SYLLABUS

Class: - B.B.A. VI Semester

Subject: - International Finance

Unit-I	Introduction: International Trade, Its Importance, Theories of International Trade- Theory Comparative Costs, Classical Theory, Absolute Advantage, Hecksher-Ohlin Theory, Free Trade V/S Protection-Barriers To Foreign Trade, Tariff And Non-Tariff Barriers.
Unit-II	Balance of Payment : Meaning Of BOP, Components Of BOP, Importance Of BOP, Meaning Of Deficit And Surplus, Equilibrium, Disequilibrium And Adjustments, Methods Of Correcting Disequilibrium, Accounting Principles In BOP.
Unit-III	Foreign Exchange Markets: Defining Foreign Exchange Market, Its Structure, Settlement System, Exchange Rate, Participants, Understanding SPOT And Forward Rates, Foreign Exchange Quotations, Premium And Discount In Forward Market, Cross Rates, Inverse Rates And Arbitrage.
Unit-IV	Exchange Rate Determination: Determination Under Gold Standard And Paper Standard, Factors Affecting Exchange Rates, Purchasing Power Parity Theory, Demand And Supply Theory, Equilibrium Rate Of Exchange, Fluctuating V/S Fixed Exchange Rates, Exchange Control, Objectives Of Exchange Control
Unit-V	Instruments: ADR, GDR, Euro Currencies, International Commercial Papers.
Unit-VI	International Financial Institutions: Introduction To IMF, Its Importance, Functions and Significance.

B.B.A. VI Semester **Subject: International Finance**

Unit – I

International Finance

DEFINITION OF LNTERNATIONAL TRADE
C. F. Stanlake - "International Trade is an exchange of goods and services across national boundaries".
Harrold "International Trade appears when the division of labour is pushed beyond national frontiers."
P.T. Ellsworth "International Trade is trade that crosses national boundaries"
Encyclopedia Britannica "International Trade may be defined simply as the exchange of goods and services among nations.

SIMILARITIES IN INTERNATIONAL TRADE AND INTERNAL TRADE

1. Objectives of the Trade - All trade activities are guided by the profit motive.
2. Voluntary Transactions - In both types of trade, they undertake, voluntary and free transactions.
3. Transactions of Goods- In both trade parities undertake the transaction of necessary goods which they require.
4. Two Parties - Buyer (importer) and seller (exporter) in both types of trade.
5. Similarity in nature - The basis of trade in both the cases is division of labour and specialization due to which there will be difference in production price.
6. Optional Bargain - Trade is always voluntary and optional prices.
7. Sales and Marketing Efforts - in all types of trade activities in order to have success and to attract more and more customers.
8. Common commercial Services - In all trades, common commercial services in the form of banking, insurance, communication, transportation and godown etc. are common.
9. Development of cultural and Social Relations - As the trade between different regions develops, the social and cultural relations.
10. Application of comparative cost advantages theory - In both trades.
11. Advantages to Both Parties - In both trades, both trading parties get benefit of trade.
12. Similarity in Operations - In both trades, the basic activities and operation are same.
13. Division or Labour and specialization - Both trades are based on division of labour and Specialization.

DISSIMILARITIES IN INTERNATIONAL TRADE AND INTERNAL TRADE

1. Difference in the mobility of labour and capital
2. Difference in the laws of Returns
3. Different in natural and Geographical conditions
4. Difference in monetary System
5. Difference in international Monetary Institutions
6. Difference in National Policies
7. Difference in Commercial Laws
8. Obstacles to the Import and Export of the Commodities
9. Separation of the Markets
10. Difference related to classes
11. Different Political System
12. Different Business Customs
13. Difference in Objectives
14. Different in Weighs and Measures
15. Difference in distance between buyer and seller
16. Different in Statistical Information
17. Difference in terms of Trade
18. Problems in Payments

19. Existence of trade and Exchange Control
20. Problems of Transportation
21. Different in Competition Level
22. Different Specific Problems
23. Effect on Movement of Capital

THE NECESSITY OF INTERNATIONAL TRADE

1. **ECONOMIC NEED**
   a. To Fulfill the Fundamental Necessities of the Masses
   b. To Import Necessary Technology
   c. For Accelerating the Pace of Economic Development
   d. To Take the Benefits of International Division of Labour and Specialization
   e. For Accumulating Foreign Exchange Reserve
   f. Theory of Opportunity Cost
   g. To Create Infrastructure in the Economy
   h. To take the Comparative Cost Advantages
   i. Difference in Development Level
2. **GEOGRAPHICAL NEED**
   a. Geographical Location and Natural climate
   b. Unequal Distribution of Natural Resources
   c. Natural Calamities
   d. Difference in Hunan Resources
3. **SOCIAL NEED**
   a. Materialistics Attitude
   b. Difference in Culture and Civilization
   c. Desire for Different Tastes and Varied Consumption
4. POLITICAL NEED
   a. Desire to Gain Political Power and Strength
   b. To Cater Imperialistic Interest.
   c. For Political Stability

Theories of International Trade

International trade has become an integral part of each and every economy of the world. It has been in existence since ancient times among nations. It has grown tremendously in modern times. A very pertinent question is this regard is why do nations engage in trade? Why international trade? Why a separate theory is required for international trade? What are the theoretical explanations of the reasons for and pattern of international trade. What are important bases of international trade? A number of international economist and management scholars have attempt to answer these questions and to provide theoretical explanations of the reasons and bases of international trade. A number of theories have been put forward to explain the basis of international trade. A number of theories have been put forward to explain the basis of international trade.

On this aspect, there are two views-

A. The classical view and
B. The modern or Ohlin's view

A. THE CLASSICAL VIEW

Absolute Cost Advantage Theory: Adam Smith

This theory of international trade is propounded by Adam Smith (1723-1790) father of Modern Economics. This theory is also known as free trade theory as it assumes no restriction on international trade by any country. According to this theory, the basis of international trade is absolute cost advantages. The trade between two countries will be commodity at an absolute advantage over the other country and other country produce another commodity in the same manner at an absolute advantage over the first country, then both countries would gain by in trade.

The classical economies considered the principle of division of labors as the basis of international trade.

Adam smith was the first economist who sowed the seeds of classical theory of international trade. He was a staunch advocate of free trade and a critic of protectionism. He argues that the application of the principle of division of labours to international trade is advantageous to all nations because it causes each country to specialize in those goods which it is best suited to produce most cheaply. He held that free trade between countries brings about an optimum allocation of productive resources of the world, leading to a enhancement of real income of the trading countries.

In this context, Adam Smith developed the law of absolute cost advantage, for international trade. According to him, trade occurs between two countries if one of them has an absolute advantage in producing one commodity and the other country having absolute advantage in producing some other commodity. In other words, each country specializes in the production of that commodity in which it; enjoys an absolute cost advantage and trades with other countries would result in; optimum allocation of the resources in the world and hence productivity will boost.

This can be illustrated with the help of an illustration. Suppose there are two countries, A and B and each of them can produce say two commodities wine and cloth. As per the assumptions of the classical; economists, all costs are measured only in terms of labour.

If in country A, one unit of the labors per day can produce 25 barrels of wine or 10 bales of cloth. In country b, the same amount can produce 10 barrels of wine or 15 bales of cloth.
The cost conditions in country A and B are given below –

Commodity	Production of one unit of labour per day	
	Country A	Country B
Wine	25 barrels	10 barrels
Cloth	10 bales	15 bales

A has an Evidently country A has an absolute cost advantage over country B in the production of wine (for 25 barrels are more than 10 barrels), while country B has an absolute advantage over country A in the production of Cloth (for 15 bales, are more than 10 bales).

Thus, country A will specialize in the production of wine in which it has an absolute cost advantage over country B and country B will specialize in producing cloth in which it has an absolute advantage over country A.

The trade between the two countries then will benefit both of them. As it is can be seen that with 2 units of labors, country A will now produce 50 barrels of wine and country B 30 bates of cloth as a result of specialization and international trade. In the absence of international trade, there will be only 35 barrels of wine and 25 bales of cloth produced by cloth produced by both the countries with their

Comparative Cost Advantage Theory : David Ricardo (1817)
The renowned classical economist David Ricardo agreed with the analysis of Adam Smith that international trade would be mutually beneficial if one country has absolute advantage over another in one line of production and another country in other. But Ricardo went flintier and showed that the countries can very well gain by trading even if one of the countries is having an absolute advantage in both the goods over

another, provided the extent of absolute advantage is different in the two commodities in question or the comparative advantage is greater in respect of one goods than in that of other. In other words there are comparative differences in cost. To illustrate the comparative cost advantage, Ricardo has taken the hypothetical example of production costs of wheat and cloth in England and Portugal.

Comparative Cost Advantage

Country	No of Units of Labour Per Unit of wine	No of Units of Labour Per Unit of Cloth
Portugal	80	90
England	120	100

"Each country will specialize in the production of those commodities in which it has greater comparative advantages or least comparative disadvantage."

-David Ricardo

A country will export those goods in which the comparative advantage is the maximum and it would import those goods in which its comparative disadvantage is minimum.
In fact, the doctrine of comparative costs was developed, by Ricardo out of his (classical) labours theory of value. According to this theory, the value of any commodity is determined by the labours costs. It asserts that goods are exchanged against one another according to the relative amount of labours embodied in them. The labours cost principle is however, based on the following assumptions –

Assumptions – This classical theory of international trade is based on following assumptions -

1. There are two countries.
2. There are two commodities
3. There is only one factor of production i.e. Labour.
4. Labour theory of price determination is applicable
5. Labour is homogeneous
6. Labour is perfectly mobile and dynamic within the country but static and immobile between countries.
7. The cost ratio between the two commodities is assumed to be constant since production is considered to be subject to the law of constant returns.
8. Tastes in demand and technical level and resource in supply remain unchanged.
9. There is perfect competition in both the markets.
10. There is full employment
11. There is no transportation cost.
12. There is Free Trade or there are no restrictions, barriers and hurdles in international trade.
13. There is barter economy.
14. Both countries are at equal development levels.

According to the principle of comparative costs, under free trade conditions, a country specializes in the production of a commodity in which its comparative advantage is greater or its comparative disadvantage is lesser. Each country exports a commodity in the production of which it has a greater comparative advantage or a lesser comparative disadvantage.

Suppose that there are two countries Portugal and England and that each of them can produce wine and cloth. The relative cost conditions of both these countries are given in the table below:

From the above example, we can calculate the domestic ratio of exchange between the two goods Portugal and England.

Domestic ratio or exchange in Portugal:
1 unit of wine = 0.88 units of cloth.(80/90)
1 unit of cloth = 1.13 units of wine. (90/80)

Domestic ratio of exchange in England:
1 unit of wine = 1.2 units of cloth. (120/100)
1 unit of cloth = 0.83 units of wine. (100/120)
Now let us note the comparative cost ratio of wine and cloth in the two countries.

Comparative cost ratio in Portugal:
For wine (80/120) = 0.66.
For cloth (90/100) = 0.90.

Comparative, cost ratio in England:
For wine (120/80) = 1.50.
For cloth (100/90) = 1.11.

It can be seen from the above analysis that Portugal has comparative cost advantage in production of both wine and cloth. This is because the labours cost for producing 1 unit of wine in Portugal is only 66% of the labours cost require to produce 1 unit of wine in England. Similarly Portugal incurs only 90% of the labours cost incurred by England in the production of 1 unit of cloth.

On the other hand England incurs 150% and111% of the labours cost incurred by Portugal on the production of 1 unit of wine and cloth respectively. Thus, England has a comparative disadvantage in the production of both the commodities

According to Ricardo, trade would still take place between Portugal and England because Portugal has greater comparative cost advantage (67%) in the production of wine 'while England has comparatively a lesser cost disadvantage (111%) in the production of cloth. Thus, Portugal will specialize in the production of wine and England would specialize in the production of cloth.

Gains from International Trade
The gain from trade for each country would depend upon the rate of exchange or terms of trade. As a result of specialization by Portugal in wine due to its greater comparative cost advantage and specialization by England in cloth due to its lesser comparative cost disadvantage there will be an increase in the output of both the commodities. Hence the trade between them will be beneficial to both of them gain from trade.

In no Trade situation, if each of them produces one unit of wine and one unit of cloth Portugal will use 80 + 90 = 170 hours of labors and England will use 120 + 100 = 220 hours of labours. So to produce 2 units of wine and 2 units of cloth, both the countries taken together would use 390 hours of labours (i.e., 170 + 220 = 390)
However even the after specialization Portugal will devote 170 hours of labours to produce wine only and England will devote 220 hours of labours to produce cloth only. Hence the output of wine in Portugal would be 2.125 units: and the output of cloth in England would be units. Hence the same amount of labours produces a larger amount of both the commodities after specialization.

Under the international trade, the exchange of commodities depends upon the domestic rates of exchange, namely, 1 unit of wine = 0.89 units of cloth in Portugal for 0.89 (80/90) and I unit of wine = 1.20 units of cloth in England for 1.20 (120/100).

When Portugal and England trade with each other, the actual rate of exchange or the terms of trade will lie between 0.89 and 1.20 units of English cloth for one unit of Portuguese wine. When the international trade takes place, Portugal gains, if by exporting one unit of wine it nets more than 0.89 units of cloth from England. England gains, if by exporting less than 1.2 units of cloth it gets one unit of wine from Portugal.

If, for instance, as Ricardo said, the rate of exchat.ge fixed is unit of wine for one unit of cloth, Portugal benefits because it gets one unit of cloth Portugal benefits because it gets one unit of cloth at a labours cost of 8O hours of labours which would have cost 90 hours of labours if it had produced it at home. Hence Portugal saves 10 hours of labours. It also means that Portugal gets 0.11 units of extra cloth from England for one unit of wine exported. England benefits because it gets one unit of wine for 100 hours of labours ambodied in one unit of cloth. If England had produced one unit of wine at home, it would have cost it 120 hours of labours. It also means that England gets 0.17 units of more wine to every unit of cloth exported.

Thus, this theory shows how countries tend to gain under the condition of free trade when there is international division of labours and specialization based upon the comparative cost advantage. As a, result, the world output of goods produced with a given amount of resources will be larger than without international specialization.

In this example, Portugal produces both commodities at low cost in comparison to England, so there will be no trade because of lack of absolute advantage, but comparatively production of wheat is at low cost and has comparative advantage over England (80/170 < 90/100) or she has 67% low cost and cloth 111% (100/90) high. If in England cost of cloth is 135 instead of 100 then there be no comparative advantage to any country and hence three will be no trade possible.

Thus; the theory of comparatively cost in international trade is applied and each country tends to produce not necessarily what it can produce more cheaply than another country but those commodities which it can produce at the greatest relatives advantage or at the lowest comparative costs.

Critical Evolution of the Theory:

1. It Depends on labour Theory
2. Unrealistic Assumption of Constant Cost
3. Some Static Assumptions:- Many static assumptions like fixed tastes, identical production functions between trading countries and fixed supplied of land labour and capital etc.
4. No Transport Cost Assumption
5. Assumption of Perfect Mobility Inside and Immobile Outside-
6. Not Applicable for more than two countries
7. Assumption of Full Employment
8. Assumption of Perfect Competition.
9. One Sided theory
10. Not Practicable in Defence and strategic Areas
11. Complete Specialization Not Possible
12. No Free Trade
13. In Complete, Artificial and Impracticable for Developing Nations-

The Modern Theory of Factor Endowments or the Heckseher – Ohlin Theory

Introduction

Benin Ohlin formulated the General Equilibrium or Factor Endowment or Factor Proportions Theory of International Trade. It is also known as the Modern Theory of International Trade or the Heckscher-Ohlin (H.O.,) Theory. In fact, it was Eli Heckscher, Ohlin's teacher, who first propounded the idea in 1919 that trade results from differences in factor endowments in different countries, and Ohlin carried it forward to build the modern theory of international trade.

Theory The H.O. theory states that main determinant of the pattern of production, specialization and trade among the regions availability of factor endowments and factor prices. Regions or countries have factor endowments and factor prices. "Some countries have much capital, other have much labour. The theory now says that countries that are rich in capital will export capital-intensive goods. To Ohlin, the immediate cause of international trade always is that some commodities can be bought more cheaply from other regions,, whereas in the same region their production is possible at high prices. Thus the main cause of trade between regions is the difference in prices of commodities based on relative factor endowments and factor prices.

This theory is also known as the "Factor Proportion Analyse" and the "General Equilibrium Theory". This theory was developed by two Swedish economists Eli Heckscher (1920) and his students Berlil Ohlin (1933).

The modern theory is an extensional general equilibrium theory of value. According to this theory, there are no fundamental differences but only quantitative differences between inter-regional trade and international trade. According to Ohlin

"International trade is but a special case of inter-local or inter-regional trade". Hence there is no need to have a separate theory of international trade. The immediate cause or international trade is the difference in commodity price which is due to the difference in the factor supplies in the two countries. A country produces and exports that commodity which uses more intensively the country's relatively abundant factor for production. These differences in factor supplies arise due to disparities in natural endowment and factor endowments. These resources bestowed upon a country by nature. Natural endowment include climate, whether water, rainfall, natures of soil, forest wealth and minerals. Factors endowment refers to the relative amounts of factors of production a country has i.e. land Labour and capital. A country may have more capital and less of labour and vice versa. A country may use factor of production in different combinations or proportions. This is called factor proportions or factor intensely.

A county will export that commodity which it can produce by using its abundant factor more intensely and import that commodity which it cannot produce using scarce factors intensely. On this reasoning, the differences in comparative costs or advantages can be attributed to differences in factor endowment.

Its Assumptions

Before analyzing the theory in detail, we discuss below its assumptions –

1. It is a two-by-two two countries (A and B), two commodities (X and Y), and two factors of production (capital and labour)
2. There is perfect competition in commodity as well as factor markets.
3. There is full employment of resources.
4. There are quantitative differences in factor endowments in different regions, but qualitatively they are homogeneous.
5. The production functions of the two commodities have different factor intensities, i.e. labour-intensive and capital-intensive.
6. Factor intensities are non-reversible.
7. There is perfect mobility of factors within each region but internationally they are immobile.
8. There are no transport costs.
9. There is free and unrestricted trade between the two countries.
10. There is constant return to scale in the production of each commodity in each region.
11. Tastes and preferences of consumers and their demand patterns are identical in both countries.
12. There is no change in technological knowledge.

13. There is incomplete specialization. Neither country specializes in the production of one commodity.

Its Explanation

Give these assumptions, Heckscher and Ohlin contend that the immediate cause of international trade is the difference in relative commodity price caused of differences in relative demand and supply of factor (factor prices) as a result of differences in factor endowment between the two countries. Fundamentally, the relative scarcity of factor-the shortage of supply in relation to demand is essential for trade between two regions. Commodities which use large quantities of scarce factors are imported because their prices are high while those using abundant factors are exported because their prices are low. The H.O. theorem is explained in terms of two definitions-

1. Factors abundance (or scarcity) in terms of the price criterion;
2. Factor abundance (or scarcity) in terms of the physical criterion

We discuss these on by one below –

1. Factor Abundance in terms of Factor Prices - Heckscher – Ohlin explain richness in factor endowment in terms of factor prices. According to their definition, country A is abundant in capital if (Pc/Pl)A<(Pc/Pl)B, where Pc and Pl refer to prices of capital and labour, and the subscripts A and B denotes the two countries. In other countries. In other words, if capital relatively cheap in country A, the country is abundant in capital, and if labour is relatively cheap in country B, the country is abundant in labour. Thus country A will produce and export the capital-intensive good and import the capital intensive good.
   This establishes the H.O. theorem that the capital abundant country will export he relatively cheap capital intensive commodity, and the labour abundant country will export the relatively cheap labour intensive commodity.
2. Factor Abundance in Physical Terms – Another way to explain the H.O. theorem is in physical terms of factor abundance. According to this criterion, a country is relatively capital abundant if it is endowed with a higher proportion of capital and labour, than measured in physical amounts Ca/La> Cb/Lb, where Ca and La are the total mounts of capital and labour respectively in country B.
   The H.O. theorem is physical criterion will be valid only if tastes (demand or consumption preferences) for each commodity in the two countries are identical.

Its superiority over the classical theory of international trade in many aspects

1. **International Trade A special Case –** The H.O. theory us superior to the classical theory in that it regards international trade as a special case of interregional or inter local trade as distinct from the classical theory which considers international trade totally different from domestic trade.
2. **General Equilibrium theory –** The H.O. analysis is cast within the framework of the realistic general equilibrium theory of values. It frees the classical theory from the defunct and unrealities labour theory of value.
3. **Two factors of Productions –** the H.O. model takes two factors-labour and capital as against the one factor (labour) of the classical model, and is thus superior to the latter.
4. **Differences in Factors Supplies –** The H.O. theory is superior to the RIcardian theory in that it regards differences in factors suppliers as basic for determining the pattern of international trade while the Ricardian theory takes no notices of it.
5. **Relative Prices of Factor –** The H.O. model is realistic because it is based on the relative price of goods, while the Ricardian theory consider the relative prices of good only.
6. **Relative Productivities of Factors –** H.O. theory consider differences in relative productivities of labour and capital as the basis of international trade, while the classical theory takes the productivity of labour alone. Hence the former is more realistic than the letter.
7. **Differences in Factor Endowments –** The H.O. model is based on differences in factor endowments in different countries as against the quality of one factor labour in the classical theory. Thus the

former is Superior because it lays emphasis not only on the quality but also on the quantity of factors in determining international values.

8. **Causes of Differences in Comparative Costs –** According to Samuelson, the Ricardian theory could not explain the causes of difference in comparative advantage. The merit of H.O. theory lies in explaining the same satisfactorily.
9. **Positive Theory –** The classical theory demonstrates the gains from trade between the two countries. This is related to the welfare theory. On the other hand, the H.O. model is scientific and concentrates on the basis of trade. It, thus partakes of the positive theory.
10. **Location Theory –** According to Haberler, the H.O. theory is a location theory which highlights the importance of the space factor in international trade while classical theory regards the different countries as space less markets. Thus the former theory is superior to the latter.
11. **Production function of two countries –** The H.O., theorem is explicitly based on the assumption of production functions of the two countries. On the other hand, the classical theory is based on difference in the production of the trading countries.
12. **Complete specialization –** The H.O. model realistic than classical theory in that the former leads to complete specialization in the production of one commodity by one country and of the other commodity by the second country when they enter into trade with each other. By contrast, the trade between countries may not lead to incomplete specialization in the classical theory.
13. **Future of Trade –** According to Lancaster, the H.O. theory is superior to the classical theory because it refers to the future of trade. In the classical theory, difference in comparative costs between two countries is due to difference in the efficiency of labour. If, in future, labour becomes equally efficient in both the countries, there will be no trade between them. But in the H.O. theory trade will not cease even if labour becomes equally efficient in the two countries because the basic of trade in factor endowments and process.

Critical Evaluation of Modern Theory –

1. It takes into consideration all the cost not only the labour cost and not only the labour cost as in classical theory.
2. This theory introduced the economics of large scale production and claimed that these economies created an additional basis for international trade.
3. The classical economists felt the need of a separate and distinct theory of international trade while Ohlin was of the opinion that there was no need of a separate theory. The difference between the two was one of the degrees not of kind.
4. Modern theory of emphasis the differences in factor endowments.
5. The classical theory does not explain why there are differences in comparative cost but modern theory is able to do so.
6. The classical theory is unrealistic where as modern theory is realistic.

Short Comings or Criticism of Modern Theory:

1. It is Based on wrong and Over Simplified Assumptions So It is Unrealistic
2. It Only Provides a Partial Equilibrium.
3. It fails to Explain Leontief Paradox
4. Highly Static in Nature
5. Commodity Prices Determine Factors Prices
6. Trade with Identical Factor
7. Trade Possible in differential products.
8. Production Function not identical
9. No International: Immobility of Factors
10. Homogeneity of the Productive Factors
11. It Ignores Factor Reversal

UNIT- II
BALANCE OF PAYMENTS
Equilibrium, Disequilibrium in BOP

EQUILIBRIUM, DISEQUIBRIUM& ADJUSTMENT IN B.O.P

Equilibrium in balance of payments

The Balance of payment of a country is said to be in equilibrium when the receipt from the rest of the world is equal to the payment to the rest of the world. In such a case, the demand for foreign exchange is exactly equal to the supply of it.

Disequilibrium in balance of payments

The Balance of payment of a country is said to be in disequilibrium when the receipt from the rest of the world is not equal the payment to the rest of the world. In such a case, the demand for foreign exchange is also not equal to the supply of it.

Disequilibrium in balance of payments

- Deficit B.O.P (Receipt < Payments)
- Surplus B.O.P (Receipt > Payments)

1. **Deficit B.O.P –** There will be a deficit in the balance of payments when the receipt from the rest of the world falls below the payment to the rest of the world. Therefore, demand for foreign exchange exceeds its supply
2. **Surplus B.O.P –** There will be a surplus in the balance of payments when the receipt from the rest of the world exceeds the payment to the rest of the world. Therefore, supply for foreign exchange exceeds its demand.
3. **Deficit is bad than surplus –** It is very seldom that there is perfect equilibrium in the country's balance of payments. It is either in de 9cit or in surplus. The surplus disequilibrium is not as bad as the deficit disequilibrium. The reason is that the burden of bringing about adjustment in the balance of payments falls more heavily on the deficit than on the surplus countries.
4. **Current A/c d is balanced through capital A/C –** In economic sense a country is either in deficit or surplus in accounts of balance of payments. The deficit or surplus in the current account is met by transfers in the account. In other words, practically the balance of payment is made to balance through the capital account. Suppose there is deficit in the current account of the balance of payments. This deficit can be covered by –
   a. Drawing upon the country's foreign exchange reserve
   b. By borrowing from foreign countries
   c. By IMF grants or
   d. By exporting gold.

Types of disequilibrium in balance of payments

- STRUCTURAL DISEQUILIBRIUM
- CYCLICAL DISEQUILIBRIUM
- SECULAR DISEQUILIBRIUM

All these three are briefly explained here: —

a. **Structural Disequilibrium —**If the disequilibrium is caused due to fundamental changes in the demand and supply of import and export is called structural disequilibrium. The causes of these changes are as follows —
   1. Changes in Pattern of Production - If the pattern of production changes, naturally these will demand and supply of imports and exports.
   2. Changes in the Pattern of Demand — Due of change in the income and living standard there will no drastic changes in the pattern of demand and it will create disequilibrium
   3. Changes in Terms of Trade — if terms if trade changes, it will cause ell her positively or adversely the equilibrium of balance of payment.
   4. Institutional Changes – Due to changes in the commercial set up of the country and changes in the commercial policy will also give birth to disequilibria.
   5. Changes in Pattern of Trade — If the pattern of trade or the composition of imports and exports chances, it will cause imbalance.
   6. Changes in Long Term Capital Flow — The fluctuations occurred in the long term capital flow of entry will contribute to imbalance in the balance of payment.
   7. **Loss of Capital —** Due to natural calamities like earthquake floods, famines or due to political .et, if there is loss of capital and production this will adversely affect the balance of payment.

b. **Cyclical or Monetary Disequilibrium --**These types of imbalances occur due to operation of cycles in the economy under cyclical disequilibrium, if prices rise in prosperity and decline in depression, a country with a price elasticity for imports greater than unity will experience a tendency for a decline in the value of imports in prosperity, while those for which import price elasticity is less than will experience a tendency for increase. In these types of imbalances under developed countries suffer both from low prices in depression which hurt exports and from high income in prosperity which give rise to heavy imports. These cyclical disequilibrium occurs due to following reasons :
   1. Charge in General Price Level
   2. Change in Monetary Income
   3. Change in Exchange Rate

c. **Secular Disequilibrium:** It is also cared as long term disequilibrium. They occur because of long run and drastic changes in an economy. From a traditional society to the precondition of take off. In initial stages of development domestic investment exceeds domestic savings and imports exceed exports. Imbalance arises owing to lack of sufficient funds to finance excess imports. It may result due to capital outflow falls short of surplus savings. The major causes of long term or secular disequilibrium are the long run changes in following —
   1. Capital Formation
   2. Enhancement of level of Industrialization
   3. Technological Changes or Advancement of Techniques
   4. Increase in Population
   5. Changes in the Available Resources
   6. Changes in Organizational Setup
   7. Expansion of the Market

CAUSES OF DISEQUILIBRIUM IN BALANCE OF PAYMENT

There are a number of causes of disequilibrium in the balance of payment. These various causes may be broadly classified under four heads.

A. Natural Factors
B. Economic Factors
C. Political Factors
D. Social Factors

A. Natural Factors - Natural calamities such as roods, famines, earthquakes may easily cause disequilibrium in the balance of payment by adversely affecting agricultural and industrial production in the country. The exports will decline and imports will go up causing a discrepancy in the country's balance of payment.

B. Economic Factors — There are several economic factors which may cause disequilibrium. Various economic factors many cause development disequilibrium, cyclical disequilibrium, secular disequilibrium and structural disequilibrium.. Other important economic factors are enumerated below –

1. Huge Development Program — For developing countries, they resort to process of economic planning for their development, which needs huge resources in the forms of capital machinery and raw materials and the major par t of it is being imported.
2. High Growth in Imports — Due to several reasons like more population, develops planning, many countries have high growth rate of imports and this will cause disequilibrium.
3. Slow Growth in Exports — These countries have very low growth of export due to highly traditional items of exports which have highly inelastic demand in foreign countries.
4. Lack of Proper Use of Foreign Exchange Reserve — Many countries due to improper and underutilization of their foreign exchange reserve face disequilibrium.
5. Increasing Burden of Payments of Foreign Debt — Due to highly international indebtedness many countries continuously under the pressure of payment of their foreign loans and due their high debt service burden they face disequilibrium.
6. Rising Inflation — Due to rising inflation, exports will decline resulting in disequilibrium.
7. Capital Movement — The large scale capital movement will also cause disequilibrium in the balance of payment of a country.
8. Weak Terms of Trade — Due to weak terms of trade, many countries face adversity and disequilibrium.
9. Increasing Deficit Financing-- Due to paucity of capital, many countries resort to deficit financing and in order to control the abuses of deficit financing they resort to borrow more foreign capital that will result into disequilibrium.
10. Increasing Protectionism in Developed Countries — Highly developed countries resort to severe protectionist measures against developing nations like imposition of 301, 302 and 303 by USA against India and China.
11. Lack of Import Substitutions —Due to lack of import substitution in the developing countries and the discovery of new substitutes of exports and development of alternative sources of supply by developed countries, there will be disequilibrium in the balance of payment.
12. Decline in Foreign Aid -- The developed countries are not inclined to support developing countries in their process of development and the trend of international trade has declined from 1 % of their GNP to below 0.25%. This situation also has led to disequilibrium
13. Increase in Population -- In many countries population has grown with high rate of growth that has also resulted into disequilibrium.
14. Enhanced Defence and Security Expenditure — Due to tremendous increase in defense and security expenditures many countries are facing disequilibrium
15. Bad Effects of Smuggling — Due to high tariff structure, there is problem of smuggling and it also causes disequilibrium.
16. High Cost of Democratic Setup — Developing countries incur huge expenses in maintaining their democratic setup. The politician and diplomats incur tremendously, the dear foreign exchange on their foreign visits and foreign offices.
17. Increasing Expenses on Social Security — Die to increasing expenses on social security also, many countries have been facing disequilibrium.

C. **Political Factors -** The political factors may also cause serious disequilibrium in the country's balance of payments. For example, the existence of political instability may result in disrupting the entire production system of the country which may cause decline in exports and increase in imports. Likewise the payment of war reparations or indemnities. The imposition of heavy war reparation on Germany after I world war produced a serious disequilibrium in its balance of payment. Outbreak of vim; or changes in the world trade routes will also cause disequilibrium.

D. **Social Factors -** Many social factors also affect disequilibrium. For example, changes in tastes preferences and fashions. Operation of demonstration effects may also cause disequilibrium.

CORRECTION OF BALANCE OF PAYMENT DISEQUILIBRIUM

There are various measures available to eliminate the disequilibrium in the balance of payments. They may be classified broadly into two broad sub-heads, namely,

1. Automatic Measures and
2. Deliberate Measures

Automatic Measures

- Under this, the classical view of the "Automatic Adjustment Mechanism" is employed. This worked well under the "Gold Standard. It may be adopted in paper currency standard also.
- The theory of automatic correction is that if the market forces of demand and supply are allowed to have free play, in course of time equilibrium will be automatically restore (For example, in case of deficit in balance of payment, the demand for foreign exchange exceeds its supply and this result in an increase in the exchange rnte and a fall in the external value of home currency. This makes the exports of the country cheaper and imports dearer than the before. Consequently, the increase in exports and fall in imports restore the balance of payment equilibrium. The balance of payment disequilibrium may be corrected by adjustments in price income and capital flows.
- The automatic measures do not produce the desired result in the short period. They are also not effective in dealing with serious and fundamental disequilibrium in the balance of payments. Therefore a country should resort to certain deliberate measures of bring about an improvement in the balance of payments.

Deliberate Measures

As the name suggests, deliberate measures refer to correction of disequilibrium by means of certain steps taken purposefully and deliberately with this objective in view.

The various deliberate measures may be broadly categorized into three subheads —

A. Monetary Measures
B. Non-Monetary Trade Measures
C. Miscellaneous Measures

A. Monetary Measures - The important monetary measures are explained below:

1. Monetary Contraction - A country can resort to this policy of monetary contraction to remove the disequilibrium in the balance of payment. It will reduce the purchasing power, aggregate demand and domestic prices and increase in exports. Thus, fall in imports and rise in export will help to correct the disequilibrium.
2. Policy of Devaluation — By decreasing the value of domestic currency in terms of other foreign currencies will help the country increase export and curb import. This will help in correcting the disequilibrium.
3. Foreign Exchange Control — In modern time, almost all countries of the world resort to various forms of exchange control for their benefits. Under this, the government assumes complete control over the foreign exchange reserves and earnings of the country.
4. Check on Inflation - In order to contro rising domestic prices in the country, there should be rigid-control on inflation so that export should grow.
5. Adopting Policy of Deflation — By deflating the currency a country tries to reduce cost and prices. This policy will stimulate exports and check imports thus correcting disequilibrium.

B. **Non-Monetary or Trade Measures -** Trade measures nave two aspects –

a. Exports Promotion and
b. Imports Control

I) Exports Promotion – There is no alternative to promote export in order to rectify the adversity in balance of payment. Exports may be encouraged by

a. Abolition or reduction of export du ties.
b. Providing more export incentives and facilities of exporters.
c. Extending export subsidies to export industries.

II) Imports Control — Import may be controlled by following ways:

a. By imposing or enhancing import duties
b. By restricting imports through import quotas (Unilateral, Bilateral and Global Quota System) licensing.
c. By prohibition of import-- This is an extreme measure under which the government completely prohibits the import of certain goods which are considered to be non-essential from the national point Of view.

C. Miscellaneous Measures — In addition to monetary and non-monetary measures mentioned above, there are a number of other measures that can help in making the balance of payments position more favorable. Some of them are discussed below

I) Foreign Loans — In order to reduce the deficit in balance of payment, government can also secure loan from foreign countries, banks and international organizations like IMF, World Bank and others.

II) Encouragement to Foreign Investment —All steps should be taken to encourage foreign investment and capital. The government induces foreigners particularly the foreign institutional investors (FLLs) to make investment in the country offering them all sorts of incentives and concessions. This will improve the position of balance of payment.

III) Incentives to Foreign Tourists — The government should provide all types of incentives to foreign tourists to visit the country in large numbers through development of tourism. The country could earn huge foreign exchange and that will be helpful in correcting disequilibrium.

IV) Incentives to Enhance Inward Remittances—Government should provide better incentives to their emigrants or Mils living abroad to remit more and more to their country for solving the problems of balance Of payments.

V) Postponement of Debt Payments - For temporary relief, a country can enter into agreement with its counterpart lending country to postpone the payment of debt.

VI) Effective Check on Smuggling - Government should curb smuggling and save foreign exchange. This will also help in correcting disequilibrium.

B.B.A. VI Semester **Subject: International Finance**

UNIT – III

FOREIGN EXCHANGE RATES, EXCHANGE FLUCTUATIONS & OBTAINING FORWARD COVER

Foreign Exchange: Meaning -
Foreign exchange is the mechanism by which the currency of one country gets converted into the currency of another

In the sense of rate of exchange – According to this sense, foreign exchange refers the rate of exchange or the rate at which the currency of one country is converted into the currency of another country. In other words, the external value of domestic currency is the rate of exchange.

FERA/FEMA defines the term "Foreign exchange means foreign currency and includes –

1) All deposits, credits and balances payable in any foreign currency and any drafts, traveler cheque, letters of credit and bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency.
2) Any instrument payable at the option of the drawer or holder thereof or any other party thereto, either in Indian currency or in foreign currency or partly in one and partly in the other. Thus, foreign exchange includes foreign currencies, balances kept abroad and instruments payable in foreign currency with the help of which countries of the world clear off their international obligations.

Problems of Foreign Exchanges –

1) Existence of different currencies with different values
2) Disequilibrium in demand and supply of currencies
3) Lack of stability in exchange rates
4) Problem of the methods of international payments
5) Problem of the methods of international payments
6) Problem of transfer of payments
7) Problems of determination of rate of exchange
8) Problems of restrictions imposed by countries

Causes of Exchange Rate Fluctuations –

1) ***Changes in the demand and supply of foreign exchange*** – The changes in demand and supply of foreign exchange influence the balance of payment of a country in short-term and it also affects the aggregate volume of capital movement. These changes in demand and supply will either increase or decrease the rate depending upon the changes in the supply and demand of foreign exchange.
2) ***State of International Trade*** – The state of international trade of a country or changes in the volume of imports and exports will also affect the rate. If there is adversity in trade and it increases further, this deficit in trade will adversely affect the rate and vice versa in case of a favorable trade balance.
3) ***Monetary Policy*** – Monetary policy particularly the regulation of money supply and frequent changes in money supply will affect the fluctuation in rate of exchange.
4) ***Speculative Activities*** – These activities substantially affect the exchange rate as under speculative activities the exchange rate is highly fluctuated.
5) ***Capital Movement*** – External borrowing assistance and aid and other financial foreign investment will affect the exchange rate.

6) ***Activities of Middlemen and Brokers*** – These activities are carried out to dispose off securities by buying in cheaper market and selling in the expensive and costlier security markets to earn profit by the brokers and these activities affect the demand and supply of foreign exchange, it naturally affects exchange rate.

7) ***Industrial Factors*** – In case of industrial development, there is more investment of foreign capital and rate will be favourably affected and vice versa.

8) ***Currency Conditions*** – The currency conditions also deeply affect the rate of exchange.

    a. *Inflation* – Due to decrease in purchasing power, the rate turns against the country.

    b. *Deflation* – Due to deflation, there will be more foreign capital into the country and the rates will turn in favour of the country.

    c. *Devaluation* – The policy of devaluation will also affect the rate as it will affect the import, export and capital movement.

9) ***Political Conditions*** – There are several political factors which also affect the rate, like political stability in the country. The position of peace or war or national security problems, need heavy expenses on defence etc.

10) ***Fiscal and other economic policies*** – If government is adopting deficit fiscal policy, it will enhance inflation and rate will be adversely affected.

11) ***Policy of protection*** – In case of extending protection to domestic industries for promoting export and substituting imports in the long run, there will be positive effect on exchange rate.

12) ***Exchange Control*** – A country will like to stabilize the rate through various measures of exchange controls. These controls invariably affect exchange rate.

13) ***Capital Market and Stock Exchange Condition*** – The rate is also influenced by various transactions performed at stock exchanges or capital market. As it is well-known various type of securities like shares, stocks, debentures, bonds are bought and sold everyday on the stock exchanges and they affect the demand and supply of foreign exchange.

14) ***Banking Condition*** – Many factors related with banking also influence the rate like;

    a. Bank rate of the central bank

    b. Arbitrage operations

    c. Sale and purchase of bills, instruments and traveler cheques etc.

    d. Issuing of credit instruments

15) ***National Income*** – Increase in national income will lead to an increase in investment, production and consumption and accordingly these it will have effect on the exchange rate.

16) ***Resources Discoveries*** – When there are discoveries of resources that will help those countries to rise in their value of exchange rate. A good example is the "Petrol-dollar" in many gulf countries due to "oil".

17) ***Psychological Factors*** – It has powerful influence on exchange rates sometimes aggravating the trend set by other factors. The bull (Purchasing heavily expecting a rise in price) and bear (selling heavily expecting a fall in price) operations are the example of psychological factors.

18) ***Technical and Market Factors*** – There are huge isolated transactions in the market and seasonal variations in the demand and supply. These factors may upset the balance of demand and supply of foreign exchange.

19) ***Other Factors and Conditions*** – There are several other factors like aid, gift, amount of compensation and many other transfer payments which also affect the rate.

Foreign Exchange Rates (Meaning and types) –

Foreign exchange rate refers to the rate at which the currency of one country can be converted into the currency of another country, the rate of exchange, thus, indicates the exchange ratio between the currencies of two countries, for example, if one US$ is equal to forty Indian Rupees. What this implies that one US$ can fetch forty rupees in the exchange market.

Dealings in foreign exchange market are carried out at specified rate or price of a unit of one currency in terms of other currency. It could be regarded as an external value of domestic currency in terms of other foreign currencies. Simply the rate is parity between two currencies. The rate at which one currency buys exchanges for another currency is known as foreign exchange rate. The rate of exchange is expressed in foreign exchange market in two ways-

i) Expressing the rate in terms of domestic currency. By taking the one unit of foreign currency we take the value of domestic currency. For example, one US dollar is equal to forty Indian rupees. This is also called as direct rate
Direct method US$ 1 = Rs. 40.00
ii) Expressing the rate of exchange in terms of foreign currency or indirect rate method – In this method, the home currency unit is kept constant and foreign currency unit is varied. The rate is stated to be quoted in the indirect method. For example Indirect Method – Rs. 100 = $2.50.

Types of foreign exchange rates –

There are several types of foreign exchange rates. The important types are as follows –

1) ***Normal rate and actual rate*** – Normal or true rate or par of exchange rate is determined by forces that are of different nature from those influencing the actual rate. Normal rate may be fixed through exchange control while the actual rate or current rate or market rate is determined by the market forces of demand and supply of foreign exchange. This actual rate fluctuates from day to day due to changes in demand and supply but these changes take place around the rate which is called normal rate. The actual rate may be above or below the normal rate. For example, if the normal rate of Re and $ is 40:1 the actual rate may be 42:1 or 33:1.
2) ***Spot rate and forward rate*** – The spot rate refers to that rate of exchange at which the delivery of foreign exchange is made to the buyer by the seller at the spot or delivery of currency bought or sold is immediate. Forward rates are those quoted for forward or future delivery of currency, the rate off exchange is fixed at the time of deal but actual delivery is affected at contacted future date at this rate. The forward rate is quoted either at premium or at a discount over the spot rate. This rate is calculated by making an allowance of premium or discount or in other words, forward margin is adjusted.
3) ***Single rate and multiple rates*** – In general circumstances, there is only one single rate for all purposes. But in certain special circumstances, a country may adopt more than one, two or three rates with another currency. This is known as the multiple exchange rate system. For example, the government of a country adopts one rate for export and another for imports.
4) ***Direct rate and indirect rate*** – From the point of view of expressing the quotation in the foreign exchange market, the rate could be direct and indirect. Under direct rate, the foreign currency unit is kept constant and the home currency is varied, the rate is said to be quoted in direct method. While in indirect method of quotation, the home currency unit is kept constant and foreign currency unit is varied, the rate is called indirect. For example: Direct rate US$ 1 = Rs. 40/-   Indirect rate Rs. 100 = $2.50.

5) ***Buying rate and selling rate*** – As the foreign market is very lucrative and competitive market, the parties engaged in this business, naturally desire to earn maximum profit. The dealers will quote the rates of foreign currencies in two ways. They will give low rate when they will buy foreign currency and change high rates in case of sale of foreign exchange. These buying and selling rates are quoted on the basis of T.T., M.T. or bills.
6) ***Favourable Rate and Unfavourable Rate*** – The rate of exchange can either be favourable or unfavourable to a country. It the external value of the domestic currency increased in terms of the foreign currency, there will be favourable rate and vice-versa.
7) ***Official and Unofficial exchange Rates*** – When the International trade and other transactions are carried on the basis of pre-determined and authorized rates, these rates are called official rates and if the transactions are executed on the basis of other rates, they are called unauthorized and unofficial rates. These rates are also termed as Black Market rates.
8) ***Fixed and Flexible Exchange Rates*** – The fixed rates of exchange refer to maintenance of external value of the currency at a pre-determined level that is fixed by the country. Whenever the rate differs from this level, it is corrected through official intervention. After the collapse of gold standard, IMP was instituted under article IV of IMP fixed exchange rates system was adopted and member countries adopted this system and agreed not to change these rates except in consultation with the fund. This system was abolished in 1978 with the amendment in the article of IMF, still the fixed rates continue in many countries in the form of pegging their currencies to a major currency. The world economy now has been living in an era of flexible or floating exchange rates. Currencies outside their home countries have lost the character of money and have become more like commodities.
   The flexible free or floating rates refer to the system where the exchange rates are determined by the conditions of market forces viz the demand and supply of foreign exchange in the market. The rates are free to fluctuate according to the changes in demand and supply forces with no restrictions on buying and selling of foreign currencies in the exchange market.

Advantages/Arguments in Favour of Flexible or Floating Rate –
1) Independent monetary policy
2) Adjustment of Balance of Payments
3) It does not Affect International Trade Adversely
4) It enables to have natural rate
5) Protection from shocks of inflation
6) It does not adversely affect investment
7) Easy in Operation
8) Indicator of real economic position
9) Control on speculation

Exchange rate adjustment –

The Indian rupee is linked to a basket of important currencies of the country's major trading partners. The major objective of exchange rate policy is to adjust exchange rates in such way as to promote the competitiveness of Indian exports in the world market. Adjustments in the external value of the rupee are therefore made from time to time.

The Reserve Bank of India effected an exchange rate adjustment on 1 July, 1991 in which the value of the rupee declined by about 7 to 9 percent against the major currencies (the pound sterling, the US dollar, the deutsche mark, the French franc and the yen). There was another exchange rate adjustment on 3 July, 1991 in which the value of the rupee declined by about 10 to 11 percent against the major currencies. Between 28 June and 3 July, 1991, the rupee depreciated by about 8 percent vis-à-vis the basket of 5 currencies while this, basket appreciated vis-à-vis the rupee by about 23 percent. These adjustments had been necessitated by the growing external and internal imbalances in the economy. The balance of payments situation had become very critical and that was reflected in the sharp drawdown on, and low level of, foreign exchange reserves. Since October, 1990 there has been an appreciation in the relatively high rate of inflation in the country and a much slower rate of depreciation in the nominal exchange rate leading to erosion in the international competitiveness of the economy. It was equally necessary to curb destabilizing market expectations which were generated by perceptions of a growing misalignment of the exchange rate. It is expected that these exchange rate adjustments will stop further deterioration in the country's balance of payments in the short run and improve it in the medium term by improving the trade balance.

The primary objective of the exchange rate adjustment is one of strengthening the viability of external payments position, i.e., to ensure that exchange rate movements maintain a reasonable incentive for export promotion and encourages efficient import substitution activities, and at the same time, to stem the flight of capital from Indian and discourage flow of remittances from abroad through illegal channels. In the immediate short run, exchange rate adjustment is expected to facilitate realization of outstanding export receipts the accelerate, in general, the inflow of remittances by quelling de-stabilizing market expectations. Downward adjustment in the exchange rate raises the relative price of traded goods (by increasing the domestic price of foreign currency) to non-traded (or home) goods, thereby encouraging production of tradable while discouraging their consumption. This expenditure-switching effect at a macro level results in correcting the imbalances in the trade and current account.

Many of India's trade competitors made substantial exchange rate adjustments over the past few years. China and Indonesia, for instance, depreciated their currencies against the US dollar more than India did despite their lower inflation. Over the period end-December 1980 to end-December 1989, China depreciated by 68 per cent and Indonesia by 65 percent while India depreciated by only 53 percent against US dollar, whereas the increase in consumer prices in China and Indonesia were lower at 100 percent, and respectively, against India's 114 percent over the same period.

Between October 1990 and March 1991 the REER of the rupee appreciated by about per cent as a result of a much slower rate of depreciation in the nominal exchange rate (2.4 per cent against the major five currencies over the same period) and the widening inflation differentials as the country's domestic inflation accelerated after October 1990. Further, in the five month period between February 1991 and Jun 1991, the nominal effective exchange rates of rupee decreased only by 2.5 percent while the inflation differentials continued to widen. All this resulted in an erosion of India's international competitiveness.

To restore the competitiveness of our exports and to bring about a reduction in trade and current account deficits, a downward adjustment of the rupee had become inevitable. The Reserve Bank of India effected the exchange rate adjustment in two steps in early July 1991. The timing of the exchange rate adjustment was necessitated by the need to nullify adverse expectations and restore international confidence. On the other hand, the magnitude of the adjustment was predicted on the need to restore competitiveness of the country vis-à-vis her competitors in trade. On July 1, 1991 the value of the rupee declined by 8 to 9 per cent against the major currencies (pound sterling, the US dollar, the deutsche mark, the yen and then French franc). On July 3, 1991, the value of the rupee was further lowered by 10 to 11 percent against the major currencies.

In determining the extent of adjustment, the relevant factors were differentials in the price levels between Indian and her major trading partners; the extent of real depreciation of the currencies of competitors; the degree of correction required in our balance of payments; and market expectations. Taking all these factors into account the magnitude of downward adjustment in external value of the rupee by about 23 percent was appropriate.

A basic requirement for the success of this policy is that relative price change should bring forth requisite change in production and consumption patterns. Exchange rate depreciation could lead to an improvement of the current account only if export volumes rise and/or import volumes fall sufficiently to outweigh the price effect. Besides, lags in such response to exchange rate changes are also to be reckoned with. There is the well known "J curve" effect of the improvement in balance of trade occurring after an initial deterioration. However, following the stringent monetary restrictions on imports, the expected deterioration of trade deficit did not happen. The trade deficit during the first six months of the financial year 1991-92 contracted significantly.

INTERNATIONAL CAPITAL MARKET

The subject of foreign exchange is, in the words of H.E. Evitt, "… that section of economics science which deals with the means and methods by which rights to wealth in one country's currency are converted into rights to wealth in terms of another country's currency." As the further observes, it "involves the investigation of the method by which the currency of one country is exchanged for that another, the causes which render such exchange necessary, the forms which such exchange may take, and the ratios or equivalent values at which such exchanges are affected."

There are different interpretations of the terms foreign exchange, of which the following two are most important and common:

1) Foreign exchange is the system or process of converting one national currency into another, and of transferring money from one country to another (Dr. Paul Einzig).
2) Secondly, the term foreign exchange is used to refer to foreign currencies. For example, the Foreign Exchange Regulation Act, 1973 (FERA) defines foreign exchange as foreign currency and includes all deposits, letters of credits and bills of exchange, expressed or drawn in Indian currency, but payable in any foreign currency.

Functions of International Capital Market –
The foreign exchange market is a market in which foreign exchange transaction take place. In other words, it is a market in which national currencies are bought and sold against one another.

A foreign exchange market performs three important functions:

Transfer of Purchasing Power: The primary function of a foreign exchange market is the transfer of purchasing power from one country to another and from one currency to another. The international clearing function performed by foreign exchange markets plays a very important role in facilitating international trade and capital movements.

Provision of Credit: The credit function performed by foreign exchange markets also plays a very important role in the growth of foreign trade, for international trade depends to a great extent on credit facilities. Exporters may get pre-shipment and post-shipment credit. Credit facilities are available also for importers. The Euro-dollar market has emerged as a major international credit market.

Provision of Hedging Facilities: The other important function of the foreign exchange market is to provide hedging facilities. Hedging refers to covering of export risks, and it provides a mechanism to exporters and importer to guard themselves against losses arising from fluctuations in exchange rates.

Dealings on the Foreign Exchange Market –
A very brief account of certain important types of transactions conducted in the foreign exchange market is given below –

- ***Spot and Forward Exchanges:*** The term spot exchange refers to the class of foreign exchange transaction which requires the immediate delivery, or exchange of currencies on the spot. In practice, the settlement takes place within two days in most markets. The rate of exchange effective for the spot transaction is known as the spot rate and the market for such transactions is known as the spot market.

The forward transaction is an agreement between two parties, requiring the delivery at some specified future date of a specified amount of foreign currency by one of the parties, against payment in domestic currency by the other party, at the price agreed upon in the contract. The rate of exchange applicable to the forward contrat is called the forward exchange rate and the market for forward transactions is known as the forward market.

The foreign exchange regulations of various countries, generally, regulate the forward exchange transactions with a view to curbing speculations in the foreign exchanges market. In India, for example, commercial banks are permitted to offer forward cover only with respect to genuine export and import transactions.

Forward exchange facilities, obviously, are of immense help to exporters and importers as they can cover the risks arising out of exchange rate fluctuations by entering into an appropriate forward exchange contract.

- ***Forward Exchange Rate***: With reference to its relationship with the spot rate, the forward rate may be at par, discount or premium.
    - At par: If the forward exchange rate quoted is exactly equivalent to the spot rate at the time of making the contract, the forward exchange rate is said to be at par.
    - At Premium: The forward rate for currency, say the dollar, is said to be at a premium with respect to the spot rate when one dollar buys more units of another currency, say rupee, in the forward than in the spot market. The premium is usually expressed as a percentage deviation from the spot rate on a per annum basis.
    - At Discount: The forward rate for a currency, say the dollar, is said to be at discount with respect to the spot rate when one dollar buys fewer rupees in the forward than in the spot market. The discount is also usually expressed as a percentage deviation from the spot rate on a per annum basis

- ***Futures***: While a futures contract is similar to a forward contract, there are several differences between them. While a forward contract is tailor-made for the client by his international bank, a futures contract has standardized features – the contract size and maturity dates are standardized. Futures can be traded only on an organized exchange and they are traded competitively. Margins are not required in respect of a forward contract but margins are required of all participants in the futures market – an initial margin must be depositied into a collateral account to establish a futures position.

- ***Options***: While the forward or futures contract protects the purchaser of the contract from the adverse exchange rate movements, it eliminates the possibility of gaining a windfall profit from favorable exchange rate movements. For example, if an Indian exporter has forward contract to sell his future dollar receipts at $1 = Rs 48, he is protected against the risk of a depreciation of the dollar by the time he receives the payment (for example, $1 = Rs. 46). However, the forward contract prevents him from gaining the profit of possible appreciation of the dollar (say, $1 = Rs. 50). Currency options are designed to overcome this problem.

  An option is a contract or financial instrument that gives the holder the right, but not the obligation, to sell or buy a given quantity of an asset at a specified price at a specified future date. An option to buy the underlying asset is known as a call option, and an option to sell the underlying asset is known as a put option. Buying or selling the underlying asset via the option is known as exercising the option. The stated price paid (or received) is known as the exercise or striking price. The buyer of an option is known as the long and the seller of an option is known as the writer of the option, or the short. The price for the option is known as premium.

- ***Swap Operation***: Commercial banks who conduct forward exchange business may resort to a swap operation to adjust their fund position. The term swap means simultaneous sale of spot currency for the forward purchase of the same currency or the purchase of spot for the forward sale of the same currency. The spot is swapped against forward. Operations consisting of a simultaneous sale or purchase of spot currency accompanied by a purchase or sale, respectively, of the same currency for forward delivery, are technically known as swaps or double deals, as the spot currency is swapped against forward.
- ***Arbitrage***: Arbitrage is the simultaneous buying and selling of foreign currencies with the intention of making profits from the differences between the exchange rate prevailing at the same time in different markets.

  For illustration, assume that the rate of exchange in London is £1 = $2 while is New York £1 = $2.10. This presents a situation where in one can purchase one pound sterling in London for two dollar and earn a profit of $0.10 by selling the pound sterling in New York for $2.10. This situation would, hence, lead to an increase in demand for sterling in London and consequently, an increase in the supply of sterling in New York. Such operation, i.e., arbitrage, could result in equalizing the exchange rates in different markets (in our example London and New York).
  Arbitrage in foreign currencies is possible because of the case and speed of modern means of communication between commercial centers throughout the world. Thus, an operator in New York might buy dollars in Amsterdam and sell them a few minutes later in London.
  The effect of arbitrage, as has already been mentioned, is to iron out differences in the rates of exchange of currencies in different centers, thereby creating, theoretically speaking, a single-world market in foreign exchange.

UNIT - IV

OBJECTIVE OF EXCHANGE CONTROL

In many countries of the world exchange control is regarded as a necessary evil. There are several objectives in practising exchange controls. The main objects of foreign exchange control may be stated as follows:

1. Conservation of Foreign Exchange :

Exchange control may be introduced by the monetary authority to conserve the gold, bullion, foreign exchange currencies, etc., i.e., foreign exchange resources, of the country. It may be necessary to ensure the availability of sufficient amount of foreign exchange needed to buy essential foreign goods.

2. Check on Flight of Capita:

Under the free exchange system there is the danger of huge outflow of capital which may weaken the country's economy. Especially erratic shifting of capital tend to accentuate the disequilibrium in the balance of payments and it also adversely affects future growth of the country. Exchange control, however, offers a prompt and effective means to prevent such capital outflows.

3. Correcting Disequilibrium in Balance of Payments:

To correct the deficit in the balance of payments, the country needs to put a curb on imports. For this purpose, the use of Foreign exchange earnings by exporters for import of goods must be checked through appropriate exchange control. Again, exchange control is essential to implement an import policy very effectively. In short, exchange control may be introduced to protect the country's balance of payments.

4. Stabilisation of Exchange Rates:

In a free exchange market, exchange rate is a fluctuating phenomenon. Thus, exchange control may be adopted to maintain exchange rates at an arbitrarily chosen fixed point.

5 . Protecting the Interest of Home Producers:

Exchange control may be used for giving protection to domestic producers by restricting the competition from foreign traders through import control.

6 . Redemption of External Debt:

The Government may use the exchange control device to obtain foreign exchange needed for repaying or servicing of its foreign loans.

7 . Effective Economic Planning:

For successful economic planning, foreign trade has to be coordinated with planned programmes and the outflow of capital should be restricted in order to make it available to domestic industries. Thus, for mitigating the economic repercussions of foreign trade endangering economic plans, exchange control becomes inevitable.

8 . Maintaining Over-value of Home Currency:

Sometimes exchange control is used in order to maintain the external value of the country's currency at an overvalued level. For this purpose, the available foreign exchange resources are rationed for use of specific and important purposes only and the government thereby, seeks to adjust total demand with total supply of foreign currencies.

9 . Generating Public Revenue:

Under exchange control, by adopting multiple exchange rates system, the Government can yield revenue income through difference of average buying and selling rates, less costs of administration.

10 . To prevent Spread of Depression:

Depression in a big country may spread from country to country via international economic relations. Exchange control may work as a preventive against such spread of depression by controlling the main doors - imports and exports

PROCEDURE FOR EXCHANGE CONTROL

- For purposes of exchange control, Government designates a central control agency, usually the central bank to function as the actual buyer and seller of foreign exchange on government account.

- Under the most comprehensive form of exchange control, exporters and other recipients of foreign exchange are not free to dispose of their foreign exchange earning in any manner they like.
- They are required to surrender all their foreign exchange for local currency. To ensure against evasion, export licences, which certify the delivery of foreign exchange to the exporters, must be presented to customs officials before shipment is permitted.
- This is how the government secures its supply of foreign exchange. The central bank or control agency is in a position to ration its supply of foreign exchange for any uses that may be found desirable.
- In allocating foreign exchange to various buyers (importers), the central bank takes into account the needs of the country. Relatively liberal rations of exchange will be allowed for the import of only those goods which are essential to the functioning of the economy, such as basic foodstuffs, raw materials, capital goods etc. while the control agency can flatly refuse to release exchange for luxury goods or non-essential commodities.
- It should be noted that all systems of exchange control are not necessarily so rigorous. If the balance of payments pressure is not severe, controls may involve no more than general supervision of applications received for foreign exchange.
- There are two ways of regulating exchange rates: (i) The monetary authorities undertake to buy and sell foreign exchange in unlimited amounts at the official exchange rates. People are free to buy any amount of foreign exchange for any purpose. The purpose of such type of exchange control is to avoid fluctuations in the exchange rate and stabilise it.
- The difference between the demand for and the supply of foreign exchange at fixed exchange rates at different times is adjusted by variations in the foreign exchange reserves of the central bank.
- The Exchange Equalisation Account established in April 1932 in the U.K., and the Exchange Stabilisation Fund instituted in January 1934 in U.S.A. provide examples of this method of exchange control, (ii) Another method of exchange control restricts the freedom of the people to buy foreign exchange. Under this type of control, there is a rationing of foreign exchange, and allocation is made among the importers for specific purposes only. It is the most drastic method usually employed for achieving various purposes as we have seen above.

Free Exchange Market :

When exchange control is not very rigid, together with exchange restrictions adopted by the government, a free exchange market is also allowed to operate to a limited extent.

Often the central bank releases, in addition to the official exchange in the country, a certain amount of exchange to maintain a free exchange market. All exchange earnings drawn from certain exports may be allowed to go into the free market, where they are sold to the highest bidder.

Exchange rates in the free market are invariably higher than the official rate, for the obvious reason that foreign exchange supply is less than the demand in the free market. Moreover, the exchange control agency may desire the free market rate to be higher than the official exchange rate by a certain percentage, so that importers disqualified for official exchange have to pay a premium.

It is obvious that, when exchange control exists, there is generally a black market in foreign exchange and various methods of evading the control. Foreign currencies or drafts payable in foreign currencies may be smuggled into the country

Causes of Exchange Rate Fluctuations –

20) ***Changes in the demand and supply of foreign exchange*** – The changes in demand and supply of foreign exchange influence the balance of payment of a country in short-term and it also affects the aggregate volume of capital movement. These changes in demand and supply will either increase or decrease the rate depending upon the changes in the supply and demand of foreign exchange.

21) ***State of International Trade*** – The state of international trade of a country or changes in the volume of imports and exports will also affect the rate. If there is adversity in trade and it increases further, this deficit in trade will adversely affect the rate and vice versa in case of a favorable trade balance.
22) ***Monetary Policy*** – Monetary policy particularly the regulation of money supply and frequent changes in money supply will affect the fluctuation in rate of exchange.
23) ***Speculative Activities*** – These activities substantially affect the exchange rate as under speculative activities the exchange rate is highly fluctuated.
24) ***Capital Movement*** – External borrowing assistance and aid and other financial foreign investment will affect the exchange rate.
25) ***Activities of Middlemen and Brokers*** – These activities are carried out to dispose off securities by buying in cheaper market and selling in the expensive and costlier security markets to earn profit by the brokers and these activities affect the demand and supply of foreign exchange, it naturally affects exchange rate.
26) ***Industrial Factors*** – In case of industrial development, there is more investment of foreign capital and rate will be favourably affected and vice versa.
27) ***Currency Conditions*** – The currency conditions also deeply affect the rate of exchange.
    a. *Inflation* – Due to decrease in purchasing power, the rate turns against the country.
    b. *Deflation* – Due to deflation, there will be more foreign capital into the country and the rates will turn in favour of the country.
    c. *Devaluation* – The policy of devaluation will also affect the rate as it will affect the import, export and capital movement.
28) ***Political Conditions*** – There are several political factors which also affect the rate, like political stability in the country. The position of peace or war or national security problems, need heavy expenses on defence etc.
29) ***Fiscal and other economic policies*** – If government is adopting deficit fiscal policy, it will enhance inflation and rate will be adversely affected.
30) ***Policy of protection*** – In case of extending protection to domestic industries for promoting export and substituting imports in the long run, there will be positive effect on exchange rate.
31) ***Exchange Control*** – A country will like to stabilize the rate through various measures of exchange controls. These controls invariably affect exchange rate.
32) ***Capital Market and Stock Exchange Condition*** – The rate is also influenced by various transactions performed at stock exchanges or capital market. As it is well-known various type of securities like shares, stocks, debentures, bonds are bought and sold everyday on the stock exchanges and they affect the demand and supply of foreign exchange.
33) ***Banking Condition*** – Many factors related with banking also influence the rate like;
    a. Bank rate of the central bank
    b. Arbitrage operations
    c. Sale and purchase of bills, instruments and traveler cheques etc.
    d. Issuing of credit instruments
34) ***National Income*** – Increase in national income will lead to an increase in investment, production and consumption and accordingly these it will have effect on the exchange rate.
35) ***Resources Discoveries*** – When there are discoveries of resources that will help those countries to rise in their value of exchange rate. A good example is the "Petrol-dollar" in many gulf countries due to "oil".
36) ***Psychological Factors*** – It has powerful influence on exchange rates sometimes aggravating the trend set by other factors. The bull (Purchasing heavily expecting a rise in price) and bear (selling heavily expecting a fall in price) operations are the example of psychological factors.
37) ***Technical and Market Factors*** – There are huge isolated transactions in the market and seasonal variations in the demand and supply. These factors may upset the balance of demand and supply of foreign exchange.

38) ***Other Factors and Conditions*** – There are several other factors like aid, gift, amount of compensation and many other transfer payments which also affect the rate.

UNIT - VI

INTERNATIONAL MONETARY FUND (IMF)

Introduction: -

Even before the Second World War came to an end, monetary experts in USA and UK Started thinking over the monetary problems likely to be faced after the war. Two different plans were chalked out, one by Mr. Keynes an American author and the other by Mr. White-a British author, and were named after them as Keynes Plan and White, Plan. The two sets of proposals were subjected to intensive discussion and served as the basis for the Bretton woods conference.

A landmark in the history of would economic co-opeation is the creation of the IMF. The birth of the fund lies in the breakdown of the gold standard. With the end of the gold standard in the thirties, all countries realized the need for international co-operation in economic affairs, as veritable chaos had resulted in the system of foreign exchange rates and international trade after the end of the gold standard. In short, international trade & investments passed through the worst period in the thirties. It was then recognized that the monetary disorder of the world could be corrected only by mutual agreement between nations having international economic relations. The formation of IMF was decided in the Bretton Woods Agreement, embodying a working mechanism for the smooth settlement of international payments in order to achieve the objectives. The IMF itself was organized in 1946, and commenced operations in March, 1947.

The International Monetary Fund was establishing held on 27th December, 1945 but it actually started operations from 1st March, 1947 and the first transactions were made in May, 1947. The funds of the IMF are subscribed to by the member countries. Each member country subscribes to the Fund as per its quota fixed by the IMF at the time it's joining the Fund 25% of the quota or 10 percent of the members holding of gold and U.S. dollar, whichever is less, is subscribed to gold and the remainder in national currency. Now, the system of depositing gold as a part of its subscription has been discontinued and the accounts of IMF are kept in SDR (Special Drawing Rights) .

The Fund has 146 member countries, accounting for about 80 per cent of the total world production and 90 per cent of the total world trade. Russia is a member of the fund.

Key IMF activities

The IMF supports its membership by providing

- policy advice to governments and central banks based on analysis of economic trends and cross-country experiences;
- research, statistics, forecasts, and analysis based on tracking of global, regional, and individual economies and markets;
- loans to help countries overcome economic difficulties;
- concessional loans to help fight poverty in developing countries; and
- Technical assistance and training to help countries improve the management of their economies.

Objectives of the IMF

1) To promote international monetary co-operation through a permanent institution which provides machinery for consultation and collaboration on international monetary co-operation.
2) To facilitate the expansion of balanced growth of international trade, and to contribute for the promotion of the productive resources of all members as the primary objectives of economic policy.
3) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
4) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade?

5) To lend confidence to members by making the fund's resources available to them under adequate safeguards thus providing them with opportunity to correct maladjustments in their BOP without resorting to measure destruction of national or international prosperity.

Function of IMF

1) It functions as a short term credit institution.
2) It provides machinery for the orderly adjustment of exchange rates.
3) It is reservoir of the currencies of all the members countries, for which a borrower nation can borrow the currency of other nation.
4) It grants loans for financing current transactions only and not capital transactions.
5) It tries to provide for an orderly adjustment of exchange rates, which will improve the long term BOP position of the member countries.
6) It also provides a machinery for international consultations.

The IMF & India –

- Till recently, India's official economic policy during the planning era has been to assign a commanding position to the public sector in the mixed economy, with a view to preventing the concentration of economic power in the hands of few private sectors & to check the inflow of foreign capital as well as imports in order to provide protection to the domestic industries.
- Indian industrial strategy has always remained dependent on foreign capital inflows. This is because India has never made any serious efforts in developing indigenous technologies.
- Whenever India experienced a FOREX Crisis, these international authorities tried their best to dilute Indian industrial and trade policies.
- In 1966, for instance, when India had a severe BOP deficit the World Bank insisted on a degree of imports liberalization for its financial support for BOP adjustments.
- In the 70s and onwards, India had to change her economic policies quite often. Most of such changes were towards the process of liberalization, attributed to the IMF pressure.
- In 1991, When India was confronted by a severe FOREX and financial crisis, the IMF & World Bank came to its rescue not with sympathy but to fulfill their long cherished objective.
- India was forced to accept all the conditions of IMF for such assistances.
- India was asked to globalize its economy very rapidly with an open door policy of free trade.
- The country had to change the planning strategy & to redesign it on market friendly approach.
- Under the zeal of globalization of the Indian economy less attention was paid to its age old problems of poverty, inequality & chronic unemployment.

WORLD BANK OR IBRD

The International Bank for Reconstruction and Development (popularly known as World Bank) was set up as a result of the decision taken in Bretton woods Conference, New Hampshire. The conference was held in July 1944 and attended by 44 nations. It decided to set up two organizations the IMF and the IBRD to solve the monetary and financial problems of the less developed countries likely to be faced in post-World War II period. The IMF (International Monetary Fund) has already been discussed in question **2.4.** In this question, we shall discuss the other organization IBRD (International Bank for Reconstruction and Development).

International Bank for Reconstructions and Development (IBRD)

The IBRD or World Bank was set up on December 27, 1945 when their article of agreement was signed by 29 Governments in Washington D.C. On 30th June 1983, 144 countries were its members. **The Principal purposes** as set forth in its articles of agreement (charter) are as follows-

(i) **to assist in the reconstruction and development of its member countries by facilitating** the investment of capital for productive purposes, thereby promoting long range growth of international trade and improvements in standard of living;

(ii) **to promote private foreign investment** by guarantees of, and participation in, loans and other investments made by private investors; and

(iii) when private capital is not available on reasonable terms **to make loans for productive purposes** out of its own resources or the funds borrowed by it.

Activities. In order to achieve these purpose, the charter authorizes the world Bank to engage in the following financing activities-

(i) It may **lend funds directly,** either from its capital funds or from the funds it borrows in private investment markets.

(ii) It may **guarantee loans** advanced by others or it may participate in such loans.

(iii) **Loans may be advanced to member countries** directly or to any of their political subdivisions or to private business or agricultural enterprises in the territories of members.

In its efforts to make loans for developmental purposes, the World Bank has provided loans to the developing countries for developmental projects and programmes because credit rating of many developing countries is poor hence they feel difficulties in raising funds in international capital markets. The World Bank, therefore, is vital source to the developing countries, when the member Government, in whose territory the project is located, is not the borrower, the World Bank asks the member Government for a guarantee.

The Bank's subscribed capital as on 30th June, 1983 was $ 52 billion (SDR 39.41 billion).

Some basic provisions of Bank loan.

Some characteristics of Bank loans are-

(i) They are meant for high priority productive purposes mainly to develop the infrastructure for the development such as generation and distribution of electric power, rail, roads, ports and inland waterways, airlines and airports etc.

(ii) They must be used to meet only the foreign exchange component of the projects.

(iii) The interest rate of the Bank is somewhat lower but related to market rate. The lending rate of the Bank is calculated by adding 0.5 percentage points to the cost of lending to the Bank during the preceding six months of pool outstanding borrowings made since July, 1, 1982. On July, 1, 1982, the bank adopted a policy of resetting its lending rates half-yearly. At that time, the lending rate was every half year. The rate has been used at 8.50 per cent from January 1, 1986 for the half year ending on 30-6-1986. This is seventh consecutive revision since July 1, 1982.

(ii) They are not tied.

There are **two subsidiaries of the World Bank:**

(1) International Development Association (IDA)

Considering the need for structuring the economy of less developed countries, the World Bank set up the International Development Association (IDA) in 1960. It is an aiding centre for several developing countries who look up to it for financial assistance. As such countries (mainly countries of South Asia and Africa) have low domestic resources and on the other hand are not in a position to pay high rate of interest and short maturity periods. The IDA offers credit to the eligible developing countries on extremely favourable terms.

IDA interest-free credits are available to Governments only and may be obtained on payments of nominal service charges at 0.75% per annum. The period of repayment is 40 years, excluding 10 years for initial grace period.

IDA and India. India has been the largest beneficiary from IDA. Since its inception India's share is 40% of IDA funds. India got aid from IDA $ 578 M (current) during Third Plan, which was tripled to about $ 1,556 m (current) during the Fourth Plan. It touched a new height of nearly $ 5,581 m (current) during the Fifth Plan.

(2) **International Finance Corporation (IFC).** It is also an affiliate of the World Bank and was set up in 1956. It extends credits to private business enterprises. "It provides equity and loan capital for private enterprises in association with private investors and management, encourages the development of local capital market and stimulates the international form of private capital.

The project, for which the corporation advances assistance, must satisfy the following conditions-

(i) It should have the prospects of earning profits.
(ii) It should boost the economy of the best country.
(iii) Local investors should be able to participate in the project in the beginning of the project or later.
(iv) The requires funds for the project are not available from private investors at reasonable terms.
(v) The management should be capable and experienced.
(vi) The sponsor of the project has a substantial holding in the enterprise.