

# **MAR GREGORIOS COLLEGE OF ARTS & SCIENCE**

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Affiliated to the University of Madras  
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## **DEPARTMENT OF COMMERCE**

**SUBJECT NAME: INTERNATIONAL TRADE**

**SUBJECT CODE: DSA01**

**SEMESTER: I**

**PREPARED BY: PROF.S.ARUNA**

**Course Objectives:**

1. To acquire specialised knowledge in international trade
2. To learn about WTO and how globalisation of Economy takes place.

**UNIT I**

Theories of International Trade – Ricardo – Haberlers Opportunity cost -Heckscher Ohlin theorem.

**UNIT II**

Trade policy – case for protection – Regional integration – European Union – EEC-UNCTAD –GATT – Asian – Development Bank.

**UNIT III**

WTO – Functions of WTO – An Overview.

**UNIT IV**

Balance of payments – Disequilibrium – Remedies – Exchange control – Purchasing Power parity Theory.

**UNIT V**

International monetary system – IMF – SDR – International liquidity – IBRD.

**SUGGESTED READINGS**

1. K.R.Gupta – International Economics, Atlantic Publisher Distributors Pvt Ltd.
2. P. Saravanan –International Marketing
3. S.Sankaran – Money, Banking and International Trade, Margham Publication, Chennai.
4. Francis Cherunilam – International Trade and Export Management, Himalaya Publishing House.

## UNIT I

Theories of International Trade – Ricardo – Heckscher Ohlin theorem

After reading this Unit, you will be able to: understand the different theories of free trade; appreciate the advantages of or gains from international trade; identify the limitations of theories of free trade; and situate the theories explained in the present context of globalization and trade liberalization

## INTRODUCTION

A sound understanding of trade theories has assumed greater importance in the realms of trade policy-making in the context of recent 'trends and debates on globalization and trade liberalization. Given this imperative an attempt has been made to first, present different theories of the classical vintage in a simple manner. The theories are posited in such a way that they highlight how different determinants were emphasized upon by different trade theorists in order to emphasize the potential gains from international trade. Some of the major limitations of these theories are also important to understand and it is undertaken with a view to compare and contrast different strands of thoughts.

Initially, an explanation is rendered to the pure theory of international trade as propounded by Adam Smith through the theories of absolute advantage. This is contrasted with the advancements made by Ricardian comparative costs concepts, the Heckscher-Ohlin Theorem and its Extensions in the forms of Stolper-Samuelson theorem, Rybczynski theorem and factor-price equalization theorems are presented. Finally, a brief discussion on the empirical testing of comparative cost and the Heckscher-Ohlin Theorems is also given.

## THEORIES OF ABSOLUTE ADVANTAGE

Based on the considerations of absolute advantage, Adam Smith argued as to how countries can gain through international trade. This forms the basis for the pure theory of international trade. The theory of absolute advantage can be explained through a simple example. Suppose two goods A and B can be produced by labour alone. It takes 100 units of labour to manufacture one unit of good A in country X but 200 labour units in country Y. Conversely, it takes 200 units of labour to manufacture one unit of good B in country X but only 100 labour units in country Y: In other words, country X is more efficient in producing good A, because it uses less labour per unit of output than country Y: By the same logic, country Y is more efficient in producing good B. Then country X is said to have the absolute advantage in producing good A, while country Y has an absolute advantage in producing good B. Now country Y may gain by producing one unit of B, using 100 labour units, and exporting it to country X in exchange for one unit of A. In effect, country Y has used 100 labour units to obtain one unit of A indirectly, rather than using the same labour to produce 0.5 unit of A directly.

Correspondingly, country X must have used 100 units of labour to produce the unit of A for export, in exchange for which it received one unit of B. But if it had tried to produce one unit of B itself, it would have required 200 units of labour. Thus, it may be concluded that by

trading, both countries could have gained by having more of both goods. The above example clearly demonstrates that two countries can gain through international trade if they have absolute advantage in producing different goods. However, gains from international exchange of goods need not be limited to the

Situations of absolute advantage. It was later shown by Ricardo as to how the benefits from trade can be reaped also in situations of comparative advantage, which came to be known as the theory of comparative advantage

#### RICARDIAN COMPARATIVE ADVANTAGE AND OPPORTUNITY COST

It is important to highlight that the obviousness of gains from trade within the framework of absolute advantage of Adam Smith was never questioned by David Ricardo. However, the contribution of Ricardo was to show how two countries can derive gains from trade even if one country has absolute advantage as compared to another country in the production of all goods. The question then arises whether in a situation in which country X producing all goods with less labour cost than country Y would lead to gains from trade accruing to both the countries X and Y? To understand this, we may refer to the model, which was used by Ricardo to 'propound the theory of comparative advantage.

Illustratively, England and Portugal were chosen as examples by Ricardo. Both the countries produced two goods viz. wine and cloth. Portugal was assumed to be using lesser units of labour in producing not only cloth but also wine. The first two columns of Table 1.1 show what the cost conditions in the two countries were. It is clear that, Portugal has absolute advantage in the production of both wine and cloth because the number of hours of labour required for the production for each unit of the two goods is lesser in Portugal than in England. The obvious question arises whether the two countries would gain from trade? In fact, both England and Portugal would gain from trade if the concepts of opportunity costs manifested in comparative advantages are understood at this stage. The opportunity cost of a good A is defined as the amount of another good, i.e. B, that has to be given up in order to produce an additional unit of A. As demonstrated in Table 1.1 the opportunity costs of producing wine and cloth in England and Portugal are lower than each other in such a way that England should produce and export cloth to Portugal and the latter should produce and export wine to the former.

**Table 1.1: Labour Cost and Opportunity Cost Comparisons**

Country	Labour cost of production (in hours)		Opportunity cost of production	
	1 unit of cloth	1 unit of wine	1 unit of cloth	1 unit of wine
England	100	120	$100/120 = 0.83$	$120/100 = 1.2$
Portugal	90	80	$90/80 = 1.12$	$80/90 = 0.89$

Let us explain it further. Portugal has the lower opportunity cost of the two countries in producing wine (0.89 as compared to England's 1.2), while England has the lower opportunity cost in producing cloth (0.83 as compared to Portugal 1.12). Therefore, Portugal has a comparative advantage in the production of wine and England has a comparative advantage in the production of cloth and both the countries should export to the other country the good in which it has a comparative advantage.

This brings us to the definition of comparative advantage. A country has a comparative advantage in producing a good if the opportunity cost of producing that good is lower at home than in the other country.

It needs to be highlighted that the difference in opportunity costs between two countries in the production of the same good or the presence of comparative advantage in one country vis-a-vis another arises due to technological differences.

## HECKSCHER-OHLIN THEOREM AND ITS EXTENSIONS.

The theory of comparative advantage in the Ricardian work was explained in terms of a one-factor model, where the only factor was labour. The comparative advantage was determined by technological differences. The Ricardian work of comparative advantage was further improved upon in the Heckscher-Ohlin (H-O) model. The H-O model was first conceived by two Swedish economists, Eli Heckscher and Bertil Ohlin. Rudimentary concepts were further developed and added later by Paul Samuelson and Ronald Jones among others. Hence the extension of H-O model is referred as Heckscher-Ohlin-Samuelson (H-O-S) model. In this model, trade between different countries is caused due to differences in relative factor endowments of those countries. It is a theory of long-term general equilibrium in which the two factors are mobile between sectors. Thus the H-O framework sheds new light on the determinants of trade in terms of 'factor proportions'.

Furthermore, it provides insights into the effects of trade on factor use and factor rewards. In its extension, the Heckscher-Ohlin-Samuelson (H-O-S) model demonstrates how the free movement of goods between countries may bring about the factor-price equalization.

There are four main theorems in the H-O-S model (hereafter called the H-O model for convenience):

(I) the Heckscher-Ohlin theorem, (ii) the Stolper-Samuelson theorem, (iii) the Factor-Price Equalization theorem, and (IV) the Rybczynski theorem. These are explained below.

**Theorem** According to the H-O Theorem, the determinants of trade are explained in terms of factor endowments of countries and factor intensities of goods. A country specializes in and exports that good, which intensively uses its most abundant factor. For example, if a country like India is abundant in labour then India would mainly

specialize in labor-intensive goods that would form a large share of its export basket. In the same vein, India would import capital-intensive goods from countries that are capital-abundant. It is the ratio (or proportion) of one factor to another that gives the model its generic name:

The factor-proportions model. In the H-O model the ratio of the quantity of capital to the quantity of labour used in a production process is the capital-labour ratio. Therefore it is assumed that different industries producing different goods have different capital-labour ratios. In a model in which each country produces two goods, an assumption must be made as to which industry has the larger capital-labour ratio. Thus, if the two goods that a country can produce are electronics and textiles, and if electronics production uses more capital per unit of labour than is used in textiles production, we can say that the electronics production is capital-intensive relative to textiles production. Also, if electronics production is capital-intensive, it implies that textiles production must be labor-intensive relative to electronics.

Countries have different quantities or endowments of factors capital and labour, available for use in the production process. Thus, some countries like the US are well-endowed with physical capital relative to its labour force. In contrast, many less developed countries have very little physical capital but are well-endowed with large labour forces. The ratio of the aggregate endowment of capital to the aggregate endowment of labour is used to define relative factor abundance between countries. Thus if, for example, the US has a larger ratio of aggregate capital per unit of labour than India's ratio, we would say that the US is capital-abundant relative to India. By implication, India would have a larger ratio of aggregate labour per unit of capital and thus India would be labour-abundant relative to the US.



According to the H-O model, trade takes place in a gainful manner with important effects upon prices, wages and rents (factor prices), when countries differ in their relative factor endowments and when different industries use factors in different proportions. This is explained by Figure 1.1.

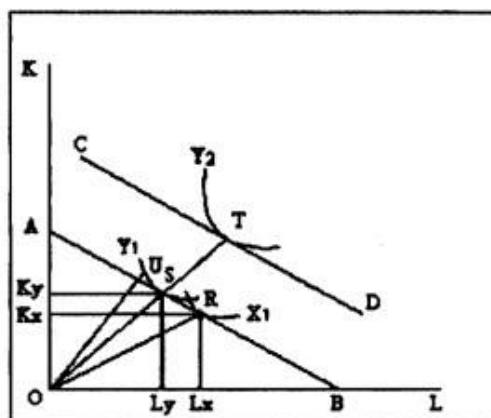


Figure 1.1: Equilibrium in production under free competition

If two goods,  $X$  and  $Y$ , are produced with different production functions, a possible equilibrium situation is as shown in Figure 1.1. At points  $R$  and  $S$  the factors of production are allocated so that the quantities specified by the isoquants ( $X_1$  of  $X$  and  $Y_1$  of  $Y$ ) are being produced at the lowest possible cost given the factor prices. In other words, at  $R$  and  $S$  the two isoquants are tangential to the lowest possible isocost line, which has a slope equal to the factor price ratio, the line  $AB$ . It follows that the ratio of the marginal product of labour to the marginal product of capital is the same for the two products, and that both are equal to the ratio of the wage rate to the return to capital (the negative of the slope of the line  $AB$ ).

Another possible equilibrium is shown by points  $R$  and  $T$ , where again the slope of the  $X$  isoquant at  $R$  is equal to the slope of the  $Y$  isoquant at  $T$  and both are equal to the given factor ratio.

An alternative way of deriving this important result is to draw upon another

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standard result from microeconomics, that a producer facing given factor and Theory producer prices will maximize his profits by purchasing factors to the point where the value of the marginal product of each factor (the marginal product times the price of the good) is equal to the price of the factor.

Algebraically, using  $MPL$  and  $MPK$  to show the marginal products of labour and capital respectively,  $P$  for prices,  $w$  as the wage rate, and  $r$  as the return to capital, we have  $MPL \cdot P = w$  and  $MPK \cdot P = r$  from which it is easy to show that in order to maximize profits the producer must combine capital and labour so that  $MPL \cdot P = w$  and  $MPK \cdot P = r$ . If the producer were producing good  $Y$  at a point such as  $R$  rather than point  $S$  then he would not be maximizing profits. At  $U$  the marginal product of capital in producing  $Y$  is lower than it is at point  $S$ , and so the value of the marginal product of capital in producing  $Y$  at point  $U$  (the marginal product times the price of  $Y$ ) is lower than the cost of the unit of capital. Similarly, the value of the marginal product of labour at point  $U$  is higher than the cost of the labour. Profits would be increased by employing more labour and less capital, the capital-labour ratio would decrease, and we would move to a point such as  $S$  or  $T$ . If for some reason factor prices were to change, factor intensities would also change. Let us assume that the price of labour compared with the price of capital increases. Then more capital-intensive methods of production will be used in both lines of production, as shown in Figure 1.2. Before the price change  $OA$  of capital cost the same to purchase as  $OB$  of labour, but after the change  $OA'$  of capital costs the same as  $OB'$  of labour, and  $OA''$  of capital costs the same as  $OB''$  of labour. In two budget lines Fig-

12: Factor prices, factor intensities and production costs A'B' and A'' B'' are parallel, and steeper than the original budget line AB. As labour is now more expensive and capital is cheaper than before, so that methods of production become more capital-intensive for both goods. If the desired production of X is still X, then the capital and labour combination will be at point R : and the higher capital labour ratio in X is shown by the slope of line OR ' being steeper than that of line OR. Similarly, quantity Y, of good Y will now be produced at point S: and the slope of the line OS', and the slope of the line Os' is steeper than that of line Os. Let us explore the logic of the H-O theorem. It may be recalled that the H-O theorem predicts the pattern of trade between countries based on the characteristics of the countries. The H-O theorem says that a capital-abundant

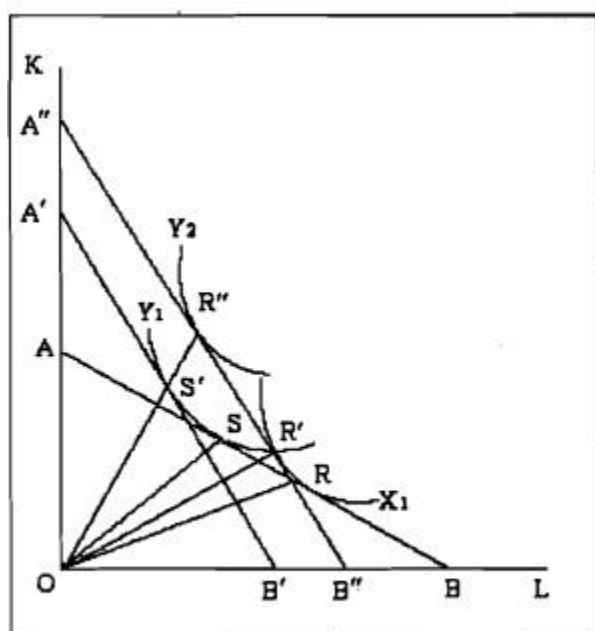


Figure 1.2: Factor prices, factor intensities and production costs

Country will export the capital-intensive good while the labour-abundant free %de Theory country will export the labor-intensive good. A capital-abundant country is the one that is well-endowed with capital relative to the other country. This gives the country a propensity for producing the good which uses relatively more capital in the production process, i.e., the capital-intensive good. As a result, if these two countries were not trading initially, i.e., they were in autarky, the price of the capital- intensive good in the capital-abundant country would go down (due to its extra supply) relative to the price of the good in the other country. Similarly, in the labour-abundant country the price of the labor- intensive good would be going down relative to the price of that good in the capital-abundant country. By the same token, labor-intensive goods would be costly in the capital-abundant country and capital-intensive goods would be available at a high price in the labour abundant country. Once trade is allowed, profit-seeking firms will move their products to the markets that temporarily have the higher price. Thus the capital-abundant country will export the capital-intensive good since the price will be temporarily higher in the other country. Likewise the labour-abundant country will export the labor- intensive good. The trade flows will rise until the price of both goods are equalized in the two markets.



Difference in assumptions as compared to the Ricardian

The H-O model incorporates a number of realistic characteristics of production that are left out of the simple Ricardian model. Recall that in the simple Ricardian model only one factor of production, labour, is needed to produce goods and services. The productivity of labour is assumed to vary across countries, which implies a difference in technology between nations. It is the difference in technology that motivated advantageous international trade in the model. It is worth-highlighting that a major distinction between the H-O model and the Ricardian model is in terms of technology- assumption. The production technologies differ between countries in the Ricardian framework whereas the H-O model assumes that production technologies are the same. The reason for the identical technology assumption in the H-O model is perhaps not so much because it is believed that technologies are really the same (although a case can be made for that), instead the assumption is useful because it enables us to visualize precisely how differences in resource endowments are sufficient to cause trade and its concomitant impacts.

## UNIT II

Trade policy – case for protection – Regional integration – European Union – EEC- UNCTAD – GATT – Asian – Development Bank.

. From the concept of absolute advantage to comparative advantage and thereafter the concepts of factor endowments and factor intensities helped us to understand the gains from trade and the determinants of trade. But the real world international trade patterns and features posed analytical challenges in as much as the traditional theories were unable to explain a large part of global trade. The alternative explanations came forth in a quest to identify the determining factors of trade that were better approximations of reality. Such theoretical departures also influenced the policy-practice at both the national and global levels. When free trade theories could not hold the test of time due to assumptions like perfect competition, arguments in favor of protection were advanced. It had a developmental angle but on occasions it also justified unfair trading practices. Countries practiced the policy of import-substitution and import protection especially in the developing world. But later it was observed that while this had a beneficial effect on building a manufacturing and economic base in these countries, it also generated undue economic rents and made them 'high-cost poor quality' economies. As a response to correct these anomalies and some success of East Asian economies, an open trade or a freer trade policy was advocated.

International Trade: Classical economic analysis shows that free trade increases the global level of Theory output because free trade permits specialization among countries. Specialization allows nations to devote their scarce resources to the production of the particular goods and services for which that nation has a comparative advantage. The benefits of specialization, coupled with economies of scale, increase the global production possibility frontier. An increase in the global production possibility frontier indicates that the absolute quantity of goods and services produced is highest under free trade. Not only are the absolute quantity of goods and services higher, but the particular combination of goods and services actually produced will yield the highest possible utility to global consumers. Free trade policies are often associated with general laissez-faire economic policies, which permit faster growth. Laissez-faire policies-the absence of government intervention in trade,

entrepreneurship and investment-is often positively correlated with high per capita' income. Voluntary exchange, by virtue of its voluntary nature, is beneficial to the parties involved. Thus, the restriction on voluntary exchange, restricts commerce and ultimately the accumulation of wealth.

Thus, countries switched over to the of export-promotion and import liberalisation from policies of import substitution. Such a move also made the arguments for having a freer trade renew at the multilateral level as well. While the multilateral negotiations of to Uruguay Round to establish WTO was in progress, in parallel the predilections of the new trade theory and the strategic trade theory in favors of infant industry protection or protection to strategic industries through government's role was also gaining momentum. Trade distortionary policies were advocated in response to imperfect markets and existence of restrictive business practices, the unfair trade practices. The present era is nothing but a reflection of coexistence of both theory and practice of free trade doctrine on one hand and government's support to sectors on the other. Both trade liberalization and protection find their ways in the policy-domains all over the world

### THE CASE FOR FREE TRADE

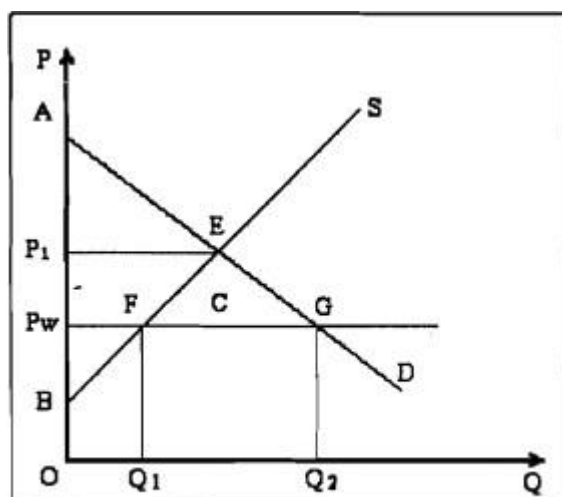
A situation of free trade is one where countries engage international trade without imposing any policy restrictions that interfere with the free flow of goods and services across international boundaries.

Assuming that countries specialize in the production of goods and services in which they have a comparative advantage, each country will export the good(s) which it produces relatively efficiently and imports goods in which it has a comparative disadvantage. In the absence of policy restrictions on the international exchange of goods and services, prices of goods in the. Domestic economy tend to be the same as those prevailing in the rest of the world.

With free trade domestic firms are exposed to competition from international firms. If a domestic firm charges a price which is higher than the Trade and Welfare price prevailing in the world market, then domestic consumers would prefer to import this good instead of buying it from the domestic firm. Thus with free trade firms are subject to the discipline of international competition and domestic consumers tend to benefit most in this situation.

**Benefits of Free Trade** In what follows, we use standard cost-benefit apparatus that analyses welfare gains and losses to various economic agents like households (consumers) and firms (producers) to compare alternatives situations like free trade and autarky.

**When Domestic Industry is Perfectly Competitive** We will use a simple diagram (Figure 3.1: Benefits of Free Trade) to illustrate the benefits that accrue to a country engaging in free trade. The main assumptions underlying the diagrammatic analysis are (a) perfect competition in the domestic industry; (b) the industry being considered is a small part of the country's economy (so we can use partial equilibrium analysis); and (c) the country is a small player in the international market for the product, which means that it can import any amount at the world price  $P_w$  (it is a price-taker in the world mar



Source : Figure 6.1 in Sildar (2003), p.121.

**Figure 3.1: Benefits of Free Trade**

The downward sloping line AD represents the demand curve for the product of industry X, while the upward sloping line BS represents the domestic supply curve of the industry. In the absence of trade, domestic price of the product of industry X is  $P_1$ . In this case total social welfare  $W$  is equal to the area of triangle AEB. You should note that  $W = \text{Consumers' Surplus (Area of triangle AP, E)} + \text{Producers' Surplus (Area of triangle BP, E)}$ . Let world price of good X,  $P_w$  be below  $P_1$ . This means the domestic consumers will be better off importing the good. With free trade, good X will be imported and the price of good X in the domestic market will be forced down to  $P_w$ . Obviously, domestic firms cannot charge a price higher than  $P_w$ , as nobody would buy the good at a higher price if cheaper imports are freely accessible. With trade, total domestic demand at price  $P_w$  is  $Q_2$ , which is met in part by domestic supply (of amount  $OQ_1$ ) and partly by imports (amounting to  $Q_2 - Q_1$ ). You should note there is a net gain in social welfare in the post-trade situation, amounting to the area C. Consumer surplus has increased from  $AP_1E$  to  $AP_wG$  while producers' surplus has fallen from  $BP_1E$  to  $BP_wF$ , giving a net gain in welfare of area C. In principle, the losers (the producers) can be compensated by the gainers (the consumers). From the diagram it should be clear to you that the extent of gain in social welfare is positively related to the gap between  $P_1$  and  $P_w$ . Using Figure 3.1 above we have just carried out a partial equilibrium analysis of free trade for an industry. Here we have not considered the second effects of trade on the economy. In particular we have not taken into account the effects of trade on factor markets, on the terms of trade, or on the Balance of Payments and exchange rates. However, if the industry being analyzed has considerable weight in the national economy these secondary effects can be quite important.

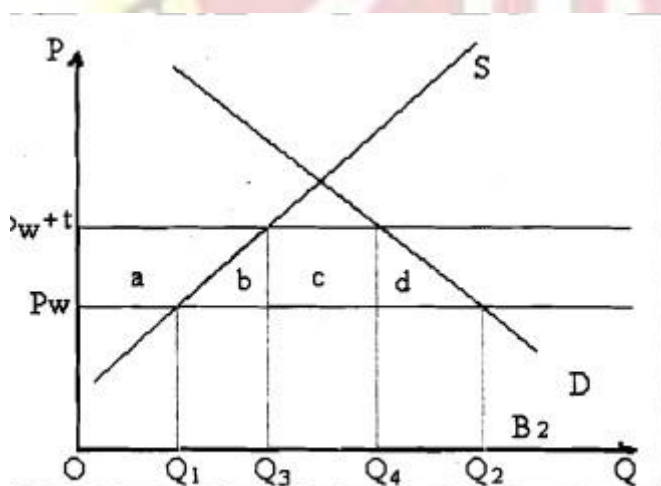
Economists have always acknowledged the benefits of international trade. Gains from trade arise due to specialization in production along lines of comparative advantage, leading to efficient allocation of scarce resources within nations. Gains also arise from exchange between countries, with each country exporting the goods, which it produces relatively most efficiently and importing goods at a cost lower than that of domestic production. Therefore, trade can potentially be welfare improving for the world as a whole. Yet, in practice, trade barriers restricting the cross-border flow of goods and services, are erected by virtually every trading nation in the world. What justifies the use of protectionist measures, given the many

benefits of International Trade: Policy free trade? What are the various ways in which countries practice trade protection?

### THE INSTRUMENTS OF TRADE PROTECTION

Using Figure '4.1, we will can out a simple cost-benefit analysis of the impact of a tariff on various economic agents like consumers, producers and the government in a partial equilibrium framework. We assume that the country is a small open economy that cannot: Figure 6 3 in affect world market Figure 4.1 Before addressing the question of why countries use protectionist measures, what are the tools or instruments of trade protection? The tools of trade protection that countries typically use to restrict imports can be broadly classified into price related measures such as tariffs and non-price measures or non-tariff barriers (NTBs). A tariff is a tax levied on imports. Tariffs may be applied to imports of both final and intermediate goods. This aspect is taken into account while assessing the extent of protection extended to domestic industry by the tariff. We will learn about a concept called the 'effective rate of protection', which is used to measure the extent of actual protection granted to value added in a particular industry by the entire tariff structure (covering final and intermediate goods). Non-tariff barriers (NTBs) are applied to quantities and other attributes of traded goods and services. We discuss each of these instruments of trade protection, in turn.

A tariff or import duty essentially alters the relative prices of traded goods Vis a Vis non-traded goods in the domestic market. Tariffs may be specific or ad valorem. Specific tariffs are levied as a fixed amount per unit of the good (e.g., Rs.400 per box of imported dates). While, ad valorem duties are levied as a fixed percentage of the total value of the goods (e.g., 30% duty on imported computer parts).



Source : Figure 6.3 in Sikdar (2003), p. 133.

**Figure 4.1 Effect of a Tariff**

Prices. The implication of this assumption is that the tariff leaves world market price of the good unaffected, while raising its price in the domestic market. In the Figure 4.1 above we consider the domestic demand and supply curves of the imported good. The world market price of the good is  $P_w$ , and this is the price that would prevail in the domestic market under free trade. Thus with free trade, domestic production of the good would be  $Q_1$ , domestic demand  $Q_2$ , and the difference  $Q_2 - Q_1$  would be imported. A specific tariff rate of  $t$  per unit drives a wedge between the world price and domestic market price of the imported good. Post-tariff, price in the domestic market rises to  $(P_w + t)$ . As a result, domestic production

increases from  $Q_1$  to  $Q_2$ , while consumption falls from  $Q_2$  to  $Q_4$ . Now let us consider the costs imposed by the tariff. Owing to the tariff, domestic consumers suffer a loss in consumer surplus equal to the area  $(a + b + c + d)$ , compared to free trade. This loss arises because consumers must now pay a higher price  $(P_w + t)$  for the good and also because they now consume  $Q_4$  amount less of the good than with free trade. However, domestic producers gain from the price rise, with the area  $a$  representing the increase in producer surplus. The government also gains from the tariff as it earns a revenue. The imports are now  $Q_3 - Q_4$  units, each paying a tariff of  $t$  per unit, so the tariff revenue is given by the rectangle with area  $c$ . Clearly the loss to consumers exceeds the gain to producers and the government taken together, indicating that the tariff results in a net social loss to society equal to the sum of the areas  $b$  and  $d$ .

Area  $b$  measures the loss in social welfare from the production distortion due to the tariff. It represents the higher cost of producing  $Q_3$  domestically rather than importing this amount; Area  $d$  is the welfare loss due to the consumption distortion created by the tariff. It represents the cost of not consuming  $Q_4$ , an amount whose value to consumers exceeds the cost of importing it. You should note that our partial equilibrium analysis of the impact of a tariff, focuses simply on the market for the imported good. Repercussions on a number of important issues like terms of trade, BOP, factor markets etc., are left out of this framework, as in case of our analysis of the benefits of free trade. In particular, our analysis does not attach any weight to employment in the sector being granted tariff protection. If the import-competing sector accounts for a significant share of total employment, the measures of welfare loss would have to be adjusted accordingly. In reality, employment is often the most important reason underlying the imposition of protectionist trade policies.

### Effective Rate of protection

So far we have concentrated on tariffs imposed on a final good. But tariffs may be imposed on intermediate goods as well. Obviously tariffs on raw material and intermediates would raise the cost of production for domestic industry. This factor needs to be taken into account while measuring the extent of protection awarded to domestic industry by any given tariff structure (comprising tariffs on final goods and intermediates). The Effective Rate of protection (ERP) measures the extent of protection granted to domestic industry by the given structure of nominal tariff rates. It measures the change in value added in domestic industry due to tariff protection. By definition, where  $ERP_F$  is the ERP on the final good  $F$ ;  $V_T$ , is value added in the production of  $F$  after tariff; and  $V_w$ , is value added in the production of  $F$  at world market prices, i.e.  $V_w$  is the value added under 'free trade'.

Remember, value added is the difference between the prices of the 'final good' produced by an industry, less the cost of inputs required per unit of production of the final good.

### Non-Tariff Barriers

Non-Tariff Barriers (NTBs), unlike tariffs, may impose direct restrictions on the inflow of imported goods. For instance, conventional NTBs like import quotas directly restrict the quantum of imports into the domestic country. While other NTBs discussed below restrict the flow of traded goods in a more indirect manner. From the following discussion you will see how countries are resorting to newer, more indirect forms of NTBs, most often in

order to circumvent the directives of multilateral trade agreements like the WTO

### Quotas

Import quotas impose direct restrictions on the quantum of imports into a country. In practice quotas are administered through a system of import licenses. Only license holders are given permission to import specified quantities of the imported good into the domestic market. You will see that with a quota the domestic price of an imported good will always be higher than its world market price.

License holders buy the imported goods at world market prices and then sell at higher prices in the domestic market. In what follows we will examine the impact of an import quota under different market structures in the domestic economy

### Theories of Protectionism

Having examined the case for free trade, we will now look at some of the reasons why countries deviate from a strategy of free trade and adopt protectionist measures . . . - You will see that protectionist policies are often undertaken primarily to protect the incomes of particular interest groups within society. Also there are theoretical arguments that show that sometimes protectionist policies can increase national welfare.

### The Terms of Trade Argument

One argument for adopting protectionist measures is based on cost-benefit analysis. This applies in the context of large countries. In the context of international trade a large country is one whose actions regarding the decision whether or not to restrict trade flows has direct repercussions on the world price of goods.

When a large country imposes import restrictions (say, via an import tariff), this serves to reduce world demand for the importable and thus the price of the importable good in the world market. That is, by imposing tariff restriction on imports, a large country is able to affect the price of foreign exporters. The tariff leads to a lowering of the price of imports and thus results in a terms of trade benefit for the country. However this benefit must be compared with the cost of the tariff. As we will see in the next section, a tariff impacts on the price of the importable good and changes relative prices of the importable vis a vis the exportable goods. Thus the costs of a tariff are measured by the distortion in production and consumption incentives, associated with the change in domestic relative price ratios. Under certain conditions it can be shown that the benefits of a tariff, due to the improvement in terms of trade, outweighs the costs of the tariff. This is the terms of trade argument for protectionism. In fact it can be shown that there exists a sufficiently small but positive tariff-rate, at which the terms of trade benefits outweigh the costs. This means that at small tariff rates a large country's welfare is actually higher; as compared to a free trade situation. As the tariff rate is increased, however, the costs of protection begin to grow more rapidly than the benefits.

### Regional integration:

Regional integration helps countries overcome divisions that impede the flow of goods, services, capital, people and ideas. These divisions are a constraint to economic growth,

especially in developing countries. The World Bank Group helps its client countries to promote regional integration through common physical and institutional infrastructure.

Divisions between countries created by geography, poor infrastructure and inefficient policies are an impediment to economic growth. Regional integration allows countries to overcome these costly divisions integrating goods, services and factors' markets, thus facilitating the flow of trade, capital, energy, people and ideas.

Regional integration can be promoted through common physical and institutional infrastructure. Specifically, regional integration requires cooperation between countries in:

- Trade, investment and domestic regulation;
- Transport, ICT and energy infrastructure;
- Macroeconomic and financial policy;
- The provision of other common public goods (e.g. shared natural resources, security, and education).

Cooperation in these areas has taken different institutional forms, with different levels of policy commitments and shared sovereignty, and has had different priorities in different world regions.

Regional integration can lead to substantial economic gains. Regional integration allows countries to:

- Improve market efficiency;
- Share the costs of public goods or large infrastructure projects;
- Decide policy cooperatively and have an anchor to reform;
- Have a building block for global integration;
- Reap other non-economic benefits, such as peace and security.

However, there are risks to regional integration that need to be identified and managed.

- Countries may have different preferences on priorities for regional integration, depending on their connectivity gaps, economic geography, or preferences for sovereignty in specific areas.
- Regional integration's impact on trade and investment flows, allocation of economic activity, growth, income distribution are often difficult to assess.
- Lack of adequate complementary policies and institutions may lead to inefficient outcomes. For instance, policy barriers at the border may offset the gains transport infrastructure cooperation.
- Regional integration creates winners and losers, notably within countries. Policies and institutions are needed to ensure that regionalism is inclusive and social, environmental, governance risks are managed.

## The European Union:

The European Union is a unified trade and monetary body of 27 member countries.<sup>1</sup> It eliminates all border controls between members. The open border allows the free flow of goods and people. There may be police checks, based on police information and experience, that are not equivalent to border checks.<sup>2</sup>

Any product manufactured in one EU country can be sold to any other member without [tariffs](#) or duties.<sup>3</sup> Practitioners of most services, such as law, medicine, tourism, banking, and insurance, can operate a business in all member countries.<sup>4</sup>

### Purpose

The EU's purpose is to be more competitive in the global marketplace. At the same time, it must balance the needs of its independent fiscal and political members.

Its 27 member countries are Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden.<sup>1</sup>

### How It Is Governed

Three bodies run the EU. The EU Council represents national governments. The Parliament is elected by the people. The European Commission is the EU staff. They make sure all members act consistently in regional, agricultural, and social policies. Contributions of 120 billion euros a year from member states fund the EU.

Here's how the three bodies uphold the laws governing the EU. These are spelled out in a series of treaties and supporting regulations:<sup>5</sup>

1. The European Commission proposes new legislation. The commissioners serve a five-year term.<sup>6</sup>
2. The European Parliament gets the first read of all laws the Commission proposes. Its members are elected every five years.<sup>7</sup>
3. The European Council gets the second read on all laws and can accept the Parliament's position, thus adopting the law. The council is made up of the Union's 27 heads of state, plus a president.<sup>8</sup>

### Currency

The euro is the common currency for the EU area. It is the second most commonly held currency in the world, after the U.S. dollar. It replaced the Italian lira, the French franc, and the German Deutschmark, among others.<sup>9</sup>

The value of the euro is free-floating instead of a fixed exchange rate.<sup>10</sup> As a result, foreign exchange traders determine its value each day. The most widely-watched value is how much the [euro's value is compared to the U.S. dollar](#).<sup>11</sup> The dollar is the unofficial world currency.<sup>12</sup>

**European Community (EC)**, previously (from 1957 until Nov. 1, 1993) **European Economic Community (EEC)**, byname **Common Market**, former association designed to [integrate](#) the economies of Europe. The term also refers to the "European



Communities,” which originally [comprised](#) the European Economic [Community](#) (EEC), the [European Coal and Steel Community](#) (ECSC; dissolved in 2002), and the [European Atomic Energy Community](#) (Erratum). In 1993 the three [communities](#) were subsumed under the [European Union](#) (EU). The [EC](#), or Common Market, then became the principal component of the EU. It remained as such until 2009, when the EU legally replaced the EC as its institutional successor.

The EEC was created in 1957 by the [Treaty of Rome](#), which was signed by [Belgium](#), [France](#), [Italy](#), [Luxembourg](#), [the Netherlands](#), and [West Germany](#). The [United Kingdom](#), [Denmark](#), and [Ireland](#) joined in 1973, followed by [Greece](#) in 1981



and [Portugal](#) and [Spain](#) in 1986. The former [East Germany](#) was admitted as part of reunified Germany in 1990. The EEC was designed to create a common market among its members through the elimination of most trade barriers and the establishment of a common external trade policy. The treaty also provided for a [common agricultural policy](#), which was established in 1962 to protect EEC farmers from agricultural imports. The first reduction in EEC internal tariffs was [implemented](#) in January 1959, and by July 1968 all internal tariffs had been removed. Between 1958 and 1968 trade among the EEC's members quadrupled in value.

Politically, the EEC aimed to reduce tensions in the aftermath of [World War II](#). In particular, it was hoped that [integration](#) would promote a lasting reconciliation of France and Germany, thereby reducing the potential for war. EEC governance required political cooperation among its members through formal supranational institutions. These institutions included the Commission, which formulated and administered EEC policies; the Council of Ministers, which enacted legislation; the [European Parliament](#), originally a strictly consultative body whose members were delegates from national parliaments (later they would be directly elected); and the [European Court of Justice](#), which interpreted community law and arbitrated legal disputes.

Members revamped the organization several times in order to expand its policy-making powers and to revise its political structure. On July 1, 1967, the governing bodies of the EEC, ECSC, and Euratom were merged. Through the [Single European Act](#), which entered into force in 1987, EEC members committed themselves to remove all remaining barriers to a common market by 1992. The act also gave the EEC formal control of community policies on the [environment](#), research and technology, education, health, [consumer protection](#), and other areas.

By the [Maastricht Treaty](#) (formally known as the Treaty on European Union; 1991), which went into force on November 1, 1993, the European Economic Community was renamed the European Community and was embedded into the EU as the first of its three "pillars" (the second being a common foreign and security policy and the third being police and judicial cooperation in criminal matters). The treaty also provided the foundation for an economic and [monetary union](#), which included the creation of a single currency, the [euro](#). The [Lisbon Treaty](#), ratified in November 2009, extensively [amended](#) the governing documents of the EU. With the treaty's entry into force on Dec. 1, 2009, the name European Community as well as the "pillars" concept were eliminated.

## UNCTAD

The United Nations Conference on Trade and Development was established in 1964 as a permanent intergovernmental body. UNCTAD is the part of the United Nations Secretariat dealing with trade, investment, and development issues.

**Headquarters location:** Geneva, Switzerland  
**Founder:** United Nations General Assembly  
**Founded:** 30 December 1964

**Head:** Acting Secretary-General; Isabelle Durant

**Parent organization:** United Nations General Assembly; United Nations Secretariat

**Formation:** 30 December 1964; 56 years ago

Globalization, including a phenomenal expansion of trade, has helped lift millions out of poverty. But not nearly enough people have benefited. And tremendous challenges remain.

We support developing countries to access the benefits of a globalized economy more fairly and effectively. And we help equip them to deal with the potential drawbacks of greater economic integration. To do this, we provide analysis, facilitate consensus-building, and offer technical assistance. This helps them to use trade, investment, finance, and technology as vehicles for inclusive and sustainable development.

Working at the national, regional, and global level, our efforts help countries to:

- Comprehend options to address macro-level development challenges
- Achieve beneficial integration into the international trading system
- Diversify economies to make them less dependent on commodities
- Limit their exposure to financial volatility and debt
- Attract investment and make it more development friendly
- Increase access to digital technologies
- Promote entrepreneurship and innovation
- Help local firms move up value chains
- Speed up the flow of goods across borders
- Protect consumers from abuse
- Curb regulations that stifle competition
- Adapt to climate change and use natural resources more effectively

Together with other UN departments and agencies, we measure progress by the Sustainable Development Goals, as set out in Agenda 2030.

We also support implementation of [Financing for Development](#), as mandated by the global community in the 2015 Addis Ababa Agenda, together with four other major institutional stakeholders: the World Bank, the International Monetary Fund, the World Trade Organization, and the United Nations Development Programme.

While we work mainly with governments, to effectively deal with the magnitude and complexity of meeting the Sustainable Development Goals, we believe that partnerships and closer cooperation with the private sector and civil society are essential.

Ultimately, we are serving the citizens of the [195 countries](#) that make up our organization. Our goal is prosperity for all.

GATT:

The General Agreement on Tariffs and Trade (GATT), signed on October 30, 1947, by 23 countries, was a legal agreement [minimizing barriers to international trade](#) by eliminating or reducing [quotas](#), [tariffs](#), and [subsidies](#) while preserving significant regulations.<sup>1</sup> The GATT was intended to boost economic recovery after World War II through reconstructing and liberalizing global trade.

The GATT went into effect on January 1, 1948.<sup>2</sup> Since that beginning it has been refined, eventually leading to the creation of the [World Trade Organization \(WTO\)](#) on January 1, 1995, which absorbed and extended it.<sup>3</sup> By this time 125 nations were signatories to its agreements, which covered about 90% of global trade.<sup>4</sup>

The Council for Trade in Goods (Goods Council) is responsible for the GATT and consists of representatives from all WTO member countries. As of September 2020, the chair of the Goods Council is Swedish Ambassador Mikael Anzén.<sup>5</sup> The council has 10 committees that address subjects including market access, agriculture, subsidies, and anti-dumping measures.<sup>6</sup>

## KEY TAKEAWAYS

- The General Agreement on Tariffs and Trade (GATT) was signed by 23 countries in October 1947, after World War II, and became law on Jan. 1, 1948.
- The purpose of the General Agreement on Tariffs and Trade (GATT) was to make international trade easier.
- The General Agreement on Tariffs and Trade (GATT) held eight rounds in total from April 1947 to December 1993, each with significant achievements and outcomes.<sup>7</sup>
- In 1995, the General Agreement on Tariffs and Trade (GATT) was absorbed into the World Trade Organization (WTO), which extended it.

### Understanding the General Agreement on Tariffs and Trade (GATT)

The GATT was created to form rules to end or restrict the most costly and undesirable features of the pre-war protectionist period, namely quantitative trade barriers such as trade controls and quotas. The agreement also provided a system to arbitrate commercial disputes among nations, and the framework enabled a number of multilateral negotiations for the reduction of tariff barriers. The GATT was regarded as a significant success in the post-war years.

One of the key achievements of the GATT was that of trade without discrimination. Every signatory member of the GATT was to be treated as equal to any other.<sup>8</sup> This is known as the [most-favoured-nation principle](#), and it has been carried through into the WTO.<sup>9</sup> A practical outcome of this was that once a country had negotiated a tariff cut with some other countries (usually its most important trading partners), this same cut would automatically apply to all GATT signatories. Escape clauses did exist, whereby countries could negotiate exceptions if their domestic producers would be particularly harmed by tariff cuts.<sup>10</sup>

Most nations adopted the most-favoured-nation principle in setting tariffs, which largely replaced quotas. Tariffs (preferable to quotas but still a trade barrier) were in turn cut steadily in rounds of successive negotiations.

### History of the General Agreement on Tariffs and Trade (GATT)

The GATT held eight rounds of meetings between April 1947 and December 1993. Each of the conferences had significant achievements and outcomes.

- The first meeting was in Geneva, Switzerland, and included 23 countries. The focus in this opening conference was on tariffs. The members established tax concessions touching over US\$10 billion of trade around the globe.<sup>7</sup>
- The second series of meetings began in April 1949 and were held in Annecy, France. Again, tariffs were the primary topic. Thirteen countries were at the second meeting, and they accomplished an additional 5,000 tax concessions reducing tariffs.<sup>7,11</sup>
- Starting in September 1950 the third series of GATT meetings occurred in Torquay, England. This time 38 countries were involved, and almost 9,000 tariff concessions passed, reducing tax levels by as much as 25%.<sup>11</sup>
- Japan became involved in the GATT for the first time in 1956 at the fourth meeting along with 25 other countries.<sup>12</sup> The meeting was in Geneva, Switzerland, and again the committee reduced worldwide tariffs, this time by US\$2.5 billion.<sup>7</sup>

- ADB was conceived in the early 1960s as a financial institution that would be Asian in character and foster economic growth and cooperation in one of the poorest regions in the world.
- A resolution passed at the first Ministerial Conference on Asian Economic Cooperation held by the United Nations Economic Commission for Asia and the Far East in 1963 set that vision on the way to becoming reality.
- The Philippines capital of Manila was chosen to host the new institution, which opened on 19 December 1966, with 31 members that came together to serve a predominantly agricultural region. Takeshi Watanabe was ADB's first President.
- During the 1960s, ADB focused much of its assistance on food production and rural development.

Founded in 1966, the Asian Development Bank's (ADB) headquarters are in Manila, Philippines. The Asian Development Bank's primary mission is to foster growth and cooperation among countries in the Asia-Pacific Region.<sup>1</sup> the ADB assists its members and partners by providing loans, technical assistance, grants, and equity investments to promote social and economic development.

The ADB has been responsible for a number of major projects in the region and raises capital regularly through the international [bond markets](#). The ADB also relies on member contributions, retained earnings from lending, and the repayment of loans for the funding of the organization.

## KEY TAKEAWAYS

- The Asian Development Bank's (ADB) primary mission is to promote economic growth and cooperation in the Asia-Pacific Region.
- The majority of the ADB's members are from the Asia-Pacific region.
- The ADB provides assistance to its developing member countries, the private sector, and public-private partnerships through grants, loans, technical assistance, and equity investments to promote development.

### How the Asian Development Bank Works

The Asian Development Bank provides assistance to its developing member countries, the private sector, and [public-private partnerships](#) through grants, loans, technical assistance, and equity investments to promote development. The ADB regularly facilitates policy dialogues and provides advisory services. They also use co-financing operations that tap a number of official, commercial, and export credit sources while providing assistance.

Membership in the ADB is open to members and associate members of the United Nations Economic Commission for Asia and the Far East, as well as other regional countries and non-regional developed countries that are members of the United Nations or of any of its specialized agencies.

### Recent Initiatives

Since the beginning of the COVID-19 pandemic at the start of 2020, the ADB has committed more than US \$17.5 billion to help its developing member countries address the impacts of COVID-19 and address vaccination needs, and has mobilized a further \$12.5 billion in co-financing from partners.

Through a \$9 billion Asia Pacific Vaccine Access Facility, or APVAX, announced in December 2020, the ADB is providing funding for vaccine procurement, logistics, and distribution.<sup>2</sup>

From 31 members at its establishment in 1966, ADB has since grown to 68 members—of which 49 are from within Asia and the Pacific and 19 outside. Membership as of Q1 2021 includes: <sup>3</sup>

### UNIT III

#### WTO – Functions of WTO – An Overview.

The World Trade Organization came into being in 1995. One of the youngest of the international organizations, the WTO is the successor to the General Agreement on Tariffs and Trade (GATT) established in the wake of the Second World War.

So while the WTO is relatively young, the multilateral trading system that was originally set up under the GATT is over 70 years old.

The past 70 years have seen an exceptional growth in world trade. Merchandise exports have grown on average by 6% annually. This growth in trade has been a powerful engine for overall economic expansion and on average trade has grown by 1.5 times more than the global economy each year. Total exports in 2019 were 250 times the level of 1948. The GATT and the WTO have helped to create a strong and prosperous trading system contributing to unprecedented growth.

The system was developed through a series of trade negotiations, or rounds, held under the GATT. The first rounds dealt mainly with tariff reductions but later negotiations included other areas such as anti-dumping and non-tariff measures. The 1986-94 round – the Uruguay Round – led to the WTO's creation.

The negotiations did not end there. In 1997, an agreement was reached on telecommunications services, with 69 governments agreeing to wide-ranging liberalization measures that went beyond those agreed in the Uruguay Round.

In the same year, 40 governments successfully concluded negotiations for tariff-free trade in information technology products, and 70 members concluded a financial services deal covering more than 95% of trade in banking, insurance, securities and financial information.

In 2000, new talks started on agriculture and services. These were incorporated into a broader work programme, the Doha Development Agenda, launched at the fourth WTO Ministerial Conference in Doha, Qatar, in November 2001.

The new work programme included negotiations and other work on non-agricultural tariffs, trade and the environment, WTO rules on anti-dumping and subsidies, trade facilitation, transparency in government procurement, intellectual property and a range of issues raised by developing economies as difficulties they face in implementing WTO agreements.

Negotiations on these and other topics have resulted in major updates to the WTO rulebook in recent years. A revised Government Procurement Agreement – adopted at the WTO's 8th Ministerial Conference in 2011 – expanded the coverage of the original agreement by an estimated US\$ 100 billion a year.

At the 9th Ministerial Conference in Bali in 2013, WTO members struck the Agreement on Trade Facilitation, which aims to reduce border delays by slashing red tape.

When fully implemented, this Agreement – the first multilateral accord reached at the WTO – will cut trade costs by more than 14% and will lift global exports by as much as US\$ 1 trillion per year.

The expansion of the Information Technology Agreement – concluded at the 10th Ministerial Conference in Nairobi in 2015 – eliminated tariffs on an additional 200 IT products valued at over US\$ 1.3 trillion per year. Another outcome of the Conference was a decision to abolish agricultural export subsidies, fulfilling one of the key targets of the UN Sustainable Development Goal on “Zero hunger”.

Most recently, an amendment to the WTO’s Intellectual Property Agreement entered into force in 2017, easing poor economies’ access to affordable medicines. The same year saw the Trade Facilitation Agreement enter into force.

### WTO agreements

How can you ensure that trade is as fair as possible, and as open as is practical? By negotiating rules and abiding by them.

The WTO’s rules – the agreements – are the result of negotiations between the members. The current set is largely the outcome of the 1986- 94 Uruguay Round negotiations, which included a major revision of the original General Agreement on Tariffs and Trade (GATT).

The Uruguay Round created new rules for dealing with trade in services and intellectual property and new procedures for dispute settlement. The complete set runs to some 30,000 pages consisting of about 30 agreements and separate commitments (called schedules) made by individual members in specific areas, such as lower tariffs and services market-opening.

Through these agreements, WTO members operate a non- discriminatory trading system that spells out their rights and their obligations. Each member receives guarantees that its exports will be treated fairly and consistently in other members’ markets. Each promises to do the same for imports into its own market. The system also gives developing economies some flexibility in implementing their commitments.

### Goods

It all began with trade in goods. From 1947 to 1994, the GATT was the forum for negotiating lower tariffs and other trade barriers; the text of the GATT spelt out important rules, particularly non- discrimination. Since 1995, the Marrakesh Agreement Establishing the WTO and its annexes (including the updated GATT) has become the WTO’s umbrella agreement. It has annexes dealing with specific sectors relating to goods, such as agriculture, and with specific issues such as product standards, subsidies and actions taken against dumping. A recent significant addition was the Trade Facilitation Agreement, which entered into force in 2017.

### Services

Banks, insurance firms, telecommunications companies, tour operators, hotel chains and transport companies looking to do business abroad enjoy the same principles of more open trade that originally only applied to trade in goods. These principles appear in the General Agreement on Trade in Services (GATS). WTO members have also made individual commitments under the GATS stating which of their service sectors they are willing to open to foreign competition, and how open those markets are.

### Intellectual property

The WTO’s Intellectual Property Agreement contains rules for trade in ideas and creativity. The rules state how copyrights, patents, trademarks, geographical names used to identify products, industrial designs and undisclosed information such as trade secrets – “intellectual property” – should be protected when trade is involved.

### Dispute settlement

The WTO's procedure for resolving trade conflicts under the Dispute Settlement Understanding is vital for enforcing the rules and therefore for ensuring that trade flows smoothly. Governments bring disputes to the WTO if they think their rights under the WTO agreements are being infringed. Judgements by specially appointed independent experts are based on interpretations of the agreements and individual members' commitments. The system encourages members to settle their differences through consultation with each other. If this proves to be unsuccessful, they can follow a stage- by-stage procedure that includes the possibility of a ruling by a panel of experts and the chance to appeal the ruling on legal grounds.

Confidence in the system is borne out by the number of cases brought to the WTO – more than 500 cases since the WTO was established compared with the 300 disputes dealt with during the entire life of the GATT (1947-94).

### **Trade monitoring**

The WTO's Trade Policy Review Mechanism is designed to improve transparency, to create a greater understanding of the trade policies adopted by WTO members and to assess their impact. Many members see the reviews as constructive feedback on their policies. All WTO members must undergo periodic scrutiny, each review containing reports by the member concerned and the WTO Secretariat. In addition, the WTO undertakes regular monitoring of global trade measures. Initially launched in the wake of the financial crisis of 2008, this global trade monitoring exercise has become a regular function of the WTO, with the aim of highlighting WTO members' implementation of both trade- facilitating and trade-restricting measures.

### **Building trade capacity in developing economies**

Over three-quarters of WTO members are developing or least-developed economies. All WTO agreements contain special provisions for them, including longer time periods to implement commitments, measures to increase their trading opportunities and support to help them build the infrastructure needed to participate in world trade.

A WTO Committee on Trade and Development looks at developing economies' special needs. Its responsibility includes implementation of the WTO agreements, technical cooperation and the increased participation of developing economies in the global trading system.

The Aid for Trade initiative, launched by WTO members in 2005, is designed to help developing economies build trade capacity, enhance their infrastructure and improve their ability to benefit from trade-opening opportunities. So far, over US\$ 400 billion has been disbursed to support Aid for Trade projects. A Global Review of the initiative is held every two years at the WTO's headquarters.

The Enhanced Integrated Framework (EIF) is the only multilateral partnership dedicated exclusively to assisting least developed countries (LDCs) in their use of trade as an engine for growth, sustainable development and poverty reduction. The EIF partnership of 51 countries, 24 donors and eight partner agencies, including the WTO, works closely with governments, development organizations, civil society and academia. The EIF has invested in over 170 projects, with US\$ 220 million committed to supporting the poorest countries in the world.

Another partnership supported by the WTO is the Standards and Trade Development Facility (STDF), set up to help developing economies meet international standards for food safety, plant and animal health and access global markets. The WTO houses the Secretariat and manages the STDF trust fund, which has provided financing of over US\$ 50 million to support projects in low-income economies.



### Technical assistance and training

The WTO organizes hundreds of technical cooperation missions to developing economies annually. It also holds many trade policy courses each year in Geneva for government officials. Regional seminars are held regularly in all regions of the world, with a special emphasis on African countries. E-learning courses are also available. In 2019, some 22800 participants benefited from WTO training aimed at improving understanding of WTO agreements and global trade rules.

### Functions

The WTO's overriding objective is to help trade flow smoothly, freely and predictably. It does this by:

- administering trade agreements
- acting as a forum for trade negotiations
- settling trade disputes
- reviewing national trade policies
- building the trade capacity of developing economies
- cooperating with other international organizations

### Structure

The WTO has 164 members, accounting for 98% of world trade. A total of 25 countries are negotiating membership.

Decisions are made by the entire membership. This is typically by consensus. A majority vote is also possible but it has never been used in the WTO, and was extremely rare under the WTO's predecessor, the GATT. The WTO's agreements have been ratified in all members' parliaments.

The WTO's top level decision-making body is the Ministerial Conference, which meets usually every two years.

Below this is the General Council (normally ambassadors and heads of delegation based in Geneva but sometimes officials sent from members' capitals) which meets several times a year in the Geneva headquarters. The General Council also meets as the Trade Policy Review Body and the Dispute Settlement Body.

At the next level, the Goods Council, Services Council and Intellectual Property (TRIPS) Council report to the General Council.

Numerous specialized committees, working groups and working parties deal with the individual agreements and other areas, such as the environment, development, membership applications and regional trade agreements.

## UNIT IV

Balance of payments – Disequilibrium – Remedies – Exchange control – Purchasing Power parity Theory

### BALANCE OF PAYMENTS

The balance of payments accounts are an integral part of the national income accounts for an

open economy. They record (in principle) all transactions between 'residents' of the country concerned and those of other countries, where 'residents' are broadly interpreted as all individuals, businesses, and governments and their agencies; international organizations are also classified as 'foreign' residents for this purpose. The balance-of-payments accounts, however, serve another purpose. The balance of a country's foreign transactions, and the accompanying issues of the exchange rate and reserves (whether of gold or of foreign currencies) has long been a focus of interest for policy-makers.

The Balance of Payments: Book-Keeping the balance of payments is essentially an application of the double-entry bookkeeping, since it records both transactions and the money flows associated with those transactions. Transactions, which give rise to money receipts from the rest of the world, are recorded in the credit side of the balance of payments. On the other hand, transactions, which lead to monetary payments abroad, are recorded in the debit side of the balance of payments accounts. If we do this in a proper way debits and credits will always be equal, so that in an accounting sense the balance of payments will always be in balance. An accounting balance is however not synonymous with balance of payments equilibrium. It is important to keep in mind that a balance-of-payments account records flows between countries over a specified period of time (usually a year for the full accounts, but often less for some components of the accounts). Some items in the balance of payments are readily identified as flows, such as exports. Other items, however, are flows arising from changes in stocks. Traditionally there are two basic elements in a perfectly compiled set of balance-of-payments accounts: the current account and the capital account. Each of these is usually subdivided, the former into visible and invisible trade and unrequited transfers, the latter into long-term and short-term private transactions and changes in official reserves. The essential difference between the two is that capital account transactions necessarily involve domestic residents either acquiring or surrendering claims on foreign residents, whereas current account transactions do not. In practice there is a third element, the 'balancing item' or 'errors and omissions', which reflects our inability to record all international transactions accurately.

#### The current account

Records imports and exports of goods and services and unilateral transfers. Balance-of-payments accounts usually differentiate between trades in goods and trade in services. The balance of exports and imports of the former is referred to as the balance of visible trade or as the balance of merchandise trade. It is often useful for economic purposes to distinguish between factor and non-factor services. Trade in the latter, of which shipping, banking and insurance services, and payments by residents as tourists abroad are usually the most important, is in economic terms little different from trade in goods. That is, exports and imports of such services are flows of outputs whose values will be determined by the same variables that would affect the demand and supply for goods. Factor services, which consist of interest, profits and dividends, are on the other hand payments for inputs. Unilateral transfers, or 'unrequited receipts', are receipts, which the residents of a country receive 'for free', without having to make any present or future payments in return. Receipts from abroad are entered as positive items, payments abroad & negative items. The net value of the balances of visible trade and of invisible trade and of unilateral transfers defines the balance on current account. Table 7.1 shows the various components of the current accounts of India in 2004-05. Notice that there is a large deficit in merchandise trade, but an almost equally large surplus in miscellaneous services, which would include export revenues earned by call centers and other information technology enabled services (ITES). Also notice that private

transfers (mainly remittances from NRIs) far exceed official transfers (foreign aid in the form of grants from other countries).

### The capital account

Records all international transactions that involve a resident of the country concerned changing either his assets with or his liabilities to a resident of another country. As we noted earlier, transactions in the capital account reflect a change in a stock - either assets or liabilities. 77609 96318 2785 93533 2 1098 20486 612 709759 It is often useful to make distinctions between various forms of capital account transactions. The basic distinctions are between private and official transactions, between portfolio and direct investment, and by the term of the investment (i.e. short or long term). Direct investment is the act of purchasing an asset and at the same time acquiring control of it (other than the ability to re-sell it). Portfolio investment by contrast is the acquisition of an asset that does not give the purchaser control. An obvious example is the purchase of shares in a foreign company or of bonds issued by a foreign government. Loans made to foreign firms or governments come into the same broad category. Such portfolio investment is often also distinguished by the period of the loan (short, medium or long are the conventional distinctions, although in many cases only the short and long categories are used). The distinction between short-term and long-term investment is often confusing, but usually relates to the specification of the asset rather than to the length of time for which it is held. The purchase of an asset in another country, whether it is direct or portfolio investment, would appear as a negative item in the capital account for the purchasing firm's country, and as a positive item in the capital account for the other country. That capital outflows appear as a negative item in a country's balance of payments, and capital inflows as positive items, often causes confusion. One way of avoiding this is to consider the direction in which the payment would go (if made directly).

The purchase of a foreign asset would then involve the transfer of money to the foreign country, as would the purchase of an (imported) good, and so must appear as a negative item in the balance of payments of the purchaser's country (and as a positive item in the accounts of the seller's country).

### THE REMAINING ITEMS IN THE BALANCE OF PAYMENTS

The balance-of-payments accounts are completed by the entry of: other minor items that can be identified but do not fall comfortably into one of the standard categories; errors and omissions, which reflect transactions that have not been recorded for various reasons and so cannot be entered under a standard heading, but which we know must appear since the full balance-of-payments account must sum to zero; and changes in official reserves and in official liabilities that are part of the reserves of other countries. Errors and omissions (or the balancing items) reflect the difficulties involved in recording accurately, if at all, a wide variety of transactions that occur within a given period (usually 12 months). In some cases there may be such a large number of transactions that a sample is taken rather than recording each transaction, with the inevitable errors that occur when samples are used. In other cases, problems may arise when one or other of the parts of a transaction takes more than one year. For example, with a large export contract covering several years some payment may be received by the exporter before any deliveries are made. But the last payment will not be made until the contract has been completed. Dishonesty may also play a part, as when goods

are smuggled, in which case the merchandise side of the transaction is unreported although payment will be made somehow and will be reflected somewhere in the accounts. Similarly, the desire to avoid taxes may lead to under-reporting of some items in order to reduce tax liabilities. Finally, there are changes in the reserves of the country whose balance of payments we are considering, and changes in that part of the reserves of other countries that is held in the country concerned. Reserves are held in three forms: in foreign currency, usually but not always the US dollar, as gold, and as Special Drawing Rights (SDRs) borrowed from the IMF. Note that reserves do not have to be held within the country. Indeed most countries hold a proportion of their reserves in accounts with foreign central banks. The changes in the country's reserves must of course reflect the net value of all the other recorded items in the balance of payments. These changes in reserves will of course be recorded accurately, and it is the discrepancy between the changes in reserves and the net value of the other recorded items that allows us to identify the errors and omissions.

### DEFICIT AND SURPLUS IN THE BALANCE OF PAYMENTS

The conventional focus is on three main imbalances that may occur within the balance of payments. The first is the current account and for the trade account. The basic balance is defined as the sum of the current account balance and the net balance on long-term capital, which were then seen as the most stable elements in the balance of payments, and so placed 'above the line'. A worsening of the basic balance (an increase in a deficit or a reduction in a surplus, or even a move from surplus to deficit) was seen as indicating a deterioration in the (relative) state of the economy. An alternative approach is to consider whether the net monetary transfer that has been made by the monetary authorities is positive or negative - the so-called settlements concept. If the net transfer is negative (i.e. there is an outflow) then the balance of payments is said to be in deficit, but if there is an inflow then it is in surplus. The basic premise is that the monetary authorities are the ultimate financiers of any deficit in the balance of payments (or the recipients of any surplus). These official settlements are thus seen as the accommodating item, all others being autonomous. The monetary authorities may finance a deficit by depleting their reserves of foreign currencies, by borrowing from the IMF, or by borrowing from foreign monetary authorities. The latter source is of particular importance when other monetary authorities hold the domestic currency as part of their own reserves. A country whose currency is 'used as a reserve currency (such as the United States) may be able to run a deficit in its balance of payments without either depleting its own reserves or borrowing from the IMF since the foreign authorities may be prepared to purchase that currency and add it to their own reserves. The settlements approach is more relevant under a system of pegged exchange rates than when exchange rates are floating. You will read about exchange rates in the following Unit in this block.

There are five different types of disequilibrium in the **BOP**:

1. Cyclical Disequilibrium.
2. Secular Disequilibrium.
3. Structural Disequilibrium.
4. Temporary Disequilibrium.
5. Fundamental Disequilibrium.

*Cyclical Disequilibrium in the BOP in the occur, the business cycle/Trade cycle follow different paths and patterns in different countries. There are no identical timing and periodicity of occurrence of cycles in different nations. No identical stabilization programs*

and measures are adopted by different states. Income Elasticity's of demand for imports in different nations are not identical. Price Elasticity's of demand for imports differ in different nations. Deficit and surplus alternatively take place during the depression and prosperity phase of a cycle. The balance of payments equilibrium is automatically set forth over the complete cycle.

Secular disequilibrium in the balance of payments is a long-term, phenomenon, caused by persistent, deep-rooted dynamic changes that slowly take place in the economy over a long period of time. It may be caused by changes in several dynamic forces or factors such as capital formation, population growth, technological changes, the growth of markets, changes in resources, etc. a newly developing nation, For instance, needs huge Investments which far exceed exports. It's domestic savings. Its imports also tend to exceed exports.

### Structural Disequilibrium

Structural disequilibrium arises from structural changes occurring in few sectors of the economy at home or abroad which may alter the demand for supply conditions for exports or imports or both.

A change in foreign demand for exports can arise from a change in technology, the invention of the cheaper substitute.

### Temporary Disequilibrium

A country's Balance of payments is of a temporary nature lasting for a short period which may occur once in a while.

Any factor which temporarily causes one-sided movement in the items constituting the Balance of payments is sufficient to **cause a disequilibrium**. This is subject to reversal within a limited period.

### Fundamental or Long Run Disequilibrium

The **long-term disequilibrium** thus refers to a deep-rooted, persistent deficit or surplus in the **Balance of payments** of a country.

It is a secular disequilibrium emerging on account of the chronologically accumulated short-term **disequilibrium deficit or surpluses**.

Monetary Measures for Correcting the Bop ↓

The monetary methods for correcting disequilibrium in the balance of payment are as follows

1. Deflation Deflation means falling prices. Deflation has been used as a measure to correct deficit disequilibrium. A country faces deficit when its imports exceeds exports. Deflation is brought through monetary measures like bank rate policy, open market operations, etc. or through fiscal measures like higher taxation, reduction in public expenditure, etc. Deflation would make our items cheaper in foreign market resulting a rise in our exports. At the same time the demands for imports fall due to higher taxation and reduced income. This would built a favourable atmosphere in the balance of payment position. However Deflation can be successful when the exchange rate remains fixed.

2. Exchange Depreciation

Exchange depreciation means decline in the rate of exchange of domestic currency in terms

of foreign currency. This device implies that a country has adopted a flexible exchange rate policy. Suppose the rate of exchange between Indian rupee and US dollar is \$1 = Rs. 40. If India experiences an adverse balance of payments with regard to U.S.A, the Indian demand for US dollar will rise. The price of dollar in terms of rupee will rise. Hence, dollar will appreciate in external value and rupee will depreciate in external value. The new rate of exchange may be say \$1 = Rs. 50. This means 25% exchange depreciation of the Indian currency. Exchange depreciation will stimulate exports and reduce imports because exports will become cheaper and imports costlier. Hence, a favourable balance of payments would emerge to pay off the deficit.

Limitations of Exchange Depreciation: - 1. Exchange depreciation will be successful only if there is no retaliatory exchange depreciation by other countries. 2. It is not suitable to a country desiring a fixed exchange rate system. 3. Exchange depreciation raises the prices of imports and reduces the prices of exports. So the terms of trade will become unfavourable for the country adopting it. 4. It increases uncertainty & risks involved in foreign trade. 5. It may result in hyper-inflation causing further deficit in balance of payments.

#### 4. Devaluation

Devaluation refers to deliberate attempt made by monetary authorities to bring down the value of home currency against foreign currency. While depreciation is a spontaneous fall due to interactions of market forces, devaluation is official act enforced by the monetary authority. Generally the international monetary fund advocates the policy of devaluation as a corrective measure of disequilibrium for the countries facing adverse balance of payment position. When India's balance of payment worsened in 1991, IMF suggested devaluation. Accordingly, the value of Indian currency has been reduced by 18 to 20% in terms of various currencies. The 1991 devaluation brought the desired effect. The very next year the import declined while exports picked up. When devaluation is effected, the value of home currency goes down against foreign currency, Let us suppose the exchange rate remains \$1 = Rs. 10 before devaluation. Let us suppose, devaluation takes place which reduces the value of home currency and now the exchange rate becomes \$1 = Rs. 20. After such a change our goods becomes cheap in foreign market. This is because, after devaluation, dollar is exchanged for more Indian currencies which push up the demand for exports. At the same time, imports become costlier as Indians have to pay more currencies to obtain one dollar. Thus demand for imports is reduced. Generally devaluation is resorted to where there is serious adverse balance of payment problem.

Limitations of Devaluation: - 1. Devaluation is successful only when other country does not retaliate the same. If both the countries go for the same, the effect is nil. 2. Devaluation is successful only when the demand for exports and imports is elastic. In case it is inelastic, it may turn the situation worse. 3. Devaluation, though helps correcting disequilibrium, is considered to be a weakness for the country. 4.

Devaluation may bring inflation in the following conditions: - i. Devaluation brings the imports down, when imports are reduced, the domestic supply of such goods must be increased to the same extent. If not, scarcity of such goods unleash inflationary trends. ii. A growing country like India is capital thirsty. Due to non-availability of capital goods in India, we have no option but to continue imports at higher costs. This will force the industries depending upon capital goods to push up their prices. iii.

When demand for our export rises, more and more goods produced in a country would go for exports and thus creating shortage of such goods at the domestic level. This results in rising prices and inflation. iv. Devaluation may not be effective if the deficit arises due to cyclical or structural changes.

## 5. Exchange Control

It is an extreme step taken by the monetary authority to enjoy complete control over the exchange dealings. Under such a measure, the central bank directs all exporters to surrender their foreign exchange to the central authority. Thus it leads to concentration of exchange reserves in the hands of central authority. At the same time, the supply of foreign exchange is restricted only for essential goods. It can only help controlling situation from turning worse. In short it is only a temporary measure and not permanent remedy.

### Non-Monetary Measures for Correcting the Bop

↓ A deficit country along with Monetary measures may adopt the following non-monetary measures too which will either restrict imports or promote exports. 1. Tariffs Tariffs are duties (taxes) imposed on imports. When tariffs are imposed, the prices of imports would increase to the extent of tariff. The increased prices will reduced the demand for imported goods and at the same time induce domestic producers to produce more of import substitutes. Non-essential imports can be drastically reduced by imposing a very high rate of tariff.

Drawbacks of Tariffs: - 1. Tariffs bring equilibrium by reducing the volume of trade. 2. Tariffs obstruct the expansion of world trade and prosperity. 3. Tariffs need not necessarily reduce imports. Hence the effects of tariff on the balance of payment position are uncertain. 4. Tariffs seek to establish equilibrium without removing the root causes of disequilibrium. 5. A new or a higher tariff may aggravate the disequilibrium in the balance of payments of a country already having a surplus. 6. Tariffs to be successful require an efficient & honest administration which unfortunately is difficult to have in most of the countries. Corruption among the administrative staff will render tariffs ineffective.

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

Types of Quotas: - 1. The tariff or custom quota, 2. The unilateral quota, 3. The bilateral quota, 4. The mixing quota, and 5. Import licensing. Merits of Quotas: - 1. Quotas are more effective than tariffs as they are certain. 2. They are easy to implement. 3. They are more effective even when demand is inelastic, as no imports are possible above the quotas. 4. More flexible than tariffs as they are subject to administrative decision. Tariffs on the other hand are subject to legislative sanction.

Demerits of Quotas: - 1. They are not long-run solution as they do not tackle the real cause for disequilibrium. 2. Under the WTO quotas are discouraged. 3. Implements of quotas is open invitation to corruption.

3. Export Promotion The government can adopt export promotion measures to correct disequilibrium in the balance of payments. This includes substitutes, tax concessions to exporters, marketing facilities, credit and incentives to exporters, etc. The government may also help to promote export through exhibition, trade fairs; conducting marketing research & by providing the required administrative and diplomatic help to tap the potential markets.

4. Import Substitution a country may resort to import substitution to reduce the

volume of imports and make it self-reliant. Fiscal and monetary measures may be adopted to encourage industries producing import substitutes. Industries which produce import substitutes require special attention in the form of various concessions, which include tax concession, technical assistance, subsidies, providing scarce inputs, etc. Non-monetary methods are more effective than monetary methods and are normally applicable in correcting an adverse balance of payments.

Drawbacks of Import Substitution: - 1. Such industries may lose the spirit of competitiveness. 2. Domestic industries enjoying various incentives will develop vested interests and ask for such concessions all the time. 3. Deliberate promotion of import substitute industries go against the principle of comparative advantage

### Exchange Control

Restriction on the use of foreign exchange by the central banks called **Exchange Control**.

When exchange control is adopted, all the exporters have to surrender their foreign exchange earnings to Central Bank.





Under exchange control, the central bank releases foreign exchanges only for essential imports and conserves the rest of the balance.

This is the most direct method of curbing imports.

Exchange control, in General, deals with the **balance of payments disequilibrium** by suppressing the deficit that is only a symptom and not the Basic Trouble.

Exchange control deals with only the deficit, not its causes, and it may irritate those causes tending to create a more basic disequilibrium.

**In other words**, exchange control can prevent a complete breakdown, but it cannot eliminate a condition of disequilibrium.

Thus, exchange control offers no permanent solution to the problem of persistent disequilibrium.

**It can**, at best be justified only as a temporary measure, to gain time while other more fundamental adjustments made to restore equilibrium in the Balance of payments.

According to this concept, two currencies are in equilibrium—known as the currencies being at par—when a basket of goods is priced the same in both countries, taking into account the exchange rates.

### KEY TAKEAWAYS

- Purchasing power parity (PPP) is a popular metric used by macroeconomic analysts that compares different countries' currencies through a "basket of goods" approach.
- Purchasing power parity (PPP) allows for economists to compare economic productivity and standards of living between countries.
- Some countries adjust their gross domestic product (GDP) figures to reflect PPP.

### Calculating Purchasing Power Parity

The relative version of PPP is calculated with the following formula:

### Calculating Purchasing Power Parity

The relative version of PPP is calculated with the following formula

$$S = \frac{P_1}{P_2}$$

**where:**

$S$  = Exchange rate of currency 1 to currency 2

$P_1$  = Cost of good  $X$  in currency 1

$P_2$  = Cost of good  $X$  in currency 2

### Comparing Nations' Purchasing Power Parity

To make a meaningful comparison of prices across countries, a wide range of goods and services must be considered. However, this one-to-one comparison is difficult to achieve due to the sheer amount of data that must be collected and the complexity of the comparisons that

must be drawn. To help facilitate this comparison, the University of Pennsylvania and the United Nations joined forces to establish the International Comparison Program (ICP) in 1968.<sup>1</sup>

With this program, the PPPs generated by the ICP have a basis from a worldwide price survey that compares the prices of hundreds of various goods and services. The program helps international macroeconomists estimate global productivity and growth.<sup>2</sup>

Every few years, the [World Bank](#) releases a report that compares the productivity and growth of various countries in terms of PPP and U.S. dollars.<sup>3</sup> Both the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) use weights based on PPP metrics to make predictions and recommend economic policy.<sup>4</sup> The recommended economic policies can have an immediate short-term impact on financial markets.

Also, some [forex traders](#) use PPP to find potentially overvalued or undervalued currencies. Investors who hold stock or bonds of foreign companies may use the survey's PPP figures to predict the impact of exchange-rate fluctuations on a country's economy, and thus the impact on their investment.

#### Pairing Purchasing Power Parity with Gross Domestic Product

In contemporary macroeconomics, gross domestic product (GDP) refers to the total monetary value of the goods and services produced within one country. Nominal GDP calculates the monetary value in current, absolute terms. [Real GDP](#) adjusts the nominal gross domestic product for inflation.

However, some accounting goes even further, adjusting GDP for the PPP value. This adjustment attempts to convert nominal GDP into a number more easily comparable between countries with different currencies.

To better understand how GDP paired with purchase power parity works, suppose it costs \$10 to buy a shirt in the U.S., and it costs €8.00 to buy an identical shirt in Germany. To make an apples-to-apples comparison, we must first convert the €8.00 into U.S. dollars. If the exchange rate was such that the shirt in Germany costs \$15.00, the PPP would, therefore, be  $15/10$ , or 1.5.

In other words, for every \$1.00 spent on the shirt in the U.S., it takes \$1.50 to obtain the same shirt in Germany buying it with the euro.

#### Drawbacks of Purchasing Power Parity

Since 1986, *The Economist* has playfully tracked the price of McDonald's Corp.'s (MCD) Big Mac hamburger across many countries. Their study results in the famed "Big Mac Index". In "Burgernomics"—a prominent 2003 paper that explores the [Big Mac Index](#) and PPP—authors Michael R. Pakko and Patricia S. Pollard cited the following factors to explain why the purchasing power parity theory is not a good reflection of reality.<sup>5</sup>

#### Transport Costs

Goods that are unavailable locally must be imported, resulting in transport costs. These costs include not only fuel but import duties as well. Imported goods will consequently sell at a relatively higher price than do identical locally sourced goods.<sup>6</sup>

#### Tax Differences

Government sales taxes such as the [value-added tax](#) (VAT) can spike prices in one country, relative to another.<sup>6</sup>

### Government Intervention

[Tariffs](#) can dramatically augment the price of imported goods, where the same products in other countries will be comparatively cheaper.<sup>6</sup>

### Non-Traded Services

The Big Mac's price factors input costs that are not traded. These factors include such items as insurance, utility costs, and [labor costs](#). Therefore, those expenses are unlikely to be at parity internationally.<sup>6</sup>

### Market Competition

Goods might be deliberately priced higher in a country. In some cases, higher prices are because a company may have a [competitive advantage](#) over other sellers. The company may have a monopoly or be part of a [cartel](#) of companies that manipulate prices, keeping them artificially high.<sup>7</sup>

### The Bottom Line

While it's not a perfect measurement metric, purchase power parity does allow for the possibility of comparing pricing between countries that have differing currencies.

## UNIT V

International monetary system – IMF – SDR – International liquidity – IBRD.

The International Monetary Fund is a 189-member organization that works to stabilize the global economy.<sup>1</sup>

### Objectives

The IMF meets its goal by targeting three objectives:

1. It monitors global conditions and identifies risks among its member countries.
2. It advises its members on how to improve their economies.
3. It provides technical assistance and [short-term loans](#) to prevent financial crises. The IMF's goal is to prevent these disasters by guiding its members.

**Survey Global Conditions:** The IMF has the rare ability to look into and review the economies of all its member countries. As a result, it has its finger on the pulse of the global economy better than any other organization.

The IMF produces a wealth of analytical reports. It provides the [World Economic Outlook](#), the [Global Financial Stability Report](#), and the [Fiscal Monitor](#) each year. It also delves into regional and country-specific assessments. It uses this information to determine which countries need to improve their policies. Hence, the IMF can identify which countries threaten global stability. The member countries have agreed to listen to the IMF's recommendations because they want to improve their economies and remove these threats.<sup>2</sup>

**Advice Member Countries:** Since the Mexican peso crisis of 1994–95 and the [Asian](#)

[crisis](#) of 1997–98, the IMF has taken a more active role to help countries prevent financial crises. It develops standards that its members should follow.<sup>3</sup>

For example, members agree to provide adequate [foreign exchange reserves](#) in good times.<sup>4</sup> that helps them increase spending to boost their economies during [recessions](#). It reports on member countries' observance of these standards.

The IMF also issues member country reports that investors use to make well-informed decisions. That improves the functioning of [financial markets](#). The IMF also encourages sustained growth and high living standards, which is the best way to reduce members' vulnerability to crises.

**Provide Technical Assistance and Short-term Loans:** The IMF provides loans to help its members tackle their [balance of payments](#) problems, stabilize their economies, and restore [sustainable growth](#).<sup>5 6</sup>

#### IMF Structure

The IMF chief has been Managing Director Kristina Gergiev since Sept. 25, 2019. The Managing Director is the chief of the IMF's 2,700 employees from 147 countries.<sup>11</sup> She supervises four Deputy Managing Directors. She is Chair of the 24-member Executive Board.<sup>12</sup>

The [IMF Governance Structure](#) begins with the IMF Governing Board which sets direction and policies. Its members are the finance ministers or central bank leaders of the member countries. They meet each year in conjunction with the World Bank. The International Monetary and Financial Committee meets twice a year. These committees review the international monetary system and make recommendations.<sup>13</sup>

#### Members

Rather than listing all 189 members, it's easier to list the countries that are not members.<sup>14</sup> the seven countries (out of a total of 196 countries) that are not IMF members are Cuba, East Timor, North Korea, Liechtenstein, Monaco, Taiwan, and Vatican City. The IMF has 11 members that are not sovereign countries: Anguilla, Aruba, Barbados, Capo Verde, Curacao, Hong Kong, Macao, Montserrat, Netherlands Antilles, Saint Maarten, and Timor-Leste.

Members do not receive equal votes. Instead, they have voting shares based on a quota. The quota is based on their economic size. If they pay their quota, they receive the equivalent in voting shares. The [Member Quotas and Voting Shares](#) was updated in 2010.<sup>15</sup>

## History

The IMF was created at the 1944 Bretton Woods conference. It sought to rebuild Europe after World War II. The Conference also set up a modified gold standard to help countries maintain the value of their currencies.<sup>16</sup> The planners wanted to avoid the trade barriers and high-interest rates that helped cause the Great Depression.

### The main functions of International Monetary Fund

#### 1. Exchange Stability:

The first important function of IMF is to maintain exchange stability and thereby to discourage any fluctuations in the rate of exchange. The Fund ensures such stability by making necessary arrangements like—enforcing declaration of par value of currency of all members in terms of gold or US dollar, enforcing devaluation criteria, up to 10 per cent or more by more information or by taking permission from IMF respectively, forbidding members to go in for multiple exchange rates and also to buy or sell gold at prices other than declared par value.

#### 2. Eliminating BOP Disequilibrium:

The Fund is helping the member countries in eliminating or minimizing the short-period equilibrium of balance of payments either by selling or lending foreign currencies to the members. The Fund also helps its members towards removing the long period disequilibrium in their balance of payments. In case of fundamental changes in the economies of its members, the Fund can advise its members to change the par values of its currencies.

#### 3. Determination of Par Value:

IMF enforces the system of determination of par values of the currencies of the member's countries. As per the Original Articles of Agreement of the IMF every member country must declare the par value of its currency in terms of gold or US dollars. Under the revised Articles, the members are given autonomy to float or change exchange rates as per demand supply conditions in the exchange market and also at par with internal price levels.

As per this article, IMF is exercising surveillance to ensure proper working and balance in the international monetary system, i.e., by avoiding manipulation in the exchange rates and by adopting intervention policy to counter short-term movements in the exchange value of the currency.

#### 4. Stabilize Economies:

The IMF has an important function to advise the member countries on various economic and monetary matters and thereby to help stabilize their economies.

#### 5. Credit Facilities:

IMF is maintaining various borrowing and credit facilities so as to help the member countries in correcting disequilibrium in their balance of payments. These credit facilities include-basic credit facility, extended fund facility for a period of 3 years, compensatory financing facility, stock facility for helping the primary producing countries, supplementary financing facility, special oil facility, trustfund, structural adjustment facility etc. The Fund also charges interest from the borrowing countries on their credit.

#### **6. Maintaining Balance between Demand and Supply of Currencies:**

IMF is also entrusted with important function to maintain balance between demand and supply of various currencies. Accordingly the fund can declare a currency as scarce currency which is in great demand and can increase its supply by borrowing it from the country concerned or by purchasing the same currency in exchange of gold.

#### **7. Maintenance of Liquidity:**

To maintain liquidity of its resources is another important function of IMF. Accordingly, there is provision for the member countries to borrow from IMF by surrendering their own currencies in exchange. Again for according accumulation of less demand currencies with the Fund, the borrowing countries are directed to repurchase their own currencies by repaying its loans in convertible currencies.

#### **8. Technical Assistance:**

The IMF is also performing a useful function to provide technical assistance to the member countries. Such technical assistance is given in two ways, i.e., firstly by granting the members countries the services of its specialists and experts and secondly by sending the outside experts.

**Moreover the Fund has also set up two specialized new departments:**

ADVERTISEMENTS:

- (a) Central Banking Services Department and
- (b) Fiscal Affairs Department for sending specialists to member countries so as to manage its central banks and also on fiscal management.

#### **9. Reducing Tariffs:**

The Fund also aims at reducing tariffs and other restrictions imposed on international trade by the member countries so as to

cease restrictions of remittance of funds or to avoid discriminating practices.

### 10. General Watch:

The IMF is also keeping a general watch on the monetary and fiscal policies followed by the member countries to ensure no flouting of the provisions of the charter.

Exchange Standard regime ceased to exist after 1973 and floating or flexible rate system came into vogue. The era of IMS since 1973 is better described as managed float or no system. Along with tracing the evolution of different IMS since 1873 we will also focus our attention to BoP or external adjustment in an open economy. In this regard, we will discuss the price and income adjustments under fixed rate and monetary approach to BoP under floating rate. We will sum up our discussion by noting relative strengths and weakness of fixed and flexible exchange rate regimes.

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## 8.2 FIXED EXCHANGE RATES UNDER GOLD STANDARD (1880-1914)

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From antiquity to modern times, countries operated on a *specie commodity standard*, implying the predominance of metals like gold and silver as the circulating media of the economy. Because of some particular attributes gold and also silver have been considered as the most suitable commodity money. These attributes include scarcity, durability, divisibility, homogeneity, and consistency of quality. The acceptability of these metals as money was also aided by the fact that they were widely recognised to have value in non-monetary uses (e.g. jewellery, industrial), they enjoyed relatively stable value in terms of other commodities, and their quality could be verified or certified by experts. In their purest form, specie commodity standards operated on the basis of full-bodied coins, the monetary value of which equalled the value of the metals they contained. Sovereigns themselves frequently reduced the gold (or silver) content of the coins they minted, a practice called *debasement*. Coin debasement is the predecessor of the modern devaluation of currency, usually led to a loss of coin's value. Both full-bodied and debased coins were in circulation. People generally tend to hoard fuller bodied coins for their own accumulation and used debased coins for transaction purposes. Fuller bodied

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coins could also be melted to be sold as metal, exported, or even sent to the coinage to be exchanged or coined into new, debased coins. Same face values were assigned to fuller bodied and debased coins. Debased coins were overvalued since they were assigned a higher face value than their metal contents justified. Going by this logic, fuller bodied coins were overvalued relative to the debased coins. The end product was that debased money – overvalued as a medium of exchange – would remain in circulation, while full bodied coins – undervalued as a medium of exchange – would disappear.

In the above backdrop, we have to understand the fixed exchanged rate regime as evolved through the Gold Standard. Britain operated under a gold standard for most of the nineteenth century . It was not until 1870s it achieved widespread adoption. Most European countries, led by Germany in 1871, moved toward the Gold Standard during this decade and the United States followed suit in 1879. By 1880 the Gold Standard became a full-fledged international monetary system with the adherence of major countries. For the next three decades, until its abandonment after the outbreak of World War I in 1914, the international gold standard reigned supreme and came to incorporate the major trading countries and colonial territories of the time.

### **8.2.1 Salient Features of the Gold Standard**

The Gold Standard can be characterised in terms of three basic "rules of the





game". They are as follows:

- i) A country fixed the value of its currency in terms of gold. It was done by the government setting a fixed price of the gold in terms of its own currency and intervening in the gold market (through purchase and sale) to maintain that price. This establishes a two-way convertibility between the domestic currency or coin and gold. For instance, the US set the gold price at \$20.67 per ounce and the US government was ready to buy or sell gold at this price to maintain the price of gold at that level. Gold values of any two currencies operating under the Gold Standard, specified their relative value. This relative value was referred to as *mint parity* or *mint exchange rate*. For example, the gold value in Britain was set at £4.24 per ounce. Given the US price of gold \$20.67 per ounce, the implicit relative value of the dollar in terms of the pound or the mint parity exchange rate of dollar in terms of pound was approximately \$4.87 ( $=\$20.67/£4.24$ ) per pound, which remained so during 1880-1914. Note that the mint parity exchange rate of dollar in terms of pound was an implicit exchange rate. The direct market exchange rate between dollar and pounds was decided by the interaction of demand for and supply of dollar in the British foreign exchange market. The direct rate did not deviate much from the mint parity rate due to the free flow of gold among the countries. We will now learn why this was the case.
- ii) Under pure gold standard, free trade in gold was assured. Both imports and exports of gold were free and unrestricted. This free trade in gold ensured that market exchange rates would not deviate much from the mint parity. Let us consider an example here. Suppose the US dollar-pound exchange rate is \$5.00/£, which is significantly different from the mint parity of \$4.87/£. In this case, one would purchase say an ounce of gold in the US at a cost of \$20.67 and sell it in Britain to get £4.24, and then exchange this pound

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in the British foreign exchange market to obtain \$21.20 ( $=£4.24 \times \$5.00/£$ ). Thereby, he would make a profit of \$0.53 per ounce of gold ( $=\$21.20 - \$20.67$ ) by freely buying and selling gold across countries. This process of buying and selling to take advantage of different prices in different markets is known as arbitrage, and those who engage in these transactions are known as arbitrageurs. Returning to the above example, market exchange rate would fall, as arbitrageurs tend to sell more pounds to acquire dollar in the British market. In the absence of transaction costs, market exchange rate of dollar in terms of pound would match with the dollar-pound mint parity rate. However, the transaction costs in the form of shipments of gold, prevented the market exchange rates to equate with the mint parity rate. But the market rates confined within narrow limits around mint parity rates. These limits were known as *gold points*.

- ii) The Central Bank or the monetary authority has to hold gold reserves in a direct relationship to the money notes it issues. With this provision the monetary authorities could engage smoothly in their purchases and sales of gold and would not land up in situations of not being able to fulfil sudden demand for gold on the part of the public. The gold backing provides for a certain amount of gold behind the currency issued, thereby assuring the convertibility of the currency into gold. This gold provisioning imposed some discipline on monetary expansion in the economy. The Central Bank can issue new currency only by acquiring gold from the public. The main

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source of changes in the money supply is given by the amount of gold available to domestic residents. Supply of gold can alter on account of (a) increase in gold production, some of which are sold directly to the domestic residents and the rest to the government, and (b) balance of payments surplus implying domestic residents receive gold for their net sales to the foreigners. For both (a) and (b) domestic money supply would rise. Note that the role of the Central Bank under a pure gold standard is limited to purchasing gold acquired by domestic residents and issuing notes in exchange.

### 8.2.2 Experiences with the Gold Standard Regime (1880-1914)

The Gold Standard regime of 1880 to 1914 is not a smoothly operated regime in which countries abided by the key rules of the game mentioned in the previous section. Even though major European countries and the US adopted and remained on the Gold Standard during 1880-1914, a number of other countries either abandoned the system or otherwise avoided adopting it. Some countries pegged the value of their currencies directly to sterling and held foreign exchange reserves (mostly sterling) to support their parity. Such an arrangement is known as Gold Exchange Standard. The latter was based on the convertibility of sterling into gold and the confidence the traders has in use of sterling as international means of payment. The sterling enjoyed this position due to the most influential position held by Britain in the world economy at that time.

Gold Standard regime can definitely be claimed as the fixed exchange rate regime as the countries adhering to this regime did not change their mint parities during the period and hence, there was hardly any deviation of the exchange rates of the major currencies from the respective mint parities. One

*Meaning of International Liquidity:*

The academic circles throughout the world have remained greatly concerned with the problem of international liquidity.

The problem is, by no means, of a recent origin. One of the basic factors for the breakdown of the gold standard in 1931 was the failure of the leading gold standard countries to cope effectively with the problem of international liquidity, which was created by the inadequacy of gold reserves with the debtor countries and those which had balance of payments deficit coupled with the reluctance to lend on the part of those which were strongly placed in the matter of international payments.

The pinch of the problem of inadequacy of gold and foreign exchange reserves was felt more particularly in the post-war period when the European countries launched programmes of rehabilitating and reconstructing their economies and the developing world initiated the programmes of economic development. The resultant balance of payment deficits of almost chronic character intensified the pressure of demand for the international exchange media.

The controversies about the evolution of an acceptable international system of payments became much more intense during 1950's and

1960's. No doubt, a system of Special Drawing Rights has been evolved by the IMF, yet the international economic world remains dissatisfied and the payment adjustments and availability of foreign exchange still remain as the unresolved problems.

The term 'International Liquidity' means all the financial resources and facilities that are available to the monetary authorities of individual countries for financing the deficits in their international balance of payments when all other sources of supply of foreign funds prove insufficient to ensure a balance in international payments.

In the words of Brahamanand, "The term 'International liquidity' refers to the supply of certain categories of financial assets or claims which are created by all the different countries and international financial organisations in the international community, as receptacles of calculable ready purchasing power over all the domestic currencies in vogue".

The international liquidity may be distinguished from the domestic liquidity. While the latter includes, apart from money, the time deposits, postal savings, co-operative society deposits, treasury bills, short-term bonds, the former, which refers to the various ways by which the different countries can raise their ready purchasing power over the goods of other countries without initially affecting their own trade balance, includes the official reserves, namely gold held by the central banks and treasuries of different countries.

The international liquidity, however, does not include a great deal of the financing of the international trade, viz., the vast complex of private foreign exchange holdings and bank and trade credits. The credit supplied by the international institutions like the Export-Import Bank, the World Bank, International Finance Corporation and International Development Association for the specific purposes of trade too remain excluded from the international liquidity. From the point of view of an individual country, the international liquidity has the demand and supply aspects. The demand for international liquidity arises out of demand for imported goods and services, capital outflows and unilateral transfers. The supply of liquidity concerns the sources of international liquidity.

These sources include gold mines in the country, export receipts, capital inflows and unilateral transfers. An excess of demand over supply causes depletion or shortage of international liquidity reserves. On the opposite, an excess of supply over demand would make addition to international liquidity reserves of a given country. A distinction can be made between the unconditional and conditional liquidity. The unconditional international liquidity is constituted by a country's official gold stock, its holding of foreign currencies and SDR's, its net position in the IMF and private holding of international assets. In case of all such reserves, there are no conditions or restrictions upon the user's right to borrow.

The conditional international liquidity consists of borrowed funds of a country from other countries or international lending institutions. The lenders impose certain conditions or restrictions upon the use of funds by the borrowers. The conditions may be concerning specific projects or programmes, repayment provisions and specified economic policies. The purpose for enforcing these conditions is to prevent the misuse of liquidity by the borrowing country.

In the absence of sufficient amount of international liquidity required to maintain balance of payments equilibrium, the deflation of incomes or the retention of direct controls over trade and payments will have to be resorted to. In the present day world economy, committed fully to the pursuit of full employment and high rates of economic growth, restoration of payments equilibrium through deflationary policies is unimaginable.

Similarly, taking recourse to controls and provoking retaliation from other countries, may prove to be self-offsetting. A proper solution to this problem is to supply the international economy an adequate amount of liquidity. But, unfortunately, the total gold and foreign exchange reserves with the countries other than the United States have dwindled greatly during the post-war decades. It is



actually the depletion of international reserves that has forced many countries to persist with direct controls over trade and payments.

*Aspects of International Liquidity:*

**There are three main aspects of international liquidity:**

### **1. Nature:**

The outstanding external debts of a country may be settled in three different ways.

Firstly, the debts may be liquidated through the transfers of gold or of some currency, universally acceptable and convertible to the creditor country. Throughout the latter half of the 19th century, sterling which was convertible into gold served as a universally acceptable currency, and side by side with gold, it constituted an international reserve. Since 1930's, the U.S. dollar has come to assume the predominant role in the settlement of external deficits. **Any currency which is to serve satisfactorily as a reserve currency must satisfy according to W.M. Scammel the following conditions:**

(i) It must be the currency of some great trading nation and one which may be earned easily through normal trade and whose balances carry the promise that these may be exchanged for goods both desirable in themselves and for the world demand which exists for them.

(ii) The currency must be relatively more stable than other currencies.

(iii) The currency must be supported in its home country by great and experienced banking institutions of skill and probity.

(iv) The currency must be free from recurrent scarcity.

No currency of the world strictly conforms to these criteria. In the words of Scammel, "These are exacting criteria for an international currency to conform to and it is doubtful if they were met precisely by sterling in its heyday, still less by the post-war dollar. But any currency which is a candidate for international usage must approximate to these criteria and the extent to which it conforms is likely to determine its success."

Secondly, the international payments may be made through what we may call the "accumulation facilities". In this method of debt settlement, a country accepts the payments of debts in the debtor's currency, allowing the proceeds to accumulate in the debtor country as bank deposits or short-term assets. This form of debt settlement is, however, limited by the extent to which foreign countries are prepared to accumulate the currency of the debtor country.

The main instance of it is the accumulation of sterling balances in England for the supply of war materials and services during the Second World War. Such accumulation can be liquidated in various ways. The holder of accumulations may use them to buy goods or services in the country where it has accumulated. These may be used by the holder-country in a third country, which may provide the facility of convertibility into another currency or into all currencies. Another alternative is that these may become permanently funded debts held in debtor country by the creditors. Thirdly, international debts may be settled by drawing rights upon foreign currencies. These may be in the form of foreign loans to the debtor nation or in the form of outright gifts such as those made by the United States of America under the European Recovery Programme. These may also include the drawing rights upon the International Monetary Fund which is in essence nothing more than a pool of currencies to provide additional drawing rights for member nations and thus raise the world stock of international liquidity.

### **2. Size:**

The consideration of the size of stock of international liquidity is very important, since it represents the resources whereby the existing exchange rate is maintained. The distinction must be made in this connection between the reserves which a country must hold for the purpose of dealing with balance of payments deficits, and the reserves required to sustain a high import surplus attendant upon the programme of economic development.

At present our main concern is with the payments difficulties. But still the necessity of international liquidity cannot be discussed in isolation of its requirements for development. A country which has reserves adequate only for alleviating payments difficulties, may find it difficult to cope with heavy demands of liquidity for financing economic development.

**The aggregate world reserves of international liquidity necessary for smooth operation of the world payments are contingent upon the following three factors:**

(i) the policies of leading economies, with regard to exchange rates are important. A larger world stock of international liquidity will be required under a regime of fixed exchange rates. In such a situation, even at equilibrium levels, more reserves will be required than in case of flexible exchange rates.

(ii) The policies of the leading economies with regard to the control of their levels of income and employment also help determine the optimum level of reserves. In a fully employed economy, the balance of payments deficit can be met through a deflation of income.

If the government in that country is committed to maintain a high level of income and employment, deficits must be met through drawings upon reserves. "As long as", says Scammel, "deflation as a means of balance adjustment is foresworn by the great economies, they must be prepared for recurrent calls upon national currency reserves and must accumulate reserves large enough to meet these."

(iii) The character of international trade— whether it is bilateral or multilateral, also influences the optimum size of international reserve holdings. If a mechanism of fully convertible currencies exists, the holding of a single national reserve of gold and currencies will be capable of liquidating liabilities in any country. If, on the opposite, the currencies are not convertible, a country must hold a reserve of the currency of every country (or group of countries), with which it trades and with whom it may incur a deficit.

Actually it is very difficult to estimate accurately the amount of international liquidity that a country commands. The published figures include only gold and foreign exchange in the hands of the monetary authority as the only known categories of reserves. It is not possible to assess accurately the quantum of reserves a country can draw upon in a situation of dire need.

For instance, when in the autumn of 1956 speculative pressure against sterling threatened the reserves, it was known that the British government could muster actual reserves greatly in excess of published figures of gold and dollars in the Exchange Equalization Account.

### **3. Distribution:**

The world stock of international liquidity must be ideally distributed among the countries in relation to their needs, which can be determined by the degree of fluctuation to which a country's balance of payments is subject, the volume of its trade and the requirements of its development. The present state of distribution of liquidity is by no means ideal.

The underdeveloped world is in a dire need of liquidity both for the payments adjustments and economic development. But the resources available to them are utterly inadequate as compared with the excessive stocks of liquidity held by the more developed countries.

The problem of the inadequacy of international liquidity is evident from the increasing balance of payments difficulties and poverty of the individual countries. It also fully impresses the fact that the media of international payment—gold and foreign exchange reserves—have failed to grow at a rate fast enough to meet the growing demand for them. This has been reflected in a consistently low ratio of reserves to imports for the world as a whole since the early 1950's. On an average, this ratio has been around 31.5 percent during 1970's and 1980's. It reflects an overall liquidity shortage faced by the world community.

Although the international reserves (in SDR term) have expanded to a large extent from 46 billion dollars in 1949 to SDR 2170 billion in 2009, yet both the developed and under

developed countries have continued to feel their inadequacy.

The problem of international reserves has become so acute that even the leading countries of the world today are under excessive strain. The gravity of the situation can be judged from the fact that the balance of payments compulsions forced even the United States to devalue her currency twice within a short span of 14 months between December 1971 and March 1973.

*Role of IMF in Enlarging International Liquidity:*

There is no doubt that the willingness of advanced countries to reduce their trade surpluses is the real long-term and permanent solution to the problem of international liquidity shortage. But so long as equitable trade arrangements are not made, the satisfactory short-term solution has to be evolved.

Since the IMF has been the principal source of the supply of world liquidity, it has a very vital role in resolving this problem in satisfactory manner. In order to augment the world liquidity resources, the IMF has adopted various measures from time to time.

**(i) Increase in IMF Quotas:**

With the object of facilitating greater availability of exchange reserves to the member countries, the IMF has raised the member countries' quota from time to time. Upto the close of 1988, there had been eight revisions of IMF quota. The member countries' quota which was just 3.5 billion U.S. dollars originally, had raised up to 205 billion dollars or 145 billion SDR's by the end of 1993. In the Twelfth General Review of Quota in January 2003, the maximum quota of member country was raised to SDR 213.7 billion.

In 2009, the member countries' quota stood at SDR 217 billion, out of which India's share was SDR 4.16 billion. Out of it, about 21 percent was allocated only to the United States and 44 percent to five leading advanced nations. The access to international liquidity for the rest of the world was still inadequate.

**(ii) Financial Accommodation:**

The IMF attempts to meet the short-term credit requirements of the members for the adjustment of balance of payments deficits. The member countries can borrow up to 25 percent of their quota almost automatically without any constraint. It is called as gold tranche. In subsequent years, they can borrow 25 percent of their quota each time, called as credit tranche. Such drawings are subject to progressively higher interest rates along with certain other conditions. The repayments have to be made within three to five years.

**(iii) Raising of the Limit of Borrowing under Credit Tranche:**

The borrowing limit for the member nations under the credit tranche has been gradually raised over the years. At present the members can draw up to the equivalent of 450 percent of their new quotas on the total net use of Fund's resources. The limit of borrowing is to be reviewed every year. The raising of borrowing

limit is a step in the right direction to relieve the shortage of international liquidity.

**(iv) Standby Arrangements:**

In 1952, the standby arrangements were introduced to permit member countries assurance of additional reserves in the event of need or emergency. England got the assistance under this arrangement in 1956 after Suez Crisis. The other countries too availed of these arrangements from time to time.

**(v) Swap Arrangements:**

The central banks of the Group of Ten (Group of 10 leading industrialized countries) entered into an agreement in earlier

1960's, under which they could exchange each-others' currencies and also provide short term credit to tide over their temporary balance of payments disequilibrium. Such an arrangement has the approval of the IMF but it is not directly under the purview of it.

This arrangement is very limited and cannot help relieve the liquidity shortage faced by the countries other than those included in the privileged Group of ten.

**(vi) New Credit Facilities:**

With the object of relieving the international liquidity shortage, the IMF has been expanding credit facilities since 1960's. The new credit facilities instituted by it include Compensatory Financing Facility (CFF), Buffer Stock Financing Facility (BSFF), Extended Fund Facility (EFF), Supplementary Financing Facility (SFF), Oil Facility and Trust Fund.

**(vii) Special Drawing Rights:**

A revolutionary innovation made by IMF to tackle the problem of international liquidity has been the introduction of the scheme of Special Drawing Rights (SDR's) in early 1970's. This scheme is intended to create and issue the SDR's as unconditional reserve assets.

The IMF creates SDR's at regular intervals and allocates them to the member countries on the basis of each member's quota. For this purpose, the Fund keeps a Special Drawing Account. A country can have easy access to the reserves of any currency by agreement and the intermediation of IMF.

The transfer of reserves from one member to the other up to the limit of borrowing country's quota is facilitated through book entries in the Special Drawing Accounts of the borrowing and lending countries. In all these transactions, the IMF acts like a clearing house.

Initially the Fund created SDR 9.3 billion over the three years between 1970 and 1972, allocating them to 112 participants in the SDR scheme. In 1978, the Fund decided to raise them by SDR 4 billion in each of the years 1979, 1980 and 1981. In 2009, allocation of SDR's by the IMF among the member countries stood at SDR 217 billion.

Although IMF has acted as the principal source of international liquidity creation and distribution, and it has achieved also some measure of success, yet the problem of international liquidity is still far from being resolved. The surplus countries even at present are not willing to recognise that their accumulations of large exchange reserves are the root cause of the whole problem and the solution of the problem of inadequacy of international liquidity fundamentally rests in the reduction of their surpluses.

Unless they do recognize this fact and do reduce their surpluses, the LDC's cannot get rid of their deficits and the problem of international liquidity will continue to plague the international trade relations.





The International Bank for Reconstruction and Development (IBRD) was created in 1944 to help Europe rebuild after World War II. Today, IBRD provides loans and other assistance primarily to middle income countries. IBRD is the original World Bank institution. It works closely with the rest of the World Bank Group (IBRD, IDA, IFC, and MIGA) to help developing countries reduce poverty, promote economic growth, and build prosperity. IBRD is owned by the governments of its 188 member countries.

#### Objectives of World Bank:

To provide long term capital to members countries for economic reconstruction and development.

To induce long term capital investment for assuring BOP equilibrium and balanced development of international trade

To promote capital investment in members countries by

following ways To provide guarantee on private loans or capital

investment

If capital is not available even after providing guarantee, then IBRD provides loans for productive activities on considerate conditions.

To ensure the implementation of development projects so as to bring about a smooth transference from a war time to peace economy.

#### Capital Resource of World Bank:

Initial authorized capital of World Bank was \$10,000 million, which was divided in one lakh shares of

\$ 1 each. The authorized capital of World Bank has increased \$ 24 bn to \$27 bn. Members countries repay the share of the World Bank in the following way:

I. Only 2% of allotted share are repaid in gold, US dollar or SDR.

ii. Every member country is free to repay 18% of its capital share in its own currency

iii. The remaining 80% is deposited by the member country on demand by the World Bank.

### **Functions of the World Bank:**

Presently the World Bank is playing the main role of providing loans for development works to member countries, especially to under developed countries. The bank provides loans for various development projects of 5 to 20 years duration.

i. Bank can grant loans to member's countries up to 20 % of its share in paid up capital.

ii. Bank also provides loans to private investors belonging to the members on its own guarantee, but private investors need to take permission of its native country. Bank charges 1% to 2% as service charge.

iii. The quantum of loan service, interest rate, terms and conditions are decided by the World Bank itself.

iv. Generally bank grant loans for a particular project duly submitted to the bank by the member country.

v. The debtor nation has to repay either in reserve currencies or in the currencies in which the loan was sanctioned.

### **World Bank Lending to India:**

India has been borrowing from the World Bank for various projects in the area of poverty reduction, infrastructure and rural development etc. IDA funds are one of the most concessional external loans for government of India and are largely used in the social sector projects that contribute to the achievement of the millennium development goals. The first World Bank loan to India was in 1948 of US\$ 86 bn. The debt disbursed and outstanding as on March 2011 for IBRD is US\$ 11.28 and for IDA it is US\$ 27 bn.

### **Appraisal of the World Bank Activities:**

Bank has sanctioned 75% of its loans to developing countries of AFRICA, Asia and Latin America while only 25% was given to developed nations of the Europe. But still it is believed by most of the countries that the developed countries do have good command on the governing body of World Bank because of their largest contribution to the exchequer of the bank.

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