by the importer. On the value date, the U.S. bank will dedit the importer's account, and the exporter will have his account credited by the French correspondent.

At the time of the initial agreement, the trader provides a clerk with the pertinent details of the transaction. The clerk, in turn, constantly updates a *position sheet* that shows the bank's position by currency (as well as by maturities of forward contracts). A number of the major international banks have fully computerized this process to ensure accurate and instantaneous information on individual transactions and on the bank's cumulative currency exposure at any time. The head trader will monitor this information for evidence of possible fraud or excessive exposure in a given currency.

---

*Adopted from Alan C. Shapiro, Multinational financial Management, Prentice-Hall of India, New Delhi, 1999, pp 42-43.

Because spot transactions are normally settled two working days later, a bank is never certain until one or two days after the deal is concluded whether the payment due the bank has actually been made. To keep this credit risk in bounds, most banks will transact large amounts only with prime names (other banks or corporate customers).

Forward Contract

A forward foreign exchange contract is an agreement between two parties to exchange one currency for another at some future date. The rate at which the exchange is to be made, the amounts involved and the delivery date are determined at the time of the agreement.

Let us look at value dates for forward transactions. In one-month forward purchase of say Indian rupees against Canadian dollar, the rate of exchange is fixed on the transaction date. The method of arriving at the value date is : first determine the value date for a spot contract between the same currencies down on the same date and then add one *calendar month* to arrive at the value date. For example, for one-month forward transaction entered into on January 20, the spot value date is January 22 and one month forward value date is February 22. In case the value date arrived at is ineligible because of bank holidays, then it shifted forward to the next eligible business day. But one important difference is rolling forward must not take you into the next calendar month. It must be shifted backward. For example, one month forward deal is done on January 26. The spot date is January 28. One month forward value date is February 28. If February 28 is bank holiday, we cannot shift forward because that goes into March, assuming it is not a leap year. Hence, it must be rolled back to February 27.

Participants

The major participants is the forward market are:

Arbitrageurs want to earn profits by taking advantage of differences in interest rates among nations. They use forward contracts to eliminate the exchange risk involved in transferring their funds from one nation to another.

Traders use forward contracts to eliminate the risk of loss on export or import orders that are dominated in the foreign currencies.

Hedgers are generally multinational companies, which engage in forward contracts to protect the home currency value of various foreign-currency denominated assets and liabilities on their balance sheets that are not to be realized over the life of the contracts.

Speculators, in contrast to these three types of participants, actively expose themselves to currency risk by buying or selling currencies forward in order to profit from exchange rate fluctuations.

Forward Premium and Discount: In case a quoted currency is more expensive in the future than it is now in terms of the base currency, the quoted currency is then said to stand at a premium in the forward market relative to the base currency. Conversely, the base currency is said to stand at a discount relative to the quoted currency.

Swap Rate: In the interbank market, dealers quote the forward rate only as a discount from, or a premium on, the spot rate. This forward differential is known as the swap rate. A foreign currency is at a forward discount if the forward rate expressed in dollars is below the spot rate. On the other hand, a forward premium exists if the forward rate is above the spot rate.

A swap transaction is a combination of a spot and a forward in the opposite direction. For instance, a bank will buy deutschemarks spot against US dollar and simultaneously enter into a forward transaction. With the same counter party to sell deutschemarks against U.S. dollar. A 30-day dollar-deutschemark swap will consist of a spot purchase (sale) of dollars against the mark coupled with a 30-day forward sale (purchase) of dollar against mark. Swap is a temporary exchange of our currency for another with an obligation to reverse it at a specific future date. Forward contracts without an accompanying spot deal are known as outright forward contracts.

9.5. Foreign Exchange Market In India

The foreign exchange market in India has under some significant changes since independence and more particularly during the beginning years of 1990's. Table 9.2. provides a bird's –eye - view of the major changes.

Table 9.2. Major Changes in the Exchange Rate Regime in India: 1966-94.

Year	Type of Change
1966	The rupee was devalued by 57.5% against the sterling on Jumb
1967	Rupee-sterling parity changed as a result of devaluation of sterling
1971	Bretton Woods system broke down in August. Rupee briefly pegged to the U.S. dollar at Rs.7.50 before repegging to sterling at Rs.18.9677 with a 2.25% margin on either side.
1972	Sterling was floated on June 23. Rupee-sterling parity revalued to Rs. 18.95 and then in October to Rs.18.80.
1975	Rupee pegged to an undisclosed currency basket with margins of 2.25% on either side. Intervention currency was sterling with a central rate of Rs. 18.3084
1979	Margins around basket parity widened to 5 % on each side in January.
1991	Rupee devalued by 22% on July 1 and July 3. Rupee dollar rate depreciated from 21.20 to 25.80. A version of dual exchange rate introduced through EXIM scrip scheme giving exporters freely tradable import entitlements equivalent to 30-40% of export earnings.
1992	LERMS (Liberalised Exchange Rate Management System) introduced with 40-60 dual rate for converting export proceeds, market determined rate for all but specifies imports and market rate for approved capital transactions. US dollar became intervention currency from March 4. EXIM scrip scheme abolished.
1993	Unified market determined exchange rate introduced for all transactions. RBI would buy spot US dollars and sell US dollars for specified purposes. It will not buy or sell forward, though it will enter into dollar swaps.
1994	RBI announces substantial relaxation of exchange controls for current account transactions and a target date for moving current account convertibility

Adopted from Pradhan, H.K. "Exchange Rate Policy of India, Export-Import Bank of India, Occasional paper No. 22, Bombay, 1993.

The RBI's forex policy in the 1980's was limited to pegging the rupee rate in the morning and responding to volatility in the market during the day by changing its reference dollar rates every time the market threatened to break out of the controlled range. It would also change the rupee rate in case undue movements were noticed.

The devaluation of the rupee in 1991 brought about a sharp drop in its value against the dollar. The decline was hardly surprising, given the great strain on the economy during the 1990's. Many factors, including domestic political crises and increase in oil prices, contributed to the decline in the rupee value. India's credit rating was downgraded twice and with installment payments against some foreign loans coming due, the economy nearly collapsed.

Meanwhile, in 1991 a new government was sworn in and the rupee was devalued by a total of 22 per cent. Simultaneously, dramatic changes were made in trade policy: the negative list for imports was significantly shortened and a new instrument (the Exim scrip) created to provide exporters with additional returns. Thus began the process of economic liberalization. This was clearly the first step towards the supposed market determination of the rupee.

In the Union budget for 1992-93, the rupee was made "partly convertible", or more correctly, partly floating, thus ushering in Liberalized Exchange Rate Mechanism (LERM). Under the new scheme, 40 per cent of the export receipts (denominated in dollars) was to be surrendered to the RBI at a predefined (official) rate, the proceeds would be used for import of items such as petroleum, fertilizers and edible oils.

By February 1993, the rupee was falling fast. Finally, is the Union budget for 1993-94, "full convertibility" of the rupee was allowed.

The growing depth of the Indian forex market in the 1990's reflects essentially the result of the implementation of a number of recommendations of three important committees. They are: the High Level Committee on Balance of payments (Chairman: Dr. Rangarajan); The Report of the Expert Group on Foreign Exchange Markets in India (Chairman: Sri O.P. Sodhani) and the Committee on Capital Account Convertibility (Chairman: Sri S.S. Tarapore).

The Committee on Capital Account convertibility submitted its report in 1997. The report highlighted the benefits of a more open capital account. Keeping in view the recommendations of the report, India has over the years liberalized certain transactions in its capital account. Vastly altered and liberal policy environment for the external sector is reflected in the Foreign Exchange Management Act, 1999 (FEMA), which replaced the earlier Foreign Exchange Regulation Act, 1973 (FERA). The new Act sets out its objectives as "facilitating external trade and payment and "promoting the orderly development and maintenance of foreign exchange market in India."

The Structure of the Indian Foreign Exchange Market

The forex market in India consists of three segments. The first segment consists of transactions between the RBI and the Authorized Dealers (ADs). The ADs are mostly commercial banks. The second segment in the interbank market in which the ADs deal with each other and the third segment consists of transactions between ADs and their Corporate customers. In the retail segment, in addition to the ADs, there are moneychangers, who are allowed to deal in foreign currencies. The retail market caters to the needs of tourists.

There has been a considerable improvement in the forex market turnover in the recent years. The total turnover, i.e., merchant and interbank taken together, in the forex market increased by six fold between the period 1987-88 to 1999-00. The average monthly turnover increased from about US $17billion in 1987-88 to US $50 billion in 1993-94 and further to US $ 109 billion in 1998-99.

The proportion of interbank turnover in total turnover increased from 82 per cent in 1987-88 to 91 per cent by 1991-92 but declined to less than four-fifth, by 1999-00. As regards the classification by way of spot and forward transactions, available data for the recent period indicate that the merchant segment is dominated by spot transactions, while the inter bank segment is dominated by forward transactions, while the inter bank segment is dominated by forward transactions. During 1999-00, spot transactions accounted for about 55 per cent of total merchant turnover, which the forward transactions famed 40 per cent of total inter bank turnover.

9.6. Summary

The foreign exchange market is an electronically linked network of banks, foreign exchange brokers, and dealers whose function is to bring together buyers and sellers of foreign exchange. The trading of currencies takes place in foreign exchange markets whose primary function is to facilitate international trade. This chapter deals with the most important foreign exchange market – the interbank market – including the spot market, and the forward market.

The participants in foreign exchange market are : tourists and travelers (i.e., retail market)., wholesale market (i.e., interbank market) brokers and the nation's Central bank. The International Standards Organization (ISO) has developed three-letter codes for all the currencies which abbreviate the name of the country as well as the currency.

Foreign exchange transactions can be classified into spot and forward transactions, depending on the time elapsed between the transaction date and the settlement date. A third type called swaps are combination of a spot and a forward transactions. A spot deal is made for settlement in two working days' time. A forward contract is an agreement between two parties to exchange one currency for another at some future date. The major participants in the forward market are: Arbitrageurs, traders, hedgers and speculators.

The foreign exchange market in India has undergone significant changes, particularly during the beginning years of 1990's. Vastly altered and liberal policy environment for the external sector is reflected in the Foreign Exchange Management Act, 1999 (FEMA), which replaced the earlier Foreign Exchange Regulation Act, 1973 (FERA).

9.7. Key Words

Direct quote : It gives the quotation in terms of the number of units of home currency necessary to buy one unit of foreign currency.

Foreign Exchange Market: It is an electronically linked network of banks, foreign exchange brokers, and dealers whose function is to bring together buyers and sellers of foreign exchange.

Forward Contract: It is an agreement between two parties to exchange one currency for another at some future date.

Indirect quote: It gives the quotation in terms of the number of units of foreign currency bought with one unit of home currency.

Settlement date: Settlement date or the value date is the day on which a transaction takes place by transfers of deposits between the two parties.

Spot Contract: A spot deal is made for settlement in two working days, time.

Swap transaction: It is a combination of a spot and a forward in the opposite direction.

9.8. Self Assessment Questions

1. Explain the following terms:
   (a). Interbank market
   (b). Bid rate
   (c). Offer
   (d). Value date
2. Distinguish between:

(a). Direct quote and indirect quote

(b). Primary price makers and secondary price makers.

3. What is spot contract? Explain the mechanics of spot transactions.
4. How value dates are determined in forward contracts? Identify the major participants in the forward market?
5. Comment on the initiatives taken to widen and deepens the forex market in India.

9.9. Further Readings

1. Adrian Buckley, Multinational Finance, Prentice-Hall of India, New Delhi, 2001.

2. Alan C. Shapiro, Multinational Financial Mangement, Prentics-Hall of India, New Delhi, 1999

3. Apte, P.G., International McGraw-Hill, New Delhi, 1999.
4. Bhalla, V.K., International Financial Management, Anmol Publications, New Delhi, 2001.

ANNEXURE 9.1.
SELECTED ISO CURRENCY CODES, BY CONTINENT AND COUNTRY

Africa

Country	Currency	Code
Algeria	Dinar	DZD
Angola	Kwanza	AON
Botswana	Pula	BWP
Central African Republic	Equat. CFA Franc	XAF
Chad	Equat. CFA Franc	XOF
Congo	Equat. CFA Franc	XAF
Egypt	Pound	EGP
Ethiopia	Birr	ETB
Ghana	Cedi	GHC
Kenya	Shilling	KES
Liberia	Dollar	LRD
Libya	Dinar	LYD
Madagascar	Franc	MGF
Mauritius	Rupee	MUR
Morocco	Dirham	MAD
Mozambique	Metical	MZM
Namibia	Dollar	NAD
Nigeria	Naira	NGN
Senegal	West. CFA Franc	XOF
Seychelles	Rupee	SCR
Somalia	Shilling	SOS
South Africa	Rand (Fin)	ZAL
South Africa	Rand (Com)	ZAR
Sudan	Dinar	SDD
Swaziland	Lilangeni	SZL
Tanzania	Shilling	TZS
Tunisia	Dinar	TND
Uganda	New Shilling	UGX
Zaire	New Zaire	ZRN
Zambia	Kwacha	ZMK
Zimbabwe	Dollar	ZWD

America

Country	Currency	Code
Argentina	Peso	ARS
Bahamas	Dollar	BSD
Bermuda (UK)	Dollar	BMD
Bolivia	Boliviano	BOB
Brazil	Cruzeiro Real	BRR
Canada	Dollar	CAD
Caymen Islands	Dollar	KYD
Chile	Peso	CLP
Colombia	Peso	COP
Costa Rica	Colon	CRC
Cuba	Peso	CUP
Ecuador	Sucre	ECS
Guatemala	Quetzal	GTQ
Haiti	Gourde	HTG
Jamaica	Dollar	JMD
Mexico	Peso Nuevo	MXN
Nicaragua	Cordoba Oro	NIO
Panama	Balbao	PAB
Paraguay	Guarania	PYG
Peru	Nuevo Sol	PEN
Trinidad & Tobago	Dollar	TTD
United States of America	Dollar	USD
Uruguay	Urug, Peso	UYU
Venezuela	Bolivar	VEB
West-Indies	W-I Dollar	XCD

Asia and Australia

Country	Currency	Code
Afghanistan	Afghani	AFA
Australia	Dollar	AUD
Bahrein	Dinar	BHD
Bangladesh	Taka	BDT
Brunei	Dollar	BND
Bhutan	Ngultrum	BTN
China	Remnimbi Yuan	CNY
Hong Kong	Dollar	HKD
India	Rupee	INR
Indonesia	Rupee	IDR
Iraq	Dinar	IQD
Iran	Rial	IRR
Israel	Shekel	ILS
Japan	Yen	JPY
Jordan	Dinar	JOD
Kirgistan	Som	KGS
Kuwait	Dinar	KWD
Laos	New Kip	LAK

Lebanon	Pound	LBP
Malaysia	Ringgit	MYR
Mongolia	Tugrik	MNT
Myanmar (Burma)	Kyat	MMK
Nepal	Rupee	NPR
New Zealand	Dollar	NZD
North Korea	Won	KPW
Oman	Rial	OMR
Pakistan	Rupee	PKR
Quatar	Riyal	QAR
Saudi Arabia	Riyal	SAR
South Korea	Won	KPW
Singapore	Dollar	SGD
Sri Lanka	Rupee	LKR
Syria	Pound	SYP
Taiwan	Taiwan Dollar	TWD
Thailand	Baht	THB
United Arab Emirates	Dirham	AED
Vietnam	New Dong	VND
Yemen	Rial	YER

Europe

Country	**Currency**	**Code**
Austria	Schilling	ATS
Belgium	Franc	BEF
Bulgaria	Lev	BGL
Czeck Republic	Crown	CZK
Cyprus	Pound	CYP
Croatia	Dinar	HRD
Denmark	Crown (Kroner)	DKK
Finland	Markka	FIM
France	Franc	FRF
Germany	Mark	DEM
Great Britain	Pound	GBP
Greece	Drachma	GRD
Hungary	Forint	HUF
Ireland	Pount (Punt)	IEP
Italy	Lira	ITL
Luxemburg	Franc	LUF
Netherlands (The)	Guilder	NLG
Norway	Crown (Kroner)	NOK
Poland	Zloty	PLZ
Portugal	Escudo	PTE
Romania	Lei	ROL
Russia	Ruble	RUR
Slovakia	Crown	SKK
Spain	Peseta	ESP
Sweden	Crown (Kroner)	SEK
Turkey	Lira	TRL

Note: In the three letter ISO code, the first two letters refer to the country and the third to the currency.

10. Measurement Of Foreign Exchange Exposure And Risk

Objective

The objectives of this lesson are to:

- understand the concept of exposure and risk.
- explain various types of currency exposure and the methods available for its measurement.
- discuss accounting treatment of transaction and translation exposure.
- understand tax treatment of foreign exchange gains and losses

Structure

10.1 Exposure And Risk : Concept

The general concept of *foreign exchange exposure* refers to the degree to which a company is affected by exchange rate changes. In other words, an asset, liability or income is said to be exposed to exchange risk when a currency movement will change its home currency (HC) value. The term 'exposure' signifies that a company has assets, liabilities or income streams denominated in currency other than its own. *Risk* avises because currency movements may alter home currency values.

In the words of PG Apte, "Exposure of a firm to a risk factor is the sensitivity of the real value of the firm's assets, liabilities or operating income, expressed in its functional currency, to unanticipated changes in the risk factor."

Some important points about this definition are in order:

10.2. Classification Of Foreign Exchange Exposure And Risk

All foreign currency denominated assets, liabilities and income streams are exposed to exchange risk.

Firms which have cross-border transactions are severely exposed. But even "purely domestic" firms which have absolutely no cross-border transactions are also exposed because

their suppliers, customers and competitors are exposed. Figure 10.1 presents a schematic picture of currency exposure. The first type of exposures are known as *accounting exposures.* Accounting exposures can be distinguished into two categories, viz., *transaction exposure* and translation exposure.

10.2.1. Values of assets, liabilities or operating income are to be denominated in the *functional currency* of the firm. This is the primary currency of the firm and in which its financial statements are published. For most firms it is the domestic currency.

10.2.2. Exposure is defined with respect to *The real values,* i.e. values adjusted for inflation. While theoretically this is the correct way of assessing exposure, in practice due to the difficulty of dealing with an uncertain inflation rate this adjustment is often ignored, i.e. exposure is estimated with reference to changes in nominal values.

10.2.3. The definition stresses that only *unanticipated* changes in the relevant risk factor are to be considered. The reason is that markets will have already made an allowance for *anticipated* changes.

Translation exposure. The second type of

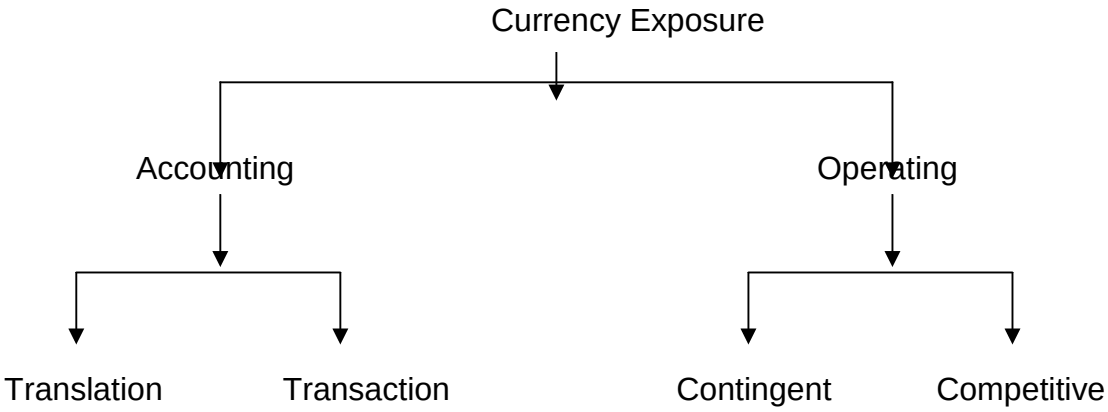


Figure 10.1 Classification of Currency Exposure

Exposures consisting of contingent and competitive exposures is also collectively known as *operating exposure.* Operating is often referred to as economic exposure.

10.3. Accounting Exposures

Accounting exposures relate to items that presently appear on the balance sheet and income statement on the firm. Accounting exposures arise from the need, for purposes of reporting and consolidation, to convert the financial statements of foreign operations from the local currencies (LC) involved to the home currency (HC)

Transaction exposure arises because a payable or receivable is denominated in a foreign currency. Translation exposure arises on the consolidation of foreign currency – denominated assets and liabilities in the process of preparing consolidated accounts.

Transaction exposure is a comparatively straightforward concept but translation exposure is more complex. We now proceed to discuss these.

10.3.1. Transaction Exposure

Transaction exposure stems from the possibility of incurring future exchange gains or losses on transactions already entered into and denominated in a foreign currency. For example, when Microsoft sells a computer software to a bank in England, it will not be paid until a later date. If that sale is priced in pounds, Microsoft has a pound transaction exposure. A company's transaction exposure is measured currency by currency and equals the difference between contractually fixed future cash inflows and outflows in each currency. Some of these unsettled transactions, including foreign-currency-denominated debt and accounts receivable, are already listed on the firm's balance sheet. But other obligations such as contracts for future sales or purchases are not reflected in the balance sheet.

10.3.2. Translation Exposure

The main difference between transaction and translation exposure is that the former has impact on cash flows while the latter has no direct effect on cash flows. According to Alan Shapiro, translation exposure is simply the difference between exposed assets and liabilities. The controversies among accountants centre on which assets and liabilities are exposed and on when accounting – derived foreign exchange gains and losses should be recognized (reported on the income statement). A crucial point is that no cash flows are necessarily involved.

There are four basic translation methods. They are: the current / non -current method (sometimes called the traditional or working capital method), the monetary/non-monetary method, the temporal method and the current rate method. Each method has its own assumptions as to the applicability of historical or current rates to various balance sheet items. Table 10.1 summarises the translation rules of each of these four methods.

10.3.3. Current /Non current Method

In this method, all the foreign subsidiaries current assets and liabilities are translated into home currency at the current exchange rate. Each non-current asset or liability is translated at its historical exchange rate (that is, at the rate in effect at the time the asset was acquired or the liability incurred.

The income statement is translated at the average exchange rate of the period, except for those revenues and expense items associated with non current assets or liabilities.

Table 10.1 Translation Rules used in Different Methods

	Current/ Non current		Monetary / Non monetary		Temporal		Current rate	
	CR*	**HR****	**CR***	**HR****	**CR***	**HR****	**CR***	**HR****
ASSETS Current Assets Cash/Marketable securities	X		X		X		X	
Receivables [#]	X		X		X		X	
Inventory (at cost)	X			+	X		X	
Prepaid expenses	X			+		+	X	
Fixed assests less Accumulate depreciation		+		+		+	X	
Good Will		+		+		+	X	
LIABILITIES Current Liabilities	X		X		X		X	
Long term debts		+	X		X		X	
Deffered income taxes		+	X		X		X	
Equity ***	**Res.**		**Res.**		**Res.**		**Res.**	

*CR= Current rate; **HR= Historical rate

*** Adjusted for the translation gain/loss

[#] Any long-term receivables (settlement date beyond one year) will be translated at the historical rate, under the current / non-current method

The latter items, such as depreciations expense, are translated at the same rates as the corresponding balance sheet items. Therefore, it is possible to see different revenue and expense items with similar maturities being translated at different rates.

10.3.4. Monetary / Non-Monetary Method

The Monetary/non-monetary method differentiates between monetary assets and liabilities. Monetary items such as cash bills payable and receivable, and long-term debt are

translated at the current rate. Non-monetary items such as inventory, fixed assets and long-term investments are translated at historical rates. Income statement items are translated at the average exchange rate during the period, except for revenue and expense items related to non-monetary assets and liabilities. The latter items, essentially depreciation and cost of goods sold, are translated at the same rate as the corresponding balance sheet items.

10.3.5. Temporal Method

The main difference between the temporal and monetary/non-monetary methods arises in the case of certain items of inventory where stock is stated in the original accounts at market value (where it is below historic cost) the temporal method would translate it at the current rate while the monetary / non-monetary approach would use the historic exchange rate. Income statement items are translated at an average rate for the reporting period. However, cost of goods sold and depreciation related to balance sheet items carried at past prices are translated at historical rates.

Adopted from V.K. Bhalla, *International Financial Management* Anmol Publications, New Delhi, 2001. P.415.

10.3.6. Current Rate Method

According to this method, all balance sheet and income items are translated at the current rate. Accounting exposure in given, simply by net assets or shareholders' funds (sometimes called equity). This method has become increasingly popular worldwide.

10.3.7. Impact of the choice of Translation Method

Keeping in view the diversity of translation methods in the consolidation of financial statements, the choice of translation method can have a significant effect on home-currency accounting results. In fact, identical firms could share different translation gains or losses merely because they used different methods of translating their foreign subsidiaries accounts.

Example

An Australian company has set up a subsidiary in India on 1st January 199X. The underlying transactions were booked at the prevailing exchange rate, say Rs.20/$A. Table 10.2 exhibits the opening balance sheet and its rupee equivalent are shown in columns (1) and (2).

The Indian subsidiary could not begin operations in the first quarter of 199X. So that at fiscal year and i.e., 31 march 199X, the rupee balance sheet was exactly the same as on 1st January 199X. But during this quarter, rupee depreciated by 25 per cent against the $A so that the closing rate of exchange was Rs.25/$A. This rate was applied in the consolidation of some or all of the subsidiary's items, depending on which translation method was used. The results obtained by applying each of the four methods are shown in columns 3 to 6. If the rupee had appreciated or $A depreciated and the new exchange rate is Rs.12.50/$A, the impact of the use of each translation method on the consolidated of the balance sheet is shown through columns 7 to 10 of Table 10.2. This explains the implications of the use of different methods with results ranging from a loss of $A 1,050,000 to a gain of $A 1,075,000 and revaluation results can vary from a gain of $A 2,400,000 to a loss of $A 1,750,000.

Operating Exposure

Insert table Ms Excel sheet

10.4. Operating Exposure (Economic Exposure)

Many authors use the term "Economic Exposure" to refer to the concept of "Operating Exposure." This group of exposures consist of contingent and competitive exposures.

Economic exposure is concerned with the present value of future operating cash flows to be generated by a company's activities and how this present value, expressed in parent currency, changes following exchange rate movement.

Out of the two types, contingent exposures have a much shorter time horizon. Some of the situations in which such exposures arise are:

1. An export or import deal in being transacted and prices are yet to be finalized. Fluctuations in the exchange rate will probably influence both and then it will be converted into transactions exposure.
2.
3. The firm has submitted a tender bid on an equipment supply contract. If the contract is awarded, transactions exposure will arise.
   In the above examples, currency movements will affect future cash flows.

Competitive exposure, on the other hand, is the most crucial dimension of currency exposure. Its time horizon is longer than that of transactions exposure. Its focus is on long run survival and value of the firm. For instance, a firm is involved in producing goods for export and / or import substitutes. It may also import a part of its raw materials and components. A change in exchange rate gives rise to a number of concerns for a company. Some of them are:

1. What will be the effect on sales volume if prices are maintained? If prices are changed?
2. Material costs of imported inputs will increase following a depreciation of the home currency.
3. Manpower costs may also increase if cost of living increases and wages have to be raised.

Competitive exposure is also known as "Strategic Exposure." It influences the firm's choice of market-products, sources of inputs, location of manufacturing activity and decisions as to whether foreign operations should be started.

D.E. Logue quoted a number of examples from recent history which bring out the nature of operating exposure:[1]

1. In the late 1970s, Laker Airways started offering cut-price, trans-Atlantic air travel to British tourists taking vacations in the U.S. The dollar was weak and tourist traffic was strong. Laker then expanded its dollar started rising and

---

1. D.E. Logue, "when theory fails : Globalisation as a Response to the (Hostile) Market for foreign Exchange", *Journal of applied Corporate Finance,* Vol.81, No.3 (Fall), 1995, pp.39-48

continued to climb for nearly four years. On the other hand, the transactions exposure on servicing the dollar liabilities and on the other the operating exposure due to falling tourist traffic created severe cash crunch for Laker. The strong dollar meant that U.S. vacations were an expensive proposition for British tourists. Ultimately, Laker Airways went bankrupt.

2. The relentless rise of the dollar during the first half of eighties eroded the competitive position of many American firms. Firms like Kodak found that most of their costs were dollar denominated while their sales wise in all parts of the world, denominated in a number of foreign currencies, which were falling against the dollar. The firm faced stiff competition from Japanese firms such, as Fuji both is the US market as well as the firm in the third country markets. Kodak could not raise its prices without significant loss of sales. Companies like International Harvestor found themselves in a similar position and even moved some of their manufacturing operations out of US.

3. Conversely, when the dollar started falling against the yen and deutschemark around mid – 1985 and continued to fall for over two years, Japanese and German carmakers found their operating margins being squeezed. They responded partly by staring manufacturing operations is US and partly by moving up market into premium-priced luxury cars where consumer sensitivity to price increase is relatively less.

4. Indian marketers of cars and two wheelers with significant import content denominated in yen have found that the persistent strength of the yen has meant cost increases which they have not always been able to pass on to the consumer because of depressed demand conditions and competitive considerations.

5. American pharmaceutical multinational like Merck have found that during periods of strong dollar, their cash flows denominated in dollars tend to shrink while bulk of their R & D expenditures are donominated in dollars. Shortage of internally generated cash tends to have adverse impact on their R & D budgets, which are a crucial factor in their long-run competitiveness.

10.5. Accounting Treatment Of Transaction And Translation Exposure

In recording and reporting the effects of transaction and translation exposures, the accountant has to deal with the three important issues:

1. Which exchange rate should be used to translate asset and liability items? Historical, current or some average rate? Historical rate means the exchange rate ruling at the time the asset or liability came into existence.

2. Where in financial statements should the gains / losses be shown? Should they be merged with the income statement or should a separate account be kept to be subsequently merged with the firm's net worth?

3. What are the tax implications of the various choices made regarding (1) and (2) above?

P.G. Apte examined the various alternatives, which are discussed in brief here under:[1]

1. Asset and liability items are recorded at the rate prevailing at the time they are acquired.

2. Items which are settled during the current accounting period are revalued at the rate prevailing at the time of settlement. This gives rise to exchange gains or losses, which are taken to the income statement.

3. For items not settled within the accounting period, they are taken to the balance sheet either at the historical rate or at the closing rate. In the latter Case a loss or a gain is made the treatment of which depends on the nature of the item and whether it is a gain or a loss. Losses are normally shown in income immediately while gains may be shown in current or future income statement according to some set procedure.

4. When items such as receivables and payables in foreign currency are hedged by means of a forward contract, the forward rate applicable in the contract is used to measure and report such items. The difference between the spot rate at the inception of the contract and the forward rate is recognized in income.

5. Suppose an asset was acquired at home, financed out of a foreign currency borrowing. A substantial depreciation of the home currency takes place. Further, there is no practical means of hedging the liability. In such cases, the exchange loss is sometimes regarded as an adjustment to the cost of the asset and the asset is carried at the adjusted value.

6. For translating a foreign entity's balance sheet into the parent's currency of reporting various methods can be followed. The *closing rate* method uses the rate prevailing on the parent's balance sheet date. The *current – non-*

---

1. Adopted from P.G. Apte, *International Financial Management,* Tata McGraw-Hill, New Delhi, 1999, PP.43-44

current method uses the closing rate for current assets and liabilities and historical rates for non-current assets and liabilities. The *temporal* method translates cash, receivables and payables at the closing rate while other items are translated at historical rates. The *monetary – non-monetary* method translates monetary assets and liabilities (e.g. receivables and payables, cash, etc.) at the closing rate while non-monetary assets and liabilities (e.g. inventories) are translated at historical rates. In contrast to the current – non-current method, the major difference arises in translating long-term debt for which the monetary – non-monetary method uses the closing rate. This can give rise to large translation losses or gains. For revenue and expense items from the income statement, there is a choice between using the rase prevailing at the time. The transaction was booked or a weighted average rate for the period covered by the statement.

10.6 Tax Treatment Of Gains And Losses

Foreign exchange transactions can result in a gain or loss in case the relative value of the two currencies changes between contract date and the date of payment of the contract. There can be a gain or loss in one currency expressed in terms of the other.

Similarly when accounts expressed in one currency are translated into another currency, the profit or loss on foreign exchange may affect the taxation charge imposed on the company at home or abroad. But the complication start when the tax rates differ between countries. Certain countries differentiate between foreign exchange deals covering revenue and those covering capital transactions. Two authorities in some countries ignore foreign exchange gains or losses unless they are actually realized. Tax authorities in other countries consider unrealized gains and losses to be fullytaxable. The overall objective of the tax policy is to arrange matters in such a way that gains on exchange rate adjustments are made to arise in a form which are not taxable and losses is a form which are allowable against other income.

Companies adopt two basic approaches in the tax treatment of foreign exchange gains and losses. The firm approach is called *Separate Transactions* approach. This approach treats the foreign exchange bought or sold as an asset. The gain or loss on foreign exchange is then separated from any gain or loss on the underlying transaction. The tax effect will arise when the transaction is closed by payment, not when the contract is signed.

The *integrated approach* on the other hand, ties the foreign exchange gain or loss into the contract it finances. This theory assumes the foreign currency as a medium of exchange rather than an independent asset. Any profit or loss on foreign exchange would be added to or subtracted from the profit on the underlying transaction. The tax treatment of this or lose might be affected by the nature of the underlying transaction, that is whether it is of a capital or revenue nature.

10.7. Tax Effects And Exposures In A Multinational Context[1]

The purpose of this section is to illustrate calculation of before-tax and after-tax exposures in a multi currency, multinational context.

We will employ the following notations

PC: Parent's currency	SC: Subsidiary's currency
TC: Third currency (other than PC or SC)	
ER: Exchange Rate	AT: After-tax.
A/R: Accounts Receivables	A/P: Accounts Payable
TP: Tax Payable	RE: Retained Earnings

We will make the following assumptions about the exchange rates:
At time t_o, the beginning of the accounting period,

SC 1 = PC 1 = TC 1

At time t_1, the end of the accounting period,

SC 1 = RC 1.1 = TC 1.2

Hence PC 1 = TC I.0909 (=1.2/1.1)

Thus over the accounting period, SC appreciates against PC by 10% and against TC by 20%. PC in turn appreciates against TC by 9.09%.

Before-Tax Exposures

Transactions Exposure: Suppose the subsidiary books on A/R of TC 100 at time t_o. It is valued at giving rise to a before tax loss of SC 16.67

t_0 ……. TC 1 = SC 1 TC 100 = SC 100

t_1..... TC 1.2 = SC 1 TC 100 = SC 83.33

Translation Loss (SC16.67)

1. Adopted from P.G. Apte, *International Financial Management* , Tata Mc-Graw Hill, New Delhi, 1999, PP.54-56.

Translation Exposure: As we have seen translation exposures do not involve actual cash flows. The magnitudes of notional losses and gains depend upon the method used. For the sake of completeness we will review a few examples of translation exposure.

Translation of local currency exposure: Suppose the subsidiary has an A/R of SC 100, denominated in its own currency.

At t_0 ……. SC 1 = PC 1 PC 1 = SC 100 = PC 100

t_1..... SC 1 = PC 1.1 PC 1.1 = SC 100 = PC 110

Translation gain 10

Translation of Third Currency Exposure

Suppose the subsidiary has an A/R of TC 100 denominated in the third currency.

At t_0 ……. SC 1 = TC 1= PC 1

TC 100 = SC 100 = PC 100

t_1..... SC 1 = TC 1.2 = PC 1.1

TC 100 = SC 83.33 = PC 91.6674

Translation Loss (SC 16.67) (PC 8.3326)

Translation of intra corporate exposure: For transactions within the corporation, e.g., between the parent and the subsidiary, intra corporate translation exposure *before tax* is zero irrespective of the currency of denomination because on consolidation the opposite items cancel out.

Suppose the subsidiary has on its books a payable to the parent, denominated in the parent's currency of PC 400.

At time t_0,

Parent		Subsidiary	
A/R	PC 400	A/P	LC 400 (=PC 400)

At time t_1

Parent		Subsidiary	
A/R	PC 400	A/P	LC 363.6364 (=PC 400)

From a consolidated point of view, the A/R of the parent offsets the A/P of the subsidiary. However, as we will see below, the subsidiary makes a transaction gain when it settles the payable since its currency has appreciated against the PC. This gain results in additional tax liability.

After-Tax Exposures

Local Currency Exposure: As we saw above, when the subsidiary has an asset or liability denominated in its own currency, it leads to translation exposure for the parent. We will assume that pure translation gains or losses have no tax effects. Hence this exposure is same on after-tax basis as before-tax basis calculated above.

Third Currency Exposure: Now suppose that the only exposure the subsidiary has is a receivable of TC 100 denominated in the third currency.

At time t_0,

TC 100 = SC 100 = PC 100

At time t_1,

TC 100 = SC 83.33 = PC 91.6674

The parent incurs a translation loss of PC 8.3326; however, since the subsidiary has made a transaction loss of SC 16.67, it gets a tax credit. Assuming the tax rate to be 50%, the tax saving is worth SC 8.34, which when translated at the closing rate is worth PC 8.9870. Thus on an after-tax basis, the parent has gained (8.9870 – 8.3326) = PC 0.6544.

This "gain" can be interpreted as follows. If the subsidiary collects the receivable at t1 and remits it to the parent it would be worth PC 100.6544, consisting of the PC value of the receivable, 91.6674, and the PC value of the tax saving, 8.9870.

Intra Corporate Exposures : As before, let the subsidiary have a payable of PC 400 to the parent. As discussed above, there is no translation exposure on a before-tax basis. However, when tax effects are taken into account the situation is different. When the PC depreciates against the SC, the subsidiary makes a *transaction gain* worth SC [400 – (400/1.1)] = SC 36.3636. This entails an additional tax liability of SC 18.1818 which when translated into PC at the rate of SC 1 = PC 1.1, generates a loss of PC 20 for the parent.

10.8. Illustrative Problem

Translate the following balance sheets of the two subsidiaries of ABC Inc (a US MNC) into US dollars, using : (a) monetary-non-monetary method, and (b) the current method of translation.

	U.K. Subsidiary (Millions of Pounds Sterling)		French Subsidiary (Millions of French Frances)	
	12/31/97	12/31/98	12/31/97	12/31/98
Cash and marketable securities	120	143	2,143	1,915
Accounts receivable	315	407	4,020	3,775
Inventories	612	750	3,950	3,850
Fixed assets (net)	1,350	1,300	7,010	6,850
Total assets	**2,397**	**2,600**	**17,123**	**16,390**
Bank loans	500	450	3,000	2,800
Accounts payable	490	553	4,873	4,658
Long-term debt	650	700	4,250	4,000
Net worth	757	897	5,000	4,932
Total Liabilities and net worth	**2,397**	**2,600**	**17,123**	**16,390**

Assume the following exchange rates
12/31/98 £ 1.00 = US $1.40
US $1.00 = FF 7.25

12/31/97 £ 1.00 = US $1.05
US $1.00 = FF 9.00

Show also how the parent company will reflect the exchange gains (losses) in its consolidated statements, using the monetary-nonmonetary method as against the current method.

Answer

U.K. SUBSIDIARY
(Million of U.S. Dollars)

		£ 1.00 = $1.40	
	£ 1.00 = $1.05 12/31/98	Current 12/31/98	Temporal 12/31/98
Cash and marketable securities	150	200	200
Accounts receivable	427	570	570
Inventories	788	1,050	788
Fixed assets (net)	1,365	1,820	1,365
Total assets	2,730	3,640	2,923
Bank loans	472	630	630
Accounts payable	581	774	774
Long-term debt	735	980	980
Net worth	942	942	539
Adjustment to stockholders equity		314	
Total liabilities and net worth	2,730	3,640	2,923

Translation gain (loss) (404)
Exchange gain (loss) under the current method:
(Exposed assets – exposed liabilities)
(Change in exchange rate)
= (2,600 – 1,703) ($0.35) = $314 million
Exchange gain (loss) under the monetary- nonmonetary method =
(Exposed assets – exposed liabilities)
(Change in exchange rate)
= (550 – 1,703) ($0.35) = - $ 404 million

FRENCH SUBSIDIARY
(Million of U.S. Dollars)

		$1.00 = FF 7.25	
	$1.00 = FF 9.00 12/31/98	Current 12/31/98	Temporal 12/31/98
Cash and marketable securities	212.8	264.1	264.1
Accounts receivable	419.4	520.7	520.7
Inventories	427.8	531.0	427.8
Fixed assets (net)	761.1	944.8	761.1
Total assets	**1,821.1**	**2,260.7**	**1,973.7**
Bank loans	311.1	386.2	386.2
Accounts payable	517.6	642.5	642.5
Long-term debt	444.4	551.7	551.7
Net worth	548.0	548.0	393.3
Adjustment to stock holders, equity		132.2	
Total liabilities and net worth	**1,821.1**	**2,260.7**	**1,973.7**

Translation gain (loss) (154.7)
Exchange gain (loss) under the current method:
=(16,390 – 11,458) ($0.1379 – 0.1111)=(4.932) (+ $0.0268) = - $132.2 million

Exchange gain (loss) under the monetary – nonmonetary method (temporal):
$(5,690 – 11,458) ($0.1379 - $0.1111)=(-5,768) (+$0.0268)= -$154.6 million

10.9 Summary

The concept of *exposure* refers to the degree to which a company is affected by exchange rate changes. *Risk* arises because currency movements may alter home currency values.

Accounting exposures relate to items that presently appear on the balance sheet and income statement of the firm. Accounting exposures can be distinguished into two categories, viz., *transaction exposure* and *translation exposure.* Transaction exposure stems from the possibility of incurring future exchange gains or losses on transactions already entered into and denominated in a foreign currency. Translation on exposure, on the other hand, is the difference between exposed assets and liabilities. There are four basic translation methods. They are: the current/non-current method, the monetary/non-monetary method, the temporal method and the current rate method. Each method has its own assumptions as to the applicability of historical or current rates to various balance sheet items.

Exposures consisting of contingent and competitive exposures is collectively known as *operating exposure or (economic exposure).* Economic exposure is concerned with the present value of future operating cash flows to be generated by a company's activities and how they present value, expressed in parent currency, changes following exchange rate movement. Out of the two types, contingent exposures have a much shorter time horizon.

Competitive exposure (also known as *strategic exposure)* influences the firm's choice of market-products, sources of inputs, location of manufacturing activity and decisions as to whether foreign operations should be started.

When accounts expressed in one currency are translated into another currency, the profit or loss on foreign exchange may affect the taxation charge imposed on the company at home or abroad. Two basic approaches which companies adopt in the tax treatment of foreign exchange gains and losses are discussed in brief.

10.10 Key Words

Accounting exposure: Accounting exposures arise from the need, for purposes of reporting and consolidation, to convert the financial statements of foreign operations from the local currencies (LC) involved to the home currency (HC).

Exposure: Exposure refers to the degree to which a company is affected by exchange rate changes.

Operating exposure (Economic exposure): This is concerned with the present value of future operating cash flows to be generated by a company's activities and how this present value, expressed in parent currency, changes following exchange rate movement.

Risk: Risk arises because currency movements may alter home currency values.

Transaction exposure: It stems from the possibility of incurring future exchange gains or losses on transactions already entered into and denominated in a foreign currency.

Translation exposure: It is simply the difference between exposed assets and liabilities. Translation exposure has no direct effect on cash flows.

10.11 Self-Assessment Questions

1. Explain the distinction between exchange rate exposure and risk.
2. If you have an asset in a foreign currency and the currency appreciates against your home currency, you are always better off comment.
3. Why are even cash flows of a purely domestic firm exposed to exchange rate fluctuation?
4. What is translation exposure? Transaction exposure?
5. What are the basic translation methods? How do they differ?
6. Calculate the balance sheet translation gain/loss using the all-current, current/non-current, monetary/non-monetary and temporal methods, for the following.

   U S parent company

   Indian subsidiary

Indian rupee depreciates from Rs.43.50 to Rs.47.50 against dollar. The balance sheet is as follows:

	Rs. Crore
Cash	20
Marketable securities (valued at cost)	40
Inventory (written down to current market value)	100
Fixed assets	140
Total assets	**300**
Short-term payables	80
Long-term debt	120
Total liabilities	**200**
Net worth	100

7. "Two basic approaches are discernible in the tax treatment of foreign exchange gains and losses." Outline these two basic approaches.

10.12 Further Readings

1. Adrian Buckley, *Multinational Finance,* Prentice-Hall of India, New Delhi, 2001.
2. Alan C. Shapiro, *Multinational Financial Management* Prentice-Hall of India, New Delhi, 1999
3. P.G. Apte, *International Financial Management,* Tata McGrow Hill, New Delhi, 1999
4. V.K. Bhalla, *International Financial Management,* Anmol Publications, New Delhi, 2001

Dr. N.V.R. Jyothi Kumar

Table 10.2.
FINANCIAL STATEMENT IMPACT OF TRANSLATION ALTERNATIVES

(US$ thousands)

			After Devaluation of Local Currency (LC25-$A)				After Revaluation of Local Currency (LC12.5/$A)			
	Local Currency (LC)	$A Prior to exchange rate changes (LC20=$A)	Monetary! Non-monetary	Temporal	Current! Non-Current	Current rate for all assets and liabilities	Monetary! Non-monetary	Temporal	Current! Non-Current	Current rate for all assets
	1	2	3	4	5	6	7	8	9	10
ASSETS										
Current Assets										
Cash, marketable securities, and receivables	60,000	3,000	2,400	2,400	2,400	2,400	4,000	4,000	4,000	4,000
Inventory (at cost)	82,500	4,125	4,125	3,300	3,300	3,300	4,125	5,500	5,500	5,500
Prepaid expenses	3,000	150	150	150	120	120	120	150	200	200
Total current assets	145,500	7,275	6,670	5,850	5,820	5,820	8,275	9,650	9,700	9,700
Fixed Assets less Accumulated Depreciation	75,000	3,750	3,750	3,750	3,750	3,000	3,750	3,750	3,750	5,000
Goodwill	52,500	2,625	2,625	2,625	2,625	2,100	2,625	2,625	2,625	3,500
Total Assets	273,000	13,650	13,045	12,225	12,195	10,920	14,650	16,025	16,075	17,200
LIABILITIES										
Current Liabilities	67,500	3,375	2,700	2,700	2,700	2,700	4,500	4,500	4,500	4,500
Long-term debt	97,500	4,875	3,900	3,900	4,875	3,900	6,500	6,500	4,875	6,500
Deferred Income taxes	3,000	150	120	120	150	120	200	200	150	200
Total Liabilities	168,000	8,400	6,720	6,720	7,725	6,720	11,200	11,200	9,425	11,200
Capital Stock	42,000	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100
Retained Earnings	63,000	3,150	4,225	3,405	2,370	2,100	1,350	2,725	5,550	3,900
Total Equity	105,000	5,250	6,325	5,505	4,470	4,200	3,450	4,825	7,650	6,000
Total Liabilities plus equity	273,000	13,650	13,045	12,225	12,195	10,920	14,650	16,025	16,075	17,200
TRANSLATION GAIN/LOSS	---	----	1,075	355	-780	-1050	-1750	-375	2,400	750

II. International Financial Institutions – I

Objectives:

After studying this lesson, you should be able to:

- Know the origin objectives, structure and functioning IMF and world Bank (IMRD).
- explain the need of international liquidity and the role played by the IMF in maintaining international liquidity.
- understanding the role played by IMF and world Bank in reconstruction and development of world economics with special reference to Indian economy.

Structure:

11.1. Introduction

During the World War II, the world nations felt the need for international cooperation in the field of International trade and commerce. In 1943, the U.S. Treasury published a proposal for the establishment of an International Stabilisation Fund. The U.K. also proposed the establishment of an International clearing Union around the same time. The USA's proposal is know as *White Plan* (Mr. White is the author) and the UK's proposal is known as *Keyne's Plan* (author is Keynes) subsequently, a joint plan is prepared in 1944 which became the basis for International Monetary and Financial Conference at Bretton Woods, New Hampshire, USA in 1944. Representatives of 44 nations attended the conference to discuss the major international problems. An agreement was reached to establish the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). The IBRD is popularly known as *World Bank.*

11.2. International Monetary Fund

The need for an organization like the International Monetary Fund (IMF) became evident during the Great Depression that affected the world economy in the 1930s. The Depression was devastating to all walks of economic life. Agricultural prices fall below the cost of production, land values plummeted, factories stood idle, banks made their depositors penniless and millions of workers were without jobs.

The devastation also affected International Finance and monetary exchange. A widespread absence of confidence in paper money led to a grater demand for gold beyond what national treasuries could supply. Consequently, many countries were compelled to abandon the

gold standard. Due is uncertainty about the value of money that no longer bore a fixed relations to gold, exchanging money became very difficult between the nations. Some governments restricted the exchange of domestic for foreign money. Other Governments, desperate to find foreign buyers for domestic agricultural products, made these products appear cheaper by selling their national money below its real value. This practice, known as competitive devaluation, evoked retaliation through similar by trading rivals. The relation between money and the value of goods became confused. Under such conditions the world economy languished. Between 1929 and 1932 prices of goods tell by the 48 percent worldwide, and the value of international trade fell by 63 percent.

Several international conferences convened during the 1930s, to address world monetary problems ended in failure. Two original thinkers, Harry Dexter White in the United States, and Keynes in the united kingdom, put forward almost simultaneously in the early 1940s proposals for the establishment of a permanent cooperative international institution. The system would facilitate the unrestricted conversion of our convency into another. After much negotiation under difficult wartime conditions, the international community accepted the system and an organization to supervise it. Final negotiations for establishing the International Monetary Fund took place among the delegates of 44 nations gathered at Bretton Woods, New Hampshire, USA in July 1944. The conference has given birth to the twin international financial institutions, Viz., International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). IBRD is popularly known as World Bank.

Thus the IMF was established to promote economic and financial cooperation among its members in order to facilitate the expansion and balanced growth of World Trade. It started functioning from March 1, 1947. In early 1999, the Fund had 182 members.

11.2.1. Objectives of the IMF

The purposes of the IMF, as set forth in the Articles of Agreement, are :

1. To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration in international monetary problems.
2. To facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
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 a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth in world trade.
5. To lend confidence to members by making the Fund's resources available to them under adequate safeguards, then providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
6. In accordance with the above, to shorten the duration and Lessen the degree of disequilibrium in the international balance of payments of members.

11.2.2. Organisation Structure

The structure of the IMF consists of a Board of Governors, an Executive Board, a Managing Director, a Council and a staff with its headquarters in Washington, USA.

The Board of Governors is at the top in the structure of the IMF. It is composed of our Governor and one Alternate Governor appointed by each member. Generally, a member appoints its Minister of Finance or the Governor of its Central Bank as its Governor. The Alternate Governor can participate in the meetings of the Board but has the power to vote only in the absence of the Governor.

The Board of Governor meets once in a year and reviews previous year's activities of the Fund. It also takes policy decisions. Special meetings can be convened by any of the five members having 25 percent of the total voting right. The majority of decision – making power of the Board of Governors have been delegated to the Board of Executive Directors such as decisions on access by the members to the Fund's resources, decisions on changes and remuneration and the review of consultations between the Fund and its members.

The Executive Board has 21 members at present. Five Executive Directors are appointed by the five members (USA, UK, Germany, France and Japan) having the largest quotas. The sixth Executive Director is appointed by Saudi Arabia as it has the two largest contributors to the Fund. The remaining 15 Executive Directors are elected by the remaining member countries.

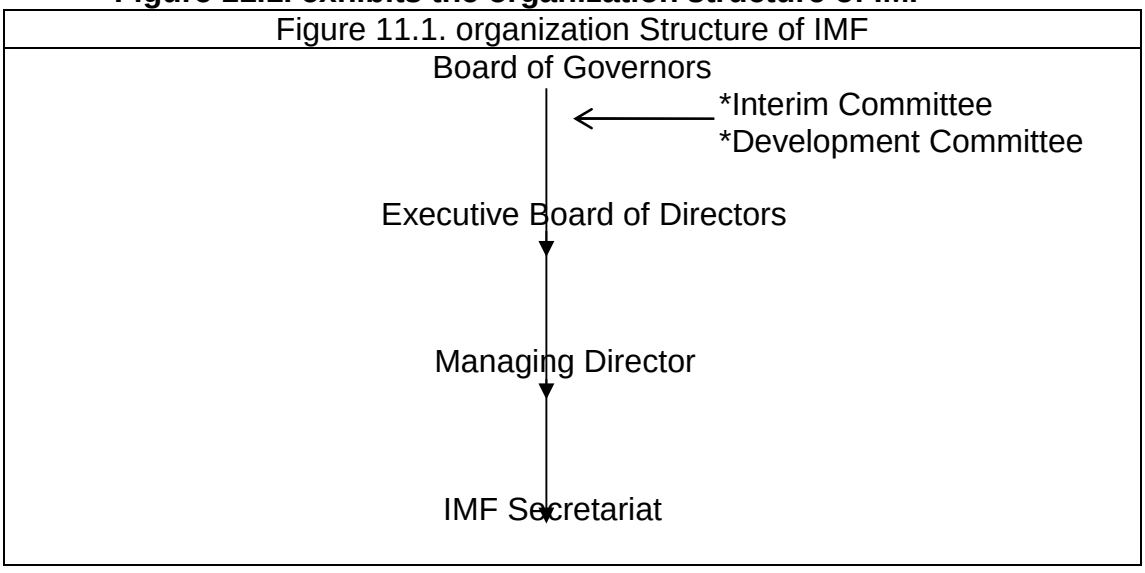
The Executive Directors elect the Managing Director who is a politician or an important international official. He is a non-voting chairman of the Board and the head of the Fund Staff.

The Interim Committee was established in October 1974 to advise the Board of Governors on supervising the management and adaptation of the international monetary system in order to avoid disturbances that might threaten it. At present, it has 22 members.

The Development Committee was also established in October 1974 and has 22 members. Its objective is to advise and report to Board of Governors on all aspects of the transfer of real resources to developing countries.

Figure 11.1. exhibits the organization structure of IMF

Figure 11.1. organization Structure of IMF



11.2.3. Resources of IMF

The resources of IMF come from two sources, Viz., (a) subscriptions by members, and (b) Borrowings

Subscriptions and Quotas

The Fund has a General Account based on quotas allocated to its members. Each member country is assigned a quota that governs the size of its subscription, its voting power, and its drawing rights.

Quotas of the member countries are determined on the lines:

(i) 2 percent of the national income of the member country.
(ii) 5 percent of the gold and US dollar reserve of the member country.
(iii) 10 percent of the average annual imports of the member country.
(iv) 10 percent of the maximum variation in annual exports of the member country.
(v) The sum of (i), (ii), (iii) and (iv) increased by the percentage ratios of average annual exports of national income.

A member, in general, is required to pay about 25 percent of its quota in Special Drawing Rights (SDRs) or in currencies of other members selected by the IMF. It pays the remaining amount in its own currency. Quotas of the members are reviewed at internals of not more than five years.

Borrowings

The IMF is authorized to supplement its resources by borrowing. It borrows funds from the governments, central banks and private financial institutions of the industrialized nations, the Bank for International Settlements BIS) and from OPEC countries. Under the General Agreement to Borrow (GAB), eleven industrial countries have undertaken to lend to the IMF.

Financing Politics and Facilities

The significant method by which the IMF makes its resources available to members is by selling to them the currencies of other countries or SDRs in exchange for their own currencies. The main objective of making the Fund's resources available to members is to meet balance of payments needs.

The Fund's resources are provided through:

(a) Permanent policies (The Tranche Politics) for general balance of payments purposes;
(b) Permanent facilities for specific purposes; and
(c) Temporary facilities.

Permanent Policies (Tranche Policies)

Reserve Tranche

A shortfall of the member's currency with Fund over its quota is called ***Reserve Tranche.*** The member can draw 25 percent of its reserve tranche automatically from the Fund. The member country has to repay such loans within a period of five years. No interest is levied on such drawings.

Credit Tranche

The remaining balance of quota, after drawing 25 percent of reserve tranche is called *Credit Tranche.* Members may request standby arrangements in excess of this limit. Drawing

from the credit tranche is conditional. The members can draw up to 300 per cent of their new quotas.

Permanent Facilities

The Compensatory and contingency Financing Facility

The compensatory Financing Facility (CFF) was established in February 1963 with a view to assist members experiencing balance of payments difficulties attributable to shortfalls in earnings from merchandise exports.

The compensatory and contingency Financing Facility (CCFF) superseded the CFF in August 1988. Besides keeping the essential elements of the CFF, the CCFF developed a mechanism for contingency financing to support adjustment programmes approved by the IMF.

Buffer Stock Financing Facility

This Facility was created in 1969. The purpose is to provide assistance to member countries in financing approved international buffer stocks of primary products. A member can have outstanding purchases under the facility of 4 to 45 per cent of quota.

Extended Fund Facility

This Facility was established in 1974. Its objective is to provide credit to member countries to meet the balance of payment deficits for longer periods. Ordinary resources are made available to cover purchases up to 140 per cent of quota over a period of up to three years.

Temporary Facilities

The members may make use of temporary facilities established by the Fund with borrowed resources. The supplementary Financing Facility (SFF) was created in 1979 to provide assistance to members facing the serious problem of balance of payments, which is larger in relation to their quotas. This facility is intended to benefit the developing countries.

Conditionality

Conditionality is an essential element of the Fund's role in helping alleviate the balance of payments problems of member countries. The IMF's guidelines regarding conditionality:

(a) Provide for the phasing of purchases.
(b) Highlight the need to adopt corrective measures at an early stage of their balance of payments difficulties.
(c) Emphasise the necessity of paying due regard to socioeconomic objectives, as well as political situation, including the causes of their balance of payments problems.
(d) Provide for a flexible approach on the number and content of performance criteria depending on members' diverse problems.

The appropriateness of any particular set of conditionalities for a country needs to be carefully evaluated. The IMF's conditionality has generally been monetarist and deflationary, obliging governments to reduce their demand for imports by curtailing overall demand – cutting back on spending, private and public as well. An alternative strategy would have been adjustment with growth, which would have aimed more at promoting production, both to increase exports and to meet a higher proportion of local demand from local production. Although there have been indications of a change of IMF policy is this direction, there is as yet no well-articulated agenda of reform.

11.3. INTERNATIONAL LIQUIDITY AND SPECIAL DRAWING RIGHTS

International liquidity is defined as the aggregate stock of internationally acceptable assets held by the central bank to settle a deficit in a country's balance of payments. International liquidity is also known as international reserves.

In other words, international liquidity encompasses the international reserves and the facilities for international borrowing for financing the balance of payments deficit. International reserves include official holdings of gold, foreign exchange, SDRs and reserve position in the IMF. International liquidity does not include private holdings of gold, private holdings of foreign exchange and long term international financing.

There is a distinction between owned and borrowed reserves. Foreign exchange surpluses, after meeting all current and capital account obligations of the country, and the official gold stock of a country constitutes its owned reserves. Direct investments by foreign countries and capital imports in the form of borrowings from abroad constitute borrowed reserves.

11.3.1. The Need of International Liquidity

The need of International Liquidity arises due to increasing balance of payments deficits of the most of the countries in the world. Too much dependence on imports has necessitated larger inflow of aid and foreign investment. As a result, debt serving and payments of dividends and royalties on private foreign investment have grown. All there have led to further shortage of foreign exchange reserves. The majority of developed countries have surpluses in their balance of payments. They are creditors of developing nations and do not charge any interest in getting rid of their surpluses with a view to increase international liquidity.

11.3.2. International Reserves

The main characteristics of international liquidity or international reserves are:

- Decline in the relative share of gold holdings of the member countries from 956 million ounces in 1950 to 940 million ounces in 1991.
- Marked increase in the share of foreign exchange reserves from $14.6 billion in 1950 to SDRs 32 billion in 1994.
- Increase of SDRs from 8.7 billion in 1972 to SDRs 16 billion in 1994.
- Increase of international reserves from $50.1 billion in 1950 to SDRs 841 billion in 1994.

Without doubt, international liquidity has been on the rise but they have not been increasing in the volume and value of world trade.

11.3.3. Special Drawing Rights (SDRs)

The IMF introduced a schemes for the creation and issue of Special Drawing Rights (SDRs) in early 1970. SDRs are also known as Paper Gold. The main feature of the SDRs in that they are to be distributed among participants in proportion to their Fund quotas. The Fund pays interest on all holdings of SDRs kept in the Special Drawing Account and changes interest at the same rate on all allocations to member countries. Therefore, the members whose holdings exceed their allocations earn net interest and those whose holdings are below allocations pay net charges at the current interest rate.

There are three main uses of the SDR:

(a) ***Transactions with designation:*** Under this, the Fund designates a participant in the SDR scheme who has a strong balance of payments and reserve position to provide currency in exchange for SDRs to another participant needing its currency. The currency to be exchanged for SDRs may belong to the designated participant or/and to other participants.

(b) SDRs are used in all transactions with the Fund.

(c) ***Transactions by agreement:*** The Fund permits sale of SDRs for currency by agreement with another participant.

The total holdings SDRs were SDR 13.1 billion in 1979, SDR 17.3 billion in 1980 and SDR 21.4 billion in 1981. No further allocation of SDRs has been made since 1981.

The SDR scheme has been criticized for favouring the advanced nations. The four countries viz., The USA, The UK, Japan and Canada have been allotted about 45 per cent of the total SDRs which shown unfair distribution of international liquidity. The allocation of SDRs to developing nations is too low as compared to their needs. A proposal has been made by the developing countries to request the IMF to study the question of establishment of a direct link between SDRs and development finance. It requires the allocation of increased SDRs to the developing countries on the basis of their development needs.

11.4. INDIA AND THE IMF

India is one of the founder members of the IMF. Till 1970 India's quota in the Fund was the fifth. The quotas of Japan, Canada and Italy increased more than that of India with the increase in the Fund quota after May 1970. Consequently, India lost an opportunity to hold a permanent position as Executive Director of the Fund. With the Ninth Review of Quotas, India's quota in the IMF declined from 2.45 percent to 2.27 percent. However, in absolute terms, India's quota increased from SDR 2.2. billion to 3.05 billion from January 1993. with effect from 1999, India's quota is SDR 4.2 billion i.e., nearly 2 per cent of the total quota of the Fund.

India has been our of the main beneficiaries of the IMF financial assistance. Between 1947 and 1955, India borrowed $100 million twice to tide over its balance of payments difficulties. Between 1957 and 1975, India borrowed a sum of $1764 million. In 1979, India entered into agreement with the IMF for a loan of $5.6 billion. Till 1984, India had drawn $3.9 billion only in view of the improvement in the reserves position.

In 1990, India faced with serious balance of payments situation due to Gulf Crisis, India approached the IMF for financial assistance under its modified Compensatory and Contingency Financing Facility (CCFF). Member countries, in general, get 50 to 60 percent of their quotas in loans. However, India received more than 100 percent of its quota. India's quota in the Fund is $3.01 billion and its gross drawings from the Fund from January 1991 to June 1993 is $3.5 billion.

11.5. World Bank

The International Bank for Reconstruction and Development (IBRD) or the World Bank was established in 1945. It is a sister organization of the IMF. The World Bank has two affiliates viz., The International Development Association (IDA), established in 1960 and The International Finance Corporation (IFC), established in 1956.

11.5.1. Functions

The IBRD or the World Bank performs the following functions:

1. To assist in the reconstruction and development of territories of its members by facilitating the investment of capital for productive purposes, and the encouragement of the development of productive facilities and resources in less developed countries.
2. The promote private foreign investment by means of guarantees on participation in loans and other investment made by private investors, and when capital is not available on reasonable terms, to supplement private investment by providing finance for productive purpose out of its own resources or from borrowed funds.
3. To promote the long-range balanced growth of international trade and the maintenance of equilibrium in the balance of payments of member countries by encouraging international investment for the development of their productive resources, thereby assisting in raising productivity, the standard of living and conditions of workers in their territories.
4. To arrange the loans made or guaranteed by it in relation to international loans through other channels so that more useful and urgent small and large projects are dealt with first.

11.5.2. Membership

The members of the IMF are the members of the World Bank. In case a member resigns its membership, it is required to pay back all loans with interest on due dates.

11.5.3. **Organisation**

The IBRD, like the IMF, has a three-tier structure with a president, Executive Directors and Board of Governors. The President is elected by the Bank's Executive Directors whose number is 21. Of these, five are appointed by the five largest shareholders, namely the US, the UK, Germany, France and Japan. The remaining 16 are elected by the Board of Governors. There are also Alternate Directors. The Executive Directors decide about policy on the basis of the Articles of Agreement. The President has a staff of more than 6,000 persons. The Board of Governors is the supreme body. Every country appoints our Governor and an Alternate Governor for a period of five years. The voting right of each country is related to its financial contribution.

11.5.4. Guiding Principles

The World Bank is guided by certain polices in its lending activities. They are:

a) The Bank should assess the repayment prospects of the loans.
b) The Bank should lend only for specific projects which are designed to contribute directly to productive capacity and of a high priority nature.
c) The Bank expects the borrowing country mobilize its domestic resources.

d) The Bank reviews the progress of projects and helps the borrower, in the technical and administrative aspects.
e) The Bank indirectly promotes local entrepreneur ship.

11.5.5. Landing and other Activities

The Bank is a corporate institution whole capital is subscribed by its member countries. The bank provides the following facilities to member countries:

Structural Adjustment Facility : (SAF)

Since 1985, the Bank has introduced SAF to achieve the objectives of (a) contributing to a more sustainable balance of payments in the medium and long term and to the maintenance of growth in the face of severe constraints, and (b) Laying the basis for regaining momentum for future growth.

Enhanced Structural Adjustment Facility (ESAF)

In 1987, the Bank has set up the ESAF with a view to offer concessional resources to low-income member countries. Like the SAF, ESAF is also meant to reduce the balance of payments of the borrowing nations and stimulate growth.

Special Action Programme (SAP)

The Bank started the Special Action Programme (SAP) in 1983 to help member countries in adjusting to the difficult economic environment. The SAP had been highly successful in meeting its objectives, according to the Bank.

11.5.6. Critical Appraisal

The World Bank has been successful in achieving its objective of reconstruction and development. The Bank helped in the reconstruction of Europe, after its destruction in the World War II.

The Bank for two decades since its inception was concentrated mainly upon capital infrastructural facilities such as power generation and distribution, railways and roads, ports, telecommunications and irrigation. Since 1970s, the bank has started to provide financial and technical assistance for industrial and agricultural projects. The present development strategy aims at improving the productivity and standard of living of people of developing countries. Hence, the World Bank has been financing projects for rural development and agriculture, primary education, family welfare, health, low-cost housing and drinking water.

Critics, however, have levelled certain criticisms against the lending policies of the World Bank. Some of them are:

1. The Bank charges a high rate of interest on loans.
2. In order to increase funds to developing nations for their economic and social uplift, the Bank established the International Development Association (IDA) in 1960. But, the lending activities of the Bank account for only a small proportion of the total aid to developing countries.
3. The Bank's lending procedure is discriminatory for developing countries because it emphasizes the repaying capacity of the borrowing country.

4. Another limiting factor is the size of the funds available with the Bank. The availability of the funds depends on the willingness of the developed countries to contribute. It is argued that the USA which is the largest contributor, is not only reluctant to increase its own contribution, but also reluctant to let other countries to do so since its own voting power would be correspondingly reduced.

Despite above criticisms, one should realize the useful role played by the world Bank in extending various types of assistance to the different categories of countries. The increase in the membership of the World Bank is a clear indication of its utility.

11.6. India And The World Bank

India is one of the founder members of the World Bank. India was the largest beneficiary of the World Bank until China became its member. The Bank has been assisting India by granting loans, providing expert advice and sending study teams. There is a Chief of Mission of the Bank at New Delhi for monitoring and consultations on its aided projects in our country. In 1997, the World Bank assistance to India was $1068 amounting to about 5 percent of the total Bank assistance. Over the years, the roles of the World Bank and the IDA, an affiliate of the former, reversed with regard to the assistance to India. This aspect is discussed in chapter 12.

11.7. SUMMARY

The Bretton Woods conference gave birth to the twin international financial institutions, viz., International Monetary Fund (IMF) and the International Bank for Restriction and Development (IBRD). IBRD is popularly known as World Bank.

The IMF was established to promote economic and financial cooperation among its members in order to facilitate the expansion and balanced growth of world trade. It started functioning from March 1. 1947. In early 1999, the Fund had 182 members.

The structure of the IMF Consists of a Board of Governors, an Executive Board, a Managing Director, a Council and a staff with its headquarters in Washington, USA. The resources of IMF come from two sources, viz., (a) Subscriptions by members and (b) Borrowings. The significant method by which the IMF makes its resources available to members is by selling to them the currencies of other countries or SDRs in exchange for their own currencies.

International liquidity is defined as the aggregate stock of internationally acceptable assets held by the central bank to settle a deficit in a country's balance of payments. The need for international liquidity arises due to increasing balance of payments deficits of the most of the countries. The IMF introduced a scheme for the creation and issue of Special Drawing Rights in early 1970. SDRs are to be distributed among participants in proportion to their Fund quotas.

India is one of the founder members of the IMF. In 1990, India faced with serious balance of payments situation due to Gulf Crisis. Member countries generally get 50 to 60 per cent of their quotas in loans. However, India received more than 100 per cent of its quota.

The International Bank for Reconstruction and Development (IBRD) or the World Bank was established in 1945. The members of the IMF are the members of the World Bank. The IBRD, like the IMF, has a three-tier structure with a President, Executive Directors and Board of Governors. The World Bank has been financing projects for rural development and agriculture, primary education, family welfare, health, low-cost housing and drinking water. India was the largest beneficiary of the World Bank until China became its member. The Bank has been assisting India by granting loans, providing expert advice and sending study teams.

11.8. Key Words

Conditionality: It is an essential element the IMF's role in helping alleviate the balance of payments problems of member countries.

Credit Tranche : The remaining balance of quota, after drawing 25 per cent of reserve tranche is called Credit Tranche.

International Liquidity: International Liquidity is the aggregate stock of internationally acceptable assets held by the central bank to settle a deficit in a country's balance of payments.

Quotas: The IMF has a General Account based on quotas allocated to its members. Each member country is assigned a quota that governs the size of its subscription, its voting power, and its drawing rights.

Reserve Tranche: A shortfall of the member's currency with the IMF over its quota is called Reserve Tranche.

Special Drawing Rights: The IMF introduced a scheme for the creation and issue of Special Drawing Rights in early 1970. Also known as paper Gold, the main feature of the SDRs is that they are to be distributed among participants in proportion to their Fund quotas.

11.9. Self Assessment Questions

1. Discuss the origin, objectives and functions of the IMF.
2. Briefly discuss the organization structure, financial resources and the role played by the IMF in the world economy.
3. Discuss the functions and role of World Bank.
4. Explain the role played by SDRs in maintaining international liquidity.
5. Evaluate the role of IMF and IBRD vis-a-vis India.

11.10. Further Readings

1. Francis Cherunilam, International Economics, Tata McGraw-Hill Publishing Company Limited, New Delhi, 1999.
2. K. Viyanna Rao and P. Subba Rao, International Banking, Telugu Akademi, Hyderabad, 1989.
3. M.L. Jhingan, International Economics, Vrinda Publications (P) Ltd., Delhi, 2000.
4. P. Subba Rao, International Business, Himalaya Publishing, Membai, 2001
5. Raj Agrawal, International Trade, Excel Books, New Delhi, 2001.

Dr. N.V.R. Jyothi Kumar

12. International Financial Institutions – II

Objectives

After going through this lesson you should be able to:

- know the objectives, structure, functions, etc. of the IDA, IFC and MIGA
- understand the role played by the Three affiliates of the World Bank in Indian economic development
- discuss the functions and role of the ADB and the BIS

Structure:

12.1. Introduction

This lesson deals with the objectives, structure, functioning, etc. of the International Development Association (IDA), The International Finance Corporation (IFC), the Multinational Investment Guarantee Agency (MIGA), The Asian Development Bank (ADB) and the Bank for International Settlements (BIS).

The World Bank Group

The world Bank has three affiliates, Viz., The International Development Association (IDA), The International Finance Corporation (IFC), and the multinational Investment Guarantee Agency (MIGA). These are discussed hereunder:

12.2. International Development Association

The international Development Association (IDA) was established in 1960 primarily to provide financial assistance to the poorer developing member countries. The IDA is often called the soft loan window of the World Bank.

Objectives:

The main objectives of the IDA are :

1. To provide assistance for poverty alleviation to the poorer countries
2. To provide concessional financial assistance and macroeconomic management services to the poorest countries in order to raise their standard of living. These include human resource development such as population control, health care and education.

Membership

Membership of the IDA is open to all members of the World Bank. The IDA's members are divided into two parts. In Part I are the developed countries. There are 24 countries in this group. This group is known as G-24 Part II consists of all the developing nations.

Organisation

The President of the World Bank is its head. The organization of the world Bank is also the organization of IDA. The staff of the World Bank also serve the IDA.

Credits

IDA loans are known as Credits. Only the governments of member countries can borrow from IDA. The Countries whose per capita income is less than US $695 at 1990 prices are eligible to borrow. Credits are given for such projects for which no assistance is provided by the World Bank.

The following criteria are observed while approving an IDA credit:

1. Poverty Criterion: A Country with a high population and low productivity, thereby leading to a low standard of living of the people.
2. Performance Criterion: This involves past success in project execution and satisfactory economic policies of the country.
3. Project Criterion: The proposed project must yield financial and economic returns to justify them.

Generally, conditions of IDA loans include:

a) Repayment period is 35-40 years.
b) Grace period is 10 years.
c) Administrative fee is 0.75 per cent on the disbursed amount.

12.2.1. India and IDA

As discussed in chapter 11, India was the largest beneficiary of the world Bank-IDA assistance until China became a member of the World Bank in 1980.

As regards the assistance to India, it seems the roles of the World Bank and the IDA reversed over the years of the total IBRD-IDA assistance to India in 1974-75, IDA accounted for 75 per cent and the World Bank for 25 per cent. In 1998, the IBRD accounted for about 65 per cent and the IDA about one-third of the total aid. The decline in the share of soft loan increases the debt burden of our country. During 1995-96, India received $ 1.3 billion interest IDA loan for elementary education health and nutrition, food safety, etc.

12.3. International Finance corporation

The International Finance Corporation (IFC), which was established in 1956, is an affiliate of the World Bank. But the IFC is a separate entity, legally and financially. Its main function is to promote productive private investment in developing countries. The purpose of the IFC, as outlined in its articles of Agreement, is "to further economic development by encouraging the growth of productive private enterprise in member countries, particularly in the less developed areas. Thus supplementing the activities of the IBRD."

12. 3. 1 Organisation

Only a member of the World Bank can be the member of IFC. It has its own operating and legal staff but draws upon the World Bank for administrative services. The IFC's organization structure is on the pattern of the World Bank. The administration authority of the IFC is vested in the Vice-President of the IFC. The IFC has light departments relating to investment, capital markets, legal matters, etc.,

Assistance

The IFC provides assistance to private companies in three ways:

(a) **Direct Investment**: IFC makes investments with private investors from the capital exporting country and / or from the country in which the enterprise is located. IFC's investment should not be more than half of the capital requirements of the enterprise.

(b) **Foreign and Local Capital**: The IFC promotes productive private investment in developing countries in the form of equity or loan investment. It also underwrites equity capital

(c) **Technical Assistance**: The IFC gives technical assistance to project sponsors so that their enterprises will be more productive. It helps member governments in evolving suitable policies so as to create the necessary investment climate.

The IFC has a separate department for addressing the financial market needs and problems of developing countries. In 1984, the IFC began to expand its activities in assisting the physical and financial restructuring of existing enterprises.

12.3.2. IFC and India

India is the second major beneficiary of IFC assistance. The IFC invested over $48 million in India in the form of loans and equity. The on-going economic reforms have significantly enhanced the role of the private enterprise, which means a greater role for the IFC in the country's industrial development.

The IFC identified five priority areas in India for strengthening its activities. They are :

a) Developing India's capital market by investing in a range of financial service firms.
b) Stimulating the flow of foreign investment and technology into India.
c) Intensifying efforts to enable Indian companies gain access to funding in the international financial markets.
d) Strengthening the financial position of Indian companies by increasing equity and reducing debt levels.
e) Investing in India's infrastructure.

12.4. Multinational Investment Guarantee Agency

The Multinational Investment Guarantee Agency (MIGA), the newest affiliate of the World Bank, was established in 1988. MIGA was created to supplement the function of World Bank and IFC. MIGA is joint venture of World Bank and IFC.

Objectives

a) To encourage the flow of direct foreign investment into developing member countries.
b) To provide insurance cover to investors against political risks.
c) To protect investors against non-commercial risks viz., any danger involved in currency transfer, expropriation, war and civil disturbance and breach of contract by governments.
d) To insure new investments, expansion of existing investments, privatization and financial restructing.
e) To provide promotional and advisory services to the governments of developing countries.
f) To establish credibility among investors and higher credit rating among global banking and financial markets of its members.

Progress

In order to become a member of the MIGA, a country has to ratify the convention and pay its capital subscription. By 1996, 128 countries had become its full-fledged members.

The MIGA insures 90 per cent of the investment subject to a limit of $50 million per project. It covers insurance for projects for 15 years. The projects have to achieve the environmental and development objectives of the World Bank.

The MIGA has signed over 220 contracts of guarantee for investments in more than 40 developing countries. It issued investment guarantee contracts for $862 million. It started IPA-NET programme which facilitates the exchange of information among members of the international investment community.

12.4.1. India and MIGA

India signed the MIGA convention in 1992. The insurance guarantee of the MIGA to direct foreign investments and the help rendered by its advisory services are expected to benefit the programmes for industrial development in the context of the on-going economic reforms.

12.5. Asian Development Bank

The Asian Development Bank (ADB) was established in 1966 under the auspices of the United Nations Economic Commission for Asia and Far East (ECAFE) to meet the development needs of Asian countries, with its headquarters at Manila in the Philippines

Objectives

Some of the objectives of ADB are :

a) To promote public and private investment in the ECAFE region for economic development.
b) To utilize the available resources for financing economic development. In order to achieve this, it gives priority to those regional and sub-regional as well as national projects and programmes which contribute to the harmonious growth of the entire region.

c) To provide technical assistance for the preparation, financing and implementation of projects and progammes for economic development.
d) To Cooperate with the United Nations and other international institutions and organizations and national entities in the investment of development funds in the region.

Membership

The ADB has a membership of 56 countries at present. The following countries can become the members of the ADB:

a) Member of the ECAFE
b) Associate members of ECAFE
c) Other countries of the ECAFE region which are the members of the United Nations or any of its specialized agencies.
d) Developed Countries outside the ECAFE region, which are the members of the UN or any of its specialized agencies.

Management

The President in the CED of the ADB. Each Country nominates a Governor and an Alternative Governor to the Board of Governors. The Board of Governors delegated its executive authority to the Board of Directors. The Board of Directors consists of 10 members. Seven Members belong to regional countries and three to non-regional countries.

Financial Resources and Assistance

The initial capital of the AADB was $2.9 billion. It was raised to $25 billion in 1992. Fifty per cent has been contributed by Japan and the remaining by its member countries. The ADE also issues debentures, accepts deposits and borrows from the international capital markets in order to increase its resources.

The ADB provides financial assistance in the form of grants and loans. The Bank offers three types of loans : project loans, sector loans and programme loans. The Bank advances loans out of its ordinary funds Reserve and Special Funds reserve. Out of the Ordinary Funds Reserve the ADB gives direct loans for development projects or specific projects. Direct loans are for a period of 20 years.

The ADB established special funds such as the Asian Development fund, multipurpose Special Fund and Agriculture special fund for sector lending. These funds are utilized for development projects of high priority. Generally, these loans are given for longer periods at lower interest rates.

12.5.1 Functions of ADB

Technical assistance is provided to member countries out of the technical Assistance Special Fund. It may be in the form of grants or loans. The ADB also provides advisory services to the members in ECAFE region. The ADB conducts research surveys in order to formulate policies for the future. It brings out an annual report, which focuses the achievements and problems relating to the economic development of the member countries.

The Bank's greater emphasis in the 1990's would be towards achieving the twin objectives of attaining sustainable economic growth and reduction in poverty in the ECAFE region.

12.5.2. Evaluation

The total assistance of the ADB had risen to $ 6-09 billion in 1995. The Bank has been offering assistance in the areas of agriculture, agro-based industries, energy, development banking, transportation, communication, education and health.

M.L. Jhingan pointed out that even though the Bank has made long strides in providing assistance for the economic development of its ECAFE member countries, it is dogged by a number of problems.

a) Its financial resources are limited because the regional member countries are mostly poor. Developed countries are not prepared to contribute much.
b) There have been negative transfers to the Bank during the last few years from such countries as Fiji, Malaysia and Philippines.
c) Loan sanctions have increased from the Asian Development fund, but their disbursements have been less.

12. 6. Bank For International Settlements

Each country has a central bank, which is responsible for the policies that effect the value of its currency in world markets. Despite the unique nature of each country's central banking system, there is some resemblance of international cooperation in the form of the Bank for International Settlements (BIS) in Basel, Switzerland. The BIS acts as a central banker's bank. It gets involved in swaps and other currency transactions between central banks in the major industrial countries.

Commercial banks have operated in increasingly competitive markets for financial services fostered by the process of financial liberalization. At the same time, the 1980's brought first an escalation of exposure to bad loans in the developing Countries. These loans jeopardized profitability and capital. Further, differences among major industrial countries in the stringency of capital requirements created competitive inequalities among globally active banks.

The industrial countries, bank supervisory authorities met in Basle in 1986, at the BIS. Its purpose was to propose an initial plan to link common minimum – capital requirements for international banks to their credit – risk exposures, including both on – balance sheet exposures such as loans and off-balance sheet exposures such as loan commitments. In March 1987, the USA and Britain reached agreement on the common definition of capital adequacy. In June 1987, Japan joined them. The consensus was subsequently broadened after discussions among the Group of Ten Countries, culminating in the Basle Accord on capital Adequacy in 1988. According to this scheme, each on and off balance sheet item is assigned a weight reflecting its relative credit risk and minimum levels are set for the ratio of bank capital total risk – weighted exposure.

12.7. Summary

The World Bank has three affiliates, viz., The International Development Association (IDA), the International Finance Corporation (IFC), and the multilateral Investment Guarantee Agency (MIGA). This chapter also deals with the objectives, structure, functioning, etc., of the Asian Development Bank (ADB), and the Bank for International Settlements (BIS)

The IDA was established in 1960 primarily to provide financial assistance to the poorer member countries. The IDA is often known as the soft loan window of the World Bank. India was the largest beneficiary of the World Bank IDA assistance until China became a member of the World Bank in 1980.

The main function of the IFC is to promote productive private investment in developing countries. The on-going economic reforms have significantly enhanced the role of the private enterprise, which means a greater role for India's industrial development.

The MIGA was established in 1988. It was created to supplement the function of World Bank and IFC

12.8. Self-Assessment Questions

1. What are the objectives of the International Development Association? To what extent it has been successful in helping the developing countries?
2. Critically evaluate the working of the International Finance Corporation
3. What is Multinational Investment Guarantee Agency? Explain its objectives and working?

12.9. Further Readings

1. Francis Cherunilam, International Economics, Tata McGraw-Hill, New Delhi, 1999.
2. M.L. Jhingan, International Economics, Vrinda Publications, Delhi, 2000.
3. P. Subba Rao, International Business, Himalaya Publishing, Mumbai, 2001.
4. Raj Agarwal, International Trade, Excel Books, New Delhi, 2001.

Dr. N.V.R. Jyothi Kumar

Lesson - 13

INTERNATIONAL CHAMBER OF COMMERCE (ICC)

Objectives :

After reading this lesson you will be able to :

* Undestand the need of International Chamber of Commerce (ICC)
* History, Activities of ICC and Objectives of ICC India
* Achievements of ICC India and its challenges of 21st century

STRUCTURE

13.1 INTRODUCTION

ICC is a Paris based international non-governmental organization. It was established in 1919 with a view to save world business. The main activity of ICC is harmonious trade practices in the world. It has top-level consultative status with the United Nations. It also maintains close relation with World Trade Organization. It's role is to promote global business and it's activity has increased tremendously during the regime of globalization. National Committee of ICC in India was set up in 1929. It was rechristened as ICC India with effect from March 1st, 1996. Since inception, this institution rendering various services to improve business. ICC and ICC India are elaborately discussed in this lesson.

13.2. INTERNATIONAL CHAMBER OF COMMERCE

The International Chamber of Commerce is a global business organization, which promotes trade and investment and opens markets for goods and services as well as the free flow of capital. It is an effective instrument to erase restrictions for conducting business, to expand business links and

opportunities. It is the voice of worlds business championing the global economy as a fore for economic growth, job creation and prosperity. The role of ICC has tremendously increased with the advent of globalization and the expansion of the market economy. It is the only representative body that speaks with full authority on behalf of enterprises from all sectors of the economy in every part of the world.

(i) Objectives of ICC

The objectives of ICC are to

* set rules and standards for harmonization of trade practices
* act as a defender of the multilateral trading system
* provided practical services to world business
* fight against commercial crimes
* promote growth and prosperity to the member countries
* spread business expertise and
* advocate for international business.

ii) Origin of ICC

The International Chamber of Commerce was founded in the year 1919 with an objective to serve world business by promoting trade and development, open markets for goods and services and the free flow of capital. Initial impetus of ICC came from its first president Edtinne Clementel, a former French minister of commerce. Under his influence, the secretariat of this organization was established in Paris. He was instrumental in creating ICC International Court of Arbitration in 1923.

ICC has evolved beyond recognition since those early post-war days when business leaders from the allied nations met for the first time in Atlantic City. The original nucleus, representing the private sectors of Belguim, Britain, France, Italy and the United States, has expanded to become a world business organization with thousands of member companies and associations in around 130 countries. Members include many of the world's most influential companies and represent every major industrial and service sector.

iii) Working of ICC

The super governing body of ICC is known as ICC World Council. It is the equalent of the general assembly of a major inter governmental institution. The major difference is that the delegates are business executives and not government officials. The ICC council is supreme governing body. National Committees name delegates to the council. Council normally meets twice a year. Ten direct members from countries where there is no national come may also be invited to participate in councils work.

iv) National Committees and Groups

National committees and groups represent the ICC in their respective countries. The national committees and groups make sure that ICC takes account of their national business concerns in its policy recommendations to governments and international organizations. The Council elects the Chair-

man and Vice-Chairman for a two-year term. The Chairman, his immediate predecessor and the Vice-Chairman form the Chairmanship. The Council also elects the Executive Board responsible for implementing ICC policy, on the Chairman's recommendation. The Executive Board has between 15 and 30 members, who serve for three years, with one third retiring at the end of each year.

v) ICC Secretariat

The Secretary General heads the International Secretariat and works closely with the national committees to carry out ICC's work programme. The secretary General is appointed by the Council at the initiative of the Presidency and on the recommendation of the Executive Board. Member companies and business associations can shape the ICC stance on any given business issue by participating in the work of ICC commissions. Commissions are the bedrock of ICC, composed of a total of more than 500 business experts who give freely of their time to formulate ICC policy and elaborate its rules. Commissions scrutinize proposed international and national government initiatives affecting their subject areas and prepare business positions for submission to international organizations and governments.

vi) Membership

There are two ways to become a member of International Chamber of Commerce. One way is through affiliation with an ICC national committee or group. Another way is by direct membership with ICC international secretariat when a national committee/group has not yet been established in their country or territory. National committees have to pay an annual subscription to ICC's International Secretariat in Paris to meet administrative expenses of this organization. The rate is proportionate to the economic importance of the country they represent. National committees are financially independent of the central body and are free to establish the level of their own membership subscriptions.

Direct members over in two categories with their annual dues.

a) 1500 EUR (approximately US$ 1500) per year for 'local' members, i.e. local chambers of commerce, local companies, professional individuals;

b) 3000 EUR (approximately US$ 3000) per year for 'national' members, i.e. national chambers of commerce, national trade associations, national business organizations, as well as companies with a predominant international activity, and occupying a leading position in the country.

vii) Special Status of ICC

ICC has top-level consultative status with the UN, where it puts forward the views of business in industrialised and developing countries. It also maintains close relations with the World Trade Organisation (WTO), the Organisation for Economic Cooperation and Development (OECD), the European Union, and other inter-governmental and non-governmental bodies. ICC permanent representatives at the UN in New York and Geneva monitor developments affecting business within the UN and its specialised agencies.

ICC makes sure business concerns are constantly brought to the attention of governments, both through its international headquarters in Paris and the representations of ICC National Committees throughout the world. An example of this political activity is the ICC President's annual meeting with the head of the host government of the Group of Eight Economic summit. On that occasion, ICC submits policy recommendations on behalf of world business for the consideration of the G8 leaders at the Summit.

viii) Specialist Divisions and Practical Services

ICC adapts its services to meet the changing needs of businesss. The following are some services rendered by ICC.

a) ICC International Court of Arbitration : The world's leading body for the resolution of business disputes by arbitration.

b) ICC Institute of World Business Law : Conducts research, training and the dissemination of information among practitioners and scholars in the field of international business law.

c) ICC Commercial Crime Services (CCS) : This specialized division is the ICC's umbrella organisation covering commercial crime, maritime crime, and counterfeiting.

d) ICC Publishing SA : Publishes practical reference works for the conduct of international business, based on the ICC's work programme. New guides and corporate handbooks are added to the list every year. All current publications may be ordered from ICC United Kingdom.

e) ICC World Chambers Federation (WCF) : The world forum for chambers of commerce works to strengthen chambers worldwide. It provides technical assistance and training programmes for those in Central and Eastern Europe, and the developing world. The WCF also manages the ATA Carnet system for temporary duty-free imports.

f) ICC Conferences and Congresses : May be held anywhere in the world, providing an opportunity for business people to learn from each other's experiences.

g) UCP 500 : The ICC's Uniform Customs and Practice for Documentary Credits first came out in 1933. These rules are used by banks around the world. A new version was published in 2002 and includes the supplement for electronic presentation (eUCP).

h) ICC Incoterms : ICC published the first nine Incoterms in 1936. They have been revised whenever necessary, and the current version is ICC Incoterms 2000.

ix) Technical Commissions of ICC

One of ICC's main activities is the harmonisation of trade practices. ICC rules on documentary credits are used by banks throughout the world, and ICC Incoterms - International commercial terms defined by the ICC - are applied by importers and exporters worldwide.

ICC also draws up voluntary codes for business, which set ethical standards. In 1996, it issued its Rules of Conduct to Combat Extortion and Bribery in International Business Transactions, which

companies are urged to use to develop their own codes of conduct. ICC's Business Charter for Sustainable Development contains 16 principles governing every aspect of a company's activities in relation to the environment, from product design to customer advice. ICC's marketing codes cover direct marketing, advertising, sales promotion and sponsorship.

Specialist ICC Commissions meet regularly to review issues affecting business, among them banking, competition, the environment, financial services and insurance, intellectual property, marketing, air, maritime and surface transport, taxation, and trade and investment policy. Commission members include senior executives of major international companies, law firms, and academics. The Commissions make critical assessments of legislative proposals and other developments affecting their fields, and communicate these views to governments and international organizations.

X) Advantages to Member Countries

ICC members are at the forefront of business self-regulation. ICC is world leader in setting voluntary rules, standards and codes for the conduct of international trade that are accepted by all business sectors and observed in thousands of transactions every day. Member companies and business associations are instrumental in the development of such key international trading instruments as Incoterms, the Uniform Customs and Practice for Documentary Credit (UCP 500) and GUIDEC (a set of guidelines for ensuring trustworthy digital transactions over the Internet.)

ICC's privileged links with major international organizations, including the UN and its specialized agencies and the World Trade Organization, allow the organization to effectively represent the interests of its members in international fora. ICC members prepare business positions for submission to international organizations and also, through ICC's global network of national committees, to governments. By being part of ICC, members gain influence both at national and international level. ICC offers members many of the advantages of belonging to a prestigious club and the chance to forge business relationships at the highest level at exclusive ICC events.

xi) Activities of ICC

The activities of ICC cover a broad spectrum i.e., from arbitration and dispute resolution to make case for open trade and the market economy system, business self-regulation, fighting corruption combating commercial crimes. As ICC has direct access to national governments all over the world through its national committees the ICC secretariat feeds business views is to inter governmental organizations on issues that directly affect business operations. The activities of ICC are discussed below :

ICC sets rules and standards relating to international business issues. The following are certain rules and standards.

a) ICC International Court of Arbitration, which was established in 1923, comprises of various rules for setting business disputes. Since 1999, the Court has received new cases at a rate of more than 500 a year.

b) ICC's Uniform Customs and Practice for Documentary Credits (UCP 500) are the rules that banks apply to finance billions of dollars worth of world trade every year.

c) ICC Incoterms (International Commercial Terms) are standard international trade definitions used every day in countless thousands of contracts. ICC model contracts make life easier for small companies that cannot afford big legal departments.

d) ICC is a pioneer in business self-regulation of e-commerce. ICC codes on advertising and marketing are frequently reflected in national legislation and the codes of professional associations.

Promoting growth and prosperity :

a) ICC supports government efforts to make a success of the Doha trade round. ICC provides world business recommendations to the World Trade Organization.

b) ICC speaks for world business when governments take up such issues as intellectural property rights, transport policy, trade law or the environment.

c) Signed articles by ICC leaders in major newspapers and radio and TV interviews reinfornce the ICC stance on trade, investment and other business topics.

d) Every year, the ICC Presidency meets with the leader of the G8 host country to provide business input to the summit.

e) ICC is the main business partner of the United Nations and its agencies.

Spreading business expertise :

a) At UN summits on sustainable development, financing for development and the information society, ICC spearheads the business contribution.

b) Together with the United Nations Conference on Trade and Development (UNCTAD), ICC helps some of the world's poorest countries to attract foreign direct investment.

c) In partnership with UNCTAD, ICC has set up an Investment Advisory Council for the least-developed countries.

d) ICC mobilizes business support for the New Partnership for Africa's Development. At ICC World Congresses every two years, business executives tackle the most urgent international economic issues.

e) The World Chambers Con-gress, also biennial, provides a global forum for chambers of commerce.

f) Regular ICC regional con-ferences focus on the concerns of business in Africa, Asia, the Arab World and Latin America.

Advocate for international business

a) ICC speaks for world business whenever governments make decisions that crucially affect corporate strategies and the bottom line.

b) ICC's advocacy has never been more relevant to the interests of thousands of member companies and business associations in every part of the world.

c) Equally vital is ICC's role in forging internationally agreed rules and standards that companies adopt voluntarily and can be incorporated in binding contracts.

d) ICC provides business input to the United Nations, the World Trade Organization, and many other intergovernmental bodies, both international and regional.

The voice of international business

Traditionally, ICC has acted on behalf of business in making representations to governments and intergovernmental organizations. Three prominent ICC members served on the Dawes Commission which forged the international treaty on war reparations in 1924, seen as a breakthrough in international relations at the time.

A year after the creation of the United Nations in San Francisco in 1945, ICC was granted the highest level consultative status with the UN and its specialized agencies. Ever since, it has ensured that the international business view receives due weight within the UN system and before intergovernmental bodies and meetings such as the G8 where decisions affecting the conduct of business are made.

Defender of the multilateral trading system

ICC's reach - and the complexity of its work - have kept pace with the globalization of business and technology. In the 1920s ICC focused on reparations and war debts. A decade later, it struggled vainly through the years of depression to hold back the tide of protectionism and economic nationalism. After war came in 1939, ICC assured continuity by transferring its operations to neutral Sweden.

In the post-war years, ICC remained a diligent defender of the open multilateral trading system. As membership grew to include more and more countries of the developing world, the organization stepped up demands for the opening of world markets to the products of developing countries. ICC continues to argue that trade is better than aid. In the 1980s and the early 1990s, ICC resisted the resurgence of protectionism in new guises such as reciprocal trading arrangements, voluntary export restraints and curbs introduced under the euphemism of "managed trade".

Practical services to business

ICC keeps in touch with members all over the world through its conferences and biennial congresses - in 2004 the world congress will be in Marrakesh. As a member-driven organization, with national committees in 84 countries, it has adapted its structures to meet the changing needs of business. Many of them are practical services, like the ICC International Court of Arbitration, which is the longest established ICC institution. The Court is the world's leading body for resolving international commercial disputes by arbitration. A record number of more than 590 cases came before the Court in 2002. In December alone, the Court registered more than 80 new cases, an all-time record for a single month.

The first Uniform Customs and Practice for Documentary Credits came out in 1933 and the latest version, UCP 500, came into effect in January 1994. These rules are used by banks throughout

the world. A supplement to UCP 500, called the eUCP, was added in 2002 to deal with the presentation of all electronic or part electronic documents. In 1936, the first nine Incoterms were published, providing standard definitions of universally employed terms like Ex quay, CIF and FOB, and whenever necessary they are revised. Incoterms 2000 came into force on 1 January 2000.

In 1951 the International Bureau of Chambers of Commerce (IBCC) was created. It quickly became a focal point for cooperation between chambers of commerce in developing and industrial countries, and took on added importance as chambers of commerce of transition economies responded to the stimulus of the market economy. In 2001, on the occasion of the 2nd World Chambers Congress in Korea, IBCC was renamed the World Chambers Federation (WCF), clarifying WCF as the world business organization's department for chamber of commerce affairs. WCF also administers the ATA Carnet system for temporary duty-free imports, a service delivered by chambers of commerce, which started in 1958 and is now operating in over 57 countries.

Another ICC service, the Institute for World Business Law was created in 1979 to study legal issues relating to international business. At the Cannes film festival every year, the Institute holds a conference on audio visual law.

The fight against commercial crime

In the early 1980s, ICC set up three London-based services to combat commerical crime : the International Maritime Bureau, dealing with all types of maritime crime; the Counterfeting Intelligence Bureau; and the Commercial Crime Bureau. A cybercrime unit was added in 1998. An umbrella organization, ICC Commercial Crime Services, Coordinates the activities of the Specialized anti-crime services. All these activities fulfil the pledge made in a key article of the ICC's constitution : 'to assure effective and consistent action in the economic and legal fields in order to contribute to the harmonious growth and the freedom of international commerce."

Challenges of the 21st Century

After the disintegration of communism in eastern Europe and the former Soviet Union, ICC faced fresh challenges as the free market system won wider acceptance than ever before, and countries that had hitherto relied on state intervention switched to privatization and economic liberalization. As the world enters the 21st Century, ICC is building a stronger presence in Asia, Africa, Latin America, the Middle East, and the emerging economies of Eastern and Central Europe. Today 16 ICC commissions of experts from the private sector cover every specialized field of concern to international business. Subjects range from banking techniques to financial services and taxation, from competition law to intellectual property rights, telecommunications and information technology, from air and maritime transport to international investment regimes and trade policy.

Self-regulation is a common thread running through the work of the commissions. The conviction that business operates most effectively with a minimum of government intervention inspired ICC's voluntary codes. Marketing codes cover sponsoring, advertising practice, sales promotion, marketing and social research, direct sales practice, and marketing on the Internet. Launched in 1991, ICC's Business Charter for Sustainable Development provides 16 principles for good environmental conduct that have been endorsed by more than 2300 companies and business associations.

13.3 INTERNATIONAL CHAMBER OF COMMERCE OF INDIA

Set up in 1929, Indian National Committee of International Chamber of Commerce (INC-ICC) is one of the most active chapters of the ICC, the world's apex business organization. In its fold, it has a large membership of enterprises, chambers of commerce, trade & industry associations. It is the forum, which makes it easier to do business internationally. It was rechristened as ICC INDIA, effective March 1, 1996.

The International linkages of ICC INDIA are far and wide. The ICC network speaks, directly and indirectly, for thousands of corporations and industrial and trade associations in over 140 countries.

13.3.1. Objectives of ICC India

The ICC INDIA is established to fulfill the following objectives :

a) To participate in the promotion of the activities of International Chamber of Commerce.

b) To facilitate commercial interaction among member countries.

c) To evolve business view on all international matters relating to finance, industry, commerce and environment, among others.

d) To encourage progress, promote peace and cordial relations among countries and their citizens by the cooperation of businessmen and organizations.

e) To nominate members on the bodies of ICC to represent Indian Business interests.

f) To do all such things as may be incidental or conducive to the proper representation of the commercial, industrial, financial, shipping and trading interests of India in the organization and work at the international Chamber.

13.3.2. Services of ICC INDIA

a) It settle international contractual dispute, protecting business from commercial frauds and counterfeiting or promotion of trade and joint ventures, the ICC INDIA provides most useful services to business.

b) It informs about scheduled ICC conferences and symposia, which will help members up-date information relating to their business.

c) It organises Seminars/Workshops/Symposia on various aspects of business facilitation from time to time and invites distinguished business leaders/experts for lectures/discussions.

d) It offers a number of books and cooporate hand-books publisher by ICC publication division on topics including banking practices, arbitration proceedings, finance, commercial problems, environment and telecommunications, at a price.

e) It helps members to avail services of ICC International Court of arbitration for the settlement of commercial disputes; the ATA Carnet System for temporary duty-free imports; the ICC Institute of International Business Law and Practice; the International Bureau, which combats maritime fraud; and Counter-feiting Intelligence Breau.

b) Information is sent to members on specialised ICC commissions made up of business experts, which meet regularly to formulate policies on a broad range of issues affecting commerce, investment and business practices.

13.3.3. Main Achievements :

Achievements of ICC INDIA are many and varied. To name a few :

a) It was through its initiatives that the All India Shippers Council was established in 1967.

b) It hosted the ICC Congress in 1965. That was incidentally the first congress to be held in India and second in Asia; a pioneering effort that paid rich dividends in terms of introducing India to foreign investors.

c) Dr. Bharat Ram, an eminent Industrialist, was first to be elected as President of ICC from Asia (1969-71). After a gap of 22 years, another eminent Industrialist from India, Mr. Hari Shankar Singhania assumed Presidentship in the years 1993-1994.

d) Organised 29th Congress of ICC in 1987 and the conference theme was "The Dynamics for Global Progress."

e) ICC - CACCI Regional Conference was organised in November 1992. Theme of the conference 'private Sector for Rapid and Efficient Economic Growth'.

f) It hosted ICC "Dynamic Asia" Business Opportunites Conference in New Delhi in March 1995.

g) Active participation in recent ICC World Congress and World Chambers Congress.

h) Hosted President & Secretary General of ICC in 2001-2002.

13.3.4. Benefits of ICC India

Membership in ICC INDIA brings many concrete benefits to both individual companies and to the cause of private enterprises in general. ICC INDIA members can -

a) Cut costs for business by using ICC trade facilitation activities.

b) Achieve better conditions for profitable international trade and investment.

c) Promote their companies' reputation in the World forum especially through World Chambers Networks.

d) Enrich their organisations particular area of expertise through their executive involvement in ICC INDIA projects.

e) Make invaluable contacts of the ICC - a meeting place for business people from all over the world in every sector.

f) Develop practical policies of use to business everywhere.

g) Get help with their company's needs and problems in international trade.

h) Obtain advance information on policy and practical issues affecting the context in which international business operates.

i) Unique opportunities for the shared expertise through ICC working groups.

j) Access to essential ICC publications, conferences and services at much discounted price.

ICC INDIA has been playing a pivotal role in the deliberations of the ICC designed to promote world trade. Today, the voice of Indian business is projected at ICC councils and through ICC and UN and its specified agencies. India has had the unique opportunity to host two conclaves of ICC in 1965 and in 1987 which brought together world business community to this land of infinite opportunities. It is a matter of honour for India that Dr. Bharat Ram, an eminent industrialist from India, had become the president of ICC for the period 1969-71. After 22 years, another leading industrialist, Mr. Hari Shankar Singhania was elected President for the years 1993 & 1994. Important Industrialists from India have been serving in the ICC board. Ably supported by an efficient secretariat, the ICC INDIA offers an unmatched opportunity for Indian business to go global.

13.4. SUMMARY

International Chamber of Commerce is a non-governmental institution established in 1919. It serves world business by promoting trade, investment and open markets for goods and services, as well as free flow of capital. Their head quarter is Paris. The governing body of ICC is known as ICC world council. National Committees or groups represent ICC in their respective countries. ICC secretariat executes the activities of ICC.

ICC consists of specialist divisions and practical services such as international court of Arbitration, Institute of World Business Law, Commercial Crime Services, Publishing SA, World Chambers of Federation and Conferences and Congresses. The activities discharged by ICC are setting rules and standards, promoting growth and prosperity, spreading business expertise, advocate International business etc.

After the disintegration of Communism in Eastern Europe, ICC faced fresh challenges as the free market system won wider acceptance than ever before, and countries that had hitherto relied on state intervention switched to privatization and economic liberalization. In the 21st century, companies look to ICC as they meet the challenges of globalization and adjust to a world in which the state's role in the economy is no longer pre-eminent. Building on its experience in promoting an open international trade and investment system, ICC is adapting its rules and codes of conduct to today's business conditions and introducing new ones. In particular it is creating rules and principles to meet the requirements of electronic commerce. National Committee of ICC was set up in 1929 and rechristened as ICC India in 1996.

13.5 KEYWORDS

UCP 500 :	Uniform Customs and practice which was come out in 1993
Incoterms :	International Commercial Terms
Multilateral Trading :	Trading among various countries (more than two countries).
Euro Dollars :	Dollars deposited with the Euro banks outside the USA.
IBRD :	International Bank for Reconstruction and Development is an international development bank emerging under the Bretton Woods Agreement.

13.6. SELF -ASSESMENT QUESTIONS

1. Write the role of International Chamber of Commerce for promoting world business.
2. What is meant by International Chamber of Commerce? What are its activities?
3. What is ICC India? What are its objectives and achievements?
4. Discuss the origin working of ICC and its Advantages?
5. What are the specialist divisions and practical services of ICC?
6. What are the services of ICC India?

13.7. FURTHER READINGS

B. Rama Rao, - Evolution of Central Banking in India

Y. Venugopal Reddy, - Monetary and Financial Sector Reforms

Vijay Joshi and I.M.D. Little - India's Economic Reforms 1991-2001.

D.M.Mithani & E. Gordon - Banking, Theory and Practice.

Unit- 14

International Monetary Problems and Special Drawing Rights

14.0 AIMS AND OBJECTIVES

This unit seeks to identify the international monetary problems that arose on the aftermath of the Second World War and measures taken to solve these problems. It will enable you to appreciate that international monetary problems are too ticklish and sensitive and hence they require a careful handling at the hands of the monetary authorities.

After going through this lesson you will be able

- to identify the major problems confronting the international monetary system;
- to list out the characteristics of a good international monetary system;
- to analyse the reasons for the collapse of the Bretton Woods system;
- to get a bird's eye view of the present international monetary system.
- to describe the aims, objectives and functioning of the Bretton Woods system particularly IMF; and
- to appreciate the evolution, concept, working and limitations of IMF and 'Special Drawing Rights'.

STRUCTURE

14.1 INTRODUCTION

The term international monetary system also known as international monetary order or international monetary regime refers to the 'set of rules, regulations, and conventions that govern the financial relations among nations'. The financial relations among the nations of the world can be conducted in a varied ways. Accordingly, the international financial system can assume different forms. What ever may be the systems, there are some common features among different systems. They are i). the role of exchange rates and ii) the nature of the reserve asset. Based on these common features or criteria, the international monetary system can be identified. The subject matter of international finance is related to the analysis of the difficulties associated with the conversion of one currency into another currency. It is for this reason that the exchange rates

play a crucial role in international monetary system. Based on the degree of flexibility (or rigidity) in the exchange rates, we can classify various possible exchange rate regimes. As we know there are two polar extreme systems of exchange rates viz., rigidly fixed exchange rates and freely floating exchange rates. In between these two extreme systems there are a large number of possible alternate systems such as adjustable peg system, crawling peg and managed floating. In recent years different economists advocate target zone approach. We have learned about these types of exchange rates in Unit-7. Another dimension of monetary system is the nature of the reserve assets held. Generally, the international monetary reserves are divided into two categories viz., commodity reserves and fiduciary reserves. Commodity reserves such as gold have intrinsic value besides their money value. On the other hand, fiduciary reserves such as national currencies or SDRs do not have intrinsic values. Based on the nature of reserve asset used, the international monetary system can be divided into three groups viz., pure commodity standards, pure fiduciary standards and mixed standards. Economists often use different names to refer to the same system depending on the criterion that they want to emphasize. For instance, when they want to give more emphasis on the type of exchange rates, gold standard is referred to as the system of fixed exchange rates and when they want to give more emphasis on the nature of reserve asset used they refer it as pure commodity standard.

14.2 OBJECTIVES OF INTERNATIONAL MONETARY SYSTEM

A monetary system is not an end itself. It is a means to an end. The main end or objective of the international monetary system is to over see that the fundamental economic processes of production exchange and distribution to operate as smoothly as possible. In view of this reason, Adam Smith described the international monetary system as the Great Wheel. When the wheels run as smoothly as possible the international economic system will also operate as smoothly as possible.

A good International Monetary System should serve the following objectives:

i) to facilitate the balanced growth of world trade;
ii) to promote efficient allocation of resources across the world so as to maximise the total world output and employment;
iii) to foster economic growth and improve social conditions world wide by encouraging fuller utilisation of productive resources; and
iv) to achieve the desirable distribution of economic welfare among the nations as well as among different groups within each nation.

In a well organised international monetary system there should be free flow of commodities, capital, labour, and other resources and there should be no place for direct controls and regulations even for balance of payments reasons. A good monetary system is one that reconciles the elements of cooperation and rivalry that exist among the nations. In order to reap the gains that accrue to nations as a result of international specialisation and division of labour, there must be some minimum degree of consistency and harmony in the economic policies followed by the trading nations.

14.2.1 TESTS TO ASSESS THE EFFICACY OF INTERNATIONAL MONETARY SYSTEM

Economists have developed three important tests in order to appraise and analyse efficacy of an international monetary system in achieving the stated objectives. They are **adjustment, liquidity and confidence.** The term 'Adjustment' refers to capacity of a nation under a particular monetary system to maintain or restore equilibrium in balance of payments without resorting to trade distorting methods. The term 'Liquidity' refers to the adequacy of international reserves or liquid assets. The term 'Confidence' refers to the absence of destabilizing or panicky shifts from one reserve asset to another when there are many reserve assets under that particular monetary system. Let us throw some more light on these concepts and understand clearly their precise meaning.

The process of **adjustment** in balance of payments is necessary whenever a country faces deficit or surplus in balance of payments. Every adjustment involves some costs to the nation and to the rest of the world. For instance, in order to correct the deficit in the balance of payments, the country has to deflate the economy (i.e., reduce the prices and incomes of the people) and accept some amount of unemployment. Similarly, a surplus country has to accept a higher level of inflation. In this connection the role of a good international monetary system is to assist the country to choose those policies or mixer of policies that minimizes the cost of adjustment to the country and see that the cost of adjustment is distributed equitably among all the participating countries.

The term **liquidity** in international finance refers to the volume of gross international monetary reserves that are used in the settlements of trade transactions. A good international monetary system should ensure adequate growth of monetary reserves in the world. Under the present international monetary system, international liquidity consists of total official holdings of gold, convertible foreign currencies such as dollars, pound sterling, Euro, Dutch mark, Yen and special reserve asset viz., Special Drawing Rights. In the short period if imports are more than exports, there will be temporary deficit in the balance of payments. This temporary or short-term deficit in balance of payments is generally settled by drawing from the official international reserves held by the country. Only if the deficit in the balance of payments is persistent and continuous, then the country would go for 'adjustment' process. Even in this case the available of adequate international liquidity would give choice for the government concerned to choose among various policy options. The creation of reserve assets involves costs and benefits. The problem in the international finance is how to distribute the costs and benefits that arise out of the issue of international reserve asset. The profit that is associated with the issue of money or reserve asset is known as **Seigniorage.** The term seigniorage refers to the difference between the face value money and its intrinsic value. This is a once for all gain accruing to the issuer of the currency known as seigneur or king. Under commodity standard such as gold standard the seigniorage will be very low because the cost of making gold coin will be very high. But under pure fiduciary standard like paper standard the seigniorage will be very high. When the currency of a particular country such as U. S. dollar is taken as the reserve asset, then there will be more seigniorage to U. S. if U. S. does not pay any interest amount on the holders of U. S. dollars as reserve asset. As we are going to see in the later part of this unit, this was one of the important reasons for the collapse of the Bretton Woods system.

Confidence refers to the absence of destabilizing shifts from one reserve asset to other reserve assets when there were many reserve assets. When there are several reserve assets, there is always the danger of destabilizing shifts from one reserve asset to another as predicted by the Grasham's Law "Bad Money Drives out Good Money". For the smooth functioning of international monetary system, the holders of the reserve assets should have confidence on them and should continue to hold it. The confidence crisis arises when the holders of the reserve asset feel that their reserve assets may not be converted into other desired reserve assets. A good international monetary system should have adequate safeguards against such confidence crisis or at least must be able to withstand the crisis.

Check Your Progress:

State the objectives of a good monetary system.

_____
_____
_____
_____
_____
_____

What is a seigniorage?

_____
_____
_____
_____
_____
_____

14.3 THE BRETTON WOODS SYSTEM

The international Gold Standard that was well established by 1870 has brought about stability in exchange rates and greatly promoted international trade. The system worked well for over 50 years and it collapsed in 1920s due to several reasons creating a vacuum in international monetary system. There were competitive devaluation for 'beggar my neighbour' goals. Exchange controls, restrictive trade practices, and bilateral trade agreements were the order of the day. The international investments were also affected to a great extent. In short, confusion and chaos prevailed in the international monetary system during the inter-war period, which was the worst period in the annals of world monetary system. Several nations proposed individual proposals to over come the horrors and terrors of the international monetary system. While Britain proposed "Keynes' Plan", America proposed "White's Plan". It was recognised that international monetary disorder could be corrected only through mutual understanding and multilateral cooperation. Hence, combining the salient features of Keynes' Plan and White Plan, the experts approved the establishment of Bretton Woods System at a United Nations Monetary and Financial Conference held at Bretton Woods, New Hampshire, from 1st - 22 July 1944. Under this system, the twin institutions viz., International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD were established. The Fund started functioning from 1st March 1947.

14.3.1 WORKING OF THE BRETTON WOODS SYSTEM

The Bretton Woods system under the supervision of International Monetary Fund (IMF) established a fixed exchange rate system in 1944. The American dollar was chosen as the key or reserve currency. The par value of dollar was fixed in terms of gold and the par values of all other currencies were fixed in terms of dollar. Under the system an American dollar was equal to 35 ounces of pure gold. The monetary authorities in USA were committed to buy and sell gold in unlimited quantities in fixed price of $35 per ounce of gold. The dollar could fluctuate around 1% of the par value. The par values of other currencies were not allowed to change except in case of fundamental dis-equilibrium in balance of payments when devaluation up to 10% was allowed with prior permission of IMF. The system worked fairly well up to 1971. But due to certain inherent problems in the system, the fixed exchange rate system came to an end in 1971 when major international currencies were floated.

14.3.2 REASONS FOR THE COLLAPSE OF THE BRETTON WOODS SYSTEM

During the era of Bretton Woods System, the International Monetary System confronted with three interrelated problems viz., Confidence, Adjustment and Liquidity.

14.3.2.1 CONFIDENCE PROBLEM

As we have learned already, Confidence refers to the absence of destabilizing shifts from one reserve asset to other reserve assets when there were many reserve assets. Under the Bretton Woods System the confidence problem arose out of the ability of United States to honour her commitment to buy back dollars from the member countries at the fixed price of $35 per ounce of gold. It should be noted that US had persistent deficit in her balance of payments. These deficits were financed by creating more dollars. The rest of the world, which accumulated these dollar balances, feared that the rise in US deficit and consequent fall in the value of dollar may erode the real value of their dollar holding. Hence, the rest of the world had an urge to convert their dollar holdings into gold. The open market price of gold was ruling well above the official price of gold of $35 per ounce (as committed by US). Under such circumstances, doubts arose to the rest of the world over the US's ability to buy back her accumulated dollar balances at the fixed price of $35 per ounce.

14.3.2.2 ADJUSTMENT PROBLEM

As we know, the term 'Adjustment' refers to the capacity of countries to maintain or restore equilibrium in balance of payments without taking recourse to extreme measures. Deficit in the balance of payments is a two-sided coin. The responsibility of adjustment should rest both on deficit and surplus countries. But the under the Bretton Woods system, the burden of adjustment fell heavily on the deficit countries and surplus countries have not taken any initiatives in the adjustment process. More over, there was asymmetry in the adjustment process between US dollar and other currencies. When member countries had deficit in balance of payments, they could devalue their currencies up to 10% and in exceptional cases up to 20% of their par values. But the same facility was not extended to US when her budget ran on deficits.

14.3.2.3 LIQUIDITY PROBLEM

The process of trade liberalisation under the auspices of GATT and WTO has pushed forward the volume of trade to a great extent necessitating increasing amounts of international liquidity. The term 'liquidity problem' refers to the adequacy of international means of payments in view of expanding world trade. The problem relates to the need for creating a new international reserve asset as a substitute for gold and dollar. Of all the problems, there has been a great deal of discussion about the problem of international liquidity. Therefore, let us examine the international liquidity problem in detail.

The problem of international liquidity is two-dimensional viz., quantitative and qualitative. The quantitative nature of the problem relates to adequacy of international liquidity. The qualitative aspect of the problem relates to the nature and composition of the reserve assets. The major problem of the international monetary system pertains to quantitative aspect of the international liquidity. Even though there is no problem of inadequacy of international liquidity in the current situation, it is feared that there may be shortage of international liquidity in future. The basis of fear is not unfounded. The present international monetary system does not provide any guarantee that international liquidity will automatically increase in future with the increase in world trade. The inadequacy fear is logical outcome of the slow growth of gold reserves in relation to the rate of increase in international trade and transactions.

The world stock of gold and exchange reserves has grown at a very slow rate since 1964. In fact the total world gold reserves have actually declined from SDR 41.9 billion in 1965 to SDR 36.1 billion in 1971. The pressure of demand for monetary reserves have been growing at such a rapid rate that even the leading member countries have been frequently compelled to devalue their currencies. Even the mighty U.S. dollar was devalued twice within a period of less than 14 months after 1971. However, there are certain countries like West Germany, Switzerland, and Japan that could be considered as liquidity surplus pockets in a world where a majority of countries face acute shortage of liquidity. Majority of developing countries of Asia and Africa are considered to be the liquidity deficit pockets. Therefore, the problem is not only one of increasing the quantity of international liquidity, but also one of proper and equitable distribution of liquidity among the developed and developing countries of the world. Before the emergence of the system of floating exchange rates in 1973, many proposals were made to augment the international liquidity. Let us briefly discuss these proposals.

1. **TRIFFIN'S PLAN:**

As early as in 1958, Prof. Robert Triffin submitted his plan to solve the problem of world liquidity. According to this plan the I.M.F. was to become the world's central bank. The member countries could deposit their local currencies in this bank in exchange for foreign currencies required by them. The member countries were also required to keep their foreign exchange reserves with the bank. The bank would act as a clearinghouse for settling all transactions of the member countries. This plan did not materialise because the member countries were reluctant to surrender their foreign exchange reserves to I.M.F.

2. **BERNSTEIN'S PLAN:**

Prof. Bernstein, the then Executive Director of IMF, proposed a plan to solve the international liquidity. According to this plan, IMF should float debentures, which should be subscribed, by the rich countries like USA, UK, France, West Germany, Canada and Japan. The proceeds of the loan should be utilised to advance loans to countries confronted with balance of payments difficulties. IMF later accepted the plan and it was implemented from 1962. Under this plan an amount of $6 billion in 8 currencies was raised. This plan also could not solve the liquidity problem of the countries entirely.

3. **RAISING THE OFFICIAL PRICE OF THE GOLD:**

Under the Bretton Woods system, the official price of gold was fixed at $35 per ounce of gold. President Charles de Gaulle of France suggested raising the official price of gold (which was nothing but devaluation of dollar). Even though it was expected to raise the quantum of international liquidity, it would favour only three countries viz., France, South Africa and the former USSR, which had huge stocks of gold reserves. Hence, it would lead to mal-distribution of international liquidity. Hence, USA was not in favour of it. Nevertheless, consequent upon the Smithsonian Agreement, the official price of gold was raised from $35 per ounce to $38 per ounce in December 1971 and again to $42.2 per ounce in February 1973. This, to a great extent solved the problem of international liquidity.

14.3.2.4. THE IMMEDIATE CAUSES OF COLLAPSE

The devaluation of pound sterling in 1967 could be stated as the beginning of the series of events that led to ultimate collapse of the system in 1971. The devaluation could not have been averted even with substantial help from the United States and other countries. This incidence has cast doubts about America's commitment to maintain the official price of gold at $35 an ounce. Consequently the flight from the dollars to gold in early 1968 accelerated.

14.3.3 THE SYSTEM OF MANAGED FLEXIBILITY OR ADJUSTABLE PEG

The system of fixed exchange rates under the supervision of IMF came to an end in February 1973. Major currencies in the world began to float. It should be noted that the system of freely floating exchange rates automatically ensures equilibrium in balance of payments and hence there will be no demand for international liquidity. However, except a few countries, majority of countries including developing countries has opted for the system of managed flexibility. Under this system, countries keep the currency peg constant up to a point where they could manage the currency peg with the available foreign exchange reserves. Once, the foreign exchange reserves are exhausted, they move to a higher level of peg. The currency peg can be to gold or key currencies or to a basket of currencies. If sudden devaluation is considered to be harmful to the exporters and importers, a variant of this policy is practiced. It is known as Crawling Peg or Trotting Peg or Gliding Parity. Under this system, the exchange rates of the currency are changed as frequently as possible by very small proportions as and when required.

Check Your Progress:

What do you mean by the problems of confidence, adjustment and liquidity?

_____
_____
_____
_____
_____
_____
_____

What is the immediate cause of collapse of the Bretton Woods System?

_____
_____
_____
_____

14.4 INTERNATIONAL MONETARY FUND

As noted already one of the two institutions established under the Bretton Woods system was the International Monetary Fund (IMF). It was only under the supervision of IMF the Bretton Woods System was working. Hence, let us know more about the IMF, its objectives, functioning and limitations.

14.4.1 OBJECTIVES OF THE INTERNATIONAL MONETARY FUND

The following are the major objectives of the International Monetary Fund:

i. To promote international monetary cooperation among the member countries.
ii. To facilitate the expansion and balanced growth of international trade and thereby to promote the employment, real income and productive resources of the member countries.
iii. To ensure stability in foreign exchange rates as instability breeds adverse repercussions on international trade.
iv. To establish a system of multilateral trade and payments and to eliminate exchange controls with a view to giving encouragement to the flow of international trade.
v. To correct short-term maladjustment in the balance of payments of countries by providing liquidity from the Fund's resources so that countries need not resort to extreme acts of changing the par values of their currencies even to correct such short-term deficits.
vi. To shorten the duration and lessen the degree of disequilibrium in the international balance of payments of the members.

14.4.2 STRUCTURE AND ORGANISATION OF IMF

The IMF is an autonomous ogranisation affiliated to the UNO with its headquarters at Washington. Thirty, out of 44 countries represented at the Bretton Woods conference and became the original members of the Fund by accepting its membership on or before December 1945. Micronesia became the 178th member of the IMF on July 24th, 1993. The ruling body of

the Fund is the Board of Directors consisting of one representative and one alternative representative appointed by each member. Normally the Board meets once in a year and takes the crucial decisions like admission of new members. The working powers of the Fund are delegated to the 20 Executive Directors of the Fund among whom the countries with the largest quota nominate five members. Every country has a quota. It is fixed on the following criteria:

i). Two per cent of national income,
ii) Five per cent of gold and dollar reserves,
iii). Tern per cent of average annual imports,
iv). Ten per cent of maximum variation in annual exports,
v). The sum of the first four is increased by the percentage ratios of the annual exports of national income.

Each member country is required to subscribe its quota partly in gold and partly in its own currency. To be more specific, a member country should contribute gold equal to 25 per cent of its quota or 10 per cent of its gold stock and US dollar holdings which ever is less. The portion of nation's quota paid in nation's own currency should be in the form of deposits in the nation's central bank. Thus the Fund gets pool of foreign currencies and gold to lend.

The quotas are reviewed in every five years and enhanced according to changes in the bases for determining the quota limit. The total Fund's quota as on July 31, 1994 stood at SDR 144 billion and as on 31st March 2001 at SDR 300 billion. The permanent members of the IMF are U. S. A., U. K, France, Germany, Japan, Italy and Canada who respectively hold 17.5 per cent,

14.4.3 FUNCTIONS OF IMF

1. To ensure exchange stability in the world by maintaining par values of the currencies of the member countries.
2. To set right fundamental dis-equilibrium in the balance of payments of changing the par values of the currencies.
3. To eliminate or minimise the short-term dis-equilibrium in the balance of payments by selling or by lending foreign currencies to the member countries.
4. To provide technical assistance to the member countries on economic and monetary matters.

14.4.3.1 EXCHANGE STABILITY

As already noted in the last chapter, the main objective of the IMF was that of maintaining stable exchange rates as under gold standard. As there are also some advantages in the system flexible exchange rates, IMF tried to combine both even though it tilted more towards the fixed exchange rates. The IMF chose the American dollar as the key or reserve currency. The par value of dollar was fixed in terms of gold and the par values of all other currencies were fixed in terms of dollar. Under the system an American dollar was equal to 35 ounces of pure gold. The monetary authorities in USA were committed to buy and sell gold in unlimited quantities in fixed price of $35 per ounce of gold. The dollar could fluctuate around 1per cent of the par value. The brand with was widened from one per cent to 2.25 per cent after Smithsonian

Agreement of December 1971 and further to five per cent after the Second Amendement to Articles of Agreement with effect from April 1978.

14.4.3.2 CHANGES IN THE PAR VALUES

The par values so determined need not be fixed rigidly. If the Fund finds that there is fundamental dis-equilibrium in the balance of payments of a country, it can change the par values of the currencies. According to the regulations of IMF any member country after consultation with the Fund can change the existing par value of its currency by 10 per cent in either direction. To do so, it need not obtain the prior permission of the Fund. In case the proposed change was less than 20 per cent, the member country should obtain prior permission from IMF. The IMF in turn has to take its decision within 72 hours. On the other hand, if the proposed change was more than 20 per cent, member country has to seek prior consent of the Fund. In this case the Fund gives its consent only if two-thirds of the members are in favour of it. Thus the IMF gives consent to change in the par value of the currency of a member country only if it is satisfied that there has been a fundamental problem in the balance of payments of the country. If any member country devalues its currency without the consent of the Fund, its membership can be terminated after giving notice. Obviously, the Fund sought to promote exchange stability without exchange rigidity as well as exchange anarchy. This system of managed flexibility combined the features of both the gold standard and the paper standard and avoided competitive exchange devaluation.

Though the early years of the functioning of IMF was disappointing with regard to exchange stability, the situation improved considerably in 1950s and 1960s. Due to some inherent problems in the working of the system, the Federal Republic of Germany and Netherlands decided to give up the par values of their currencies. Canada already introduced a floating rate a year ago. On August 15, 1971 the U.S. A. suspended the official convertibility of dollars into gold or other reserve assets. Thus the system of fixed exchange rates under the supervision of IMF came to an end.

14.4.3.3 PROVISION OF INTERNATIONAL LIQUIDITY

IMF provides to types of fiancés viz., drawings from the quotas and loans. Drawing from the quota is relatively easy and carries a low interest rate. On the other hand, loans from other sources carry a high rate of interest.

1. <u>THE FIRST FIVE CREDIT TRANCES:</u>

The total amount that a member country can draw from the Fund is linked to the size of its quota and the amount of the Funds holdings of its currency. Each country's drawing right is divided into five parts. The first is called the 'gold tranche' because it corresponds to country's subscription in gold. The next four facilities are called First, Second, Third and Fourth Credit Trannches each equaled to 25 per cent of its quota. A country can automatically utilise gold tranche without any conditions imposed upon. The first credit tranche can also be utilised without much difficulty. There after the conditions for drawing on the Fund becomes more and more stringent. These are known as 'conditional liquidity'. The extent of unconditional

liquidity provided by the Fund is relatively small when compared to the conditional liquidity. At present the Fund's unconditional liquidity is over SDR 6 billion while the supply of conditional liquidity is more than SDR 16 billion. Both types of liquidity are growing over the years. Many new types of credit facilities are created and extended to the member countries.

2. STAND-BY CREDIT SCHEME:

In 1952, the Fund created a new type of credit facility known as 'Stand-by Credit' for those members who do not need liquidity immediately. Under this scheme once the assistance is approved, a member can draw the specified limit of foreign exchange from the Fund within the specified period without any further application.

3. GENERAL ARRANGEMENTS TO BORROW (GAB):

IMF also extends credit to its member under another scheme known as General Arrangements to Borrow (GAB) since 1964. Initially the scheme was intended to be in force for five years. But it continued even after the expiry of five years. Under GAB, IMF could borrow up to 10 billion of the currencies of ten major industrial countries in the case the Fund was confronted with serious foreign exchange crisis. The Group of ten could utilise this facility. The assistance under this scheme was increased from SDR 6 billion to SDR 17 billion in 1983. Later this facility was extended to all other countries.

4. SPECIAL DRAWING RIGHTS (SDRS):

In spite of several facilities created by IMF, the problem of international liquidity could not be solved by the Fund to the fuller extent. Hence, a new scheme known as Special Drawing Rights (SDRs) was instituted in 1969. Under this scheme, the Fund created SDR 9.5 billion additional drawing facilities for its member countries. The scheme was accepted in a joint Conference of IMF and World Bank in October 1967. The final shape was given to it on 3rd October 1969 and it came into force from 1st January 1970. The new scheme known as 'Paper Gold' was an important milestone in the international monetary system in solving the problem of international liquidity of the member countries. We shall discuss the SDR facility in detail in a later part of this lesson.

5. SPECIAL OIL FACILITY:

IMF set up the 'Oil Facility' in 1974 with SDR 2.5 billion as an initial amount. The scheme was intended to provide liquidity to countries hit hard by the steep rise in oil prices in 1973 by OPEC countries. A contribution to this facility was made by OPEC as well as by several developed countries. Loans under this scheme was made to non-oil developing countries for a period ranging from 3 to 7 years primarily to meet the deficit arising out of oil imports. This facility was terminated in 1976 despite protests from the developing countries.

6. COMPENSATORY FINANCING FACILITY:

In 1963, 1 MF created another important Scheme known as Compensatory Financing Facility. Under this scheme the Fund provided finance to the member countries to finance their bop deficits resulting from the short fall in export earnings which are beyond their control. A member country confronting with such problem could have borrowing facilities up to 25 per cent of its quota. Later, this limit was raised to 50 per cent of the member's quota. However, US

urged that in view of 1983 increase in IM.F quota from 62 billion dollar to 91 billion dollars, there was less need for CFF.

7. SUPPLEMENTARY FINANCING FACILITY:

The Interim Committee of the fund at its meeting held in April 1977 recognised the urgent need for a supplementary arrangement of a temporary nature. The fund received a substantial amount of resources by borrowing from the surplus countries. The facility became effective in February 1979.

8. TRUST FUND:

To provide special balance of payments assistance on concession terms to eligible developing countries, Trust fund was established. The major source of the fund was the profit from the sale of a portion of the Fund's own gold resources. The Trust fund, which was established in 1976, was wounded up on April 30, 1981. The total assistance provided under this scheme amounted to SDR 2991 million. India was the major beneficiary of this scheme with total assistance of SDR 529 million.

9. AID FOR THE POOR NATIONS:

In response to the increasing pressure from the poor countries, a new subsidy plan was created on December 21, 1980. Under this plan, loans worth of SDR 3,937 billion were available to 83 low-income countries at a concessional rate of 0.5 per cent interest.

10. STRUCTURAL ADJUSTMENT FACILITY:

The IMF created structural Adjustment Facility (SAF) in 1988 with SDR 2.7 billion to support structural adjustments in low-income countries with chronic BOP problems. The resources for this facility came from repayments of loans from the Trust Fund. These resources were found to be inadequate to over come increasingly severe payments difficulties and to carry out fundamental structural reforms in these economies. Accordingly, in the middle of December 1987 IMF established another facility known as Enhanced Structural Adjustment Facility (ESAF) with SDR 6 billion additional resources. Under this scheme eligible member countries could receive up to 250 per cent of quota over a 3-year period. In exceptional cases the facility could provide assistance up to 350 per cent.

11. POVERTY REDUCTION AN D GROWTH FACILITY (PRGF):

In order to reinvigorate the fight against the poverty, the enhanced structural adjustment facility (ESAF) was renamed as Poverty Reduction and Growth Facility. IMF finance is committed to ensure poverty reduction along with economic reforms and good governance. Under PRGF concessional loan facility is extended to low income countries for poverty reduction. Table 5.4.1 provides details of utilisation of three major facilities viz., Stand – by Credit, Extended Finance Facility and Poverty Reduction and Growth Facility as on 31st March 2002.

Table –14.1
Utilization of IMF Finance under Major Facilities up to March 2002
(In Million SDRs)

S. No.	Name of the Facility	Amount Approved	Un-drawn Balance
1.	Stand – by Credit	43,509.50	22,400.64
2.	Extended Fund Facility	7,642.83	4,946.80
3.	Poverty Reduction and Growth Facility	4,370.88	2,918.90
	Total	55,523.21	30,266.34

Source: IMF (2002**), IMF Survey, Vol. 31, No. 8**, 29th April.

14.4.4 SPECIAL DRAWING RIGHTS

In contrast to the pre-war international monetary system, which was characterized by 'gold standard', the post-war period was characterized by 'gold exchange standard' wherein U.S. dollar has been serving as the reserve asset as good as gold. But due to several reasons such as weak position of U.S. dollar, speculation in gold, change in Euro-dollar market etc., this system was subjected to severe stress and strain and finally led to its collapse. Confidence, adjustment and liquidity were the three major problems identified in the system. To solve these problems, reform of international monetary system was considered to be inevitable and accordingly many proposals were put forward. One such measure was the introduction of Special Drawings Rights (SDRs) commonly known as paper gold in 1967. It aimed at limiting the future role of gold, dollar and sterling and at the same time broadening the functioning of the IMF. SDRs are the international reserves allocated to the member countries. Possession of SDRs entitles a country to obtain a defined equivalence of currencies of other participating countries. Creation of SDRs increased the resources available with the Fund and there by supplements the existing reserve assets. SDRs are transferable among member countries and certain eligible international organisations. They form genuine supplement to the existing international monetary reserves. Each SDR unit was initially defined in terms of gold with one unit of account equal to 1/35th of an ounce of gold or one US dollar as one US dollar was equal to 1/35th of an ounce of gold then. After devaluation of dollars twice in in 1971 and 1973, SDR became equal to $1.20 approximately. After collapse of the Bretton Woods System and the consequent wide fluctuations in major currencies of the world, the IMF calculated the daily value of each SDR unit as a weighted-average of a basket of 16 representative currencies in 1974. In 1981 the IMF moved to five-currency basket from 16-currency basket and there by highly simplified the calculation of SDR value. Under the new system, US dollar accounted for 42 per cent, German Mark 19 per cent, Japanese Yen, French Franc and British Pound accounted for 13 per cent each. SDRs is not backed by gold or any currency. It gets its strength from the fact that IMF members are willing to use it as a reserve currency and as a means of payment between central banks in exchange for national currencies. The original installments of SDRs were distributed to the members according to their quota in the Fund. All members of IMF are required to accept SDRS in exchage for their national currencies up three times of their quota. They receive interest (now)

at the market rate of interest on their excess holdings. A member can draw upon its SDR account if it has a balance of payments problem or if it wants to augment her reserve position. However, over a five year period her average SDRs balance with the Fund should not fall below 15 per cent of its allocation. A country need not consult the IMF before drawing her SDRs balances. SDRs are not subject to IMF's conditionality. Countries that draw SDRs have to pay interest (now) at the market rate of interest. The members of IMF control the volume of SDRs. It cannot be increased unless 80 per cent of IMF votes are cast in favour of the increase. It should be noted that the number of votes that a country has depends upon the size of the quota of the member.

14.4.4.1 Working of SDRs

A clear-cut mechanism was devised to implement the scheme. Under this system, a country (say India) needing convertible foreign exchange resources has to apply to the Fund for the use of SDRs. On receiving an application, the Fund would designate another country (say Japan) whose balance of payments and reserves position was sufficiently strong. This country is known as the designated country and it would meet the foreign exchange needs of India. Then India can draw on the Japan up to 200 per cent of amount of SDRs allocated to the designated country viz., Japan. Let us suppose that India has been allotted a quota of 2000 units and the designated country Japan a quota of 3000 units. Now if India seeks convertible foreign exchange of 1000 units, for which Japan has been designated by the Fund. So India has to give up 1000 units of its SDR holdings to Japan in exchange for n equivalent amount of convertible foreign exchange. India thus becomes a debtor country and Japan a creditor country. The debtor country India has to pay an interest at 1.5 per cent per annum on the units surrendered to the creditor country. It should be noted that the designated country, Japan cannot provide convertible currency in exchange for the SDR units in excess of twice the quota of SDRs allotted to it i.e., more than (3000 X 2 =6000 units. IMF allocated $9.5 billion in Special Drawing Rights during 1970, 1971 and 1972. Further allocations were also made in the years 1979-1981. No SDR allocations were made since 1981.

14.4. 5. MAJOR ACHIEVEMENTS OF IMF

IMF was instrumental in achieving its primary goal of promoting exchange stability. The degree of exchange stability achieved in the post-IMF period was remarkably superior to the situation witnessed during the inter-war period. Exchange rates broadly remained stable from 1947 to 1971.

Secondly, IMF serves as an excellent forum for discussion of economic, fiscal ad financial policies of member countries particularly with regard to balance of payments. IMF has created an impression among the member countries that their economic problems were not the exclusive concern of the members alone but of whole world.

Thirdly, IMF has greatly promoted international trade by facilitating multilateral payments and also by providing liquidity to over come short-term deficit in the balance of payments of the countries. This has greatly reduced the need for imposing import quotas and resorting exchange controls and multiple exchange rates system.

Fourthly, in the early years, the IMF had a conservative approach and it was reluctant to provide assistance to purposes other than correcting deficit in balance of payments. But in recent years the Fund has been extending credit more liberally even to solve such social problems as poverty and underdevelopment. During 1950s and 1960s, the period of repayment of loans was between 3 to 5 years. But now loans under EFF carry repayment period of 4 to 10 years and that from Fund's own resources between 3 ½ to 7 years. Hence, the quantum of borrowings from IMF also has increased sharply.

Fifthly, the Fund has been instrumental in securing all the advantages of managed flexibility system and avoiding the disadvantages. It has helped to maximize employment and accelerate economic development and economic stability.

Lastly, the Fund has been very considerate towards the needs of the newly developing countries. It liberally assists to maintain a healthy balance of payments, monetary stability, and to promote economic development program. The Fund also provides technical assistance to its members in this respect. The funds experts have assisted many member countries to design appropriate monetary fiscal and exchange rate policies.

The officers of fiscal affairs Department advise member countries on matters relating to tax policy, tax systems, tax administration, budgeting etc. Administrative officers of the member countries get trained at IMF Institute.

14.4.6 CRITICAL EVALUATION OF THE FUNCIONING OF IMF

In spite of the aforesaid achievements of IMF, it is not free from criticisms. Firstly, IMF is considered to be a conservative organization that does not respond quickly to changes in the global economic scenario. Secondly, the rate of interest charged for loans by IMF is considered to be very high. It ranged between 12 per cent to 16 per cent. Thirdly, IMF has been insisting on stricter and stricter conditionality clauses over the last three decades, which the borrower countries must fulfill. For example, up to 1970 the IMF was insisting on reduction in public expenditure for meeting deficit in balance of payments of the countries. From 1979 onwards, IMF has been emphasizing an increase in the productivity and improvement in resource allocation in programmes, which have acquired financial support from IMF. The Fund also wants the member countries to collaborate with the World Bank. When India borrowed 5.6 billion US dollars from IMF in 1979, it laid down stringent conditions regarding performance criteria relating to savings, exports, and imports. Fourthly, the IMF has been providing inadequate short-term credit. As a result the Group of Ten has entered into 'Swap Arrangement' whereby the countries exchanged each other's currencies and also provided short-term credit to tide over temporary deficit in balance of payments position. Such Swap Arrangements resulted in the emergence of 'Euro-dollar Market'. Fifthly, the IMF has failed in its primary objective of maintaining exchange stability. The original permitted level of 'plus or minus one per cent change' in the par values of the currencies of the countries was not practiced at all. Member countries some times devalued their currencies even more than 20 per cent. When the Bretton Woods system collapsed in 1971, IMF was reluctant to interfere in the exchange stability of the currencies of the countries. Since then the member countries have been practicing different policies such as 'managed floating', 'joint floating', and 'pegged exchange rates' etc. Sixthly,

IMF has also miserably failed to eliminate the practice of exchange controls in the member countries. The policy of and the practice of exchange controls went on unabated as before. The system of multiple exchange rates also prevailed in some form or other. Last but not the least, the IMF is accused of meting out discriminatory treatment in favour of developed countries and against the interest of the developing countries. IMF is dubbed as 'the Rich countries club'. Though the developing countries constituted the majority, the rich countries particularly the US dominated the decision making process at the IMF.

14.4.7 INDIA AND THE IMF

India is one of the founder members of the IMF. Until 1970 India's subscription quota was the fifth largest and hence India enjoyed the privilege of appointing a permanent Executive Directors. But after May 1970 the subscription quotes of Japan, Canada and Italy increased and became more than that of India. Now in the IMF's total capital base of $300 billion, U.S. accounts for the largest quota of 17.63 per cent followed by Japan 6.32 per cent Germany 6.17 per cent, France and U.K., with a quota of 5.1 per cent each.

When India became the member of IMF, par value of Indian rupee was fixed at 0.28601 grams of gold or 30.2 U. S. cents. With devaluation of rupee in 1949 and 1966 par values were changed. For instance, after 1966 devaluation the par value of Indian rupee was reduced to 0.118489 gams of gold or 13.33 U. S. cents.

India happens to be one of the major beneficiaries of the IMF assistance. It has got financial assistance under various facilities. Between 1947 and 1955 India borrowed twice to the tune of $100 million to meet deficits in the balance of payments. Between 1957 and 1975, India borrowed eight times from IMF to the extent of U.S. $ 1764 million. India also obtained concession assistance to the extent of SDR 529.01 million between July 1978 and February 1981 under the IMF's Trust Fund. India got sanctioned a loan equivalent to U.S. $5.6 billion from IMF in 1979. India drawn U.S. $ 3.9 billion from 1981 to till April 1984 and it declined to utilise the remaining portion of the sanctioned loan as the interest burden was very high.

In addition to large quantum of loans from IMF, India has also benefited from her membership of the IMF. India has got substantial amounts of loans from her sister institution viz., World Bank. These were long-term loans utilised for various development projects. India has been getting advisory help from the Fund under surveillance condition. The IMF has also been providing short-term training courses to Indian personnel on monetary, banking and financial, exchange and balance of payments policies. This is the one side of the issue. In order to have a holistic picture, we have to analyse the darker side of the issue.

Until 1991, India's official economic policy has been to assign commanding heights to the public sector in the mixed economy. It has to strive to prevent the concentration of economic power in a few hands and the flow of foreign capital as well as imports in order to extend protection to the domestic industry. These types of protective economic policies were at odds with the free enterprise, free market and free trade philosophy of IMF and the World Bank. IMF and World Bank have never appreciated India's policy of commands and controls. Hence, these institutions always tried to impose their views whenever the opportunities arose. For instance, in 1966 when India experienced, severe balance of payments difficulties, the IMF insisted on a degree of import liberalisation as a quid pro Que. for its financial assistance for balance of payments

adjustments. Yielding IMF's pressures, India has to liberalise her trade po9licies since mid 1970s. Mrs. Indira Gandhi had to change her quasi-socialist policies and accept the market ideology of the IMF. Again to crush political opposition against IMF's policies, Mrs. Gandhi had to clamp emergency in India in June 1975. A very persistent, calculated and long-term campaign was launched by the Bretton Woods twins t see that India opens up its doors to western private investment, western technology and western exports on a growing scale.

The worst part of IMF's conditionalities on India occurred when India had to borrow 5.0 billion SDR or Rs.5000 crore-loan in November 1981. It carried an interest rate of 10-12 per cent. India was forced to change her export, import and monetary and other policies as per the guidelines laid down by the IMF while sanctioning the loan. This was tantamount to gross interference in domestic economic affairs. This gave rise to heated controversy both inside as well as outside the Parliament. Due to improvement in balance of payment position, India decided not to draw 1.1 billion SDR.

In 1991 when India was confronted with a severe foreign exchange and financial crisis due to the gulf war, the IMF and World Bank came to her rescue not with sympathy but to accomplish their long-cherished objective. India was compelled to accept structural adjustment brining down the fiscal deficit, opening the economy to foreign investment, liberalisation of trade and other conditions. India had to globalise her economy very rapidly with open door policy. The so-called New Economic policy of 1991 with all its dimensions towards liberalisation, privatisation and globalisation was chalked out under IMF's direction. India changed her economic policy in an unprecedented speed and rapidity mainly to satisfy the IMF's conditionalities. In the urge to satisfy the whims and fancies of IMF, India seemed to have side tracked the pressing problems of poverty, inequality and chronic unemployment.

Check Your Progress:

How is the quota of a member country of IMF fixed?

_____
_____
_____
_____

What do you mean by par values? How are they determined under IMF?

_____
_____
_____
_____

What are Special Drawing Rights?

_____
_____
_____
_____

14.5 LET US SUM UP

The term international monetary system refers to the set of rules and conventions governing the international payments relating to trade and capital flows. A good international monetary system ensures easy settlements in balance of payments, provides adequate liquidity and instills confidence in the minds of traders and businessmen. Economics have devised these criteria in order to evaluate the working of a good monetary system. The monetary system that prevailed during the post war period is known as Bretton Woods System. Under this system, the International Monetary Fund (IMF) was established in 1944 along with the World Bank. The major objectives of its establishment were to promote international monetary cooperation, to promote international trade, to ensure exchange stability, to facilitate multilateral system of payments, and to provide liquidity to countries suffering from short-term deficit in balance of payments. It is an autonomous organisation with its headquarters at Washington. Every member country has a quota whose size is based on GNP, trade and other criteria. The international monetary Fund introduced gold exchange standard under which United States' dollar was given a key or reserve currency standard. The par value of dollar was fixed in terms of gold and the par values of other currencies were fixed in terms of dollar. It was a system of fixed exchange rates. As deficit in balance of payments is inevitable under the system of fixed exchange rates, the IMF has provided international liquidity from its own as well as borrowed resources. It has created several facilities like Credit Tranches, Standby Credit, General Arrangements to Borrow, Special Oil Facility, Compensatory Financing Facility, Supplementary Financing Facility, Trust Fund, Structural Adjustment Facility, Poverty Reduction and Growth Facility etc. In addition to these, IMF has created a new reserve asset known as Special Drawing Rights (SDRs) popularly known as Paper Gold. IMF has been by and large instrumental in fulfilling its objectives. It has ensured exchange stability and avoided the bitter experiences of the inter-war period. It has ensured adequate international liquidity to the member countries. Nevertheless, IMF has been criticised for its conservative and pro-capitalist policies. It is argued that IMF has been showing stepmother attitude towards the needs of the developing countries. India has also benefited a lot from its member ship in IMF. It has availed finances from IMF several times even though India has to accept the unwanted conditions imposed by the IMF.

14. 6 KEY WORDS & CONCEPTS:

Bretton Woods System : The system that was established after the Second world war to over see the rules and conventions governing the international payments and exchange rates.

Key Currency : A internationally acceptable currency which is used for setlling international trade transaction.

Dollar Exchange System : Under Bretton Woods System dollar was taken as the key currency and it was fully convertible into gold.

Liquidity Problem : The term 'Liquidity' refers to the adequacy of international reserves or liquid assets.

Adjustment Problem : The term 'Adjustment' refers to capacity of a nation under a particular monetary system to maintain or restore equilibrium in balance of payments without resorting to trade distorting methods.

Confidence Problem : The term 'Confidence' refers to the absence of destabilizing or panicky shifts from one reserve asset to another when there are many reserve assets under that particular monetary system.

Triffen's Plan : According to Triffen's Plan submitted in 1958, the I.M.F. was to become the world's central bank. The member countries could deposit their local currencies in this bank in exchange for foreign currencies required by them. The member countries were also required to keep their foreign exchange reserves with the bank. The bank would act as a clearinghouse for settling all transactions of the member countries.

Bernstein's Plan **:** Prof. Bernstein, the then Executive Director of IMF, proposed a plan to solve the international liquidity. According to this plan, IMF should float debentures, which should be subscribed, by the rich countries like USA, UK, France, West Germany, Canada and Japan. The proceeds of the loan should be utilised to advance loans to countries confronted with balance of payments difficulties

Special Drawing Rights **:** A Special reserve asset called paper gold created in 1968 to supplement the existing international reserves by I. M. F.

14.7 BOOKS FOR FURTHER READING:

1 Mannur, H. G. (1983), ***International Economics,*** New Delhi: Vikas Publications.

2. Pugel, Thomas A. & Peter H Lindert, (2000)***, International Economics***, New York: Irwin Mc Graw-Hill.
3. Mithani, D.M. (1999), ***International Economics,*** Mumbai: Himalaya Publishing House.
4. Government of India (2002), ***Economic Survey- 2001-2002.***
5. Seth, M.L. (2000), ***Monetary Economics***, Agra: Lakshmi Narain Agarwal.
6. Simha, S.L.N. (1996), ***Fifty Years of Bretton Woods Twins (IMF and World Bank),*** Chennai: Institute for Financial Management and Research.

14.8 MODEL EXAMINATION QUESTIONS:

Answer the following Questions in about 15 lines.

1. What are the characteristics of a good monetary system?
2. Give the structure and organisation of IMF.
3. State the Objectives and functions of IMF.
4. What do you mean by international liquidity?
5. Distinguish between conditional and unconditional liquidity.
6. Write a brief note about the Structural Adjustment Facility.

Answer the following Question in about 30 lines.

1. Elucidate the major reasons for the collapse of the Bretton Woods System.
2. Examine the problems of adjustment, liquidity and confidence.
3. Enumerate various liquidity facilities created by the IMF.
4. Evaluate the working of SDR facility.
5. Critically examine the functioning of the International Monetary Fund.
6. Analyse the role of IMF in solving India's balance of payments problem.

******

LESSON – 15 EXTERNAL VALUE OF RUPEE

15.0 OBJECTIVE

In this lesson an attempt is made to examine the overall trends in the external value of India's rupee. Since pre-independence to present the changes in the external value of India's rupees are discoursed briefly. After thoroughly going through this lesson you will be able to know about:

* External value of the Rupee in the Brettonwoods system.
* India's shift to Basket Peg system in 1975.
* India's move to a more flexible system.
* Full convertibility on current account.
* Convertibility on Capital account.

STRUCTURE:

15.1 INTRODUCTION:

The evolution of the currency system in British India corresponded to the pattern of British requirements. India's exchange rate has been managed traditionally ever since it adopted a Sterling Peg in September 1931, even after Britain's withdrawal of the gold standard, the Rupee's fixed link with Sterling continued. After the establishment of the Bretton Woods

system in which India was a founder member, by communicating to the Fund, India administered a par value that was not to disturb the Rupee's parity with Sterling.

15.2. EXTERNAL VALUE OF THE RUPEE IN THE BRETTON WOODS SYSTEM:

The establishment of the Bretton Woods System at the close of the war in 1944 in which India was a founder member, logically implied that India should break her ties with the Sterling area. This is so because, the Sterling area with exchange controls operating around it, was definitely incompatible with the IMF objective of "the establishment of a multi-lateral system of payments in respect of current transactions between members and … the elimination of foreign exchange restrictions which hamper growth of world trade". [Article 1(iv) of the IMF]. Nevertheless, the immediate post-war period did not involve any significant change in the working of the Sterling area arrangement and, India's continued membership in that association in turn meant no substantial change in her exchange rate arrangement.

Thereafter we noted a shift India's external transactions from the mid-fifties towards the non-Sterling countries. This was so because by the beginning of the 1960s (February 1961), the phenomenon that Sterling gradually became an informal and voluntary association with the restoration of total full current account convertibility to Sterling and the Dollar pool arrangement within the Sterling area dismantled, gave a big push in India to her drive for diversification of transactions away from U.K. and the rest of the Sterling area, a drive which at first started after the 1949 Sterling devaluation, particularly with regard to India's export. The share of India's current spending (imports plus invisible payments) in the Sterling area declined from nearly a half of the total in the mid-fifties to just under a fifth by the end of the sixties. Similarly, the share of India's current receipts (exports plus invisible receipts) from the region declined by more than half from 54 per cent of the total of 26 per cent over the same 15-year period. This altogether reflects the intensity of the trade and exchange controls erected against the non-Sterling world. Sterling continued to be the intervention currency of the system, the authorities kept parity with Sterling and kept the bulk of foreign balances in Sterling. This situation would have continued but for two developments: first, the deterioration of India's BOP by early, 1966-67 and second, the devaluation of the Pound in November 1967 from 2.80 to 2.40 (14.3 pera cent) (Rupee-Sterling parity changes to 1 = Rs.18), which gave a significant jolt to the Sterling area.

15.3. RUPEE DEVALUATION IN 1966 AND EXCHANGE RATE REGIME PRIOR TO 1975:

India's BoP, which remained in difficulty throughout the decade after the mid-1950s, became critical by early 1966-67. The government's measures in the form of export subsidies, import restriction and incentives for foreign remittance proved inadequate and, with the situation worsening, the government under the World Bank's pressure took the radical decision of devaluation of the rupee by 36.5 per cent on June 6, 1966: Rupee-Sterling parity changes to 1 = Rs.21.

Following devaluations, major events happened substantially in India's exchange rate regime. They were: (a) Britain entered into agreement with India to restrict the drawing down of Sterling reserves from September 1968. This, to some extent, revives the formal nature of the

Sterling area arrangement; (b) Rupee pegged to the US Dollar on August 22, 1971. India adopted a Dollar peg in August 22, 1971, for the Rupee and this development is significant. (c) Rupee re-pegged to Sterling on December 19, 1971 at the Central rate of 1 = Rs.18.9677, (d) Pound floated on June 23, 1972 consequent upon the worsening BoP situation in the U.K., India's maintenance of the parity with the Sterling remained unchanged. This repeated the events of 1931.

The authorities policy of a Sterling peg during 1972-75 resulted in large depreciation of the Rupee against other major currencies: 10 per cent against the Dollar, 13 per cent against the Yen, 34 per cent against the deutsche Mark and 18 per cent against the French Franc other than Sterling: the effective exchange rate of Sterling declined by 22 per cent during June 1972-June 1975, the large nominal depreciation of the Rupee by about 20 per cent during the Sterling peg (1972-75) had been beneficial from the view point that it helped in improving the competitive position of India's exports: the volume of India's exports recorded a remarkable growth by an annual rate of 8 per cent during that period. The share of India's exports to OPEC nations rose sharplyfrom 5 per cent in 1973-74. Although this arrangement of the Sterling peg had been beneficial, it could at best be a transitional arrangement applicable during a period of considerable uncertainty at home and abroad.

In brief, prior to 1975, the external value of the Rupee was determined by its historical link with the Pound-Sterling which also enabled the Rupee to participate in the par value Bretton Woods system. With the collapse of the Bretton Woods system in 1973, as a result of growing financial strains and external imbalances, the world moved to what is now known as a system of generalized floating. This implied that no enumerative or anchor existed for the system as a whole, a role played by gold. Individual countries were free to peg their currencies to any other currencies, or basket of currencies, such as the IMF's Special Drawing Rights (SDRs) or to allow the exchange rate to vary according to market forces or some other type of adjustment mechanism. The generalized floating experience of the early Seventies imposed severe downward pressure on the Pound Sterling against other major international currencies, resulting in a misalignment of the Rupee vis-à-vis the other currencies. The link system, besides importing volatility also rendered the exchange rate regime passive, subjecting it to policy changes in the U.K. economy, rather than to domestic policy initiatives. On 25 September, 1975, therefore, the Indian authorities introduced a basket peg and the Rupee was delinked from the Pound Sterling and its external value was determined with reference to a basket of a selected number of currencies of India's major trading patterns with the Pound Sterling as the intervention currency.

15.4. FLOATING Vs FIXED EXCHANGE RATES:

In the post-Smithsonian era, the currencies have been on various types of floating systems due to the abandonment of the convertibility of US dollar. Single float, joint float, managed float etc., are examples of such floats. The system of fixed exchange parties (par values) was given decent burial following the breakdown of the Bretton Woods system in August 1971.

Floating rate is a rate, which is allowed to fluctuate freely according to supply and demand forces. Such float is a free float if no intervention takes place by the central bank of the country. In the real world, some degree of intervention exists which leads to a managed float. Such managed floats are either single or joint. Dollar, sterling and Yen were floating with varying degrees of intervention within a band of 2.25 per cent on either side and they are single floats. The European Common Market countries (West Germany, Frances, Belgium, Netherlands, Luxemburg and Ireland, Denmark and Sweden) are under a joint float within a narrow band called "Snake in theTunnel". The new IMF policy is to keep relatively stable exchange rates within a wider band of fluctuations. Indian rupee is kept relatively stable with the help of a basket of currencies, upto July 1991, when the rupee was devalued and LERMS' was adopted later.

15.5. SHIFT TO A BASKET PEG SYSTEM SINCE 1975:

It would not be out of place here to examine the conditions of the Indian economy during that period which was essentially characterized by a decline in the inflation rate especially from the second half of 1974-75 and also in the index of wholesale prices in the second quarter of 1975-76 as compared to the previous year. The agricultural situation and industrial production somehow registered buoyancy with signs of an exceptional harvest in 1975-76, and with improvement in production. On the external front, import prices continued to rise faster than export prices resulting in further deterioration of India's terms of trade. In this situation, there were sharp increase in the import prices particularly of oil, fertilizers and food. The Rupee's continuing link with the Pound was considered to be an aggravating factor in this regard, as the Annual Report of the RBI, 1975-76, stated that: The effect of this change (from the Sterling peg to the basket pet) has been to stabilize the value of Indian Rupee vis-à-vis currencies other than Sterling and to increase the purchasing power of the Rupee in terms of Sterling. This has contributed to some extent to the stabilization of prices, by preventing an increase in the prices of imported commodities and services.

The developments which significantly influenced India's decision to shift out of the Sterling peg to basket peg on the ground that it is more able to stabilize the effective exchange rate, prices and output can be summarized as: For the satisfactory operation of a floating exchange rate system, there was minimum institutional back-up. India at this stage could hardly afford the scrapping of controls on trade and capital flows on the reason that floating always pre-supposes the existence of a well-knit domestic financial market, often integrated with international financial market with extensive freedom of movement of capital flows externally. From early 1973, developing countries were gradually shifting from single currency pegs to multi-currency pegs.

By December 1974, the India's foreign exchange guarantee agreement with Britain expired and, therefore, the Sterling balances were subject to fluctuations in the value of Pound, which is still weak in the market. This prompted India to accelerate the diversification of foreign exchange reserves away from Sterling from early 1975, which culminated ins the scrapping of the Rupee's tie with Sterling on September 25, 1975.

With the existing system of exchange controls in India, a free-floating rupee was out of question in the eighties. The rupee is not strong enough to withstand the speculative onslaughts. Our trade would have suffered. Alternatives left to the monetary authorities in India were, therefore, to link it with $, or a combination of some major currencies like the SDR. Since both $ and were having their own problems, the choice has fallen on a basket of currencies but unlike the 16 major currencies in the case of the SDR, at that time only 5 major currencies having good trade connections with India in 1975 were chosen in its basket. The SDR valuation would have been unrealistic for India as some of the currencies represented in SDR have no relations with India's trade. The basis of SDR valuation was itself changed to a bag of five currencies in 1981. It was felt that it would be advantageous for India to link the rupee to a mix of currencies properly weighted as this would give greater stability and more certainty so that India's trade and investment abroad would not suffer. The import bill and debt-servicing burden are heavy for India and it would be necessary to have relative stability in the exchange rate. The fact that moderate depreciation took place in effect as against $, DM etc., would have probably helped our export trade in particular.

15.6. INDIA'S MOVE TO A MORE FLEXIBLE SYSTEM:

Initially, the Indian basket system had a band of 4.5 per cent. Since January 30, 1979, the band had been widened to 10 per cent. The broadening of the basket margins on January 30, 1979 and maintaining the basket-determined value of Rupee to + 5 per cent which came into effect from April, 1978, is a significant event in the evolution of the Indian exchange rate regime. Here the exchange rate acted as an important instrument for achieving alternative macro-objectives other than stability including the Bop adjustment without in any way violating the basic basket rule by fixing a more appropriate exchange rate for the Rupee (RBI Statement).

The experience of the managed float regime under a basket arrangement was favourable at the outset with the Rupee appreciation by 7.16 per cent against the US dollar during 1975-81. This exchange rate variability of the Rupee did not have an adverse impact on export growth, on an aggregate. However, the exchange rate risk, as reported by its variability, had significant impact on the prices of exports. Increased remittances from the Gulf coupled with the healthy growth in India's exports eased the pressure on the BOP and the current account recorded a surplus in 1976-77 and 1977-78 by an account of Rs.1525.8 crores and Rs.1734.7 crores respectively.

The second oil shock in 1979 was not however, accompanied by the favourable factors. Fiscal deficits became large and persistent. The miniaturization of a sizable portion of the fiscal deficit led to monetary expansion and thereby created an inflationary situation which has its spill-over effects in terms of an increase in the demand for imports as well as a rise in the domestic production costs of exports. Compensatory policy action was necessitated and this required for external sector policies to take on a distinct export bias since 1978-79. As a result, the regime of managed float came under considerab le pressure, and the Rupee, which had been appreciating upto 1980-81, took a turn for the worse and started to decline since 1981-82.

15.6.1 India's Exchange Rate Adjustment, July 1991

By 1990-91, it was evident that both macro-economic policy and structural factors had contributed to misalignment (i.e., over-valuation or under-valuation in the exchange rate). The fiscal deficit grew at an alarming pace, creating a problem of monetary overhand and endangering price stability. There was a growing divergence in the parallel market rate of "hawala rate" from the official rate in spite of the frequent adjustments in the exchange rates effected by RBI. Among the structural factors, the striking ones relate to tariffs, which were at an abnormally high level at around 300 per cent and stringent capital and exchange controls. Capital inflows from commercial sources started dwindling away following the successive downgrading of the country's credit rating by international agencies, and as the oil prices rise took place with the Gkulf War crisis, leading to dangerously sharp decline in foreign exchange reserves, the international confidence began to ebb away resulting in a large outflow of capital particularly from the non-resident deposits. The cumulative effect of these factors was the unprecedented balance of payments crisis in 1991.

As part of the crisis management the Reserve Bank of India (RBI) effected a two-step discrete downward adjustment in the external value of the Rupee in July 1991 instead of the usual gradual small step adjustment by virtue of which the Rupee in order to gauge the reaction of the market, was adjusted downwards by 7-9 per cent against the five major currencies on July 1, 1991, and on July 3, 1991; the Rupee was further devalued by about 11 per cent against these currencies. As a result, between June 28 and July 3, 1991, the value of the Rupee declined by 17-19 per cent vis-à-vis the five major currencies while these major currencies appreciated vis-à-vis the Rupee by about 21 to 23 per cent. This significant exchange rate adjustment was done with a view to quadding the destabilizing market expectations, restoring international confidence in the value of the Rupee and stemming capital outflows, shorting up the level of reserves and improving the country's international competitiveness which was considered eroded in the global market due to high domestic inflation since October, 1990. After the two-step discrete devaluation of the Rupee, the basket system was somewhat abandoned in favour of a Dollar peg by keeping the value of Rupee stable with Dollar.

An adjustment of the magnitude undertaken in July 1991 cannot be taken repeatedly to tide over balance of payments difficulties, given the stance of competing countries and the implied requirement of deflationary demand management policies, hence the need for a market-related exchange rate policy. The Liberalized Exchange Rate Management System (LERMS) was consequently introduced in March 1992. The introduction of LERMS implied a partially floating dual exchange rate with an official rate pegged to Dollar and an inter-bank rate determined at the market. The dual exchange rate system involved surrender of 40 per cent of all foreign exchange remittances, whether earned through exports of goods and services or remittances at the officially fixed rate and the remaining 60 per cent to be sold at a market determined rate. The foreign exchange surrendered at the fixed official rate financed the import of essential items such as petroleum, oil products, fertilizers, defence and life-saving drugs and government departmental imports and the balance financed other imports like raw materials, components and also capital goods.

This arrangement was timely and constituted a considerable improvement over the earlier exchange rate system, which involved in effect a multiple exchange rate system characterized by highly restrictive trade regime. The dual exchange rate was designed to liberalize trade, by subsidizing imports, and initiate a move towards convertibility of the Rupee; this move towards partial convertibility of the Rupee had cleaned up the trade system by eliminating licenses and the associated delays and inefficiencies over a wide range of current account transactions. At one stroke, a large number of import categories, which required the issue of separate import-entitlements called "EXIM scrips", were eliminated and were made freely importable. Instead of the need to issue EXIM scrips for each transaction, the system was much simple and operated through banks and authorized dealer on foreign exchange.

Although the dual exchange system represented an improvement of trade regime thus functioning effectively with the market determined exchange rate, and exhibited remarkable stability, it did not continue indefinitely because it involved an implicit tax on exports and allowed for the rationing of subsidized foreign exchange for certain inputs which could lead to distortions in resource allocation over time. Moreover, this anti-export bias-the Rupee price of exportable was lower than that of import substitutes was hardly justifiable in the context of the need for a big jump in export growth in order to sustain the economic reform programme. The process of dismantling the managed float regime ultimately culminated in the unification of the official and market rates in March 1993. The combination of the earlier devaluations and the unification measure resulted in a real effective depredation of the Rupee of around 20 to 25 per cent in real terms between July 1991 and March 1992 and about 35 per cent in nominal terms. Since March 1993 the nominal exchange rate had been constant and there had been a small real appreciation. The Rupee had been strong as a result of a dramatic current account improvement and a surge in capital inflows. The RBI had intervened and increased reserves substantially.

Another move towards reform of the exchange rate regime was the relaxation of controls over foreign exchange transactions. Significant among these was the abolition of the advance deposit scheme on imports on non-capital goods.

15.6.2. Convertibility on Current Account

We have traversed quite a long from a Sterling peg to a basket system, to a partial float and then to a full float. Finally, the exchange rate is now under a 'managed float' regime controlled by the Reserve Bank of India with the nominal exchange rate targeted, broadly speaking, to achieving the real exchange rate, which yields a sustainable current account deficit. The Rupee remains more or less stable, although at time there are signs of instability. We think this will continue to be a sensible strategy over the medium-term future in which capital movements are likely to be volatile.

Turning to the objective of exchange rate policy in the present 'managed float regime', we feel that the exchange rate should be maintained at such a level as to progressively reduce the current account deficit and eventually generate a current account surplus. The most crucial aspect of the balance of payments in India from a medium-term perspective is the prevalence of the relatively high international indebtedness and the debt service obligations. India has a huge external debt US $ 95.2 billion at the end of September 1998 to be serviced for which current

account surpluses are to be generated. For that purpose, the authorities have to be alive to the need to maintain a competitive exchange rate meaning thereby that the possibility of the real appreciation of the Rupee has to be prevented. Whatever be the reasons for a real appreciation of the Rupee, be it occurred either on account on an appreciation of the nominal exchange rate or to a large inflation in India, the authorities need to intervene to offset real appreciation and should look into an appropriate exchange rate system (which includes the exchange rate arrangement and exchange rate policies) that will accommodate the diverse economic structures and institutional arrangements. In choosing an appropriate system for the country, the authorities may be guided by four criteria that, when applied, must take into consideration of the economic characteristics and circumstances of the country. These criteria may be applicable to all other developing countries.

The first is: Does the system help or hinder macro-economic policy in pursuit of objectives ? The important test of the appropriateness of the system is whether the variability in exchange rate impinge upon or facilitate the achievement of the ultimate targets of domestic economic policy like price stability, high employment and sustainable economic growth.

The second criterion is: How effective is the arrangement in promoting external payments adjustment under which the country's current account position can both be financed by normal capital flows without recourse to under restrictions on trade, special incentives to flow of capital, and disincentives to outflows of capital of wholesale unemployment and disequilibria in BoP over a reasonable time period can be eliminated through external payments adjustment?

The third criterion is: How does the arrangement affect the volumes and efficiency of world trade and capital flows? As the global welfare is generally increased by an expansion of world trade and investment, this criterion refers to the efficiency of trade and investment.

Finally, the fourth criterion is: How robust or adaptable is the system to significant changes in the global economic environment? The rationale for this criterion is that there are substantial costs associated with changing an exchange rate system, especially under crisis conditions. Other things being equal, it is better to have an exchange rate system that is relatively robust or adaptable to changes in the global economic environment than one that is not. Under conditions of high international capital mobility or rapid or abrupt changes in comparative advantage, such a system may have to perform well.

15.6.3. Convertibility on Capital Account

There are many advantages to justify the introduction of convertibility on current account. In this context, it is worthwhile to note that export growth, inward remittances, direct foreign investment and allocative efficiency will not depend entirely on current convertibility alone, in most cases other complementary measures suited to the context are needed. Trade liberalization in general is an important complementary measures. Other measures like expanding the outlays of foreign currency conversion and simplification of procedures for industrial investment are also important. A view loomed large for quick announcement of full convertibility of the Rupee on capital account. The argument was that full convertibility will bring about equilibrium in the Indian external sector by bringing in capital flows to finance

whatever current account gap that may result if only we keep the interest rates high enough. This argument is in line with the Mundell-Fleming Open Economy Model (See Mundell, 1962 and Fleming, 1962), which extends the Keynesian Fix Price Model for well-developed domestic financial markets. In furtherance of globalization efforts of the economy the RBI appointed committee on Capital Account Convertibility has recommended ka phased programme of liberalizing capital account transactions with a $\pm$ 5% band centered around a neutral REER movements.

In retrospect, after two massive doses of devaluation in 1991 and a brief period of EXIM scrips and the partial convertibility of the Rupee with a two-tier system, the full convertibility of the Rupee on the current account put in place in March 1993 has worked in favour of opening up of the economy and its integration with the world economy. Thereafter from March 1993, there was a prolonged stability in the exchange rate of the Rupee, except in October 1995 when the nominal exchange rate fell to Rs.435.65 per US Dollar in terms of Foreign Exchange Dealers' Association in India (FEDAI) indicative rates, amplified by speculative factor and again in January and February 1996 when the two incidents put Rupee under pressure in the wake of unfounded expectations about the external payments situation. The widening of the current account deficit in the face of a rising trade deficit, an ebbing of capital flows and the pronounced appreciation of the US Dollar against major international currencies triggered off market expectations and resulted in a depreciation of the Rupee. After reasonable stability, the exchange rate of the Rupee against the US Dollar came under downward pressure since the last week of August 1997. This may be attributed to the East Asian financial crisis (which erupted in July 1997 and broadened in 1998) and uncertainties related to domestic developments. However, since September 1998, the Rupee has shown slight appreciation against the US Dollar. At the end of May 1999, the exchange rate vis-à-vis the US Dollar was Rs.42.50, recording a cumulative depreciation of about 7.1 per cent from the end March 1998 level of Rs.39.50. The RBI has come forward to take actions to quell persistent volatility or misalignment and to maintain orderly market conditions to ensure that the exchange rate remains consistent with economic fundamentals. Thus it appears that the practice of stabilization of the exchange rate of the Rupee has continued to become an important factor in guiding the conduct of exchange rate policy. Stability in the exchange rate will persist in the long-run if there was a sustained effort to ensure a reasonable stable real effective exchange rate and suitable monetary policy measures and other measures are geared to such an extent so as to counter speculative pressure on the Rupee and to ensure orderly foreign exchange market conditions.

15.7. SUMMARY:

To conclude, the exchange rate regimes in India as they have evolved since Independence in line with the planned developed process clearly reflect that the exchange rate mechanism has served as one of the arms of the overall trade policy in pursuit of industrialization drives. Of late, reasonable stability in the external value of the Rupee is strongly felt in the context when our country is struggling hard to become internationally competitive by an effort to integrate its economy with the world economy or faces the difficulty of international trading environment brought about by the economic and financial crisis in East Asia and the like. A sustained rapid growth in exports remains the most crucial ingredient for ensuring long-term external viability as well as maintaining a pragmatic and flexible exchange rate consistent with preservation and

improvements of our country's external competitiveness. But it needs to be recognized that the success of the structural adjustment in India should be judged not only by the stability of the exchange rate alone but also by the growth and structural transformation of the economy which requires a lot of other institutional changes within the economy as well.

15.8. MODEL QUESTIONS:

1. Examine the trends in the external value of rupee under the Brettonwoods system
2. Analyse the implementation of fixed and flexible exchange rates in Indian economy
3. Write about the recent developments taken place in the external value of rupee
4. Elucidate the dimensions relating to the convertibility of rupee on current account
5. Examine the need for convertibility on capital account

15.9. REFERENCE BOOKS:

Joseph, Mathew (1992), Exchange Rate Policy: Impact on Exports and BoP, Deep & Deep Publications, New Delhi.

Karmakar, Asim, K. (1994), External Value of the Rupee and India's Balance of Payments-A Macro-economic Assessment, Conference Volume of the IEA.

RBI, RBI Bulletin, various years and Report on Currency and Finance, various years.

Rangarajan, C. (1991), 'Recent Exchange Rate Adjustment', Cases and Consequences, RBI Bulletin, Bombay, September.

Sesadri, R.K. (1993), From Crisis to Convertibility: The External Value of the Rupee, Orient Longman, Calcutta.

Weiss, John (1995), Economic Policy in Developing Countries-The Reforms Agenda, Harvester Wheatsheef, London.

LESSON – 16 : INTERNATIONAL DEBT

16.0 OBJECTIVE:

The prime objective of this lesson is to examine the different dimensions of International debt which is very important phenomena in the International Finance. After going through this lesson you will be able to know about:

* The Nature of International Debt
* The Magnitude of External Debt
* The Factors behind the International Debt Crisis
* Management of External Debt

STRUCTURE

16.1 INTRODUCTION:

External borrowing does help achieve faster rate of growth through bridging the investment-saving gap or import-export gap, but it is not an unmixed blessing. If the terms are hard, the burden of servicing will be larger, and if the borrowed funds are not utilized effectively,

enough savings will not be generated to a level to repay the debt. Indebtedness will then attain unmanageable proportions that may adversely affect the process of growth.

A few countries have quickened the pace of economic development with the help of foreign borrowings and there are a number of others where growing indebtedness has posed a serious problem. The management of external indebtedness, especially since the early 1980s when it had turned alarming, has achieved international dimensions and has become an integral part of international finance.

16.2. NATURE OF EXTERNAL DEBT:

16.2.1 The Changing Nature of External Debt

The nature of external debt has been changing over the decades. Till the first half of the 20^{th} century, loans flowed mainly from private sources. They carried long maturity and were directed mainly to high-income and resource-rich countries. In some cases, the empire met a part of the budgetary deficit of the colonies, though it was not a common phenomenon. The problem of external debt appeared in two types of countries: those where cyclical fluctuation hit the economy pushing down the exports and made repayment of loans difficult, and those cases where domestic revenues were stagnant and fiscal deficit was expanding. Defaults were settled normally through negotiation.

During the 1950s and 1960s, the majority of loans originated from multilateral sources, such as the World Bank, IFC, etc. but at the same time, the role of bilateral loans was no less important. Since the terms of the loans were comparatively soft, the debt problem was never serious. During the 1970s especially after the oil price hike, the liquidity position of the international banks improved significantly with huge deposits of the oil-exporting countries. Consequently, there was a spurt in international bank lending. Bank loans were characterized by high rate of interest and short maturity. As a result, by the 1980s, international indebtedness turned unmanageable. Among the middle-income countries, it was evident mainly in the form of debt owed to international banks. Among the low-income countries, the debt was owed mainly to official sources. As a result of a number of debt-relief measures taken during the 1980s and 1990s the problem eased to some extent after the mid-1990s but the nature and structure of debt remained almost the same.

16.2.2 Debt Structure and Debt Indicators

External debt is a combination of long-term debt, short-term debt and the IMF credits. Long-term debt forms the main component of total debt. It is either a public and publicly guaranteed debt or a private non-guaranteed debt. Issue of bonds and borrowings from commercial banks create private non-guaranteed debt, while official debt is concerned with the multilateral and bilateral loans (World Bank, 1999).

A particular amount of debt may be burdensome for one set of countries, but the same amount may not be burdensome for another set of countries. In fact, debt burden is a relative concept. It is assessed in relation to the country's national income; export earnings or its foreign exchange reserves because if a country has large export earnings or a large national income, it

would be easy for it to service its debt. On the contrary, even a small debt may prove burdensome if the country's foreign exchange earnings are poor. Thus, whenever an external debt burden is analysed, a few ratios are taken into account. Some of the more important ratios are:. External debt/export ratio, External debt/GNP ratio, Debt-service ratio and International reserves/external debt ratio

16.3. MAGNITUDE OF EXTERNAL DEBT:

For analyzing indebtedness, countries are grouped as middle-income and low-income countries in view of the fact that the debt problem of these two sets of countries is different. In the case of middle-income countries, the private non-guaranteed debt is important and so the high interest rate has been the prime factor behind growing indebtedness. In the case of low-income countries, on the contrary, loans from official sources are large and the burden of high interest rates does no matter so much.

Even among these two sets of countries, some countries are severely indebted. Among the rest, some are moderately indebted, while the others face only a small debt problem. This distinction is based on the present value of the debt to export ratio and the present value of the debt to GNP ratio. Severely indebted countries are those where PV of debt/export ratio is grater than 220 per cent and PV of debt/GNP ratio is higher than 80 per cent. Moderately indebted countries are those where their two ratios are 132 to 220 per cent, and 48 to 80 per cent respectively. According to a World Bank study during early 1999, 12 countries were grouped as severely indebted middle-income countries (SIMIC), 32 countries were grouped as severely indebted low-income countries (SILIC), 21 countries were classified as moderately indebted middle-income countries (MIMIC) and 14 countries were identified as moderately indebted low-income countries (MILIC) (The World Bank, 1999).

Table 1 shows the external debt burden of different groups of countries. The figures show that in all the different groups of countries, the long-term debt has always formed a major part of the total debt stock. The external indebtedness never mattered till 1970 but it tended to build up during the 1970s and became large by 1980. Between 1970 and 1980 total debt stock in all groups of countries, except the MILIC group, rose to over ten-fold. The rate of increase was lower during 1980-1990 but in absolute terms, the external debt stock increase was the largest during this period. The annual average of increase in absolute terms during 1990 and 1995 was lower than in 1980-1990. It is remarkable that within the following four years, that is, during 1996 through 1999, the absolute amount of debt declined only in two groups of countries, viz., SIMIC and MILIC. All this probably happened because of the positive impact of the debt-relief measures and also owing to economic reform measures in the developing countries that had concentrated more on foreign investment than on external loans.

In the SIMIC group, the EDT/XGS ratio rose from 151 per cent in 1980 to 295 per cent in 1990 and to 423 in 1999. A similar trend was found in case of the EDT/GNP ratio that rose from 33 per cent to 47 per cent during 1980-90 and then declined marginally to 46 per cent by 1999. On the contrary, the TDS/XGS ratio went up during the 1990s and international reserves constituted about one-fifth to one-seventh of the total stock of debt during different periods, except in 1990.

TABLE 1. Debt Burden among Developing Countries

	1970	1980	1990	1995	1999
Severely indebted middle-income countries					
Total debt stock (US $ billion)	22	235	514	638	535
Out of which: long-term debt (US $ billion)	22	182	411	499	428
EDT/XGS %	-	151	295	288	423
EDT/GNP %	-	33	47	39	46
TDS/XGS %	-	28	27	31	81
Res./EDT %	-	19	9	17	14
Severely indebted low-income countries		60	201	266	357
Total debt stock (US $ billion)	6	47	171	187	290
Out of which: long-term debt (US $ billion)	6	106	457	488	310
EDT/XGS %	-	31	141	128	108
EDT/GNP %	-	11	23	21	24
TDS/EXGS %	-		4	3	12
Res./EDT %	-				
		150	387	538	727
Moderately indebted middle-income countries	14	104	308	425	596
Total debt stock (US $ billion)	14	90	162	176	138
Out of which: long-term debt (US $ billion)	-	37	33	45	55
EDT/XGS %	-	14	24	23	18
EDT/GNP %	-	31	14	20	25
TDS/EXGS %	-				
Res./EDT %		59	164	204	89
	13	49	141	183	78
Moderately indebted low-income countries	13	170	286	242	203
Total debt stock (US $ billion)	-	24	38	42	65
Out of which: long-term debt (US $ billion)	-	12	26	24	13
EDT/XGS %	-	30	8	24	14
EDT/GNP %	-				
TDS/EXGS %		647	1510	2068	2528
Res./EDT %	61	473	1206	1622	2061
	61	88	162	150	114
All Developing countries	-	27	33	38	37
Total debt stock (US $ billion)	-	13	18	16	17
Out of which: long-term debt (US $ billion)	-	36	17	24	31
EDT/XGS %	-				
EDT/GNP %					
TDS/EXGS %					
Res./EDT %					

EDT=Total debt stock, XGS = export of goods and services, GNP = gross national product, TDS = Total debt service, Res. = International reserves held.

Source: The World Bank, Global Development Finance, Washington D.C., various issues.

In the SILIC group, the EDT/XGS and EDT/GNP ratios were still higher and the TDS/XGS ratio was lower than in case of the SIMIC group because the export performance of the former was poor and moreover, their GNP was naturally lower than that of the latter. It is because the low-income countries had borrowed mainly from the official sources where the rate of interest was lower. These countries did not have large international reserves compared to the SIMICs and so the reserves/EDT ratio was lower. In MIMICs, the burden of debt was definitely lower than in case of SIMICs. And similarly, in MILICs, the burden of debt was lower than in SILICs, but EDT/XGS and TDS/XGS ratios were higher in the case of MILICs than in MIMICs because of their lower export performance. The MILICs possessed lower foreign exchange reserves and so this ratio too was lower in their case than in the case of MIMICs.

When one looks at the developing countries in general, the picture is not very different. However, in the case of the HIPCs, for which data for 1997 are available, the picture is somewhat different. The absolute amount of debt was lower at US $ 205.7 billion, but the EDT/XGS ratio was the highest in view of their poor export performance. The TDS/XGS ratio was not very high as they has received largely confessional loans (The World Bank, 1999).

16.4. FACTORS BEHIND THE DEBT CRISIS:

It would be interesting to refer to the factors responsible for the international debt crisis of early 1980s. These factors can be grouped broadly under two heads, namely the changes in the international economic environment and the defective policies pursued by the borrowing countries themselves.

16.4.1 Changes in the International Economic Environment

The most significant change in the international economic environment was the first oil shock of 1973-74. The balance of payments position of the non-oil-producing donor countries worsened. Their ability to lend as well as to replenish the IDA's resource pool was badly affected and weakened the flow of multilateral and bilateral resources. The ODA was the worst victim. The flow of ODA as percentage of total official lending dropped from 67 per cent in 1970 to 60 per cent by 1980. This means that the share of non-confessional official loans got larger and resulted in greater interest burden on the developing borrowers. The aftermath of the oil shock was evident not only in the risen official non-confessional loans but also in the rapidly expanding international bank loans.

Over-lending was followed by an abrupt cutback of lending. The debt problem would not have been serious had there been regular flow of loans and the borrowing countries could have got new loans to repay the older ones. But unfortunately, this did not happen and some of the oil-exporting countries turned net borrowers by 1982.

Apart from the activities of the international banks, it was the transition from inflation to disinflation that aggravated the problem of indebtedness. Funds were borrowed in the 1970s when inflation was high and real interest rate was low or, in some cases, negative, but during the 1980sk when the industrialized countries adopted restrictive monetary policies, disinflation began to appear.

16.4.2 Emerging recession

The 1980s decade dawned with emerging recession among many of the industrialized countries. In the face of recession, the developing countries were struggling hard to augment their export. Simonsen (1985) explains that during 1974-80, the floating rate of interest on loans to net oil-importing developing countries had averaged 10.7 per cent, but the debt problem was not serious because exports of these countries had expanded at 21.1 per cent. During 1981-82, however, the growth rate of export plummeted to 1.0 per cent against the upsurge in interest to 16.3 per cent and the debt burden turned serious as a consequence.

The deteriorating terms of trade of the net oil importing developing countries during 1980-82 caused the debt crisis. In the first half of the 1970s there was a commodity boom. The prices of many primary commodities in real terms rose that in turn lowered the cost of borrowing. The lower cost of borrowing motivated the developing countries to jack up expenditure and to borrow more but when the export prices fell during the 1980s, the borrowing countries suffered severely and found it difficult to repay external loans (Cline, 1984).

The borrowed funds can be utilized in two ways: they can be spent and that cannot help the borrowing country to repay its debt, or they can be invested which leads to generation of income and saving and builds up the ability to repay the debt. However, as Dornbusch and Fischer (1986)k point out, many Latin American countries adopted a defective policy and financed primarily consumption and government deficit rather than investment. Kharas and Levinsohn (1988) find that in case of 12 out of 26 countries, the level of consumption rose with an increase in borrowings in which case, external debt problem was bound to emerge. Even if the foreign borrowings were used for investment, profitability of investment was always doubtful. Diaz-Alejandro (1984) argues that many of the Latin American countries suffered from a deterioration in investment productivity after 1973 which was an important factor behind the debt problem.

Some of the significant factors behind the external debt problem during the early and mid-1980s, continued into the 1990s. There were some additional factors operating during this period. The first, was the break-up of the erstwhile USSR. The economy of most of the countries coming out of the USSR bondage was so weak that their trade with the rest of the developing world came to be at the lowest ebb.

16.5. MANAGEMENT OF EXTERNAL DEBT:

Debts are owed either to official lenders or to private lenders, mainly international banks. The tools of management of these two forms of debts are alike to a great extent, but as they differ as to details, let us discuss the techniques and plans of management separately.

16.5.1 Management of Official Debt

The problem of debt was foreseen long ago and, with this in view, the Paris Club was set up in 1956. It took concrete shape in 1961 and since then, various types of negotiations have been taking place for implementing debt relief measures. Broadly speaking, relief measures under the aegis of the Paris Club comprise cancellation, refinancing and rescheduling of debts.

In December 1991 the Toronto Terms were revised and renamed Enhanced Toronto Terms. They were intended for the same group of countries but the role of cancellation of debt was enhanced: one-half of the debt was to be written off and the other half was to be rescheduled to a 23-year maturity including a 6-year grace period and at market-related rates. Between December 1991 and December 1993, this benefit was availed by 16 countries. On the whole, between 1981 and 1993, on an average, 18 countries availed of debt relief under the aegis of the Paris Club every year . The Houston Terms were adopted almost simultaneously with the Toronto Terms, in September 1990. Their approach was almost similar to the menu approach where ODA debts and non-ODA debts were treated differently. Under the London Terms that were prevalent between December 1991 and December 1994 the net present value (NPV) of debt was to be reduced by 50 per cent. The Naples Terms that became effective from January 1995 went in for a drastic cut in the size of debt. They were meant for 67 per cent NPV reduction on eligible non-confessional debt (50% in case of Cameroon, Guinea and Honduras). The debt-relief measures under the Lyon Terms that were initiated in January 1996 were even more beneficial for the borrowers as they stressed on 80 per cent NPV reduction.

One of the latest moves of the Paris Club has been to initiate the Heavily Indebted Poor Countries (HIPC) Initiative in 1996. It is proposed as a comprehensive solution to the unsustainable level of debt owned by the 40 poorest countries in the world. The purpose is to focus resources on countries with a solid track record of performance with the help of the adjustment programmes of the World Bank and the IMF. During the first two years of this scheme, 31 out of 40 countries fulfilled the eligibility criteria for debt-relief assistance and they availed of the facilities under this scheme (World Bank, 1999). According to an IMF study, the effective NPV debt reduction under the HIPC Initiative was 95 per cent by July 1998 (IMF, 1998). Confessional assistance for debt relief is provided by different bilateral sources. The World Bank has a special debt-reduction facility that has benefited many, especially the sub-Saharan countries.

16.5.2 Management of Non-official Debt

As far as non-official debt is concerned, in the early 1980s the international banks adopted a ‘short-leach’ approach when they rescheduled and rolled over debt service due from debtors over a short period ranging from one year to two years. Following this approach, they adopted multiyear rescheduling arrangement that offered consolidation of debt with longer maturity. The IMF and the World Bank guided these moves and at the same time provided finance to the borrowing countries for taking up adjustment measures. Debt reduction measures were thus combined with economic development programmes.

The short-leach approach was found yielding positive results. There was a buoyant recovery in 1984. The growth rate in the industrialized countries averaged 5.0 per cent. At the same time, interest rates, LIBOR ebbed from 19 per cent in 1981 to 11 per cent in 1984. Thus the two factors behind the crisis of early 1980s-recessionary trends and high interest rate-disappeared automatically by the mid-1980s. Some of the key debtors ran current account surpluses. Economic growth in Latin American countries again turned positive to 3.7 per cent in 1984 compared to (-) 1.2 per cent in 1982 and (-) 2.6 per cent in 1983 (Cline, 1989).

The success of debt management of 1983-84 was short-lived. In 1985 the mood began to swing once again in pessimism. Argentina and Brazil moved from military to civilian rule and in this process, the IMF-led adjustment programme was temporarily suspended. Mexio had to face fiscal erosion, rising inflation and weakening oil prices. It needed fresh loans, but the banking community was hesitant to give them. In such cases, a medium-term management of debt was required. Fortunately, the then secretary of the treasury in the US government, James Baker drafted a medium-term plan in 1985 that was implemented subsequently.

The Baker Plan called for banks to provide new lending of US $ 20 billion over a three-year period between 1986 and 1988 to 15 (later on to 17) highly indebted countries. The amount was to cover 2.5 per cent of them existing exposure every year. The target was conceived on a net disbursement basis, that is over and above the repayment of principal but not the interest payment.

Baker himself was not happy with the outcome of his plan and so in 1987, he introduced an improved version of the plan, known as the market-based menu approach. The improved plan adopted a case-by-case approach and tuned each financial package to the specific needs of each debtor country and to the specific constraints of the banks. It stressed upon the need for axing the net outflow of funds from the debtor countries to US $ 15.0 billion annually during 1989-1991from a level of US $ 28.6 billion annually during the Baker plan period.

The plan sought to introduce instruments that could make the banks' increasing exposure more attractive. Debt conversion programmes, relenting rights, new money bonds, etc. were some of the new features. Capitalization of interest was allowed, although Baker admitted that it was not a permanent solution. Its debt conversion plan included primarily debt-equity swap, debt-for-development swap and buy-backs. In debt-equity swap, the banks buy debt at a discount, the central bank of the debtor country redeems the debt to the new creditor in local currency and the local currency is invested in the equity.

The Brady plan, named after Nicholas Brady, the US Secretary of the Treasury, stressed voluntary debt reduction through increasing the role of official lenders and through forgiveness. Brady-type deals involved the exchange of loans for agreed financial instruments followed by the deposit of collateral and the necessary payment in cash. The US treasury zero-coupon bonds normally provided principal collateral. Short-term Us treasury bills were used for interest collateral.

Some of the countries were prompt in repayment of principal but defaulted on interest payment, while some others paid the interest and defaulted on principal repayment. A huge balance of arrears of interest was converted into post-due interest bonds that involved comparatively short maturity and grace period. Normally, such bonds yielded market rate of interest, LIBOR plus a few percentage points.

16.6. SUMMARY:

External borrowing helps bridge the savings gap and the foreign exchange gap and thereby permits warranted rate of investment and growth. There is no serious problem of debt if

the terms of loans are soft and sufficient income, saving and export surpluses are generated for making the process of development self-reliant. Till the 1970s there was no debt problem. It tended to build up during the 1970s and turned unmanageable by the 1980s. The debt problem of middle-income countries has been different from that of the low-income countries. In the former, commercial debt is significant, while the latter face problems primarily the official debt. However, since 1995 the external debt problem among developing countries has tended to soften on account of proper debt management. The different ratios indicating indebtedness too have been improving.

The factors behind the debt crisis include changes in international economic environment on the one hand, and the defective economic policies pursued by the borrowing governments, on the other. The oil shock of the 1970s, abrupt cut-back of lending by the international banks in 1980s, transition from inflation to disinflation, and recession and deteriorating terms of trade of the primary goods-exporting borrowers were some features of the international economic environment that aggravated the debt problem. Some of these factors were present in 1990s but there were additional factors during this period, such as the break-up of the erstwhile USSR, the Gulf war and the financial crisis in East Asia. These factors delayed any improvement in the debt crisis.

As far as management of debt is concerned, the Paris club negotiations under different terms have a significant role in cancellation and refinancing of debt and rescheduling of repayment so as to lower the burden of external debt among developing countries, mainly the low-income countries. For commercial debt, the short-leash approach of early 1980s, the Baker plan in its earlier version and in the revised one known as the market-based menu approach, and the Brady initiative are of special significance. Though they were not entirely successful, they certainly ameliorated the situation.

16.7. MODEL QUESTIONS:

1. What were the factors behind the international debt crisis of 1980s ?
2. Explain Baker Plan for alleviating international debt problem.
3. How far was market-based approach different from the original Baker plan ?
4. Explain Brady Initiative.
5. What have been the measures adopted for reducing official debt ?

16.8. REFERENCE BOOKS:

1.The World Bank (1985), World Development Report, Washington, D.C.
2. Cuddington, John T. (1987), Capital Flight: Estimates, issues and expectations, Princeton University Studies in International Finance, No.58.
3. (1989), The Baker Plan and Brady Reformulation: An evaluation, in Ishrat Hussain and Ishac Diwan (Eds.), Dealing with the Debt Crisis, Washington, D.C., The World Bank, 176-196.
4. Humphreys, C. and J.Underwood (1989), External Debt Difficulties of Low-income Africa, in Hussain and Diwan, op.cit., 45-63.
5.(1996), World Debt Tables, Washington, D.C.
6. (1999), Global Development Finance, Washington, D.C.