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PAPER - XII

MONEY, BANKING, INTERNATIONAL TRADE AND INSTITUTIONS

Lesson (1-20)

CONTENT

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SYLLABUS

Money, Banking International Trade and Institutions

Money - Functions - Role of Money - Circular Flow of Money Evolution. Monetary Systems - Gold Standards - Bi-mentalist and Paper Currency. Commercial Banks -Types - Functions - Employment of funds - Banking systems Type of deposit - Customer service in commercial banks - Banking legislation and Reforms, Cheques and bill of exchange - Crossing of cheques - Endorsement - Payment of customer cheque - Marking of cheque - Protection given to a paying ba.1ker - Refusal for payment - Collection of Cheques - Protection to collecting banker - Collecting banker and presentation for acceptance.

Study of India's Foreign trade - Its Distribution and Growth - Foreign Trade Policy and Practice - Export Promotion.

Foreign Exchange - Balance of Payment and Exchange Control -Licensing Procedure.

Export Promotion - Incentives and Subsidies - State Trading - Theory of Foreign trade.

International Institutions - International Monetary Fund (IMF) - IBRD Asian Development Bank.

SUGGESTED READINGS

K.P.M. Sundaram:	Money Banking and International Trade.
Man Mohan Singh:	Indian's Export Trends
G.M. Meir:	International Trade and Development
Crowther:	An Online of Money
M.Radhaswamy and S.V.Vasudevan	Text Book of Banking,
Dosai, Vasanth:	Indian Banking - Nature and Problems

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LESSON 01

MONEY

OBJECTIVES

After studying the lesson, you should be able

- to understand the Barter system
- to know the evolution of money and kinds of money.

STRUCTURE

1.1 Introduction

1.2 Barter system

1.3 Difficulties of Barter

1.4 The evolution of money

1.5 Kinds of money

Summary

1.1 INTRODUCTION

Very broadly 'money' can be stated as a medium of exchange choosen by common consent, It can be any commodity, but is generally accepted in payment for goods or services received or is settlement of Debt. Eg., you can buy books (goods) or pay the Doctor for his services or repay a lean I received from a friend (settlement of Debt) with money.

There has been no unanimity, on the part of economists in defining money. Different definitions of money have been given by different economists, each concerning the different aspects of money. According to Sir John Hicks “Money is defined by its functions: any thing is money which is used as money; “money is what money does.” According to Scilovsky, “Money is a difficult concept to define. Partly because it fulfils not one but three functions, each of them providing a criterion of moneyness. Those of a unit of account, a medium of exchange and a store of value.” The above definition's highlights the functional aspects of money. Some attempt to define money in terms of its general acceptability; like that of D.H. Robertson, according to whom money in “anything which is widely accepted in payment for goods, or in discharge of other kinds of business obligations.” According to seligmen, “one thing that possesses general acceptability.” is money. This is to circumvent the legal definition of money according to which "anything which the state declares as money is money." There are occations when people refuse to accept the legal money for exchange of goods and in other cases accept other things which are not legally defined as money, like cheques, commercial bank notes etc.

The concept of money as drill as, money used in its present form had under gone wide change over its earlier ones. No sooner man started civilised life the need for exchange was felt and he started following the barter system.

1.2 THE BARTER SYSTEM

Before the evolution of money, the various material needs of mankind was obtained on the basis of direct exchange of goods and services. This was known as the barter, system India have to make payments to exports in England. The Indian importers can buy titles of English money from Indian exporters and make payments to England exporters. Similarly the English importers can buy titles to Indian exporters. Thus, in every country, there are buyers of foreign money (or titles to it) and the sellers of foreign money and supply of other words, there is demand for foreign money and supply of foreign money. Demand for, and supply of foreign money determine the rate at which foreign money can be purchased (or home currency sold) and sold (or home currency purchased) These buyers and sellers collectively constitute the foreign exchange market.

This is, however, a very simplifies statement of the theory. In the actual world, exporters and importers do not directly deal with one another. The banks (exchange banks or other banks who also deal in exchange) serve as middleman. Importers buy titles of foreign money from banks and exporters sell titles to foreign money to banks. The banks make a profit by acting as intermediaries between the two.

1.3 DIFFICULTIES OF BARTER

The barter system has the following basic difficulties, which led to the evolution of money.

1. Lack of Double Coincidence of Wants: The functioning of the barter system requires a double coincidence of wants on the part of those who want to exchange goods or services. It is necessary for a person who wishes to trade his good or service to find some other person who is not only willing to buy his goods or service, but also possesses those goods which the former wants. For example, a person possesses a horse and wants to exchange it for a cow. In the barter system he has to find out a person who not only possesses a cow but also wants a horse. The existence of such a double coincidence of wants is a remote probability. For, it is a very laborious and time consuming process to find out persons who want each other's goods, often the horse-owner would have to carry through a number of intermediary transactions. He might have to trade his horse for some sheep, sheep for some goods and goats for the cow he wants. To be successful, the barter system involves multilateral transactions which are not possible practically. Consequently, if the double coincidence of want is not matched exactly, no trade is possible under barter. As a matter of fact, it might be stated that only the lack of double coincidence of wants and mutual willingness to exchange goods or services that led to the evolution of money as medium of exchange.

2. Lack of a Common Measure of Value: Another difficulty under the barter system relates to the lack of a common unit in which the value of goods and services could be measured. Even if two persons who want each other's goods meet by coincidence, the problem arises as to the preparation in which the two goods should be exchanged. There being no common measure of value, the rate of exchange might be fixed arbitrarily or according to the intensity of demand for each other's goods. Consequently, one party is likely to be always at a disadvantage in terms of trade between the two goods or the rate at which the two goods are exchanged.

Moreover, under a barter system the value of each good is required to be stated in as many quantities as there are types and qualities of other goods and services. In the words of Culbertson, "In a barter system, prices of goods are quoted in terms of other goods. Thus excluding the price of each good in terms of itself (which is always unity) a system with 'n' goods, has n x (n- 1) barter prices." For example, it there are 100 different types and qualities of goods and services in the barter economy, the value of each would have to be stated in terms of 99 others. Thus these 100 different goods and services would require as many as 4,950 exchange rates, for the barter economy to operate smoothly. In other words in a barter economy with 'n' number of goods the number of exchange rates required would be equal to $\frac{n(n-1)}{2}$.

The lack of a common unit in a barter economy makes accounting an impossibility because a balance sheet would consist of a long physical inventory of the various types and qualities of goods owned and owed. Similarly, it is difficult to draw and interpret the profit and loss accounts of even a small shop. That is why the existence of the barter system is associated with a small and primitive society and was confined to a local market.

3. Indivisibility of Certain Goods: The barter system is based on the exchange of goods with other goods. It is difficult to fix exchange rates for certain goods which are indivisible.

Such indivisible goods pose a real problem under barter. A person may desire a horse and the other a sheep and both may be willing to trade. The former may demand more than four sheep for a horse but the other is not prepared to give five sheep and thus there is no exchange. If a sheep had been divisible, a payment off our and a half sheep for a horse might have been mutually satisfactory. Similarly, if the man with the horse wants only two sheep, then how will he exchange his horse for two sheep. As it is not possible to divide his horse, no trade will be possible between the two persons. Thus indivisibility of certain goods makes the barter system inoperative.

4. Difficulty as Storing Value: Under the barter system it is difficult to store value. Anyone wanting to save real capital over a long period would be faced with the difficulty that during the intervening period the stored commodity may become obsolete or deteriorate in value. As people traded in cattle, grairs, and other such perishable commodities, it was very expensive to store and rear impossibility to prevent their deterioration and loss over the long period. For example there was an interesting story of a musician giving a concert for which he was rewarded with an elephant and 10 cows. Though elated at the beginning he found to his dismay later, that he had to give many concerns in order to get food to feed the herd he was presented with and keep them alive.

5. Difficulty in Making Deferred Payments: In a barter economy it is difficult to make payments in the future. As payments are made in goods and services, debt contracts are not possible due to disagreements on the part of the two parties on the following grounds. (1) It would often invite controversy as to the quality of the goods or services to be repaid. (2) The two parties would often be unable to agree on the specific commodity to be used for repayment. (3) Both parties would run the risk that the commodity to be repaid would increase or decrease in value over the duration of the contract. For example, if a transaction is entered into to repay in wheat after, say, 6 months time, wheat might rise markedly in value in terms of other commodities, to the debtor's regret, or decrease markedly in value, to the creditor's regret after the said six months. Thus it is not possible to make payments involving future contracts under the barter system, without running the risk of loss either by the debtor or the creditor.

6. Lack of Specialisation: Another difficulty of the barter system is that it is associated with a production system where each person is a jack-of-all trades. In other words, a high degree of Specialisation is difficult to achieve under the barter system. Specialisation and interdependence in production is only possible in an expanded market system based on the money economy. As remarked by coulborn, "Barter is only tolerable, that too only in very simple circumstance. But as soon as division of labour develops to a considerable extent, money becomes necessary to facilitate exchange."

The above mentioned difficulties of barter have led to the evolution of money. As rightly summed up by Halm, “it is next to impossible that all wishes of bartering individuals should coincide as to the kind, quantity and value of the things which are mutually desired especially in a modern economy in which on a single day millions of persons may exchange millions of commodities are services.”

1.4 THE EVOLUTION OF MONEY

The origin of money is lost in antiquity. Even the primitive man had some sort of money. The type of money in every age depended on the nature of its livelihood. In a hunting society, the skins of wild animals were used as money. The pastoral society used livestock whereas the agricultural society used grains and food stuffs as money.

The Romans used cattle and salt as money at different times. It is from these two words that the word "pecuniary" relating to money is derived from the Latin word "pecudes" for cattle; and the word "salary" is derived from the Latin word "salarium" which meant salt-money.

Certain Indian tribes on the American convinent used workpun, a beaded belt of sea shells, as money. Squissel skins were used as currency in Mongolia. Stones, shells, spears, iron, fish-hooks and many other articles have also served as basic money in various parts of the world in place of direct barter of goods. So the first siege in the evolution of money is the use of commodities as money.

The Evolution of Money Could be Traced in the Following Manner.

***Commodity Money*:** In the earliest period of human civilisation, money commonly used was commodity money. Any commodity that was generally demanded was chosen by common concert as a medium of exchange. Earlier the commodities chosen as money were commonly-consumed articles such as rice, wheat, tobacco, cattle etc. However, in many cases, the commodity chosen to serve as money depended upon such factors as location of the community, climate and cultural and economic development. For instance, communities living by the sea-share chose shells as medium of exchange; in cold countries, skins and furs were commonly used as money; and in tropical countries, elephant tusks, plumage of birds and tiger teeth served as money.

***Metallic Money*:** With progress of civilisation and economic advancement of people, metals came to be the most suitable as money. Metals which served as money were gold, silver, copper, etc. From the beginning, the kings, everywhere and retained the right to issue coins often with their own image and to certify to their weight and quality. Money advantages were available under the system of coingage. Coins were convenient to be used as media of exchange. They were issued in different denominations and hence were useful for all types of transactions. They were divisible into small units. They were homogeneous and their value was certain because of the king's seal impressed upon them. They could be easily handled and stored. But there had always been one difficulty about coins, viz., tampering with coins practised by governments and dishonest businessmen and traders.

***Paper Money*:** The next stage in the evolution of money was the introduction of paper money. Paper money originally came as receipts given against metallic money often gold and given in printed paper. It was found inconvenient as well as dangerous to carry gold or silver coins from place to place and European merchants adopted the practice of carrying paper showing their title to metallic money, which they had kept with famous goldsmiths for safe custody. At first, paper money was simply a substitute for metallic money. Currency notes bose the legend."On demand I promise to pay the bearer the sum of..." equivalent to the gold value and were signed by the issuing authority. Then the system of monopoly note issue by only one bank, viz., The central bank of the country came into vogue. In the 20th century, currency notes ceased to be representative, in character since their convertibility into gold and silver was slowly given up. At present, a very large, part of legally accepted money consists mainly of currency notes or paper money issued by the central bank of the Government, not necessarily backed up by gold or silver.

Credit Money: Almost side by side with paper money, credit money emerged. Credit money, also known as bank money, refers to bank deposits kept by people with banks which they can withdraw at any time they like or transfer to someone else, through an instrument known as the cheque. The cheque itself is not money but it performs the same functions as money as for instance, payment for purchases. Hence the bank cheque is considered as credit money or near money. Most large transactions now-a-days are financed through cheques and only small transactions are managed through currency notes.

Thus in the evolution of money , commodity money replaced barter in the first instance but it gave place to metallic money which in turn was replaced by paper currency. Now-a-days cheques and bank drafts are used increasingly. For larger transactions, while paper money is used for. smaller transactions.

1.5 KINDS OF MONEY

If we ask any educated middle-class person how much money he has, he may mention that he holds a certain amount of cash and a certain account he has in a bank in the form of a deposit. There are thus two types of money.

a) Common money or current money consisting of coins of different metals and paper currency notes of the central bank of the country, and

b) Bank money, consisting of bank balances or bank deposits which can be with drawn by the depositor at any time he likes.

The common money is used for all types of transactions, by all persons and are backed by the Government of the country.

Bank money i.e. bank deposits is generally used for large transactions but has no backing by the Government.

Metallic Coins: Metallic money referred to earlier denotes coins made of metals such as gold, silver, copper, etc. Metallic money was of two types; Full-bodied coins and token coins.

Full-bodied or natural coins were those coins whose face value that is, the value marked on them was equal to their intrinsic, value on the value of the metal out of which the coins were made. These full-bodied coins generally served as the standard coins, and the values of all other coins were fixed with reference to the standard coins. Token coins, on the other hand, were those coins whose face value was far more than their intrinsic value. They were generally of lower denominations and were mostly made of silver and base metals like copper, nickel or bronze. The token coins were intrinsically of far lower value but got their value because of their relation to or connection with the standard full-bodied coins.

Paper Money: Paper money is of two types representative paper money and Fiat money. The representative paper money was converted generally allowed to be standard full bodied money on request. The value of such paper money was dependent on the value of the standard coin (gold or silver) in to which the paper currency note was convertible. The representative paper money was also called as credit money, i.e. promise-to-pay-money. It pre-supposed the existence of another form of basic or common money into which could be redeemed. The present-day currency note is not representative paper money, as it is not convertible. Fiat money is money by command (Fiat means "let it be done"). For example If the Indian Government authorises that a piece of paper be called Rs.10 or Rs.100 and also if it does not promise to redeem it or convert it into other forms of money, it is termed as fiat money. Fiat money is backed by *legal tender* power which means that, the said currency is enforced by law. The debtor is authorised by law to offer it in payment of his debt. In present days most of the countries follow the issues of fiat money issuing method.

Legal Tender Money: Legal tender money is money which is backed by law and refusal to accept it as a medium of payment will be punishable by the state. Legal tender money is of two types: limited legal tender money and full or unlimited legal tender money. Limited legal tender money is one which has to be accepted as legal tender only up to a certain limited amount. For instant in India, one and two paise coins have only limited legal tender; one can refuse to accept them if offered beyond the prescribed limit. Unlimited legal tender money is one which has to be accepted as a mode of payment up to any amount. The rupee in India is an example of unlimited legal tender money.

Optional Money: Optional money refers to those forms of money which need not necessarily be accepted in the discharge, of debts, but which are generally accepted chiefly due to its convenience. Bank cheques and bank drafts are examples of optional money. A creditor need not accept a cheque from a debtor in discharge of a debt. Technically speaking, optional, money is not proper, as it does not carry with it the essential characteristic of general acceptability.

SUMMARY

In the evolution of money, commodity money replaced barter in the first instance but it gave place to metallic money, which in turn was replaced by paper currency. Today, cheques and drafts are used increasingly for larger transaction while paper money is used for smaller transaction.

KEYWORDS

- Conversely
- Diverge
- Prosperity
- Remittance

REVIEW QUESTIONS

1. State the difficulties of Barter system
2. Briefly explain the evolution of money.
3. What are the various kinds of money? Explain.

SUGGESTED READINGS

1. K.P.M. Sundaram - Money Banking and International Trade
2. Crowthev - An Online of Money

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LESSON 2

FUNCTIONS AND SIGNIFICANCE OF MONEY

OBJECTIVES

After reading this lesson, you should be able

- To know the primary and secondary function of money.
- To understand the Balance of payments.
- To know about money in a socialist economy.

STRUCTURE

2.1 Introduction

2.2 Primary function

2.3 Secondary function

2.4 Contingent function

2.5 Significance of money

2.6 Balance of payments

2.7 Money in a socialist economy

Summary

2.1 INTRODUCTION

"Money is what money does." In modem time, money performs a number of functions. Writers like kindly classified these functions under three headings for study purposes. They are:

a. Primary functions,

b. Secondary functions, and

c. Contingent functions.

Let us describe each of them briefly.

2.2 PRIMARY FUNCTIONS

The two primary functions of money are to act as a medium of exchange and as a unit of value.

***Money as a Medium of Exchange*:** This is the primary function of money because it is out of this function that its other functions developed. By serving as a medium of exchange, money removes the need for double coincidence of wants and the inconveniences and difficulties associated with the barter system. The introduction of money as a medium of exchange segregates a single transaction of barter into two separate transactions that is of sale and purchase, thereby eliminating the double coincidence of wants. This function of money also separates the transactions in respect of time and place because, the sellers and buyers of a commodity are not required to perform the transactions at the same time and place. For example the seller of a commodity can sell the same at a place, get money and can buy any commodity, of his need after some time and at a different and convenient place.

When money acts as a medium of exchange, it means that it is generally acceptable. It, therefore, affords the freedom of choice. With money, we can buy an assorted bundle of goods and services. At the same time, we can purchase the, best and also bargain in the market. Thus money gives us a good deal of economic independence and also perfects the market mechanism by increasing competition and by widening the market.

As a medium of exchange, money acts as an intermediary. It facilitates exchange. It helps production indirectly through specia1isation and division of labour which, in turn, increase efficiency and output. According to Prof. Walters, money, serves as a 'factor of production', enabling increase in and diversification of output.

Money also facilitates trade. When acting as an intermediary, it helps one good or service to be traded indirectly for others.

***Money as Unit of Value*:** The second primary function of Money is to act as a unit of value. Under barter one would have to resort to some standard of measurement, such as a length of sorting or a piece of wood. Since one would, have to use a standard unit for measuring the length or height of any object, it is necessary that the particular unit should be accepted as the standard. Money is the standard for measuring value; just as the yard or metre is the standard for measuring length. The monetary unit measures and expresses the values of all goods and services. In fact, the monetary unit expresses the value of each good or service in terms of the monetary unit. There can be no pricing process without a measure of value.

The use of money as a standard of value eliminates the necessity of quoting the price of appeal in terms of oranges, the price of oranges in terms of nuts, and soon as in the case of barter. Unlike barter, the prices of such commodities are expressed in terms of 50 many units of dollars, rupees, francs, pounds, etc. depending on the nature of the monetary unit in a country. As a matter of fact, measuring the values of goods and services in the monetary unit facilitates the problem of measuring the exchange values of goods in the market. When values are expressed in terms of money, the number of prices for a commodity are reduced from n (n - 1) in barter economy to only one in monetary economy.

Money as a unit of value also facilitates accounting. Assets of all kinds, liabilities of all kinds, income of all kinds, and expenses of all kinds can be stated in terms of common monetary units to be added or substracted.

Further, money as a unit of account helps in calculations of economic importance such as the estimation of the costs, and revenues of business firms, the relative costs and profitability of various public enterprises and projects under a planned economy, the gross national product etc. As pointed out by culbertson, "prices quoted in terms of money become the focus of people's behaviour their calculations, plans, expectations, and contracts focus on money prices,"

2.3 SECONDARY FUNCTIONS OF MONEY

There are three secondary functions of money: Standard of deferred payments, store of value and transfer of value. They may be described as follows: .

Standard of Deferred Payments: Just as money facilitates current transaction of goods and services through its function as a medium of exchange, so also it facilitates credit transactions, that is, exchange of present goods against future goods. This function of money is commonly called as standard of deferred payments-in fact, it is better to regard this function as part of its function as a medium of payment. Money has always been used as a standard of deferred payment from the earliest times but it has attained greater significance with the emergence of trade in the present times, which is based mostly on credit.

***Store of Value*:** As soon as the practice of employing a certain commodity as a medium of exchange becomes general, people begin to store up such a commodity in preference, to others. For money represents goods and services and the person who accumulates money is really accumulating potential goods and services. Money therefore, serves as a store of value. A store of value implies the shifting of purchasing power from the present to the future. But we should not over emphasise this function of money. As value of money does not remain stable, money may become a poor asset in times of high size in prices (i.e. fall in the value of money). In such periods, people get rid of money as fast as possible and prefer any other durable commodity as a store of value. Money, therefore, is not a proper or a perfect store of value.

At one time, gold and silver coins served as store of value and still later currency notes performed this function. In these days, however, bank deposits represent people’s savings. Bank deposit is nowadays considered equivalent to money since a person who has a bank account can spend it at any time and in any way he likes.

Money is desired not only as a store of value but also to serve as a liquid asset. Money is a liquid asset as it can be used by the possessor to buy any other asset at any time. All other assets-landed property, commodities, securities, etc.- can be purchased through money. And the advantage of money as a liquid asset over all other assets is that while money can be converted into any asset at a moment's notice, other assets cannot be so converted. More over these assets may be sold only at. reduced prices. Everyone, therefore, likes to hold sufficient amount of cash reserve either to meet-day-to-day expenses, or to tide over unexpected emergencies or for purposes of speculation (as, for instance, buying an asset at a lower price as-and when available to sell it later at a higher price). The demand for money as a liquid asset may be considered as part of the function of money as a store of value.

3. *Transfer of Value*: Money helps us to transfer payments from one person to another and from one place to another. Money is readily accepted by all and in all places and there is no difficulty in transferring even a crore of rupees from a person or institution in Delhi to another in Bombay or Madras. In these days, such transfers of value do not take place through currency notes but through bank cheques or bank drafts. In the absence of money, transfers of value between places will have to be in terms of goods, which would be difficult highly inconvenient and unsafe, it not impossible. .

2.4 CONTINGENT FUNCTIONS

Money also performs certain contingent or incidental functions, according to Prof. David Kinley. They are:

i) *Money as the Most Liquid of all Liquid Assets*: Money is the most liquid of all liquid assets in which wealth is held. Individuals and firm may hold wealth in infinitely varied forms. "They may, for example, choose between holding wealth in currency, demand deposits, time-deposits, savings, bonds, treasury Bills, short-term government securities, long-term government securities, debentures, preference shares, ordinary shares, stocks of consumer goods, and productive equipment." All these, are forms of wealth which are considered as near liquid. Which can be converted into money considered a liquid asset.

ii) *Basis of the Credit System*: Money is the basis of the credit system. Business transactions are either in cash or on credit. Credit economises the use of money. But money is at the back of all credit. A commercial bank cannot create credit without having sufficient money in reserve. The credit instruments drawn by businessmen have always a cash guarantee supported by their bankers.

iii) *Equaliser of Marginal Utilities and Productivities*: Money acts as an equaliser of marginal utilities for tile consumer. The main aim of a consumer is to maximize his satisfaction by spending a given sum of money on various goods, which he wants to purchase. Since prices of goods indicate their marginal utilities and are expressed in money, money helps equalising the marginal utilities of various goods. This happens when the ratios of the marginal utilities and prices of the various goods are equal. Similarly money helps in equalising the marginal productivities of the various factors. The main aim of any produced is to maximize his profits. For this, he equalise the marginal productivity of each factor with its prices. The price of each factor is nothing but the money he pays for using such factor and the price of his product is the money he receives for his goods or services.

iv*) Measurement and Distribution of National Income*: It was not possible to measure and distribute the national income under the barter system. Money has made both these possible. It not only helps in measuring national income but also in its distribution. This is done when the various goods and services produced in a country are assessed in money terms and the factors are paid wages, interest, profits and sent in terms of money.

It is on the basis of these functions that money guarantees. The solvency of the payer and provides options to the holder of money to use it any way, he likes.

STATIC VS DYANAMIC FUNCTIONS OF MONEY

According to paul Eirzing, the function of money can be classified into two broad categories. viz, static and dynamic functions. *Static functions* of money are those which indicate that money does not influence actively the economic system and that it is used only as a passive technical tool to ensure a smooth and better operation of the economic system. The traditional functions of money, viz., medium of exchange, measure of value, standard of deferred payments and a store of value, are the static functions of money. If the role of money were restricted to those static and conventional functions, monetary policy would be a comparatively simple matter; it will only mean maintaining a reasonable degree of stability in the value of money.

A part from the above functions of money, paul Einzi adds one more technical or static function of money, i.e, money as the medium through which the price mechanism operates. In a free enterprise economy, production and distribution of goods and services are based on the price system. It is the price system or price mechanism which tells (a) the producers, what to produce and how much to produce and (b) the consumers, what to consume and how much to consume. The price mechanism plays a social role in directing, guiding and controlling all the economic activities in the capitalist economy. But what are prices? Price are" the value of goods and services, expressed in terms of money. Without the existence of money, we cannot have a system of prices. It is therefore, clear that money does not only help in the exchange of goods (medium of exchange) and serve as a device to measure the value of goods and services, but it is the medium through which the price mechanism helps to establish a balance between demand and supply, and reconcile the interests of the producers and the consumers.

***Dynamic Functions of Money*:** Dynamic functions of money are those by which money tends to exert a powerful influence on the economic system through its influence on the price level, on the volume of production, on the distribution of wealth, on consumption and so on. Money is capable of stimulating or hindering economic and social progress. In a general way, it may even influence the course of history and the march of civilisation. In recent years, the dynamic functions of money have come to the emphasised by economists. These dynamic functions are of fundamental importance in the determination of economic trends.

Firstly, the more important dynamic function of money is its influence on the national economy through a rise or fall in the price level (or conversely and consequent to a fall or size in the value of money). A general rise or fall in the price level affects, for better or for worse, the welfare of all the sections of the community. In fact, the effect of inflation and deflation goes much beyond the immediate period; it may affect even the course of history. For example the depression (meaning a great crush or fall in money value) of 1929-33 was an important factor for the re-arming of Germany and for the Second World War.

Secondly an intelligent and progressive application of the monetary system can help in better and fuller utilisation of the natural and human resources in the country and of the scientific and technological improvements that are taking place. This will result in an increase in gross national product and a higher standard of living. This is what is being attempted in many under-developed countries. On the other hand, a narrow view and wrong application of the monetary system may hinder economic growth. Any abuse of the monetary system will ruin a country. For example the excessive printing of currency notes, or too much of credit creation by Banks might lead to undesirable or adverse effects in the economy which might be against social or public interest. .

Thirdly the monetary system is of great significance to modem governments. With the help of the monetary system, governments are in a position to spend much more than what they raise by way of taxation. They are able to borrow any amount of money from the monetary system. Public debt of I Indian now runs to over Rs.13,000 Crores as compared to less than Rs.3000 Crores in 1950-51. It is in this way that the Governments is able to undertake many social, economic, political and military policies irrespective of costs, which would not be. possible in the absence of the dynamic functions of money.

***An Evaluation. of the two Functions*:** In the past, econ1ijnists emphasised only the static or technical functions of money. They insisted that money was adopted and maintained for meeting the requirement of its technical functions and that it was not meant to bring about changes in the price level or to regulate the bends in economic activities of a country. Besides, in everyday life the static functions of money are usually much in evidence and its dynamic functions are kept in the back- ground. But Paul Eirzing is of the opinion that the dynamic functions of money are as important as its static functions. A clear appreciation of the dynamic functions of money will enable the monetary authorities to use money as an engine of economic and social progress.

Generally speaking, the measures taken to ensure that money is able to fulfill its technical functions satisfactorily are identical with those required for performing its dynamic functions. Sometimes, however, this may not be the case. Static functions demand a stable value of money; but from the point of dynamic functions, it may be necessary to depart from stability. For instance, in a period of depression the stimulation of business activity by increasing circulation of money may be necessary from the point of dynamic functions. In any case, it is necessary to evolve a system of management of money which will help in the proper performance of both these functions, in order that money can be made use of as an efficient tool for economic development of a country.

2.5 SIGNIFICANCE OF MONEY

Money is of vital importance to the operation of the national and international economy. Money plays an important role in the daily life of a person whether he is a consumer, a producer, a businessman, an academician, a politician or an administrator. “An individual need not be an economist to be actually aware that money plays an important role in modem life; he need think only of his own experience.” We study below the importance of money in a modem economy.

REMOVES THE DIFFICULTIES OF BARTER

The importance of money lies in that it removes the difficulties of barter. There is no necessity of double coincidence of wants and possessions in the modem monetary economy. It also overcomes the difficulty created by the indivisibility of commodities. There are no problems of storage and transfer of values. Money removes these difficulties of barter by acting as a standard of value, 8S a store of value, as a medium of exchange, and as a standard of deferred payments. Here in lies the importance of money in a modem economy.

To the Consumer: Money has significance to the consumer. The consumer receives his income in the form of money rather than in goods and services. With money in hands, he can get any commodity and service he likes, in whatever quantities he needs and at any time he requires. As pointed out by professor Robertson, "Money enables man as consumer to generalise his purchasing power, and to make claims on society in the form which suits him best." Not only this, money acts as an equaliser of marginal utilities for the consumer. The main aim of a consumer is to maximise his satisfaction by spending his limited income on different goods which he wants to purchase. Since prices of goods indicate their marginal utilities and are expressed in money, Money helps in equalising the marginal utilities of goods. This is done by substituting goods with higher utilities for others having lower utilities. Thus money enables a consumer to make a rational distribution of his income on various commodities of his choice.

To the Producer: Money is of equal importance to the producer. He keeps the. accounts of the values of input and output in money. The raw materials purchased, the wages paid to workers, the capital and all expenses of production are entered in his account books. The sale of products in money terms are his sale proceeds. The difference between the two gives him profit. Thus a producer easily calculates not only his costs of production and receipts but also profit with the help of money value.

Further money helps in the general flow of goods and services from agricultural, industrial and tertiary sectors of the economy because all these activities are performed in terms of money. As pointed out by Prof. Robertson, "Money enables man as a producer to concentrate his attention on his own job, and so to add more effectively to the general flow of goods and services which constitutes the income of the society."

In Specialisation and Division of Labour: Money plays an important role in large scale specialization and division of labour in modem production. As aptly said the specialisation and division of labour on which the modem economic structure is formed would be impossible if everyman had to spend a large part of his time and energies in bartering his products for the materials of his industry and the goods which he requires for his own consumption. Money helps the capitalist to pay wages to a large number of workers engaged in specialised jobs on the basis of division of labour. Each worker is paid money wages in accordance with the nature of work done by him. Thus money facilitates specialisation and division of labour in modem production. These, in turn, help in the growth of industries.

It is, infact, through money that production on a large scale has been made possible. All inputs like raw-materials, labour, machinery, etc. are purchased with money and all output is sold in exchange for money is rightly pointed out by Prof. Pigou, "In the modem world industry is closely enfolded in a garment of money."

***As the Basis of Credit*:** The entire modem business is based on credit and credit is based on money. All monetary transactions consist of cheques, drafts, bills of exchange etc. These are credit instruments which are not money. It is the bank deposit that are money. Banks issue such credit instruments and create credit creation, in turn, plays a major role in transferring funds from depositors to investors. Thus credit expands investment on the basis of public saving lying in bank deposits and helps in maintaining a circular flow of income within the economy.

***As a Means of Capital Formation*:** As a corollary to the above, money acts as a means to capital formation. Money is a liquid asset which can be stored and storing of money implies savings, and savings are kept in bank deposits to earn interest on them. Banks, in turn, lend these savings to businessmen for investment in capital equipment, buying of raw-materials, etc. From different sources and places. This makes capital mobile and leads to capital formation and economic growth. In present days apart from bank deposits a number of other avenues of investment are also available like investment in securities, mutual funds etc. helping capital formation.

AS AN INDEX OF ECONOMIC GROWTH

Money is not only a means to capital formation, but is also an index of economic growth. The various indicators of economic growth are national income, per capita income and economic welfare. These are calculated and measured in money terms. Changes in the value of money or prices also reflect the growth of an economy. Fall in the value of money indicated by rise in prices means that the economy is not progressing in real terms on the other hand, a continuous rise in the value of money (or fall in prices) reflects retardation of the economy. Stable prices imply a growing economy. Thus money is an index of economic growth.

IN THE DISTRIBUTION AND CALCULATION OF INCOME

The rewards to the various factors of production in a modern economy are paid in money. A worker gets his wages, capitalist his interest, a land lord his rent, and an entrepreneur his profit. But all are paid their rewards in money. An organiser is able to calculate the marginal productivity of each factor in terms of money and pay it accordingly. For this, he equalises the marginal productivity of each factor with its price. Its price is, in fact, its marginal productivity expressed in terms of money. As payments are made to various factors of production in money. The calculation of National income becomes easy.

***In National and International Trade*:** Money facilitates both national and inter-national trade. The use of money as a medium of exchange, as a store of value and as a transfer of variations in balance of trade figures are likely to be misleading as they are due to random fluctuations and seasonal fluctuations. Random fluctuations are due to import or export of large single items and abnormal charges in the general level of stock or the incidence of dock and transport charges. Seasonal fluctuations tend to have a clearly unfavourable influence due to the adverse effect on exports. However Balance of Trade is the major component of the Balance of Payments.

2.6 BALANCE OF PAYMENTS

Balance of payments is a record of all monetary transactions between the residents of a particular country and the residents of all other countries over a given period of time, say a year. By "residents" we mean individuals, business firms, government agencies or other institutions and organisations legally domicile in the country. Hence, a branch of a foreign firm established in India would be treated as any other Indian enterprise for balance of payments purposes. But international organisations or agencies of foreign firms not legally established in India are not considered as residents. It may also be defined as a "systematic and complete record of a country's monetary payments to foreigners and its receipts from foreigners." It is more comprehensive in scope than balance of trade.

Items includes in the balance of payments accounts are:

1. Expenditure of foreign travelers and transportation services rendered by companies to foreigners for freight or passenger transport.
2. Insurance and reinsurance premiums paid by foreign residents.
3. Interest dividends, rents and profit paid by foreigners to the residents of a country.
4. Fees paid to contractors and engineers of the country by foreigners
5. Firm rentals, patent, copyright and trade mark royalties paid to the residents of a country by foreigners.

6. "Gifts" of cash, merchandise or services made by foreigner residents.
7. "Purchases of property" belonging to the residents of a country by foreign residents.
8. Sales of a country's resident-owned or issued to foreign residents. .

useful lubricant, enabling the economic machine to function continuously and smoothly."

***To the Society*:** Money confers many social advantages. It is on The basis of money that the super structure of credit is built in the society which simplifies consumption, production, exchange and distribution. It promotes national unity when people use the same currency in every nook and comer of the country. It acts as a lubricant for the social life of the people, and oils the wheels of material progress. Money is at the back of social prestige and political power. According to Prof. Devenport, "Almost all great political issues and almost all international complications rest upon a pecuriary standard."

Thus money is the pivot round which the whole science of economics clusters.

DEFECTS OF MONEY

The Bible rightly says, "The love of money is the root of all evil". Perhaps acting on this saying of the Bible the classical economists did not attach much importance to money. They regarded it as a veil or garment or wrapper for goods and services. According to them, money is simply a tool of convenience to facilitate the exchange of goods and services, but it is not a determinant of the quantities produced. The evils of money are shrouded behind a monetary veil, and what really happens behind the evil in sometimes quite different from what appears to take place On the surface. This extreme view has been discarded. Now economists regard money not merely as veil but as an extremely valuable social instrument promoting wealth and welfare.

But money which is a useful servant, often misbehaves when it tries to act like a master. This leads to a number of defects of money, which are discussed below.

ECONOMIC DEFECTS

***Instability in the Value of Money*:** The first draw back of money is that its value does not remain stable overtime. When the value of money falls, it means rise in the price level or inflation. On the contrary, rise in the value of money means fall in the price level or deflation. These changes are brought about by increase or decrease in the supply of money. Quantum charge in the value of money are disastrous and even moderate changes have certain disadvantages, on the economy as a whole.

Inflation or fall in the value of money causes direct and immediate damage to creditors and consumers. On the contrary, deflation or rise in the value of money brings down the level of output, employment and income. Thus instability in the value of money adversely affects consumers, producers and other sections of the society.

UNEQUAL DISTRIBUTION OF WEALTH AND INCOME

The second defect of money is that, changes in the value of money lead to unequal distribution of wealth and income. Inflation or deflation which brings benefits to some and damages to others leads to redistribution of wealth and income. The violent fall in the value of money between 1914 and 1920 and its almost equally violent rise in the immediately following years led to a great and often arbitrary redistribution of income and wealth not only between social and industrial classes, but between different persons in the same class in many countries in the world. Such changes in the structure of the society widen the differences between the rich and the poor and lead to class conflict. Such inequalities and conflicts tend to weaken the capitalist system.

***Cyclical Fluctuations*:** Another defect of the institution of money is that it leads of cyclical fluctuations in the economy. When the supply of money increases it leads to a boom and when it contracts there is a slump. In a boom, output employment and income increase which lead to over production. On the contrary the decline during a depression, leads to under consumption. Such cyclical fluctuations bring untold miseries to the people. But in a barter economy, they do not exist at all.

This does not mean that we should go back to the barter era and give up the use of money. In face, the defects, of money arise when it is used in an uncontrolled manner. As has been correctly pointed out by Prof. Robertson, "money, which is a source of so many blessings to mankind becomes also, unless we can control it, a source of peril and confusion."

NON-ECONOMIC DEFECTS

Besides, the above noted economic drawbacks of money the institution of money has brought down the moral and political bank ruptcy and artificiality in religion based on materialism. In fact, money is “the cause of theft and murder of deception and betrayal”.

All these defects are not due to money but are the result of the attitude of man towards the use of money. It is of immense importance to every type of society whether it be capitalist or socialist. It is impossible to imagine this world without money. Money is an indispensable lubricant and a tool of convenience, for a continuous and smooth functioning of the economic machine. But its uncontrolled use, instead of solving, creates many complicated problems. It is these complex problems that led Disaraeli to remark, "Money has made more people mad than love." So the best way is to keep money under control like a faithful and obedient servant and not to let it take the role of a master. The controlling authority over money is the government which achieves this by a judicious monetary policy.

SIGNIFICANCE OF MONEY IN A CAPITALIST ECONOMY

Money occupies a central position in a capitalistic economy. So much so, the modem economy is rightly known as the money economy. The influence of money is to be found in every section of the economy. The widespread use of money and credit and the changes in the value of money have profound influence on economic activity. According to Prof. A.C.L. Day, there are four reasons why money has become so important and significant in a capitalistic economy.

i) *Medium of Exchange and Significance of Money*: One important reason why money occupies a central po sition in a capitalistic economy is the function of money as a medium of exchange and of payments. Everything can be brought and sold, i.e., exchanged through the medium of money. Goods and services are exchanged through money. Shares and bonds (which are known as claims to wealth) are bought and sold in the form of money . Similarly, taxes to the Government are paid in money. In other words, money is used as the general medium of exchange and of payments. Without it, there can be no trade and, therefore, no large scale production.

ii*) All Incomes are in the Form of Money*: Another significant role of money in a capitalistic economy is that all incomes received by the various factors of production in the form of money. This necessarily follows from the fact that money serves as a general medium of exchange and of payments in settlement of debts. The firm which sells its goods receives money in payment, its income, therefore, consists of money. The lecturer who sells his services to the college gets his salary in the form of money. Since every payment is made in money, every income is a money income (payment by one becomes income for another). Thus, in a modern economy, all incomes are money incomes.

iii) *Wealth Consists Mostly of Money*: Thirdly, money constitutes the most important form of wealth in modern times. Every one - individuals, institutions, companies and the Government - wishes to hold some cash to meet current obligations. The amount of cash held by people will naturally differ from individual to individual and from institution to institution. A rich man will obviously keep more cash than a poor man. But everyone will have to keep some cash with himself or as deposit in a bank.

iv*) Money is a Claim*: The significance of money in a capitalistic economy arises from the fact that money is used as a claim. Money is a claim in two senses. For instance, the currency note is a claim on gold or silver coins or bullion or for that matter any commodity.

There is, however, another and more important sense in which money is used as a claim. Money is used to buy anything or claim anything which it helps to buy. All are willing to accept it and use it in their transactions. Hence money becomes a general purchasing power; it is a claim to anything and everything which can be bought and sold. Apart from these four important reasons, there are others which show the significance of money in modem times.

v) *Significance of Money in Consumption*: In a capitalistic economy the consumer is the king. The consumer receives his income in the form of money, which he can convert into anything he likes. The consumer does not maximise satisfaction, in the absence of money. On the other hand, when a consumer receives his income in the form of money, he can distribute it on the different goods in such a way that his total satisfaction will be the highest. The use of money and the system of prices give the consumers the necessary freedom to choose and substitute between goods and services, that is choose (a) the type of goods they like (b) The variety of goods they like, and (c) The amounts which they would like to consume.

vi) *Significance of Money in Production*: Production of commodities of any choice using inputs of one choice in a capitalistic production economy. Industrial production is based on minute, division of labour or specialisation which implies that the worker cannot be paid in the commodity he produces and also the existence of an extensive market to dispose of the commodity. It is money which has made possible extreme specialisation and, therefore, large - scale production.

Again, money enables everyone to concentrate his attention on his own job, without bothering about all other things and thus to add more effectively to the general flow of goods and services which constitute the real income of society. It is clear, therefore, that without money, modem specialisation is impossible; and without specilisation, modem capitalist economy cannot exist. "

Money helps producers to discover - through the price mechanism - what people want and how much they want. It enables the producers to decide on what they should produce and in what quantities and to make the best use of the available economic resources.

The producers use money to purchase materials for the construction of their factories; they use it to buy the supplies and materials necessary for their equipment. They bid competitively in the markets of the world for the raw materials used in the process of manufacturing. They employ money as a means of attracting to their organisations the requisite labour force and officials.

D.H. Robertson brings out the 'importance of money to society in a clear way. "The existence of a monetary economy helps society to discover what people want and how much they want it and so to decide what shall be produced and in what quantities, and to make best use of its limited productive power. And it helps each members of society to ensure that the means of enjoyment to which he has access yield him the greatest amount of actual enjoyment which is within his reach.

vii) *Significance of Money in Trade*: One of the back bone of capitalistic economy is free trade In commodities. We have already shown how the basic purpose of money is to facilitate exchange of goods and services (i.e., trade). In a primitive economy, there was very little of trade. Naturally, the system of exchange was barter with extension of trade, the need for money rises. Large scale production and extension of markets to sell the goods produced are impossible without the use of money. In the last two hundred years, trade has become very extensive and to facilitate this, new types of money have been evolved. The use of bank cheques and bank drafts facilitates buying and selling of goods as well as payment.

Not only internal trade, but international trade too is possible through money. It is true that currency of one country may not be acceptable in another country. For instance, a 100 rupee note is readily acceptable in India but it cannot be used in England or U.S.A. to buy even a packet of cigarettes. However, trade between two countries is financed by means of bank drafts.

Trade, both internal and international, is very important and in dispensable for modern large-scale production. But money is the medium by which trade is undertaken. If there were no money, there would be no extensive trade; if there were no trade, there would be no large-scale production and no modern capitalistic economy.

MEANS OF CAPITAL FORMATION

The very basis of capitalism is the capital and money is the most liquid form of capital. The growth of the capitalist economy depends upon the capital accumulation. And capital accumulation is a process where by people save out of their money incomes, deposit them with banks and other financial institutions which, in turn, lend them to agriculturists, industrialists, transporters and other businessmen for investment in capital assets. The different stages in the process of capital formation under capitalism -receiving income, saving and investing - are all performed in money terms.

LINK BETWEEN THE PRESENT AND THE FUTURE

Money establishes a link between the present and future through the freedom of enterprise and freedom of consumption under capitalism. The freedom of consumption on the part of the consumer leads to freedom to save a part of his money income. Savings leads to the production of capital goods via investment and capital goods contribute to the growth of the economy. Thus it is through money that consumers save in the present and saving helps in production in the future. Similarly, freedom of enterprise under capitalism helps the businessman and the trader to make payments in the future for bargaining's made in the present. This is possible, through money when the goods are stored in the present and sold in the future. It is in these ways that money helps to establish a link between the present and the future.

2.7 MONEY IN A SOCIALIST ECONOMY

A socialist economy is one in which the entire economic activity is planned and executed by state agencies. There will be no free market and no private property. The question is whether money has any role to play in such a completely controlled, regulated and guided economy. Marx, Lenin and other prominent socialists condemned money; Marx even believed that money was the major cause for the exploitation of labour by the capitalists. Marx visualised an ideal communist. State where money would be abolished and where goods would be exchanged for goods.

When the Bolshevic (Communist) party came to power in Russia after the Russian Revolution of 1917, it attempted to replace money in selected areas by introducing a system of cards (against currency notes and coins). It also endeavoured to abolish the use of money through extensive direct controls and free distribution of goods. It was "hoped to effect a transition to a natural economy in which purchase and sale, and the medium with which they were carried out - that is money - would have no place." It was soon realised that it was impossible to usher in communism without money and money calculation. As Leon Trotsky, one of the founders of Bolshevik Russia, clearly stated:

"The blue prints produced by the offices must demonstrate their economic expediency through commercial calculation without a firm monetary unit, commercial accounting can only increase the chaos."

***Money is Essential as a Medium of Payment*:** In 1921, Lenin formulated the Famous New Economic Policy (NEP) which introduced the system of "state capitalism." In the new system, money was retained and was given much importance in the determination of prices and wages. In 1928, the first Five-year plan was introduced; since then many more Five-year plans have succeeded one after the other. Even though socialist planning and control existed, production and income transactions were carried on through money. Wages and salaries are paid in money and goods and services are bought and sold in terms of money. Thus even though the price system is given as interior and sub-ordinate position and does not always serve as a guide to production and consumption, yet the socialist Russian economy depends upon money as a medium of payment and as a standard of value.

***Money is Essential to Guide Economic Activity*:** Theoretically monetary system in perfectly consistent with a socialist economy. In the first instance the system will have to exist in order to guide economic activity as in a capitalist economy. Oscor Lange has expressed the opinion that in a socialist economy price system serves as an efficient guide to economic activity. But then, price system will have no meaning unless prices are expressed in terms of money.

***Money is Needed for Allocation of Resources*:** Secondly, the planning authority in a socialist economy has the responsibility of allocating economic resources in different lines of production. This can be done on the basis of social needs etc., but without the help of a pricing system the process of allocation becomes almost impossible. George Halm, who along with Von Mises, attempted to show the imposibility of pricing process in a socialist economy, wrote: "Even if the aims of production should be determined by a dictator, the allocation of resources according to these aims would have to be the result of the working of a pricing process by means of which it is possible to compare the usefulness of the available resource in different fields of employment."

***Money is Needed for Distribution of Income*:** Thirdly, even in a socialist economy, the distribution of goods among the millions of consumers in an equitable manner will be difficult in the absence of a monetary mechanism. Marx's ideal solution of "to each according to his need" is impracticable because there is no objective criterion of judging the needs of people. Any type of distribution qy the state either according to need of individuals or according to their usefulness to society or their position in the party, etc. is bound to prove highly irrational and arbitrary. Hence such distribution will be resented and criticised by the consumers. Therefore, distribution even in a socialist economy may have to be left to be guided by the pricing system based on money.

Thus, the socialist economy will have to remain a money economy, even if every sector of it is planned and directed by the planning authority. But since the pricing mechanism is given a slightly minor role in such an economy, money is also given a minor role is influencing economic activity.

SUMMARY

The significance of money is, it removes the difficulties of barter. It acts as a standard of value, as a store of value, as a medium of exchange and as a standard of deferred payments. The rewards to the various factor of production in a modern economy are paid in money. Eventhough money has several benefits, it holds some defects. Money which is a useful servent, often misbehaves when it tries to act like a master. This leads to a number of defects of money, which are discussed above.

KEYWORDS

- Retardation
- Pecuriary
- Miseries
- Quantum
- Slump

REVIEW QUESTIONS

1. What are the functions of money?
2. Distinguish between the static and dynamic functions of money?
3. How money removes the difficulties of Barter? Explain.
4. State the defects of money.

SUGGESTED READINGS

1. Oliver G. Wood Jr. – Introduction to money and Banking.

LESSON 3

THE CIRCULAR FLOW OF MONEY

OBJECTIVES

After reading this lesson, you should be able

- to understand the circular flow of money.
- to familiar with savings and investement
- to analyse the policy significance of the circular flow of money.

STRUCTURE

3.1 INTRODUCTION

Modern economic life is characterised by continuous flow of money payments. In every economy people are busy in producing and consuming goods and services. Though we speak of producers and consumers as if they are two different groups of persons; really speaking, they are the same persons. Every person is both a producer as well as a consumer. A person gets an income as a producer, which he uses on goods and services as a consumer. There may be isolated cases of a person who is only a consumer but not a producer. We can ignore him. Thus, when the owners of factors of production sell their services, to business units, they receive income by way of wages, interests, rents and profits, which the) spend on the purchase of consumption goods.

Again, the money which the consumers pay while making their purchases passes successively through the hands of retailers, wholesalers and manufactures until at last, it again reaches the hands of consumers as wages, interests, rents and profits. Thus there is a circular flow of money in an economy.

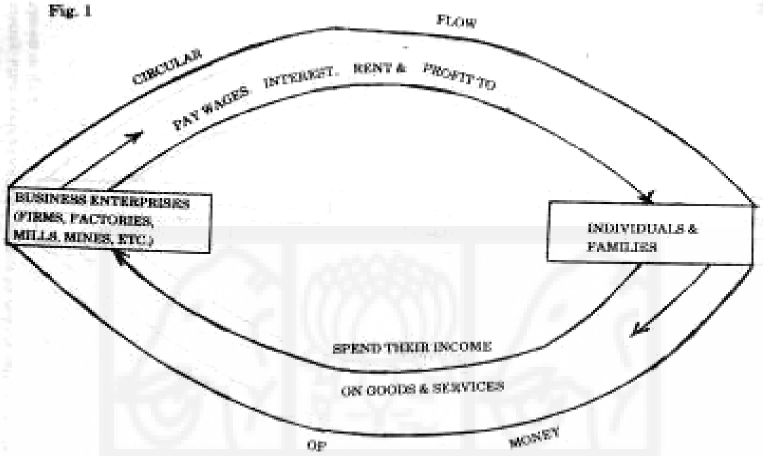
***A Simple Model of Circular Flow*:** The following figure illustrates the circular flow of money in an economy:

This diagram shows how business enterprises of all types:

a) make payments to individuals and households for the supply of factor services, which they use to produce goods; and

b) receive payments from individuals and households to whom they have sold their finished produces.

Fig. 1



Likewise, individuals and households make as well as receive payments. They make payments to business enterprises for the goods and services which they consume. They receive payments for their contribution of factor services.

The importance point to remember is that the entire amount of money which is paid out to factor owners by business enterprises is paid back by the factor owners (individuals and households) to business enterprises. There is thus a circular and continuous flow of money. So long as nothing happens to interrupt the circular flow of money, the economy will continue to work indefinitely producing the same volume of goods and services, paying out and receiving back the same amount of money, at the same or constant prices. But an important requisite for constant flow of goods and services at constant prices is that there should be no leakage of money out of active circulation - whatever is paid out to factor owners should come back by way of expenditure on goods and services.

3.2 SAVINGS AND INVESTMENT

The above model of circular flow of money is too simple as three important assumptions have been made: We have not considered savings, the existence of imports and exports and the role of the Government. Individuals and business units save part of the income they receive. Savings imply leakage from the flow of money since they represent the amount of money taken out of the money flow. We can assume that savings are not hoarded away but are made available to the loanable funds market or capital market. Business enterprises borrow from the market for purpose of investment. If the savings of the individual and business units come back to the money flow through borrowings and investments in business enterprises, the money flow will be maintained constant and in economic activity and prices will be constant. In other words, so long as flow of funds into the capital market (savings) and the flow of funds out of the capital market (investments) are equal, the circular flow of money will maintain itself without any interruption or change.

A more complex model. The model of circular flow of money, after savings and borrowings have been introduced, is shown in fig 2.

Suppose the borrowings from the capital market for purposes of investment are lower than savings. In such a case, the flow of money in the economy will be reduced (since excess of savings over investment represents leakage of money out of the system). The demand for final goods will be reduced and, therefore, prices will fall. On the other hand, if borrowings for investment are more than savings this would be possible if past hoarded money is brought into circulation or new money is pumped into circulation), there will be increase in the flow of money, greater demand for goods and hence higher prices.

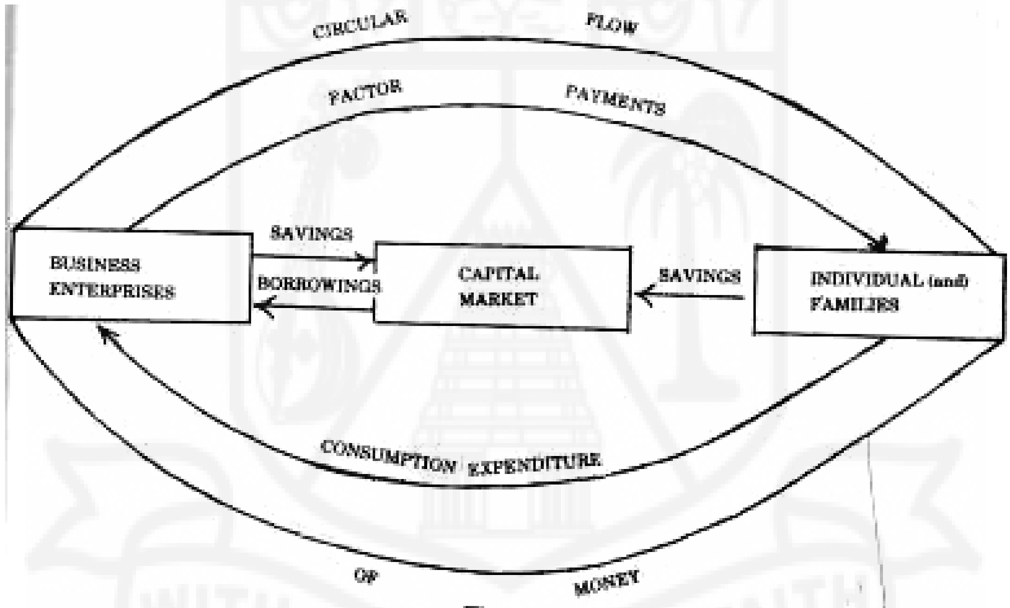


Fig 2

Other factors affecting circular flow are international trade and Government financial and monetary transactions. International trade has two aspects - imports and exports. Imports have to be paid for, while exports represent payments by foreigners. It is not necessary that payments in (for exports) and payments out (for imports) should be exactly equal; if it were to be so, then the circular flow of money will not be affected on the other hand, excess of imports over exports will reduce the money flow, while the excess of exports over imports will increase the money flow. In both the cases, the circular flow of money will be disturbed. An important condition for the maintenance of a steady flow is that any excess of saving over investment within the economy should be balanced by an excess of exports over imports. Absence of such a balance will lead to expansion or contraction of the flow of money which in turn will affect the volume of production and level of prices.

Dealings to the Government: The existence of the Government affects the flow of money in two ways: on the one hand, the Government receives taxes from individuals and business enterprises and thus reduces their disposable income. On the other hand, it provides services as well as makes many transfer payments to individuals, both of which have the effect of increasing the income of the individuals. Similarly, the government's expenditure on the goods and services of business enterprises and subsidies and bounties to business enterprises will have the effect of increasing the money income of the latter. The introduction of international trade and the existence of the Government make the circular flow of money still more complicated. There can now be leakage from money flow not only within tae country but also outside, through international trade. Public authorities also enter the capital market both as savers as well as borrowers.

The circular flow of money; after taking into consideration all these factors is shown in fig 3:

Hence it is found that in practice the continuous and smooth flow of money will be far more difficult. It is not possible to imagine that there would be equality between:

a) factor payments and consumption expenditure.

b) flow of funds into and out of the capital market.

c) receipts for exports and payments for imports; and

d) Government's tax revenue will be equal to its expenditure on services

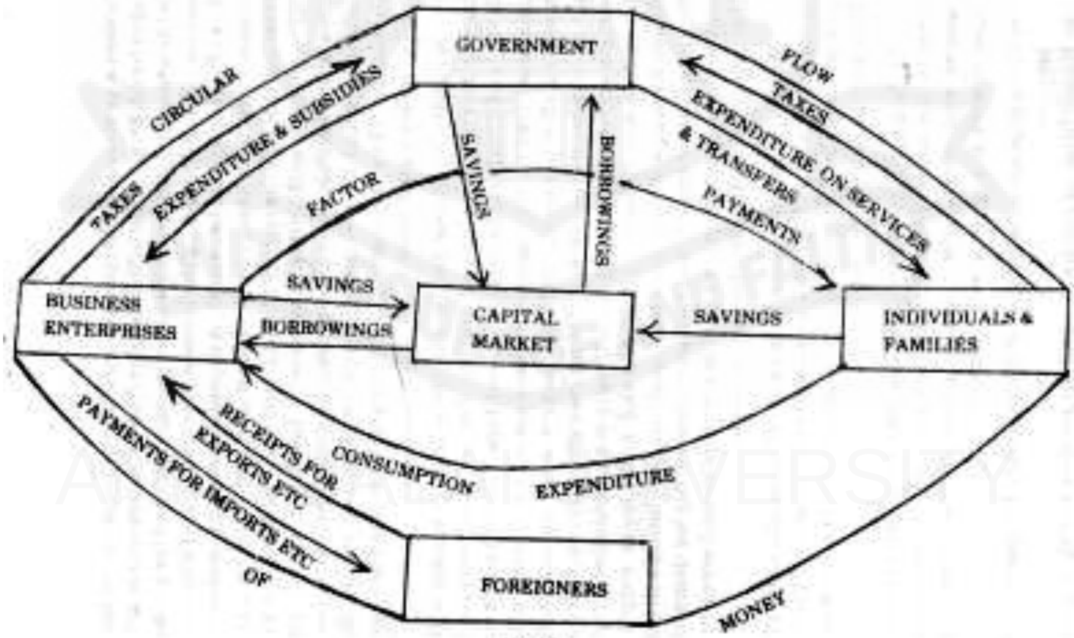


Fig 3

There is thus high possibility of net leakage of money out of circulation or new money finding its way into the circular flow. Accordingly, the smooth circular flow of money is an economy with constant production and prices will be very difficult to achieve is practice. .

3.3 WEAKNESS OF THE MODELS

The models of the working of the monetary system assuming continuous flow of money from one group to another is a highly simplified one. In practice, an economy is far more complicated. In the group of business enterprises, there are hundreds and thousands of industries making and receiving payments. Like wise in the group of individuals and families there are millions of persons involved receiving payments (as owners of factor services) and making payments while buying goods and services. However, inspite of their simplicity, the models of circular flow of money only show the way the system works.

3.4 POLICY SIGNIFICANCE OF THE CIRCULAR FLOW OF MONEY

We can learn something more than the models of circular flow of money. So long as nothing happens to interrupt the circular flow of money, the economy would continue to function at an even speed. But the moment the circular flow of money is interrupted, difficulties will occur in the working of the economy. Any interruption in the various points of flow will reflect itself either in the decrease or increase in the flow of money.

For instance, a decrease in circular flow of money may be brought about either by increased savings of the community or through a reduction of bank loans and advances (i.e. bank credit). Given the total supply of money, any attempt to save more will result in reduced total spending leading to reduced factor income and employment and also prices. This will set in motion a cumulative deflationary trend in the economy on the other hand, an increase in the circular flow of money will result in the opposite trend - an increase in income, demand for goods and services and prices. In the interest of economic stability, the flow of money should be smooth. A depression with its tendency towards great unemployment of men and materials can be reversed through the release of additional amount of money by the monetary authorities. Conversely, too much money in circulation which leads to greater demand and higher prices (an inflation) could be reversed through reduction of money in circulation. Thus the concept of the circular flow of money has a great policy significance.

Secondly, whatever happens in the economic system will tend to create a cumulative situation. For instance, increased savings will lead to a decrease in expenditure. This will result in decreased income for business enterprises which in turn will make smaller payments to factor owners who, in turn, will spend less on final goods; and this process will continue. Once a certain amount of money leaks out, there is a cumulative trend towards lower income, lower demand and lower output. Similarly, a new dose of money pumped into circulation will set in a cumulative trend towards higher income, higher demand and higher output. Kenyes based his multiplier and acceleration principles on the circular flow of money.

Thirdly, money flow can help us to calculate the national income of a country. Money flow expresses the value of all goods and services, the national income of the country is estimated. This may be done in two ways:

A) *Adding Expenditures*: We can add up all the expenditures the country, for it is expenditures which constitute income and which give value to goods and services. The expenditures in a country will consist of:

a) Consumption expenditure of house holds for goods and services;

b) Expenditure of companies and corporations on (i) capital goods (ii) addition to inventories or increases in their stock of goods; and

c) Government's expenditure on goods and services.

Apart from these three expenditures, there would be those goods and services which are produced in the economy but exported (i.e. sold outside the economy). The money value of exports should be included in the total value of goods and services produced within the economy but the value of imports should be deducted from the total money value of goods and services. Thus the gross national income of the economy consists of expenditure of consumers on final consumption goods and services, the expenditure of companies and corporations on capital goods including stocks of goods, Government's expenditure on goods and services and finally net exports (excess of exports over imports). This will give us the money value of gross national income at market prices.

B) *Adding Incomes*: We can find out the national income of a country by adding together wages, interests, rents: and profits. This method derives the national income as a set for total net incomes received by individuals and business enterprises. The figure arrived at is known as national income at factor cost. But this figure will necessarily be lower than the figure arrived at by the first method. This is so because business enterprises which receive income need not distribute the entire amount by way of factor payments. They may save part of their incomes (e.g., by way of undeclared dividends.) Besides, part of the income received by business enterprises by way of prices of goods includes indirect taxation (such as excise tax and sales tax on goods) by the Government. If the necessary adjustments are made, the two figures will be equal. Thus the circular flow of money can be used as the money value of an economy's income (i.e. national income). It is of added significance because the concept of national income has enormous importance in the formulation of economic policy.

SUMMARY

In the model circular flow of money the important point to remember is that the entire amount of money which paid out to factor owner by business enterprises is paid back by the factor owner to business enterprises. Thus there is a circular and continuous flow of money. The economy will continue to work indefinitely, producing the same volume of goods and services.

KEYWORDS

- Cumulative
- Interrupt
- Indefinitely
- Deflationary

REVIEW QUESTIONS

1. Explain the circular flow of money in an economy.
2. What are the policy significance of the circular flow of money?

SUGGESTED READINGS

1. D.M. Mithani - Money, Banking and Foreign Trade.

WITH COURAGE AND FAITH
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LESSON 4

MONETARY STANDARDS - GOLD STANDARD

OBJECTIVES

After reading this lesson, you should be able

- to know about monetory standard
- to understand the metallic and gold standard.
- to analyse the decline and fall of gold standard.
- to get knowledge about domesting and international gold standard.

STRUCTURE

4.1 INTRODUCTION

The standard money, is that legal money is which the government of the counting itself discharges its own obligations. The monetary standard is thus, synonymous with the standard money adopted by a country's monetary authority. The gold standard could work only if the rates of game were observed which could be observed under normal conditions.

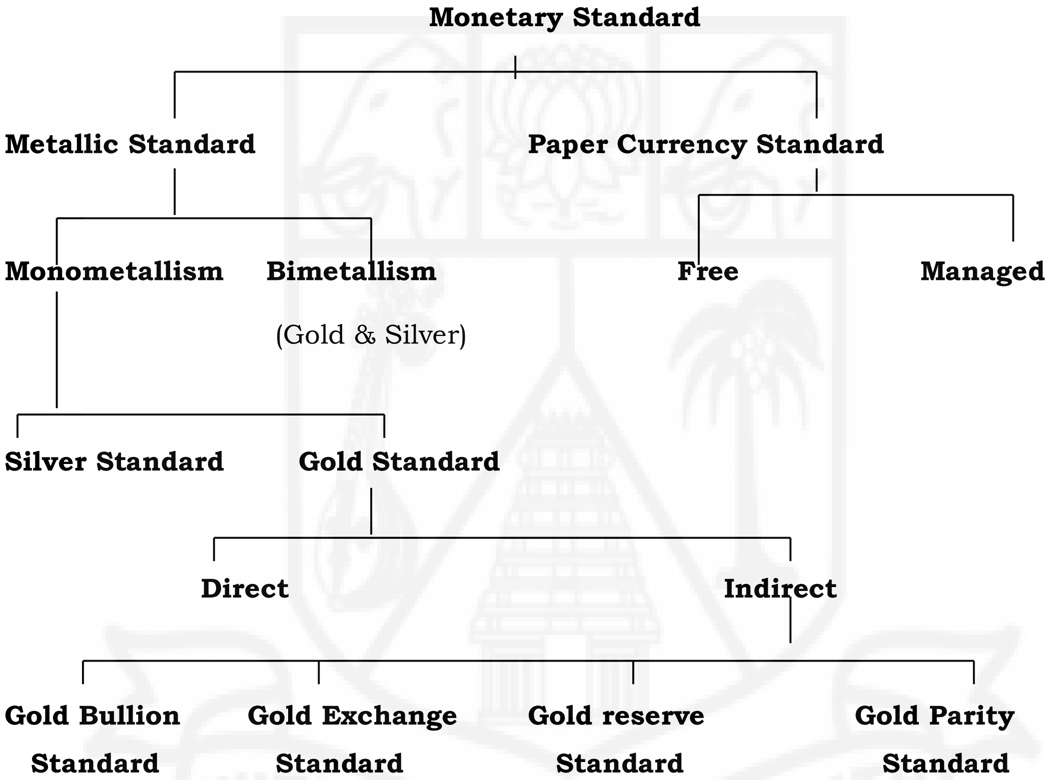
4.2 MONETARY STANARD

The term 'monetary standard' refers to the type of standard money used in a country. The standard money, is that legal money in which the government of the country itself discharges its own obligations. The monetary standard is thus, synonymous with the standard money adopted by a country's monetary authority. If the standard money happens to be made of gold the country is said to be on the gold standard. If the standard money is of paper, the monetary standard is referred to as paper standard.

A monetary standard is basically national in character since it is intended by the monetary authority to cater to the internal requirements of the country in so far as it provides a medium of exchange and a measure of value within the borders of the country. But the monetary standard has also its international aspects. It has to facilitate international payments. A sound monetary standard has, thus, two main objectives: (i) to maintain stability in the currency's internal value or the internal price-level, and (ii) to maintain stability in the currency's external value, i.e., its exchange value in terms of foreign currencies.

4.3 TYPES OF MONETARY STANDARD

The various types of monetary standard can be shown with the help of the chart below.



4.4 METALIC STANDARDS

Even in very early times, when direct exchange or barter had given place to indirect exchange through some medium of exchange, men realized the basic weakness of money viz., its unstable value. But they always desired that the money serving as the medium of exchange must have a high degree of stability of value. The looming question was how to ensure stable value or a constant value to the currency unit.

In the past, people widely held that a country's currency could have a constant and fixed value only if it consisted of or was convertible to a standard metal-gold or silver or both. A good monetary standard would be one which would keep the value of monetary unit relatively stable. If prices were high in one year and low in another, business activity would be disrupted and all economic calculations would prove wrong and, therefore a good monetary standard was essential.

Three kinds of monetary standards, had been in vogue in different periods of time. They are (a) Mono-metallism. If the monetary unit is made up for convertible to only one metal, either gold or silver, the country is said to be on mono - metallism. Normally in most countries in the past, it was mono metallism with gold as the commonly used metal, which was popular. (b) Bi - metallism. If the standard monetary unit is defined in terms of both gold and silver, the system is called bi-metallism. In this system, the country's currency is redeemable in gold or silver, or both. (c) paper currency standard. If a country's currency consists of paper currency notes which are not redeemable in gold or silver, it is said to have an inconvertible paper currency system. This lesson deals with the first, namely, the gold standard.

4.5 THE GOLD STANDARD

The gold standard is a monometallic standard in which the value of the monetary unit is fixed in terms of a specified weight and purity of gold. According to Robertson, Gold standard is one in which a country keeps the value of its monetary and the value of a defined weight of gold at an equality with one another. Coulborn's defines that, "The gold standard is an arrangement whereby the chief piece of money of a country is exchangeable with a fixed quantity of gold of a specified quality."

4.6 TYPES OF THE GOLD STANDARD

The meaning of the gold standard, as given above, relates to its general form. But different countries at different times adopted different types a gold standard. They are:

1. Gold Currency Standard: This standard prevailed prior to 1914 in the UK, USA and few other countries. It was also known as the gold coin standard, gold circulation standard or full or pure gold standard. It had six main features: (i) gold coins of a definite weight and fineness circulated within the country. For instance, in England the sovereign was the gold coin which contained 123. 2744 grams of gold of 11/12th purity. (ii) the gold coin (i.e. Sovereign in Britain) was full and unlimited legal tender. (iii) Non-gold metallic coins and paper currency notes also circulated side by side but they were convertible on demand into gold coins at fixed rates. (iv) There was free coinage in gold. Any body could take gold or jewellery to the-mint for coinage. (v) Gold coins could be freely minted for other purposes. (vi) Export and import of gold were free and unrestricted. Since this standard was costly to operate, it was given up after the first world war in favour of the gold bullion standard.

2. *Gold Bullion Standard*: This standard was in operation in the 'UK from 1925-31 and in India from 1927-31. This monetary system had five distinguishing features: (1) Gold coins did not circulate within the country. The legal tender currency in circulation consisted of paper currency notes and token coins of silver and other metals. (2) These were convertible at fixed rates into gold bars or bullion.

For instance, in England currency notes were convertible into gold bars containing 400 oz. of gold at the fixed price of £ 3-178 -10 d per oz. of 11/12th fineness. When India adopted this system in 1927, rupees were convertible into gold bars containing 40 tolas at the price of Rs. 27-7 annas- 10 pieces per tola. (3) For converting currency into gold, the monetary authority was required to keep gold bars in reserve. (4) The monetary authority also bought gold from the public at fixed prices. (5) Gold was freely exported and imported.

3. *Gold Exchange Standard*: This system was in operation in India between 1898 to 1913 and in a number of eastern countries which were pure and did not possess sufficient gold. But most of such countries were under the colonial rule and their currencies were linked with the currency of the ruling country. The principal features of this monetary system were; (i) Gold coins did not circulate within the country. (ii) The currency consisted of paper notes and token coins of silver and or other metals. (iii) These were not convertible into gold coins or bullion. (iv) But the local currency was linked with some foreign currency which was on gold currency standard. (v) It was convertible into such foreign currency at a fixed rate. For instance, the Indian rupee coins were convertible into British sterling at the ratio of 1s-4d per rupee. (vi) Since the currency was indirectly linked with gold, prices of goods and services were consequently determined by the price of gold. (vii) Gold could not be exported and imported freely. Only the monetary authority was authorised to export or import gold. But actually payments were made in the currency of the two countries. For instance, rupee and sterling securities were bought and sold by England and India respectively at the fixed exchange rate of 1s-4d per rupee. .

4. *Gold Reserve Standard*: England was the first country to abandon the gold standard in 1931, followed by the USA in 1933 and france in 1936. This lead to instability in their exchange rates. To maintain exchange stability, they entered into Tripartite Monetary Agreement in September 1936 and they were joined by the Netherlands, Belgium and Switzerland in the same year. This agreement came to be known as the Gold Reserve standard and worked successfully till the outbreak of the second world war in September 1939. The main features of this system were; (a) There were no gold coins within the country. (b) The currency consisted of paper notes and token coins of cheap metals. (c) This currency was inconvertible into bullion. (d) Under the Agreement, each country maintained an Exchange Equalisation fund which maintained gold, local currency and foreign exchange. The exchange rate was stabilised by purchase and sale of foreign exchange or gold from the fund. (e) There was no free export or import of gold except by the fund authority for maintaining stability in the exchange rate. Such gold was meant to be kept in the fund. (f) There was strict secrecy about the reserves of gold and foreign exchange kept in the fund.

5. *Gold Parity Standard*: This system emerged with the establishment of the International Monetary fund in 1944. It does not possess any of the features of the various gold standards explained above. Under this system, every country had to declare the par value of its monetary unit in terms of a fixed quantity of gold. So this is .not gold standard in the real sense of the term, except that it aims at keeping the exchange rate of the currency stable in terms of gold. As observed by Crowther, "But whatever form the gold standard may take, its essential characteristic is that the currency is, either directly or at one remove, either in volume or in value, linked to gold". Rules of Gold Standard. According to Prof. Crowther, ''The Gold standard is a jealous God. It will work, provided it is given exclusive devotion". What it implies is that the gold standard yields results only it its rules are properly observed.

1. *Policy of Free Trade to be Adopted*: Gold standard can work effectively only if there is complete freedom of trade in the country. In other words, the government of the country should impose no restrictions of any kind on imports and exports. Any restrictions imposed on imports or exports will serve only to obstruct the working of the gold standard. For example, if the government follows a protectionist policy and subjects imports to quotas takes duties and licences, or imposes restrictions on gold exports, there is bound to emerge a disequilibrium in the balance of payments which will not be corrected through the process of gold imports-exports.

2. No Restrictions on Gold Imports-Exports: For the effective functioning of the gold, standard, it is essential that there should be no restrictions imposed on the imports and exports of gold. Gold should move freely from one country to another country. If a country accumulates imported gold and does not allow it to be exported, then other countries will have to face problems due to lack of adequate gold stocks.

3. Elasticity in the Economy of the Country: For the successful functioning of the gold standard, it is essential that the economy of the country should be flexible. In other" words, the government of the country should allow gold imports and exports to exert their full effect on the internal price-level: The monetary authority of the country should vary the money supply in accordance with changes in its gold reserves. For example, if the balance of payments of a country is unfavourable, then that country should allow gold to be exported to correct the deficit in its balance of payments. With gold exports, the reserves of the country decline and ultimately the monetary authority has to contract the currency in circulation in the same proportion. The contraction in currency results in a fall in the internal price-level, encouraging exports and discouraging imports. As a consequence, the deficit in the balance of payments disappears. Like wise a gold-importing country is required under the rules of the gold standard to expand the currency in circulation in proportion to the increase in its gold reserves. As a result, internal prices rise, discouraging exports and encouraging imports of goods. Thus, the surplus in its balance of payments disappears. According to the rules of the gold standard, a gold-importing country should expand its currency and credit, while a gold-exporting country should contract its currency and credit.

4. No Interference with Domestic Prices: A country on the gold standard should not manage or interfere with domestic prices, but should leave them free-to respond to the movements of gold between the countries concerned.

In essence, the basic rule of the successful working of the gold standard is that there should be no management of this monetary standard in any case. The entire mechanism should be left free to respond, as it will, to the free economic forces operating in the world.

4.7 DOMESTIC AND INTERNATIONAL GOLD STANDARDS

Gold standard has two functions to perform, viz.

(a) regulating the volume of currency within the country, and (b) stabilising the rate of exchange. The first function is really concerned with the important task of stabilising the internal value of the currency. This is commonly known as the domestic function or aspect of the gold standard or simply the domestic gold standard. The second function aims of stabilising the internal value of the currency (which is based on the external value of the currency). The second function may be called the international aspect of the gold standard or simply international standard. Growther had brought out the distinction between the two systems in the following manner: "The cardinal point in the domestic gold standard is clearly the proportion of volume enforced by law between the gold reserve and the currency. The essence of the international gold standard is the convertibility of the currency into gold-that is, the fixed proportion of value between a unit of gold and a unit of currency." Thus the domestic gold standard is a system in which the currency unit is expressed interms of weight of gold and the volume of currency is made dependent upon the volume of gold reserves; international gold standard, on the other hand, implies the combination of more than one currency and is a device for preserving a fixed exchange rate in all gold standard countries.

DOMESTIC GOLD STANDARD

In its domestic aspect, the gold standard performs the important function of controlling the volume of money in the country. The supply of money depends upon the amount of gold reserves available. Increase of gold, through gold imports, will expand the volume of money in the country, while contraction of gold reserves through gold exports, will have the effect of contracting the volume of money in the country. Further since monetary authorities have the obligation to redeem paper currency notes into gold, the volume of gold reserves will clearly lay down the volume of paper money issued. There is therefore, a definite restriction imposed on the monetary authorities to issue paper currency.

Further gold influences not only the volume of currency but also the volume of bank deposits. Any change in the supply of currency notes changes the volume of cash which commercial banks possess and a change in cash available will force banks to give more or less loans; and, as will be discussed later, more. Bank loans and advances will result in more bank deposits. Thus the volume of bank money is dependent upon the volume of currency issued by the monetary authorities which in turn depends upon the volume of gold. The whole structure of money and bank credit in domestic gold standard is built on the foundation of gold.

INTERNATIONAL GOLD STANDARD

In a sense, the international aspect of the gold standard has been regarded as more important than the domestic aspect. Gold is an internationally traded and, therefore, accepted material and consequently the price of gold will be the same throughout the world, learning minor differences because of transport and insurance charges. The adoption of gold by a number of countries makes it possible to have an international medium of exchange and standard of value.

When a number of countries are on the gold standard that is under the international gold standard, gold becomes the medium of exchange and the standard of value in all countries. Besides, there is a free market for gold and gold is allowed to be freely exported and imported. This is an essential requirement, for the absence of it will make it a domestic system.

The main objective of the international gold standard is to bring above fixed exchange rates. Since the gold standard countries have fixed the value of their currencies to gold. There is an automatic parity of foreign exchanges. Such a rate is known as mint par of exchange. The market rates of exchange fluctuate round about the mint par of exchange.

THE WORKING OF THE GOLD STANDARD

The gold standard was meant to create confidence in the mind so the public in the paper money, (b) to bring about stable exchange rates between countries, (c) to provide an international medium of payment and (d) to correct an adverse balance of payments. It was an automatic standard since it could work in an automatic manner without interference or management from the monetary authorities. We shall illustrate pre-automatic working of the gold standard by taking a simple but highly imaginary example.

Correcting an Adverse Balance of Payments: Suppose India and England are on the gold standard. Suppose India experiences at favourable balance of trade and excess of exports over imports. The result will be import of gold into India, which will lead to currency and credit expansion. Such a currency expansion will lead to a rise in prices and profit margins consequently this would result in greater investment, production and employment. Ultimately income will rise and so too costs. Increase in income India will lead to greater demand for goods from other countries. At the same time rise in costs and prices will discourage exports to foreign countries, since foreigners will not like to buy from India as prices of Indian Goods are higher than that of theirs thus imports into India will increase and export from India will decrease. This automatically sets in the process of restoration of equilibrium.

Equilibrium Restored: Mean while, loss of gold by England, as a result of adverse balance of trade, will lead to contraction of currency in England, resulting ultimately in the contraction in income and fall in costs there. Hence England will import less from India because of lower income in England and high prices in India. At the same time exports to India from England will be stimulated since prices are higher in India than . England. Thus England will experience a favourable balance of payments, Ultimately, gold which had come earlier would leave India; England would get back gold which had left it in the previous period.

In this way, gold movements between countries tend to be self-correcting in the long run. Hence there cannot be a persistent and sustained one-side movement of gold.

Movement of Capital and Equilibrium: There is one more reason which help to restore the equilibrium in the balance of payments of gold-losing and gold receiving countries. In the country which loses gold, interest rates rise due to the contraction of currency and credit. A rise in interest rates will attract short-term capital from foreign countries and will correct the adverse balance of the gold losing country. On the other hand, the gold receiving country will experience it decline in interest rates which will stimulate the outward movement of short-term capital.

Thus equilibrium is brought above in two ways; (a) changes in internal prices and costs of production, and (b) changes in interest rates. Further equilibrium is brought about by the co-operation at both the countries. This system of ensuring equilibrium has been called as price-specie flow mechanism. The essential condition is that the monetary authorities should observe the rules of the gold standard.

Thus under the gold standard, an expansion of contraction of currei1cy within the country or disequilibrium in international payments will be automatically corrected without any interference by the government or the monetary authorities. In fact, the monetary authorities are asked to follow the gold game, i.e., not to neutralise the automatic working of the gold standard. Under international gold standard there is a close relation between price levels in the various countries. Price level in terms of gold tend to be the same in all the gold standard countries; and since each monetary unit is fixed in terms of gold, prices in terms of monetary units tend to fluctuate in a parallel manner in all gold standard countries.

Suppose, the price of goods and services in terms of gold tend to be higher, say in India, than in other countries, India will be a good market to sell in but a poor market to buy from. On the other hand, other countries in which prices are low, will be good markets from which to buy but poor markets in which to sell. As a result, India will import more from foreign countries but export less to them; India, therefore, will experience an adverse balance and the other countries, a favourable balance. Gold will flow from India to other countries to balance international payments. But the flow of gold out of India will reduce the supply of money and thus lower price levels in India. The flow of gold into lower priced countries will tend to rise their price levels. Unit price-level relationship between. the two countries are brought into equilibrium. Thus, the automatic functioning of the gold standard brings about a proper distribution of gold among the various countries and keeps price levels in line with each other.

The advocates of the gold standard place great emphasis OD this automatic working of the gold standard.

But a number of practical problems crept in the working of gold standard, as a result of which slowly countries started opting away from this system. .

4.8 THE DECLINE AND FALL OF THE GOLD STANDARD

The gold standard could work only if the "rules of the game" were observe which could be observed under normal conditions. But when the first world war broke out in 1914, the belligerent countries went of the gold standard because they had to suspend convertibility of currency into gold. They withdrew gold coins from circulation and replaced then by paper currency notes. England prohibited the meeting of gold coins and the export of gold though it did not stop conversion of notes into gold coins. Some of the countries did make payments to the neutral countries in gold. During the war, the belligerent countries suffered from inflation of varying degrees. But they could n6t be controlled because the countries could not observe the rules of the game. So the gold standard virtually broke down during the war period.

After the War, most countries suffered from inflation of varying degrees which made it difficult to fix gold value of domestic currency at pre-war rates. Great Britain in order to maintain its prestige opted to return to the gold standard at the pre-war parity and it was commonly estimated that the pound was overvalued by 10 per cent. This was because the price level in Britain was higher than in America by this percentage. The actual exchange rate was -fixed at $ 4.866= £1 but the equilibrium rate was $ 4.38 = £1. So British goods were over priced and that of America's under-priced. This adversely affected British exports and favoured imports from America. But Italy overvalued its Lir8- and France undervalued its Franc. By 1928 the restoration of the gold standard was complete.

But it was not the same gold standard which existed before the 1914 War. Rather, it was a truncated gold standard with failure of the governments to follow the "rules" of the gold standard game. Consequently, with the beginning of the Great Depression in 1929, the final of the gold standard began. Four South American countries were the first to go off the gold standard by the end of 1930. England, along with twenty-two other countries, abandoned the gold standard in 1931. By the end of 1936, practically all countries had left the gold standard. .

Causes of the Break down of the Gold Standard: Economists have pointed to a number of causes which led to the break down of the gold standards. The monetary authorities of the different countries were no longer exclusively devoted to the aims of the gold standard as they had been before the war. As put by Crowther, "Gold standard is a jealous God. It will work provided it is given exclusive devotion." They were not prepared to follow the rules of the gold standard. After the restoration of the gold standard in 1920's every country wanted to have price stability, whereas the main objective of the gold standard was to maintain exchange stability. Since price stability was not compatible with the maintenance of the gold standard, it broke down for failure of observe this golden rule of the game. ",

2. The technical task of maintaining exchange stability was more difficult than before the first world war. Exchange stability could be maintained by making adjustment in the internal price levels of countries. But it was difficult to make constant readjustment in prices due to three reasons: (i) The domestic currencies were either overvalued or undervalued; (ii) There was downward rigidity in the wage-Cost structure in case of downward readjustment of prices; and (iii) Since the short-term funds of hanks could not be influenced still more difficult by changes in the rate of interest the process of readjustment become. The short-term funds were affected more by speculation or fear than by the interest rate.

3. The imposition of Reparations and the insistence on the repayment of War debts from Germany made it difficult for the foreign market to be controlled by the weapons of the gold standard. To pay Reparations and war debts, Germany had to buy dollars irrespective of its gold reserve position and the bank rate and the countries, which received such payments could not make adjustments accordingly.

4. Almost every country imposed high tariffs. Imposition of high tariff especially by the creditor countries restricted imports from debtor countries. This was a clear violation of the rule of the gold standard which assumed free flow of goods from and to other countries. When a debtor country was losing gold, it was essential for it to lower internal prices in order to expand exports. But high tariffs by the creditor countries prevented the expansion of exports and thus made adjustments in foreign exchange difficult. This led many countries to abandon the gold standard.

5. The central banks failed to observe the golden rule: "expand credit when gold is coming in; contract credit when gold is going out." The United States and France which were receiving gold did not expand, credit sufficiently. On the other hand, Germany and Great Britain which were losing gold tried to make adjustments by borrowing from the gold-receiving countries. This meant the non-observance of the rule of the gold standard. Consequently the quantum of money was not equal to the gold levels. These added, to some other immediate causes, resulted in the break down of the gold standard from 1930 onwards.

The first cause was the steep fall in the price levels of a number of countries. This brought a fall in the demand for exports and reduced the foreign exchange earnings of exporting countries. The earnings of the countries which depended on exports of raw materials declined considerably when prices fell sharply. They could not protect their gold reserves from falling as they continued to make gold payments for their international obligations.

The next immediate cause for the abandonment of the gold standard was the virtual cessation of international lending from 1929. Many debtor countries had been borrowing from the United States to meet their international payment and protect their gold reserves during 1920-27. But with the coming in of the Great Depression, such countries, stopped borrowing and found it difficult to make repayments of interest and principal because their earning were declining.

Another immediate cause was the presence of large short-term international debts against London and New York financial markets. These were payable on demand at short notice. A wave of fear caused the lenders of these short-term funds or "Hot Money" to ask for their payments. It all started with the failure of the largest bank in Austria, the Credit

Anstalt, in May 1931. This led to wide Panic in international banking in Germany, France, United States and Great Britain resulting in run on banks with the result that they stopped payments and froze credits in terms of gold. This ended the gold standard finally. Hawtrey observes, "The immediate cause of the crisis, it is true, was the withdrawal of foreign money, first from Austria and Germany and then from England. But this was the result of distrust, and the distrust was directly due to the appreciation of gold."

4.9 MERITS AND DEMERITS OF THE GOLD STANDARD

Merits Of Gold Standard

According to the advocates of the gold standard, there were a number of advantages of the gold standard which were as follows:

1. Created Confidence: The gold standard creates confidence in the minds of the public since the common circulating medium consisting predominantly of currency notes was convertible to gold coins or gold bars or drafts convertible to gold. The advocates maintained that gold was an internationally accepted medium of payment and that the people had complete confidence in the currency system which was linked to or based on gold.

2. Stability in the Rates of Exchange: The gold standard brought about stability in the rate of exchange between countries. Every member country declared the value of its currency in terms of weight in gold; and the exchange rate, therefore, was automatically fixed with reference to the gold contents of the respective currencies. This was known as the mint par of exchange and there was very little chance for the rate of exchange to fluctuate under gold standard.

To take a simple example, suppose the Indian rupee consisted of 5 grains of gold while the English pound sterling contained 100 grains of gold, then Re 1 would exchange for £ 1/20 or £1 would be equal to Rs.20. This rate was known as the mint par of exchange, i.e. the rate at which the currencies could exchange for gold at the respective mints. The actual exchange rate would be a little more or a little less than the mint par, to allow for cost of transporting gold between countries. The greatest merit of the gold standard, therefore, was that' the exchange rate was fixed between the gold profits. .

3. Automatic Working: The gold standard worked in an automatic fashion. As it was seen earlier, an adverse or ; favourable balance or an. inflation or deflation was automatically corrected without much interference from the Government or the montary authority.

4. Stability in Internal Prices: Under the gold standard, there would be comparative stability in internal prices. Of course, prices would rise or fall but the changes in prices would be related to the amount of gold in the country and to international trade. Thus import of gold would lead to rise in prices; export of gold would result in contraction of prices. But the rise in prices would not be too high to make it an inflation; so also contraction of prices would not be so bad as to make it a depression. Thus, gold standard was said to bring about relative stability in prices.

5. Medium of Payment Between Countries: Gold standard was s to be useful because under it gold was the medium of payment between countries, and, therefore, all the currience of gold standard countries were automatically related to one another. This promoted international trade and facilitated international investments. Balance of payments could be easily settled through the use of gold.

Demerits Of Gold Standard

At one time the gold standard was considered the best system of currency, but in course of time since many practical problems were faced it led to criticism. The critics pointed out that the advantages claimed for the gold standard did not actually exist.

1. The System was not Simple: The gold standard was not as simple as was claimed by its supporters. The gold coin standard and to some extent gold bullion standard might be considered simple and might have secured the confidence of the public. But the gold exchange standard which connected the currency with foreign currently was far from simple and was beyond the comprehension of the common man. Moreover, the people's concept of money and monetary media had undergone a complete change. There was a time when people accepted the currency notes, only because they could be converted whenever needed into an equivalent amount of gold coins or gold bars. But now-a-days currency notes are accepted as money on their own right. Hence the claim made in favour of the gold standard that it created public confidence, may not have any meaning in the present days.

2. lf Failed Often: The gold standard was characterised as , a "fair weather standard" for it worked smoothly in times of peace and in normal times but during periods of wars and economic crises, it invariably failed. But the necessity for a standard was to be found during periods of war and not during peace-time-just as the need for a friend was in times of difficulties and not informal periods. Consequently people lost faith in the gold standard.

3. It Scarified Internal Price Stability: The gold standard scarified internal stability in order to secure external stability. It was accepted that the gold standard ensured fixed exchange rate which, was necessary for smooth international trade. But the question was whether, internal stability in prices was not superior to stability in the rate of exchange. Generally, people preferred stability of prices with in the country to stability in the rate of exchange.

4. It was not Automatic: The gold standard did not work automatically as was claimed by its supporters. The monetary authorities had to manage the gold bullion and gold exchange standards. In the case of the gold exchange standard especially, the monetary authorities had to maintain two reserves and buy and sell foreign drafts against local currency.

5. Automatic Working was a Defect: Even assuming that the automatic working of the gold standard was true, it was not considered a merit but a demerit. For example, an excessive demand for foreign goods, reason for some say because of war, world force a country, to export gold as a result of unfavourable balance of payments. According to the rule of the gold standard, gold exports would be responsible for the contraction of currency and decline of prices. But unfavourable balance would tend to become permanent and thus the country would start losing all its gold. It would be better to suspend the gold standard as early as possible, At the same time foreign countries which experienced favourable balance of payments with the country would import gold, and consequently expand currency and experience inflationary trends. While the earlier country would experience of severe deflation, the latter one would experience a hyper-inflation. Inflation and deflation never did any good to the economy or the society. The automatic working of the gold mechanism would be all right if the disequilibrium in the balance of payments was for a short period and promptly corrected itself later. But if the disequilibrium tended to become continuous or chronic, it would be a calamity for gold standard countries.

6. A Country could not Follow an Independent Economic Policy: Under gold standard, the difficulties and problems of one country would be passed on to other countries also. In fact, it would be difficult for a country to follow an independent policy under the gold standard. Whenever a country or group of countries decided to follow an independent or its own national economic policy, it had to sacrifice the gold standard in the first instance.

Downfall Of The Gold Standard

After the First World War, the four rules of the gold standard which were pillers of the standard were not honestly and faithfully observed by the countries of Western Europe.

That was a major cause of the downfall of the good, standard.

Following were the causes of the downfall of the gold standard.

1. Violation of the Rules of the Gold Standard: The violation of the rulers of the gold standard by the countries concerned was indeed a major cause of the downfall of this system. The non-observance of these rules undermined automatic working of the gold standard. For example, the U.S.A. did not expand its currency and credit in con formity with the inflow of gold. This was a blatant violation of the rules of the gold standard.

2. Abandonment of the Policy of Free Trade: The abandonment of the policy of free trade by several European countries after the First World War directly contributed to the decline of the gold standard. Britain, France and the U.S.A imposed a variety of restrictions on their imports with the result that the debtor countries had no chance to repay their debts in terms of goods and services. They were rather forced to repay their debts in gold; their gold stocks were seriously depleted and they were forced to go off the gold standard.

3. Unbalanced Distribution of Gold Stocks: As a result of violation of the rules, the distribution of gold stocks among the various countries became unbalanced. Countries like France and the U.S.A. came to accumulate too much of gold, while countries of Eastern Europe and Germany were confronted with a serious shortage gold. The Former countries did not allow their increased gold stock to exert its influence on their respective price-levels, while the latter countries imposed a variety of restrictions on gold exports to protect their reserves from further depletion. Despite these restrictions, their gold stocks continued to decline. Ultimately, they were forced to give up the gold standard.

4. Payment of War Reparations: After the First World War, the victory nations like the U.S.A. and France forced the defeated Germany to pay war-reparations in gold, not in goods and services. Germany was already short of gold. So it decided to abandon. the gold standard.

5. Rise of Economic Nationalism: A wave of economic nationalism swept Europe after the First World War. Each country tried to be self-sufficient as far as possible. In a fit of sudden protectionism, the countries of Europe imposed exasperating restrictions on each other's goods. This spirit of economic nationalism was contrary to the gold standard which prohibited the imposition of any kind of restriction on imports or exports.

6. World Depression of 1929: The world Depression of1929 delivered the greatest blow at the gold standard. Several banks in European countries failed, giving a rude shock to public confidence in banking. The people of these countries demanded gold in exchange for paper currency. But the governments of these countries expressed their inability to meet the public demand for gold in view of their depleted stocks. One by one these countries went off the gold standard.

7. Havoc Caused by Short-term or Refugee Capital: After the First World War, the countries of Europe imposed a variety of irritating restrictions on foreign capital. Frightened by these restrictions, Foreign capital moved from country to country in search of security. This is why it was referred to as “Refugee capital.” The sudden movement of refugee capital from one country another created serious problems for both the countries. For example, the sudden withdrawal of their capital from Britain by the French capitalists in 1931 created an unlimited demand for gold which the Bank of England could not meet in view of its depleted gold stocks. As a result, Britain abandoned the gold standard in-September 1931.

8. Political Instability: In the post-war period, there was serio\t'8political instability in the countries of Europe. This had adverse reaction on the functioning of the gold standard. There were interruptions in the international movements/of capital which forced these countries to give up the gold standard.

9. Inelasticity in Internal Prices in the Post-war Period: Flexibility in the internal: place-level is an essential prerequisite for the success of the gold standard. With a fall in the gold reserves of the country, it would be essential to contract the currency in circulation in the same proportion to bring the prices down. To bring the prices down, it would also necessary to reduce production costs in industries. But reduction in the production costs became rather difficult tin view' of the stiff. opposition of the trade unions in the post-war period. Thus, Internal prices could not be reduced despite the contraction of currency in circulation. This inelasticity in the internal price-level proved fatal for the gold standard.

10. Lack of Co-operation Among Countries of the World:_An essential condition for the success 6fthe gold standard is the existence of political and economic co-operation among the countries of the world. But in the post-war period there was complete absence of co-operation among the gold standard countries. Every country was motivated by its own selfish interests. No country was willing to sacrifice it own welfare in a bid to help other countries. No country step in the direction of international co-operation. The fall of the gold standard had thus become inevitable.

SUMMARY

There are number of courses which led to the breakdown of the gold standards. Some are failure of its technical tasks, imposition of high traffic etc. The merits of gold standard are it created confidence, stability in the rates of exchange and internal prices and medium of payment between countries. The demerits are, it was not simple, often techniques, the country could not follow an independent economic policy.

KEYWORDS

- Belligerent
- Truncated
- Abandoned
- Reparations
- Depleted

REVIEW QUESTIONS

1. Explain briefly the various types of monetary standard.
2. What are the causes of breakdown of gold standard?
3. State and explain the merits and demerits of the gold standard.
4. What are the causes of the downfall of gold standard?

SUGGESTED READINGS

1. D.M. Mithani - A treatise on Money, Banking and theory of Income.

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LESSON 5

PAPER CURRENCY STANDARD OR MANAGED SYSTEM

OBJECTIVES

After studying this lesson, you should be able

- to understand the special feature of paper currency system.
- to know the priniciple and methods
- to familiar with methods of note issue.
- to know merits and demerits of paper currency.

STRUCTURE

5.1 INTRODUCTION

In the history of monetary systems, paper currency has had a bad reputation. In the past when countries were wedded to gold or silver standards or both, inconvertible paper currency systems was used only at a last resort, under difficult circumstances when adherence to metallic standard was impossible. Generally, paper currency systems are associated with extreme inflations. But since 1931, the experience of England and other managed paper currency systems has been responsible for a certain amount of respectability for the system and also for dispelling a great deal of suspicion formerly held by the people regarding paper currencies.

5.2 SPECIAL FEATURES OF PAPER CURRENCY SYSTEM

The paper currency standard is distinct from other monetary systems in two respects. First, under paper currency system gold or silver is of no significance, because under this standard there is no redemption or convertibility of the paper currency to any metal. As a result, the volume of paper currency in the country is not limited by considerations of the supply of metals but by considerations of convenice of the Government or the issuing authority. But in a significant sense, the volume of paper money issued will be so adjusted as to bring about stability in prices and incomes. Secondly, the paper currency system is nationalistic, since there is no common link between the different paper currency systems of different countries. On the other hand, the gold standard is international since all those countries with the same metallic base are connected together.

The paper currency system is known as managed system to distinguish it from the gold standard which is considered automatic. Since the intrinsic value of paper money is nothing and since its value as money is derived from the command (or "fiat") of the Government, it is often referred to as fiat money (i.e., money by command) .or fiat standard. In order to maintain the system under control of paper currency is followed according to certain principles and standard methods are followed for note issue.

5.3 PRINCIPLES AND METHODS OF NOTE ISSUE

A good paper currency system should possess certain important qualities. It should command the confidence of the public and for this it should be based on adequate gold or silver reserves. The system should be elastic, specially for an economy like India which is developing; elasticity implies that the volume of current notes should increase or decrease according to the need for money for exchange purposes. Further, a good paper currency should be economical, automatic and secure. To bring about such a sound note issue system, two principles of note issue have been advocated they are the currency principle and the banking principle.

Currency Principle

The currency principles of note issue is based on the assumption that a good and sound currency system can command the greatest confidence of the general public only if it is convertible to gold or silver; in other worlds, note issue should be backed by cent percent gold or silver reserves. The currency principles assumes that, for every currency note issued, there should be an equivalent amount of gold or silver available with the monetary authorities to enable the latter to pay off anyone who is interested in covering his currency notes into monetary metal. Under this principle, the paper currency notes can be converted into monetary metal. Under this principle, the paper currency is taken as a convenient and economical device to prevent waste in circulation of precious metals.

Banking Principles

The banking principle note issue is based on the fact that the man in the street may not be keen to get his currency notes converted into gold or silver. It is not, therefore, necessary to maintain 100% metallic reserve against note issue. It will be sufficient if only a certain percentage or part of the paper currency notes is kept in the form of gold or silver,. The banking principles, it may be observed here, is derived from the practice of commercial bank to keep only a certain percentage of cash reserve against their deposit liabilities, though maximum safety of banks will necessitate 100% cash reserves against their deposit liabilities.

Evaluation Of The Two Principles

The currency principle of note issue has now here been adopted, for it makes the currency system inelastic. This is so because, under the system, monetary authorities will have to have an equivalent amount of gold for every currency note issued. Besides, such extreme caution is not necessary since, as pointed out above, the common man is not always interested in converting his currency notes into gold or silver. But the great merit - if it can be so termed - of the system is that it leaves nothing to chance or whims of the monetary authorities. But in reality the principle cannot be put into practice by any country, leave alone under developed countries. Above all after the fall of gold standard the relevance of such a principle is totally lost mainly because the convertibility of currencies is not a reality but only a myth. People's confidence in paper currency system in these days is no more dependent upon gold and silver but upon the efficiency of the government to maintain the value of the currency unit. If a country has so much gold as to back up its paper currency system with 100% gold reserves, it can add up to its own prestige by adopting a full-fledged gold currency standard. After all, such a rich country would gain nothing by adopting a paper currency system and attempt to secure the confidence of the general public.

The banking principle has come into vogue everywhere. The principle is based on the commonly observed fact that not all are interested in the convertibility of currency notes. In this sense, the system is economical since it does not require large metallic reserves. Moreover, it gives a great degree of autonomy to monetary authorities to increase and decrease supply of money according to certain pre-determined economic objectives. The banking principle, therefore, has been preferred to the currency principle and note issue every where is based on this principle.

5.4 METHODS OF NOTE ISSUE

An analysis regarding the merits of the different systems of note issue followed by central banks has little significance in these days when monetary problems of far greater importance have come to occupy the attention of the people. However, during the 19th century and in the beginning of the 20th century, discussion among economists regarding different systems of note issue used to be violent. Broadly speaking, there are two systems of note issue - the simple deposit system based on the currency principle and the partial deposit system based on the banking principle.

1. Simple Deposit System

Under the simple deposit system, all notes are backed by equivalent amount of gold or silver or both. This system was based on the 'currency principle' according to which a good note issue system should command the greatest degree of confidence of the people and this would be possible only when for every currency note there would be an equivalent amount of gold and silver. As a rule, the simple deposit system has never been put into practice.

2. Partial Deposit System

Under the partial deposit system some portion of note issue is backed by gold or silver and some portion is issue against securities. This system is based on the 'banking principle' according to which a good note issue system should be elastic and need not be cent per cent backed by precious metals. For, at any one time, only a few people would attempt to convert currency notes into gold and silver. The partial deposit system, which is found in practice everywhere, has a number of versions chief among them are:-

(a) Maximum Fiduciary Issue

(b) Fixed Fiduciary Issue

(c) Proportional Reserve System

(d) Minimum Reserve System.

(a) Maximum Fiduciary Issue System: Under this system, there is a maximum limit up to which the central bank is authorised to issue notes without any gold reserves. But there has to be full backing of gold reserves beyond this limit. The central bank is, however, authorised to raise or lower the maximum fiduciary limit and to fix the amount of gold reserves. Thus this system is not rigid but is elastic. It is also economical because the gold reserves can be kept to the minimum to meet the requirement of trade and industry. In case the central bank fixes the fiduciary limit very high, there may be excess of notes in circulation there by leading to inflation. This system was in operation in France, Japan, Russia, Norway, Finland and England.

(b) Fixed Fiduciary Issue System: Under this system, a fixed amount of notes is issued by the central bank against reserves of government securities. Such amount is issued on the faith or fiduciary of the central bank and is called the fiduciary limit. The central bank is required to keep hundred percent gold reserves beyond the fiduciary limit. The fiduciary limit is raised from time to time with the expansion of trade and industry. This system was introduced in England in 1844, in India in 1860, followed by Japan and Norway.

This system ensures security, inspires public confidence, and is without any danger of mismanaging the currency through the over issue of notes by the central bank.

But it has also certain disadvantages. It is a rigid and inelastic system because in need of a financial emergency, notes cannot be issued without keeping cent per cent gold in reserve. This actually happened in England .l on several occassions when the Bank Charter Act of 1898 had to be suspended to allow the Bank of England to issue notes without any reserves. second, the system is inconvenient because in the event of a fall in gold reserves, the Central Bank has to withdraw notes from circulation with the result that the quantity of money is reduced in the country with its adverse effects on prices, trade and industry. Third, this system is uneconomical because gold reserves are blocked up with the Central bank. It was, therefore, abandoned by all countries after the First World War, when these problems were felt with full impact.

(c) Proportional Reserve System: In this system, a certain percentage of the total notes issued by the central bank has to be in gold reserves and the remaining in the form of government securities. This percentage varied between 25 to 40 per cent in countries like Switzerland, Holland, Belgium, U .SA and India which adopted this system. This system is simple and elastic. The money supply can be changed in the percentage of gold reserves. Still, this system has certain drawbacks. It is uneconomical because large quantities of gold reserves have to be kept which cannot be issued for productive purposes. Second, if the gold reserves fall, the reduction in currency in circulation may be more than in proportion to the fall in reserves. This may lead to deflationary tendencies. The opposite may happen when gold reserves increase.

(d) Minimum Reserve System: Under the minimum reserve system, the central bank is authorised to issue notes up to any extent but it must keep a statutory minimum reserve of gold and foreign securities. India adopted this system of note issue in 1956 after discarding the proportional reserve system. Accordingly, the Reserve Bank of India was required to keep a minimum reserve of Rs.200 crores of which Rs.115 crores was in gold and Rs.85 crores in foreign securities.

This system is highly useful for developing countries because they can meet their financial requirements by printing more notes. They can also reduce the money supply to check inflation. It is, therefore, an elastic system. Further it is very economical because only a small and fixed amount of gold is required to be kept in reserve.

Despite these merits, the minimum reserve system is a dangerous tool in the hands of the monetary authority. It can print any number or notes, there by creating inflationary pressures within the economy by excessive printing of notes and thus lose confidence of the people. On the other hand, an efficient and honest administration can transform the economy by a judicious use of this system.

Conclusion: It can be concluded from the discussion of the various systems of note issue that an ideal system should fulfill the criteria of elasticity, economy, stability, convenience and safety. Every country tries to adopt that system which is flexible enough to meet its needs of growth and development. On this criterion, the minimum reserve system stands out unique -among all the system of note issue.

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5.5 MERITS AND DEMERITS

After the general abandonment of the gold standard in 1931, almost all countries had adopted the paper currency standard. In fact, the present age is the age of the paper currency standard.

The Following Are The Merits Of Paper Currency Standard

(1) Stability in the Internal price-level: Under this system, the monetary authority (or, the Central Bank) can establish stability in the internal price-level by regulating the supply of money according to the trade requirements of the country. For example, if, as a result of the development of trade and commerce, the demand for money increases, (he monetary authority will increase the supply of money without the necessity of increasing its metallic reserves.

(2) Freedom in Management : Since the currency under this standard is not linked with any metal, the monetary authority is free-to manage the money supply according to the trade r" requirements of the country.

(3) Ensures Fun Employment of Resources: According to Mrs. Joan Robinson, gold standard is. a deflation prone monetary system. Under this system the economic resources of the country are not fully employed and, consequently, unemployment spreads in the economy. But, under paper currency standard, each country managers its money supply in such a manner as to ensure fun employment of its productive resources. The government is free to determine its monetary policy under paper currency standard. This monetary standard is looked upon as an indispensable instrument for accelerating the economic development of a country. .

(4) Elasticity in money supply: Since the monetary authority can adjust the money supply according to the trade requirements of the country. This system possesses the essential quality of elasticity in money supply. The elasticity of this magnitude is not i to be found in other monetary standards.

(5) Internal Economy can be insulated from External Instability : Under this system the economy of the country can be protected from the adverse effects of instability to be found in other countries. The gold standard, as we had seen earlier, does not possess this quality in an adequate measure. Under this standard, the slump in one country soon finds its way to another country. But this does not happen under paper currency standard.

(6) More conductive to Economic Development : The paper currency standard is better suited to an underdeveloped, backward country because it enables it to develop itself speedy through deficit financing instand of looking for financial resources through taxation and public borrowings.

(7) More suitable for National Emergencies: The paper currency standard enables a country to meet national emergencies like war and other natural calamities in a better and more effective manner than any other metallic standard.

This found practical application during the Second World War, which was fought on the financial front as well in most of the countries of the world, through over-issue of paper currencies. .

The Principal Demerits of Paper Currency Standard may be Summarized as Follows:

(1) Danger of Inflation. The greatest defect of this standard is that the danger of inflation is almost inbuilt in it, the reason being that the currency of the country is not linked with metal. Hence, it is easier to increase the supply of money under this system. The monetary authority can increase the supply of paper money monetary authority can increase the supply of paper money without keeping additional metallic reserves. Governments are often tempted to meet their increased expenditure during times of war or in the midst of a slump by putting the printing press into motion. This often results in a state of inflation with serious consequences for the economy.

(2) Instability in Internal prices. There are violent fluctuations in internal prices under this system. Since the intrinsic value of paper currency is zero, there is infact, no lower limit to a fall in its value. In other words, the value of paper money cannot fall to zero under metallic standard because the value of metallic coins cannot fall below their intrinsic value. The prices can rise to any height under paper currency standard.

(3) Instability of Exchange Rates. Since the currency has no link with any metal under paper currency standard, there are wide fluctuations in foreign exchange rates with adverse effects on the country's foreign trade. Exchange instability does not take place under gold standard, because under this system the currency of every country is linked with gold. Since frequent changes do not take place in the price of gold, the exchange rates between different currencies remain more or less stable. But under paper currency standard, there are wide and violent fluctuations in the exchange rates of different currencies. To remove this drawback of the paper currency standard, the countries-of the world have now resorted to the technique of exchange control in an increasing measure.

(4) Absence of Automatic Working. Like the gold standard, the paper currency standard does not work automatically. To make it work, the government has to intervene from time to time.

As already pointed out, almost all the countries of the world had J adopted paper currency standard after the general abandonment of the gold standard in 1931. But, as a result of the adoption of the paper currency standard, a number of difficulties arose in foreign trade and international settlements. These difficulties became still more serious during the Second World War. To remove these difficulties of the paper currency standard, an International Monetary Conference was held at Brettonwoods in 1944. According to the plan prepared at this conference two international institutions, namely, the International Monetary Fund (I.M.F), and the International Bank for Reconstruction and Development (LB.R.D) were to be brought into existence. The difficulties of the paper currency standard were considerably reduced as a result of the establishment of these two instituti6ns. The various countries of the world make international payments through the medium of these institutions. The main objectives of these institutions were; (i) to bring about stability in the international price-level, (ii) to establish stability in foreign exchange rates, (iii) to aid import-export of foreign capital, (iv) to render active help in the economic development of backward and under developed countries, (v) to encourage international lending, and (vi) to promote monetary co-operation among member-countries. Thus these international institutions have removed to a great extent the main defects and drawbacks of the paper currency standard.

SUMMARY

The danger of inflation is inherent in the paper currency standard. As such, all efforts should be made by the Monetary Authority to ensure that inflation is kept at bay, in order to underplay this defect of the paper currency standard.

KEYWORDS

- Fiduciary
- Abandonment
- Indispensable
- Magnitude
- Intrinsic

REVIEW QUESTIONS

1. State and explain the special feature of paper currency system.
2. What are the two principles of note issue?
3. What are the various partial deposit system found in practice? Explain briefly.
4. What are the merits and demerits of paper currency standard?

SUGGESTED READINGS

1. M.C. Vaish - Money, Banking Trade and Public Finance

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LESSON 6

COMMERCIAL BANKS – FUNCTIONS

OBJECTIVES

After studying this lesson, you should be able

- ❖ To know the banking in olden times, modern era and banking development in India.
- ❖ To get knowledge about functions of a modern commercial bank.

STRUCTURE

6.1 INTRODUCTION

The word 'bank' is said to be of Germanic Origin, cognate with the French word, banque and the Italian word, banca, both meaning bench. The word may have derived its meaning from the practice of the Jewish money-changers of Lombardy, a district in north Italy, who in the middle ages used to do their business, sitting on a bench in the market place. This etymological origin of the word gets further relevance from the derivation of the word, bankrupt, from the French word, banque-route and the Italian word, banka rotta, meaning broken bench, probably due to the then practice of breaking the bench of the money-changer when he failed.

6.2 BANKING IN OLDEN TIMES

Indigenous bankers: Banking existed in India in one form or the other from. times immemorial. Earlier records show that a few centuries before Christ, India had a system of banking which admirably suited her needs. There were bankers in all important trade centres. They performed the usual functions of lending money to traders and craftsmen and sometimes placed funds at the disposal of kings for financing wars. Most of the loans were on an unsecured basis but pledge of movables and mortgage of immovables were not unknown. From the laws of Manu, the great Hindu jurist, it appears that deposit banking in some form was known in India in ancient times. Rules and rates relating to deposits and advances were laid down. Hundis or indigenous bills of exchange came into use about the 12th century A.D. The indigenous bankers not only lent money but also financed inland and foreign trade. During the Mogul period, metallic money (though known as far back as the Hindu Era) was issued and the indigenous bankers added one more line of money-changing to their already profitable business. They started exchanging money circulating in one part of the country with the money current in another part of the country keeping a good margin for themselves. The indigenous bankers could not, however, develop to any considerable extent the system of obtaining deposits from the public, which today is an important function of a banker.

Banking -Agency Houses

After the entry of foreign traders into India and. the establishment of the East India Company, Indigenous banker suffered greatly due to severe competition from the banks set up by the East India Company on modern lines. The first bank came into existence in 1688 in the province of Madras as a Government institution. In 1724 another bank was set up in Bombay. In Madras also another bank was started later on the same lines. Modern banking business on Western lines was mostly developed during the beginning of the 18th century, when the employees of the East India Company started commercial banks with the name of "Agency Houses". A large number of "British Agency Houses" came up in Calcutta and Bombay. The first bank called the Bank of Hindustan was established in 1770 in India. Due to the famine of 1788 and its effects, the bank could not function well as was closed in 1791. The Bengal Bank which was started in 1786 was also dissolved in 1791. Due to the mushroom growth of banks and agency houses there were frequent bank failures. Hence it became necessary to codify the rules and regulations for a systematic development of banking in India. Consequently the companies Act was passed in 1833 to control their activities. Subsequently, the system of Agency houses disappeared creating a big void in banking activity.

6.3 THE MODERN ERA IN BANKING

The modern era in banking may however be said to have been ushered into India with the establishment of the Bank of Bengal in 1809 under the Government charter and with Government participation in the share capital. On similar lines the Bank of Bombay and the Bank of Madras were established in 1840 and 1843 respectively. These three banks which came to be known as the Presidency banks, were quasi-central banks and were given powers to issue notes, but since their notes did not become popular these powers were withdrawn in 1862. As the century progressed there was a mushroom growth of banks and from 1860 joint-stock banks with limited liability began to appear on the scene.

6.4 BANKING DEVELOPMENT IN INDIA SINCE INDEPENDENCE

The India Banking system has made remarkable progress since independence. Joint stock companies doing banking business were many in number then, and they are concentrating only in towns and big cities. There was no uniform law governing the banking activities.

The evolution of the India banking system as an instrument of economic change started when the planning era was started in the fifties. The first step in this direction was the nationalization of Imperial bank of India in 1955.

The imposition of social control on banks in 1968 was followed by the rust instalment of nationalisation in 1969. The second instalment of nationalisation of banks was made in 1980.

Historical Phenomenal Growth

The decade of 1980s witnessed certain major development in the banking sphere. The coverage of banking in terms of branch network and mobilisation of savings reached high peaks. The number of bank branches increased from 3,570 in 1980-81 to 56,960 in 1988-89. As a result, on an average there is a branch for every 12,000 population as against 19,000 at the beginning of the decade. The proportion of rural branches to the total number of branches increase from 50% in 1980-81 to 56% in 1988-89.

Another development of significance was the diversification of financial services. Banks have set-up independent corporate units to provide assistance in the areas of equipment leasing, capital market operations, mutual funds, venture capital, treasury management, housing etc.

One more area where a revolutionary change is taking place is the rural lending through the concept of services area approach. In terms of this approach, each of the rural and semi-urban branches of banks has been allocated an area of operation covering specific villages. The branches have to prepare village-wise profiles credit plans and catalyse their economic development for betterment of income levels of the villages. Thus the nationalised banks in India playing an important role in countries economic development both in rural and urban areas.

6.5 FUNCTIONS OF A MODERN COMMERCIAL BANK

Banks playa very useful and important role in the economic life of a every nation. They have control over a large part of the supply of money in circulation and through their influence over the volume of bank money, they can influence the nature and character of production in any country. The functions of modern commercial bank are broadly divide into two categories.

FUNCTIONS OF COMMERCIAL BANKS

PRIMARY FUNCTIONS	**SUBSIDIARY FUNCTIONS**
1. RECEVING DEPOSITS	1. AGENOES SERVICES
2. GRANTING LOANS	2. GENERAL UTILITY SERVICES
3. INVESl1NG IN GOVERNMENT SECURITIES	
4. REMITTANCEOFFUNDS	
5. CREATION OF CREDIT	

6.6 PRIMARY FUNCTIONS

1. Receiving Deposits

The Primary functions of a bank are the receipt of deposits repayable on demand and provision of credit facilities to merchants and manufacturers for productive purposes. In the course of its business, a bank accepts, cash and creates bank deposits and concerts those deposits again into cash. It also transfers deposits from on person to another. The deposits may be current deposits withdrawable on demand by cheque or time deposits withdrawable either on the expiry of fixed period or after the lapse of a stipulated period of notice. Deposits are also received on savings account, subject to certain restrictions. The acceptance of deposits is a source of definite convenience to depositors. Banks protect the funds of depositors from loss or theft and afford an easy and convenient means of transferring funds through cheques. On time deposits, banks pay certain percentage of interest, while on current deposits generally no interest is paid.

2. Granting Of Loans

All commercial banks are both borrowers and lenders of money. They act as intermediaries between the saving public and investors. They mobilise the dormant capital of the nation and provide capital for productive purposes. The money collected from depositors will be lent to producers and businessmen. The credit facilities provided by a bank may assume several forms. They may be loans with or without collateral security, overdrafts on, current accounts or cash credits. By far the most popular method of lending is by discounting bills of exchange because such loans are self-liquidating in character. A commercial bank is a profit- seeking institution. On the deposit attracted by it, it offers a lower rate of interest. But, on the loans it grants, it charges a higher rate of interest. The difference between them constitutes profit to the bankers.

a. Loans

Loans are granted to people against the security of gold and movable and immovable properties. The borrower can withdraw the entire amount of loan immediately or according to his requirements. Interest is charged on the whole amount from the date of the loan to the date of repayment.

b. Cash credit

Banks sanction a credit limit to the borrower on the security of goods in trade. The godowns in which the goods are kept will be the possession of the bank. The .borrower is allowed to withdraw either the whole amount on in parts subject to the credit limit sanctioned but on the actual amount used.

c. Over drafts

Under this method, the customer is allowed to overdraw his account. That is the bank allows the customer to withdraw more than what he has deposited. This facility is available only to those customers whom the banks feel reliable. An overdraft limit is sanctioned and the customer is allowed to withdraw amounts according to his needs not exceeding this limit. Interest is charged only on the amounts withdrawn. Generally current account holders utilise this facility.

d. Discounting bills

This is a very good mode of granting loans. It combines liquidity, safety and profitability. Traders sell their bills receivable to the bank at a discount. This discount is the reward for banks for waiting until the due date. If banks need cash, these bills can be rediscounted with the central bank.

3. Investing In Government Securities

This is the third main function of a commercial bank. A banker, as we have seen, employs the major part of the deposits he accepts from the public in loans and advances to his customers. But in order that in his pursuit to maximize profits the'banker does not overlend to the determent of the depositors interest.

The banker should invest certain percentage of his funds in giltedged securities, ie. promissory notes issued by tile Central and State Governments and bonds and debentures issued by statutory bodies such as Port Trust etc. These securities are liquid because they can be converted into cash whenever needed. They can also be deposited with the central bank in -order to satisfy the, cash reserve ratio. Further these securities also yield some income for the bank by way of interest.

4. Remittance Of Funds

Banks arrange transfer of funds cheaply, expeditiously and safely from the place of their availability to the place, where they are needed. The transfer is effected by demand draft, man transfer or telegraphic transfer. Demand draft is a cheque drawn by one branch of a bank on another branch of it. By special arrangements, the draft can be issued on a branch of another bank also. The purchaser of the draft has to present it at the branch on which it is, drawn either for encashment or for getting it credited to his account. Mail transfer is an advise sent by one branch of the bank by mail to another branch to credit to the account, or pay the amount to the beneficiary under transfer. Telegraphic transfer is similar to mail transfer, any the advise is sent by telegram. Special codes are used to authenticate the message and avoid unauthorised transfers. In addition to these, travel cheques are issued to facilitate those on travel within the country or abroad. Discounting of foreign bills of exchange also effects the transfer of funds.

5. Creation Of Credit

In the process of accepting deposits and granting loans banks create money. Money is said to be created when banks by its lending activity make a net addition to the total supply of money in the economy. A deposit with a bank that can be withdrawn on demand is as good as cash-inhand because cheques can be issued and used as currency notes. Bank deposits are of two types.

I. Primary deposits

These arise when banks accept deposits from the public. When a customer keeps his surplus money in the bank, a deposit account is opened in his name. It makes no addition to the stock of money in the country. Currency money is simply converted into deposit money. On such cases the role of the bank is only passive so these deposits are called passive deposits.

II. Derivative or active deposits

These arise when bank lend money. A bank by experience knows that all the primary deposits are not withdrawn at anyone given time so it is sufficient to keep a portion of the primary deposits in liquid cash. The remaining amount can be advanced as loans to the people who are in need of money. When the loan is sanctioned, an account is opened in the name of the borrower and the amount is-deposited into his account. As the customer is allowed to withdraw by means of cheques, it is as good as cash. In this way it adds to the total supply of money in circulation. ThereforeSayers remarked that 'Banks are not merely purveyors of money, but also in an important sense manufacturers of money.

6.7 SUBSIDIARY FUNCTIONS

In addition to the above main functions, commercial banks perform a- multitude of other functions. A large number of these functions are performed for the convenience of customers and are sometimes incidental to the main functions of banks. These are referred to as subsidiary functions of banks and may be classified as

1. Agency Services and
2. General Utility Services.

1. Agency services

Bankers perform certain functions for and on behalf of their customers. For instance, customers may deposit their stocks and shares with their bankers and issue instructions to collect on their behalf, interest and dividends on them. Bankers would be prepared to render this service to their customers, sometimes in return for a small commission.

Customers may issue certain standing orders to their bankers asking the latter to pay on their behalf, insurance premia, subscription to clubs, societies, etc. Bankers execute these standing orders and charge the amounts concerned to the accounts of their customers.

Banks act as a agents and trustees of their customers. If customers wish to purchase or sell securities in stock markets, bankers render all assistance possible in this behalf. Further, if customers have to send money from one place to another, bankers arrange for the remittance of funds.

Bankers may act as agents, correspondents and representatives of their customers. All these are described as agency services because bankers act in all these cases as agents of their customers.

2. General util1ty services

Generally banks provide locker facilities for the safe keeping of valuables, Jewellery, documents etc. at a nominal charge. To ensure maximum security they provide double keylockers. Thus banks act as custodian of valuables. They issue drafts, travelers cheques, etc. for the benefit of the people to enable them to transfer their funds safely from place to place. Banks provide travelers cheques free of charge.

Sometimes banks act as a referee to the financial standing and credit worthiness of customer. When people take loans from any financial institution or other parties they are required to provide reference to their bankers in which they maintain their accounts so that their credit worthiness and financial stability can be verified by the prospective creditors. When new companies are not able to mobilise capital for investment, banks may provide underwriting facility by purchasing the new issue of shares and securities of the company. Banks collect information relating to business, trade and general economic conditions in the country and publish monthly quarterly journals which are very useful and informative to the public. Banks may also deal in foreign exchange. They collect foreign exchange and make payments in the local currency. They also finance foreign trade of a country and discount the bills of exchange of the exporters. Bankers also help the- importers by accepting the bills drawn by foreign exports. Banks issue letters of credit to help the traders and businessmen to obtain credit at distant places. Thus banks perform a large number of subsidiary services which are very useful to the people in general and customers in particular.

SUMMARY

The Indian Banking System has made remarkable progress since independence. The evolution of the Indian Banking System as an instrument of economic change started when the planning era was started in the fiftees. Banks play a very useful and important role in the economic life of a every nation. The function of a modern commercial bank are broadly divide into two categories. Primary functions and subsidiary functions. Banks have control over a large part of the supply of money in circulation and through their influence, they can influence the nature and character of production.

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KEYWORDS

- Multitude
- Por reyods
- Pursuit
- Debentures

REVIEW QUESTIONS

1. Discuss the nature and functions of the commercial bank?
2. What are the subsidiary services of a modern commercial bank?

3. Give a description of the functions of a commercial bank?
4. What are the Principles and functions of a commercial bank?
5. Describe the evolution of modern commercial banking.

SUGGESTED READINGS

1. B. Ramachandra Rao - Current trends in Indian Banking
2. Gulsan - Banking law of Practice.

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LESSON 7

BANKING SYSTEMS

OBJECTIVES

After studying this lesson, you should be able

- To know about branch banking
- To familiar with unit banking, mixted banking, group banking, chain banking, correspondent banking
- To understand the reserve bank policy.

STRUCTURE

7.1 INTRODUCTION

The development of commercial banking institutions has taken place under different banking systems in different countries. The two principal commercial "banking systems that have been in vogue are the unit banking system and the branch banking system. Besides these two principal banking systems after which commercial banks in most countries of the world have been organized, mention may also be made of the group banking and chain banking systems which have been generally in vogue in the United States of America. There is also the mixed banking system which is commonly found in Germany. Mention will also be made of the correspondent banking system.

7.2 BRANCH BANKING

Branch banking is a system of banking where each bank as a single entity having one board of directors and one group of shareholders has a number of its offices spread all over the country to undertake business in all places on a large scale according to the policy laid down and instructions issued by the Head Office.

The banking system of England offers an example of the branch banking system, where in each commercial bank has a net work of branches spread throughout the country. In the initial stages of banking development, each bank in England consisted of a single office with few or no branches. In the process of evolution, banking organisation developed in the direction of branch banking. As a result of a continuous process of amalgamation and consolidation, which went on for over a center, there exist today only a few banks, of which the 'Big Five' the Midland, the Ll9yds, the Barclays, the West minister and the National Provincial - are the most important. The Big five of England have between them 9000 branches and control about seventy five percent of the banking resources of the country. As the pivot of the organised and centralised system stands the Bank of England - the old Lady of the Thread needle Street which Banking Systems is the central bank of the country and the earliest of the joint stock banks to be established there. Under the shade provided by this giant, commercial banks were established and developed. In this process, the Bank of England became the natural leader of commercial banks and its advice is instinctively obeyed and respected. This obedience came not as a result of any compulsion but is due to the sheer force of tradition and custom. Like the political institutions of England, the banking institutions of the country work on the basis of conventions and traditions which have the force of unwritten laws.

Branch Banking In India

The development of branch banking in India has been lopsided with an undue concentration of banking offices in large towns and cities. Since 1939 there has been a considerable expansion of banking offices in India. Much of this expansion is not quite healthy. A part of it represents careless expansion on the part of banks with inadequate financial resources and following unsound methods with the result that as many as 254 banks went info liquidation in 1941-46, although in the period circumstance were favorable to their growth. Again, there are many urban centres, not to speak of rural areas, which cannot boast of a single banking office. The villages are very inadequately served by post offices and co-operative credit societies. Commercial banks do not find it profitable to open branches in rural areas because of the absence of prospects of making profits. The concentration of banking offices in big towns and cities to the comparative neglect of rural areas has resulted in (a) excessive competition between banks in the urban area; and (b) the failure of the banking system to mobilize the savings of the people in rural' areas for economic development of the country.

Banking Regulation Act 1949

The banking regulation act of 1949 places certain restrictions on the opening and removal of branches so as to ensure proper branch banking development. Banks will have to obtain prior sanction from the Reserve Bank of India in writing for opening a new branch or removal of an existing one. Instead of several banks opening branches in a particular place, they should try to open new branches in places where there are no banking offices. By such a policy they can avoid unhealthy competition which they are having so far in attracting deposits and granting loans.

7.3 RESERVE BANK POLICY

Prior to 1956, the Reserve Bank followed a cautious policy of branch licensing since' the banking. system was in the process of consolidation. In 1956 and again in 1959 the policy was liberalised allowing branches to be opened rather freely. On account of this policy, the pace of branch expansion was accelerated. But the extension of banking facilities to rural and semi-urban areas was not achieved. The branch licencing policy was reviewed by the Bank in 1962. All the Indian banks were advised to formulate branch expansion, programmes and to secure the Bank's approval in advance. A list of unbanked centres was also supplied to them so as to facilitate't1ie selection of centres suitable to them. As a result, the branch expansion programme was accelerated.

7.4 NATIONALISATION OF BANKS

Consequent on the nationalisation of 14 banks in July 1969 the pace of branch expansion has been accelerated, with particular emphasis to the provision of banking facilities in unbanked centres. The Reserve Bank drew up a programme of branch expansion in December 1969 for major Indian Banks. Nearly seventy percent of the bank offices were opened in rural and semi-urban centres. The qualitative implication of the changes, particularly since a major portion of the banking sector was brought under public ownership and RBI direction and government recommendations.

Advantages Of Branch Banking

1. Banks having branches all over the country command huge financial resources. They are formed with a sufficient capital and collect huge deposits through their countryside offices. In case there is a crisis, they are strong enough to tide it over.
2. They are enabled to balance their deposits and investments. The surplus available at one office is invested at another where it is needed. In fact, there are many places where large deposits were received but there are no channels of investments. As against this, there are places where there are many channels of investments.
3. The area of operation being very wide, they are enabled to diversify their investments. They do not have to play their eggs in one basket. They invest in several places and in several kinds of industries so that if there is a crisis at one place or in one industry, it does not affect them much.
4. By diversifying their resources they are able to put them to the most productive use and thus- contribute to increase production and national income. They tend to equalise rates of interest over different regions.
5. A branch manager is not forced to invest locally if investment is not safe. It can be transferred to the head office which will utilise it at a safer place. Managers are transferred from time to time from on place to another, they

can tide off undesirable local influences and pass on the responsibility to the head office. They do not have their personal favourites as well.

6. Management of such institutions is more efficient, they are in a better position to effect internal and foreign exchange business also as they have a network of their branches. They can also have their small offices in small places under supervision of responsible officers at important branches.
7. The central bank of the country can regulate banking business of a limited number of banks having a number of branches more effectively than of a number of unit banks spread all over the country. It can issue directions to and carry on supervision over them conveniently.

Disadvantages

1. Branch banking usually suffers from red tapism. Men on the spot do not have necessary initiative. They have to wait to the instruction of the head office and to take great pains in explaining their view point. A good deal of correspondence sometimes has to be carried often without success and resulting in delay.
2. Branch managers are not familiar with local conditions and special problems thereof. They also lack personal touch. They are thus neither of so much use to the locality nor to the institution they work for.
3. Under branch banking the banker-customer relationship may not be harmonious as it is not possible for the banker to identify a huger number of customers. There is a lack of personal touch and contact between the banker and customer. If the manager does not know the local languages, it will bean additional disadvantage to speak with all types of customers for improving his contacts with them.
4. Critics of branch banking system also say that under this system, local funds are sometimes utilised elsewhere to the disadvantages of the locality.
5. When there are very few banks with branches spread over the whole country, economic power tends to concentrate in the hands of a few persons. Sometimes there is interlocking of directors and a few influential persons in the country acquire monopolistic, power over the national finance. Of course this defect can be remedied by law as this has been done in India.
6. Under branch banking system in view of the very large number of employees there are more possibilities of emergence of Trade Unions among the bank employees. The employee-employer relationship may not be harmonious due to some differences between the workers and management. This may lead to more strikes and lock-outs causing wastage of several man-days of work.

7.5 UNIT BANKING

Meaning: Unit banking is a system under which each single unit carries on its operations only at one place-usually there are no branches and if there are any they are only a few which may be counted on fingers. The size of such a bank is very small, its capital resources, deposits and investments being very much limited.

Origin: Although branch banking has made rapid strides ever since World War: II, the United States of America may be rightly regarded as the home of the unit banking system. While it cannot denied that the importance of unit banking in the counting system has declined, even at the end of 1975 unit banks predominated in number and out of 14,457 total banks as many as 9,334 were unit banks operating through a single office.

Peculiar Feature Of American Banking

The peculiar feature of American banking system is the existence of twelve Federal Reserve Banks, unlike in other countries where there is only one central bank. The operations of commercial banks in U.S.A. are governed not by a single set of national law, but by the legislative output of the Federal Congress and fortynine states. Banks chartered under State Laws are known as 'State Banks'. while banks established under Federal Laws are called 'National Banks'.

The American Constitution - Business Of Banking

The American Constitution grants power to both the Federal and State Legislatures to enact laws regulating the business of banking. Some States do not allow opening of branches at all while some States only allow opening of branches either in the same town or in the same State. California allows branches anywhere in the state but Newyork permits branches only with in the same town.

Important Forces On American Banking

There were two important forces operating to shape the structure for banking in U.S.A. free enterprise in 19th century and the fear of 'Money Trust'. The fear of financial concentration in the hands of a few banks has been responsible for placing stringent legal restriction on opening of branches. Americans by their very nature . are opposed to any type of monopoly power, either in the political field or in the economic field. The stockholdecs of banks feared extinction of their influence if branch banking was allowed to develop. The large business corporations used to wield considerable influence over local banks and kept them in virtual bondage by the threat of withdrawal of deposits. These corporations stood in way of bank amalgamation as it would take away their power. Besides, to develop into the branch banking system, America would have needed thousands of banks amalgamation. The head office and branches would have been separated by a distance equal to between London and Moscow.

Advantages Of Unit Banking

1. Local funds are used to meet local needs. In case, there is no local need they can be invested in Government securities or handed over to other banks.
2. The unit banker has local knowledge. He knows internal conditions of the local industries and local people. Thus he is in a better position to assess their needs and gauge their credit-worthiness. Hence, he can be of better help to the locality and also in a better position to watch the interests of the bank itself.
3. Decisions are quick in such institutions. There are no management and supervision difficulties. Chances for frauds and irregularities are also minimised. Wastage can also be avoided.
4. As the bank is a small unit there may not be any problem of management supervision and control. As the number of workers is small within a bank the employee-el1mloyer relationship is likely to be more happy and harmonious. The scope for strikes and lock- outs is less as any dispute between the workers and the management can be solved by direct discussions.
5. This system does not help in the formation of monopoly and concentration of economic power in the hands of a few individuals as there is a large number of small independent banks.

Disadvantages

1. The resources of unit banks are limited, and hence they are more likely to fall prey to any crisis. Several unit banks failed in USA during the crisis of 1930s. This also happened with Indian banks so long as their number was sufficiently high in our banking system.
2. They also lay their eggs in one basket and hence come to grief when a local industry falls in difficulty.
3. Their resources being limited they cannot provide finance to large scale industries and business. They can not operate in small towns where they cannot find enough business.
4. They are also not in a position to employ trained staff as they are not in a position to pay them decently.
5. They do not inspire confidence amongst their people as their resources are very much limited. Hence, they fail to attract deposits from all and sundries.
6. Unit managements are subjected to local influence and if they refuse accommodation to influential persons because of their not being enough credit-worthy, they may become annoyed and harm them.

7.6 MIXEQ BANKING

Origin And Development

Mixed banking system refers to that banking system under which the commercial banks make long-term loans to industry. In England, commercial banks are mainly concerned with supplying the short-term credit requirements of trade and commerce. Generally the commercial banks refrain from supplying the long-term credit to the industry. In short, the British commercial banking system keeps aloof from financing the long-term credit requirements of industries.

As against this British trend, the commercial banks in Germany, Belgium, Hungary and the Netherlands have greatly assisted in the industrial development of these countries by giving long-term loans to industries. In mixed banking, the commercial banks promote the. industrialisation of their country and come forward to provide the initial capital to the newly started industries. Alongside the task of providing capital to industries, mixed banks also perform the functions of deposit banks. To the extent commercial banks in India have come forward to provide long-term capital to small and medium-sized industries they can be said to perform the functions of mixed banks.

The development of mixed banking in Germany has been due to several historical reasons. The scarcity of capital and absence of suitable entrepreneurs in Germany led the commercial banks to collaborate closely with industries in the interest of country's rapid industrial development. Due to the shortage of capital which might be due to the absence of mobilisation of savings, industries in Germany became dependent upon the commercial banks for the supply of necessary capital funds. Consequently, commercial banks participated in a big way in providing capital to industries both by granting long-term loans and by floating debentures of joint-stock companies.

Mixed Banking In India

Banking in India followed the British pattern-it was pure deposit banking. But some sections of Indian Public opinion always favoured mixed banking. They are enamoured by the success of investment banking in the development of German industries. The central Banking Enquiry Committee (1931) recommended a limited participation of Indian banks in industrial finance. The Shroff Committee 1954 recommended their participation in an indirect way, i.e. through purchase of shares and debentures of Industrial Finance Corporation and State Finance Corporation. The Reserve Bank of India itself got interested in financing industries indirectly. It purchased shares of Industrial Finance Corporation of India which was set up in after 1948 and the various state Industrial Finance Corporation which were set up after 1951. Finally in 1964, it set up Industrial Development Bank of India as a subsidiary fully owned by it. In the same year; it participated in the setting up of Unit Trust of India by subscripting to half of its initial capital i.e. to the extent of Rs. 2.50 crores. Indian joint stock banks following its lead also subscribed to the share capital of these industrial finance institutions.

Advantages

1. It enables the banks to become active partners in the important task of country's economic development by promoting the development of industries the country.
2. Banks can help the industries by either underwriting their equity and debenture issues or by granting them advances in anticipation of such issues in future.
3. Banks can also provide the industries sound financial advice about the outlook in the investment market.

Disadvantages

1. During depression the prices of shares and other industrial securities depreciate. Consequently, a considerable portion of commercial banks asset portfolio disappears through loss of value. This was what happened in the USA, France, Germany, Japan and other countries during the great depression of the thirties when many banks failed as they were placed in a hopelessly unliquid position and they had to close their doors.
2. It was found that some banks indulged in the promotion of several unsound schemes and pushed up their securities on the stock exchange with a view to earn profit and then leave the public to suffer from the inevitable losses.
3. They were responsible for the creation of industrial cartels and syndicates in connection with the schemes which they financed. These were monopolistic in character and were condemned as injurious to the interests of the people at large.

7.7 GROUP BANKING

Group banking which has expanded phenomenally in the . U.S.A. since World War II. Under the group banking system two or more banks are directly or indirectly controlled by an Association, Trust, or Corporation. In this system there will be centralised management and control of all banking units by a holding company. When a big bank wants to become more powerful it begins to acquire control over a large number of small banks. Before the Great Depression this system of group banking was popular. But due to a large number of bank failures this system lost its importance.

Advantages

1. It is said to be a substitute of branch banking to a considerable degree and many of the advantages of branch banking economies of scale, better and extensive customer services, Great mobility, efficient management training programmes, etc. are also claimed for group banking. Group banking in the USA has most developed in those ten states which restrict branch banking but allow bank holding companies.
2. The chief feature of the group banking system is the centralised management and control of all group units by a holding company

notwithstanding that each bank has got I~ separate entity. The supporters of the group banking system point out that the chief merit of this banking system lies in economising in the maintenance of large cash reserves.

3. All members of the group can pool their resources to finance large borrowers. Moreover, advantages of economies of scale in banking operations can be enjoyed by cutting down operating costs, by purchasing supplies in bulk and by improving the efficiency of management.

Disadvantages

1. It is difficult to exercise a direct and effective control over the member units.
2. The failure of one member of the group affects all others.
3. It is difficult to supervise all units simultaneously and the holding company may utilise the surplus reserves of the group for furthering its own economic interests.
4. Under the group banking system a banking company and a non- banking company may be subsidiaries of the same holding company.
5. The group banking system leads to monopoly, thereby restricting efficiency which grows as a consequence of healthy competition among banks.

7.8 CHAIN BANKING

Under this system two or more banks are owned and controlled by one person or group of persons. The chain banking system was popular in U.S.A. till the twenties of this century. This system collapsed during the great depression period due to a large number of bank failures.

The main feature of the chain banking system is the control of two or more banking companies by a single person, by members of the same family, by the same group of persons through the ownership of stock, through common membership on the board of directors of the banks or otherwise. This system was developed in the United States of America around the mid nineteenth century and reached the apex of popularity in the twenties of this century. In 1925 there were no less than chains comprising of 933 banks in the United States of America and these were mainly concentrated in California, Washington, New York, Idaho, Georgia and Minnesota. Most chain banking systems are seemingly small, being usually confined to two or three banks, although some chains involve substantially larger number of banks. Consequently, the extent of centralisation shows wide variations. Unlike group banking, chain, banking has also developed largely as a substitute for branch banking and more than, 80 percent of the chain banks are located in 'those states in the USA: which prohibit branch banking. The chain banking system has more or less the same advantages and disadvantages which are in the group banking system.

7.9 CORRESPONDENT BANKING

Correspondent banking system which is highly developed in the United States provides a mechanism which knits together the unit banking system in the country. The unit banks are linked together by the 'Correspondent system'. A bank in a small town has a 'Correspondent Bank' in a neighbouring city, while the city bank in turn has its own correspondent bank in the financial centres - New York and Chicago. Thus practically all the unit banks are/linked directly or indirectly to the big banks of New York. Thus function of a correspondent bank is to facilitate clearing of cheques and movement of funds. It receives deposits of surplus. funds of country banks and lends them in time of need. .

In actual practice, the Correspondent banking system is more" complicated than this description since small" upcountry banks typically maintain not one but five or six correspondent relationships and large banks may have 30 or 40 correspondent relationships. The small bank is the small community which holds" deposits with the city bank is the respondent bank while the city by holding the deposits for the small bank is the correspondent bank. The correspondent banking system is mutually advantageous both for the respondent and for their correspondent banks. The correspondent banks perform the two important services of outside cheque clearing and loan participation for their respondent banks while they benefit from the deposit funds of their respondent banks.

The days of unit banks have now gone. In U.S.A. where unit banking system flourished till 1930, it is since then being replaced by branch banking system. In India as well, smaller banks have been amalgamating either amongst themselves or with bigger banks since 1950. .

SUMMARY

The two principle commercial banking systems that have been in rogue are the unit banking system and the branch banking system. The structure of banking systems are branch banking, unit banking, mixed banking, group banking, chain banking, correspondent banking. The banking regulation out of 1949 places certain restrictions on the opening and removal of branches so as to ensure proper branch banking development.

KEYWORDS

- Lopsided
- Pirot
- Consolidation
- Amalgamation

REVIEW QUESTIONS

1. Discuss the relative advantages and disadvantages of Unit and Branch Banking System?

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2. Compare the merits and demerits of unit and branch banking? Which system is suitable to India.
3. What do you understand by the following Group Banking, Chain Banking, Correspondent Banking? How do they help Unit Banking?
4. Write a note on mixed banking in India? Discuss the merits and demerits of this system.
5. Discuss the various types of Organization of Commercial Banks? Which system is suitable to our country.

SUGGESTED READINGS

1. M.L. Tandon - Banking Law and Practice.
2. Desai Vasant - Indian Banking – Nature and Problem.

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TYPES OF DEPOSITS AND CUSTOMER SERVICE

OBJECTIVES

After studying this lesson, you should be able

- to familiar with current account
- to know about recurring deposits, special deposit, and fixed deposit
- to find the customer service in commercial bank.

STRUCTURE

8.1 Introduction

8.2 Current account

8.3 Recurring and special deposits

8.4 Call and fixed deposits

8.5 Period of deposit

8.6 Customer service in commercial bank

Summary

8.1 INTRODUCTION

The ordinary relationship between a banker and a customer is that of a debtor and creditor. When the customer deposits the money the banker is a debtor to his customers. The relationship on the other 'hand is reversed when the customer borrows from the banker. Initially, all the accounts are opened with a deposit of cash money by the c1JStbmer and hence these accounts are called deposit accounts. The bulk of resources of a bank are mobilised by accepting deposits from the public. Accepting of a deposits of money from public is one of the important functions of banker according to the definition of banking as given in the Banking Regulation Act, 1949.

The banker solicits deposits from the public, engaged in numerous economic activities and different walks of life and having different financial means. The banks have introduced different types of accounts with various facilities which may suit the needs of customers. Bankers; normally, receive money in:

i. Current accounts;

ii. Saving deposits;

iii. Call and fixed deposits;

iv. Recurring deposits.

Besides the above, various novel schemes have been recently I introduced by the bankers to attract deposits from the public, e.g. student deposit accounts, multipurpose deposit scheme, super savings scheme, Pigmy deposit scheme, Janata deposits, premium prize deposits certificate etc. Latest and most important innovation is the provision of free life insurance cover to saving bank account holders 'with certain limitation to age and amount.

8.2 CURRENT ACCOUNT

Current deposits form the most important kind of bank deposits. In the case of. these deposits, the banker undertaken to honour his customer’s cheques so long as the latter's account is in credit. In other words, the customer can withdraw the whole 1of the account standing to his credit (subject to the minimum balance he has to keep) by drawing a single cheque or a number of cheques. The customer deposits cash, cheques and drafts drawn in his favour into the accounts. The banker collects the cheques and drafts drawn in, the customer's favour and credits the amount to the customer's credit. The customer has to fill in the paying-in-slip-from at the time of depositing the amount in the bank.

Current deposits are of great convenience to banks' customers. As cash and cheques are sent to the bank, they are safe. The customer can secure an overdrafts with or without security. The banker has to keep sufficient cash with himself in order to honour the customer's cheque. No interest is usually allowed on current accounts.

The bank issues a pass book at the time of opening a current account. All transactions in respect of that account are entered in the pass book and, the customer can compare the entries there in with the entries in his own cash book. Alternatively, monthly statements showing the transactions between the banker and customer are furnished to enable the customer to compare the transactions entered in the statement with the 6ntries made in his own cash book.

Advantages

1. Opening of a current account is a source of great convenience to the customer.
2. As cash, cheques and drafts are deposited In the bank's account, they will be perfectly safe.
3. The customer can make his payments more conveniently. He need not count cash at the time of making payments. This not only obviates errors but saves time.
4. Payment to creditors situaed at distant places is facilitated.
5. Collection of cheques drawn on banks situated outside his place of business becomes easier.
6. The paid cheque form at the bank serves as a receipt. It can be referred to in case of dispute. Normally, however, the person receiving a cheque will have to give a stamped receipt for the amount of the cheques.

2. Savings Deposits

Savings deposits are those on which banks place some restrictions on their withdrawal. The interest on these deposits is calculated on the minimum balance maintained during a specified period of each month. Generally the interest rate is very low. Savings deposits are of two types. In the case of ordinary savings deposit the minimum balance to be maintained is fixed at a low level. The depositor does not enjoy the use of cheque facility. He can withdraw money from his account by means of withdrawal, forms provided by the bank. In the case of special savings account the babker insists on a minimum amount of balance to be maintained in the account. The depositor is given the facility of withdrawing money by means of cheques.

Saving bank account is meant for lower and middle classes who wish to save a little of their current incomes for future needs and also want to earn some interest on their deposited savings.

To encourage savings habit among people, allow depositors to open savings accounts. As the name indicates these accounts are opened for the purpose of saving. Interest is allowed on minimum balance as at the close of any day between the tenth and the last day of each calendar month; Interest is credited to the account every six months. The number of withdrawals is generally restricted. Rules in this regard may vary from bank to bank, and from time to time.

Who can open a savings account

1. By a person on his/her own behalf.
2. By more than one person payable to anyone or more of them or survivor or survivors.
3. By a guardian on behalf of minor, in which case a declaration as to the data of birth of the minor should be obtained from the guardian.
4. By the minor himself/herself for reasonable amounts provided the minor produces satisfactory proof about his/her date of birth.
5. By one person for another person with the stipulation that. the deposit can be withdrawn by the latter only on his or her attaining the majority or marriage or some other specified time.
6. By Secretaries, Treasurers, Managers or other Officers of non- trading concerns such as schools, clubs, hospitals, religious and charitable institutions. However in these cases, the rules and bylaws governing such institutions and all other necessary information should be furnished to the bank when the account is opened.
7. Savings bank account in the name of the Trading concern (be it a proprietorship, firm or joint stock company) can be opened for placing their special funds such as Provident fund etc. But they cannot open Savings Bank Accounts for conducting trade.

8.3 RECURRING AND SPECIAL DEPOSITS

With a view to extending greater services and, at the same time bringing to their fold the idle money lying with the people, bankers have devised many special deposit schemes. Some such deposits are akin to term deposits with or variations and some combine in them the features of term and savings deposits. Of theses, the cash certificates and recurring deposits are the most popular.

Cash certificates promise their purchasers to hand them, on their maturity a certain sum of money known 8$ the face value of the certificates, usually in round sums like Rs. 1,000/-. The purchasers pay a lower amount when they are purchasing the certificate. This initial deposit with the interest compounded there on amounts to the face value on the maturity date. These certificates can be surrendered to the bank before maturity but only in accordance with the rules governing such certificates, and the purchaser of these certificates will have to lose a part of the interest. Recurring deposits are also very popular. This is only a variant' of the savings bank account introduced by banks in recent years. The idea behind this account is to incalculate the habit of savings among the people on a regular basis by offering an incentive in the form of a higher rate of interest. It stands favourable as compared to the rate of interest on the savings bank account. The deposits may be made in multiples of Rs.5/- or 10/-, every month for a certain period. The period of recurring deposit varies from bank to bank.

The depositor is allowed to close the account before maturity, but is allowed a lesser rate of interest depending upon the period for which the deposit has run. These accounts are transferable from one branch to another without charge. Further the account can be opened by a person himself, by more than one person jointly, by a guardian in the name of a minor or even by a minor. The monthly instalments should be paid before the last working day of that month. The accumulated amount along with interest is payable after a month of the payment of the last instalment.

8.4 CALL AND FIXED DEPOSITS

Many a time, customers obtain deposit receipts which are payable at call or after a short notice, e.g. three days, twenty days notice. Such deposits fall. Within the category of call and short term deposits and carry interest according to the notice period for a withdrawal.

Fixed deposits, also known as time deposits or term deposits, are repayable after the expiry of a certain period of time for which the deposit is kept. The depositor agrees not to draw the amount before the time agreed has expired. The position of the banker in respect of such deposits is of a debtor who need not repay the amount till its maturity. He does not become a trustee even after the maturity date and the customer allows the deposit to be with the banker. Cheque facilities are not allowed and the customer cannot draw cheques on the deposit even after the expiry date.

Fixed deposits are very popular in India and they are especially beneficial to the banker. As such deposits are not withdrawable before their maturity; till that date the banker can invest funds in whatever channel he desires without any fear of withdrawals- against the-deposits. For the customer too these deposits are beneficial, as to a certain extent they combine in them the advantages of investment m industrial , securities and the security of investing in banks. The rate of interest paid, on such deposits are higher than those paid on other deposits.

8.5 PERIOD OF DEPOSIT

The fixed deposits are acceptable for varying periods. Normally they are not accepted for periods less than a month, though the bills may accept them in some exceptional cases. Deposits accepted for less than 15 days are known as Short Term Deposits. No interest is paid on money deposited for less than 15 days. The interest is paid on money deposits varies in accordance with the period for which they are deposited. -The interest rates in India are regulated by the Reserve Bank of India. No bank is allowed to pay interest at rates higher than the one fixed by the Reserve Bank.

Loan On Fixed Deposit

The fixed deposit holder can raise a loan against his deposit with the bank. As per Reserve Bank of India instructions, advances up to 75% of the total deposit amount can be made. The interest payable on such loans is 2% over the rate stipulated in the deposit receipt. At the time of getting also the deposit receipt, duly discharged, has to be surrendered to the bank. It is returned to the borrower on Payment of the loan.

Interest On Overdue Deposits

Interest ceases on the date of maturity. But banks may, at their discretion, allow interest thereon if the fixed deposit is renewed. The overdue interest allowed, however, does not exceed the rate applicable to the period for which deposit is desired to be renewed. The interest prevailing at the time of renewal is the interest allowable in such cases.

Payment Before Due Date

Sometimes the bankers, in order to oblige their customers, allow them to withdraw their fixed deposits before due dates. In such cases, either the customer forgoes the interest accrued on the deposit or he borrows the amount required against the security of fixed deposit at a rate of interest which is generally two to two and half percent higher than the rate allowed on the deposit. Before making the advance, the depositor is required to discharge the Deposit receipt along with other papers. Sometimes, banks encash the deposit receipts before the date of maturity if so desired by the depositor.

Not Transferable

A deposit receipt is not a negotiable instrument and cannot be transferred by endorsement and delivery. This is made clear by printing the words 'Not Transferable' on the face of the receipt. It can, however, be assigned to a third party by the depositor by handing over the deposit receipt duly discharged--together with a letter giving up his rights in the deposit in favour of the assignee. The assignee in such case gets no better title than the transferor.

Payment Of Interest

The interest on deposit is payable normally at the rate of maturity but the banks usually pay interest monthly or quarterly or Half yearly also at the request of the depositor who is required to present the receipt for the purpose of making necessary entry regarding payment of interest on the back thereof. The withdrawal of interest or principal is Dot permitted through cheque. But the banker may, at the request of the party, credit the amount of interest or the principal or both to his savings or current account from which the depositor may withdraw the same through cheques.

Attachable Under Garnishee Order

The term deposit is attachable under the garnishee order and by revenue authorities. When such orders are received, the banker should not pay the amount to the depositor but await instructions from appropriate authorities.

Exempted From Stamp Act

The deposit receipts are exempted under the Stamp Act. The law of limitation takes effect from the due date of the receipt. But as long as the receipt is renewed, or till the interest is being paid on the deposit, the law is not applicable.

Loss Of Deposit Receipt

If the production. of the deposit receipt has been made a prerequisite for payment of the deposit, the bank cannot be held' , answerable if it refuses to pay the amount till the receipt is' produced. But if the receipt has been lost by the depositor, bankers usually pay the amount after obtaining an indemnity bond from him. A duplicate receipt is prepared and dealt with as if it were the original.

In short, the bankers are making all efforts to increase their deposited by devising many attractive schemes. That they have amply succeeded in their efforts bas been proved by the increase in deposits with these banks during the last few years, particularly after the nationalisation of banks.

8.6 CUSTOMER SERVICE IN COMMERCIAL BANKS

We are 21st year of bank nationalism. But how best is the customer service in banks? People from all walks of life, including bankers, have expressed concern for falling customer service standards in banks. This seems to be double dimensional problem. It is a fact that in the provision of most services, particularly by the public sector institutions, the customer occupies a back seat. It is true of banks also. The other dimension is the rising expectations of the quality of service provided by the banks. In the coming years, bankers would be under increasing pressure from the restlessness with the service, and they will have to devise suitable ways to face this challenge.

Banks And Competition

Customer service will be the vital area for banks in the coming years. With a wide variety of investment avenues, it will be the efficiency in services which will ultimately weigh with the customers. As T.K Sinha, Managing Director, State Bank of Bikaner and Jaipur I has puts it. "Funds acquisition rather than funds application will assume primary importance in the period ahead. With the different type of financial assets with attractive returns available to the investor, competition for funds will increase phenomenally. The financial intermediation service is likely to face great competition from the corporate sector. They will have to develop new products to meet the challenge."

Wide Variety Of Customer Service

Customer service includes a wide variety of activities. It does not simply mean that the customer gets his payment across the counter or he purchases drafts and travellers cheques within time stipulated. In fact it covers the entire parts' of contact between the customer and the bank. Highlighting the role of the customer in banks, T.K Sinha further says, "A bank's business is its customer. Hence customer orientation in' all aspects 'of its operation is a sine quanon for efficient functioning. This ideas is embedded in the commitment to strive for excellence in customer service. Customer service is not merely the fulfillment of government recommendations or mechanical adherence to time norms for various transactions. It is a philosophy an attitude of professional commitment. It is not amenable to rote memorisation but is something to believe in.

The idea underlying this philosophy is that the ultimate satisfaction of customers' want is the economic and social justification of the organisations existence. In the final analysis, it is the customer who makes the economic system function and in a volatile and competitive setup sufficient resources-human and financial must be mobilised towards determining and then satisfying the customers' need.

“As bankers are well aware, the modern customer does not visit a branch merely to deposit cash or encash a cheque. His demands and expectations are more sophisticated and varied. Bankers must, therefore, look carefully at their existing product lines and concentrate on the development of new services. The primary prerequisite for this is a thorough understanding of bank customers who they are, where they are and what they need. All this requires rethinking and a dramatic change from the traditional mode of banking strategy.”

Relationships

The relationship between a simple customer and the complex banker, who mostly hails from the middle class society has become formal, bureaucratic and procedural. The banker has become increasingly paternalistic in his attitude towards the service he renders to the poor customers. Apathy, passivity and impersonality in their approach has increased, particularly among the city-bred bankers. The number of employees who are 'status quo' lovers who detest changes and who are not prepared to take risks has increased enormously.

Measures To Improve Customer Services

In recent years, banks have initiated several measures to improve customer service. By creating customer service cells in big centres, attending to customers' complaints has become prompt. Providing instant credit of certain amount of outstation cheques, extending services in time frame, adopting more helping attitude by speeding up of loan sanctions and settlement of claims and extending facilities for nomination in accounts are a few other measures available to the customer today.

Visible Improvement In Services

Despite all these measures in the last few years, there has been no visible improvement in customer service. In January 1988, the findings of a National Sample Survey on Public Sector Banks carried out by the Operations Research Group (ORG) covering 2,100 account holders from 35 urban locations in the Country were made available. The survey inter alia revealed that staff attitude, slow service and unfavorable procedures and terms were among the more frequently mentioned complaints against banks.

There are conflicting views about the quality of customer service in banks. While the intemperate and busy customer in metropolitan/bigger urban centres complains about the deterioration in customer service, empirical studies/surveys carried out by the National Institute of Bank Management (NIBM) and other research institutions indicate that majority of the customers are satisfied with the service rendered. However, there is always scope of improvement.

Influencing Of Factors

It is worthwhile to stress that customer service is considerably influenced by the quality and job knowledge of bank personnel. In experienced and ill informed staffs tend to postpone decision making and their decisions when taken might turn out to be unsound. Frequently, their anxiety for playing safe leaves them to taking decisions which may not be of much help to customers.

The indecision finds strange expression, normally some indulge in passing the buck, some in pushing up the papers up and others in strictly abiding by rules and not to go beyond the written word. There is also growing feeling that taking decisions is riskly.

Enthusiasm of bank employees for understanding intensive development and other activities for the benefit of customers is also curbed on account of fear of audit and inspection. Circumstances in which decisions are taken by the branch staff cannot be reconstructed to enable the auditor to appreciate decisions in the right spirit or to recognise marginal deviations from the procedure. Sometimes minor procedural lapses and lacunae have to be overlooked to achieve faster development. After all only a non performer can have a faultless record.

Suggestions For Improvement

To improve the banker customer relationship, it will be necessary to motivate the bank staff at various levels. Mere instructions of controlling offices and visit of officials will not be enough. However, a far reaching measure that would really act as a catalyst and fuse together all the staff employed by the banking industry in the service of the customer is the introduction of an incentive programme that would reward good performance.

Whatever the intentions of the higher echelons of the banking bureaucracy and howsoever attractive the customer service oriented measure and mechanism on paper, the stark truth is that there can be no significant improvement so long as the attitude of the front line staff who actually come into contact with the customers does not change. drastically. The establishment of customer service centres though good in itself is no solution to the problem which has been bedeviling our banking system. The real problem is of staff and managerial attitudes and nut mechanisms.

Discourtesy and delay are two sides of the same coin. These are absolute indicators of inefficient service. Impoliteness has no existence in business. By scant courtesy and contempt, a businessman is digging his professional grave. By unreasonable delay and indifference, the seller is hastening premature closure of the unit. Banker is a businessman. He should acquire business culture and its literature, know its ethics and ground rules.

Public Relations And Banks

Banks deal with the public relationship with public should be cordial and conducive. Public relation is nothing but private and personalised business relation. Servicing a customer is nothing but an attempt to satisfy his aspirations. In satisfying a customer, the custodian also derives pleasure. For customer service, the atmosphere in a branch should be primarily conducive.

In a branch the rivalry among diverse union members may also cause a vitiated atmosphere. These members are well protected by the unions at the industry level. It is when the staff find that their trade unions can get anything they want they become more loyal to the unions rather than to the organisation and any attempt to discipline the staff is generally resisted by trade union leaders.

This phenomenon adds a dimension to the poor quality of work and lack of proper attitude to work. Hence discipline needs to be enforced though the process of discipline has to be more persuasive rather than punitive. The trade union leaders should be appraises about their important role in rendering customer service. They could be involved in educating their members, to have dialogue with them so as to create a positive environment to assist the banking industry as a partner in the implementation of better customer service.

Staff Orientation

Improvement in customer service can be brought about only by the active involvement of staff at all levels which could be brought about by proper perception of bank employees'. Improvement in personal relationship by the management can also be expected to motivate bank staff at various levels in providing improved services to the customers. The bank staff particularly at lower level has hardly any involvement or sense of pride in their jobs.

Thus it might be necessary to create right work ethics in the banks.

Besides, conscious efforts are needed to introduce job enrichment and discretion, particularly in the duties of clerical staff. Highly educated people joining the banks find it difficult to rec0ncile with the approach of their sepiors who have been promoted mostly on seniority basis. They are demotivated and demoralised and show lack of commitment. Promotional opportunities and job enrichment by giving them responsibility commensurate with their qualifications are considered necessary.

A bank which is interested in attracting more and more customers should train its employees to behave politely and attend to its customers' needs promptly and accurately. Humility and modesty which are important elements in human behaviour need to be reinforced. The bank staff particularly counter staff should be exposed to the human resource development' programmes which are designed to improve customer oriented behaviour attitudes.

Performance appraisal of bank employees should aim at objective assessment of what the employee does and how h1s/her capability can be utilised to the fullest' extent. The process of concurrent evaluation, followup and feed back through existing stages of recruitment, training and promotion has to be made more practical and innovative. 6ank management can seek the help of behavioural employee attitude behaviour to tone up their efficiency.

Educate The Bank Customers

Along with the bank staff, there is need for educating bank customers. Several customers are not aware of banking practices and hardly a few are aware of their rights. There is need to create consumer consciousness at all -levels in the banking industry. "Customer meets" arranged by banks are a step in their direction. Bodies like All India Bank Depositors' Association consulted by bank managements in this regard.-It is necessary for a banker to educate the public to avoid many misunderstandings and frictions that are likely to be generated because of the high expectations in the minds of the public and the limited resources and their infrastructure at the disposal of banks.

It is the bankers' duty to inform public about banking rules and practices and guide them properly. It is also true that at times complaints a.re not genuine and customers adopt an unreasonable and annoying stand. At times there may be valid reasons for such complaints.

Publicity

But the point to be understand is that instead of making the public aware of the constraints which often come in the way of prompt and efficient service, banks often project a none-too-real picture in their advertisements. The result is that the same people who are prepared to wait for hours together to get a railway ticket or wait in a long queue for postal covers or payment of income tax or electricity bills, etc. are not inclined to tolerate any delay at bankers counters.

There is need to arouse consciousness in both customers and employees that they have to be fair to each other in their demands, expectations and obligations and exercise a joint control on customer service.

Apart from performing the main functions of accepting deposits and granting loans and advances a banker performs a number of services to the customer like collection of money on behalf of customers, making payments, purchases and sale of securities, Advising customers on stock exchange securities, arranging for remittance of funds on behalf of customers. acting as trustee, executors, administrators or attorney of customers, serving as correspondents and representatives of customers and receiving valuables and safe securities for safe custody etc. In addition to these services the banker performs a number of services to the customer in the bank itself. Teller counter service, cheque clearance service, immediate issue of drafts, equity fund scheme, entrepreneur scheme, consultancy cells, trepreneur Development Programme, Computer service for quick. clearance all the services are great helpful to the customer of a bank.

The arrangement of customers meet, customer's service counters, teller counter service, cheque clearance service arc greatly appreciated by the public also. The trend world over, including in centrally planned economies, clearly indicates that unless Bank organisations improve their cost effectiveness and make available their services to their customers, in the most economical manner their survival would be jeopardy. This message which is spreading across the world, bring home to the basic fact that it must gear up the systems and procedures so as to make the organisations increasingly customer oriented. Customer service does not mean merely service Customer service improving productivity, reducing costs and toning up efficiency. Bank in the public sector have a great responsibility since public orientation is the very raisin 'd' etre of their being. Higher order of skills and expertise are essential for providing better customer service.

A number of steps were taken to improve the customer service in banks. Banks have, by and large, implemented most of the recommendations of the Working Group on Customer Service. To deal with customers' problems more effectively, it was advised that such recommendations, as were accepted for implementation, should be furnished to branches by way of a compendium. The specific areas on which banks were advised to take action include:

1. Immediate credit of outstation cheques for value not exceeding Rs. 2,500/-
2. Payment of interest, at savings bank rate, f9r delay in collection of instruments beyond 14 days.
3. Introduction of nomination facilities for deposit accounts.
4. Display of time - norms at branches for routine services
5. Disposal of deceased accounts, upto Rs.25,000 without succession certificate, etc.
6. Setting aside a customers' day every month.
7. Visit to rural branches by executives, etc.

SUMMARY

Commercial bank is mainly an intumediary agency of medium and short term funds. An effective banker is one who carefully mobilizes savings of the community in larger quantities and put these funds in productive and pryitable investement, current deposit are to great convenience to bank customer saving bank account is meant for lower and middle classes, who wish to share little amount of their income.

KEY WORDS

- Accordance
- Oblige
- Curbed

REVIEW QUESTIONS

1. Discuss in detail the special features of the different types of deposits with a bank?
2. What are the different classes of accounts in which deposits are received by a bank? Give important characteristic of each.
3. What are the different ways in which bank deposits arise? State how far they provide a source of strength of a banker?
4. Write a brief on time deposits and their importance to the commercial banks?

5. Briefly explain the customer service provided by the commercial bank in India.

SUGGESTED READINGS

1. D.A. Egginton - Accounting for the Banker
2. K.C. Shekar - Banking Theory and Practice

ANNAMALAI UNIVERSITY

LESSON 9

BANKING LEGISLATION

OBJECTIVES

After studying this lesson, you should be able

- to understand the banking companies act
- to find the banking reforms.
- to analyse the factors restricting operations of small banks.

STRUCTURE

9.1 INTRODUCTION

The word "Bank" is said to be of Germanic Origin, cognate with the French word, banque and the Italian word banca, both meaning bench. The word may have derived its meaning from the practice of the Jewish money changers of Lombandy, a district in North Italy who in the middle ages used to do their business. Sitting on a bench in the market place. This etymological origin of the word gets further relevance from the deriviition of the word bankrupt, from the French word banque-route and the Italian word bank arotta meaning broken bench due probably to their practice of breaking the Bench of the money changer when he failed.

The indigenous sector consists of the Ubiquitous individual money-lender. These money lenders charge interest at very high rates and the effect of borrowing from them other proves disastrous. Banks we know today are modem Institution and may be said to have been a gift to India by its alien rulers namely the British. The modem era in Banking may however be said to have been emerged into India with the establishment of the Bank of Bengal in 1809 under the Government charter with Government Participation in the Share Capital. Since then number of Banks have been established in India and a major miscestone was the Nationalisation of Banks in 1969 with a view to serve the people in a better manner.

Formarly, a Joint Stock Banking in India was Governed by the Companies Act of 1913. Banks were requried to Culm certain formalities in the mattter of preparation of the Balance Sheet or Statement of attain twice a year. Certain amendments were made in the 1913 Act by the Indian Companies Act of 1936. According to the Act of 1936, A Bank was defined as one whose principal business was the accepting of deposits of money and lending of money receiving valuables not safe custody promotion any business through syndicates etc. A very important provision of this Act was that a Bank should not be managed by a managing Agency. The 1913 and 1936 Acts covered all companies but contained provisions affecting particularly Joint Stock banks. But in 1949, the Banking Companies Act was passed and came into force in March 1949. It is a comprehensive legislation applying to all Banking Companies except Co-operative Banks.

The Exchange Banks operate in India under certain restrictions as provided under Section 11 and 22 of the Banking Regulation Act 1949 such as:

1. The Government or law of the country in which they are incorporated shall not discriminate in any way against Indian Banks.
2. Their officer shall be confined mainly to the Towns.
3. The aggregate value of their respective Paid up Capital and reserves shall not be less than 15 lakhs.
4. 75% of their deposits in India shall be held and invested in India.
5. An audited Balance Sheet and Profit and Loss Account of their business done in India in a calender year shall be published and a copy thereof displayed in a common place.

A Commercial Bank used to be defined as a Bank that caters to the needs of trade and commerce accepts deposits and. lends to trade, commerce and Industries.

A Scheduled Bank is a Bank which is included in the Second Schedule of the Reserve Bank of India Act 1934. A Bank qualities to be unlisted in the second Schedule vide Section 42 (6) of the same Act.

According to the Banking Regulation Act of 1949, a Banking Company is one which accepts for the purpose of lending or investment deposits of money from the general public. It may also do other business related to Banking such as borrowing and lending of money, discounting of bills of Exchange and hundis granting letters of credit, receiving valuables for safe custody. The other important provisions of the Act are:

1. ***Licensing etc:*** All Banks will have to be licensed by the Reserve Bank of India. No Bank can carry on Banking Business unless it holds a licence from the Reserve Bank of India. Before granting licence, the Reserve Bank of India will see whether the interests of the depositors are fully protected. Whether the affairs .of the Bank are conducted in the interests of the depositors and income of foreign incorported Banking in India, whether no discrimination is practised against Indian Banks in the foreign country concerned. No Bank can open branches without prior permission from the Reserve Bank of India.
2. ***Capital:*** The Act of 1949 includes elaborate provisions regarding the capital structure of Banking companies. The subscribed capital of a Bank should

not be less than one-half of the authorised capital and paid up capital should not be less than one-half of the subscribed capital. The capital should consists of ordinary shares only. The purpose of these provisions is to prevent Banks from working with dangerously low levels of capital reserves and to protect the interests of depositors.

3. ***Management*:** The management of a Banking company cannot be undertaken by managing Agents. None who is convicted of an offence involving moral turpitude, or is adjudicated insolvent or is engaged in any other business, or is a director of any other company not subsidiary of the concerned Bank can be appointed managing director or manager of a Bank. The remuneration cannot exceed reasonable amount fixed by the Reserve Bank and it must not be in the form of commission on profit. The contract of service, except in the case of directors cannot be for more than 5 years at a time. The purpose of these provisions is to remove gross abuses of Bank Managers.

To prevent Monopoly control by a small group of financiers or promoters, the Act of 1949 provides that voting rights should be strictly proportionate to the contribution to the paid up capital subject to the maximum of 5 per cent of the total voting rights of all the shareholders.

4. ***Profits and Reserve Fund*:** Every Banking Company should maintain cash reserves with the Reserve Bank of India in the ratio of 5 per cent against demand deposits and 2 per cent against time deposits. Besides, every Banking company should maintain not less than 20 per cent of the total of its time and demand liabilities in the form of cash, gold or other approved securities.

5. ***Restrictions on Business of Banks*:** Commercial Banks should not assume trading risks with the depositors money and therefore they should not undertake direct or indirect trading. They should not acquire immovable property unless it is required for their own operations. They should not form any subsidiary company unless it is incidental to Banking business. No Bank should hold more than 30 per cent of its own Share Capital. A Bank cannot give loans or advances on the security of its own shares or grant unsecured loans or advance loans to any of its directors or to firms or to companies in which it or its director's are interested. The purpose of these provisions is to protect the depositors money being that out or inverted in highly risky ventures.

6. ***Powers of the. Bank*:** The Reserve Bank of India may determine the policy in relation to advances to be followed by Banking Companies generally or by any Banking Company in particular. Every company is bound to follow this policy. The Reserve Bank may also give directions to Banking Companies, generally or in particular as regards the purpose for which advances mayor

may not be made, the margins to be kept in respect of secured advances and the rates of interest to be charged on advances etc., Besides the Reserve Bank, on its own initiative or under orders from the Government of India, may in respect of the working of any Banking Company its books and its advances. It can recommend to the Government that any particular Bank should be prohibited from receiving fresh deposits or to wind up such a Bank. It can direct Banks to amalgamate if it will promote the efficiency of the concerned Banks.

These are the provisions of the Banking Regulation Act of 1949. This Act was amended in 1956 and additional powers were given to the Reserve Bank of India as regards the terms of appointment of directors and chief executive officers, issue of directions to Banking companies in relation to matters of policy or administration etc. Another amendment in 1959 empowered the Reserve Bank to remove from office the chairman or any director or a manager of a Banking company who had been found guilty under the law. It enabled the Reserve Bank to apply for winding up of a Banking company under certain circumstances. In the middle of 1968, the Banking Regulation Act was further amended to, incorporate the social control provisions. Under the new amendement, every Banking company has to reconstitute its Board of Directors. Each Bank will have a professional Banker and not industrialist as a full- time chairman. Every foreign Bank will have to appoint an advisory Board. Under the new Act, new loans and advances cannot be granted to directors or to companies in which they are interested. The Act has widened the scope of the Reserve Bank's powers regarding control over Bank advances. Finally, the Act empowers the Government to take control provisions and policies.

9.2 THE BANKING COMPANIES ACT

The purpose of the Act and the subsequent amendments of the Act were to protect the interest of the depositors which were almost completely neglected by many Bankers in their anxiety to earn large profits. The Reserve Bank of India is also the custodian of the interests of the depositors and it is natural that it should be given the powers to protect the depositors interests. Again, the greatest need in India is to create a sound banking system which enjoys the confidence of the public. This can only be done through strict control, superstitions and Inspection and elimination of financially weak units through amalgamation with biggest units. It is true that at every stage, a commercial Bank has to get the consent of the Besure Bank and this may restrict the freedom and initiative of the banking company. It is also true that the power of Inspection, if not used properly, may create suspicion in the minds of depositors about the financial soundness of an otherwise sound Bank. But all there were sought to be justified on the ground of creating a sound Banking system, with the Nationalisation of the 14 commercial Banks in 1969 a major part of the Banking system has come under Government control.

9.3 BANKING REFORMS

Ever since the Nationalization of Banks in 1967 the Banking Industry is growing to meet the needs of people from various walks of society. While every commercial organization be it a bank, an Industry or a trading house will have profit as one of its objectives, the structure of an organization will vary from organization to organization. Prior do Natinalisation of Banks structure of the Banking Industry did not assume considerable significance. Banks were owned by corporate entities and each Bank had an administrative set up to sit its requirements. Subsequent to growth in all spheres of Banking, the number of branches increased considerably bringing down the average precautions covered by a Bank Branch from about 65,000 in 1969 to about 12,000 recently. Besides, the possible increase in deposits and advances has resulted in pressures on the Banking system. Large number of small loans to the renewal population, loans to the weaker sections in the urban and metropolitan areas, credit facilities to small scale Industries and tiny sector, financing of increasing volume of export/import trade and opening of a large number of branches in the Unbanked out under banked rural areas have thrown up many challenges to the Banking Industry. In some cases, besides crediting certain difficulties in efficiently administering the branches of the Banks. It has also resulted in pressures on profitability Recent indications on profitability of public sector Bank have also brought to the focus the question of reforming of the public sector Banks.

The advocates of reforming of public Sector Banks base their case for reforming of public sector Banks on the main assumption that the profitability of public sector Banks will improve after restructuring. This is on the idea that reforming alone is responsible for the losses for some of the public sector banks.

Immediately after Nationalisation of major Banks in 1969 the Structure of the Banking Industry was left undisturbed partly on grounds of expediency and partly as a matter of deliberate policy to retain all the competition among Public Sector Banks. It was also envisaged that this will lead to greater efficiency and productivity. But those who are not infavour of retorming point out that the size of a Bank or the structure of the Banking Industry cannot alone be the factor contributing to the problems of the public sector banks, more particularly that relating to profitability. Within the public sector banks group, there are Banks which are running on efficient and profitable lines.

One could see that size or structure cannot be factors exclusively responsible for the problems of some of the Public Sector Banks. The main factors may be the structure of a particular Bank or business environment of the bank having considerable impact on its productivity. Even within the public sector banks the performance varies considerably.

Due to differences in accounting practices, the published profits of various Banks may not be quite comparable, Yet, they do give fair idea of the comparative position of profits of various Banks. Further, the lack of transparency in the Balance Sheets of Banks does not facilitate disclosure of the true picture of the state of the assets and liabilities of Banks. In the absence of transparency, comparing of profitability also may not be helping us to reach precise conclusion. But they will provide good indicators.

The size or structure could not have caused the problems being faced by some of the public sector Banks. There are other factors such as organizational culture, leadership, making strategies, employee motivation Industrial relations and the like.

Mergers of Banks may also become difficult exercise particularly when attempt has been made to match different cultures and hierarchies. There may be some scope there for merging banks. The real thing is that the Banks must ensure the quality of their assets. Now the time has come to study the costs and benefits of earlier bank mergers in depth. It should cover not merely the money costs and benefits, but also most money costs and non-money benefits which are many in number.

Another point for pondering is that Branch expansion of public sector Banks that their further expansion in rural and semi-urban areas is continued only to the geographical zones when they already here considerable pressure. It property utilized, this itself will ensure a better organizational structure and viability of public sector Banks.

The structure of public sector banking as it exists today may be left undisturbed. Each Bank should undertake and indepth study of its strengths and weakness, opportunities for business and growth and then arrive at time bound action progamme. During this period, they will continue to be monitored by the Reserve Bank of India. If even after a period of 2 or 3 years things don't improve substantially, there arise question of their merger with other Banks. Independent of or as a part of their total reforming of public Sector Banks should be quickly decided and acted upon.

Reforming is not an end but only a means to an end. Every organization has to be so structured that its objectives are efficiently achieved. If the objective is not achieved, a detailed examination should be undertaken. The increasing tendency to find structural and systematic solutions to behavioural and managerial problems should be carefully avoided.

9.4 FACTORS RESTRICTING OPERATION OF SMALL BANKS THE PRIVATE SECTOR

Banks face a large number of constraints in their working. Though most of them care profits, they are severally handicapped by their limited resources. Constraints of network, lack of image and lack of partonage by the Government and public sector undertakings. To cap it ask, some of the Government Departments and Public Sector Undertakings do not accept letters of credit. Drafts, Bank guarantees, etc., issued by the private Sector Banks. In fact, there are also cases on

Public Sector Undertakings even returning to accept cheques drawn on the private Sector Banks by people dearing with them.

Another Problems faced by Private Sector Banks relates to their network of Branches. Their not having branches at all important industrial commercial centres affects their business considerably. If a private sector bank branch does not have its branches at a growing centre, this branch of the private Sector Bank cannot issue drafts or collect instruments payable at their centres except by using the series of another bank under Agency Agreement. Besides, administrative and accounting difficulties. Such an arrangement will also result in reduced income to the Bank or higher cost to the consumers. Because of this, some of the customers of the private Sector Banks more over to larger Public Sector Banks. Alternatively, some of them have their borrowing arrangements with the private Sector Banks but go to the Public Sector Banks for the remittance I collection Business. There are also cases where businessman come to private sector banks for their credit requirements and go to the public sector banks for their non-funded business. This clearly is to the disadvantage of the private sector Banks.

The Private Sector Banks are entrusted wit~ the same responsibilities as that of the public sector banks. The expectations from Private Sector Banks in respect of priority Sector lending, lending under differential rate of interest, financing under service area approach. Under IRDP etc., are same as in the case of Public Sector Banks. The Private Sector Banks are happily shouldering these social commitments like their counterparts in the Public Sector. At the same time when they are denied Government Patronage by way of deposits from Government Undertaking it hurts them financially and psychologically. Vicured in the context of same interest cost, same wage cost and some social responsibilities, this discrimination is not justice. The efforts of the Private Sector Banks in getting these problems solved, have not yielded any results so far. The Union Government have issued a circular at the instance of the Reserve Bank of India that Public Sector undertakings, in variably the patronage is extended only to public sector banks. The contuntion that every customer has a right to choose his Bank is right as a argument but dies not solve the problem of the Private Sector Banks which are being discriminated against. To improve the viability of the private sector banks as also to remove this injustice a more committed intervention by the Reserve Bank of India and Government of India is called far.

Rightly speaking every organization should be viable and be competitive enough without subsidies. But in the case of Private Sector Banks, they have to lend to certain categories of borrowers at concessional rates to meet social obligations. At the same time, they are divided the reciprocal patronage by the Government Undertakings. As these Banks are meeting their social obligation not withstanding their handicaps. The subsidies of the kind suggested above should be treated as partial compensatory gesture and not as subsidiaries.

Like in the case of public sector banks the Private Sector Banks should be allowed to continue as they are. However each private sector bank should strive hard to increase its resources base and viability. Constant efforts should be made by these Banks to strengthen there net owned funds by ploughing net profits and increasing equity. There should also endeavour to upgrade the professional skills of their employees at various levels. Given there efforts on their part and support from the Reserve Bank of India.

The Private Sector Banks can continue to pay a very useful role in the Indian Economy.

1. Restructuring of Banking Industry and disturbing trends in, the profitability of Banks are to be debated.
2. Restructuring of Public Sector Banks is advocated on the Premise that if will improve their profitability.
3. Size and structure cannot be factors exclusively responsible for, the problems of some of the public sector Banks. Mergers may also become difficult exercises partiabily.
4. Branch expansion of Public Sector Banks have to be so administered that their future expansion in rural and semi-urban areas is continued only to the geographical zones there they already have considerable presence.
5. For the present, the structure of the Public Sector Banks must be left undistrubed.
6. The increasing tendency to final structural and systematic solutions to behavioural and managerial problems should be carefully avoided.
7. The private Sector Banks face a large number of constraints in their working though most of them earn profits.
8. Another Problem faced by Private Sector Banks relates to their network.
9. The private sector Banks are entrusted with the same responsibilities as that of Public Sector Banks.
10. Reserve Bank of India should grant additional concessions to Private Sector Banks.
11. The Private Sector Banks do not have structural problems. As they are small in size, they do not have problems of communication.
12. The need for functional approach to Banking Structure is not felt at the present state.
13. Till such time, economic development on par with the developed countries, takes place, the present Banking Structure can be allowed to continue.

SUMMARY

A banking company is one which accepts for the purpose of lending or investment deposits of money from the general public. It may also do other business related to banking such as borrowing and lending of money, discounting of bills of exchange etc. the banking companies act was to protect the interest of the depositors neglected by many bankers in their anxiety to earn layer profits.

KEYWORDS

- ❖ Etymological
- ❖ Ubiquitous
- ❖ Superstitions
- ❖ Suspicion

QUESTIONS

1. Discuss briefly the main features of recent banking legislation of India?
2. Discuss the need for Banking reforms and how will it help the Progress of Banking in the Country?
3. The structure of Indian Banking Industry is to be radically changed for better performance - comment.

SUGGESTED READINGS

1. M.C. Vaish - Money, Banking and Public Finance
2. Gulsan - Banking Law and Practice

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LESSON 10

NEGOTIABLE INSTRUMENTS

OBJECTIVES

After studying this lesson, you should be able

- to find the characteristic of negotiable instrument.
- to know about bil of exchange and its essentials
- to analyse the difference between bill of exchange and cheques
- to understand the crossing of cheque, types and significance of crossing.

STRUCTURE

10.1 INTRODUCTION

In the business world certain documents are very freely used for the purpose of monetary dealings and commercial transactions. These documents are called as “Negotiable instruments”. Here negotiable means “transferable from one person to another person for some valid consideration. Contract without consideration is for a reasonable or proper consideration the transferred or can be changed hands. INSTRUMENT document by which a right is created in favour of that is why a negotiable Instrument may be defined as a written document having a right of transferability from one person to another for some valid consideration. The property or value mentioned in the document will passes to other person known as transferee for value. This transfer of document can be taken place just by delivery or indorsement. Endorsement means writing on the face or back of the instrument for the purpose of Negotiation. The person who signs on the document is known as 'indorsen'. The person to whom the instrument is favoured or indorsed is known as the “indorsee”. If no space is left on the document it can be done on a separate slip which can be attached to the document. This is called "Allonge" .

The law relating to Negotiable Instruments is contained in the Indian Negotiable Instruments Act 1881. Sec. 13 of the Negotiable Instrument Act 1881 does not define a negotiable instrument. But the Act specifically mentions only three kinds of Negotiable Instruments means a promissory Note, Bill of Exchange and cheques. Even though the Act specifies only three kinds of instruments, any other instrument which fulfills the conditions of negotiability can also be added to the list. It implies that Indian courts can follow the practice of English courts in deciding any other instruments other than mentioned in the Act for practical purposes. But the necessary condition is that the purported document, must satisfy the other conditions. Then only it can be accepted or valid.

Justice Wills defines a negotiable Instrument as one the property in which is acquired by anyone who takes it bonafides and for value not withstanding any defect of title in the person from whom he took it.

10.2 CHARACTERISTICS OF A NEGOTIABLE INSTRUMENT

The important characteristics are as follows:-

1. Every Negotiable Instrument is drawn for consideration.
2. A Negotiable Instrument may be transferred by endorsement and delivery if it is an instrument payable to order and by delivery if it is a bearer instrument.
3. TITLE OF HOLDER FREE FROM ALL DEFECTS AND DEFICIENCIES: The transferee who takes the instrument with bonafide intention and for a valid consideration gets a good title and also he is not affected by any defects or deficiencies in the title of the transferor.
4. Presumptions mentioned in Sec: 118and 119 such' as consideration date, time of acceptance, time of transfer, order of indorsement stamp, proof of protest etc., are also applicable and if anyone challenges, the onus is laid on the shoulders of ,the party to prove the validity of such presumptions. There are two types of Negotiable Instruments.

1. Negotiable by statue .

Ex: - Promissory Notes, Bills of Exchange and cheques.

2. Negotiable by custom or practice.

In England there are several types of instruments are in vogue such as dividend warrants, share certificates, circular notes etc. But in India Promissory notes, pay orders Railway receipts have also been considered by custom or business practice.

1. Instruments negotiable by delivery - Bearer Bonds, Share scripts etc.
2. Negotiable by indorsement and delivery - Bank demand drafts, Bills of lading, Railway/Air receipts etc.
3. Government Promissory Notes.

A commercial letter of credit is not negotiable, but the benefit of the credit being in a choose in action.

Choose In Action

A choose in action is a legal expression to narrate all personal rights of property which can be claimed or enforced by action and not by taking physical possession. A Bill of exchange, a promissory note, a cheque, a life policy are chooses in action. A choose in action is equivalent to 'actionable claim' vide Sec. 3 of the transfer of property Act.

Holder: - Under Sec. 8 of the Negotiable Instrument Act the holder of a negotiable instrument is entitled to receive or recover the amount mentioned thereon. A person can sue on a negotiable instrument only when his name appears it as the payee or indorsee, if the instrument is payable to bearer, he is the possession there of.

Holder in due course:- Under Sec. 9 of the Act a holder in due course is any person who for consideration became the possession of a promissory note, bill of exchange or cheque if payable to bearer of the payee if Payable to order before the amount mentioned if became payable and without having sufficient cause to believe that any defect in the -title of the person from whom he derived his title.

A holder in due course must satisfy the following conditions.

1. On paying a valuable consideration, he became either the possessor of the Instrument if payable to the bearer or indorses thereof if payable to order.
2. He had come into the possession of the instrument before the amount due there under became actually payable.
3. He had come to possess the instrument without having sufficient cause to believe drat any defect existed in the title of transferor from whom he derived his title.

Privileges Of A Holder In Due Course

1. According to Sec. 20 of the Negotiable Instrument Act any person signing and delivering to another person a stamped but otherwise inchoate instrument is debarred from asserting, as against a holder in due course, that the instrument has not been filled in accordance with the authority, the stamp being enough to cover the stated amount.
2. According to Sec. 42 in case a bill of exchange is drawn payable to the drawer's order in a fictitious name is endorsed by the same, it is not permissible for the acceptor to say against the holder in due course that such name is fictitious.
3. In case a bill or note is negotiated to a holder in due course, the other parties to the bill or note cannot avoid liability on the ground that the delivery of the instrument was conditional.

4. The person liable to negotiable instrument cannot set up against the holder in due course the defenses that the instrument had been lost or obtained from the former by means of an offence or by way of fraud for unlawful consideration.
5. No maker of a promissory note, and no drawer of a bill or cheque ,and no acceptor of a bill for the honour of the drawer shall, in a suit thereon by a holder in due course be permitted to deny the validity of the instrument as originally made or drawn.

Difference Between A Holder And A Holder In Due Course

The Sensitive difference between a holder and a holder in due course is that a holder in due course may have a better title than the person from whom he took it, had whereas a holder gets no better title.

1. A holder may become the possessor or payee of an instrument even without consideration, whereas a holder in due course is one who acquires possession for consideration.
2. A holder in due course as against a holder, must become the possessor payee of the instrument before the amount thereon becomes payable.
3. A holder in due course as against a holder t must have become the payee of the instrument in good faith.

Cheque

***Definition*:** A cheque is a bill of Exchange drawn on a specified banker and not expressed to be payable otherwise than on demand (section 6, Negotiable Instrument Act). A cheque is a species a bill of Exchange. But it has the following two additional qualifications.

1. It is always drawn on a specified banker and it is always payable on demand.
2. All cheques are bills of exchange, but all bills of exchange are not cheques.
3. A cheque being a specie of bill of exchange, it must under Section 5 be signed by the drawer and must contain an unconditional order on a specified Banker to pay certain sum of money to or to the order of the specified person or to the bearer of the Instrument.
4. All cheques are bills of exchange but all bills of exchange are not cheques.

The essential features of a cheque are:-

1. ***A cheque must be in writing:*** The writing may be in ink or in pencil in print or by a type writer. A cheque written with an ordinary lead pencil is not accepted by the Bankers in as much as such writing can be easily altered and it is difficult to know whether such alteration is authentic or not. There is no hard and Jast rule as to who will write the body of a cheque. The drawer as well as any other person can write or fill in a cheque.

2. ***A cheque must be drawn as a banker:*** The Banker on whom a cheque is drawn is called the drawee thereof he is also the paying Banker. Blank cheques bound in Books with the name of the Bank as well as of the branch at which the drawee's account is maintained and a serial number printed thereon are as a rule supplied by the banker to his customers and though not legally necessary it is only against such cheques that withdrawals are allowed. But printed cheque forms have forms this advantage that the Banker can verify the genuineness there of i.e., whether they are from the cheque book issued in the customer's account which goes a long way in preventing fraud.
3. ***A cheque must be signed by the maker*:-** The maker of a cheque is called the drawer thereof anybody capable of contracting can draw cheques and can bind himself and be bound thereby.

A signature in pencil, though legally valid is not accepted by bankers. Nor is a facsimile signature impressed upon a cheque by means of a rubber stamp accepted. The signature must be of the customer himself of his authorised agent and must agree with the specimen of his or his agents signature recorded with the Banker. Signature of an illiterate person by a mark or by thumb impression may be accepted provided the mark a thumb impression is attested every time. by a person known and acceptable for the purpose to the Banker. To avoid future complications, it is not desirable that an employee of the bank should attest such mark or thumb impression.

4. A cheque must contain an unconditional order to pay on demand. A just request to payer the making of the order to pay conditional upon the happening of a future event or ordering to pay at a future date i.e., not on demand will not constitute a cheque.
5. A cheque must be for a sum certain which must be payable is money only. The amount payable upon a cheque must be specifically mentioned in it and must be expressed both in words and figures the expression in words being ended with the word 'only'. If the amount of a cheque differs in words and figures the amount in words should be accepted vide Sec. 18 of the N.I. Act which reads as under:-

If the amount undertaken or ordered to be paid is stated differently in figures and in words, the amount stated in words shall be the amount undertaken or ordered to be paid. If in a cheque the amount is given only in figures the cheque is not accepted. Where however the amount is given in words only the cheque is usually accepted.

6. A cheque may be drawn payable to order or to bearer cheques are printed in the form pay to . . . . or bearer, or pay to . . . in order.

The person to whom payment is directed to be made is called the payee. The payee must be named or indicated with reasonable certainity Sec. 7 (1) ofthe N.I. Act.

7. *A cheque must be dated*: - There is no express stipulation in the N.I. Act to the effect that a cheque must be dated. As, however Sec. 72 and 84 stipulate that a cheque must be presented by payment within a reasonable time of its issue it may mean by implication that a cheque must bear a date to fix the reasonable time. A cheque without date is quite valid and the banker may insert the date, but cheques without date are usually returned by bankers. A cheque may be ante-dated i.e., dated before the date of issue or post-dated i.e., dated after the date of issue.

A post dated cheque may be validly negotiated i.e., indorsed and delivered to a third person, before the date it bears and the indorsee will become a holder in due course provided he receives it for consideration and without knowledge of any defect of title there to:

10.3 BILL OF EXCHANGE

Sec. 5 of the negotiable instruments Act defines a bill of exchange as an Instrument in writing containing an unconditional order signed by the maker directing a certain person to payer a certain sum of money only to or to the order of a certain person or to the bearer of the Instrument. A bill of exchange therefore is a written acknowledgement of the debt written by the creditor and accepted by the debtor.

Parties To Bill Of Exchange

There are three parties to a bill of exchange, namely drawer, drawee and payee. The maker of the bill is called the drawer. The person who is ordered to pay is called the drawee. The person who is ordered to pay is called the drawee. The person who is entitled to receive the money is called the payee. In some cases drawer and payee may be one person.

10.4 ESSENTIALS OF BILL OF EXCHANGE

1. The following ale the essential characteristics of a bill of exchange.
2. It must be in writing.
3. It must contain an order to pay money only.
4. The order must be unconditional.
5. It must be signed by the drawer.
6. The drawer, drawee and payee must be certain.
7. The sum payable must also be certain.
8. It should be properly stamped.
9. It may be made payable on demand or after a certain period of time.

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10.5 DIFFERENCE BEIWEEN A BILL OF EXCHANGE AND CHEQUE

All cheques are bills of exchange but all bills of exchange are not cheques. The following are the difference between a bill and a cheque.

1. DRAWEE: - A cheque is always drawn an a banker. But a bill can be drawn on any person including a banker.

2. PAYMENT: - A cheque is always payable on demand but a bill of exchange may be payable on demand or on the expiry of a fixed period.

3. DAYS OF GRACE: - Three days of grace are allowed on bills payable after certain period of time. No such grace is given in case of cheques.

4. ACCEPTANCE: - A bill of exchange requires acceptance of drawee. But a cheque does not require any acceptance.

5. BEARER: - A cheque can be made payable to bearer but a bill of exchange payable on demand cannot be made payable to bearer.

6. NOTICE OF DlSHONOUR:- Notice of dishonour of a bill is necessary no such notice is required in the case of a cheque.

7. STOPPING THE PAYMENT:- The payment of a cheque may be countermanded or stopped by the customer. But payment of a bill after acceptance cannot be countermanded.

8. CROSSING:- A cheque can be crossed generally or specially. But a bill of exchange cannot be crossed.

9. STAMP:- A Bill of exchange must be stamped, but cheque does not require any stamp.

10. STATUTORY PROTECTION:- A Banker is given statutory protection with regard to payment of cheques in certain cases. No such protection is available to the drawee or acceptor of a bill of Exchange.

11. NOTING AND PROTEST:- A cheque is not noted or protested for dishonour and is generally inland. A bill may noted or protested for dishonour. It may be in land or foreign bill.

10.6 CROSSING OF CHEQUES

A cheque may be drawee crossed or open i.e., without crossing crossing is defined under sec. 123 of the Negotiable Instruments Act as follows:-

Where a cheque bears acose its face an addition of the words 'and company' or any abbrevation thereof, between two parallel transverse lines, or of two parallel transverse lines simply, either with or without the words 'not negotiable that addition shall be deemed a crossing and the cheque shall be deemed to be crossed generally.

***A Crossing therfore menans*:**

1. Either two parallel Transverse lines on the face of the cheque

2. Two parallel Transverse lines on the face of the cheque with the words 'And Company' or an abbreviation of the words such as And Co., or &. Co., between them or
3. Two parallel Transverse lines on the face of a cheque with the words 'Not Negotiable added to the lines with or without the words 'And Company' between the lines.

The parallel lines under the definition are to be transverse. Hence it may be legitimately be doubted wheather the vertical parallel lines over printed on cheques or the horizontal parallel lines Protectographed on cheques instances of both are frequent constitute a crossing.

A cheque is a bill of exchange drawn on a specified banker payable 6n demand. Cheques are of two types. Namely Open cheques and Crossed cheques. Open cheques are those which are paid over the counter of the Bank. In other words, they need not be but through a bank account. They are also called un-crossed cileques. Open cheques are liable to great risk in the course of circulation. They may be subject to the risk of fraud and forgery by unscrupulous persons and may cause loss to the bank or to the customer. With a view to avoiding such risks and protect the owner of cheques, a system of crossing is introduced. Crossing in a direction to the Banker not to pay the money across the counter. It means the Banker should pay the money only through Banker. Thus, crossing affords a security to the owner of the cheque as the cheque is payable only through the Banker. Crossing does not generally affect the negotiability of the cheque. A gossed cheque can be negotiated in the same way as un-crossed one.

10.7 TYPES OF CROSSING

There are two types of crossing. General and Special. Special crossing is defined under sec. 124 of the N.J. Act as follows:-

Where a cheque bears across its face an addition of the name of the Banker either with or without the words 'Not negotiable' that addition shall be deemed a crossing and the cheque should be <teemed to be crossed specially and to be crossed to that Banker.

A special crossing therefore means:

1. Either the simple mentioning of the name of a banker on the face of a cheque or
2. The mentioning of the name of a banker on the face of a cheque accompanied by the words 'Not negotiable' and in neither case of two parallel transerve lines are mentioned in the section as required. In practice, however a special crossing without the two parallel transverse lines is.very rarely seen. The words 'And Company' are not necessary in special crossing.

The Words 'and company':- The putting of these two words between the parallel lines in a crossing is said to be the continuation of the old practice in

England of inserting the name of the Banker in the crossing or when the banker's name was not known of writing only 'and company' so that the payee might write the name of his banker before the words.

10.8 NOT NEGOTIABLE CROSSING

A cheque may be crossed generally with the words 'Not negotiable'. It may be crossed specially with the words 'Not negotiable'. When these words are used it does not mean that the cheque cannot be transferred. It can be transferred from person to person. But, it loses the quality of negotiability. The transferee of such a cheque cannot secure a better title than that of transferor even if he takes it in good faith and for consideration. If the transferor has defective title, the transferee also gets the same defective title. It is like stolen Book or Purse. In other words the receiver of such a cheque cannot get a better title than that of the chief. So a not negotiable cheque is like a stolen book, the receiver of which does not get better title than that of the chief.

10.9 RESTRICTIVE CROSSING

Banking usage has developed another type of crossing called 'Restrictive Crossing'. In this type of crossing the words 'Account Payee', 'Account Payee Only' or A/C 'X' only are added to the general or special crossing.

The effect of restrictive crossing in that it directs the collecting Banker that the proceeds of the cheque are to be credited only to the account of payee named in the cheque. It proceeds are credited to some other account, the. collecting Banker may be held responsible. Restrictive crossing has thus the effect of restricting the Payment in certam ways.

10.10 SIGNIFCANCE OF CROSSING

The crossing of a cheque signifies that a cheque if crossed generally, must be paid only to a Banker and if crossed specially to that particular Banker to whom it is specially crossed widely sec. 126 of the Act which reads the follows:-

Where a cheque is crossed generally, the Banker on whom it is drawn shall not pay it otherwise than to a banker. Where a cheque is crossed specially, the Banker on whom it is drawn shall not pay it, otherwise than to the Banker on whom it is drawn or his agent for collection.

In view of this the payment of a crossed cheque. If demanded by the holder except through his banker must be refused and in doing so the drawee banker has no liability as the privity of contract is not between him and the holder but between him and the drawer of the cheque and the crossing on a cheque constituting the drawer's instruction upon his banker can be ignored by the drawee only at his own peril. If a crossed cheque is paid otherwise than to a banker, the paying banker will not be entitles to debit the drawer's account with the amount there of, and if by such payment the free owner of the cheque suffers loss the drawee banker is bound to make good that loans.

Sec. 129 of the Negotiable Instrument Act reads as follows:

Any Banker paying a cheque crossed generally otherwise than to a banker, or a cheque crossed specially otherwise than to the banker to whom the same is crossed or his agent for collection being a banker, shall be liable to the true owner of the cheque for any loss he may sustain owing the cheque having been so paid.

A crossing by enforcing payment only through a banker affords added protection to the payee or indorsee. In other words any body wanting to encash a crossed cheque can do it only through a bank account which certainly is more difficult than encashing it over the counter.

Who Can Cross

The drawer of the cheque can cross it generally or specially Under Sec. 125 of the N.I. Act, the holder of a cheque also can cross it generally if it was crossed generally or specialy and the Banker to whom a cheque is specially crossed can again cross it specially to another Banker as his collecting Agent. These changes do not constitute any alteration and therefore require no authentication by the drawer.

Crossed To Two Banks

If a cheque bears the special crossing stamps of more than one Bank, where a cheque is specially crossed to more than one banker, the payment thereof must be refused, unless one of the two bankersis the collecting agent of the other vide sec. 127 of the N.I. Act reads as under:

Where a cheque is crossed specially to more than one Banker except when crossed to an agent for the purpose of collection, the Banker on whom it is drawn shall refuse payment thereof.

That one of two such Bankers is the collecting agent of other will be evident when the Banker receiving the cheque for collection indorses the same in favour of the other.

Account Payee Crossing

An account payee crossing has no legal backing, but it is so much in use and for such a long time that it does not only invalidate a cheque but has acquired a legal significance. From the decided cases it appears that such a crossing is no mandate to the drawee banker, but is a notice to the collecting Banker to see that the amount of the cheque is collected only in the account of the payee. The paying banker is not required to ensure that the amount on collection of the cheque goes to the credit of the payee, but he must be on his guard that any indication to the contrary, such a signature other than or in addition to that of the payee appearing on the back of the cheque, is not religently ignored.

A cheque crossed 'Account payee only' may probably mean the same thing as a cheque crossed account payee. A cheque crossed account ABC syndicate Bank may be paid if otherwise in order even without indoresement by the payee when it is collected by the said bank.

A cheque payable to bearer and crossed account payee may be returned with the objections cheque not properly drawn or may be paid if otherwise in order ignoring the indoresement if any of.the back thereof.

Besides cheques, bank drafts, pay orders, debit notes, dividend warrants can be crossed, of these pay orders debit notes and divided warrants are not transferable.

There is no legal authority as to how a crossing should be cancelled. But crossing being a material part of a cheque cancellation thereof constitutes a material alteration.

A crossing can, therefore be cancelled only by the drawer of the cheque under his authentication. This is usually done by writing beneath the crossing 'crossing cancelled' under the drawer's signature confirming to the specimen recorded wiith the Banker. As both the above forms are prevalent, it cannot be said with certainity whether the words (please pay cash) must be added to the words crossing cancelled. to make the cancellation operative. In any case the drawee Banker must be particularly careful in making payment of a cheque originally crossed and their opened.

SUMMARY

A negotiable instrument as one the property in which is acquired by any one who takes its bonafides and for value not withstanding any defect of title in the person from whom he took it. It is drawn for consideration and may be transferred b endorsement. A cheque is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand. It must be in writing and drawn as a banker.

KEYWORDS

- Indorsement
- Stibulate
- Legitimate
- Unscroputous

REVIEW QUESTIONS

1. Define 'cheque' Distinguish between a bill of exchange and a cheque.
2. What is meant by negotiable instrument? What are its characteristic features.
3. Define a holder in due course. Discuss his rights and privileges.

SUGGESTED READINGS

1. M.L. Tandon - Banking Law and Practice
2. Desai Vasant - Indian Banking – Nature and Problem

LESSON - 11

ENDORSEMENT

OBJECTIVES

After studying this lesson, you should be able

- to understand the essential of a valid endorsement and its kinds.
- to know about payment of customer cheque, bearer cheque, order cheque.
- to find the making of cheques.

STRUCTURE

11.1 INTRODUCTION

A person entitled to get money on a negotiable Instrument like a cheque can transfer his right to another. He may be a maker or holder of the Instrument. If he wants to transfer his right to another, he must sign the instrument. The signature is usually made on the back of the Instrument.

The word Indorsement is derived from Latin 'IN' meaning upon and 'DORSEM' meaning the back. So the literal meaning of the word is signing on the back of the instrument. Indorsement has been dermed in Section 15 of the N.I. Act as follows:

When the maker or holder of a negotiable Instrument signs the same otherwise than as much maker, for the purpose of negotiation on the back or face thereof, or on a slip of paper annexed there to, or so signs for the same purpose a stamped paper intended to be computed as a negotiable Instrument, he is said to indorse the same and is called the indorser. In other words "a writing on the back of an Instrument. The person to whom the Instrument is endorsed is called the 'endorsee'.

11.2 ESSENTIALS OF A VALID ENDORSEMENT

The following are the essentials of a valid endorsement.

1. It must be on the back or face of the Instrument. If no space is , left on the instrument, it must be made on a separate paper attached to it.
2. It should be made in Ink. An endorsement in pencil or rubber stamp is invalid.
3. It must be made by the maker or holder of the instrument.
4. It must be signed by the endorser.
5. It must be computed by delivery of the Instrument. The delivery must be made by the endorse himself.
6. It must be an endorsement on the entire bill. A partial endorsement does not operate as valid endorsement.

Though the Act provides for an endorsement on the face of a cheque, the universal practice in the country is to sign by way of indorsement only on the back of a cheque or bill or pronote.

Allonge

To provide space for further indorsements sometimes a slip of paper is pasted to a cheque. This slip of paper is called on Allonge. An endorsement on a cheque with an allonge attached thereto shall be made partly on the cheque and partly on the allonge.

Cheques vis-a-vis endorsement: A cheque drawn payable to order must be indorsed by the payee or his agent or by the indorsee. A cheque drawn payable to bearer does not require to be indorsed. Even if subsequently indorsed in full, or even if the indorsement appearing on it purports to restrict or exclude further negotiation, a cheque originally drawn payable to bearer, remains payable to bearer i.e., whoever presents it for payment once a bearer always a bearer. The section reads as under.

Where a cheque is originally expressed to be payable to bearer the drawee is discharged by payment in due course to the bearer thereof, not withstanding any indorsement whether in full or in blank appearing thereon, and not withstanding that any such indorsement, purports to restrict or exclude further negotiation.

11.3 KINDS OF ENDORSEMENT

Endorsement may be of any of the following kinds:- There are six types of endorsements.

1. Blank Endorsement

If the Indorses signs his name only the indorsement is said to be in blank sec. 16(1) of the N.I. Act. It is also called General endorsement. Endorsement in Blank specifies no endorsee. It is simply consists of the signature of the endorser ort the endorsement. A negotiable Instrument even though payable to order become a bearer instrument if endorsed in Blank.

2. Endorsement In Full

If the indorser signs his name and adds to the signature a direction to pay the amount mentioned in the instrument to, or to the order of, a specified person, the Indorsement is said to be in full and the person so specified is called the indorsee. An endorsement in full is also called a special endorsement. If a cheque (or bill or note) payable to order is indorsed in full, but the indorsee, indorses it in blank, the cheque becomes payable to bearer. Section 54 of the Act which reads as follows:

Subject to the provisions here in after contained as to crossed cheques, a negotiable instrument indorsed in blank is payable to the bearer thereof even though originally payable to order. But as stated in Section 49, the holder of a negotiable instrument indorsed in blank may without signing his own name by writing above the Indorser's signature a direction to pay to any other person as indorsee, convert the indorsement in blank into an indorsement in full, and the holder does not thereby incur the responsibility of an indorser.

3. Partial Endorsement

Endorsement purporting to transfer a part of the amount payable under the instrument is called partial endorsement. Such an endorsement does not operate as a negotiation of the Instrument No right of action arises under a partial endorsement.

(4) & (5) Exclusive And Conditonal Indorsement

These two kinds of indorsements are defined under Section 52 of the N.I. Act which reads as follows:

The indorser of a negotiable instrument may, by express words in the indorsement, exclude his own liability thereon, or make such liability or the right of the Indorsee to receive the amount due thereon depend upon the happening of a specified event, although such event may never happen. It is also called qualified endorsement. An endorsement may be made conditional in any of the following forms.

A) Sans recourse endorsement

An endorser may be express words exclude his own liability thereon to the endorsee or any subsequent holder in case of dishonour of the Instrument. Such an endorsement is called an endorsement sans recourse.

Ex: Pay to Babu or order without recourse to me is an example.

B) Faculative endorsement

An endorsement where the endorser extends his liability or gives up some rights under a negotiable Instrument is called facultative endorsement.

C) Sans frais

Where the endorser does not want the endorsee or any subsequent holder to incase any expense on his account on the Instrument the endorsement is "Sans Frais."

6. Restrictive Indorsement

It the indersement on a cheque payable to order is added by a direction to that effect.

Pay the contents to Babu only or

Pay to Rao for my Use or

Pay to Babu on NC of Rao.

it will be restrictive indorsement implying that tenther negotiation of the cheque is stopped and the cheques must be paid to the indorsee only on proper indorsement by him.

An endorsement may be in Ink or is Pencil but an indorsement is pencil is not acceptable as such indorsement is liable to obliteration and when made cannot be proved.

An endorsement by impressing a rubber stamp penporting to be facsimile of the payee's signature is legally valid is the stamp is put under the authority of the payee.

An endorsement by impressing a rubber test and thumb impression by an illiterate person is not acceptable unless guaranteed by the collecting banker.

11.4 SIGNIFICANCE OF ENDORSEMENTS

A cheque being the drawer's mandate upon the banker, the banker must pay the cheque only according to I the drawer's instructions. When a banker pays an order cheque it is the endorsement that supplies the necessary evidence that he has acted according to the drawer's instruction.

It is most important therefore that the paying banker should be particularly careful in respect of indorsement and in case of any reasonable derebt, retern the cheque for confirmation in order to prefect his own as well as the drawer's interest.

11.5 PAYMENT OF CUSTOMERS CHEQUE

A banker is bound to honour his customers cheques according to sec 31 of the Negotiable Instrument Act. This is more important duty on the part of a banker, but the obligation is not absolute conditional, depending for its discharge upon certain conditions.

They are:

a) The Banker must be duty required to pay. The payment of the cheque must be demanded i.e., the cheque must be presented for payment (2) the cheque must be in proper form.

b) The Banker must have sufficient tends of the drawer in his hands. There must be sufficient balance is the drawer's account to meet the cheque or cheques drawn on it and

c) The funds must be property applicable to the payment of the cheques, there should be nobar legal or otherwise prohibiting payment.

Presentment

A cheque must be presented by the holder there of or his agent at the drawee bank for payment. The drawer bank means the branch of the bank at which the customer's account is maintained. A banker is not bounel to make payment of a cheque presented for payment at any branch other than that which the drawer's account is kept.

A cheque presented at a Branch other than that at which the customer's account is kept should be returned with the objection.

Time

The presentment must be made on a working day within the Banking hours. The payment of a cheque made before or after banking hours will not be a payment I in due course and in consequence the Banker would not be discharged forms liability by such payment. The presentment must be made within a reasonable time. In drawing a cheque the drawer engages that the cheque on due presentment will be horsed. It cannot be however be expected that the drawer is account will always remain sufficiently in fund fill his liability upon the cheque is based by limitation.

Reasonable Time

According to the usage obtaining in India, the reasonable time for payment of cheques is recorded to be six months from the date of issue therefore and the six months is calculated calenderwise.

Where a cheque is not presented for payment within a reasonable time of its issue and the drawer or the person on where account it is drawers had the right at the time when payment ought to have been made as between himself and the Banker to have the cheque paid.

Proper Form Of Cheque

A cheque in order that it may be paid must be in proper form i.e., proper in all its essentiable,

1. The cheque must be drawers on the branch of the Bank
2. The cheque must be currently dated.

A cheque that is more than six months old is overdue according to the Indian custom and as such is called out of date or stale and it is not to be paid. A stale cheque is returned with objection; cheque is out of date. Not that a cheque by becoming stale is cancelled. It can be revalidated by the drawer by writing the current date.

The cheque must be duly signed by the customer or is authorised agent i.e., the signature on the cheque presented for payment must not be in pencil or by rubber stamp and must accord with specimen signature recorded with the Banker.

The drawer's signature on the cheque requires to be very carefully verified with his recorded specimen signature so that the mairs list of the paying banker namely the payment of a cheque with forged signature may be avoided.

The payee must be needed or described with reasonable certainity.

The amount must be duly expressed both in words and figures and the two must agree.

The cheque must be free from erasure overwriting, alteration.

A part from the above essentials the following are also to be fulfilled.

Sufficient Balance

In order that a cheque may be there must be sufficient balance in the customers account with the Banker. This means credit Balance as well as any overdraft or cash credit limit granted to the customer.

2. Computation Of Balance

In calculating available funds the Banker is not required to take into account the Uncleared effects, such as cheques placed in the days clearing but not yet cheared. It such amounts are credited to the customers account as a matter of practice. The amount so credited i should be deducted from the balance in honouring the customers cheques and if the balance there amived at talls short of the amount of the cheque or cheques presented the uncovered cheque should be returned with objections.

3. Where Cheques Presented Are Not Covered By Balance

A Complication may arise who such cheques drawn as account are Presented in the same clearing or almost simultaneously over the counter and the balance of the account does not cover the amounts of them.

4. Abjence Of Restriction

Before making payment of a cheque the Banker must see that there is no barlaged or otherwise to making payment of a cheque.

11.6 PAYMENT OF BEARER CHEQUES

A cheque payable to bearer is a cheque that is payable to any body presenting it for payment either though another bank when it is crossed or over the counter when it is open Le., uncrossed and the banker is fully protects against such payment when make in due course.

Cheque payable to bearer does not require endorsement but bankers, as a rule, demand the presenters signature on the back of an open bearer cheque. When presented over the counter such signature it must be noted is not an indorsement because it is not made for the purpose of negotiation. It is wanted as a discharge and can possible by dispended with duty stamped when the amount exceeds Rs. 20% when the amount is large the paying Banker should whenever possible. Obtain for safety sake apart from the presenter's signature on the back of the cheque also the confirmation of the drawer over phone.

11.7 PAYMENT OF ORDER CHEQUES

A cheque payable to order required indorsement it is not however possible for the paying Banker to know for certain that the endorsement has been made by the payee himself. It is enough for him if the indorsement purports to have been made by the payee or his agent. According to see 85 (1) of the Negotiable Instrument Act.

Where a cheque payable to order purports to be indorsed by or on behalf of the payee the drawee is discharged by payment in due course.

A paying banker is thus given legal protection against payment of order cheques even with forged endorsement.

An open order cheque even when regulary endorsed is not paid in cash over the counter unless the payee indorser is well known to the paying Banker or can establish his identity to the satisfactions of the paying Banker. This is done when the payee's indorsement is afterted by a person known and acceptable to the paying banker.

An order cheque with an irregular indorsement or with no indorsement at all, when presented by an9ther Banker either in clearing or through a messenger over the counter, is paid only when the collecting banker guarantees the irregular indorsement or the absence 2 indorsement under his certificate.

Payment Of Crossed Cheques

A Banker should examine whether the cheque presented for payment is open or a crossed cheque. If it is crossed one he should see whether it is general crossing or special crossing. If it is a open cheque he can pay cash to the payee or the holder across the counter. If it bears general crossing, he should not pay the amount across the counter. The holder must be asked to present the cheque through some banker. It should be paid to a banker. If it bears special crossing the banker should pay only the Bank whose name is mentioned in the crossing or its agent for collection. If he pays contrary to the instructions as indicated by crossing, he may be asked to pay the amount to the true owner for any loss sustained by the banker's action. Besides he will loss statutory protection in case of forged endorsement as/such payment is not regarded as payment in due course.

When a crossed cheque is dishonoured the crossing thereof is not cancelled thereby. When a crossing of a cheque is cancelled and the cheque is presented over the counter for payment in cash the paying Banker must needs be critical of such cancellation and will pay the cheque in cash only if he is satisfied as to the genuineness of the cancellation of the crossing. ..

Payment In Due Course

The payment of a cheque in order to discharge the paying Banker must be a payment in due course. A payment in due course has been defined under Section 10 of the negotiable instrument Act.

Payment in clue course means payment in accordance with the apparent tenor of the instrument in good faith and without negligence to any person in possession there of under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount therein mentioned.

The payment of a cheque in order to be a payment.Jn-due course must therefore fulfill the following conditions.

First as a cheque is an unconditional order to pay ceJ1ain sum of money only, the payment must be a payment of money only and for the full value of the cheque.

Secondly the payment must be ,made in accordance with the appearant tenor of the cheque, i.e., in accordance with what appears on the face of the cheque to be in the intention of the drawer. That is to say the banker must see whether the cheque is properly drawn or not, whether it is currently dated, post dated or state. Whether it is drawn payable to order or bearer whether it is crossed or open. In each of the above mentioned cases the paying Banker's decision as to the payment of the cheque would be different. Thirdly, the payment must be made honestly, without any malafide intention of the part of the Banker. Unless it is proved that an official of the paying banker acted fraudulently the acts of a banker are deemed to be acts done in good faith. The paying bankers position is not however very clear in regard to without negligence. Hence, the paying banker would be need liable foe negligence if he pays post dated cheque, or an order cheque irregularly indorsed or a cheque in which the drawer's signature is not genuine or if he desists from making enquiries when he should have made enquiries before making payment. .

Fourthly, the payment must be made to a person in possession of the cheque and entitled to receive payment. The first part is apparent in as much as one cannot present a cheque for payment over the counter or through another Banker unless one in possession thereof. He is entitled to receive payment is not so easy to determine. When however the circumstances of the case, the appearance and the conduct of the person presenting the cheque over the counter do not some suspicion in the mind of the paying Banker that the presentor's title to the cheque may not be all right and the cheque if otherwise in order, is paid, the payment" would be a payment in due course and the paying banker would be discharged from any liability upon the payment.

11.8 POST DATED AND STALE CHEQUES

The Banker must see that date of the cheque. The cheque should be neither post-dated nor stale. A cheque bearing a date later than that on which it is presented for payment is called post-dated cheque. That it contains a future date A Banker should not honour a post-dated cheque on account of any reasons and risks. He had no right to debit his customer's account in such a case. He will suffer loss if the customer stops payment of the cheque or dies or becomes insolvent before the due date of the cheque. A cheque is regarded as stale if it is not presented for an unreasonably period. In India a cheque is regarded as stale if it is current for more than six months. A Banker should not honour a stale cheque.

11.9 MARKING OF CHEQUES

Suppose a person sells goods to a stranger and the stranger offers to pay the amount by issuing a cheque on his Banker. He may not be willing to accept the cheque as he does not know whether the purchaser has sufficient funds are not. So the purchaser may request his banker to certify the cheque as good for payment.

Bankers in India, used at the request of their customers to mark their cheques 'Good for payment'. The practice developed out of similar practices obtained years ago in USA and in England. The marking was done by the Banker signing at a corner of the cheque under his certificate, Good for payment. This certification gives added currency to the cheque by showing on its face that it is drawn in good faith on funds sufficient to meet its payment and by adding to the credit of the drawer that of the Bank on which it is drawn.

A marked cheque used to be considered as good as cash. In marking a cheque good for payment the Banker would usually earmark an equivalent amount in the Balance of the customers account with him so that the cheque on presentment could be paid.

But it is not always the case that the customer maintained sufficient funds in his account. Particularly, when the cheque was post-dated and the marking of a customer's cheque was only a mode of accommodation granted to him. In such cases the Banker's position would be rendered extremely awaked if the customer failed according to his commitment, to keep his account in funds on the day the cheque marked good was to be presented for payment. The Bank could not be regarded as an acceptance that it did not amount to a promise by the Bank to pay the amount of the cheque whether or not there were funds to meet it. That there was no privity of contract /between the Bank and holder and the words good for payment might be constued as words of representation as to the genuineness of the cheque and of the signature.

Marking enables persons to accept such cheques even from strangers without hesitation. A marked cheque will be easily accepted as marking indicates that the cheques drawn in good faith and there are sufficient funds to meet it. When such marking by usage amounts to an understanding by the bank to honour it adds to credit of the banker to that of the drawer.

SUMMARY

A cheque drawn payable to order must be indorsed b the payee or his agent or by the indorsee. There are six different types on endorsement. They are Blank endorsement, endorsement in full, partial endorsement, Exclusive endorsement, Conditional endorsement and restrictive endorsement. It is important that the paying banker should be particularly careful in respect of endorsement.

KEYWORD

- Barlaged
- Negligence
- Facultaive
- Fasimile

Review Questions

1. Define endorsement and what are the different kinds of endorsement?
2. State what are the different methods of cheque payment by Banker's?
3. Write if short notes on marking of cheques and allonge?

SUGGESTED READINGS

1. M. Radhaswamy and S.V. Vasudevan - Text Book of Banking

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LESSON - 12

PROTECTION GIVEN TO A PAYING BANKER AND COLLECTION BANKER

OBJECTIVES

After studying this lesson, you should be able

- to know the cheques payable to order
- to know about crossed cheques
- to understand the refusal fro payment and collection of cheques
- to find the protection to collection banker.
- to familiar with presentation for acceptance

STRUCTURE

12.1 Introduction

12.2 Cheques payable to order

12.3 Crossed cheques

12.4 Refusal for payment

12.5 Collection of cheques

12.6 Protection collection banker

12.7 Collection banker

12.8 Presentation for acceptance

Summary

12.1 INTRODUCTION

A Banker generally honours or pays cheques drawn upon him by his customers. A cheque can be transferred from person to person. So it contains a number of endorsements. The Banker who has to pay the cheque cannot verify whether the signature's of all the endorsers ate genuine or not. The reason is he does not possess the specimen signatures of all the endorsers. He possesses the specimen I signature of the drawer only. So there is scope for forgery of endorsement. Suppose may "x" steal the cheque of y and endorses it by signing it as "y." As a result a banker may pay the cheque containing a forged or authorised endorsement. In such a case he will incur loss as he will be held liable to pay the amount to the true owner of the cheque. The law protects him aginst any loss arising out of honouring a cheque with forged endorsement. In other words the paying Banker is granted statutory protection in case of forged endorsement.

The paying Banker can claim statutory protection in case of forged endorsements only when he makes payment in due course.

12.2 CHEQUES PAYABLE TO ORDER

If a cheque payable to order purports to be indorsed by or 'on behalf of the payee, the drawee is discharged by payment in due course i.e., the Bank is protected if he pays the amount in accordance with the appearant tenor of the instrument in good faith and without negligence and to a person under circumstances not affording a reasonable ground for believing that he is not entitled to receive the payment. The Banker can debit his customer's account with the amount so paid even though:

1. The endorsement by the payee might turn out to be forgery.
2. The endorsement might have been placed on the cheque by the payee's agent without his authority.

The Banker can debit his customer with the amount so paid. Section 85 grants this Protection to the Banker because he is not expected to know the signatures of all the persons, excepting his customers on earth. If a customer's signature is forged and the Banker makes payment on the cheque, he cannot debit the account of the customer payment made on a forged cheque cannot be regarded as payment in due course under Section 10.

The Banker cannot also debit the account of his customer.

1. Where the payment is not made in due course and in accordance with the apparent to or of the cheque.
2. Where that is a discrepancy between the name of the payee and his indorsement.
3. Where the payment ,of a crossed cheque is made on the counter. .
4. Where the signature of the customer is forged. If the forgery is intimately connected with the negligence of the customer and is the proximate cause of loss, the banker can debit the account of the customer.

Cheques Payable to Bearer Section 85 (2) As regards bearer cheques, the rule is once a bearer cheque always a bearer cheque. A banker gets a good discharge by payment in due course of the amount on a bearer cheque to the holder of the instrument. It does not matter whether the apparent holder is the owner of the cheque br not. Anyone who happens to be in the possession of a bearer cheque can claim payment on 'it and the Banker will be justified in debiting the account of the customer when payment is made to the holder of it.

12.3 CROSSED CHEQUES

A cheque may be crossed (1) generally (2) specially.

Payment Of Cheque Crossed Generally

Where a cheque is crossed generally, it is a direction to the Banker on whom the cheque is drawn to pay it to a Banker only. The drawee Banker is discharged by payment in due course of a generally crossed cheque to a Banker.

Payment Of Cheque Crossed Specially

Where a cheque is crossed specially it is a direction to the Banker on whom the cheque is drawn to pay it only to the Banker on whom it is crossed or his agent for collection. The drawee Banker is discharged by Payment .in due course of a specially crossed cheque to the Banker to whom it is crossed or his agent for collection.

Payment Of Crossed Cheque In Due Course

If the drawee banker pays a crossed cheque in due course, he is put in the same position as it we had paid the true owner of the cheque. He can debit to his customer. It does not matter even if the amount of the cheque does not reach the hands of the true owner.

Payment Of Crossed Cheque Out Of Due Course

When a cheque is crossed generally and the drawee banker pays it otherwise than in accordance with such crossing. He is liable to the true owner of the cheque for any loss he may sustain by such default.

12.4 REFUSAL FOR PAYMENT

A Banker promises to honour cheques drawn on him by his customers. It is a statutory duty or obligation in India. If a banker dishonours or fails to pay a cheque without sufficient reason, he will be liable to pay damages to the customer. So a Banker must not refuse payment without proper and valid reason. He is not bound to honour a customer's cheque under certain circumstances.

The following are the circumstances under which a Banker can refuse payment of a cheque issued by his customer.

1. Countermanding Of Payment By The Drawer

The customer may ask his banker not to pay a particular cheque issued by him. In otherwords, the drawer may counter named or stop the payment. He should give notice to stop payment in writing. The notice should contain the number, date amount and name of the payee of the cheque. When such a notice is received by the.. Banker he is justified in dishonouring the cheque. The payee cannot claim the amount as the stopped cheque is useless. It is said that a stopped cheque becomes a piece of waste paper in the hands of the payee.

A Banker should return the cheque with the remarks "ORDERS NOT TO PAY" or payment countermanded by the drawer.

2. Notice Of Customer's Death

When a banker receives notice of customer's death or comes to know of it, he should not pay the cheques issued by his customer prior to his death. He should return with the remark “Drawer deceased”.

3. Insanity Of The Customer

When a Banker receives notice of insanity of his customer or comes to know of it he should not pay the cheques drawn by the Insane customer. However, he can honour the cheques drawn by the customer before he become insane.

4. Insolvency

When a banker comes to know that his customer has become insolvent or receives notice of presentation of insolvancy petition, he should not honour the cheques drawn by his insolvent customer.

5. Garnishee Order

When a banker receives an order from the court attaching the money belonging to the customer he should not honour the cheques drawn by the customer. An order passed by the court on a person called garnishee attaching money belonging to his customer is called a garnishee order.

6. Notice Of Assignment

When a banker receives notice that his customer has assigned the credit balance in his account to another he should not honour the cheque.

7. Knowledge Of Breach Of Trust

When a banker has knowledge that the customer operating a trust account intends to misuse the funds against the rules of the trust, he should not honour the cheques drawn by the customer.

8. Knowledge Of Defect In Title Of The Holder

When a banker has knowledge that the person presenting the cheque is not the real owner he should refuse payment.

9. Insufficient Funds

If the balance to the credit of the customer's account is not sufficient to pay the cheque the Banker should refuse payment. In case of over draft arrangement the Banker should not honour the cheque if the overdraft limit exceeds on payment of the cheque. He should not make part payment. He should return the cheque with the words "Refer to Drawer." This means that the Banker does not have sufficient funds at his disposal to honour the cheque. The words "Not sufficient funds or No funds are also used. When a cheques deposited for collection are not collected and credited, and the amount in the account is in sufficient, is insufficient, the Banker should return the cheque with the words “Effects not cleared”.

10. Post Dated Cheque

If a cheque contains a future date he must not honour such a cheque. That is, he should not pay post dated cheques. However, he can pay the cheque on the date mentioned on it.

11. Stale Cheque

If a cheque is in circulation for more than six months, it is regarded as stale or out of date. A Banker must dishonour stale cheques.

12. Drawer's Signature

If there is any difference between the signature of the drawer on the cheque and his specimen signature with the Bank he should not honour the cheques. However, he may pay the cheque after the signature is confirmed by the customer.

13. Irregular Endorsements

If the endorsement is not in proper order, the Banker is justified in dishonouring the cheque.

14. Words And Figures Differ

If the amount stated in words is different from the amount stated in figure, the Banker can refuse payment.

15. Alteration

If there is alteration on the cheque and not confirmed by the drawer by putting his full signature a banker can refuse payment.

16. Form Of The Cheque

If a cheque is not properly drawn, he is justified in refusing payment.

17. Drawn On Another Branch

If a cheque is presented for payment at a branch other than the one where the account is kept, the Banker is justified in refusing payment unless there is a previous arrangement.

In these circumstances a Banker can refuse honouring the cheques. The duty of a banker is to honour the cheques drawn by his customer. It is a statutory obligation in India. If a banker dishonours a cheque without proper reason or justification, he makes himself liable to pay damages to the customer. In otherwords, a customer has right to claim damages in case of wrongful dishongurof his cheque. According to Section, 31 of the negotiable Instruments Act if a banker having sufficient funds of his customer in his hands, properly applicable dishonours his customer's cheque, he must compensate the drawer for any loss of damage caused by such default. It a banker dishonours his customer's cheque without justification. He becomes liable to pay compensation to the drawer for injury to his credit.

The amount of compensation which a customer can claim is not limited to actual precuring loss. The customer can claim compensation or damages for long credit is the market or injury to his reputation. So a customer can claim substantial damages in case of wrongful dishonour provided he can prove that his credit has suffered on account of such dishonour. If the customer is a trader, he can claim substantial damages. The reason is his credit suffers greatly in the market. But if the customer is a non trader he is entitled to nominal wages only. But he has to prove that his credit has suttered on account of wrongful dishonour to claim substantial damages.

12.5 COLLECTION OF CHEQUES

The functions of a commercial Bank include collection of bills of Exchange and as a cheque is also a bill of exchange of cheques as well Section 6 of the Banking Regulation Act 1949. A Banker Performing this function is called a collecting Banker.

A Banker may collect cheques either as agent for collection or for himself. When he accepts the cheques paid in by his customer, collects them and credits the Proceeds to the customer's account he acts as agent for collection of his customer. But when he collects cheques as holder for value he collects the same for himself.

Holder For Value

A Banker becomes holder for value

a) When he pays cash to the payee of a cheque i.e., purchases a cheque before collection therefore

b) When he allows the customer to draw against cheques paid into his account but not yet collected, that is when there is an arrangement express or implined for such drawings, since a cusual drawing allowed once in a which against uncleared effects will not make in Banker holder for value of the cheque or cheques drawn against or

c) When he collects a cheque or cheques paid in by a customer to repay in full or in part an overdraft in his account when the Danker has same personal interest in the collection.

Collection cheques as holder for value or holder in due course serves the Banker better under circumstances when the statutory protection under section 131 of the Negotiable Instruments Act is not available that is to say when he collects an open bearer or order cheque for a customer or a crossed cheque for a person who is not a customer or when the collection is finged with negligence on his part. Even failure to obtain proper reference about the customer at the time of opening his account may not be constructed as negligence on the part of the Banker collecting cheques as holder for value or holder in due course.

But in collecting cheques as, holder for value or holder in due course the banker runs certain risks, namely the cheque may be dishonoued. When a cheque is dishonoured for want of funds the Banker has no debit recourse against the person receiving the cash in (a) above or he can debit the customer's account with the amount of the dishnoured cheque in (b) and (c) but when the drawer's . signature or an indorsement on a cheque proves to be froged the Banker becomes liable to the true owner of the cheque for the amount thereof. .

Collection Of Cheque

(A) Tender by customers

Cheques for collection are required to be tendered at the Bank under cover of paying slies in slips supplied by the Banker. The Particulars namely numbers, amounts and the name or the drawee Banks of the cheques together with the name and address and where necessary the account number of the customer, have to be noted in both the parts thereof. There is a time limit prescribed by the bankers for receiving cheques for collection on the date of receipt and the paying in slips of cheques received thereafter are marked "Late for today's collection" so as to 'avoid liability for not,collecting the cheque on the date of receipt.

(B) Presentment for payment

Cheques may be presented for payment at the drawee banks direct through messenger through the Branch offices of the collecting Banker or if he has no branch office at the place of payment of a cheque through another banker who is his agent and has a branch office at the place of payment, cheques received for collection are recorded in separate registers according to the mode of collection. Out station cheques sent to another branch or banker for collection are called occs i.e., outward cheques for collection and for ready reference bear a serial number. The proceeds of cheques collected should be credited to the customer's accounts forthwith under advise to them.

(C) Notice of dishonour

If any cheque received for collection is dishonoured, the Banker is required under the law to give notice of dishonour to the customer section 93 of the N.I. Act. The notice may be oral or in writing and may be given in person or by a messenger or may be sent by post to the customer's recorded address with in a reasonable time vide secton 106 of the N.I Act. Even when the cheque is retained for representation that is when it is rented for reason-Effects not yet cleared please present again or on the ground of any technical defect which can be remedied by the Banker before representation the Notice of dishonour should still be given. PENALTIES INCASE OF DISHONOUR OF CREATING CHEQUES FOR INSUFFICIENCY OF FUNDS IN THE ACCOUNTS (INSERTION OF NEW CHAPTER XVII comprising Section 138 to 142 in the Negotiable Instruments Actl 1881) The important provisions of these sections are as follows:

Section 138 Dishonour of Cheque for Insufficiency etc., of finds in the Accounts.

A drawer of a dishonoured cheque shall be deemed to have committed an offency and shall without projudice to any other provision of the Negotiable

Instruments Act 1881 be punished with imprisonment for a term which may extent to one year or with fine which may extend to twice the amount of the cheque or both provided:

1. The cheque has been dishonoured due to insufficiency of funds in the account maintained by him with a banker for payment of any amount of money to another person from out of that Account.
2. The payment for which the cheque was issued shared have been in discharge of legally enforceable debt or liability in whole or part of it.
3. The cheque should have been presented by the payee or the holder in due course within a period of six months from the date on which it is drawn or within the period of its validity, which ever is earlier.
4. The payee or the-holder in due course of the cheque should have given notice demanding payment within fifteen days from the drawer on receipt of information of dishonour of cheque from the Bank.
5. The drawer is liable only if he fails to make the payment within fifteen days of such notice period and
6. The payee or holder in due course of the cheque dishonoured should have made a complaint within one month of cause of action arising under Section 138.

Section 139 Presumption In Favour Of Holder

It shall be presumed unless contrary is proved that the holder of a cheque received the cheque of the nature referred in Section 138 for discharge in whole or in part of any debit or other liability.

Section 140: Defence which may not be allowed ip any prosecution under Section 138.

It shall not be a defence in a prosecution for an offence under Section 138 that the drawer had no reason to believe that when he issued the cheque that the cheque may be dishonoured for reasons mentioned in Section 138.

Credit Before Collection

At places where there is clearing the usual practice with the Bankers is to credit the customer's accounts with the amounts of cheques paid into their accounts and put in the days clearing before the proceeds th9reof are actually received by them. **Clearing**

Clearing is a method of collection, under arrangement amongst the bankers operating in a city or town of cheques drawn on their local offices and received from their respective customers. Under the arrangement there is a clearing House, of which the local Bankers become members and to which they send on all working days through representatives their customer cheques listed drawee bank wise in one or two lots at appointed times. The clearing House is located in the local office of the Reservel Bank where there is any or of the State Bank of India. The Representatives exchange the lists of cheques between themselves and bring to their respective' banks the listed cheques received from their counter parts of the other member banks. The cheques that are in order one paid, whilst those that cannot be paid on returned, each with an objection memo giving reason for return, through the clearing house to the representatives of the collecting banker in the afternoon.

Clearing has certain definite advantages. It saves times and cost as the cheques are collected through the clearing at a particular time or times of the day and avoids employment of a number of collecting peons that would have been needed in the absence of clearing. It also avoids the risks of carrying each.

Special Collection

At a place where there is clearing for collection of local cheques, a cheque paid in too late for the day's clearing is sometimes collected at the instance of the customer badly in need of each through messanger. direct from the drawee banks. The payment in such cases is not made by the drawee Bank in cash but by a debit note against which the customer is allowed to overdraw his account.

Debit Note

A debit note is an instrument of payment used by bankers for adjustment of clearing discrepancies. When there happens to be a discrepancy in the day's clearing that is when the collecting Banker changes either more or less than the total of the amounts of the cheques delivered in the clearing the amount 'charged in excess is refunded or the amount charged less is recovered by means of a debit note. The debit note is issued by the Banker who receives in excess. Debit notes are to be collected in the next day's clearing and where there is more than one clearing in a day in the ftrst clearing of the days.

12.6 PROTECTION TO COLLECTION BANKER

The Banker runs certain risks in collecting cheques. But as Banking is of vital importance to the economic life of community. Bankers have been accorded same legal protection in the matter of collecting cheques under section 131 of the Negotiable instruments Act which reads as follows:

A Banker who has in good faith and without negligence received payment for a customer of a cheque crossed generally or specially to himself shall not, in any case the title to the cheque proves defective, incur any liability to the true owner of the cheque by reason of having received such payment.

The protection given under the above section to the collecting Banker is there conditional and does not extent to the collection of open i.e., uncrossed cheques. This is a special protection given to the collecting Banker which is available to him only if he acts in good faith but without negligence. The following are some of the examples in which a banker has been deemed to has complied with the conditions as mentioned in the Act.

1. That the collection Banker has acted in good faith and without negligence. What amounts to negligence is however a question of fact in each case. Negligence means want of "reasonable case" with reference to tbe interest of the true owner. The test of "negligence" is whether the frame action of paying in any given cheque com pled with the circumstance antecedent and present was so fragrantly out of the ordinary course that it ought to have aroused senpicion in the mind of the Banker and cursed him to make enquiry.
2. That the collecting Banker has received payment of the crossed cheque for a customer. To make a person a customer of a bank it is essential that there must be some sort of account, either a deposit or a current account or some similar relation.
3. That the collecting Banker acts only to receive payment of the crossed cheque for customer. The section will be restricted to a case where the Banker is acting as an agent for collection but not to a case when the Banker is himself a bolder. For example, if a customer had overdrawn his account, it was held that the Bank was a Holder of the cheque for value and not an agent for collection.
4. That the payment bas been received only for a crossed cheque , and that cross has been made before the cheque tell into the hands of the collecting bankers. The crossing must be on the cheque before it reaches the hands of collecting Bankers. The special crossing that is branded by the Bankers on the cheques or receiving them does not constitute crossing within the meaning of the law. It is the duty of the collecting Banker to induce in his customers the habit of crossing open cheques if any received by them before tendening the same with the Banker for collection.

Crossed cheques drawn by one customer of the Banker and paid into account of another customer comes under operation of this position. Here the Banker acts both as the paying and the collection Banker paying Banker in respect of the drawers and collecting Banker in respect of depositors of such cheques. These cheques the Banker is entited to retain till the day following the day of receipt but unless received too late, they are usually disposed of on the day of receipt. In regard to such cheques the Banker must bear in mind that if the deposition customer has no title or has only a defective title to the cheque deposited he may be held liable for conversion to the true owner of the cheque even though the payment may here been made in due course. .

The intention of the bank is that the Banker should receive payment of the cheque as collecting agent of the customer and not as holder for value or holder in due course. The vital point of the matter lies in the context of the word customer for neither in the Negotiable Instruments Act nor any other Act in our country who is a customer has been defined. Here customer means a properly introduced person with current or savings Bank Account with the Bank. Thus to get the protection under this section the Banker must collect cheques not for a stranger but for a person who maintain a current or savings Bank Account with him and about whose artecedents he has made enquires and has been satisfied.

The phrase "in good faith means that the Bankers in general are supposed to act in good faith i.e., without any bad intention on their part. But the phrase without negligence is little bit difficult to understand. Negligence has not been defined in law. But Negligence implies a duty to take care and should mean failure to take care. As an agent for collections the Banker has a duty to his customer but that duty may be said to end with collection of the cheque and the crediting of the proceeds to the customer's account without a reasonable time. The Banker as agent gets no better title than that of his customer. If the customer has no title or has only a defective title to the cheque, the collection thereof becomes unauthorised and ,makes the Banker liable to the true owner of the cheque of or conversion, if the Banker fails to exercise as much area and diligence in collecting the customer's cheque as an ordinary prudent businessman would exercise in protecting his business rights: If he is not Negligent, he gets statutory protection. Negligence in collecting a cheque would these mean want of regard not only to the interests of the customer but to the interests also of the true owner thereof though there is no contract between the banker and the true owner.It follows that the main risk that the Banker runs in collecting cheques is that of conversion.

Conversion: Conversion means an unlawful possession use, disposing or destroying of goods by a person whether for his own benefit or that of another person, in a manner inconsistent with owner's right of possession. The term 'goods' used includes bills and cheques but not debts. It means a banker may become liable for conversion for a wrongful collection of a bill or cheque but no conversion arises out of any debt.

In an a.ction for conversion of goods or of a negotiable Instrument in respect of which money has been received by the person converting, it is usual for the true owner to add to his claim for conversion a claim to his use so that he may be free to recover the amount oil either of the grounds. The claim for "money had and received" against a person who had no knowledge of the rights of the true owner is apparently based on an implied promise, which the law inputs to a person dealing with the money of another, to repay that money to the lawful owner when it is demanded.

Such action against a banker are usually in the dual form and if the facts are proved the Banker cannot claim statutory protection. It is no defence on the part of the Banker to plead that he merely acted as an agent or that he acted without any wrongful intent towards the true owner or that he was in compute ignorance of the conversion.

Immediate Circumstances

1. Collection of a cheque with a forged or incorrect indorsement. It may not be possible for the Banker to defect a forged indorsemsnt but he must verify to his satisfaction that the the-rein.; If there is more than one indorsement on the cheque the Banker must see that the indorsements are appearently made by different persons that is to say they do not appear to be in the same hand writing.
2. Collection of third party cheques in accounts other than the payee's that is collection of a cheque.

The protection can be claimed by the collecting Banker when he credited his customer's account with the amount of the cheque before receiving the payment the protection is also available in respect any draft as defined in Sec 85 A (Section 131 A).

The Banker who has to pay the cheque cannot verify whether the signatures of all the endorsers are genuine or not. The reason is that he does not possess the specimen signatures of all the endorsers. He possesses the specimen signature of the drawer only. So there is scope for forgery of endorsement. Suppose ‘x’ may steal the cheque of 'y' and endorse it by signing it as 'y' As a result banker may pay the cheque containing a forged or authorised endorsement. In such a case he will incur loss as he will be held liable to pay the amount to the true owner of the cheque. The law protects him against any loss arising out of honouring a cheque with forged endorsement. In otherwords the paying Banker is granted statutory protection in case of forged endorsement.

The paying Banker can claim statutory protection in case of forged endorsement only when he makes payment in due course.

Where a cheque payable to order purports to be endorsed by or an behalf of the payee. The endorsement is regarded to have been made by the payee or another on his behalf. If such a cheque is paid in due course, the paying Banker is discharged from liability.

12.7 COLLECTION BANKER

A Banker is not bound to collect cheques and bills on behalf of his customers as it is not a legal duty or obligation. But he collects cheques and bills on behalf of his customers in order to provide a facility or service to them. He must be very careful in performing this service.

Only An Agent

When a banker undertakes to collect cheques for customer, he acts only as an agent of his customer. If the customer has a defective title, the collecting Banker will not get better title. This he will also gets a defective title. So he will be held liable for conversion of the true owner if he collects a cheque for his customer having a defective title.

A collecting Banker can claim protection against conversion under Section 131 of the Negotiable Instruments Act of the following conditions are satisfied.

1. Crossed cheque

He should have collected a crossed cheque. The reason is statutory protection can be claimed for crossed cheques only. The crossing may be general or specially crossed to him. It a: banker collects an open or an uncrossed cheque he cannot claim protection under Section 131. The cheque must have been crossed before it reached. the hands of the Banker for collection. If the cheque is crossed after it is received by the banker cannot claim protection.

2. Act as an agent

The Banker must have acted as agent of the customer. He can claim protection if he has received payment for his customer. He can enjoy statutory protection even if he has credited the customer's account before the cheque is actually collected.

3. Collection on behalf of a customer

The Banker can claim protection if he has collected crossed cheques on behalf of his customer. If he collects on behalf of a stranger he is not entitled to protection.

4. Received payment in good faith and without negligence

The Banker should have received payment in good faith and without Negligence. We can assume that the Banker always acts honestly or in good faith. The Banker should have exercised reasonable case in collection of the cheque. He should nor have acted negligently in receiving payment on the cheque. In such a case, he must pay the true pay the true owner of the cheque.

Negligence: It is a matter of circumstances the following are the examples of negligence on the part of the collecting Banker.

1. Opening an account without proper enquiries and introduction.
2. Failure to verify endorsements on an order cheque.
3. Collecting "Account payee" cheque on behalf of a person other than the payee named in the cheque.
4. Collecting cheques payable to the firm for the credit of the personal account of a partner.
5. Collecting cheques payable to a company for the credit of the personal account of its director.

The following are the instances in which a collecting Banker may lose his statutory protection on the ground of negligence opening a new Account without proper enquiries and introduction. If a banker opened an account in the name of a person those title to the cheque is found to be defective without proper enquiries and introduction he is regarded to have acted negligently. Then he will lose statutory protection. So failure to make proper enquiries or obtain letters of introduction at the time of opening account is regarded as negligence.

If a collecting Banker disregards the instruction as revealed by the cheque itself he will be regarded as negligent. The circumstances and personal knowledge of customer's position may indicate that the customer is committing breach of trust a misappropriation of trends of others. If the collecting Banker fails to make proper enquiries "when circumstances indicate breach of trust of misappropriation of funds it amounts to negligence.

12.8 PRESENTATION FOR ACCEPTANCE

A bill of exchange is not necessarily required to be presented for acceptance, before its being presented for payment. For instance, a bill payable on demand payable certain number of days after date payable on a certain day need not be presented for acceptance. Although it is a matter of common practice to obtain the acceptance of the bill by drawer at the earlier. Opportunity after it is drawn. Such an acceptance is not absolutely essential to the Bill being a negotiable instrument. For instance a person to whom a bill has been negotiated before acceptance may due there on as a holder in due course.

It should be noted that is two cases presentment for acceptance would be necessary namely:

1. When a bill is payable after sight - Presentment for acceptance is with a view to fixing the materity of the instrument;
2. Where a bill expressly stipulates that it shall be presented for acceptance.

But when a bill is not payable after sight. Presentment is unnecessary to render any Prior Party liable. It is however, Prudent for the holder of such bill to present it for acceptance, for if it is accepted he obtain the security of acceptor's signature and if it is not accepted he is relieved of the necessary presentment for payment.

A bill payable after sight is to be presented to the drawee by a person entitled to demand acceptance and it is generally the holder of the Bill who is entitled to demand acceptance. The Bill must be presented by the holder within a reasonable time after it is drawn, and in business hours on a business day either at the residence or at the place of business of the drawee. But if the Bill itself indicates a place of presentment it must be presented at the place. If the drawee cannot after reasonable search be found the Bill is to be regarded as dishonoured for non-acceptance. When authorised by agreement of usage a presentment through the Post Office by a registered letter is sufficient.

Under Section 63 the drawee is curtailed to a respite of forty eight hours to consider whether he should accept a bill presented to him for acceptance.

Presentment for acceptance is excused if the drawee is a fictitious person or if he cannot after reasonable search be found. Again even if presentment is made irregularly such as irregularity is excused if the bill has been dis-honoured by non-acceptance on some other ground.

A demand or DP bill must be presented J>y or on behalf of the drawer to the drawee with in a reasonable time for payment section 64 of the Negotiable Instrument Act. A usuance bill must be presented by a person entitled to demand acceptance to the drawee for acceptance. The presentment must be made within a reasonable time after it is drawn after receipt there of by the Banker in business hours on a business day at the place specified in the Bill or at the known place of business or residence of the drawee or wherever he may be found.

The acceptance of a Bill means the drawers assent to the order of the drawer to pay and the accepted bill becomes an evidence of debt. The acceptance must be on the face of the bill with or without the word Accepted. A qualified acceptance may be (1) conditonal i.e., when payment would depend on the fultiment of a specified condition or (2) Partial (3) Local when payment would be made only at a particular place an no where else. The Banker must not agree to a qualified acceptance without the authority of the drawer.

Presentment of a bill of exchange a its exhibition of drawee of acceptance with its apparent tenor. Presentment may be made through part by means of a registered letter if such a mode of presentment is authorised by agreement or usage. If the 'Bill is paid, the holder would have to hand it over to the payer. In default of presentment the drawer and the endorsers would be discharged from their liability to the holder.

Presentment is to be made whether by the holder of or by somebody on behalf of the holder. Promissory notes are to be presented to the maker. Bill of exchange are to be presented to the acceptor; and cheques are to be presented to the drawer.

Presentment should be made during usual hours of business. If the bill is made payable a specified period after due date or sight. If the bill is payable or demand, it must be presented for payment within a reasonable time after its receipt by the holder.

If a bill is drawn or accepted payable at specified place and not elsewhere it must be presented for payment at such a place in order to charge any party to the Bill. It however the Bill is accepted payable at a specified place presentment should be made at the place opecitied. If no place of payment is specified then the Bill should be presented for payment at the place of business or the residence of the drawee on acceptor or to him in person wherever he can be found.

A promissory note payable by instalments must be presented for payment on the third party after the date fixed for payment of each instrument.

It is the duty of the holder of cheque to present it at the Bank upon which it is drawn. If payment is returned by the bank the holder may sue the drawer. If the holder sees the drawer without first presenting the cheque at the Bank the suit it will be dismissed.

If the holder does not present the cheque at the bank in time, the position of the Bank may become unsound and it may not be possible for the Banker to honour the cheque: In this case the drawer is not liable of the Bank rejects payment on presentment. Time rule is that the cheque must be presented before the relation between the drawer and his banker has been altued to the prejudice of the drawer.

If the bill is not presented in time, the drawer is discharged, but the drawer of a cheque in case of delay in presentment, is discharged only if no one has suffered some or injury and that too, to the extent of such loss only. Therefore if the bank remains solvent the drawer will remain bound after presentment and refusal, although months I have elapsed since the drawing.

It may be recalled that in order the charge the drawer, the cheque must be presented before the relation between the drawer and his banker has been altead to the prejudiced of the drancer but in order to change any person other than the drawer the cheque must be presented within a reasonable time.

Presentment for acceptance of payment may be made not only to the drawer maker or acceptor but also to his duly authorised agent or where he is dead to his legal representative or where he has been declared an insolvant to his assignee. No presentment for payment is necessary in any of the following cases:

1. If the maker or acceptor intentionaly prevents the presentmeqt of the instrument.
2. If the instrument being payable at his pace of business be closes such place on a business day during the usual business hours.
3. If the instruments being payable at some other specified place neither he nor any other person authorised to pay it amends at such place during the usual business hours.

No presentment for payment is necessary as against any party sought to be charged with payment if he has engaged to pay not withstanding non-presentment.

No presentment for payment is necessarily as against any party if after maturity and with the knowledge that instrument has not been presented.

1. He makes a part-payment on account of the amount due on the instrument or
2. He promises to pay the amount due thereon in whose or in part.
3. He otherwise waives his right to take advantage of any detailt in presentment for payment.

When we say that no presentment for payment is necessary, he mean thereby that the instrument is taken as dishonoured at the due for presentment even though it has not been presented. The result is that the holder may sue the party liable without presentment eventhough it has not been presented. The result is that the holder may sue the party liable to presentment and the place that the instrument was not presented for payment is no detence to the claim of the holder.

An acceptance is not co-operate of binding upon the drawee until the accepted bill has been delivered back to the holder thereto. Notice of acceptance given by the drawee, to the holder also completes the acceptance.

The document must not be delivered to the drawee before acceptance or payment of the Bill in cash, or if payment is made by cheque, before collection of the cheque since such delivery would reasons the drawee from liability on the Bill.

SUMMARY

The banker has certain risks in collecting cheques. But as banking is of major importance to the economic life of community. A banker who has in good faith and without negligence received payment for a customer of a cheque crossed generally or specially to himself shall not, in any case the title to the cheque. Presentation for acceptance of payment may be made not only to the drawer or acceptor but also to his duly authorised agent.

KEYWORDS

- Proximate
- Apparent
- Fragrantly
- Curtailed

REVIEW QUESTIONS

1. State and explain the protection offered by the Negotiable instruments Act, to a collecting Banker.
2. Comment on the Statement main risk other Banker remains in collecting a cheque for a customer is that of conversion.
3. Explain what state guards should a banker adhere to if the wants to get Statutory Protection.

SUGGESTED READINGS

1. K.P.M. Sundaram - Money, Banking and International trends.
2. K.C. Shekar - Banking Theory and Practice.

ANNAMALAI UNIVERSITY

LESSON 13

INDIA'S FOREIGN TRADE AND EXPORT PROMOTION

OBJECTIVES

After studying this lesson, you should be able

- to analyse the need for international trade.
- to find the India's foreign trade and export promotion.
- to understand the commodity composition of exports and need for export promotion.

STRUCTURE

13.1 Introduction

13.2 Need for international trade

13.3 India's foreign trade and export promotion

13.4 Commodity composition of exports

13.5 Need for export promotion

Summary

13.1 INTRODUCTION

Economic well being in one of the major objective of any country and towards this end only many developmental efforts are taken up by.. the governing bodies. Many a factors are responsible and are considered for embarking on a successful developmental plan. Many a problems are also encountered, One among the various factors and problems of developmental efforts in foreign trade. World as existing today depends to a large extent on trade among various nations which is referred to as foreign trade or international trade.

13.2 NEED FOR INTERNATIONAL TRADE

A very casual examination of anyone of our day to day consumption world reveal that in one form or other, contribution from some other nation would be a part of it. We daily come across statements relating to maximizing export earnings for economic welfare and development of our nation. A question which naturally arises at this stage is the need for international trade. In other words, should we necessarily depend on or involve ourselves in trade with foreign countries? Can we not be self sufficient with out own resources and production? The need for international trade araises due to the following four possible reasons which are also explained.

1. Non-Availability Of A Specific Factor Or Factors

One fact which we are very much aware of in that resources are not evenly distributed throughout the world. Some parts of the world are rich in one resource while another part might be rich in another. Production function involves the right combination of all necessary resources. If one country is lacking in one resource - it may be a natural resource or/man made - it will have to obtain it from some other country which is prepared to sell.

So that commodity is imported. What we mean as a commodity here may be anything from raw material,' (for example crude oil) semi-finished product, spare parts, (eg. automobile Components) skilled labour, or even technical know how (eg. patents). Some of the commodities may be permanently required to be imported e in most cases the quantum of import might slowly taper down. In other words the non-availability of a specific factor may be a temporary phenomenon in most cases.

In some cases we might find a situation contrary to this phenomenon. That is there are situations where a country would be able to produce a commodity but still would import the same.

The second reason would explain this situation.

2. International Trade And Comparative Costs.

It was seen above that the resources endowment of nations differ. As a direct result of this every nation finds it relatively cheaper to produce certain goods, the resource requirement of which is fully available with them. The same goods could be produced in another country only at a higher cost than the above since they lack in resources. According to the theory of comparative costs, producers will gain from trade if each producer offers for exchange the commodity in which his production cost are comparatively lower. In other words countries will gain from trade if each country exports a commodity in which its costs of production are comparatively lower and imports goods whose costs of production are comparatively higher. There may be many reasons for the comparative differences in costs of production between different countries. Chief among them are (i) as stated in the beginning of this section, spread of resources. ego oil is available in plenty in South West Asian Countries, hence is very cheap compared to any other nation in the world. (2) Climatic differences affect not only cost and out put of agricultural products but also has a distinct say on the productivity of human labour. (3) Differences in technology and developmental factors also have an impact on comparative costs. (4) The proportion in which the factors of production are combined also results in variation in costs. Eventhough the reasons may be many the economists agree in general that comparative costs theory in a one among the main explanation for international trade.

3. Trade Due To Surplus Production

Classical theorists of economics-like Adam Smith. HIa Mynit and others have high lighted what is Considered a more realistic and ideological reasoning of international trade especially in relation to under developed nations. The two theories which explains this arc (a) the vent Of surplus and (b) the productivity theories. According to the vent for surplus theory international trade gives an outlet for the production in excess of the local demand, consumption and requirements.

When production and productive capacity is for in excess of internal requirements, the prices for the factors of production tends to be very low. To get over this the country seeks external markets. The productivity theory states that through division of labour and improved skills, leading to technical and technological inventions and innovations, the productivity of the country improves resulting in increased returns and economic development.

4. Trade Due To Product Differentiation

When different goods are produced by different firms in various nations, in selecting the goods for consumption, the tastes of the consumers become important. This is a result of product differentiation when several commodities of same description and similar prices exist. Consumers would prefer goods with designs and qualities of their individual tastes. In general it could be stated that, if inter country differences in comparative costs are not significant, product differentiation by design and quality will exert its influence resulting in international trade.

Foreign trade is important to every country. This is due to the fact that trade and commerce are not just the sum of exports and imports but they also constitute a growth factor that benefits both the exporting and importing countries.

The importance of foreign trade can be summerised in the following terms.

(1) It acts as an accelerator of industrial growth.

(2) It helps in efficient utilisation of resources, both material and human

(3) It enables fuller and effective utilisation of resources through international division of labour

(4) It also enables flow of capital, technical know how, technology and other resources.

The economic progress of most of the present day industrially advanced nations of the world may be stated as the result of their efforts in expanding international trade. The foreign trade component of countries like U.S.A, England, France, Germany etc., is found to be relatively higher than most of the other nations. A notable example is Japan. This country was able to reconstruct its economy mostly through developing its foreign trade. Japan's industries depend on foreign trade both for the supply of raw materials and for the sale of manufactured goods. It is a foregone fact that development of foreign trade is an important factor of economic development of a nation. Hence it can be stated that for the developing countries as well, development of foreign trade is of utmost importance because:- (a) Rapid industrialisation is the only solution for the problems of poverty and unemployment which is rampant in such nations. (b) Industrialisation has become a panacea for both economic and social ills. (c) But industrialisation process is obstructed by a number of hurdles chief among which is non availability of capital goods, equipment technological know) how and to an extent capital also.

Through a well planned foreign trade pattern, these developmental requirements are imported and production surplus is exported, which process is considered to induce the developmental requirements of a nation. Both components of foreign trade namely exports and imports are both inevitable and complement the developmental process. Of these two, exports have all along been considered the most important contributory to the development of a nation. Exports may be considered as an instrument for progress and prosperity especially for developing economies. The relationship between exports and economic growth in one of interdependence.

Many economists have established through extensive studies on the subject of interdependence of exports and economic growth. Shu-Chin Young had concluded that in most of the less developed countries., exports are the most important active factor in generating economic activity". He also states that exports are the major dynamic factor in determining the level of general economic activity. WA.Lewis aptly explains how expanding exports helps in economic growth by stimulating industrial growth when he says, "export industries, by stealing labour from home industries at the same time as they create more demand for these industries, stimulate home industries into innovations designed to increase their productivity."

According to Baldwin and Meiver, export sector can be described as a propulsive sector. In their view it widens the market provides economies of scale and set the pace for the multiplier acceleration process in the economy. The slow down in demand and reduced off take in the local markets can be overcome through a . diversified export sector. It is in this sense that foreign trade is referred as a balancing sector of an economy since it enables adjustment between production and consumption, or between demand and supply. With the increasing level of exports a country will enjoy the greater advantage of international division of labour which will help industries to increase their efficiency - through technological change, improved competition. It encourages those industries which has a comparative advantage through technological flow and investment flow.

Thus the relationship between exports and economic growth is well established. Undoubted by exports are a key factor in promoting economic growth and a rise in exports stimulates an increase in economic growth rather than vice-versa.

13.3 INDIA'S FOREIGN TRADE AND EXPORT PROMOTION

Having looked into the need for and importance of foreign trade in general and exports in particular in this lesson an analysis of India's foreign trade is taken up. Foreign trade analysis can basically be made by studying the contents or composition of/traded commodities as well as the countries involved in the trade. Both these aspects have significant say on the impact of foreign trade on the economy. For example, if a country is exporting primary commodities, we can roughly say that it is a country here industrialisation has yet to take place or an underdeveloped economy. If it is exporting semi-manufactured goods then it- is on the road of development and it is exporting capital goods are manufactured/Engineering goods it .is an economy which has developed leading sectors. Thus by simply considering composition of export items, we can get some idea about the developmental effort. The same can be said about the import items. Imports can be meant to feed export industries in which case it might form developmental or maintenance imports or import~ purely for Consumption purposes.

Before taking up these two aspects we shall dwell on two other general aspects namely (a) India's share in world trade and (b) Balancing trade or trade gap and trend in India's foreign trade. According to the "Direction of Trade Year Book" published by IMF there has been a steady increase in world trade interms of exports and imports. But India's share in world exports and imports followed on opposite trend. Table 13.1 shows the percentage share

Table 13.1 Percentage share or India's Trade to World Trade

Year	India's share in world exports in %	India's share in world exports in %
1950	2.13	2.02
1955	1.54	1.60
1960	1.21	1.96
1965	1.02	1.67
1970	0.66	0.66
1975	0.50	0.70
1980	1.41	0.57
1985	0.45	N.A
1990	0.52	N.A

Source: Statistical Year Book - United Nations Publications of India's exports and imports to world exports and imports. We can observe that (1) the share of India in the world trade had been very negligible ranging from 2.13% to 0.41% and (2) that the share over the years had been declining. This had been mainly due to the fact that the relative increase in India's foreign trade had been very meagre when compared to the increase in world trade in absolute terms.

Table 13.2 India's Exports as a Percentage of National Income

Year	**%**
1960-61	4.2
1970-71	3.8

1980-81	5.4
1985-86	4.7
1990-91	6.9
1990-92(P)	8.0

Source: Statistical outline of India - Total Services Ltd. - Bombay.

Table 13.3 Foreign Trade of India.

Export		Imports	Balance Of Trade
1950-51	661	650	+11
1955-56	596	679	-83
1960-61	660	1140	-480
1965-66	806	1409	-603
1970-71	1535	1634	-99
1975-76	4036	5265	-1229
1980-81	6711	12549	-5838
1985-86	10895	19667	-8772
1986-87	12452	20096	-7644
1987-88	15674	22244	-6570
1988-89	20232	28235	-8003
1989-90	27681	35416	-7735
1990-91	32553	43193	-10640
1991-92	43978	47813	-3835

Source: Economic Survey - Govt. of India

Another indicator of export performance is the percentage of exports of India's National Income Table 10.2 shows that even though the share of export trade in India's national income had been very meagre ranging around 4 to 7 percent the trend had generally been on the increase except for a few years when 'there was a slight fall.

Table 10.3 shows the value of exports and imports in India for the years 1950-51 to 1985-86 in 5 years interval and also for 1986--S7 to r 1988-89. The increase in exports upto 1965-66 which was only marginal had taken substantial increase in value from 1970-71 onwards, reaching an amount of Rs. 20,302 crores provisionally during 1988-89. The imports shows a similar trend with quantum increase from the year 1970-71 onwards. reaching an amount of Rs.28,242 crores provisionally during 1988-89. The balance of trade which is the net of exports and imports have all along shown a adverse balance meaning excess of imports over exports. In fact the figures have reached substantial levels from 1985-86 onwards.

Two broad reasons can be attributed for the above. The favourable balance of trade before 1950-51 has been due to the predominance of traditional items in the total exports. Similar to any colonial economy the majority of exports were of raw materials minerals and ores, which was used for feeding the raw materials requirements of British industries. After independence this situation slowly changed with policies of rapid industrialisation and growth of basic industries being given priorities in the successive five years plans. This necessitated the import of capital goods and to an extent raw materials requirements of the newly started industries. This resulted in the excess of imports subsequent to independence, especially from the second five year plan period onwards. 1\vo broad reasons can be attributed for the above. The favourable balance of trade before 1950-51 has been due to the predominance of traditional items in the total exports. Similar to any colonial economy the majority of exports was of raw materials minerals and ores, which was used for feeding the raw materials requirements of British industries. After independence, this situation slowly changed with policies of rapid industrialisation and growth of basic industries being given priorities in the successive five year plans. This necessitated the import of capital goods and to an extent raw material requirements of the newly started industries. This resulted in the excess of imports subsequent to independence, especially from the second five year plan period onwards.

This position had been continuing from 1985 - 86 till 1989-90 during which years the gap had been ranging around 5000 to 9000 crore rupees. In 1991-92 the deficit had been very low because of severe restrictions on imports and sizeable rupee devaluation. There was an increase in the gap during 1992-93 to around Rs. 8000 crore.

During the recent years various policy changes bad been initiated consequent to which imports and exports have been liberalized. Severe restrictions which had been imposed earlier in the form of Bar tariff walls etc had been removed. With rupee convertibility coming in, importers will have to pay for their imports either through exports or purchase of foreign currency in the open market. The previous restriction on surrender of 100% of foreign exchange to the RBI had been liberalized with partial convertibility where by only 40% is to surrendered while the balance 60% can be converted at the market rate.

The impact of such liberalizations and decontrol of imports and exports is likely to have profound effect on the balance of trade position. But during the limited period for which the policy had been in implementation the position does not seem to be discouraging. In fact there had been a notifiable reduction in the trade gap in recent years which is an encouraging trend. The long-term effects of these policy change~ will be discernable only after a few more years.

Commodity Composition Of India’s Foreign Trade

An important aspect of foreign trade of a country is the composition of traded items namely the imports and exports. Exports indicate the facts about the goods that we have and how much of such goods we can and are willing to sell. Imports indicate what types of goods we lack and how much of such goods we need or are able to get. Hence changes in the composition of trade mirror the developments taking place in the domestic structure of production over a period of time. The study of composition of foreign trade can be made by analysing the commodity composition of our exports and imports.

13.4 COMMODITY COMPOSITION OF EXPORTS

India's export committees for analysis purposes can very broadly be classified into two namely (1) Traditional items namely the imports and exports. Exports indicate the facts about the goods that we have and how much of such goods we can and are willing to sell. Imports indicate what types of goods we lack and how much of such goods we need or are able to get. Hence changes in the ,composition of trade mirror the developments taking place in the domestic structure of production over a period of time. The study of composition of foreign trade can be made by analysing the commodity composition of our exports and imports.

Commodity Composition Of Exports

India's export commodities for analysis purpose can very broadly be classified into two namely (1) Traditional items and (2) Nontraditional items. Traditional items of export commodities comprises of .

(a) agricultural and allied products constituted by 'lea, Coffee, Cereals like nice, cashew tobacco spices, fish and fish products cotton etc being some of the important products.

(b) Mineral ores comprising of mainly is more and a number of other minerals

(c) Mineral fuels and derivatives; and

(d) Manufactured products comprising of cotton fabrics, garments, jute products, leather and leather products, gems and jewellery, handicraft etc.

Non traditional items of export commodities consists mainly of engineering goods and chemical and allied products.

Table:13.4 India's Principal Export (in Rs. Crores)

	1970-71	1980-81	1989-90	1990-91	1991-92
Coffee	25	214	343	253	310
Tea	148	426	905	1075	1132
Tobacca & Mfrs.	55	125	546	625	871

Cashew Kernals	33	141	175	263	377
Spices	57	123	368	441	668
Rice	39	111	247	233	370
Fish & Mfrs.	5	224	427	440	755
Raw Cotton	31	213	687	960	N.A
Total Agricultural and Allied	487	2057	4571	6019	7638
Iron Ore	117	303	928	1050	1432
Other Ores	47	111	452	690	849
Total Mineral Ores	164	414	1380	1740	2281
Cotton Yarn Fabrics& made ups	142	408	1480	2100	3209
Garments	29	550	3224	4012	5411
Jute Yarn & Mfrs	190	330	298	300	387
Leather & Mfrs.	72	337	1951	2566	3076
Gems & Jewellery	43	642	5296	5247	6750
Other Handicrafts	30	310	989	920	1596
Chemical & Allied Products	36	235	1981	2345	3677
Engineering goods	198	874	3321	3809	5107
Total Manufactures (incl. Others)	772	3747	20310	23319	32384
Mineral Fuels & Lubricants	13	28	697	938	1022
Total (incld. Others)	1535	6711	27681	32553	43978

Source: Statistical outline of India - Tata Services Ltd - Bombay

Table 13.4 shows the principal export commodities, item wise and group wise. The nomiance of traditional items in the total exports form India is replicit. Among agricultural products, tea is considered the most important export commodity. India as been maintaining-the leading share of the world trade in Tea, the percentage share being around 20 to 25 percent among leading exporting countries. Among manufactured goods, garments gem and jewellery exports forms the leading items value wise.

What is more important is the low share of non traditional items in the total exports. Which has been ranging around 20%. This had mainly been the lagging factor, contributing to unfavourable balance of trade. Since manufactured goods, especially industrial ores, are value added in nature, increase in its share would significantly change the quality of our export value. Too much independence on traditional items will not help in improving the qualitative aspect of our exports. Various measures relating to export promotion, incentives etc has slowly started bearing fruits as is evident from Table 10.5. Table 10.5 shows the index of exports for various commodity groups and total with 1978-79 as base year. While the general index has shown an increase from 108 to 121 for the period from 1980-81 to 1986-87. Miscellaneous manufactured goods, machinery and transport equipment and chemical have shown an increase higher than the general index

Table 13.5 Quantum Index of Export (Base:1978-79=100)

Commodity Group	1980-81	1984-85	1985-86	1986-87
Food	114	107	108	105
Beverage and Tobacco	108	100	91	98
Crude Materials -inedible	147	120	119	143
Mineral Fuels	78	4139	1475	1403
Animal & Vegetable Oils	96	171	154	97
Chemical	128	185	162	199
Manufactured goods - Materials	85	90	88	101
General Index	126	136	136	149
Miscellaneous	130	114	128	139
Machinery & Transport equipment	108	121	111	121

Source: Directorate General of Commercial Intelligence and Statistics Govt of India.

This indicates that the growth rate of these items is more than that of the general growth rate.

Commodity Composition Of Imports

Commodity items of import of India can(be of three broad categories namely (a) Food and edible materials, (b) Petroleum products including crude oil and (c) Manufacturi,1g products. Table 10.6 shows the item wise value of imports into India. It can be found that petroleum products and capital is very typical of imports of a developing country. India's import bill had all along been highly influenced by the petroleum products import especially after the oil crisis years from the mid seventies. In fact the balance of trade had been heavily dictated by the world market prices of petroleum products; than any other single product category. Table 10:7 which shows the percentage distribution of import of principal commodities of import. As it could be seen machineries and petroleum products in that order has a dominating share totally. With increased internal production the share of petroleum products which had a share of 42.2% in 1980-81 has come down and taken a second place with 19.2% in 1987-88. With world petroleum price ruling easy during the recent years the total import value had ken with in manageable, proportion in the sense without any substantial unfavourable tilt in the balance of trade.

Table 13.6 India's Principal Imports (Rs. in Crores)

	1970-71	1980-81	1989-90	1990-91	1991-92
Cereals& Preparations	213	100	378	182	141
Petroleum Products	136	5264	6274	10816	13129
Edible oils	23	677	211	326	240
Chemicals	68	658	2135	2289	3523
Fertilizers	86	818	1777	1766	2259
Medical	24	85	272	468	456
paper & Board & Mfts	25	187	358	456	488
Iron and Steel	147	852	2305	2113	2154
Other Metals	119	477	1253	1102	840
Capital goods	404	1910	8831	10465	10394
Pearls precious and semi precious stones	25	417	4242	3738	4822
Total imports (incld. Others)	1634	12549	35416	43193	47813

Source: Statistical outline of India - 1992 - 93 13ta Services Ltd Bombay.

Machinery Petroleum products Metal Transport equipments Chemical, Medicines Pharmaceutical products Fertilizers Food items Paper & products Professional & . instruments Others Total

Table 13.7 Value of Principal Imports - Percentage Distribution

	1980-81	1985-86	1986-87	1987-88
Machinery	10.7	17.9	21.9	25.4
Petroleum products	42.2	26.5	15.1	19.2
Metal	10.6	9.9	10.3	8.8
Transport Equipments	3.8	2.9	4.0	3.4
Chemical, Medicines Pharmaceutical products	0.7	6.4	4.3	5.9
Fertilizers	5.8	6.2	3.6	0.8
Food Items	1.3	1.9	2.2	2.1
Paper & Products	1.5	1.1	0.1	1.2
Professional & Scientific Instruments	0.9	1.3	1.7	1.9
Others	22.5	25.9	36.8	31.3
Total	100	100	100	100

Source: Directorate General of Commercial Intelligence and Statistics - Govt. of India.

Table 13.8 Quantum Index of Imports Commodity group 1980-81 1984-85

Commodity Group	**1980-81**	**1984-85**	**1985-86**	**1986-87**
Food and Food Articles	135	250	249	230
Petroleum Products	131	114	105	109
Animal and Vegetables Oils etc.,	158	116	103	148
Chemical and related products	110	173	219	226
Manufactured Goods- Material	168	157	195	249
Manufactures and transport equipment	155	227	278	345
Miscellaneous manufactured articles	147	170	225	268
General Index	138	156	181	212

Source: Directorate General of Commercial Intelligence and Statistics - Govt. of India.

Table 13.8 shows the index value of imports into India. The general index indicates that the value of imports had grown continuously - based on 1978 - 79 as 100, to 212 upto 1986-87. Among the various commodity groups machinery and transport equipment has shown the largest quantum change which is against the general trend followed by manufactured goods - materials. Chemicals and miscellaneous manufactured articles have also shown a growth higher than the general index. As observed earlier the index value of petroleum products have comparatively been lesser than the general trend. What is of concern should be higher than the trend growth in food and food related articles. Though imports are resorted to only in times of emergency to tide over any shortfall, this is an area where the Indian economy could improve for the better. This is also true of edible oils which forms an important commodity of import, whose index values have been highly fluctuating - 158 in 1980-81, 103 in 1985-86 and 148 in 1986-87. Being an essential commodity and agro based in nature the supply of oils is highly dependent upon vagaries of monsoon and other climate related factors. As a result whenever there is an adverse climate condition affecting production, the need for imports araises to offset the demand. .

In very general terms it can be stated that Indian imports have been reasonable with in the desired trend, except for occational import of food and food related goods. What is of concern is the lack of increase in industrial production which could be used to offset the impact of increased imports.

Table 13.9 Trade with Selected Country Groups (in Rs. Crores)

	1970-71		1989-90		1990-91	
	I	E	I	E	I	E
EEC	320	282	11736	6906	12680	8951
NON EEC						
Japan	83	204	2820	2727	3245	3039
USA	453	207	4260	4474	5245	4797
Others	154	53	1341	599	2023	602
OPEC	126	99	5074	1841	7041	1831
Eastern Europe	220	323	2990	5336	3377	5819
Developing Countries	239	305	6031	4246	7965	5465

Source: Statistical Outline of India - 18ta Service Ltd - Bombay . I - import E - export

Analysis of foreign trade can also be made with reference to countries involved in the trade or the regional pattern.

To begin with foreign trade as far as India was concerned was made with UK only. This was because of the colonial bondage in which India was in. After independence trade was diversified and many regions like American, far eastern and east Europian nations were involved in the trading. A notable feature was phenominal increase in trade with East Europian countries especially with USSR.

These changes were mainly due to the following reasons.

(a) Diversification in the needs of the Indian economy araising out of development and industrialisation resulting in the need for diversification of sources of import. .

(b) Large Gids and grants were received from many countries especially USSR, which were also tied up with countries and commodities.

(c) 1rade deficits and foreign exchange crisis with capitalist countries resulted in entering into bilateral agreements with socialist countries.

(d) Political expediency called for expanding a balanced trade particularly after the Indo-Pak and Indo-Chinese wars.

Some of the notable trends in the regional pattern of foreign trade are.

1. The percentage share of free market economics like USA, Canada etc had declined compared to our total trade. This decline had be much pronounced with respect to UK.
2. The share of East Europian Countries particularly USSR had considerably increased.
3. Trade with European Economic Community Countries had been maintained with the share to total being maintained more or less at the same level. Iran had been a major trading partner.
4. Consequent to the oil crisis, trade with especially imports form OPEC countries showed significant increase.
5. Except with regard to very few countries, India had been maintaining an unfavourable trade balance with all countries.

This is mainly due to the fact that more than 50% of the total imports is accounted for by five or six countries including USA, Japan, West Germany and Iran.

6. Recently our trade with developing countries had taken a favourable turn. This had been one of the thrust ar7as due to rapid industrialisation resulting in surplus of capital goods and also due to the fact that over time India had developed the required expertese to deal in advanced machinery and other technical goods.

Table 10.9 shows the regional pattern of trade, both imports and exports, with major regional groups which has been substantiated in the above discussion.

Of late the terms liberalisation and globalization been given more thrust and trial the pattern of trade is likely to under go changes. This is also due to the fact that the USSR having broken up, trade now will have to be done more on market considerations, than on political considerations which had a dominating influence through trade agreements. As a result trade now is on more strong grounds. Even though the short term effects of the current policies are likely to be adverse the long run effects is expected to be more beneficial to the economy as a whole.

13.4 EXPORT PROMOTION

It has been well established that trade development is the basis of industrial development which forms in its turn the basis of economic development. The experience of most of the developing countries is that for industrial growth they had to depend on import of Capital goods, the production of which is lacking due to a number of reasons. Nowadays apart from capital goods, technical know how also will have to be imported. The result of such large scale imports is a highly unfavorable balance of trade which can be corrected by either (1) borrowing heavily in foreign countries and international institutions and I or (2) increasing exports. Among these the former is not a long term solution whereas the latter namely export earning would be more dependable for correcting adverse balance of trade in the long run with the added benefits to the economy and its growth.

It is only towards this end that stimulation of exports is given lots of priority especially in a developing economy, for which various export promotion measures are taken. According to the Report of the committee on Trade Policies, popularly referred to as Alexander Committee "In the Indian Context, export promotion policies need to perform two roles that of providing compensation on one hand and that of providing assistance to remove disincentives on the other.

While the former would be necessary on a sustained basis to neutralize disadvantages so long as they are present, the latter would be necessary on a selective basis for a limited period of time."

Need For Export Promotion

As stated above the need for or the nationals of export promotion basically is for two purposes (1) to provide compensation and (2) to provide assistance to remove disincentives. Hence the need for export promotion through incentives might be justified due to the following reasons. .'

(a) Due to the impostion of tariffs, licensing, quotas etc the exporters might be foarced to pay higher than the world prices for imported and/or domestically produced goods and the consequent disadvantages of high cost.

(b) As a result of such tariffs in foreign markets and sometimes in the local market as well, the relative profitability of producing exportable products might be lesser than producing for the local market.

(c) Some times due to the high cost of import materials and resources the exporters might loose their competitive edge for which compensation would enliven the export potentiality.

(d) Newly started units in the export sector might require support in some form for creating, establishing and sustinence of such units which might also be found useful and necessary in certain occations.

Some of the export promotion measures which were and are in existence in India are:-

Cash Compensatory Support (Ccs)

This is allowed on a wide range of commodities with the specific objective of compensating or reimbursing manufacturers "for the element of the non refundable taxes and duties on material inputs for goods manufactured and exported.

Duty Drawback Facility

This is another scheme which is operated as a fiscal incentive in the form of reimbursement of customs and central excise duties paid on raw materials components and packing materials both locally acquired and imported which had been used in the manufacture of goods which are exported.

100% Export Oriented Units (Eo Us)

Certain Units which intended to export a major portion of their production were declared 100% EOU. The government minimised the formalities relating to procedure for licensing. Relaxations were also made with reference to locational restrictions. Import of capital goods to such units were allowed at concessional or free of duties

Establishment of Free Trade Zones and Export Processing Zones was taken up where in, under protected conditions end stage processing, packing inspection and other related procedures are taken up.

Apart from the above detailed fiscal and monetary concessions in the form of tax relieves etc another important step taken in the field of export promotion is setting up of commodity wise- Export Promotion Councils. These councils look after all aspects of export promotion drive for specific commodities. The role of the Central Government in these councils is related to stimulation, encouragement and expert guidance as well as suggestions to increase export efforts. These Councils were established as non-profit earning registered companies. Their functions include examination of technical nature of the export products, conduct surveys and on the spot relating to price structure, cost reduction programmes, quality packing etc. Their role in establishing a report with market dealers consumers, obtaining first hand information relating to problems faced by the foreign importers, obtaining their suggestions, and thereby instilling a confidence on the products is considered to be a commendable one. This had very much helped in expanding the market and improving upon minor deficiencies which might be taken serious note of by the foreign importers. More over they also act as the spokesman as well as representative of the producers and exporters with the government helping in formulating policies and practice helpful in growth in exports. At present there are the following export promotion councils for Basic Chemicals Pharmaceutical and Soap, Cashew, Chemical and allied products, Cotton textile, Engineering, finished leather and manufactures, Gem and Jewellery, Handloom, Leather, Marine products, Mica, Personnel Plastics and Linoleum, Processed Food, Shellac Silk and Rayon, Spices, Sports goods, Tobaccoo and Wool and Woollen products.

SUMMARY

Foreign trade analysis can basically be made by studying the contents or composition of traded commodities as well as the countries involved in the Kade. India's share in world exports and imports followed on opposite trend. The share of India in the world trade had been very negligible ranging from 2.13% to 0.41%. This is mainly due to the increase in India's foreign trade had been very mearge when compared to the increase in world trade.

KEYWORDS

- Rampant
- Propelsive
- Discernable
- Priorities
- Nomiance

REVIEW QUESTIONS

1. Explain the need for international trade.
2. What are the needs for export promotion
3. Write short notes on:

   a. EOUs b. CCs

SUGGESTED READINGS

1. Man Mohan Singh - India's Export Trends
2. G. M. Mein - International Trends and Development

ANNAMALAI UNIVERSITY

LESSON 14

FOREIGN EXCHANGE

OBJECTIVES

After studying this lesson, you should able

- to know the meaning of foreign exchange
- to find the rate of exchange
- to understand the modern theory of exchange rate determination
- to analyse the demand and supply theory.
- to understand the equilibrium rate of exchange

STRUCTURE

14.1 INTRODUCTION

In every country there are people who want to make payments to foreign countries and there are others who have to receive payments from foreign countries. The rate of exchange is the amount of a foreign country that a unit of the money of the home country will purchase.

14.2 MEANING OF FOREIGN EXCHANGE

The term foreign exchange may be used in different senses. It may refer to--

a) the rate of exchange, i.e., the amount of money of a foreign country that a unit of the money of the home country will purchase; or

b) the foreign exchange operations or transactions, i.e., converting one currency into another or the machinery by which foreign payments are made;-or

c) the fund of foreign exchange(currency) at the disposal of a country.

If there were no international trade, there would be no foreign exchange. If there were only one common currency for the whole world there would then also be no problem of foreign exchange. As it is, countries by their economic relations create mutual obligations, which must be met, and the currency of the various countries being different, the problem of converting the currency of one country into that of another arises in international trade.

To take concrete example, suppose you import books worth Rs.100 from England. Indian rupees are of no use to the English bookseller. You must make payment in money, which has purchasing power in England. The English money is pound (£) sterling. You must, therefore, convert your Rs.100 into pounds sterling (or titles to pounds sterling). You can also send gold if you are allowed to export it and if you think it worthwhile to bear the cost of its transport. Similarly, a man in England might have purchased tea from an Indian firm. He must convert his pounds sterling into rupees (or titles to rupees), or send gold, if possible and if found economical.

At any moment, therefore, in every country there are people who want to make payments to foreign countries and there are others who have to receive payments from foreign countries. The former have imported, and the latter have exported goods or services. Obviously, exporters from India are entitled to receive payments from importers in England and importers in which was existing in the absence of money. In a barter economy goods buy goods, while is a monetary economy goods fetch money and money buys goods. Bartering was common in primitive societies. However, it is still practiced at places where the use of money has not spread much in many underdeveloped economies. Barter, mostly involved the direct exchange of one good for some quantity of another good. In other cases, goods exchange for services. A doctor may be paid in kind as payment for his services. Inspite of its prevalence bartering was found to be, a very inconvenient method of exchange. It involves loss of time and effort on the part of people in trying to exchange goods and services. As a method of exchange, the barter system has several serious difficulties and disadvantages.

14.3 TITLES TO FOREIGN MONEY

We have yet to explain the nature of what we have called "titles to foreign money." These may take the form of (i) Bills of Exchange (ii). Banker's Drafts, or (iii) Telegraphic Transfer. We have already explained what a bill of exchange is and we have also noted its advantages in financing foreign trade. An Indian exporters draws a bill of exchange against the English importer of his foods in terms of pounds sterling. This bill he sells to a bank or , technically, gets it discounted. He is paid the present value of the bill in rupees. An importers of English goods in India buys such a bill by paying rupees and sends it to his exporter in England who gets it discounted at a bank or receives payment from the English importer on the maturity of the bill in terms of pounds sterling.

Drafts, as we have already seen, are orders from one bank to its branch or another bank, with which the former may have account, to pay the bearer on demand as specified sum of money. In short, a draft is a cheque drawn by one bank on another in favour of a third person. You can send money to England by purchasing a draft payable in English money. This draft is sent by post to the person to whom the payment is to be made and the latter realises the money by presenting it to the bank on whom the draft is drawn.

A telegraphic transfer is an order by telegram to a bank to pay a specified sum of money to the specified person. It may be called a draft sent by wire; By this method payments are made immediately. Telegraphic Transfer (T.T.) rates are, therefore, more unfavourable to the buyer than rates charged for ordinary drafts.

14.4 RATE OF EXCHANGE

We have seen that it is the supply of, and demand for, foreign money that determine the rate of exchange, just as the market price of commodities is determined by the forces of supply and demand. We have also seen how the demand for, and supply of, foreign money (or conversely supply, of, and demand for, home money) arise. When the supply is equal to demand, the rate of exchange is said to be at par. If supply of foreign money is greater than demand, the value of the foreign money falls below (or of the home money rises above) the par. And conversely, if the demand for foreign money is greater than supply thereof, the value of foreign money rises above (or of the home money falls below) the par. Now only a small fraction of international transaction is settled through the purchase and sale of bills in the foreign exchange markets. It is now mainly, concerned with the direct exchange of one currency for another.

Up to what limits can the exchange rise above, or fall below the par? These limits are determined differently under different conditions. The par of exchange also has different meanings under different conditions.

We shall see how rate of exchange is determined under different monetary systems.

Rate Of Exchange Under Gold Standard

When the two countries concerned are on gold standard, as already explained, their currency units are either gold coins or are convertible into gold at fixed rates. Moreover, gold freely moves between the countries. The par of exchange between such countries is called the “mint par of exchange”. This is arrived at by equating the amount of gold contained in the currency units (or given in exchange for them by currency authorities respectively) of the two countries. There can be no mint par between a gold standard and a silver standard country.

For instance, before 1914, England and France were both on gold standard. Their mint par of exchange could be calculated as follows:

One English sovereign. = 7.98815 grammes of gold 11/12 fine.

= 7.32238 grammes of pure gold.

One French Napoleon (20 Francs) = 6.45161 grammes of gold 9/10 fine.

Therefore, One Sovereign = $\frac{7.32238 \times 20}{5.80645}$ francs = 25.2215francs

Thus the mint par between London and Paris was 25.2215 francs to £1. If the exchange is at par, under these conditions a French importer would get £1 in London by paying 25.2215 francs in Paris to meet his obligations. An English importer would get 25.2215 francs in Paris by paying £1 in London.

Specie Points: Now ,suppose the French people have to make more payments to the English people than the latter have to make to the former. The demand for the English money in France will be greater than it supply. The value of the £ will rise in term of the francs. The French importer will have to pay more than 25.2215 francs in order to get £1 in London. But how much more will he be willing to pay? We have already said that an importer will send gold if he can get it and thinks it cheaper to send it. Gold standard countries always provide gold in exchange for their money and allow it to leave the country. But gold involves cost of transport (shipping, insurance, interest charges, etc.) When it has to be sent out. The importer in France . will, therefore, only send gold if the rate of exchange is higher than the par to the extent of more than the cost of transporting gold from Paris to London. Suppose the cost of transporting 25.2215 francs worth of gold from Paris to London is. 3 franc. Then it will be worthwhile sending gold if the exchange rises above 25.2215 francs to the £by more than. 3 franc. If the exchange actually rises above this point, gold will begin to move from France to England. This point is thus called gold export point from the point of view of France and gold import point from that of England. This point is obtained by adding the cost of transport to the mint pair of exchange. It is also called the upper gold point or the upper specie point.

In the same way, there is a lower specie point, or gold import point for France and gold export point for England. This is obtained by deducting the cost of transport from the mint par. In the above example, it wi11 be 24.9215 francs to the £. If the exchange falls below this point, the English importers will send gold rather than purchase title to francs.

Thus if gold is available and is allowed to move freely between two countries (on gold standard), the rate of exchange will move between the two limits set by the upper and the lower gold points, also called the 'specie points'. If gold is not available, the rate of exchange will pass beyond the specie points. These are the two limits within which the fluctuations will be caused by the changes in supply of, and the demand for, foreign money, i.e., bills, drafts, T.T.S, etc.

Exchange Between Gold And Silver Standards

The above is a case where both the countries concerned on gold standard. If, however, one is on gold standard a the other on silver standard, the par of exchange will be de determined by the price of gold in terms of silver in the count on silver, and price of silver in terms of gold in the gold standard country.

Exchange Between Inconvertible Paper Currencies - Purchasing Power Parity Theory

But the most difficult case is that countries both having inconvertible paper currencies.fl6ppose England and France were both on paper currency convertible into metal. Then how many francs would have to be paid to get a £ sterling? Obviously as many as would have the same purchasing power in France as a £ has in England. If £ 1 in England purchases a collection of x commodities, then £ 1 will purchase as many francs in France as will buy the same co11ection of x commodities in France allowing for the cost of transporting commodities, from one country to the other:

Let us suppose in England £ 1 purchases x commodities.

In France, x commodities cost .25 francs. Then the rate of exchange will tend to be £ 1 = 25 francs.

Now suppose the price levels in the two countries remain the same but somehow exchange moves to £ 1 = 230 Francs.

This means that the purchasing power of the £ 1 in France is more than 25 francs. It will pay people to convert £ sterling into francs at this rate, purchase x commodities in France for 25 francs and sell them in England for one £. again, making a profit of 5 francs per pound worth of transaction. This will create a large demand for francs in England, while supply thereof will be less because very few people would export commodities from England to France. The value of the franc in terms of the £ will move up until it will reach £ 1 = 25 francs. At that point, imports from France will not give any abnormal profits. £ 1 = 25 francs is called the Purchasing Power Parity between the two countries. “While the value of the unit of one currency in terms of another currency is determined at any particular time by the market condition of demand and supply, in the long run that value is determined by the relative values of the two currencies as indicated by their relative purchasing power over goods and services. In other words, the rate of exchange tends to rest at this point which expresses equality between the respective purchasing powers of the two currencies. This point is called as the Purchasing Power Parity.”

Thus under a system of autonomous paper standard the external value of a currency is said to depend ultimately on the domestic purchasing power of that currency relative to that of another currency. In other words, exchange rates, under such a system, tend to be determined by the relative purchasing power parities of different currencies in different countries.

In the above example, if prices in France get doubled, the value of the franc will be exactly halved. The new parity will be £ 1 = 50 francs. This is because now 50 francs will buy x commodities in Francs which 25 francs did before. We suppose that prices in England remain as before. But if prices in both countries get doubled, there will be no change in the parity.

£ 2 = 50 francs

£ 1 = 25 francs

In actual practice, however, the parity will be modified by the cost of transporting goods (including duties, etc.) from one country to another.

Thus between countries on inconvertible paper, the place of the mint par is taken by the purchasing power parity. The difference is that the former is a fixed par while the later moves with movements of the price levels in the two countries concerned. Day-to-Day fluctuations around this par will take place as before due to changes in the supply of and demand for the currency in question. The limits to these fluctuations will be set by the cost of transporting goods from one country to another. Hence these limits will not be definite as were the specie points. The above diagram illustrates these points.

Criticism Of The Purchasing Powerparity Theory

This theory was popularized after World war I by Gustav Cassel, a Swedish economist. "The rate of exchange between two currencies," wrote Cassel, "must stand essentially on the question of the internal purchasing powers of these currencies." This is easily seen if we reflect on the fact that the price paid in a \ foreign currency is ultimately a price which must stand in a certain relation to the prices of commodities on the home market."

It should be noted that purchasing power parity compares the general price-levels in the two countries and not merely the price-level of goods actually entering international trade.. The prices of the latter kind of goods, of course, are the same in all countries allowing for the cost of transportation, tariff, etc. It is quite easy to verify the theory if we only compare prices of internationally traded goods. In fact, when its application is confined to such goods, it becomes an empty truism, because, as Halm says, "it is obvious that the national prices of internationally traded goods tend to equality as between different markets when translated into each other at the current exchange rates."

But, when we try to compare, the index numbers of the prices of the whole mass of goods marketed in the countries concerned, the rate of exchange will not always conform to the points thus determined. This is so because price of domestic goods may not move in the same direction, at least not in the short period, as of those entering into international trade. In the long run, of course, the rate of exchange and price-levels will tend to move in the same direction, especially if international trade is a major factor in a country's economic life. The theory, therefore, only holds good in the long period. Further, there is no permanence about the goods which do or do not enter into international trade. This depends on the rate of exchange itself. If the price of foreign money goes up, it will make profitable export of some hitherto domestic goods, and vice versa.

Even in the long period, the theroy will be valid only if the essential conditions of international trade remain unchanged. But such conditions seldom remain unchanged. For instance, the barter terms of trade are constant] y in a process of change between countries due to change in the demand for foreign goods or changes in the conditions of supply of domestic goods. Further, changes may occur in the volume of foreign loans, cost of trap-sport in any other item of invisible balance of trade.

Changes in barter terms thus brought about may disturb the relationship between the price-levels, and the parities based on such price-levels may not correspond to the rate of exchange. As Cassel observes, "Differences in the two countries' economic situation, particularly in regard to transport and customs, may cause the normal exchange rate to deviate to certain extent from the quotient of the currencies' intrinsic purchasing powers." If a country puts up tarrifs, the exchange value of its currency will rise but its price-level will remain the same.

Besides, many items of balance of payments like insurance and banking transactions and capital movements are very little affected by changes in general price-levels. But these items do influence exchange rates by acting upon the supply of, and the demand for, foreign currencies. The Purchasing Power Parity Theory ignores these influences altogether.

The theory, as propounded by Cassel, says that changes in price level bring about changes in exchanges rates but changes in exchanges rates do not cause any change in prices. This latter part is not true, for exchange movements do exercise some influence on internal prices.

In conclusion, we may say that the Purchasing Power Parity Theory attempts to explain the ultimate rather than the immediate forces determining the rate of exchange. The theory is applicable to all currencies. It is superior to the old theory according to which the rate of exchange was determined by balanced of indebtedness. This theory goes even to the root of the balance of indebtedness. It explains how balance of trade, of indebtedness itself, is determined. This theory lays proper emphasis on the influence of price-levels on the determination of rates of exchange. The actual rate at any particular moment may diverge from the equilibrium rate as indicated by the purchasing power parity due to the various factors affecting the terms of trade or the balance of payments for the time being.

14.5 MODERN THEORY OF EXCHANGE RATE DETERMTNATION:

According to Keynes there are two basic defects of the purchasing power parity theory, viz. (i) it does not take into consideration the elasticities of reciprocal demand and (ii) it ignores the influence of capital movements. In Keynes' view, foreign exchange rates are determined not only by the price movements but also by capital movements, the elasticities of reciprocal demand and many other forces affecting the demand for and supply of foreign exchange.

"By elasticity of reciprocal demand is meant the responsiveness of one country's demand for another country's exports with respect to price or income." As for price elasticity, generally speaking greater the proportion of luxuries and semi-luxuries in the exports demanded the more elastic will be the country's demand for another country's exports. It will also be more elastic 1. the greater the umber of alternative markets in which to buy and greater the capacity to produce the effective substitutes for goods imported. As for the income elasticity of demand for imports, changes in demand for goods and services and in the derived demand for foreign exchange is functionally related to the changes in national income. How far is a country's demand for another's exports responsive to a change in its national income? In other words, it is the character of the propensity to import out of a given income that is supposed to affect the exchange rates independently of international price movements.

Technological improvements adding to the productivity of the country and making its goods cheaper and better, tariff changes and exports subsidies affect exchange rates via their influence upon reciprocal demand quite independently of international of international price movements.

Capital movement both short-term and long-term are the other important influences. There is. 'hot money' flying from a country trying to make profit or avoid 1088 on exchange fluctuations and there is a 'refugee capital' seeking safety and security abroad. An actual or expected change in the domestic price of a foreign currency may lead to inflow or outflow of 'hot money' causing a further change in the exchange rate without there being price changes in either country. The inflow tends to raise the exchange value of the currency of the capital receiving country and outflow will lower it. Long-term movement of capital also has a similar effect. In view of the defects pointed out above the purchasing power parity theory does not offer an adequate and satisfactory explanation of the fluctuations in the rates of exchange. The determination of the exchange rate depends not only on international price relations but on many' other factors as mentioned above. This leads us to a more adequate explanation of the determination of foreign exchange rates, viz., and balance of payments theory.

14.6 DEMAND AND SUPPLY THEORY OR BALANCE OF PAYMENTS THEORY

The most satisfactory explanation of the determination of' the rate of exchange is that a free exchange rate tends to be such as to equate the demand and supply of foreign exchange. For example, the external value of the rupee in Bombay depends on the demand for and supply of rupees on the foreign exchange market in Bombay. The demand for rupees comes from those who offer foreign exchange in order to- obtain rupees while the supply of rupees comes from those people, who are offering rupees to obtain foreign exchange. The Indian exporters to England constitute the demand for rupees for they have a claim on pound sterling which they want to convert into rupees; and the Indian importers who have to ml1ke payments to England, offer rupees in order to get pound sterling. The intersection of the sterling-supply curve and the sterling demand-curve gives the equilibrium price of sterling that equates the amount of pound sterling offered and the amount of pound sterling demanded. If the equilibrium pound sterling price in Bombay is Rs. 13/- per pound sterling, the equilibrium price of the rupee on the London market is the reciprocal of Rs.13/- i.e., -1/13 - of a £.

Now what lies at the back of demand for and supply of foreign currency? These are the various items in the country's balance of payments. The demand for foreign exchange arises from the debit items in the balance of payments, whereas the supply of foreign exchange arises from credit items. The debit items relate to all payments made during a given period by residents of the country to foreigners, and credits include all payments received during the given period from foreigners by the residents. These payments may be on any account, e.g. goods brought and sold, services rendered and received, capital borrowed or lent. and so on. If India has a net debit, its demand for foreign exchange, say pound sterling, must exceed its supply of pounds sterling with the result that the rupee price of pound sterling will go up, or what comes to the same thing, the external value of the rupee must go down relative to pound sterling. The rupee becomes cheap in term of £. Conversely, a net credit in India's balance of payments will lead to a fall in the rupee price of £, which means a higher value of the rupee or expensive rupee relative to the £.

It is well to remember that the demand for and supply of foreign exchange in the final analysis is nothing else than the demand for and supply of foreign goods and services. As already mentioned, the supply of foreign exchange arise from the credit items in the balance of payments, while the demand for foreign exchange results from the debits. In other words, the debit and credit items in the balance of payments constitute the demand for and supply of foreign exchange.

These items can be put in the form of a balance sheet as under:

Debits (demand)	**Credits (supply)**
1. Commodity imports	Commodity exports
2. Services rendered by foreigners	Services rendered to foreigners
3. Travel expenditure by Indian nationals abroad	Travel expenditure by foreigners in India
4. Interest and dividends on Indian securities owned by foreigners.	Interest and dividends on foreign securities owned by Indians
5. Remittances and charitable contribution by Indian nationals	Remittances and charitable contribution by foreigners to Indians

6. Government expenditure by Indian Government abroad	Remittances and charitable contribution by foreigners to Indians
7. Exports of long-term capital (i.e. import of foreign stocks and bonds, Indian direct investment abroad and loans to foreigners)	Import of long-term capital (i.e., export of stocks and bonds to India by foreigners, foreign direct investment, in India and foreign loans to India.
8. Export of short-term capital (i.e increase of Indian Bank balances abroad)	8. Imports of short-term capital (i.e increase of foreign owned bank balance in India
9. Gold imports	9. Gold Imports
10. Miscellaneous import items	10. Miscellaneous export items

The balance sheet contains items both on current account (items 1 to 6) and capital account (items No.7 and 8). Among these items the largest single source of demand for and supply of foreign exchange is represented by commodity exports and imports, though the quantitative significance of the various items differs from country to country.

The balance of payments is said to be ad verse if the total of visible and invisible imports exceeds those of exports. The country is then said to have been deficit on current account which must be paid off by drawings on foreign exchange reserves or by exporting gold or by borrowings for short term from the I.M.F. or from the creditor countries. Conversely, a favourable balance of payments means that the invisible and visible exports together exceed the invisible and visible imports. Then the country has a surplus on current account and it accumulating claims on foreign currencies.

When the balance of payments is unfavourable the country will have a weak exchange rate position, there will be increase in the demand for foreign- exchange relative to the supply thereof because more payments have to be made than receiving payments from abroad. In this case there will be decline in the external value of the domestic currency. But the depreciated external value of its currency will stimulate exports and help it to wipe out the deficit. .

If a country has a surplus on current account, it is said to have a favourable balance of payments. There are more people abroad who have to make payments to this country. The demand for this country's currency will increase on the part of the holders of foreign currency. The result will be that the external value of the domestic currency will appreciate. This is how the balance of payments effecting demand for foreign exchange and supply of foreign exchange determines the rate of exchange.

The balance of payments theory of exchange rates is' superior because (a) it facilitates equilibrium analysis, (b) it is more realistic because the price of foreign currency is seen here as a function of many significant variables and not merely purchasing power expressed in general price level and above all (c) it clearly shows the possibility of adjusting balance of payments disequilibria through exchange rate adjustment rather than through domestic price deflation as implied by the parity.

14.7 FLUCTUATONS IN THE RATES OF EXCHANGE

The long-term Parity may be the mint par as under gold standard or purchasing power parity as under inconvertible paper. But during the short period, there are various causes that may lead to fluctuations in the rate of exchange above or below this equilibrium level.

These influences can be grouped under two heads:

(i) Those affecting demand for, or supply of, foreign currency, and ii) Those affecting currency conditions.

(ii) As regards the first, the demand for, and supply of, foreign currency arise from three sources:

a. Trade conditions.

b. Stock exchange influences; and

c. Banking influences.

a) Trade Conditions: T}lese affect exports and imports and hen<;e 111eSupply of, and the demand for, foreign currency respectively. When our exports are greater than imports exchange will tend to move in our favour. In the opposite case, it will tend to move against us. Exports and imports are include' not only visible but also invisible items.

b) Stock exchange Influences; These include raising of loans, repayment of interest and loans, purchase and sale of foreign securities, etc. When a loan is given by the home country to a foreign country, the demand for foreign currency increases and the value of home currency trends to fall. The same is the case when home investors purchase foreign securities or foreign investors sell home securities. The exchange moves in favour of a country when its loan are being repaid or when foreigners buy her securities, because such transaction create demand for

c) Banking Influences: Under this category come the purchase or sale or bankers, drafts, travelers letters of credit, arbitrage operations (i.e., ,buying and selling of foreign currencies to make profit out of differences in the rates in different centres), etc. The sale of a draft on a foreign center creates demand for foreign currency and raises its value or lowers the value of the home currency. The bank rate also influences exchange rates. A high bank rate attracts funds from foreign centres and thus raises the demand for domestic currency and hence its value. In the opposite case, its value falls because funds move out of the country, thus creating a demand for foreign money.

ii) Currency Condition: Actual or expected changes in the value of currency also affect its exchange rate. If there is an over-issue of currency, or an over issue is expected, people will not be anxious to invest their funds in such a country. In fact, funds will tend to move out. This is called a "flight from the currency." If people expect a currency to appreciate, they will tend to purchase this currency. for speculative gains. In the former case, the exchange rate will tend to be unfavourable and in the latter to be favourable.

Limits To Exchange Fluctuations

But these fluctuations take place within certain limits. Under gold standard, as we have already seen, such limits are indicated by the specie points or gold points.

A country is said to have a favourable exchange rate if the rate is nearer the gold import point, and unfavourable if it is nearer the gold export point. The rate is also said to be favourable when the value of the home currency becomes higher in terms of the foreign. currency or when it is likely to lead to importation of gold on account of excess of exports over imports. If the value of home currency falls or gold tends to leave the country, the rate is said to be unfavourable.

It should be remembered, however, that the terms 'favourable' and 'unfavourable' are only technical terms coming down from Mercantilist era. What is called favourable may not be really so. For example, as compared with ls.4d. the rate lst.6d is said to be f.avourable to India because at this rate the home currency buys more. But this rate was certainly detrimental to the country's buys more. But this rate was certainly determined to the country's interests as it injured both agricultural to the country's interest as it injured both agricultural and industrial interest when it was first fixed.

The rate of exchange does not rise above the gold import point (supposing it is quoted in foreign currency) because it becomes' cheaper to the foreign importer to send gold rather than to purchase our currency. Conversely the rate of exchange does not fall below the gold export point because it becomes cheaper for the home importers to make payments by sending gold out of the country rather than by purchasing foreign money.

When both the countries are on inconvertible paper, the place of the mint par is taken by the purchasing power parity. As already noted, the purchasing power parity is not fixed like the mint par, but is a moving par. Hence there are no definite limits to the movements of exchange. The fluctuation will be in accordance with changes in the demand for, and supply of, currency and in the currency conditions, as already noted.

14.8 EQUILIBRIUM RATE OF EXCHANGE

After fluctuations, the rate of exchange may reach a certain comparatively stable level which may be called an equilibrium rate. In the history of Indian currency, we read about the battle of ratios: l8d. vs. l6d. Which was the correct ratio? The advocates of each ratio said that, at the rate they recommended, there was proper adjustment between the rate and other economic factors like prices, wages, interest rates, etc. In short it was the equilibrium rate. When all relevant factors have been taken into consideration, the rate which is the most suitable may be called the equilibrium rate. It is the correct rate; at this rate there are no disharmonies in the economic system, e.g., there is cost price disparity, and no sector of economy shows any sign of maladjustment or disequilibrium.

The equilibrium rate of exchange has been defined as "the rate which, over a certain period maintains the balance of payments in equilibrium without any net change in the international currency reserves." It has also been defined "as one that maintains the balance of payments equilibrium without a degree of unemployment greater than in the rest of the world." We may also say that the equilibrium rate is one at which the demand for each currency would be equal to the supply of it and no account is taken of speculative and abnormal capital movement. It expresses a balanced relationship between different economies. At the equilibrium rate, the domestic currency is neither undervalued nor overvalued in terms of foreign currency, so that neither it gives an artificial stimulus to exports nor to imports. It remains neutral.

Halm mentions the following criteria of an equilibrium rate:

(i) It should be in conformity with an average degree of domestic stability. For instance, as has already been said, unemployment inside should not be greater than unemployment outside.

(ii) It should not be necessary to overstrain the national gold reserves nor should it lead to depletion of foreign balances to maintain this rate. If domestic currency has to be contracted for the maintenance of the rate which causes depression or impedes recovery, it is obviously not an equilibrium rate.

(iii) It should not offer any artificial advantage or inflict any 9ut-of-the-way disadvantage on foreign trade. It should remain completely neutral in matters affecting costs, prices and demand of the other countries connected with foreign trade relationship.

Exchange Stability Vs. Price Stability

Thus under gold standard, exchanges are relatively more stable and adjustments are made through gold movements with consequent effect on relative price-levels. Under inconvertible paper, adjustments are made more easily by movements in exchange. But even under inconvertible paper, exchange may be artificially controlled and kept stable. Then adjustment will have to he made by a painful movement of relative prices and costs in the countries concerned.

The question arises: Which policy should be the aim of a country to pursue - exchange stability or price stability? No stright answer can be given to this question. It will depend upon the economic conditions within the country concerned and on the volume of its foreign trade.

If the country is a large one and foreign trade plays only a minor part in its economy, and its price and cost structure is not elastic, it will be to its advantage to preserve stability of its price-level and make necessary adjustments by moving the exchange rate. On the other hand, a small country with a large amount of foreign trade and elastic price-cost structure, will do well to keep its exchange rate stable and let adjustments be made through movements of internal prices and costs. For instance, a country like India should aim at stable prices and free exchange. While for Great Britain stable exchange is the more important objective.

In recent times, however, the objective of monetary policy has shifted from both these. It is neither exchange stability nor price stability which is the aim, but the stability of economic life as a whole or smoothening out of cyclical fluctuations.

Fluctuating Vs Fixed Exchange

Should the rates of exchange be left to take care of themselves, free to move in any direction, or should they be kept stable? Something can be said in favour of each course. The advocates of flexible rates of exchanges say that a system of free rates enables a country to pursue an independent economic policy. It should look to internal stability ,i.e., stability of prices, output and employment and leave the exchange rates to vary as they would. Such a policy would eliminate outside interference with internal economy. The rate of exchange has an equilibrating influence on the balance of payments and it is better, it is said, to let this equilibrating factor work freely and automatically. The rate of exchange acts as a shock absorber. If the rates of exchange are kept rigidly fixed, the shocks of inflation and deflation from abroad are transmitted to the internal economic system. But variations in the rates of exchange can ward off the invasion of the inflationary and deflationary forces. It is also asked: "If demand and supply formula works so excellently in all economic spheres why not in the foreign exchanges?

There seems to be a great deal of force in the arguments but the policy of free fluctuating rates of exchange has been almost universally abandoned on the following grounds:

1. Since variations in rates of exchange affect imports and exports, a policy of fluctuating exchanges is inimical to, domestic stability. It will necessitate constant reshuffling of the natural resources as between the import industries and export industries, which may involve waste besides making the internal economy precarious.
2. A fluctuating rate of exchange adds to the harzards of international trade, and, by making it risky and uncertain, proves prejudicial to its healthy growth.

3. Under a system of fluctuating exchange, there are always anticipatory dealings in foreign currencies which lead to self-aggravating and cumulative movements in the rate of exchange making it highly unstable. If, therefore, there is merely an anticipation of exchange depreciation, it proves dangerous and leads to flight of capital. Thus fluctuating exchanges cannot always be relied upon to promote adjustment

4. Fluctuating rates of exchange cause windfall profits and losses. In order to be able to take advantage of a sudden turn in the rate of exchange, businessmen have to maintain a high state of liquidity which means contraction of credit, higher rates of interest and diminution in the volume of employment.

5. The fluctuating rates are also calculated-to discourage long-term international investments, since anything which dislocates internal economy must have a deterrent effect on the prospective investor.

SUMMARY

From the above discussion, it is clear that neither \ fluctuating exchange rates nor rigidly fixed rates would serve the purpose. "While exchange variations are certainly an unsuitable and undesirable means of dealing with short-term discrepancies in the balance of payments, an absolute rigidity of exchange rates in the face to drastic changes in other factors at home or abroad may thus be equally harmful. The general interest may call for an occasional revision of currency values so as to eliminate as far as possible any chronic and structural disparity between price-levels and exchange rates in different countries."

The dangers and disadvantages of the fluctuating exchanges have led to the introduction of the system of exchange control.

KEYWORDS

- Prevalence
- Primitive
- Deteriorate
- Plumage

REVIEW QUESTIONS

1. Explain how the rate of exchange is determined under different monetary system
2. What is purchasing power parity theory? explain.

SUGGESTED READINGS

1. Jiwitesh Kumar Singh - International Trade and Business

LESSON 15

BALANCE OF PAYMENTS AND EXCHANGE CONTROL

OBJECTIVES

After reading this lesson, you should be able,

- to find various kinds of balance of payments concept.
- to know the accounting balance and methods the exchange control.
- to familiar with exchange control in India.

STRUCTURE

15.1 Introduction

15.2 Kinds of balance of payments concept

15.3 Accounting balance

15.4 Methods of exchange control

15.5 Appraising the merits of exchange control

15.6 Exchange control in India

Summary

15.1 INTRODUCTION

Countries trade with one another, their exports paying for their importer. Trade refers to the export and imports of/goods only. It is also known as export and import of visible items since they consist solely of merchandise or goods, i.e. of things, which can be seen to move in ships, trains, trucks or aeroplanes across national frontiers and into customs houses where they may be counted or measured and evaluated. If the value of exports of a country exceeds the value of its imports, the country is said to have an 'export surplus' or a favourable balance of trade. If the value of its imports exceeds that of its exports the country is said to have an "import surplus'" or an adverse balance of Trade.

The terms "favourable" and "unfavourable" in balance of trade are derived from the writings of the mercantilists of the 18th century. In those days, settlement of foreign transactions was made in gold. The main objective of the mercantilist system was to achieve a continuous surplus in the balance of trade by 'building up the country's treasury in the shape of gold bullion ""1d that the greater part of the revenue of the government should come from the duties levied on imports. But nowadays, international transactions are not often settled in gold. Yet the terms "favourable", and "unfavourable" have continued to be used till today.

In practice, exports and imports of a country will rarely be equal. Balance of Trade, in other words, will not balance. During any year, a country may experience a favourable or an adverse balance of trade. It is important to note that the balance of trade includes the transactions of import and export of goods only. But in actual transactions, there are many "invisible items", which are also exported and imported. Hence, balance of trade cannot be regarded as an indicator of the external economic performance of a country, since it gives only a partial picture of the total economic transactions in international trade. It is the Balance of Payments which provides a complete record of international economic transactions. For it includes, apart from balance of trade account, the "invisible" account comprising services, gifts and charities plus capital account. value has made it possible to sell commodities not only within a country but also internationally. To facilitate trade, money has helped in establishing money and capital markets. There are banks, financial institutions, stock exchanges, produce exchange, international financial institutions, etc. which operate on the basis of the money economy and they help in both national and international trade.

Further, trade relations among different; countries have led to international co-operation. As a result, the developed countries have been helping the growth of underdeveloped countries by giving them loans and technical assistance. This has been made possible because the value of foreign aid received and its repayment by the developing countries is measured in money.

In solving the Central Problems of an Economy: Money help in solving the central problems of an economy: what to produce, for whom to produce, how to produce and in what quantities. This is because on the basis of its functions money facilitates the flow of goods and services among consumers, producers and the government. As pointed out by Robertson, "The existance of a monetary economy helps society to discover what people want and how much they want it and so to decide what shall be produced and in what quantities and to make the best use of its limited productive resources."

To the Government: Money is of immense importance to the government. Money facilitates the buying and collection of taxes, fines, fees and prices of services rendered by the government to the people. It simplifies the floating and management of public debt and government expenditure on developmental and non-developmental activities. It would be impossible for modem government to carryon their functions without the use of money.

Not only this, modem governments are welfare states which aim at improving the standard of living of the people by removing poverty, inequality and unemployment, and achieving growth with stability. Money helps in achieving these goals of economic policy through its various instruments. Prof.Pigou wrote in this connection "the institution of money is a powerful instrument promoting wealth and welfare like\the laws of property and contract, it constitutes at the least a very

1. "Direct investments" which carry a managerial interest in business firms, branches and subsidies located in a country by foreign residents.

2. Increase in foreign-owned holdings of drafts, bills, cheques, currency accounts receivable and other short-term claims payable by the residents of a country.
3. Decrease in a country's resident owned claims, deposit and balances in a banks and other financial institutions located abroad.
4. Decrease in a country's holdings of drafts, bills, cheques accounts receivable, currency and other short-term claims payable by foreign residents.
5. Repayment of by foreign governments, firms and residents of a country, agency loans and sales of a country's gold or reductions in the monetary gold stock.

Thus the balance of payment is a useful statement in the study of international economic transactions, since it presents in a few words and figures, the broad outlines of the economic, relations of a nation with the rest of the world or with selected areas and countries. Transactions entered on the balance of payments constitute the transfer of assets and liabilities, the creation or the reduction of claims or the receipts and payment of funds.

15.2 KINDS OF BALANCE OF PAYMENTS CONCEPT

The concept which is indiscriminately called the balance of payments is of three kinds:

1. The Market Balance
2. The Programme Balance
3. The Accounting Balance

1. The Market Balance: The Market Balance is a model of given situation in the foreign exchange market. It is characterised by the effective demand and supply of foreign exchange at the current exchange rate and at alternative, hypothetical rates. It is an ex-ante concept comparing autonomous spending and receipts.

"The demand for foreign exchange" represents the sum of the demands of importers, donors abroad and investors all of whom usually purchase foreign currencies in order to complete their intended external transactions. Similarly, "the supply to foreign exchange" represents the sum of foreign donations and foreign demands for the country's exports, securities etc. Like any other price, the price of foreign exchange of the rate of exchange is the product of interaction of the demand and supply schedules.

The market balance "describes the current balance" of autonomous international transactions, but it is less comprehensive than the accounting balance of payments, in projecting the character and dimensions of the country's participation in the world economy. However the market provides a much more useful tool of analysis to measure the extent of balance or imbalance of the country's autonomous intended transactions.

The market balance gives an accurate index of current international payments equilibrium or disequilibrium. The balance of payments will be in equilibrium, when the demand for foreign exchanges is just equal to the supply at the given exchange rate. The implication is that autonomous, transactions requiring foreign money payments must just be equal to autonomous transactions involving money receipts. The balance of payments will be in disequilibrium when demand and supply are not equal. Then the implication is that autonomous payments and receipts must be out of line. The problem of payments adjustment is to reconcile any such differences between autonomous demand and supply of foreign exchange at a given exchange rate.

2. The Programme Balance: The programme balance of payments of a country is "a systematic statement of sources and uses of foreign funds expected or planned over a future period of one or more years.'" It is based upon a calculation of domestic consumption and investment requirements and upon a programme of meeting an excess of requirements over resources by recourse to foreign finance expected or sought. It is essentially a forecast of the country's foreign exchange needs and desires, i.e., "it is a kind of accounting balance of the future. Deficits and surpluses are defined in terms of the gaps between these needs and desires on the one hand, and the amounts of foreign exchange to become available from all regular sources like exports, foreign investments etc.

All countries do not compute a complete programme balance of payments. But it is most useful to countries regularly dependent on foreign financial assistance to sustain certain levels of internal consumption and capital formation. Indicates the amount of financing which will be needed and for how long. Nowadays almost all developing countries compute programme balance. The ex-ante character of the programme balance is self evident. It provides financial authorities with a useful tool for analysing the suitabl1ity of current policies and plans affecting the country's international economic position. The entire programme is built around the potentialities of finding the foreign finance for the deficit.

15.3 THE ACCOUNTING BALANCE

"The accounting balance of payments of a country is a systematic record of all economic transactions between the residents of a country and foreign residents." For any specific period of time, the statistical record shows the character and dimensions of the country's international economic relationship with the rest of the world. It shows the country's trading position, changes in its official net position as foreign lender or borrower and changes in its reserve holdings. For these reasons it can' be very useful to the financial authorities than market balance and the performance balance. What we are actually going to study under balance of payments is more confined to the accounting balance of payments.

The balance of payments accounting is constructed according to the principles of double-entry book-keeping. Any transaction that gives rise to a foreign monetary claim on the home country is a 'debit' or 'minus' entry. Any transaction giving rise to monetary claim by residents of the home country on foreign countries is a 'credit' or 'plus' entry. As with any double-entry accounting statement, each credit entry must be accompanied by an equal and opposite debit entry. For example all international transactions that result in payments to India increase, India's stock of or claims on foreign currencies, and may be recorded as credit or plus entries in India's balance of payments. Similarly, all payments by India (receipts to foreigners) deplete India's stock of or claims on foreign currencies and may be recorded as debit or minus entries in the balance of payments account.

The Structure Of Balance Of Payments

A balance of payments statement summarises a nation's total economic transactions undertaken on international trade account. It is usually composed of two sections.

1. The Current Account, and
2. The Capital Account.

The division is based on the classification of economite transactions into (1) real transactions and (2) financial transactions.

"Real transactions" are those of goods "and services from one nation to another. These are income creating transactions. On the other hand "financial transactions" are those, which involve only the transfer of money or titles to investment. Financial transactions are often regarded as capital transactions. These transactions do not directly influence the level of income of the countries concerned as they are effected only through transfer of claims between the countries. They directly involve only changes in the capital or financial assets and liabilities of countries but not their output and income. Thus real or income creating transaction are entered into the current account section and financial or capital transactions are entered into the capital transactions are entered into the capital account of the balance of payments.

1. Current Account: The current account of the balance of payments recorded an monetary transactions arising out of imports and exports of goods and services, in addition to international flows of income from investments. Current account mainly consists of two Sub-groups.

(1) Merchandise or the trade account and (2) Invisible account.

In the trade or merchandise account, all goods exported and imported are recorded. The invisible account consists of services account and the gifts or charities account. The latter is known as transfer payments. The services account records all the services exported and imported by residents of the nation. In consists of such items as banking and insurance charges, interest on loans, tourist expenditure transport charges etc. Similarly the gifts or charities account consists of an items received or given away free by residents of the nation. All these are referred to as invisible transactions and therefore recorded in the invisible account.

Suppose a U.S. importer buys 100 tons tea from an Indian exporter. He pays for them by a cheque drawn on his bank in favour of the India. India now has a dollar claim on the U.S. and the tea import is recorded as a debit (minus) item in the current account of the U.S. balance of payment.

Suppose an Indian buys a ticket from Bombay to New York on a U.S. plane. He pays for it in Indian rupee. From a balance of payments standpoint the U.S.A. now has Rupee claim against India a credit (plus) on the U.S. current account.

Suppose an Indian Bank remits an interest payment on a loan that it has received from an American bank. This presents the U.S.A. with a monetary claim on a foreign country, which means a claim in the from of Rupee. This is recorded as a credit (plus) item in the U.S. current account.

Other types of services may also result in significant current account entries Insurance, premiums, royalties, consulting fees, certain military expenditures and construction fees are some of these. Another type of service entering into current transactions is the payment of interest and dividends on foreign investment is made abroad, foreigners have the use of the capital and their interest or dividend payments are classified as a return for services rendered.

A variety of other balances also exist and are used for many illustrative purposes; a balance of tourist expenditures, a balance of investment income, a balance of transport expenditures and so on.

Further the current account also include items of "unilateral transfers" in the transfer payment account. Unilateral transfers include remittances of private individuals to friends and relatives; living abroad as well as government grants to foreign countries for development assistance, disaster relief and so on.

2. Capital Account: A second major balance of payments accounts records all short-term and long-term international movement of capital. Capital account deals with payments of debts and claims. The criterion for deciding whether a given transaction should be recorded as a credit (plus) or a debit (minus) item in the balance of payments is the same as that used in connection with the current account. Any transactions that gives the home country a monetary claim on a foreign country is a credit and any transaction giving foreigners a monetary claim on the home country is a debit.

For example: an American firm invests $1 million in India by buying 20% of the outstanding of an Indian sewing machine manufacturer. This transaction is represented as a debit (minus) in the U.S. balance of payments; it is long-term private direct capital outflow.

A wealthy American decides to deposit 100,000 in an Indian bank. Again, eventhough the American retains ownership of the deposit, this gives foreigners a monetary claim on the U.S. and represents a debit (minus in the American balance of payments. It is a short-term private capital outflow. Similarly, government loans to foreigners are recorded as debit items in the home country's balance of payment.

The same holds true for direct investment of foreigners in the home country. Direct investments abroad relate only to actual flows of capital into foreign business ventures in which residents of the home country are deemed to have an important voice in management.

Short-term capital flows include purchases and sales of all types of financial assets with a maturity of less than one year. Everything else falls under the heading of long-term capital. Hence international flows of funds into demand deposits (i.e., into foreign currency bank balances) time deposits, certificates of deposit, treasury bills, bankers, acceptances and a host of similar relatively liquid assets-including long-term obligations with less than a year to maturity-all are considered short-term capital flows.

Capital account consists of such items like private capital account international institutional capital account, special and government capital account. Balances in these accounts may rise or fall from year to year depending upon the account movement or illustration in other items on capital account.

Under private capital account all the private balances held by corporate bodies or commercial banks are recorded. Private capital account usually consists of short and long period adjustments.

International institutional capital account consists of assistance from the short and long-term capital supplying agencies like I.M.F. Bank for International Settlement (BIS), World Bank, International Finance Corporation, International development association etc.,

Special account records the movements (inflow and outflow) of gold bullion.

The balance on government capital account consists of all governmental capital transactions in the form of grants or loans short-term as well as long-term.

Equilibrium And Disequilibrium In The Balance Of Payments

A nation's balance of payments is in equilibrium" when the autonomous supply of foreign exchange and the autonomous demand for foreign exchange are equal. This is an equilibrium situation where there is a monetary authority committed to maintain the exchange rate stability. The balance of payments statements is a draw up in terms of debits and credits based on, system of double entry book-keeping. If all entries are made correctly, total debits must equal total credits. This is because two aspects of each transaction recorded are equal in amount but appear on the opposite sides of the balance of payments account. In this accounting sense, balance of payment for a country must balance.

In the case of pure bilateral trade all partial balances with different countries should balance. But in case of multi-lateral trade only the balance of payments must balance. Hence, it is not necessary that the regional sub-totals in the credit account should equal the corresponding sub-totals in the debit account.

Debit or payment side of the balance of payments account of a country represents the total of all the uses made out of the total foreign exchange acquired by the country during a given period. Credit or receipt side represents the sources from which this foreign exchange was acquired by this country in the same period. The two sides as such necessarily balance. In short the balance of payments may be considered as a balance scale with every addition on one side necessitating an addition on the other to keep it in equilibrium. It should also be noted that the two accounts-current and capital in the balance of payment should necessarily balance.

If, in the actual balance of payments account, the credits, and debits do not balance. The balance, is usually achieved by adding an item called errors and omissions. In fact, the net total of errors and omission is a balancing item that compensate for any excess of recorded credits over recorded debits or vice-versa. This total can be large, when balance of payments data are collected from diverse sources.

Disequilibrium In The Balance Of Payments

A balance of payments statements comprises 'autonomous' and :induced' transactions. "Autonomous transactions" are trade transactions pertaining to exports and imports of goods and services that are undertaken for their own sake under profit or utility motive. And imbalance in the value of autonomous transaction has to be counter balanced by a corresponding change in foreign exchange reserve or short-term capital movement, which is referred to as 'induced' or 'accommodating' transaction. Induced transaction is not undertaken for its . own sake, but it emerges on account of imbalance in the balance of trade. Thus, in the process equalising balance of payments account, induced transactions are undertaken and recorded in capital account.

"These induced transactions" often involve short-term capital movements like lending or borrowing, inflow or outflow of gold addition or subtraction in foreign exchange reserves of the country etc. Since induced transactions being of a compensating, nature, any imbalance in them is not very significant. But the real problem of disequilibrium lies in the imbalance of autonomous transactions of a country. Thus the phenomenon of disequilibrium (a deficit or a surplus) in the balance of payments is viewed from the balance of transactions on current account as such. A disequilibrium a surplus or a deficit-in this sense shows a strengthening or weakening of a country's external capital position.

Kinds Of Disequilibrium In The Balance Of Payments

Disequilibrium in the balance of payments can arise owing to a large number of causes. There can be as many kinds of disequilibrium as there are many causes.

However there are three main kinds of disequilibrium. They are (i) cyclical disequilibrium (ii) secular disequilibrium and (ill) structural disequilibrium.

1 Cyclical Disequilibrium: An important characteristics of the cyclical disequilibrium is that the balance of payments remains in equilibrium over the complete cycle. It arises from the occurrence of business cycles. Business cycle can cause cyclical disequilibrium in the balance of payment under any of the following conditions.

a) "the intensity" of booms and depression differ in different countries

b) "timing" of the various phases of cycle differ in different countries

c) "income elasticities" of demand for imports differ in different countries

d) price elasticities of demand for imports differ in different countries:

a) Other things remaining the same, if the business cycle is more intense in country A than in country B, country A will suffer from a deficit during boom and enjoy a surplus during depression. Reverse will happen in country B 'during the boom, income will rise more in A than in B. Consequently, rise in the imports of A will be larger than in those of B. During the depression, decline in income in A will be larger than in B. Consequently, the decline in imports of A will be larger than in the imports of B.

b) Cyclical disequilibrium in the balance of payments will occur if the various phases of cycle occur at different times in different countries. Other things remaining equal, if the various phases of cycle in country B differing with country A by one year, the rise and decline in imports of B during the boom and depression respectively will occur with a time-lag of one year as compared with the occurrence of the rise and fall in import of A. Thus A will suffer from a deficit during boom and enjoy a surplus during depression. Reverse will happen in country B.

c) Cyclical disequilibrium may arise from difference in the income elasticities of demand for imports. Other things remaining equal, if the income elasticity of demand for imports is higher in country A than in country B. A will suffer from a deficit during the boom and enjoy a surplus during the recession. Due to comparatively higher elasticity of demand for imports, the rise and fall in imported during the boom and depression respectively will be larger in A thin in B.

d) Cyclical disequilibrium may arise from differences in the price elasticities of demand for imports in different countries. Normally prices rise during boom and fall during the depressions Other things remaining the same, if the price elasticity of demand for imports is higher in country A than in B. A will enjoy a surplus during the boom and suffer a deficit during the recession. With comparatively higher price elasticity of demand for imports fall and rise in imports in A will be larger during boom and depression respectively than in B.

2. Secular Disequilibrium: It arises from long-run and slow-moving changes in an economy as it moves from one stage of growth to another. It may be due to a large number off actors, viz., capital formation, population growth, technological changes, growth of markets, changes in resources etc. For examples in its early stage of a developing economy requires investment of a magnitude far larger than that of domestic savings, imports tend to exceed exports. If sufficient foreign capital is not forth coming it may suffer from a "secular deficit" in its balance of payments.

On the other hand, in a mature economy, savings may be far larger than those, which can be invested profitably within the domestic economy, imports tend to fall short of exports. In the absence of an outflow of capital, such an economy may enjoy a secular surplus in its balance of payments. To take another case, other things remaining equal, if the rate of growth of population is higher in country A than that in country B, country A will suffer from a secular deficit in its balance of payments with B. Other things remaining the same, an increase in population increases the need for imports and decrease; the capacity to export.

3. Structural Disequilibrium: It arises from structural changes in the demand or supply conditions of exports and or imports.

Structural disequilibrium may arise from a change in foreign demand for exports. If the foreign demand for Indian tea declines due to the say, "a change in tastes abroad" the resources employed in tea production will have to be shifted to the production of other commodities for which demand exists in abroad. If India finds it difficult to adjust the required shifts in resources, demand for imports remaining the same, it will suffer from a structural disequilibrium in its balance of payments. A similar situation can arise from a changes in fashions, change in. technology. invention of cheaper synthetic substitutes etc.

Structural disequilibrium may arise due to a change in supply. A crop failure may decrease and capacity to export and increase the need for imports and thus ca use a structural deficit in the balance of payments. A similar situation can arise from a "dislocation of production" because of strikes or other political disturbances. Structural disequilibrium may also arise from a decline in service income from abroad.

Exchange Control - Licensing Procedure

In a free foreign exchange market the exchange rate of a country's currency is determined by the forces of demand and supply of the foreign currency. However, as a consequence of frequent changes in the demand and supply functions, the foreign exchange rate also undergoes frequent oscillations. Frequent changes in the exchange rate serve as a deterrent to international trade as well as to the flow of capital between the two countries because such changes increase the uncertainty and risk involved in international payments. For this reason, even in the so-called capitalist countries, attempt is made to regulate the fluctuations in the exchange rate. In planned economies, however, such regulation becomes more direct and explicit.

Exchange control has been generally defined as "the state of regulation excluding the free play of economic forces from the foreign exchange market." Paul Einzig feels that foreign exchange control refers to all those policies of monetary authority which are introduced in a country to influence the exchange rates and markets related thereto. However, Heilperin provides the simplest definition of foreign exchange control. In his opinion, exchange control is that arrangement in which each transaction related to foreign exchange is controlled by the government. In short, exchange control refers to that policy according to which foreign exchange market is required to operate under the control of some government authority. Perhaps from this angle the following statement of Ellsworth is comprehensive enough to define exchange control.

"Exchange control... means of dealing with balance of payment difficulties, disregards market forces and substitutes for them the arbitrary decisions of Government officials. Imports and other international payments are not longer determined by international price comparisons, but by considerations of national need."

The government of a country may adopt various measures to control the transactions of foreign exchange market. The extent of control however depends on the objectives of exchange control and the extent to which the exchange control is treated as a part of the government's overall economic policy. A system with comprehensive exchange would have the following characteristics:

i. full control of the State on foreign exchange market;
ii. dealing in foreign exchange exclusively by an individual or an agency having a proper licence to that effect;
iii. exports and imports exclusively by ,those individuals or firms which have proper licences for doing foreign trade;
iv. imports are regulated by the government. However, foreign exchange is allocated among different importers on the basis of priority assigned to each category of imported goods;
v. foreign exchange obtained by exporters and others must be surrendered to the government of the central bank of the country;
vi. export of capital is strictly under government control, and
vii. foreign exchange rate is determined by the government. In other words, market forces of demand for and supply of foreign exchange are. not permitted to determine the foreign exchange rate.

In the post world war I period measures of exchange control were first adopted by the fascist governments of Italy and Germany. However, in the later years, particularly during and after the Great Depression of early thirties, governments of several other countries also followed suit and introduced policies to control and regulate their foreign exchange markets; albeit the objectives of their policies were not similar. In the present context, the exchange control has become an important part of national economic policies of not only planned or socialist countries but also of the policies adopted by the countries of the western hemisphere.

Objective Of Exchange Control

Government intervention in the foreign exchange market or exchange control can be practiced for satisfying a number of objectives. Broadly stated, the following are the main objectives of Exchange Control: .

1. Correcting the adverse balance of payments

Kindleberger feels that the major purpose of exchange control with its central element of restricting imports is the balance of payments. As we shall see later in this chapter, by overvaluing or undervaluing the exchange rate the government attempts to affect the terms of trade and thus tries to directly affect the country's export and imports.

2. Restricting the fight of capital

Sometimes regular but large scale outward movement of capital may pose a big threat to the economic stability and also to the balance of payment equilibrium of a country. Under such conditions, exchange-control may provide an effective means to check the flight of capital from the country and may thus prevent further deterioration in the country's balance of payments. Even the International Monetary Fund permits exchange control to combat the flight of capital, especially the speculative flight of capital.

3. Conservation of foreign exchange reserves

Economic development in most of the countries is presently constrained by the limited availability of foreign exchange. Their fast rising import needs generally put a big drain on their already meagre foreign exchange reserves. The governments of such countries generally resort to foreign exchange control in order to ensure a cautions use of the available foreign exchange.

Thus the conservation of foreign exchange preserves may be an important objective of exchange control, particularly in respect of developing countries. .

4. Stability of foreign exchange rates

As has been noted above, wide and frequent oscillations in the foreign exchange rate generally act as a deterrant in the international movement of goods and capital. The mechanism of Gold Standard and the ensuring automatic correction in the foreign exchange rate have now become matters of the past. Every government has to ensure that the foreign exchange rate of the nation's currency is not subjected to political, economic and other pressures, either internal or external. As a consequence, it has 'to maintain exchange rate at an arbitrarily chosen level. This level may exceed or else may fall short of the rate which would have been determined by the forces of demand and supply in the foreign market.

5. Providing protection to the nation's industries

Exchange control may also be used for protecting the nation's produces from external competitions. Under this policy, imports of certain products may be restricted or be totally banned in order to encourage domesic production of such goods.

6. Pursuing an independent policy

Sometimes exchange control is also used as a device to enable a country to pursue an independent policy of preventing depression or providing recovery from depression. Exchange control generally places a barrier between the world and domestic prices, so that monetary and general economic' policies could be chosen and executed without regard to their efforts on the balance of payments.

7. For effective economic planning

For successful economic planning, the government has to control the entire economic edifice of the country. It has to co-ordinate all economic policies in order. to accomplish the national goals contained in the plan documents. Foreign trade and capital flow has also to be regulated in order to successfully implement the programmes of national economic development.

8. Other objectives

Exchange control may also be resorted to for restricting the purchase of arms intended by an unfriendly country. Likewise, a government may try to maintain an arbitrarily fixed (overvalued) exchange rate through exchange control. A nation with heavy burden of external debts, may resort to exchange control devices for reducing the burden of debt-payment or debt-servicing.

In the following figure Indian rupees are represented as the home currency while the foreign currency is represented by the U.S. dollar. The vertical axis shows the price of one dollar in terms of Indian rupees; while the horizontal one indicates the number of dollars traded. On the basis of demand and supply functions given in Fig.1, the equilibrium exchange rate of one dollar should be Rs.5/- or one can say that I rupee equals 20 cents. This is the price which clears the market. Generally a free market, the available dollars will be allocated among various competing uses at this (equilibrium) exchange rate.

Should the Indian Government decide to fix the dollar at 4 rupees, the dollar would be undervalued (and rupee would be over-valued), as compared to its equilibrium price. In a free market, this arbitrary exchange rate is not sustainable for a long period of time; for at this rate, the supply of dollars would be cb whereas its demand would be ed. This under valuation of dollar would create excess demand for dollars in the amount bd. If the Indian government refuses to devalue Indian rupee (from 1 rupee = 25 cents to its equilibrium rate of 1 rupee = 20 cents) it would force to impose exchange control. Thus through exchange control it would be possible to maintain an exchange' rate that departs from its equilibrium value. In this situation, the allocation of available foreign exchange (dollars) in the amount cb will be done by the government through Reserve Bank of India rather than by the market demand for and supply of dollars.

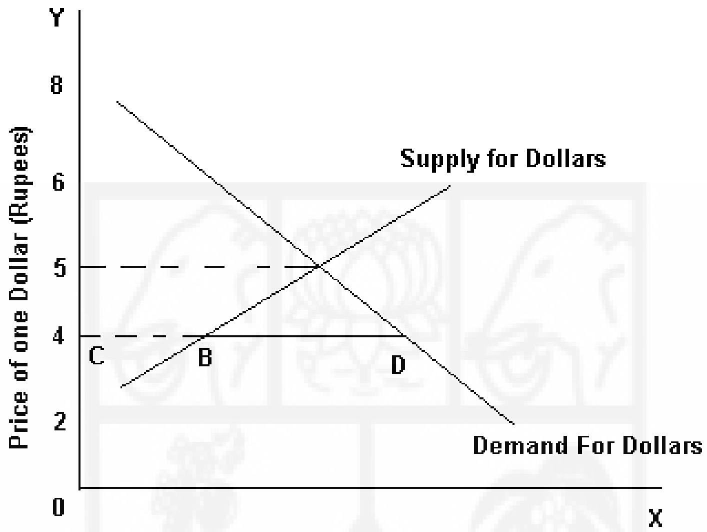

Fig. 15.1 Equilibrium and Undervalued Rates of Exchange

15.4 METHODS OF EXCHANGE CONTROL

Prof. Paul Einzig has mentioned 41 different methods of exchange control in his book. However the important methods of exchange control can be placed in the following two categories:

1. Unilateral Methods

The unilateral methods of exchange control refer to those measures which are introduced by the government of a country without involving any other government or without giving any regard to the effects of foreign exchange control on other countries. These methods include:

i) Regulation of Bank Rate and Foreign Trade;

ii) Exchange Pegging;

iii) Blocked Accounts and iv) Rationing of Foreign Exchange etc.

As noted above, these measures are adopted by a government without consulting any other government.

2. Bilateral Or Multilateral Methods

In contrast to the unilateral methods of exchange control, introduction of bilateral or multilateral methods necessarily involves two or more countries. The governments of these countries agree to introduce various methods of exchange control in order to accomplish the given (economic) objectives.

Such bilateral or multilateral methods include:

i) Clearing of Agreement;

ii) Payments of Agreements and

iii) Transfer Moratoria etc.

Obviously the successful operation of these methods can be ensured only through mutual co-operation among different signatories of such agreements.

Various methods of exchange control can also be classified into direct methods and indirect methods. Direct methods of exchange control have a direct bearing on the foreign exchange rate and availability of foreign exchange. Conversely, the indirect methods of exchange control are directed to accomplish some other major objectives. But somehow they also affect the foreign exchange market and the foreign exchange rate prevailing therein. These indirect methods also include the policies related to rate of interest and import & export trade. We shall now discuss the various methods of exchange control.

A) Direct methods

1. Buying and Selling of Currency by Government: This is probably the most convenient device of exchange control for the government of a country. If it is realised that the exchange rate of Indian rupee in the foreign exchanges is too low, the Reserve Bank of India may be directed to buy rupees against U.S. dollars (or any other popular currency). Such an operations will increase the supply of dollars and reduce its equilibrium price (exchange rate) in the free foreign exchange market. In other words, buying of rupees would increase its equilibrium rate of exchange. On the other hand, in order to bring down the equilibrium rate of exchange (or to raise the price of U.S. dollar expressed in Indian rupee), the Reserve Bank of India will buy dollars for Indian rupees in the free exchange market.

The operation of a central bank to raise the exchange rate of Indian rupee (say from 1 rupee s 120 cents; to 25 cents) is termed as pegging l'p; whereas the attempt of central bank to bring down the exchange rate of Indian rupee (reverse to above) is termed as 'pegging down'. In short, under the 'pegging up' operations a central bank must keep itself ready to buy any amount of Indian rupees and sell U.S. dollars; whereas under the 'pegging down' operations it will have to keep itself ready for selling any amount of Indian rupees and buy U.S. dollars. The central objective of 'pegging' operations is, therefore to stabilize the exchange rate of Indian rupee expressed in U.S. dollars; or of U.S. dollars expressed in Indian rupees at certain level.

In the present context however, more of the developing countries are confronted with the problem of acute shortage of foreign currencies. In the free exchange market the rate of exchange of Indian rupee would have been depressed to a very low level. 'Pegging up' operations under such circumstances would require the sale of U.S. dollars and purchase of Indian rupees in any amount by the Reserve Bank of India. How ever this does not seem possible in the present context. 'Pegging up' as a device to stabilize the foreign exchange rate is therefore a difficult task for the developing countries; as it involves holding of sufficient reserves of U.S.

dollars and/ or any other foreign currency. On the contrary, 'pegging down' is relatively easier for these countries, as it requires them to hold sufficient amount of their own currencies which they would be ready to sell for U.S. dollars in any quantity. .

2. Blocked Accounts: Under this measure, a heavily indebted country imposes restrictions on the transfer of funds by foreigners. Repayment of debt and payment of interest to creditors or payment of dividend to foreigners on their investment are stopped. Blocked accounts refer to bank deposits, securities and other assets held by foreign nationals in a country which denies them the conversion of these into their home currencies. The central bank of the country introducing the policy of blocked accounts would deposit such amounts in the accounts of such foreign nationals. However, the foreigners would not be permitted to convert such credit balances into their home currencies; albeit in certain circumstances they may be permitted to use such balances in the same country.

The device of 'blocked accounts' was first adopted by Germany in 1931, followed by Austria and a few other countries of Central Europe. In Germany such policy was directed mainly against jews who were expelled from the country and whose assets were placed in blocked accounts. U.K. also resorted to this device in 1940' albeit the government permitted such account-holders to transfer their balances to other foreigners.

'Blocked accounts' scheme is generally painful and adversely affects the reputation of a country. Further, the foreign trade of a country introducing such scheme is reduced to the minimum. Generally, exports to such a country are restricted by other countries; while payments to the former for its own exports, are blocked by the rival governments. Further more, the device of blocked accounts' leads to black marketing of the blocked assets which is known as 'black hours'.

3. Exchange Restrictions: Under this measure the government of a to reduce or restrict the flow of domestic currency in the foreign exchange market. Individuals and firms are required to receive to make payments in foreign currency exclusively through a central authority, generally the country's central bank. The exchange of domestic currency against any foreign currency can be done only with permission from such an agency.

Generally exchange restrictions are introduced along with a package of multiple exchange rates. Under this system different exchange rates are set for different categories of exports and imports. During the Great Depression of thirties multiple exchange rates were adopted in a number of Latin American countries. Later, Germany introduced various types of marks (such as, Register marks, Handel Marks, Block Marks, Travel Marks, Sonder Marks. Aski Marks etc.) for different types of payments. The method of multiple exchange rates is quite useful if a country can successfully adopt low exchange rates in respect of those currencies which are needed in large quantity for importing essential goods. Conversely, for the exports having inelastic demand, setting high exchange rate for the nation's currency will be advantageous.

It may be noted that high exchange rates also discourage the import of those goods which have highly elastic demand, whereas low rates facilitate the import of foreign goods. To quote Kindleberger, "A system of multiple foreign exchange rates can be equated to a system of tariffs and subsidies 'on imports and exports with the same effects on consumption, production, balance of payments and revenue."

However, execution of the policy of multiple -exchange rate is a difficult task. It is a complicated method of exchange control and generally results in the evolution of inconsistent cross rates of foreign exchange. Further, there is always a danger of retaliation by those countries which are adversely affected by the policy of exchange restrictions, especially by the policy of multiple-exchange rates. This may result in a further deterioration of the country's balance of payment disequilibrium. Finally, the government deciding on the adoption of such measures of exchange control must be cautious in setting exchange rates for different currencies. The government has to be strick on black-marketers etc., whose actions are likely to defeat the very purpose of exchange restrictions.

4. Rationing of Foreign Exchange: Under this system also the government forbids all purchases and sales of foreign exchange in the open market. All the foreign exchange earnings of country's exporters are acquired and allocated by the government among importers in the order of priorities assigned to different imports. These steps are taken to improve the country's balance of payments through restricting imports.

5. Exchange Clearing Agreements: Exchange clearing agreements are generally made by two countries in order to settle their accounts through their respective central banks. Under these agreements, rather than permitting individual exporters and importers to settle their accounts by calling for or making payments in foreign currencies all such entries are made in the accounts of central banks, and at the end of a given period, the final balance is used for, settling all the accounts.Each importer makes payment in the home currency to the central bank whereas every exporter receives payment form the central bank in the home currency. This arrangement saves the importer from the botheration of purchasing foreign currency and remitting the same to his creditor. Likewise, the exporter also saves himself from the botheration of collecting home currency against the cheques, bills or draft received from abroad. This is essentially an arrangement of offsetting each other's payments and usually helps those countries, which have very little foreign exchange in their reserves.

Fig. 15.2 shows a simple two-country two-trader model of foreign exchange clearing agreements. However, this model can be conveniently extended to cover a large number of exporters and importers.

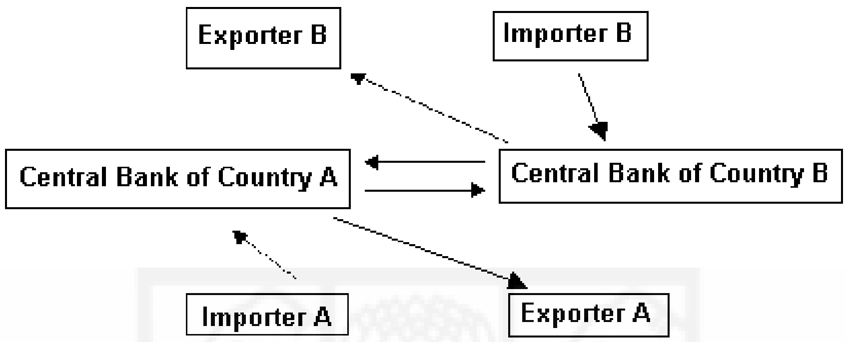

Fig.15.2 Exchange Clearing Agreement

It is evident from Fig 2 that under the exchange clearing agreement, central banks of the concerned nations assume the responsibility of receiving from the making payments to: the importers and exporters in domestic currency. At the end of the accounting period, their aggregative accounts are settled. During this period, however, foreign trade between the two countries takes the shape of barter-exchange on a national exchange. It is assumed that exporters from country A to country B will pay for the goods imported from the latter. It is the residual balance of their accounts which is eventually settled in foreign currency.

From 1931 to 1939 this device was practised by several European countries. However, this method of exchange control has not proved very popular. Briefly stated, exchange clearing , agreements suffer from the following drawbacks:

(i) Bartering of goods puts to an end the freedom of decision making in international trade. This in turn reduces the scope and quantum of a country's foreign trade. (ii) Generally economically backward countries fail to benefit from such clearing agreements. Past experience reveals that the relatively strong countries dictate their own terms in the foreign exchange clearing agreements. (iii) International trade under these agreements is no more based on any principles. Instead a country has to buy from or export goods to the other signatory of such agreement, even though such dealing may not be profitable. Germany strengthened its economy during the Great Depression through exchange clearing agreements but Hungary was compelled to buy watches from Switzerland under: their exchange clearing agreement, (iv) Since all the payments are centralised under these agreements, with every increase in the number of goods traded or in the number of exporters and importers, the concerned central banks find it increasingly difficult to manage the whole affair.

6. Payment Agreements: Under these agreements a creditor country provides acc6mmodation to a debtor country by accepting the latter goods towards the repayment of debt and payment of interest. At the same time, attempt is made by the-4lebtor country to minimise its imports from the creditor country. Thus payment agreements tend to regenerate liquidity in the international exchange arrangement. It is one of the several ways of rationing the scarce foreign exchange,

Nevertheless payments agreements help the heavily indebted countries to discharge their debts, and at the same time, enable them to continue their essential imports.

However, these agreements are also carried out by the central banks of the two contracting nations. The central banks of a country would make the necessary payment in home currency to a creditor only after hearing from its counter-part in a debtor's country that the debtor had discharged his obligation. Thus there are mutual agreements between the two central banks ensuring that adequate credit facilities are available depsite the heavy burden of de bt on either of the two countries.

7. Transfer Moratoria: This device may also be practised by a debtor country. Payments for imports, debt servicing and repayment is deferred for some time under an agreement between the two countries. The importer or the debtor discharges his obligation in the home currency and deposits the necessary amount with the central bank of his country which in turn would remit an equivalent amount in foreign currency after the expiry of the term of agreement. However, creditors are sometimes given a privilege to utilize or invest such amount in the debtor country even before the expiry of the specified period. Thus, through a moratorium on transfer-payments, a debtor country can save itself from the embarrassment and agony which it would otherwise have due to scarcity of foreign exchange.

8. Standstill Agreements: The principal objective of standstill agreements is to check the flow of capital between two countries. This is done either by installment payment of internal loans and/or by changing short-term loans into long-term loans through the device of debt-rescheduling.

9. Compensating Trade Agreements: Compensating Trade Agreement between two countries to the agreement by which country agrees to export goods worth the same value which it owes to the other nation for the goods imported by it.

A compensating agreement can be made between private firms (with or without government approval) or between government/semi-government institutions. A private compensating trade agreement involves the participation of four individual or firms. For example, let us assume cotton textiles

I from India are to be exchanged with, jute goods from Bangladesh. In order to give a formal shape to this agreement, four groups are needed; (i) Indian importer of jute goods, (ii) Exporter of jute goods in Bangladesh, (ill) Indian exporter of cotton Textiles, and (iv) importer of cotton textiles in Bangladesh. Under a compensating trade agreement the Indian importer of jute goods will make payment to the Indian exporter of cotton textiles for discharing his obligation. At the same time the importer of cotton textiles in Bangladesh will make payment in Takka (their domestic currency) to the exporter of jute goods in Bangladesh itself. Thus, compensations agreement saves the Indian as well as Bangladesh traders from the botheration of obtaining foreign exchanges.

This procedure can be explained in the following equations:

$X_j=M_j$

$X_o=M_o$

$X_j = M_o$

$X_o=M_j$

but since therefore where X_j = exports of jute goods, M_j = import of jute. goods, X_o = export of cotton textiles and M_o = import of cotton textiles. However, such agreement can be made and be enforced if only the values of exports and imports are equal.

10. Exchange Equalisation Accounts- (EEA): After the adornment of the gold standard by U.K. in September, 1931, the first "exchange equalisation account" was established by the British Government. The British government wanted to check variations in the exchange rate. Later such funds were established in Frtince U.S.A., Holland, Belgium and Switzerland too. Under this measure the Central Bank creates a fund consisting of gold, foreign currencies and domestic currency.

From time to time this fund is used for effecting sales and purchases of foreign exchange which are directed to check temporary changes in the foreign exchange rate. In its initial phase of operation the government may also issue short run bills. The mechanism of operating an EEA is simple. When a foreigner wants to buy our (domestic) currency the government would sell rupees for the same amount and buy foreign exchange or gold through the EEA. The foreigner would now hold a rupee-asset, and the Central Bank (via its EEA) would have foreign currency or gold which it would be holding outside the banking system.

B) Indirect Methods

As noted above there are a few measures which affect the exchange rate of a country via their effects on imports and exports. In other words, such methods of exchange control have indirect effect on the exchange rate. Duties on imports etc., and fixation of import quotas for example impose restrictions on imports and tend to reduce the volume of imports. Such measures are taken by the government in order to increase the value of domestic currency and to reduce the demand for-foreign exchange.

The government may also provide incentives to exporters, and through export counties or subsidies may attempt to boost exports, thus raising the demand for domestic currency. Thus restrictive policy for imports and/or provision of incentives for exports tends to increase the value of domestic currency via their influence on the demand for foreign and/or domestic currencies.

Finally, changes in interest rate may also be introduced in. order to influence the flow of capital from one country to the other. An increase in the rate of interest in one country will attract liquid funds from other countries. At the same time, such a measure will prevent outflow of capital from this country. However, reduction in the interest rate will have an adverse effect on the flow of capital.

15.5 APPRAISING THE MERITS OF EXCHANGE CONTROL

It has been stated above the country would generally resort to exchange control if only adoption of such measures is unavoidable. Exchange control protects as relatively backward nation from violent oscillations occuring in the world economy. It particularly helps those countries which have very inadequate reserves of gold and foreign currencies. Moreover, exchange control enables such countries to import foreign made products on a priority basis and helps them to improve their balance of payment situation. For all these reasons, exchange control has become an integral part of national economic policy in several countries of the world.

However, these merits of exchange control are based on the heroic assumption that these devices are "practised by a nation without inducing reaction or retaliation among other nations If several countries resort to the policy of exchange control many of its micro-level benefits will disappear. Instead simultaneous adoption of exchange control measures may have the following bad effects:

1. Developmnt Of Economic Nationalism

Chauvinistic polices introduced by the more advanced countries may often benefit them at the cost of economically backward nations. Generally, measures of exchange control are taken with a strong feeling of nationalism which goes contrary to the feeling of mutual help and economic co-operation among different nations.

2. Contraction Of International Trade

Simultaneous introduction of exchange control by many countries and attempt by all of them to limit their imports will reduce the quantum of international trade. The objective of increasing the export earnings is thus defeated by these policies of mutual distrust among different nations.

Exchange control encourages bilateral agreement: and thus does away with the advantages which different countries would otherwise be getting from multi-lateral trade and convertibility of different currencies.

3. Compulsion Replaces Choice In International Trade

In a free and competitive world market, every country is able to buy and sell goods at competitive prices. Introduction of exchange control does away with such independent decision making and makes trade possible only between two contracting nations. These countries have to trade different goods not at their competitive prices but at the prices mutually agreed upon. Generally, such agreements do not permit these countries to procure goods at their competitive (minimum) prices, as such prices will now be depending on the relative bargaining power of the contracting parties.

4. Exchange Control Gives Extensive Powers To The Government Authorities

The successful implementation of exchange control measures will largely depend on the efficiency and integrity of these officials. Generally these measures fail to accomplish the desired goals because the government officials responsible for carrying out various exchange control devices behave in an indiscriminating bureaucratic fashion. There is always a danger of losses occuring to the nation's economy on account of careless and inefficient bureaucratic decisions.

5. Since exchange control devices tend to ration the scarce foreign exchange reserves and at the same time, attempt is made to maintain an overvalued exchange rate for the domestic currency, such measures encourage black marketing and corruption in the foreign exchange markets. It also bugets smuggling of foreign currencies and/ or under-or over-invoicing in the foreign trade.

6. Exchange control offers an instant remedy for the problem of deficit in the balance of payments. However, due to its adverse effects on the quantum of foreign trade, it creates a more basic disequilibrium in the long run. Exchange control can have its desired effects only in those countries the demand for whose effects only in those countries the demand for whose exports is inelastic, and at the same time, which imports goods with a very high elasticity of demand.

Despite these limitations exchange control continues to remain an important part of national economic policies. In fact, revocation of exchange control devices by a single country will prove to be a suicidal decision unless other countries also follow suit. The International Monetary Fund is endeavouring to minimise the scope for member nation's exchange control devices, yet in the present atmosphere of mutual distrust among different nations the I.M.F. may not achieve a great success.

15.6 EXCHANGE CONTRQL IN INDIA

Exchange control in\ India was introduced during the Second World War. In September, 1939, the Reserve Bank of India issued a notification regarding the various restrictions that were imposed on the purchase and sale of foreign currencies. It declared that foreign exchange could be used only under the authority of the Exchange Control Department of the R.B.I. The use of foreign exchange was limited to some specific purposes only. Later, the entire British empire was organised into a Sterling Area. Buying and selling of various currencies of the Sterling Area and transfer of funds among the British Colonies were kept outside the scope of exchange control devices. However, payments to individuals and firms outside the Sterling Area were subjected to strict control. Further, in order to check speculative flow of capital, even the sale and purchase of currencies belonging to the Sterling Area could be done only by the authorised Banks.

As a consequence of strict control on the foreign exchange transactions during the World War II, India accumulated huge sterling balances to her credit by 1945. Her exports during the war rose faster than her imports. However, due to a persistent demand for imports and danger of exports slackening down after the war, the government chose to continue its exchange control policy even after 1945.

In March, 1947, under the Foreign Exchange Regulations Act, the Reserve Bank of India was given complete and permanent authority over the allocation of foreign exchange.

The scope of exchange control was enlarged and by July, 1947, even the currencies of Sterling Area were brought under its fold.

During the post Independence era the Government of India has maintained a strict control on our imports, whereas all out efforts have been made to increase the volume of Indian exports.

Under the Foreign Exchange Regulation Act of 1947, purchase and sale of foreign currencies in India can be done only by authorised agencies and commercial banks. These Agencies/banks can however, sell foreign currencies to those Indian firms and individuals who have obtained requisite permits from the R.B.I. to this effect. Generally, foreign exchange permits are issued only for specified purposes and to those importers who hold import-licences.

From time to time Government in its Gazette notifies changes made in the foreign exchange regulations, albeit the basic policy about the allocation of foreign exchange is governed by the Foreign Exchange Regulation of 1947.

The basic rates of, exchange of Indian rupee are determined by the I.M.F., but the market rates are allowed to fluctuate within specified limits. The Indian rupee was linked with the pound sterling for quite a long time. However, due to erosion of pound in value by 29 per cent since 1971 in relation to German mark and U.S. dollar, the Government of India delinked rupee from the British pound in September, 1975. The rupee-pound parity (exchange rate) was changed from Rs.18.60 to a pound to Rs.18.3084, representing an upward revaluation by 1.575 per cent. At the same time the Government decided to express the exchange rate of Indian rupee in terms of a basket of nine international currencies. Thus a rupee has now moved from 'monogamy' a system of ' flexible polygamy'.

SUMMARY

The balance of payments is a useful statement in the study of international economic transactions. Transactions entered on the balance of payments constitute the transfer of assets and liabilities, the creation or the reduction of claims or the receipts and payments of funds. Disequilibrium in the balance of payments can arise owing to a large number of causes.

KEYWORDS

- Reconcile
- Arbitrary
- Embrassement

❖ Discriminating

REVIEW QUESTIONS

1. What are the principal objectives of excange control? Describe the methods of exchange control.
2. What do you mean by exchange control? Describe the measures which can be adopted for achieving exchange control.
3. Distinguish between exchange management and exchange control. Why did most countries of the world adopt exchange control methods during and after the World War?
4. Describe the indirect methods of exchange control and show how far are they effective?
5. What are the main objectives of exchange control? Discuss the nature of exchange control instituted in India for the implementation of her five year plans. Examine these measures critically.
6. Write short notes on (i) Blocked Accounts (ii) Exchange Clearing Agreements, (iii) Payments Agreements,. and (iv) Multiple Exchange Rates.
7. What are the various kinds of balance of payments concepts?
8. Explain equilibrium and disequilibrium in the balance of payments
9. Discuss the various kinds of disequilibrium in the balance of payments.

SUGGESTED READINGS

1. K.P.M. Sundaram - Money Banking and International Trade

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WITH COURAGE AND FAITH
ANNAMALAI UNIVERSITY

LESSON 16

EXPORT PROMOTION - INCENTIVES & SUBSIDIES

OBJECTIVES

After reading this lesson, you should be able,

- to know the ways of promoting export production.
- to know the assistance in marketing and tax concession.
- to understand about export finace, foreign exchange and visa facilities.

STRUCTURE

16.1 INTRODUCTION

The government of Indian had set up a number of institutions whose main functions are to help on exporter in its export efforts. It is therefore, necessary for the exporter to acquaint themselves with these institutions and the nature of help they can render to them so that they can initially contact them to get whatever help they could get from these institution in exporting their products.

16.2 PROMOTION EXPORT PRODUCTION

Export production is a necessary pre-condition for export expansion. The basic idea of Government help in the area of production is to enable the exporters to undertake export production on a continuing and long-term basis by ensuring regular supply of imported/indigenous raw materials.

A) Import Facilities as Actual Users

Under the Import Policy the actual users (industrial) can meet their requirement of imported raw materials, components, consumables and spares under the following provisions:

i) Open General Licences;

ii) Supplementary Licences; and

iii) Allotment by canalised agencies.

An actual user is free to import, under Open General Licence (OGL), a large number of raw materials, components, consumables and spares required for his manufacturing purposes. Jigs, fixtures, moulds and press tools other than those listed in Appendices 1 - Part A, 2 and 3, can also be imported under OGL. These items can also be imported by export houses/ trading houses against addition licenses. Some of these items can also be imported by all persons for stock and sale.

Import Of Spares

a) Import of permissible spares other than the items appearing individually; in Appendices 2 38 and 10 (restricted/limited permissible items) will be allowed under Open General Licence subject to actual use and other conditions laid down in Appendix 6.

b) Restricted spares will be allowed on the basis of the certified value of capital goods installed or in use as on 1st April of the licensing year. However, this is limited to 2 per cent of the c.i.f. value of Imported capital goods and/or 1 per cent of the purchase price of indigenous capital goods with Imported components. Value limit for a single spare shall not exceed Rs.3 lakhs.

c) Import of emergency spares will be allowed in the case of an I actual breakdown or imminent breakdown machinery on the basis of a declaration from the Chief Executive to that effect giving the broad particulars necessitating emergency import.

d) All indigenous manufacturers of capital goods listed in Appendix 9 can get import licences for spares at 1.5 per cent of the ex-factory value of production or 2 per cent of c.i.f. value of imported components, whichever is .higher, to provide warrant after sales services to the consumers. The maximum value of such a Licence will be Rs.251akhs (Rs.50 lakhs for manufacturers of power boilers or turbo generators of capacity 60 MW and above and earth moving equipment).

e) Import of spares is also allowed to consultancy, designing and engineering firms implementing turnkey projects upto 2 per cent of the value of imported equipment or 1 per cent of the total purchase price of the indigenous equipment.

Supplementary Licences

In case the requirements of actual users (industrial) cannot be the met under the OGL provisions, they can supply for r supplementary import licences through their sponsoring authorities.

Applications for the grant of supplementary licences will be entertained only for items listed in Appendices 2 - Part B and 3 of the Import Policy. Import of items appearing in the Restricted List may be allowed by the Chief Controller of reports and Exports (CCI & E) where it is considered necessary. Import of items appearing in the Limited Permissible List may be allowed only to the extent of requirements which cannot be met from indigenous sources. Applications must be submitted with reasons why the materials are required. They would be considered on merits of each individual case.

For determining the value of the Supplementary licences, the phased man1dacturing programme of indigenisation past consumption of imported raw materials, stock in hand and those in pipeline and the value of un utilised licences will be taken into account. Import of canalised items may also be allowed by the CCI & E against a Supplementary licence if considered necessary.

Units which came into existence under the earlier licensing periods but had no or small amount of consumption of imported raw materials, etc. in any of the two preceding financial years can also apply for the supplementary licences.

Repeat Operation of Supplementary Licences -Units which exported a minimum 25 percent of their production in any of the two preceding financial years, subject to a minimum of Rs.10 lakhs in POB value, are permitted a repeat operation of the supplementary licence issued in the preceding year. The value of the supplementary licence shall remain the same. The items in the existing licence will also remain the same. This ‘repeat’ licence shall be valid for a period of 18 months from the date of endorsement. Supplementary Licences will be valid for import of additional items including an item appearing in the Limited Permissible List. The value of a single limited permissible item shall not exceed Rs.2lakhs (c.i.f.) and the total value of all items should not exceed 10 per cent of the overall value of the Supplementary Licence subject to a maximum of Rs.20 lakhs.

The 'repeat operation' facility will be allowed only once and in the following year the actual user will be required to follow' the normal procedure.

Chanlized Items

The items which have been chanalised (Appendix 5 - Parts A and B) are imported through designated public sector agencies. The chanalising agency can sell the imported goods before their actual arrival at the Indian port. In the case of items appearing in Appendix 5 - Part A, the actual users are required to register their six-monthly requirements or annual requirements with the canalising agency concerned, together with earnest money calculated at 2 per cent of the sale value of the quantity so registered or Rs.1,00,000 whichever is less.

In case the canalising agency is in a position to make the supplies, they will send requisite intimation to the actual user. In case, however, the canalising agency is unable to make supplies, it will issue a No Objection Certificate within a period of 30 days from the date of/receipt of requirements. On the basis of such as NOC, the actual users can apply for direct import licences.

The actual users can apply for direct import licences for newly canalised items to the extent of 25 per cent of their previous year's consumption of imported material. For the remaining quantity, the actual users have to approach the canalising agencies. And in case the concerned canalising agency is not in a position to arrange imports, then here too an NOC will be issued so that direct import licences can be procured.

B. Import Replenishment Licences For Registered Exporters

Registered exporters comprise merchant exporters, manufacturer-exporters and export and trading houses. The objective of import replenishment licences is to provide to the registered exporters imported materials required in the manufacture of the product exported.

1. Replenishment Licence (REP Licence) is not available for (i) re-export of imported goods without any processing, (ii) export of spares as free replenishment in the warranty period, (iii) exports to Bangladesh against Commodity Grants made in 19-75 (iv) export of goods by 100 per cent export. oriented units and units located in Free Trade Zones/Export Processing Zones, and (v) products covered in Appendix 12. All other exports are covered.

2. REP licences will be linked in each case to the export product. Products covered under this scheme are included in Appendix 17 of the Import Policy.

3. Import replenishment is made on a pre-determined percentage basis for every product covered. The extent of import replenishment permissible against each product is given in column 3 of Appendix. 17.

C. Duty Exemption Scheme

The objective of the scheme is to make available to the registered exporters the necessary inputs for export production at international prices without payment of customs duty so as to make exports competitive in the international market: But applications for grant of licences under the duty exemption scheme would not be entertained if the customs duty exemption involved is less than Rs.l0,000. Again, materials imported under the scheme would be subject to actual user condition even if the materials are given to the supporting manufacturers. More over, licences issued under this scheme will have both quantity and value limitations.

The duty exception scheme covers three categories of licences. (i). Advances Licences (ii). Intermediate Advances Licences (iii). Special Imprest Licences.

Advances licences are issued to registered exporters for import of duty-free materials for manufacture and export of the resultant products of to replenish the materials which have gone into anticipation of the grant of the advances licences. These licences are issued subject to conditions prescribed under Appendix-13-A.

Intermediate advances licences cover those cases where two manufacturing units jointly apply for advances licences for the purpose of manufacturing of the export product in more than one stage in two different industrial establishment. The duty-free materials are imported by the first stage manufactures who converts them into intermediate products and supplies them to another manufacturer for further processing and export. Both the first stage manufacturer and the ultimate exporter would have to execute separate bonds. The export obligation of the intermediate manufacturer and the ultimate exporter within the stipulated time. The manufacturer of the intermediate product will also have the option of directly exporting his product with the permission of the licensing authority provided the prescribed value addition norms are fulfilled.

Special imprest licences are issued to registered exporters for the duty0free import of raw materials and components required for manufactured and supply of products to Pre Trade Zones/Export; Processing Zones/100 percent export-oriented units as also for suppliers treated as deemed exports (explained below).

Licences are issued under this scheme only if (i) registered exporters hold valid export orders under their own names and (ii). they are able to realise foreign exchange in their own names for the products proposed to be exported. in addition, there should be a minimum value addition of 33 percent or higher as specified in Appendix 13-D of the Import policy. However, this value addition may be reduced by the Advances Licensing Committee to 25 percent in certain cases. The value addition will be calculated taking the f.o.b value of exports vis-à-vis c.i.f value of imports.

A registered manufacturer-exporter who is engaged in actual production and has been exporting during the preceding three licensing years will be eligible to obtain licences under this scheme without any specific order. The import entitlement would be based on the annual average past performance of the particular export product during the preseding three-licensing years.

The license holder under the duty exception scheme is eligible to a special REP licence after has fulfilled the export obligation. The value of the special REP licence will be equal to 10 percent of the value addition achieved (i.e. f.o.b value of exports minus c.i.f. value of imports). However, the value of the special import licence will be limited to the REP entitlement on total f.o.b value of exports as per Appendix 17 or as per para 166(2) of the Import Policy. At the time of the discharge of the export obiligation, the licensing holder indicating his REP entitlement and he has to apply for special REP licence within three months of the issue of the "Entitlement Certificate".

D. Import Export Pass Book Scheme

The scheme provides eligible exporters the facility of duty free import of raw materials, components and consumables required for the manufacturer of an export product and packing materials or mandatory spares to be re-exported along with the export product.

This scheme is applicable to registered manufacturer exporters who have been regularly manufacturing and exporting and also to Export/Trading houses who have regularly been exporting during the preceding three licensing periods. A manufacturers registered with the export promotion council concerned and having a minimum annual average domestic turnover or Rs.15 crores during the preceding three licensing periods but having no insignificant export performance will also be eligible for the issue of an Import Export Pass Book.

Pass Book licences will be issued only for export of products specified in Column 2 of Appendix 14.A at the rates specified in column 4 thereof. The total value of the Pass Book licences will be based on: (i) annual average f.o.b. exports of products covered be Appendix 14.A during the preceding three licensing periods plus 25 per cent or (ii) the best year's exports of those products in any of the three preceding licensing years plus 10 per cent whichever is more. The export value so arrived at will be further increased to 1-1/2 times to compute the value for base exports. The maximum import entitlement would be worked out by applying the relevant import entitlement rate of Appendix 14-A in the Base Exports. Exports would also include deemed exports. However, in the case of the Pass Book issued on the basis of average domestic turnover, the total import entitlement would be limited to 10 per cent of the annual average turnover.

The pass book bolder is also eligible for the issue of a special REP licence after he has discharged the export obligation as is the case with duty exemption scheme.

Other Facilities for Encouraging Export Production

1. Foreign Collaboration in Export-oriented Units

a) It will be permitted more freely in primarily export-oriented units.

b) The policy of not allowing foreign collaboration in trading activity may also be relaxed provided it is intended exclusively for exports.

c) Foreign collaboration might be considered even in the low priority sectors if the collaboration agreement provides for the greater part of production to be exported.

2. Industrial Licensing

The major focus of industrial policy is on the removal of licensing restrictions where such restrictions are proving to be a constraint in capacity creation for export production. The measures taken in this direction includes: (a) In selected areas, industrial licensing policy has been liberalised with a view to make industry competitive internationally in regard to the skills of production and technology. (b) The asset limit for MRTP companies was put up from Rs.20 crores to Rs.100 crores. (c) The policy of broad-banding has been extended to a large number of items particularly in identified thrust areas so as to provide production units with requisite flexibility to adjust their production to the prevailing international demand (d) Exemption from the industrial licensing requirements has been granted since September 1986 for any expansion of capacity exclusively for export production. Relaxation from the provisions of the MRTP Act has also been made. (e) It has been decided in principle that export production will be exempted from industrial licensing. Export sales would be excluded while computing production of an undertaking for determining its dominance (f). It has been agreed in principle that firms which are willing to export 60 per cent of their production should be allowed to manufacture selected goods with good export potential. However, the stipulation that firms should set up such industries in backward areas, remains. (g) A liberal approach would be adopted for constant upgradation of technologies in the key sectors, particularly engineering goods, which would be linked to export obligation, if necessary. A sub-committee of the FIB has been set up to provide a fast-track clearance for this purpose.

3. *Relaxation of the MRTP Act.*

Big industrial houses are allowed to enter the middle sector provided they agree to export 60 per cent of their production. Large business houses, foreign companies and dominant undertakings may also be allowed to enter the field reserved for small-scale industries provided they guarantee to export 75 per cent of their production.

Export sales will be excluded while computing the production of an undertaking for determining its dominance. In allowing automatic expansion of a dominant undertaking consideration would be given for its previous export performance.

For starting industries in the free trade zones, procedures have been liberalized. Firms desiring to do so need not give an application under the MRTP Act. There is no need to publish notices in the newspapers. The Boards of these zones function as Advisory Committee or the Licensing Committee/MRTP Committee for purposes of the MRTP Act. There is, moreover, no public hearing as in the case of applications in other places.

4. *Free Trade Zones*

There are six Free Trade Zones, at Kandla, Santa Cruz (Bombay), Cochin, Madras, Falta (Calcutta) and Noida (NEW Delhi) where facilities are available for export production. Supplies can be obtained in these ones for further production without payment of excise duty or import duty. Importation is possible without prices licensing. However, it is obligatory on the exporting units to export 100 percent of their production.

Export from these zones are not eligible for replenishment license or cash compensatory support. However all units in the Free trade Cones are eligible for a tax holiday for a period of 5 years in lieu of the esisting concession available for any continuous block of 5 years within 8 years of commencement of production.

In the Free Trade Zones, foreign investments is welcome and conditions for investment are more liable than in the domestic tariff area.

In so far as Kandla Free Trade Zone is concerned, the following special facilities are available to the units located in the Zone.

-- Transport subside is paid o the some units to compensate for the extra expenditure incurred by them on import export through Bombay Port.

-- Gujarat government pays cash subsidy on fixed investment in plant, building and machinery @15 per cent subject to a miximum of Rs.25 lakhs.

-- Purchase from Gujarat State are exempted from Gujarat sales tax.

-- Central sales tax paid on purchase from other states is reimbursed in full by the Zone administration.

-- Scarp and rejects cane be sold in the domestic market on payment of duty to the extent of 5 percent. in addition, 25 percent of production can be sold in the domestic tariff area against valid import licences.

-- Zone units are assured of regular power supply. Power cuts are not applicable in the Zone.

-- Term loans and packing credits are available at consessional rates.

5. 100 Percent Export -Oriented Units (EOUs)

These units are given all the facilities of duty-free import of capital goods, raw material and components, concession in Central excise and other Central levies and more liberal foreign collaboration terms on the lines of facilities available in free trade Zones. Unlike free trade zones, these units cane be located anywhere in India, be of any size, or even MRTP/FERA, a new factory, a new branch of existing factory or an expansion of an existing factory. The scheme is subject to the following conditions.

Such units will have to give a minimum value added of 20 percent. Domestically procured raw material will be treated as import. Export obligation will be far 10 years. This period may be reduces to 5 years in case of products with high obsolescence. The entire production shall be exported. However, they cane sell 25 percent of their production in the domestic tariff area against valid import licenses. In addition, these units can sell 5 percent of production I the domestic market provided such goods are in the nature of reject. The gestation period for generating exports would be two years from the date of sanctions after which export obligations will commence. 100 percent EOU are also entitled to a tax holiday for any continuous block of five years within 8 years if commencement of productions.

Bonding charges for individual units having bonding arrangement are to be reduces from 150 percent to 100 percent of the cost of customs tariff.

Supplies of capital goods, raw materials, stores and spares from domestic tariff area to 100 percent EOUs would be deemed as export and eligible for import replenishment. Such supplies would also be entitled to cash compensatory support to the extent of 75 % of what is admissible on similar item when physically exported of duty drawback has also been made admissible for supplies to such EOUs.

According to the latest information available, 878 applications were approved. Of the 878 approvals, 249 approvals have been cancelled and 22 units have been debonded leaving 607 valid approvals. So far 100 units have reported commencement of production and export. The cumulative export by 100 percent EOUs upto the end of March 1987 were estimated at about Rs. 492 crores.

With effect from April, 1988 100 percent EOUs and he units located in Free Trade Zone/Export Processing Zones will be given Cash Compensatory at the rate of 50 percent of the level applicable to units in the domestic tariff area.

6. Industrial Raw material Assistance Centre (IRMAC) Scheme

This scheme is intended provide off-the-shelf supply to the exporting units in case of imported items in scare supply. Such centers have been set up by the STC and MMTC. If the exporting units feel that the items are available at reasonable prices and are of requisite standards, they obtain their requirements under the IRMAC scheme on surrendering their import replenishment licences.

IRMAC facilities may also be provided to actual users and exporters in the small-scale sector by Export Corporations of the State Government registered as export houses and export/ trading houses.

7. Import of Technology

With a view of update technology for export production, applications for technology imports which involve only lumosum payment to royalty are considered more liberally. The permissible royalty for exports sales are also higher vis-a-vis domestic sales.

IN order to promote technical upgradation and modernizations, a technical Development Fund has been created to cover the foreign exchange requirement for:

a). All types of capital equipement

b). Imported technical know-know

c). Foreign consultancy services, if required

d). Import of drawing and designs , and

e). Any other inputs needed by industrial units for improving their export capability, generally or specially

The aggregate foreign exchange finance for any unit under this scheme would be limited to the foreign exchange equivalent of Rs.2 crores. The entrepreneurs will have to ensure that the proposed modernization or upgrading of technology would contribute significantly to any of the following results: quality improvement, cost reduction, productivity gains, more efficient utilization or conversion of raw materials or inputs, energy saving, enhancement of export potential and product diversifications or product mix-rationalisations.

16.3 ASSITANCE AVAILABLE FOR REDUSING THE PRICE DISADVANCTAGES

1. Supply of raw materials at international prices - this facility has been extended to all major export sectors where raw materials are used for export productions through the liberalisation of the Advance Licensing Scheme. This facility is also extended to cover components and consumables. The international price Reimbursement Scheme (IPRS) is designed to compensate the exports for higher domestic process of vital inputs like steel and aluminium. However, it is

reported that due to shortage of funds, very often exporters do not get their reimbursement in time.

2. Import of capital goods for export productions in respect of identified thrust duty free or at very low rates of duty.

3. Provisions of diesel oil at cheaper prices to firms exporting 25 percent or more of their production and desirous of installing captive power units.

4. Drawback of import duty paid on imported raw materials. In addition, a refund of excise duty is also available on exported products subject to excise duty. Effective June 1, 1988 the duty drawback rates for a large number of products have been revised upwards. Several new products have been brought under the drawback schedule For a number of new items, all industry rates have been fixed for the firs time.

For a number of products where exporters avail themselves of the benefits of Advances Licensing/Pass book Scheme for specified items, drawback rates for a large number of products have been brought under the drawback schedule. For a number of new items, all industry rates have been fixed for the first time.

On the recommendation of the Drawback Review Committee, the drawback system has been rationalized and simplified. In most cases de tailed physical and chemical testing would be avoided. The drawback claims are now sanctioned within 24 hours of presentation and the amount is then transferred to the bank account pf the exporter within 15 days.

Drawback in respect of packing materials in relation to exports of tea can be set off against export duty payable on export of tea or it may even be refunded.

5. Cash compensatory Support (CCS): The scheme of grant of cash compensatory support on export of specified non-traditional products to make Indian goods competitive in the international markets has been in operation since 1966. This form if assistance is given primarily with a view of compensating the exporter for the unrefunded taxes and levied which he has paid on the export goods and on the inputs going into the manufacture of such goods. The extent of CCS varied from product to product and ranges from 5 to 20 percent of the f.o.b value. The products which are given cash compensatory support include engineering goods, chemical and allied products, sport goods, plastic goods, processed foods, fish products, synthetic fabrics and garments , carpets and handicrafts, leather and leather goods, natural silk, madeups and garments, coir products, agricultural products, woolen textiles, cotton textiles, and jute goods. Approximately 260 items are covered by CSS.

The expenditure on cash aid increased from Rs.10.5 crores in 1967 to Rs.28.8 crores in 1970-71 to Rs.68.8 crores in 1974-75 and to Rs.344.16 crores in 1979-80. Engineering products absorbed the maximum share of cash aid(36.4 percent) in 1979-80. Other commodities were cotton textiles (13.0 Percent) leather and leather manufacturer (13.0 percent), woolen carpets rugs and druggets (8.5 percent), chemicals and allied products (7.5 percent) and jute carpet backing (3.3 percent). In 1986-87 cash aid amounted to Rs.555 crores and the budgeted figure for 1987-88 was Rs.879 crores. Subsidy per rupee of export amounts to 6.3 paise.

The government of India has reviewed the scheme of cash compensatory support. Effective from 1st July, 1986 a new scheme of CCS has come into operations and will continue till 31st March 1989. For cotton textile items the rates of CCS to be fixed under the new scheme will be valid till 31st December, 1988. The salient features of the new scheme are as follows.

i. In respect of industrial products, apart from unrebated indirect taxes, cascaded structure of taxation will also be taken into account while fixing CC rates.

ii. Compensation for market/product development will be given in a highly selective manner.

iii. For agriculture items such as fruits and vegetables, which are perishable in nature, a special compensation for high cost of transportation within India as also cost of air freight will be provided and for handicraft items, value added by labour will be one of the main factors for fixing CC rates.

iv. Discriminatory higher freight rates on account of various factors like low total volume of trade, discriminatory rates adopted by conference lines, etc., are sought to be neutralised.

v. CCS rates restricted to 25 percent of the value added i.e. fob realization less REP entitlement.

The availability of cash assistance leads to many problems, A number of instance involving misuse of cash and have been detected by the Public Accounts Committee and the Comptroller and Auditor General. There are possibilities of the importing countries accusing us of dumping and/or imposing throat competition among Indian exporters. At times, importers demand a share in the export subsides.

5. Manufacture of Bond; Though there is a provision for drawback of excise duties and import duties, businessmen are not very much satisfied as their funds are locked for a substantial period of time besides involving a lot of botheration in getting the refund. To obviate this difficulty, a provision is made for manufacture under bond. If manufacture is under bond, there is exemption from payment of customs duties and excise duties. However, to avail of these exemption actual production should be under direct supervisions of authorities concerned. However, in this respect there is a serious limitations that customs do not have their offices, at most uncountry centre. In the U.K and W.Germany, there are customs officers at every important trade center-- this facility is not available in India. Again, the cost of customs supervisions has to be borne by the part is concerned.

With effect from September, 1986 the Government has allowed CCS export of goods manufactured in 'bond' areas as well subject to two conditions. 9i) the exporter should show the minimum value addition as prescribed for advances licences and (ii) proportionate reduction in rate of CCS will be made in the case of advances and impreset licences for the import of banned and canalised items.

6. In order to boost exports of projects and consultancy services, Government of India will provide cash compensatory support (CCS) at the rate of 10 percent on net foreign exchange earnings of turkey project can package projects of civil engineering construction services, including computer services and softwares.

7. Air freight subsidy is allowed on export of leather goods. Ocean freight subsidy has also been made available to exporters of bananas to compensate for high freight rates.

8. Export sales and one sale proceedings export sales are exempted from the payment of Central Sales tax.

Assitance in the area of marketing

1. Marketing Development Assistance (MDA) : Grants are available to exporters for certain recognized export activities, such as (a) market and commodity research programmes (b) export publicity and dissemination of market information; (c) participation in foreign trade fairs and exhibitions; (d) trade delegations and study teams (e). establishment of offices and branches aboard; (f) research and development schemes

The Marketing Development Assistance also provides grants-in-aid to Export Promotions Councils and other export organizations. The expenditure on compensatory cash support to exports of select products and the subsidy paid to the banks for providing export credit to the exporters at reasonable rates of interest are also met out of the provisions under Marketing Development Assistance. The operation of the MDA is based on critical examinations of the proposals by the MDA Committee. The assistance provided by the MDA is upto 60 percent. In 1984-85, the expenditure under this head amounted to Rs. 518 crores.

The government reimbursement Indian forms 50 percent of the cost of preparation and submission of bids for turkey and construction projects, consultancy contracts as well as operations and maintenance services contracts abroad out of the MDA funds.

2. Quality Control and Preshipment Inspection: This is does to assure the foreign buyers that the quality of goods exported from India is upto the mark, 1,085 items of India's exports are covered under this scheme.

3. Bridging the Information Gap: One of the most important points made by the exporters is the yawning gap in information relating to export marketing. The Government of India has made a number of attempts to improve the flow of information. Some of the methods adopted are

a). Market Orientations Tours: The Government of India in co-operations with the ITC (UNCTAD/GATT), SIDA and the IIFT, sponsored a number of orientations tours in respect of selected non-traditional products. These tours enabled a team of Indian exporters to visit important foreign markets and study the tastes and requirements of the foreign markets and study the tastes and requirements. The members of the team were allowed to book orders in course of there investigations. The reports of these were made available to other exporters. Due to shortage ITC/SIDA funds, the programme has now been suspended. However a limited number of such tours could still be financed out of MDA funds.

b). Export Management Development programme: A 9 week programme was organized every year by the IIFT in collaborations with ITC (UNCTAD/GATT) under SIDA assistance till 1984. The programme aimed to exposing the selected young executives to the rigours of export marketing environment and developing analytical skills for proper appreciations and response to the immediate as well as long term marketing opportunities in the selected countries through marketing research on selected countries through marketing research on selected products. The reports prepared by the participants are available to other exporters.

c). A number of research studies are undertaken every year by organizations like IIFT, TDA, EPCs and commodity boards. These studies cover specific products and include overseas investigations in specific countries. Their reports usually reveal the market potential foe India's product and what could be done to exploit the available opportunities. In the late 1960s and early 1970s. a number of market surveys were commissioned by the USAID Export Promotions Divisions.

d). The TDA has been organizing buyer-seller meets,. These meets enable the Indian exporters to expose their products and to know how they can be adapted to meet the requirements of foreign buyers. The variety of products displayed as well as the number of participants have now increased.

The main objectives of the Buyer-Seller Meets are:

i. to abel the Indian manufacturers gain adequate with the quality knowledge of the demand requirements for their products.

ii. to familiarize the importers and manufactures with the quality and range of merchandise manufactured in India so as enable them to see in India possible source of supply.

iii. to identify areas of capacity creations, product development, adaptation, improvement in quality control and sales techniques.

iv. to exchange market intelligence, information on prices, quality-packing, designs, standards, etc., and

v. to establish market contact through booking spot orders and generating, designs, standards, etc, and

The TDA has also been inviting buying delegations to visit India and to see for themselves the present array of India's products and to suggest ways of adapting them to meet foreign requirements.

Some export promotions councils are organizing buyer-seller conferences. They provide a forum for an exchange of views and information on products, marketing methods, future trends and needs.

e). An information Division had been set up in the TDA. Over the years, the Trade Information Division has considerably strengthened its activities by widening its information base, establishment contacts with a number of new organisations nationals as well as international, widened its documentations services and its dissemination by bringing out a number of publications, viz Trade Intelligence Bulletin, Market Intelligence Bulletin, Market survey Reports, Reports on Contact promotions Programmes. etc., The types of information supplied by TDA include: (i) import contact for specific commodity in specific country, including agents, distributors; (ii) import regulations of overseas countries; (iii) import tariffs of overseas countries. (iv) Generalised System of preferences; (GSP) in respect of countries offering preferences; (v) import statistics on overseas countries; (vi) Overseas/Indian trade fairs and exhibitions; (vii) details of publicity media in overseas country (viii) details of Indian industrial policy including industrial licensing, foreign collaboration and joint ventures abroad; (ix) capacity and production data industry-wise for India (organised sector); (x) names and address of Indian manufacturer-exporters, export houses; (xi) Indian incentives, rates of cash compensatory support, replenishment and drawback; (xii) export documentations

The division's services are not confined TDA products bet are broad-based to include all products having export potential. So also, its services are available to the entire exporting community, members as well as non-members.

TDA also procures catalogues from overseas manufactures and department stores with a view enable the Indian exporters to collect details on prices specifications of Indian manufacturer-exporters to its foreign offices for reference by overseas by overseas importers

4. Participation in Trade Fairs and Exhibitions: The government India encourage the exporters to participate in various trade fairs and exhibitions abroad which give them an opportunity to know the requirements of foreign buyers and to exhibit their products to them. It also gives them an idea about who the competitors are, the peculiarities of the compeint products, their prices and the extent of product adaptation needed.

5. Publications: The Trade Fair Authority of India brings out regularly four journals, namely, Udyog Vypar Patrika (Hindi monthly), Indian Export Bulletin (English weekly), Midweek Review and Economic and Commercial News (English weekly). These periodicals provide authentic information on India's economy, business possibilities offered by foreign markets, Government trade policy, facilities

available for export and import and tenders floated by other countries. They also provide material to Indian Missions for their publicity efforts. The Department of Commercial Intelligence and Statistics publishes the Indian Trade Journal and the Monthly Bulletins of Imports and Exports.

The Export Promotion Councils also bring out their Home Bulletins to provide information of interest to their members. Some of these Councils also publish handbooks for the use of their exporters which detail the various procedural and other formalities to be completed by them as also the various facilities available to them.

6. Barring a few products, exporters are allowed to utilise 5 to 10 per cent of their foreign exchange earnings for undertaking export promotion activities.

7. The Government has liberalised norms regarding payment of agency commission by exporters - upto 7-1/2 per cent in the case of non-select products and 12-1/2 per cent in the case of select products. Even higher agency commission payments may be allowed on approval by the export authority of the Government of India concerned.

16.4 TAX CONCESSIONS AND OTHER FACILITIES

The Concesssion

a) In the computation of total income, Section 80-HHC allows a deduction of the whole of the profit derived from the export of goods or merchandise. (The requirement of minimum tax contained in Section 115-.J will not apply to exporting corporate assessees). This benefit would also be available to supporting manufacturers exporting through Export/Trading Houses provided that an amount equal to the amount of deduction claimed is retained as a reserve for the purpose of the business of the assessee.

b) Exemption from taxation of the profits from overseas projects to the extent of 50 per cent.

c) Exemption. from taxation of 50 per cent of royalty, commission, fees or any similar payment obtained from the exports of technical know-how and technical services.

d) A 5-years tax holiday for 100 per cent export-oriented units and for units located in Free Trade/Export Processing Zones. This benefit could be taken within 8 years of the period in which the industrial unit begins to manufacture for any 5 consecutive assessment years.

e) Concessional rates of customs duty (35 per cent) and valorem) on imports of selected items of machinery for identified thrust-export sectors.

16.5 FOREIGN EXCHANGE AND VISA FACILITIES

Foreign exchange and visa facilities are made available to obtain tender forms. conducting market surveys, for, participation in exhibitions, to meet expenses of representatives deputed abroad, for advertising abroad, to purchase samples or to obtain other technical information. For all these purposes, a blanket permit can be made available to export houses. The new blanket exchange permit scheme effective July 1987 allows a much greater degree of freedom to permit holders to draw exchange for a number of additional items and has done a way with monetary ceilings on expenditure on certain specified items.

16.6 EXPORT FINANCE

Export Finance is made available to exporters at a lower rate of interest i.e. 9-1/2 per cent. Banks can get refinance at lower rates of interest. In case they are not able to get such refinance at lower' rates of interest, they are given a subsidy of 3 per cent. Advances made to exporters are not included for liquidity purposes. Direct advances to exporters can be made to assist them in securing large export orders for c8pital goods on deferred payment basis. For this purpose, the Export Import Bank of India provides term finance in collaboration with commercial banks.

Insurance Of Risk

The Export Credit Guarantee Corporation' (ECGC) is willing to cover 90 per cent of the political and commercial risks of export operation. The banks are provided guarantee cover from 2/3rd to 90 per cent in respect of loans advanced to small merchant-exporters and for export of engineering goods and metallurgical products. ECGC has also launched an attractive scheme for small-scale exporters. For this purpose, a small scale exporter will be one whose annual export turnover is upto Rs.10 lakhs.

With effect from August, 1980, the ECGC has introduced two schemes to provide cover against exchange fluctuations at the bid/contract stage and in respect of deferred receivables including construction contracts, turnkey projects and exports under buyers' credit.

National Awards For Outstanding Export-Performance

Trophies and certificates of merit are awarded annually to exporters with outstanding' export performance. Awardees" include exporters from the small scale sector as well.

Some of the important criteria for these awards are: development of a market abroad for a product which has not been exported previously, substantial increase in export sales, preferably in non-traditional commodities and in finished products, successful introduction of a new product, product development, successful break through in foreign markets where conditions are specially difficult, etc.

Facilities available to recognised export houses/r. trading houses

(a) Release of blanket foreign exchange for

- (i) business travel abroad.
- (ii) market studies conducted by specialists deputed from India or through market research organisations abroad.

(iii) Publicity abroad. .

(iv) participation in overseas exhibition(s) trade fairs and Indian trade centres abroad; and

(v) securing samples and technical information relating to export. products and commodities-

(b) Grants-in-aid under the Code of Grants for:

i) any project for developing new products for export.

ii) exploration of new markets.

iii) overseas market surveys.

iv) publication of broachures, catalogues, price lists, etc. for use abroad.

v) advertisements for brand publicity.

vi) display of exhibits in overseas showrooms; and vii) setting up foreign offices, warehouses and after sales service.

(c) Procurement of commercial intelligence from India Government's trade representatives abroad as also from various departments and agencies of the Government.

(d) Grant of preferential treatment to their personnel for:

i) training programmes abroad as well as in institutions in India; and ii) inclusion as members of delegations sponsored by the Government of India or an export promotion organisation for visits to foreign markets.

(e) Import Facilities available to Export Houses

The following facilities have been extended to export houses:

i) Import replenishment licences to which they are eligible as registered exporters.

ii) Import replenishment licences transferred to them by others.

iii) IRMAC facilities - Import of items placed on OGL, items appearing in the Limited Permissible list and capital goods and instruments other than those in the restricted list for the purpose of stock and sale to eligible actual users.

iv) Import of one PBX/P ABX (including electronically operated) against Additional Licence in a year for use in its office.

v) Import of office machines as provided for on pages

vi) Issue of Advance Licenses/Import-Export Pass Book \ against legal undertaking in lieu of Bank guarantee.

SUMMARY

Export promotion has become an important tool in any developing country to motivate the manufacturer and businessman to enter the international market.

Most developing countries have resorted to a number of export promotion measures.

KEYWORDS

- ❖ Indigenous
- ❖ Replishment
- ❖ Discriminatory

REVIEW QUESTIONS

i) What are the facilities available to recognized export house?

ii) Discuss the facilities provided by the Government for encouraging export production.

iii) What are the assistance available for reducing the price disadvantages?

SUGGESTED READINGS

1. Man Mohan Singh - Indian's Export Trends

ANNAMALAI UNIVERSITY
WITH COURAGE AND FAITH

LESSON 17

STATE TRADING AND THEORY OF FOREIGN TRADE

OBJECTIVES

After studying this lesson, you should be able

- to clear about the rational of state trading and role of STC and MMTC.
- to understand the theory of comparative cost.
- to know about the terms of track.

STRUCTURE

17.1 INTRODUCTION

There is no precise definition of State Trading. There are various types of government participation in foreign trade, all of which can be defined as State trading. For example, in the centrally-planned economies the entire foreign trade is nationalised and is, therefore, conducted directly by government departments of government-owned corporations. On the other hand, there are countries which are essentially free enterprise economies but export and import of specific commodities are entrusted to government trading organisations or departments. For example, import of raw and unmanufactured tobacco is a State monopoly in France. The Government Food Agency of Japan regulates the import, export and internal distribution of rice, wheat and barley. Similarly, Japan Monopoly Corporation which is a State body has the monopoly rights of tobacco importation. The Australian Wheat Board has the exclusive rights for exports of wheat. There are many such instances all over the world. The third variety of State trading is found in mixed economies like India. In India, State participation in foreign trade is mostly done through government owned trading organisations or through government departments. The government-owned trading corporations are, however, commercial entities registered under the Companies Act and have the same rights and obligations as any private sector firm. There are a number of such government trading organisations, the complete list of which has been indicated separately.

17.2 RATIONALE OF STATE TRADING

State trading is resorted to for a number of reasons. In the centrally-planned economies, foreign trade as a matter of State policy is nationalised. Foreign trade in those countries is to be conducted by State trading organisations because otherwise the central planning mechanism will not function properly. In the developed free enterprise economies, State trading sometimes is practised as a source of revenue. That is why it is found that trade in products like alcohol and tobacco is subject to State monopoly. Similarly, trade in drugs and arms and ammunition is managed through State bodies in the interest of health and national security of the country. State trading in a number of agricultural products is quite common because State intervention is necessary to avoid large fluctuations in the prices and preventing deterioration in the income of the agricultural producers.

State trading, however, is more commonly practised in the developing, economies. The reasons behind this are varied. First, such countries may not have adequately developed private sector trading bodies, which can effectively participate in international commerce and also protect the national interest. Secondly, the private sector bodies, though possessing adequate trading expertise, will be solely motivated by profit consideration. However, it may be necessary from the national standpoint to promote new export items and cultivate new export markets even by sustaining short-term losses. This can be done only by government bodies having a development role and which are backed by the government so that the financial losses do not hamper the pursuit of long-term objectives. Thirdly, the centrally-planned economies have emerged as important export markets for a large nU:t1lber of developing countries including India. Since the foreign trade of these countries is invariably conducted through State trading organisations, it is found that government trading bodies are in a better position to negotiate with their counterparts in the centrally-planned economies.

Canalisation Of Imports

State participation in imports in generally motivated by some other considerations. There are: (a) to reap the advantage of bulk buying, (b) to mop up any excess profit which the private sector firms might enjoy in import business, and (c) to ensure proper internal distribution of the imported items and to maintain stable domestic price level.

Advantages Of Bulk Buying

There are essentially three elements which can be associated with the advantage of bulk purchase. First, a bulk purchaser may get better discount and trading terms. Secondly, since the bulk purchaser will be a monopolist, the possibility that prices of commodities in short supply can be pushed up by competitive bidding by the Indian importers, is eliminated. Thirdly, since the international markets of many importable items are monopolistic.. State trading will give rise to countervailing power which may mitigate to some extent the ill effects of the monopolistic market structure.

Mopping Up A Excess Profits

In a situation where demand for imports exceeds the supply of imports, there is bound to be premium on imported materials. If the import licence is issued to an importer, the premiums will accure to him. Further, the market forces will determine the extent of the premium. The higher is the excess demand for imports, the higher will be the premium. If the premium is high it means not only a correspondingly larger windfall profit to the importer but also a rise in the cost of production of those items, which use the imported material as input. Both these problems can be solved through State trading for two reasons: First, because the State trading organisations having the monopoly right to import are government organisations, the premium will accrue to the government. Secondly, the magnitude of the premium will also not be a problem because the government can decide on the prices at which the State trading organisations will release the imported materials in the domestic market.

Maintenance Of Internal Distribution

If foreign exchange availability poses no problem and the import trade is completely free, internal distribution of imported items at fair and equitable prices will not 'create any problem. But since such conditions generally do not prevail in a developing country, sporadic scarcity of imported items, will occur. To avoid these, problems, it may be necessary to hand over the import of essential items to government trading organisations, which can plan the import operation in such a way that a steady inflow will be maintained. This will avoid sudden scarcities and consequent spurt in domestic prices.

17.3 STATE TRADING IN INDIA

State trading in India has a fairly long history. State trading in-imports is first discussed followed by a discussion on State trading in exports.

State Participation In Imports

The advisability of taking over imports of certain specified items was first considered by the Government of India in 1948. The context was the abnormal increase in the price of East African cotton of which India was a bulk importer. The margin between the prices at which the import was negotiated by the Government and the domestic price thereof was so high that a 'suggestion was made that the Government of India should directly import the East Arfican cotton so that the margin between the domestic price and the c.i.f. price could accrue to the Government. The Government, however, took a decision not to take over import trade in East African cotton. Since then State trading in imports was discussed by various committees and by 1956 the Government had come to the conclusion that there should be government corporations which were to be entrusted with the function of import of specific items. Two factors persuaded the Government that canalisation of imports for some items was necessary. The first factor was the gradually increasing trade with the socialist countries. Private traders in India had not the expertise in dealing .with the Government trading organisations in these countries and, therefore, faced problems while negotiating export-import contracts. Since under the rupee-payment arrangement exports and imports have to balance, the Government of India have the responsibility to see that the import plan is fulfilled. A-State trading organisation, through which imports could be canalised, would be an effective instrument to achieve this result. The second factor was the artificial scarcity created by small importers who had been given import licences to make abnormal profits.

The State Trading Corporation of India (STC) was set up by the Government of India in 1956 which was designated as the sole import agency of such items as the Government may decide from time to time. STC, however, would import other items as well apart from the canalised items. The functions of the STC as given in the Memorandum of Association are as follows:

i) To organise and undertake trade in the State trading countries as well as other countries in commodities entrusted to the company for such purpose by the Union Government from time to time and to undertake the purchase, sale and transport of such commodities in India or anywhere else in the world.

ii) To undertake at the instance of the Union Government import and/or internal distribution of any commodities in short supply with a view to stabilising prices and rationalising distribution, and

iii) To generally implement such special arrangement for imports, exports, internal trade and/or distribution of particular commodities as the Union Government may specify in the public interest.

Very high margin of profit earned by the importers of certain consumer commodities like cassia, betelnuts, cloves, etc., for which adequate foreign exchange could not be allotted due to tight foreign exchange position, prompted the Government to take the decision of complete import canalisation of items where either the speculative profit or profit due to a wide disparity between the domestic demand-supply position was likely to be high. The success of the State canalising agency in arranging bulk import of items, initially canalised, such as raw slim, caustic soda ash, etc., at favourable prices also gave the Government more confidence in enlarging the sphere of import canalisation.

By canalising the import of speculative items, the Government managed to appropriate the profit which otherwise would have gone to the quota holders. The profits made in these operations helped the Government to pursue another policy objective, viz., export promotion. The State Trading Corporation was directed by the Government to push up export of items which are difficult to sell, and therefore may involve financial losses.

In order to offset the losses on export of difficult-to sell items, import of certain scarce commodities, such as betel nuts, copra, etc., are canalised through the State Trading Corporation. When imports of these items... are canalised through the STC, the corporation mops up a portion of the large profit which is available on these commodities

The maintenance an equitable distribution of imported materials as well as to keep the interests of the unorganized sectors of the industry intact are also considerations which forced the Government to use the instrument of import canalisation.

Stabilisation of raw material prices is another objective, which was sought to be achieved through the instrument of import canalisation. Import of mercury was canalized in 1961. The domestic sale price of mercury had shot up in 1960 to Rs.3,500 per flask against a c.i.f. price of only Rs.1,000 flask. The reason of such an abnormal rise in price was speculation. The canalisation of import through the State Trading Corporation immediately produced the desired result. The State Trading Corporation fixed its sale price at Rs.1,800 per flask and the domestic sale price stabilised at Rs.2,200 per flask. However, for the manufacturers of caustic soda, who needed mercury as a basic raw material, the STC charged significantly lower price, viz., a 15 per cent mark up on the c.i.f. price of Rs.800-900 per flask. For others, the price was Rs.1,800 as indicated above. Thus, canalisation in effect achieved two objects: first, to ensure supply of imported raw material at reasonable prices to the domestic manufacturers, and secondly, to mop up the excess profit which inevitably would be there, when adequate foreign exchange could not be allocated for the importation of an item 3.

The following items have been canalised for import (subject to changes from time to time).

Newsprint, Wool, Palm oil (edible), Rayon grade woodpulp, Synthetic rubber, Caprolactum, alkaloid benzene, Endrine technical, Chlorine diphosphate, Palm oil (soap), Sunflower seed oil, sisal/manila hemp, Parxylene, Tallow, Carbaryl technical, Tetracycline HCL, Poly filament yam, Ampicil trihyd, Art silk yam, Chloram powder, Pot. Chloride, Soya bean oil, DMT, ME glycol, Cement, Sugar, white printing paper, Non-ferrous metals, Asbestos fibre, Antimony metals, mercury and AG fluorspar.

Impact Of Canalisation

Analysing the impact of canalisation, the Ministry of Commerce submitted before the Estimates Committee:

"The effect of canalisation of import through State agencies has resulted in savings in foreign exchange on imports on account of bulk purchases and also on account of bulk shipments and in supply of raw materials to consumers in the country at reasonable rates. Other advantages are -stated to be:

a) import and distribution in a planned. and phased manner

b) long-term supply arrangements,

c) self-generation of foreign exchange through special link arrangements

d) equitable distribution in India consortiums"

However, views of the trade and industry in respect of import canalisation were not always favourable.

A major complaint of industry and trade has been regarding the pricing policy and the high service charges. It has been pointed out that in the case of some items, specially raw materials, the prices charged by the STC have been excessive.

Another complaint has been the absence of close liaison between industry and trade and the State trading agencies. At present, trade and industry have no means of knowing how exactly are the State trading agencies fixing their prices.

Analysing the Indian situation, Mr. S. Boothlilingam, Director General, NCAER, and a former Secretary to the Government of India, submitte4 before the Estimate Committee.

"Canalisation could be justified and be beneficial only in areas where two tests can be met. The firsts that the organisation must be equipped to work and actually work in such a manner that bulk purchases are made\economically taking advantage of favourable changes in the world market. The second is that the final user must get his material at least as cheaply and as quickly as he might have if allowed to import himself."

To conclude, the observations made by the Estimates Committee may be noted:

"The Committee agrees that canalisation is no doubt a question of policy which only the Government is competent to decide. They would, however, suggest that the canalisation of import of a commodity.... may be done if it serves public interest. They would also stress that before canalisation of import... of commodities was decided upon, all the important factors including the capacity of the Corporation, should be taken into consideration. They recommend that after canalisation is decided upon, the Government must exercise vigilance to see that it served the purpose for which it was undertaken."

Canalisation Of Exports

The Government's role in exports is becoming more and more important both because of the principle of canalisation as well as the better performance of State trading organisation. The basic objectives of State trading in exports are as follows:

a) It was observed in the case of certain products that there was secular decline in the total value of exports. It was thought that a government trading organisation would be able to reverse this trend by concerted action.

b) In some cases the interest competition among the Indian exporters was resulting in lower unit value realization. Entry of State trading organisation in the international market through which exports were to be canalised could result in the improvement of unit value realization.

c) There are certain products for which there may be premium in the international market. By canalising export of such products, excess profits from export operation can be mopped up by the Government.

d) Another objective of canalisation was to eliminate under-invoicing. It was found that sometimes the Indian exporters were quoting lower prices in their invoices while the world prices for such products were considerably higher. This led to the suspicion that the country had been losing foreign exchange because of the malpractices adopted by certain exporters.

e) Canalisation. was also thought of as an instrument to improve the bargaining power of Indian exporters. It was found that the principal buyers in Western Europe and the United States were large corporations and to negotiate contracts with them would require the existence of an equally large counterpart in India which would be able to supply exportable products in bulk quantities. Especially for products which originate in the small-scale sector, a co-ordinating agency like the STC would be helpful in promoting export of such products.

The following items have been canalised for export (subject to changes from time to time).

Sugar, Semi-processed, leather, Castor oii, Footwear leather Cement and clinker, Rice basmati, Shellac/lac, Opium crude, Salt, Lemongrass oil, Canvas/Plastic footwear, Molasses, Groundnut extractions, Barytes, Chrome ore, Sillimanite and Processed mica.

The State trading organisations have also a promotional role so far as exports are concerned. As regards non-canalised items, the basic objectives of the State trading corporations are:

1. To function as a catalytic agency for promoting new items of export. For example, in 1981-82 several new items were introduced in international markets by the STC including rayon viscose fabrics to the USA, textile fabrics and threads to Vietnam, green tea to Algeria and stereo music equipment to Hungary. Algeria and Libya have been identified as potential markets for a number of agricultural commodities.
2. To form consortia of manufacturers specialising in different lines like railway wagons, readymade garments, plywood, etc.
3. To provide support to traditional items, viz, jute, coffee" coir, etc.
4. To identify new export markets. STC developed several new markets during 1981-82 including Saudi Arabia and Malaysia for mango pulp, Hungary and GDR for fashion garments, the UK for golf shoe uppers, Spain for footballs

and Uganda for bicycle and bicycle parts. STC has explored South Korea and Hong Kong for export of Indian goods to third countries. STC is negotiating with Hong Kong for export of building materials and textiles for export to the USA and African countries.

5. To introduce new products in international markets particularly those manufactured by the small-scale and cottage sector such as sandalwood, billets, silver jewellery, kuth oil, dried mushroom, etc.
6. To introduce product adaptation and development keeping in line with the changes in the international markets. F0r example, Mica Trading Corporation is trying to export fabricated mica as the demand for the traditional product, viz., processed mica, is declining over the years.

The major State trading organisations in India are:

1. The State Trading Corporation of India Ltd. (STC) 2. The Projects and Equipment Corporation. of India Ltd.
1. (PEC), a wholly owned subsidiary of STC.
2. The Cashew Corporation of India Ltd. (CCI), a wholly owned subsidiary of STC.
3. The Handicrafts and Handlooms Export Corporation of India Ltd. (HHEC), a wholly owned subsidiary of STC.
4. The Minerals and Metals Trading Corporation of India Ltd. (MMTC)
5. The Mica Trading Corporation of India Ltd. (MITCO), a wholly owned subsidiary of MMTC. .
6. The Tea Trading Corporation of India (TICI), a subsidiary of STC.
7. Spices Trading Corporation Ltd.

The exports and imports of various State Trading organisations in 1982-83, 1984-85 and 1986-87 are given below:

Table 17.1 Exports and Imports of State Trading Organisation

(Rupees in crores)

	Exports			Imports		
	1982-83	1984-85	1986-97	1982-83	1984-85	1986-97
STC	630.47	719.56	543.12	1188.23	2119.00	2179.27
PEC	65.64	102.56	103.05	0.52	0.86	1.66
CCI	6.00	4.23	4.00	1.02	--	0.64
HHEC	84.94	129.27	71.54	--	--	--
MMTC	288.70	376.10	711.70	906.79	2389.30	2037.37

MITCO	21.76	27.12	23.14	--	--	--
TICI	16.00	25.00	25.69	--	--	--
	1113.51	1383.44	1481.24	2096.56	4506.16	4218.94

The total exports and imports of these State trading organisations in 1986-87 amounted to Rs.1,481.24 crores and Rs.4,128.94 crores accounting for 11.79 per cent and 21.01 percent of India's total exports and imports respectively.

A Critical Evaluation of the Working of the State Trading Corporation.

The STC completed 32 years of its existence in 1988, the following table gives an idea of its turnover in some selected years:

Table-17.2 STC's Turnover

YEAR	Export	% of canalised exports	Imports	% of canalised exports
	Total		Total	
1956-57	5.79		3.4	
1960-61	36.59		26.69	
1965-65	13.12		46.19	
1970-71	70.58		131.90	
1972-73	170.10	74	159.20	75
1973-74	272.75	88	205.97	76
1974-75	558.60	94	231.90	92
1975-76	760.11	92	216.98	72
1976-77	665.60	76	301.25	97
1977-78	557.00	57	501.81	
1978-79	601.83	70	524.82	
1979-80	636.27	66	883.77	
1980-81	440.49	48	1214.04	
1981-82	555.41	42	1209.90	
1982-83	647.00	42	1162.0	
1983-84	796.56	45	1403.38	
1984-85	719.56	29	2119.00	
1985-86	377.44	40	2158.38	
1986-87	542.12	27	2179.27	

Thus over the years and turnover of the STC has increased manifold. The increase in exports has been significant after 1971-72. They reached the maximum of Rs.796 crores in 1983-84 after which there has been a decline and in 1985-86, they amounted to Rs.377 crores only. On the other hand, there was almost a continuous increase in imports, especially in the last Between years. In 1984-85, imports amounted to Rs.2,119 crores, showing a jump of 51 percent over the previous record of Rs.1,403 crores in 1983-84. The increase in imports which have maintained more or less the same level, was largely due to the demands of the public distribution system.

One important point to be noted is that both in exports and imports, the percentage of canalised items is far higher than the percentage of non-canalised items. The percentage of canalised items varied between 74 and 94 in exports and between 72 and . 97 in imports during the period 1972-73 to 1976-77. This is because the STC's efforts are mostly guided by the policies of the Government of India from time to time and it is left with limited scope for showing its initiative in these areas. The real test of the efficiency of the STC will be the competence with which it develops non-canalised exports. But in this respect, the performance of the STC is none too good. STC's exports of non-canalised items like meat, marine products and construction material showed a decline in 1981 while the world demand for these products was distinctly strong. The STC is aware of this and is laying more emphasis on the exports of non-canalised items now. However, in recent years, exports of non-canalised items have showed an increase due to an increase in exports of engineering products, food products and textiles and garments. As a result, the percentage of canalised items was as low as 29 in 1984-85.

Products

Over a period, the products handled by STC have also shown an increase, STC - The Merchant of India, an STC publication, refers to 17 agricultural commodities, 8 consumer products, 15 items of army software, 3 items of construction material, 6 manor and a number of miscellaneous engineering items, 10 items of fresh and processed foods, 7 items of leather, 3 items of meat marine products, 19 items of textiles and garments, alcohol, sugar, molasses and castor oil. The import items include edible oil (6 "items), cement explosives, natural rubber, standard and glazed newsprint and white printing paper.

The STC has developed a sound infrastructure for development of exports in the form of 1 7 branches in India and 17 overseas offices and a large force of trained marketing personnel.

STC's Indian branches playa vital role in port clearance storage movement and distribution of imported items, in addition to procurement and shipment operations for export items. The foreign branches provide valuable support in identification of new products and markets, assessment of market potential, quality and packaging needs; preparation of new product development strategy and assistance in carrying out negotiations for import and export.

Weaknesses

Some of their major weaknesses of the STC pointed out by a study conducted by the Indian Institute of Management, Ahmedabad, were:

i) Though the objectives with which STC was established are known and clear, STC management has rarely taken any major entrepreneurial decision on its own.

ii) There seem to be no guidelines or criteria for choice by STC management of new product/markets.

iii) Not much expertise has been developed to locate and develop sources of supply for exportable products.

iv) Also n6t much expertise is developed in procuring imports from sources of supply abroad.

v) Much of expertise is in operating as an agent in processing indents and tenders and in transportation and distribution; not in merchandising, procurement or marketing.

The setback in the exports of ,non-canalised items can be attributed to the STC's failure to develop an appropriate supply base and take adequate promotional steps. among importers.

In recent years, STC has taken some major steps to improve its working. They are:

a. Diversifying the product range - it has continued to add new items to" its export basket like moccasins, orthopaedic shoes, sports shoe uppers, compressors, H.D. pipes, coco beans, peacock feather and clutch and security bags. It would lay emphasis on value added products like computer software, Maruti vehicles, scooters and mopeds, consumer electronics and packaged tea.

b. Trying to spearhead the national effort to identify new markets for Indian commodities and manufactured goods and establish itself in these markets on a long-term basis.

c. Developing a reliable supply base for production Of quality goods in association with the State undertakings, co-operative organisations and others in selected and identified sectors. If necessary, STC shall undertake investments for development of such production base.

d. Establishment of 100 per cent export-oriented production units - the product ranges identified so far are leather products, fresh and processed fruits and vegetables, meat and marine products, sports goods and engineering goods. These will be mainly set up with foreign technical and equity participation and 100 per cent buyback arrangements.

e. (e) Improvement in quality, grading, packaging, etc.

f. (f) Participation in fairs/exhibitions in India and abroad

g. (g) Evolution of B. scheme to supply raw materials at international prices for export production.

New role by 1990

Within the framework of the government policy., the new activities which the STC envisages by 1990 are:

- Build up special strengths in selected products and markets with emphasis on brand promotion.
- Use buying leverage to promote exports.
- Off-shore trade in products in which it commands special expertise and infrastructural support.
- Co-operation among the State trading organisations, particularly of the developing countries.
- Catalyse exports of small scale industry.
- Set up joint ventures for production and export.

With its long experience of exporting a wide range of products/commodities to over a hundred developing and developed countries and a sound infrastructure, STC should not merely act as acanalising agency but should organise itself as an effective trading house on the lines of Japanese trading houses. It should provide new dimensions and leadership as the biggest export house in the country.

17.4 ROLE OF STC AND MMTC IN COUNTER TRADE

The STC is a big buyer of edible oil, sugar, newsprint and a few chemicals in the international market. The STC started using its purchasing power from September 1985 to promote exports of various Indian products and services. The percentage export obligations, however, varied from item to item and time to time, depending upon market forces existing at the time of purchase. In addition, the STC also undertakes and monitors counter trade obligations of other departments and public sector undertakings.

The MMTC also lays emphasis on counter trade as a strategy to boost 'exports. During 1986-87, about Rs.240 crores worth of exports comprising agro-marine products like wheat, soyameal, shrimps, engineering products, 60vering a range from earth moving equipment to photo copiers and mineral products like iron ore concentrates were achieved through, counter trade.

Theory Of Foreign Trade

Inter-regional vs. International trade

Inter-regional trade is trade between different regions within the same country, whereas international trade is between different countries. So far we have been concerned with the problems arising out of exchange of goods and services within the same country. Now we turn to the study of the problems that relate to the exchange of goods and services between persons living in different countries.

It should be noted that the difference between interregional trade and international trade is only one of degree, not of kind . The fundamental principles in both cases are the same. International trade, like inter-regional trade, is the result of division of labour. In internal or inter-regional trade, people specialise in producing goods in which they have a greater comparative advantage; the something happens in international trade.

There are, however, several differences between home trade and foreign trade which necessitate the formulation of a separate theory of international trade:

First, within the same country, labour and capital are more mobile than they are between different countries. There are various reasons for this difference. As regards labour, as Adam Smith puts it, "Of all' sorts of luggage man is the most difficult to be transported." Several causes are responsible for this: differences of languages, traditions, religion, custom social and political life, etc., or more inertia may keep them at home. Capital is more mobile than labour. But even here people prefer to invest their savings in their own country for various reasons. An investor feels a greater sense of security if his capital is invested in his own country. An investor feels a greater sense of security if his capital is invested in his own country.

The result of this comparatively greater immobility of labour and capital between different countries is that competition fails to make costs of production of similar goods equal, as it does in the same country. This gives unequal advantages to different countries in the production of different commodities. The different countries become non-competing groups. There is another consequence of comparative immobility of labour and capitals between one country and another. Within a country, the price of a commodity, in the long run, tends to approximate to its cost of production. This is so because labour and capital can easily move into or move out of an industry, if the price is respectively more or less than the cost of production. This cannot happen in the case of international trade. Labour and capital being immobile, price and cost of production can seldom approximate. Also, the consequence of this immobility of factors internationally is that returns to factors tend to equality within, but not between, countries.

Secondly, differences in advantage may arise because of natural causes like geographical and climatic conditions. These lead to territorial division of labour and localisation of industries. For instance, some countries may have particular mineral resources like coal, iron ore, copper, etc. Others may have land or climate peculiarly suitable for certain crops, e.g., jute in Bengal. Either these advantages cannot be transferred to other countries at all or the cost of moving them is prohibitive.

Thirdly, in international trade certain problems arise out of ihe fact that countries are independent sovereign States and can pursue independent policies with respect to the movement of goods, money matters, wages and prices, fiscal matters, banking law, foreign loans, etc. Several kinds of restrictions may be placed on the movement of goods beyond their frontiers by the States.

Fourthly, different countries have different currency systems. This hampers smooth flow of trade as between one country and another. A number of foreign exchange problems arise in foreign trade which are non-existent in internal trade. To the man in the street this is the main difference between 'international and domestic trade. Really, it is not the different currencies so much as the possibility of change in their relative value which differentiates between international trade from inter-regional trade.

Fifthly, there are cultural distinctions between markets. The national markets are frequently separate from one another. For instance, the British use right hand drive cars, whereas the French use the left hand drive. Thus the markets for automobile are effectively separated. But markets are also separated by language, customs, usage, habit, taste and host of other causes of difference. Standards differ. Some goods are designed in inches; feet and short tons and others in metric measurements. "Export and import trade must get outside of the culture of the domestic market to become acquainted with different goods, described in different words, using differing measurements, bought and sold on different terms, for different currency units."

Sixthly, different countries have their separate national economic life. "Along with political independence has grown a demand for economic self-reliance, self-esteem expressed largely in plans and hopes for economic development." The national units have been striving for increasing consumption, production, capital formation, etc. Thus political and economic nationalism are rising especially in newly independent countries widening the differences between international and inter-regional trade.

To sum up the differences between international and inter-regional trade arise from-

i) factor immobility;

ii) different currencies;

iii) different national policies;

iv) separate markets;

v) politically different units; and

vi) economic nationalism;

All these causes give rise to a separate theory of international trade.

17.5 THEORY OF COMPARATIVE COSTS

The theory of comparative costs was applied to inter-national trade at first by Ricardo. He pointed out that while profits in the same country in different employments tended to equalise, this was not the case as between different countries. The reason is that there is mobility of labour within a country but not between different countries. By an arithmetical example, he showed that even if Portugal could produce both cloth and wine cheaper than England, it would pay Portugalto concentrate on the production of wine only in which her comparative advantage was greater and import cloth from England. J .S. Mill pointed out that between the limits set by the comparative costs, the terms of exchange were determined by the relative strength of demand of one country for the goods of the other, provided at the position of equilibrium imports just paid for the exports.

J.E. Cairnes questioned Ricardo's assumption that factors of production were mobile within the same country and not at all between different countries. On the whole, however, he agreed that even though non-competing groups existed within the same country, the mobility of the factors of production was sufficient for profits to tend to the same level. This did not happen as between different countries. The classical theory was thus completed with Cairnes. It was believed that while within a country commodities exchange in the ratio of their cost of production as between countries reciprocal demand was the determining factor.

Though the classical theory is accepted in its essentials by modern economists, certain modifications have occurred both in the matter of emphasis and also as regards its manner of illustration. These modifications are worth nothing:

(i) The classical economists measured costs in terms of days of labour. The modern writers state the theory in terms of the marginal costs of production as expressions of the degree of relative scarcities of the factors of production.

(ii) The Ricardian theory assumed constant returns. The modern writers have elaborated this simplified version by indicating the influence of the laws of increasing and diminishing returns. Thus if the increased scale of production reduces costs per unit, the comparative advantage will be increased. If, on the other hand, the larger output raises cost per unit the comparative advantage may diminish or even disappear.

(iii) The Ricardian theory did not explain the terms' of exchange. Early Ricardians, following Adam Smith, relied upon the "higgling" of the market, a rather vague term. According to modern analysis, the ratio of exchange is determined by the elasticities of the demand of each country for the products of the other.

In the light of the above modifications, let us illustrate the Theory of Comparative Costs in its modern version.

All trade takes place because of the differences in the cost of production. Such differences can be of three types:

i) absolute differences in costs,

ii) equal differences in costs, and

iii) comparative differences in costs

Trade is possible under (i) and (ill) but not under (iv) Let us take examples:

Absolute differences

In country A) Marginal cost of producing wheat is Rs.5 per md. cotton is Re. 10.

In country B) Marginal cost of producing wheat is Rs.10per md. cottons Re. 5 per md.

Since price tends to equal the marginal cost of production in country A, one maund of wheat will exchange for 1/2 maund of cotton. In country B, one maund of wheat will exchange for 2 maunds of cotton.

		Cost ratio
Thus in country	A : 1 wheat = 1/2 cotton	1:2
and in country	B : 1 wheat = 2 cotton	1 : 1/2

Thus A has absolute advantage in wheat and B in cotton. A will specialise in the production of wheat and B in cotton. A will gain so long as she can get more than 1/2 maund of cotton for a maund of wheat. B will gain so long as she can get a maund of wheat for less the 2 maunds of cotton. The ratio of exchange will lie somewhere between 1/2 md. and 2 mds. of cotton for a maund of wheat. The actual rate will depend on the relative elasticities of the demands of each party for the products of the other. This we shall examine later.

Trade due to absolute advantages usually exists between temperate and tropical countries on account of climatic and other differences.

Equal Differences. When the comparative advantage is equal, no trade can permanently take place between the parties.

In country A) Marginal cost of producing wheat is Rs.5 md

" " " Cotton is Rs.10

In country B) Marginal cost of producing wheat is Rs. 4 per md.

" " " cottons Rs.8

		Cost ratio
Thus in country in country	A : 1 wheat = 1/2 cotton	1:2
B : 1 wheat = 1/2 cotton	1 : 2	

Under the above conditions, no benefit will accrue to the parties through specialisation. If A specialises in wheat and B in cotton, A can only gain if 1 md. of wheat gives her more than 1/2 maund of cotton. But B will not give more than 1/2 ma und of cotton for one mannd of wheat, since she can produce that much at home by transferring productive resources from cotton to wheat. Even if trade starts, it will come to an end after some time as explained earlier.

Comparative differences in costs

When the comparative advantage is different, trade will arise and it will continue.

In country A)	Margin cost of producing wheat is Rs.7 a md.	
	" " "	cotton is Rs. 14 a md.
In Country B)	Margin cost of producing wheat is Rs. 5 a md.	
	" " "	cotton is Rs. 7 a md.

In this case, country B can produce both wheat and cotton cheaper than country A. But the comparative advantage is higher in the production of cotton than in that of wheat. On the other hand, A has a comparative disadvantage in the production of both the commodities but the disadvantage is lower for wheat than for cotton.

Thus:

		Cost ratio
Country	A: 1 md. of what = 1/2 md.	1 : 2 of cotton
	B: 1 md. of wheat = 5/7 or.	1:1-2/5 71 md. of cotton

It will, therefore, pay country B to specialise in the production of cotton and A in wheat.

It is not supposed to be that the production of cotton in A and wheat in B will altogether cease. The theory of comparative costs refers to average cost only. If every cotton farm in B has lower cost than every cotton farm in A, and if every wheat farm in A had lower costs than every wheat farm in B, then only no cotton will be produced in A and no wheat in B. But this is very unlikely. There must be some cotton farms in A whose costs are lower than some cotton farms in B. Hence, some cotton will still be produced in A and some wheat in B.

What will be the terms of trade?

B will gain as long as she can get a maund of wheat by parting with less than. 71 md. of cotton. A will gain as long as she can get more than. 50 maund of cotton by parting with a maund of wheat. The rate of exchange will lie between

1 md. of wheat = .50 md. of cotton

1 md. of wheat = .71 md. of cotton

The actual rate will depend upon the relative elasticities of demand of each party for the goods of the other.

If the demand of A for cotton is more elastic than the demand of B for wheat, the rate of exchange will be more favourable to A. This is so because A will be less anxious for cotton than B is for wheat. In the opposite case, the rate of exchange will be more favourable to B.

When the rate of exchange is favourable to A, it is nearer the 1 md. of wheat = .71 md of cotton limit. When the rate is favourable to B, it is nearer the 1 md. of wheat = .50 md of cotton limit.

The margin of gain in this example is quite narrow. In actual practice, trade will arise if the margin is fairly wide to counterbalance any in conveniences involved in such a trade.

The argument here relates to two countries, but it can be extended to cover more than two commodities and two countries without contradicting the essential principle.

Such is the theory of comparative costs. Then where exactly does the difference lie in its applicable to foreign trade?

We have said in the beginning that all trade arises because of differences in costs. In the case of the same country, there is a tendency for differences in comparative costs to disappear on account of the comparative ease with which the factors of production move from employments with lower rewards to those with higher rewards. Commodities thus tend to exchange within the same country according to their respective marginal costs of production. This adjustment does not take place between countries due to immobility of the factors of production. Thus arise permanent differences in comparative costs which make international trade profitable as explained above.

But such differences in comparative costs may arise between different regions of the same country due to the lack of mobility of the factors of production between those regions. Thus "non-competing groups" may exist within the same country. In that case, the theory of comparative costs will apply to home, trade as well. It is due to this that modern economists deny that international trade requires a special theory to explain its emergence and operation. But since differences in comparative costs are more characteristic of different countries than of the regions in the same country, special notice is taken of this theory while discussing trade between nations.

We may sum up the theory of comparative cost in general terms. An individual is able to perform many tasks but he does not perform all. He selects that work which pays him the most. A doctor can also do the dispensing but he does not do it; a lawyer can perhaps type, but he does not do it; a professor can teach his son reading in a school but he does not do it. All these people find it to their advantage, and it is also to the advantage of the community, that the inferior work is left to inferior persons. In that case, time and energy are more profitably employed.

The same principle works in international trade. Considering climatic conditions, distribution of mineral and other natural resources, geographical position and physical configuration, every country seems to be better suited for the production of certain articles rather than for others. It will be to the advantage of each country, as well as to the advantage of the world as a whole, that each country specialises in the production of those commodities for which it has greater relative advantage. In that case, the productive resources of that country will be more remuneratively employed. Among the factors that determine the commodities in which a country should specialise, we may mention the rate of exchange, the monopoly element, transfer costs, prices of the factors and their relative efficiency. A country would tend to specialise in the production of those commodities in which transfer costs and factor prices are low but productive efficiency is high.

It is generally seen that those commodities are produced where the cost of production is the least. But this fact in itself does not lie at the basis of international trade. Rather, this principle of comparative cost implies that a country may specialise in the production of certain commodities and import certain other articles, even though it can produce them at a lower cost. England imports dairy products from Denmark although their cost of production in England is less. The reason is that England is able to get much better return from labour arid capital employed in other directions, say, machinery, and the loss from the purchase of cheese and butter is more than made up. "The theory of comparative costs as applied to international trade is therefore that each country tends to produce not necessarily what it can produce more cheaply than another country, but those articles which it can produce at the greatest relative advantage, i.e., at the lowest comparative costs."

Like other economic laws that principle of comparative cost also is a statement of a tendency. In actual practice, the operation of the theory is hindered by frictional influences such as differences in language, custom, religion and above all the unwillingness of labour and capital to be guided by purely economic considerations. They are also influenced by political motives, commercial practices and general security. The cost of transport and the behaviour of the cost of production are the other limiting factors. Specialisation tends to increase the scale of production, but if the industry is subject to the law of increasing cost, the principle of comparative cost will cease to function.

Case of a backward country

What will happen if a country happens to be so economically backward that it can supply nothing to the world, that the only capacity in which it can enter the world trade is that of a buyer. There is no such possibility in the real world. Every country, however backward it may be, will be in a position to supply something. Generally in such a country wages will be low, the price level is bound to be low too so that it is worthwhile for other countries to buy something from this country.

Normally the rate of exchange comes to be settled at a level at which it is found economical for a country to import commodities in the production of which its relative disadvantage is the greatest and ex part those in which it is the least. Hence one-way traffic in the world of reality will be a rare phenomenon, may non-existent.

While explaining the theory-of comparative costs we referred to the money costs of production. But ultimately, money costs merely reflect the exchange relations between goods that lie behind them. What are then the real costs? For Ricardo, real costs were labour costs. Cost of production, -however, consists of several factors.

Costs that determine exchange relations are essentially opportunity or relative costs. These costs arise because resources in a country are scarce in relation to the demand for them. If the resources are used for one purpose, they have to be withdrawn from another purpose or alternative use. Now suppose that in a certain country to obtain a maund of wheat, resources have to be withdrawn from the production of cotton such that 1112 maunds of cotton is to be sacrificed. In that country, therefore, l' maund of wheat costs 11/2 maunds of cotton. The ratio 1: 1 V2 is the ratio of costs between the two commodities. We can term this as comparative cost ratio or opportunity cost ratio or substitution cost ratio, because this indicates the rate of substitution of one commodity for another.

These substitution ratios are likely to differ from one country to another. This is because, different factors of production are found in different degrees of scarcity in different countries. If factors could move freely from one country to another, these degrees of scarcity would have tended to equalise. But since, due to reasons already noted, the factors are not 80 mobile between countries, these differences remain and hence create more or less permanent difference in comparative cost ratios. Thus international trade is rendered possible.

The gain from international trade

The gain from all trade, including international trade, arises on account of the advantages of division of labour. Division of labour among different countries arises on account, of differences in comparative costs in addition to differences in absolute costs of production. When cost differences are equal, no net advantage accrues. We may take the examples discussed in section 2 to show how this gain emerges under (i) and (iii) and not under (ii).

Absolute diferences in cost

In country A (as is clear from the cost ratios), a unit of productive resources produces either 1 md. of wheat or 1/2 maund of cotton. In country B, a unit of productive resources produces either 1 md. of wheat or 2 maunds of cotton. If each of these countries invest two units of productive power without specialisation, the total production will be

In A = 1 md. of wheat + 1/2 md. of cotton,

In B = 1 md. of wheat + 2/ mds. of cotton

A + B = 2 rods. of what + 2112 mds. of cotton.

If A produces wheat only and B cotton only, the investment of the same productive resources will give:

A = 2 mds. of wheat

B = 4 mds. of cotton

A + B = 2 mds. of wheat + 4 mds. of cotton.

Thus, by specialisation, the same productive resources can be made to yield's surplus of 11/2 mds. of cotton. This is the gain from trade.

Equal differences in costs

In the second case, total production without specialisation and with specialisation is the same.

Without specialisation:

A = 1 md. of wheat + 1/2 md. of cotton

B = 1 md. of wheat + 1/2 md. of cotton

A + B = 2 mds. of wheat + 1 md. of cotton

With specialisation:

A producing wheat only and B cotton only:

A = 2 mds. of wheat.

B = 1 md. of cotton

A + B = 2 mds. of wheat + 1 md. of cotton

Comparative differences in costs.

In the third case, a surplus arises with specialisation.

Without specialisation:

A = 1 md.-of wheat + .50 md. of cotton

B = 1 md. of wheat + .71 md. of cotton

A + B = 2 mds. (jf what + 1.21 mds. of cotton

With specialisation: A producing wheat cotton only:

A = 2 mds. of wheat

B = 1.42 mds. of cotton

A + B = 2 mds. of wheat + 1.42 mds. of cotton

Surplus =.21 md. of cotton.

This is the gain from trade.

Factors determinint thf size of the gain

It will be clear from the above analysis that the total gain from international trade depends upon the differences in the cost ratios in the two countries. The larger the range between the comparative costs the greater the total gain. In the words of Harrod:

"A country gains by foreign trade if and when! the traders find that there editorial broad a ratio of prices very different from that to which they are accustomed at home. They buy what to them seems cheap and sell what to them seems dear. The bigger the gap between that to them seems low points and high points, and the more important the articles affected, the greater will the gain from trade be."

As regards the share of this gain accruing to the parties, this will depend also upon the terms of trade, i.e., the ratio in which wheat exchanges for cotton in our example for instance. This ratio, as we have explained, depends upon the elasticities of the demand of one country for the goods of the other, or the intensity of reciprocal demands. Whoever is more keen to purchase or sell will be the loser in the bargain.

The gain from international trade will be shared through the level of money incomes in the countries concerned. These levels also will indicate which country is getting a better bargain. A country will have a high level of money incomes if its goods are in constant demand in the outside world. Increased foreign demand will tend to raise wages in export industries. The prosperity of such industries will affect favourably the wages in other industries too. Competition will compel these other industries to bring their wages to the level of export industries. Failing this, labour will tend to move to industries offering higher wages. Thus all incomes will tend to rise. Though domestic money incomes will thus rise, the prices of foreign goods will be low and people will gain as consumers of foreign goods. Conversely, a country, whose demand for foreign goods is high, will tend to have low money incomes but will have to pay higher prices for foreign products.

Cristicism of the comparative cost doctrine or its limltations

Differences in comparative costs arise because of the fact that different countries have different factor endowments and because different commodities are best produced with a predominance of one or another factor. Trade arises out of differences in relative factor prices but trade also tends to narrow these differences.

Differences in factor endowments explain the movement of goods between tropical regions and temperate zones, between densely populated industrial countries and sparsely populated 'agricultural countries. But trade may also flourish between countries with similar factor endowment, e.g., industrialised countries, owing to differences in comparative costs produced by historically increasing returns.

But the comparative cost theory concerns itself with one side of the question only i.e., the supply side. It only tells us what goods a country will buy and sell. It does not tell us at what prices these goods be traded. For that purpose a study of the demand side' is essential. Recardo said that the law of comparative cost determines what commodities would be bought and Bold in foreign trade. Mill explained that the law of reciprocal demand set the prices at which they would be traded.

But it, is not correct to separate demand and supply sides of international trade like this. In general equilibrium theory, both demand and supply together determine the quantities of goods bought and sold as well as their prices. We are reminded here of Marshall's analogy of the pair of scissors where demand and supply are compared to upper and lower blades.

Modern economists have developed a diagrammatic analysis, which combines the production-possibilities curves for supply with community indifference map for demand. In the absence of trade, production and consumption will both take place at the tangent between the production-possibilities curve and the highest indifference curve. With trade, it is possible to effect gains, which carry each country beyond its production possibilities curve. Trade will take place at a price, the same in each country, tangent to the production-possibilities curve and a higher (for at least one country) indifference curve of the same length.

The comparative cost theory is based on static assumptions of fixed tastes, identical production functions between trading countries and fixed supplies of land, labour, capital, etc. It cannot apply to real world, which is dynamic. The static world no longer exists. Tastes change owing to demonstration effect; technology is altered by innovation; factors also change. With changing technology and factors, it is impossible to calculate comparative costs.

The comparative cost theory also ignores transport costs. When transport costs are introduced, it no longer follows that the price ratios between export and import goods are the same in the exporting and importing countries. Exports goods must be lower in price to overcome transport costs; import goods higher. If transport costs are wider than price differentials in the absence of trade, trade cannot take place. That is why many goods and services do not enter into international trade.

17.6 TERMS OF TRADE

We have said above that the share of a country in the gain arising out of international trade depends on the terms of trade. By 'terms of trade', we mean the terms at which two countries trade with each other. It indicates the quantities of goods bought and sold and the price at which they are traded. It refers to the value of a country's exports, which have to be given in exchange for its imports. It indicates the rates at which a country exchanges its own goods for that of another. If trade between two countries is such that one is specialising in agricultural production and the other in manufactures, the trade is not advantageous to the former. We might then say that the terms of trade were moving against that country or they are not favourable to it. Similarly, if a country is exporting minerals in a raw state and other raw materials, the terms of trade are unfavourable to it. Within the limits set by the ratios of comparative costs the actual rate of exchange of domestic goods for foreign goods will depend upon relative intensities of reciprocal demand i.e., country A's demand for B's goods and B's demand for A's goods.

The terms of trade can be put in the form of equation as

Prices of imports Terms of Trade = $\frac{\text{Prices of imports}}{\text{Prices of exports}}$

In order to understand how the terms of trade may have 1 changed over a period an index number of imports and exports - may be prepared. One year may be taken as the base year, (= 100) and the index for a subsequent year may be worked out. This will give a new fraction which will show how the terms moved as between two countries.

The terms of trade are of great economic significance to a country since they determine the gain that accrues to a country from international trade. If terms of trade move in a country's favour, it will increase gain from its international trade and raise in it the level of incomes. It will be quite the reverse in a country for whom the terms of trade become adverse. Suppose an agricultural revolution takes place in the countries which are markets for our agricultural goods. The results will be that our goods will no longer be in demand or demand for them will be greatly reduced. The growers will suffer and their incomes will fall.

Advantages of foreign trade

We may now refer in a general way to the various advantages that accrue to the countries engaged in foreign

(i) There is the advantage, which springs from the principle of division of labour as applied to the various countries. Foreign trade enables countries to specialise in the production of those goods for which they are best fitted, or in the production of which they enjoy the greatest advantage. This leads to the production of goods under the most favourable conditions and thus increases the total wealth and welfare of the world.

(ii) Foreign trade enables consumers not only to enjoy the products of foreign countries, which their own country could never produce, but also to get their requirements from the cheapest markets of the world. The very fact that the goods are imported from abroad shows that their price is cheaper than that of similar home products..

(iii) During times of famines and scarcity, foreign trade enables the people of a country to maintain their life and health through importation of food from abroad. In the absence of foreign trade, such famines would mean death to millions as it happened in 1943 in Bengal when Burma rice could not come owing to war conditions.

(iv) The fear of foreign competition keeps the producers at home up to the mark in their methods of production. Moreover, it tends to prevent monopolies and promotes competition generally. This keeps prices comparatively low for the consumers.

(v) By foreign trade, countries which lack essential raw materials can acquire them through imports. This encourages industrial development in lines in which the countries concerned are otherwise well-equipped. Moreover, it leads to utilisation of raw materials to the best advantage.

Disadvantages of foreign trade

The above advantages, however, are counter balanced, to some extent, by disadvantages.

In the first place, foreign trade may lead to exhaustion of essential materials and minerals of a country, which cannot be replaced. For instance, many of the important materials of India like manganese ore, mica, etc., have been exported from the country more or less in their original state. India has got very little benefit out of them. If they had been conserved, they would have brought better returns when India became industrialised subsequently.

Secondly, foreign trade exposes home industries to outside competition and even to dumping of foreign goods. The decay of the Indian handicrafts during the 19th century seriously disturbed the balance of our economy and increased pressure on land. This happened after the country was exposed to foreign competition by the development of means of communication and transport. The same foreign competition - seriously obstructed Indian industrial development on modem lines and thus perpetuated the medieval character of our economy.

Thirdly, foreign trade may adversely affect the consumption habits of a country through the importation of harmful commodities. China suffered a lot on account of the opium trade during the last century.

Fourthly, on account of the operation of the law of comparative costs a country tends to specialise in the production of only a few commodities. This seriously curtails the number of occupations available to the people. Such over concentration is bad for the stability of a country's economic life.

SUMMARY

Foreign trade makes a country's economy seriously dependent upon other countries. If due to war or any other causes. goods cannot move freely in and out of the country. its economic life may be paralysed. Moreover. any disequilibrium in the field of finance and industry tends to spread to other I countries having trade relations with it. The Great Depression of 1929-32 became universalised because of the economic interdependence of the entire .world brought about by inter, national trade relations. .

On the whole, however. the advantages of foreign trade more than outweigh its disadvantages. Most of the advantages of foreign trade accrue only when goods are allowed to move without any obstruction between the countries. At the same time, free trade also gives rise to most of the disadvantages. It is necessary. therefore. to study more closely the implications of free trade and its opposite policy, protection.

KEYWORDS

- Ammunition
- Countervailing
- Envisages
- Perpeticated

REVIEW QUESTIONS

1. Write a detailed note on state trading in India.
2. Describe briefly the weakness of STC
3. Critically examine the role of STC and MMTC in counter trade
4. State the theory of comparative costs.
5. Bring out the factors determining the size of Gain.
6. What are the advantages and disadvantages of foreign trade?

SUGGESTED READINGS

1. Dr. P.C. Joshi - Institutional Financing in India.

ANNAMALAI UNIVERSITY

LESSON 18

INTERNATIONAL INSTITUTIONS

OBJECTIVES

After readings this lesson, you should be able

- to know about International development association.
- to know the functions of World Bank and IDA.
- to know about Asian development bank, GATT and VNCTAO

STRUCTURE

18.1 Introduction

18.2 Objectives of International development association

18.3 World bank and IDA

18.4 International finance corporation

18.5 Investment policy

18.6 Asian development bank

18.7 GATT

18.8 GATT and India

18.9 UNCTAD

Summary

18.1 INTRODUCTION

At the World Bank's annual meeting held at New Delhi in 1958, the United States of America suggested for the establishment of a new international institution called International Development Association (IDA) to be administered by the World Bank. The purpose was that the IDA would provide finance to less developed member countries on a "Soft loan" basis i.e., on terms imposing a lower servicing charge on loans than the conventional Bank loans. At the meeting of the World Bank's Board of Governors on October 1, 1959, the Board of Directors was instructed to draf Articles of Agreement for such an organisation. The Agreement came into existence on September 24, 1960, after having been signed by an adequate number of countries. The IDA started its operations on November 8, 1960.

18.2 OBJECTIVES OF IDA

The objectives of the International Development Association (IDA) as laid down in its Articles of Agreement are to promote economic development, increase productivity, and thus raise standards of living in the less developed areas of the world included within the Association's membership, in I particular by providing finance to meet their important development requirements on terms which are more flexible and bear less heavily on the balance of payments than those of conventional loans, thereby furthering ,the developmental I objectives of the International Bank for Reconstruction and Development and supplementing its activities.

The IDA grants more generously development loans to developing countries. Its loans are more flexible than the World Bank loans. These loans are for 15 years at least IDA finances a certain percentage of the cost of a project that is meant not only for meeting the foreign exchange part of the project but also a part of the cost in local currency. Many countries which are not able to borrow from the World Bank because these projects are not regarded as credit-worthy, are able to secure credit from IDA. For instance, these were some kinds of projects like water supply, housing, sanitary; construction of hospitals etc., which did not satisfy the technical requirements of the World Bank and, therefore, could not be financed by it. It was the objective of providing financial help to such projects that the IDA was established. The Association has been authorised to finance any project which would contribute to the development of the area whether or not it is productive.

Again IDA loans would bear a much lower interest rate than is charged by the World Bank. Sometimes, if the conditions so warranted, there would be no interest but only an administrative charge levied on the IDA loans. In recent years, many IDA credit have been given at an interest rate of 3/4 per cent.

The other notable feature about IDA loans is that such loans can also be repaid in local currencies of the borrowing countries. The purpose of this facility is to ensure that repayments do not have an adverse effect on the balance of payments of the countries in question.

Membership And Organisation

Any member of the World Hank can become a member of the IDA provided that it is willing to subscribe to the share capital at the rate of 5% of its existing World Bank share ownership. As on June 30, 1975, 114 of the World Bank's 125 countries had been admitted to the IDA as member-countries.

The organisation of the IDA is similar to that of the World Bank. It has a Board of Governors, Executive Directors and a President, all of whom are holders of these positions in the Bank, serve ex-officio in the IDA. The Governors have delegated to the Executive Directors the same board powers as have been delegated in the affairs of the Bank. On June 30, 1975, its membership was 114 (Part 1 consists of 20 developed countries and part II consists of 94 developing countries).

Capital Sources

The member's initial subscriptions to IDA have totaled about $ 1000 million. For the purpose of subscriptions and allocation of voting power, the member countries have been divided into two parts. As noted above Part I consists of relatively more developed countries, which have paid their entire subscription in gold or in freely convertible currencies which can be used for its lending. Part II countries comprising of IDA's less developed member countries are required to pay only 10% of their subscriptions in gold or convertible funds. The remaining 90% subscription of the Part II members is to be paid in their own currencies and cannot be used for IDA loans without the concerning member's consent.

18.3 THE WORLD BANK AND IDA

World Bank and IDA both provide development assistance to the member countries. However, both the institutions are complementary. Whereas the Bank insists on the economic feasibility of projects and on the absorptive capacity of the country applying for aid, the IDA credits are designed to help the weaker-most member countries. Further, the IDA loans are given on very easy terms in comparison to Bank loans, sometimes the rate /of interest hardly covers even the administrative charges. At the same time, 40-45 years are to a member country to pay of fits loans. Unlike the World Bank, a good part the IDA loans are given as non-project aid For obvious reasons, therefore, a lion's share of the Bank loans has thus far gone to Latin American countries whereas IDA's soft lending has benefited South Asia more than any other region.

Purpose wise, transportation projects have been granted about $ 8.6 billion by both the institutions of which 75 per cent bank loans, whereas projects for agriculture, forestry etc. have been given $ 6.3 billion in the combined commitments. The IDA has provided $ 2.5 billion out of this amount, but has shown very little interest in the projects related to power, industrial development; urbanisation, water supply, tourism, population etc. Thus despite their complementary nature, the relative emphasis on the nature and 'extent of lending by the two institutions have been significantly different. Their approach to the needs of developing countries, interest rates and terms of loans have also been different.

18.4 INTERNATIONAL FINANCE CORPORATION (IFC)

After the establishment of the World Bank (IBRD) the need for establishing another international institution was realised.

The reason, as pointed out by Sir Edward Boyles, (the Economic Secretary to the Treasury) was the following. The most important argument was that the IBRD can give loans only to its member governments or against its guarantee. This provision discouraged foreign private investors because it left the door open for governments to favour one borrower over another. Moreover, it led to an apprehension in the minds of private borrowers that this condition would lead to official interference in their business. To remedy this situation, in December, 19M. United States suggested that the Bank prepare draft articles for a new corporation that may promote private investment in foreign countries. This draft was submitted to the World Bank on April 11, 1955. After it was approved by the Bank the Agreement for the International J4'inance Cooperation (IFC) came into force on July 20, 1956, "as an autonomous international institution designed to stimulate growth in its developing member-countries by investing in productive private enterprise in association with private capital and management, and without any government guarantee." The initial number of members in the IFC was 31.

Objectives

1. It makes investment in productive private enterprises in association with private investors and without government guarantee of repayment, in cases where sufficient private capital is not available on reasonable terms.
2. It seeks to bring together investment opportunities domestic and foreign private capital and experienced management.
3. It also seeks to stimulate the international flow of private capital.
4. It assists the growth of capital markets in less developed countries.

Membership And Organisation

The membership of the IFC open to all members of the World Bank to which it is affiliated. The management of the Corporation is similar to that of the Bank. Governors and Executive Directors of the World Bank representing member. countries of the Corporation serve the Corporation in a similar capacity. The President of the Bank is the Chairman of the Board of Directors of the IFC. It is on the recommendation of the Chairman, that the Board of Directors of IFC appoints its President. Thus the affairs of the IFC are fully controlled by the authorities of the IBRD (World Bank). It, however, retains a separate entity and has to maintain separate accounts.

The IFC Differs From The World Bank Is Three Important Respects:

i) It behaves like a private investment firms, with a compact staff of engineers, investment officers, accountants, and lawyers. In addition,. it hires outside consultants to deal with special technical problems or market surveys.

ii) It has the option of making fixed interest loans or make investments with equity-type features and deals directly with private business.

iii) While the Bank has sufficient funds to make substantial impact upon the economics of countries where the projects are located, the role of IFC is that of a catalyst. It employs its limited funds in conjunction with private business and investment capital in the expansion of private industrial enterprises in the development areas to achieve the same effect.

Capital Resources

The authorised capital of IFC is $ 100 million paid in U.S. dollars of 1960 equivalent or gold, and is subscribed by the members in amounts proportionate to their subscriptions to the capital of the World Bank. Its capital can be increased by a 2/2 majority of its existing members. On June 30, 1975, the Corporation's share capital was about $ 107 million. In addition, the Corporation can borrow from the World Bank for use in its lending operations an amount equivalent to four times its subscribed capital.

18.5 INVESTMENT POLICY

Mr. Robert Garner, the then president of the Corporation, enterprises in member countries, particularly in the less developed areas. It is envisaged that the Corporation's investment will never be more than half of the capital needed for a venture. The rate of interest in each case would be a matter for negotiation, depending on risks and on the other terms of the investment. In general, it would be reasonable to expect that loans would normally run between 5 and 15 years."

"For several reasons, the Corporation's investments are likely to be in industrial rather than in other fields." In brief, the loans are made on the following principles:

1. At least half of the cost of projects should be financed by local private capital, located in developing countries.
2. As a matter of policy, IFC does not invest in developed countries.
3. The enterprises granted loans are in the fields of manufacturing, processing or mining.
4. The rate of interest in each case would be a matter for negotiation depending upon the risks and on other terms of the investment.
5. The Corporation evaluate a project purely from its profit making capacity an approach which is similar to the one taken for an investment by a private capitalist.
6. The IFC has the option to convert loans into capital stock and appointments on the Board of Directors of the borrowing enterprise.
7. It has the right to sell its capital stock at any time to any person.
8. It has the right to sell its capital stock. In general, it would be reasonable to expect that loans would normally run between 5 and 15 years.
9. The IFC makes investment only when it is satisfied that the enterprise has or will have experienced and competent management.
10. The Corporation seeks to supplement and not to compete with private capital in the area for which assistance is to be given.
11. The IFC does not require a guarantee of the government, but in the case of opposition by the nations government it does not invest in that enterprise.

Until June 1971, the IFC had invested' 577.8 million in 172 industries in 47 developing countries. In India, it had invested $ 27.3 ,million in various industries such as Republic Forgo Company Limited. (Steel Forging), Kirloskar (Diesel Engines) K.S.B. Pumps Limited, Lakshmi Machines Limited (Textile Machinery), Jayshree Chemicals Limited. Indian Explosives Limited (Fertilizers), Zuari Agro-Chemicals Limited (Fertilizers) etc.

"By June 30, 1975, the Corporation'. 88 commitments had risen to Re. 1262 million of which . 859 It1il1ion had already been disbursed. This amount of $ 1262 million was sanctioned for 249. enterprises in 57 developing countries. The gross concurrent investment in all these enterprises would have been $5131 million. It is interesting to note that out of the IFC's total commitments of' 1262 million made during 19 years of it., existence,.' 779 million or about 60 percent has been made the past five years. During 1974-75 the Corporation sanctioned loans and equity investment of $ 211.7 million. Of the total disbursed amount of $ 859 million 48% was provided by U.S.A. 23% by Japan, and 11.8% by European Economic Community. About 15 per cent of the total investment was made out of the Corporation's own resources. The Corporation's portfolio investment upto June 30, 1975, amounted to Rs.895.7 million of which Rs.236.7 million was held for the account of participants in the IFC's investment operation and $ 659 million was on IFC's own account. Of this amount loans from IFC amounted to $ 517.2 million, whereas equity investments amounted at $ 141.4 million.

Out of the total disbursed amount for investment ($ 859 milllon) made by IFC until June 30, 1975, Brazil received $ 262 million, Turkey received $ 116 million whereas Yugoslavia's share was $ 79 million. The Philippines, Mexico and India received $ 76 million $ 70 million and 58 million respectively. Of the total commitments, 43 per cent were allotted to Latin American countries, 24% for Asia, 19% for Europe, 9% for African countries and 5% for Middle East.

Large part of the IFC's commitments and investments have gone for promoting iron and steel, cement, textiles, paper, chemicals and allied industries in the member countries. India had received $ 52 million and June 30, 1975, for 11 private sector projects.

Criticisms

1. The rate of interest charged by the IFC is too high which most LDC's are not in a position to pay. It charges normally 6% to 8 per cent rate of interest which is not desirable.
2. The interest payments as well as the principal is to be repaid in U.S. dollars. Most developing countries are not in a position to do so.
3. The total capital proposed to be raised for a particular . project often falls short of its requirements.
4. Sometimes the projects encounter delays in construction.

It seems, however, the above criticism are not valid. The IFC has contributed effectively in the process of industrial development of many developing countries.

18.6 ASIAN DEVELOPMENT BANK

For several years in the past the World Bank has been making efforts to set up regional development banks. As a consequence during the past ten years regional development banks have been set up for the developing countries of Latin America, Africa and Asia. As a matter of fact, a suggestion for a regional development bank for Asian countries was given in 1963 by the Economic Commission for Asia and Far East (ECAFE). The final draft for such bank was presented in December, 1965, when representatives from major Asian countries met at Manila: The Philippine's. The Asian Development Bank was formally established in December 1966.

Objectives And Functions Of The Asian Development Bank

The basic purpose for establishing the Asian Development Bank was to promote economic development of and mutual economic co-operation among the countries of Asia. The Bank thus aims at accelerating the process of economic development in the developing countries of this continent. For accomplishing this broad objective, the Bank is supposed to perform the following functions:

i) to promote the investment of public and private capital, for economic development.

ii) to channel its investable funds in the implementation of those projects which are important for developing a major sector of a country's economies.

iii) to assist member countries in co-ordinating their programmes and policies of economic development and at the same time, promote inter-regional trade.

iv) to provide; technical assistance in the execution and development of projects v) to mobilize more and more funds for, the economic development of member-countries by extending c0operation to the World Bank, ECAFE, to other U.N. bodies and public as well as private agencies located in the member countries, and vi) to take up all such activities which would help in achieving, above goals.

Capital Membership And Admtnistration

The membership of Asian Development Bank is open to all the countries of Asia, but for procuring addition resources, many developed countries of other regions ha e also been admitted into the Asian Development Bank. In June 1975, the Ban\t had enrolled 27 regional countries and 14 non-regional countries-thus raising the number of members to 41.

Expressed in terms of the current value of U.S. dollar, the authorized capital of Asian Development Bank was $ 3366 million on December 31, 1974. Thus during a short period of six years the authorised capital of ADB increased by 150 per cent. However, on December 31, 1968, the Bank's authorised capital was $1327 million. During this period, the Bank's subscribed capital has also increased from $11 70 million to $ 2770 million:

Besides its capital resources, the Asian Development has also raised funds through borrowing. During 1972, the Bank raised $ 59 million through borrowings. However, the amount of gross borrowings was only 1$4 million in 1974. On 31st December, 1973, the total outstanding borrowings of the Bank were $ 254 million. Within a year's time, however, this amount rose to $ 293 million. About 38% of this amount was in Japanese yen. It may be noted in this context that at the time of Bank's formation a member country was required to deposit only 50 per cent of its subscription in the form of gold (25%) and local currency (25%). However, the Board of Governors is free to call the balance as and when more funds are needed by the Bank. Table below shows the distribution of shares, share capital and voting power among the important member countries of the Asian Development Bank.

Thus, Japan is the principal subscriber to the Asian Development Bank. Further, it has also subscribed a sizeable portion of the Bank's share capital. .

Out of the total votes of Asian Development Bank, 20 percent have been allocated among countries equally whereas the remaining 80% of the votes have been allocated on the basis of share capital subscribed by the each member. The management of the Bank has been vested in the Board of Governors constituted by representatives of the member countries. This Board meets only once in a year and therefore, for routine decision-making and for carrying out the Bank's lending and, other operations, a ten-member Board of Directors has been constituted.

Subsciption and voting power of principal member countries in the asian development bank

(Par Value in Thousand U.S. Dollars)

Countries	Shares	Percent of Total	Par value	No. of votes	Percent of total
A-Total Regional	166141	72.35	2004.24	203941	71.05
Member of which Japan	5000	21.73	603.17	51400	17.91
India	23230	10.12	280.48	24600	8.59
Australia	21250	9.25	766.03	83100	28.95
B-Total Non-Regional Members of Which					

U.S.A	20000	8.71	241.27	21400	7.45
U.K	7500	3.26	90.47	8900	3.10
France	6250	2.72	75.39	7650	3.10
W. Germany	8500	3.70	105.54	9900	3.45
Canada	6250	2.72	75.39	7650	2.66
C. Grand Total	229641	100.00	2770.27	287041	100.00

Source: Asian Development Bank, Annual Report, 1974.

In April, 1973, the Board of Governors authorised the Board of Directors to establish a new Special Fund, now known as Asian Development Fund. This is multi-purpose special fund, the proceeds of which are to be utilized for providing concessional term-loans to the relatively poor member countries. It was decided to mobilize $ 525 million from member and non-member countries by the end of 1975. The Fund was established formally on June 28, 1974. Ten countries had subscribed $ 245.4 million by December 31, 1974 to the Asian Development Fund.

Lending operations of the asian development bank

Even though Asian Development Bank has been set up for providing help for the economic development of the developing countries of Asia, yet the Bank provides aid to the member countries only after following considerations:

i) that larger proportion of the aid should go to those countries which are relatively poorer among the developing countries.

ii) that the concerned government has approved of the loan which is being given for a private or public sector project.

iii) that a detailed report about the project has been received from the Bank's Chairman.

iv) while sanctioning a loan, the Bank also examines the - prospects of other loans which an applicant may secure from sources other than the Asian Development Bank.

v) the bank also examines the extent to which an applicant is capable of satisfying the conditions prescribed in the agreement.

vi) Generally, the recipients of Asian Bank's loans have to use such funds within the markets of member-countries, but with a two-thirds majority the Board of Directors can allow the utilization of Bank loans even in markets of nonmember countries.

vii) the Asian Development Bank would operate strictly in accordance with the principles of sound banking.

During 1968-73 the Asian Development Bank approved loans worth $ 1376 million to 21 countries. The total number of projects for which such loans were sanctioned was 189. Interestingly enough industrial development projects (including assistance given to development banks of the member countries) were given a quarter of the total aid during 1968-73 period. About 24 per cent of the aid was given for transport and communication projects whereas the proportions of electric power projects and agricultural development projects were 26.5% and 12.5% respectively. The Bank also approved loans for water supply (11.2%) and education (1.0)%. During 1974 the Bank approved loans worth $ 547.7 million of which $ 186.9 million were for industrial development and $ 134 million and transport and communication projects only $ 76.55 million and $ 81.5 million were sanctioned during 1974. Thus there is an evident shift in the sectoral allocation of Asian Development Bank's loans.

It may also be noted that during 1968-73 out of the total loans of $ 1376 million sanctioned to member countries, $ 319.7 million were given out of the Bank's Special Fund resources. During 1974, the total amount of loans given out of Special Fund resources was $ 172.86 million. The Bank charges only 1 % interest on such loans to meet its service charges. Further, such loans are generally given to extremely poor countries where the per capita income is less than $ 300, and their period of amortization is generally 40 years.

Upto 31st December, 1974, the Asian Development Bank had disbursed $ 399.3 million which forms about 21 per cent of the total loans sanctioned by this time.

During the past seven years (1968-74) 17.5 per cent of the total loans (approved) were given to the Republic of Korea, 12.57 per cent were given to the Philippines, 10.63 per cent given to Malaysia; 9.40 per cent were sanctioned for the Republic of China and 8.5 per cent were granted for Singapore. Thus, more than 58 per cent of the total loans have been so far given to the countries of eastern Asia. India which has been the largest recipient of IDA loans could not receive any loan from the Asian Development Bank. Bangladesh also received les!} than 4.5 per cent of the total Bank loans upto 1973, but her share in the loans sanctioned was raised to 9.5% during 1974.

The Asian Development Bank charges 81A per cent interest on its loans. At the time of its inception the Bank charged an interest of6. 7 /8 per cent, but then raised this rate to 7112 per cent in May 1970 and further to 8112 per cent in September, 1974.

Criticism Of The Working Of Asian Development Bank

It is alleged that even though Asian Development Bank is a bank for the countries of Asia, the policy formulation and usual working of the Bank are largely influenced by U.S. strategies. It is interesting to note that most countries which have thus for received loan from the Asian Development Bank are U.S. allies, and support the latter's policies in international politics. Probably for this reason, U.S.S.R. has not joined the Bank.

Secondly, the Bank's rate of interest is very high. The proportion of concessional loans given out of its Special Fund has been relatively very low. As a result, the Bank has not been able to provide substantial help to the poor countries of this region, and they have to bank upon other agencies for financial help for their development programmes.

Thirdly, the Asian Development Bank provides (generally) tied loans and forces the borrowing country to use these funds for specific projects only. This condition reduces the scope and jurisdiction of the Bank's loans.

Finally, most of the loans approved by the Asian Development Bank have financed the private sector projects. It is alleged that the Bank has shown very little interest in the public sector development programmes currently in vogue in most Asian countries.

There is an urgent need to redesign the lending policies of the Asian Development Bank. For a rapid and long-term economic development of Asian countries loans must be given to them on the basis of merit of each project rather than on political affiliations.

18.7 THE GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT)

The U.S.A. started thinking during the period of second World War about the economic policy to be pursued after the world war for economic development. It believed that nations should organise a body of nations which would guide the policies for trade after the war. Consultations began in Bretton Woods Conference. When the I.M.F. and the World Bank were established after the second World War it was proposed to set up a third institution, namely the International Trade Organisation (ITO) in order to promote world trade and employment. However, most nations failed to reach agreement on the scope of the ITO and the GATT was signed instead at the Hawana Conference in 1947. The GATT which had been originally intended as a purely temporary arrangement has since 1948, developed into a permanent international arrangement. Since its establishment its membership has grown from 23 to 83. New members can be admitted only if the agreement is reached among 2/3 members regarding the terms of admission. All members must accept its code of conduct, The members of GATT include most of the leading trading nations of the world, although it excludes U.S.S.R. China, and most of the communist block countries.

The GATT is a treaty collectively administered by the contracting parties. The representatives meet from time to time for negotiations and discussions. It is a treaty based on four important principles:

i) that trade between nations should be only non-discriminatory.

ii) that the tarrif should be the only instrument employed to influence foreign trade.

iii) that nations should consult with one another before taking action\that might harm other's trade; and iv) that means should be provided for the negotiations of tariff reductions.

The Agreement consists of four- parts. In Part I, the main obligations of contacting parties are laid down. Part II forms a code of fair trade while the Part III contains conditions of membership and withdrawal Finally. Part IV incorporated in 1965 relates to the expansion of trade of developing economies.

Special concessions are given to them. They (LDCs) need not offer reciprocal reduction of duties and can impose quotas for balance for payments reasons.

Objectives Of GATT

The GAIT aims at contributing the following objectives by entering into reciprocal and mutually advantageous arrangements direct to the substantial reduction of tariffs and other barriers to trade, and to the elimination of discrimination in international trade.

i) Improvement in the standard of living of member countries.

ii) Ensuring full employment and a steady growing volume of real income and effective demand.

iii) Expansion of world trade and production

iv) Ensuring the full use of the world resources.

The objectives are very common in nature. However, the GA'IT does not aim at directly achieving these objectives. The articles of Agreement, for instance contain no provisions for the direct achievement of these objectives. The specific way in which these objectives are to be achieved is through evolving a world trade pattern based upon multilaterial trade and nondiscriminatory tarrifs with the ultimate objective of reducing these tariffs to a minimum, consistent with the national objectives of the countries concerned. Therefore, the tariffs and trade restrictions (which were adopted during and after world war period) are to be reduced substantitally and not abolished. The makers of the Agreement recognised that trade barriers are essential under certain conditions. The reduction in tariffs and the elimination of discrimination are to be on a reciprocal and mutually advantageous basis. The new chapter, recently added to the General Agreement, explicitly states that the developed contracting parties should not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of less developed contracting parties.

To achieve these objectives principles predominate:

a. That trade expansion and maximum production are possible when trade is to be conducted in a non-discriminatory manner to the best market wherever that may be, rather than restricting by tariff or other barriers.

b. that the use of quantitative restrictions on trade, such as the fixation of quotas should be condemned, and

c. that the contacting party should enter into reciprocal and mutually advantageous negotiations for substantial reduction of prevailing tariffs adopted by GATT three

1. Elimination of discrimination: (the principle of most favoured nations)

To ensure against discrimination, the "Most Favoured Nation" (MFN) principle is applied. Under this principle each member nation shall be treated as well, as the most favoured nation any concession accorded to any particular member is automatically accorded to other members. Thus the negotiations at tariff conferences, although conducted bilaterally, are in effect, multilateral in as much as any reductions agreed upon, are available to all members of the GATT.

However, there are several escape clauses. In one of the conferences, the Indian delegation said, "equally of treatment is equitable only between equals." On this basis, developing countries demanded some right to discriminate.

Thus, dumping and export subsidies may be countered by measures limited to the offending country. Although partial tariff preferences are prohibited, arrangements designed to establish complete preference i in the form of C\1S00ms union and free trade areas (FT A) are permitted. Special concessions are allowed for trade with the former colonies.

2. Quantitative restrictions on imports

As a matter of principle, the GATT rules prohibit the use of import quotas but three important exceptions to this prohibitions are granted.

i) Countries confronted with balance of payments difficulties may use quotas. They may, however, be limited to the extent necessary to stop a serious decline, or forestall a threatened decline, in reserves. However, the IMF is to be consulted before such use is allowed.

ii) Under-developed countries may apply quotas but under a procedure approved by GATT: The developing nations, where the use of tariff is not applicable, may impose quantitative restrictions to protect domestic industries. Again, in applying quantitative restrictions the contracting party should aim at distributing the trade among other contracting parties in a ratio which is likely to be distributed in the absence of such restrictions. If possible, total quantity of the product to be imported during a specified period should be fixed and announced in advance.

iii) Quotas may be applied to agricultural or fishery products, if domestic production is subject to equally restrictive controls.

3. Tariff negotiations: (Reduction of Tariff)

To achieve this objective, the contracting parties recognise that tariffs are 'often an important obstacle to trade'. They are therefore authorised to occasionally sponsor negotiations for the substantial reduction of tariffs and other charges on imports and exports, especially for the reduction of such high tariffs as discourage the importation of even minimum quantities. The negotiations are to be conducted on a reciprocal and mutually advantageous basis paying due consideration to the objectives of the Agreement as also to the varying needs of individual contracting parties. These negotiations will also take into consideration the needs of less developed countries for a more flexible use of tariff protection to assist their economic development and the special needs of these countries to maintain tariffs for revenue purpose. The important rules relating to tariff negotiations are:

i) Reciprocating & Mutuality: Negotiations are on a commodity to commodity basis, and the principle of reciprocity will be the basis for argument. Here reciprocity means that if the two contracting parties, are negotiating then, the grants the concessions, the other also does the same. The concessions are given to them.

ii) Binding of low Tariffs: The negotiations shall be directed towards the reduction of tariffs or the binding of low tariffs. This provision was introduced to safeguard the interests of the low tariff countries, which had nothing to offer in negotiations.

iii) Preferential Rates and the Margin of Preference: This margin of preference is measure yea solute differences between the most favoured nation rate and the preferential rate of duty for the like product and not the proportionate relation between the two rates. Thus, if the most favoured nation rate is reduced, the margin of preference will be reduced automatically and vice-versa.

iv) Bound and Unbound Rates: Once a certain level of tariffs incorporated m the scheduled, it becomes bound against any increase. This means that the tariff concessions contained in the original scheduled annexed to the General Agreement, usually known as bound rates, came into force in 1948 for 3 years, until the end of 1950. After the expiry of 3 years a contracting party could modify or withdraw any concession by negotiation and agreement with the government with which it had been negotiated. There has /always "been the possibility that after the expiry of this, period, the contracting parties agreed to extend the assured life of the schedules. However, before the beginning of each new period opportunities had to be given to the contracting parties to negotiate for the withdrawal of tariffs or modication of any binding.

To secure stabilization and reduction of import duties six tariff conferences were held between 1947 at Annecy; 1950-51 at Torquay; 1956 at Geneva, 1960-62 at Geneva (this is known as the Dillon Round) and 1964-68 at Brussels (this is known as the Kennedy Round). Negotiations in these conferences have been product by product discussions. The first and the last conference achieved the most results - the first because at the end of the war tariffs were relatively high, and the last because the U.S.A. encouraged across the board reduction in tariffs, following the enactment of the U.S. Trade Expansion Act in 1962.

The first round of tariff negotiations, held at Geneva from April 10 to October 30,1947 was a part of the establishment of the General Agreement. The concessions exchanged in the negotiations took the form of (i) complete elimination of certain duties and preferences. (ii) reduction of duty preferences, (iii) the binding of duties at existing levels and (iv) the binding of duty-free treatment. The participating countries completed 123 sets of bilateral negotiations.

The second conference was held at Annecy in 1949. It was called primarily to facilitate the extension of GA TT to countries which could not participate in the Geneva Conference. By this time, 10 new countries had joined the GATT increasing its strength to 33. In this conference 147 sets of bilateral negotiations covering over 500 items were completed.

The third conference was held at Torquay in 1950-51. Six new countries joined it. The conference was not very successful because only 147 out of the expected 400 agreements could be concluded. The U .8.A. had already offered sufficient concession and this time it was not in a position to offer any more.

The fourth conference was held at Genera in 1956. Excepting the U.S.A. which went almost to the limit of her negotiating power and granted on imports valued at $ 900 million and obtained concessions on exports valued $ 400 million, no country felt satisfied. Several countries withdraw from the negotiations.

The fifth conference was held in Geneva in 1960-61. In this conference, the developing countries pointed out that the strict application of the principle of reciprocity in previous negotiations had practically exhausted their bargaining power and that on the other hand, industrialised countries had avoided negotiations on products of vital interest for LDCs by involving the rule whereby a country can refuse to negotiate on any product. They stressed that the conference could be successful only if the industrialised countries were prepared to grant unilateral tariff concessions. The views were strongly supported by the Haberler Report. The delegations of Australia & India submitted a number of concrete proposals designed to include in the negotiations rules, the negotiability of non-tariff measured like quotas and internal taxes. The proposals were accepted after long discussions.

The "Kennedy Round"

The sixth conference known as the Kennedy Round was opened in May, 1964. The establishment of the two regional free trade areas in Europe. - the ECM and the EFTA - and their success led the U.S. President Kennedy to suggest all round reductions in tariffs, with the main objective of reducing tariff between the U.S. and the two European groups, more specially the ECM Historically the U.S. had been one of the strongest supporter of protection, principally as a means of safeguarding the standard of living of its people against cheaper labour in the rest of the world.

The Trade Agreement Acts of the U.S. between 1934-1962 did allow for negotiated reductions in tariffs but there was a legislative provision related to "the peril point" principle. Under this principle, peril points were to be established for setting limits below which tariffs could not be lowered by the Government without the approval of the Congress. The trade Expansion Act of 1962, abolished the peril point principle and empowered the President to reduce all import duties upto a maximum of 50%.

As a member of the GATT, the U.S. had agreed at each of the tariff conferences to a number of tariff concessions, but none of these could be compared in scope or depth with those agreed at the 6th tariff conference held at Brussels between 1964 and 1968. Since the initiative for this was provided by President Kennedy, this Conference came to be known as the Kennedy Round

This Conference was attended by 50 nations. Towards its conclusion, 37 nations joined in making duty reductions covering $ 40 million of the world trade. The U.S. agreed to reduce tariffs on two thirds of her imports by an average of35% although in some cases the reduction were of the order of 50% or more.

The ECM also reduced tariffs on an average by 35%, the U.K. by 38%. Japan by 30% and Canada by 24%. These cuts were not to be implemented immediately but were to be gradually introduced over a period of 5 years.

When the Kennedy Round has been fully implemented the duties imposed on manufactured goods by the leading industrial countries will only be in the range of 5 to 15 per cent.

The incidence of the tariff reductions following the Kennedy round varied considerably among commodity groups. Chemicals. paper. base metals and other manufacturers were subject to the maximum cuts. Iron & Steel textile, fuels and tropical products by contrast, received reduction on a smaller scale.

Developing countries had hoped that the Kennedy Round would result in especially favourable treatment for exports of particular interest to them. Obviously, they were disappointed at the outcome of Kennedy Round.

Progress in the Kennedy Round was limited mainly to duty reductions on manufactured goods. (With agricultural products. the negotiations had little success. They did manage to obtain an agreement to raise the minimum world wheat price. No progress was made on dairy products, subject in many countries to direct limitations.

The Kennedy Round was the most remarkable achievement. However, by itself it is not enough as there are many other non-tariff barriers to trade that continue to exist even today.

Settlement Of Disputes

The greatest success of the GATT has been in the field of settlement of disputes. A member can bring to the annual meeting its complaint against any other member on the issue of violating the rules. In the first instance. parties are requested to settle their disputes mutually, failing which a working committee of the organisation, after carefully studying the problem, gives its own recommendation or ruling. The offending member is asked to comply with this recommendation, otherwise the aggrieved party can retaliate by withdrawing some or all concessions allowed to the offending country. In practice, offending members have often complied with the recommendations of the working committee. One of the most conspicuous cases of GATT's failure arose when the U.S.A. continuously refused to modify its import restrictions on dairy products from Netherlands. Since 1953 a panel has been set up by the members to act as an informal court to settle disputes. This panel gives hearing to both the parties, frames and considers the issues, and drafts its recommendations.

The GATT has succeeded in setting some of the most difficult and complicated cases. Settlement of disputes is not an easy job. It is very difficult to establish facts. Sometimes the roots of the dispute go 30 to 40 years back. To GATT's great credit, the Government of U.K. and Belgium at different times got approval of the legislative for complying with the recommendations of GATT.

Benefits Accuring To Under-Developed Countries Fromgatt

The less developed countries of the world are facing a number of problems in the field of foreign trade. To mention a few protection. of agriculture and domestic industries, instability of Primary markets, decline in the relative export, disequilibrium in the balance of payments etc., pose serious threat to their economic stability. These problems are a great challenge to the GATT. The success of GAT!' will depend to a considerable extend on how successfully it meets this challenge

Yet a developing country gets several advantages as a member of the GATT. It obtains through GAT!' a right to MFN treatment. Under the GATT's article XVIII, special concessions are granted to LDCs. For developing countries it provides certain special facilities contained in section A to D of the Articles. (A) Concession to promote a particular industry with a view to raise the general standard of living. (B) Quantitative import restrictions for safeguarding its external financial position and for ensuring adequate reserves for the implementation of development programmes. (C) It deals with the grant of an authorisation to developing countries to use quantitative restrictions and other similar measures which may be necessary to remove balance of payments disequilibrium. (D) To introduce necessary measures for the establishment of an industry for its economic development.

Realising the difficulties of developing countries, the GATT appointed in 1957 a Group of Experts to report on the trends in international trade with special reference to "the failure of trade of the LDCs to develop as rapidly as that of the industrialised countries, excessive short term fluctuations in the prices of primary products, and widespread resort to agricultural production." The experts submitted their report, generally referred to as Haberler Report, in 1958. As a consequence, the GATT decided to undertake its ambitious trade expansion programme. To this end, three committees were set up. One of these committees was to deal with the question of further multilateral tariff negotiations while another was to concern itself with the problems arising in trade in agricultural products. The third committee was to deal with the question of achieving an expansion in the export earnings of LDCs.

In February, 1965, when the contracting parties put into de facto application, it appointed another Committee on Trade and Development to supervise the implementation of the provisions of previous committees.

The progress, however, has not been very encouraging, and many trade restrictions inconsistent with the provisions of the General Agreement still continue. The concerned developed countries refused either to set target abolition dates, or to indicate how they intend to solve the underlying domestic economic problem. In an effect to respond to the demand of the LDCs and the felt need for more positive efforts. towards the expansion of their exports, the Committee on Trade and Development has sponsored many, other activities. An important of these is a series of studies Of the development plans of individual countries. The objective of these studies is to assess the likely trade implications of development plans of LDCs and to examine the potential role of the export sector of individual countries with a view to improving plans, coordinating the use of aid with export measures, and familiarising LDCs with one another's import requirements and the export targets. The studies are carried out in consultation with the I.B.R.D., and other international agencies concerned with foreign assistance, so as to improve the co-ordination of aid with trade efforts.

18.8 GATT AND INDIA

India has not only been participating in tariff negotiations organised under the GATT, but has also been emphatically presenting the problems and view points of developing countries in various meetings of the Committees appointed by the GATT.

However, to enjoy full benefits, a developing country like India should acquire a competitive ability whether by internal economic discipline, or by the development of external salesmanship, and strive to eschew persisting inflation, lest the Kennedy Round benefits should pass over per head.

Defect Of GATT Arrangements

1. While it is true that to provides a forum for multilateral negotiations on the basis of reciprocity and also provides machinery for discussion and settlement of disputes, yet it provides only a code of good behaviour. The Kennedy Round marks the most spectacular achievement of the GATT, yet it too is merely an improvement. The GATT has no super national authority and often escape clauses have been used by member countries to justify protection.

2. The membership is diverse, and therefore, there is no possibility of general rules. Economic motives and political motives are entangled.

3. Combination of the principle of non-discrimination with the principle of reciprocity entails built-in-biases and problems. Reciprocity means that there must be atleast two bargainers, and to offer a non-discriminatory treatment, a country must have a strong competitive position in world markets on the one hand, and protected domestic market on the other. Nondiscrimination implies that a major trading nation must forego reciprocity.

4. Negotiations are on a ,commodity to commodity basis and therefore, there is a bias in favour of trade with each other as against trade with the third parties.

5. In principle, the GATT recognizes that -multilateral bargaining is better than the bilateral, but the reciprocity principle ensures that bargaining will be dominated by the larger trading countries. Once again, the essential dispute is between reconciling the needs of non-discrimination with the principle of reciprocity.

6. The GATT is not a representative body as it excludes most of the communist block countries, as well as a large number of newly independent developing economies. It is labelled as a "rich countries club" where the interests of the U.S and its European allies predominate. Entry of Japan into the GATT. was delayed for a long time, and even to this day many countries have invoked special provisions of the charter under which Japan is not offered the MFN treatment.

Due to these difficulties, the LDCs cannot go far enough to solve their foreign trade difficulties. It is in this context that the UNCTAD (United Nations Conference on Trade and Development) took place. We shall discuss the objectives and the success of UNCTAD in the following chapter.

18.9 THE UNITED NATIONAL CONFERENCE ON TRADE AND DEVELOPMENT - (UNCTAD)

Prior to the birth of UNCTAD international problems in the Areas of trade and aid were discussed mostly within the framework of GATT which mostly benefited the trade of developed countries. Thus it was the search for a new programme of international economic co-operation designed to reduce the "trade gap" of developing countries which led to the creation of UNCTAD. UNCTAD was established as a perm4nent organ of the General Assembly of the United Nations on December 30, 1964. In order to uf1derstand the establishment and the working of the UNCTAD, it is necessary to review briefly the background of this organisation.

An encouraging sign of the 1960's for the developing countries of Asia, Mrica and Latin America was the growing awarness among the developed countries of the need for a global effort to reduce the disparities between the rich and the poor nations, the developing and developed countries. When the General Assembly o(,the United Nations decided in its 16th session (December 1961) to designate 1960's as the "United Nations Decade of Development", a concrete step was taken in this direction. The session also adopted the objective for underdeveloped countries, a minimum annual rate of growth of national income at 5% at the end of the decade and called on all member states to help the less developed countries achieve this goal.

Developing countries had by this time emerged as independent national states. They were all former colonies or dependent territories of European powers. As such, there was a widespread feeling of discontent with what is termed as the colonial pattern of trade in which the colonies became suppliers of raw materials and markets for the manufactured products or) European nations. 'therefore, on attaining independence, they, set upon a policy of industrialisation through protective barriers. This policy of protection was further strengthened by arguments given by Nurkse and Prebish. These arguments were: (i) that the demand for primary products in world market is income inelastic (dy 1) and, therefore, specialisation in primary products should be given' up in favour of a more diversified industrial structure and (ii) that the terms of trade of primary products and manufactured goods showed a secular decline against the primary products. Therefore, the pattern of trade where primary products were exported for manufactured goods was not beneficial for the producers of primary products. Over the years industrialisation policies based upon arguments such as these were adopted by every developing country. However, experience proved that such a policy was be set with many problems. It was, by and large, antitrade biased. It was felt that even though international trade cannot be the main instrument of economic growth as it was during the 19th century, yet, trade should playa more useful role as an instrument for promoting economic growth in the poorer countries.

Economic development necessitates a large increase as well as imports. As a general rule import requirements in the early stages of growth tend to rise at least as fast as income. Whereas in 1950's export earnings of less developed countries grew at only about 3.5% per annum. Thus it was realised that the persistence of these trends would lead to a widening gap between the developing countries import needs and their capacity to finance these imports. This need was filled in the 1950's through liberal foreign aid. However, the estimated requirements of external resources for developing countries is much greater than the likely amount of aid. Therefore, on the one hand, there arose a pressure for increasing the amount of aid provided by rich nations. On the other hand, the nations which had obtained large amount of aid began to realise that the real value of aid was much less than the money value because of the terms and conditions attached to external credits. It was also felt that the repayment and the burden of debt service of foreign aid will ultimately have to be met through larger trade flows. Hence the awareness that something needs to be done to make an expansion of world trade possible such that it would benefit the developing nations was widely shared by all nations.

Trade policies of the primary goods producing countries were also conditioned by the fact that primary product prices were highly unstable. If some arrangement could be worked out to stabilize agricultural and primary product prices, the developing countries themselves can liberalize their trade policies. The existing arrangement regularizing international trade was the GATT arrangement. The GATT had failed to look after the export interests of developing countries. Its composition was such that most developing countries failed to get adequate representation or to have their demands heard.

The ideas of international co-operation were carried forward further, the 17th session of the General Assembly decided to convene a United Nations Conference Trade and Development (UNCT AD) in 1964. India was one of the members of the Preparatory Committee and the first conference was held in Geneva towards the end of March. 1964. It lasted till June that year. Apart from the representatives of 118 countries, the Conference had observers from the GATT (General Agreement on Tariff & Trade), 13 U.N. specialised agencies and several inter-governmental economic organisations. At that time (March-June, 1964) it was not mean t to be a permanent organ of the United Nations. It was only in December, 1964, that the UNCTAD emerged as a permanent organ headed by a Secretary-General and with its own permanent Secretariat.

The conference considered issues relating to expansion and financing of international trade, international commodity problems, trade in manufacturers and semi-manufacturers, improvements in the invisible trade of" developing countries, implications of regional economic groupings, etc.

The decisions of the conference were incorporated in a Final Act, which recommended that the 19th session of the General Assembly should establish the conference as an organ of the Assembly to meet at least once in 3 years and that the functions of the UNCTAD would be the following:

Functions Of UNCTAD

1. To promote international trade, specially with a view to accelerating economic development, particularly between countries at different stages of development, between developing countries and between countries with different social organisation.

2. To formulate principles and policies on international trade and related problems of economic development and suggest steps to put them) into effect.

3. To review and facilitate the co-ordination of activities of other institutions in the U.S. System.

4. To initiate action with the competent organs of the U.N. for negotiation and for the adoption of multilateral trade arrangements; and 5. To serve as a centre for harmonising the trade and related development policies of government and regional economic groupings.

Membership And Management Of UNCTAD

The UNCTAD is now, therefore, a permanent body. Its membership is open to all members of the U.N.O., the International Atomic Energy Agency, and other specialised U.N. Agencies. Each member has one vote. While procedural matters are decided by a simple majority of these present and, voting, decisions on matters of a substantive nature require a two-third majority.

The permanent organ of the Conference is the Trade and Development Board comprising 55 members which meet twice a year. It has four organs which meet annually. These organs are the committees on:

i) Commodities

ii) Manufacturers

iii) Shipping and Invisibles and

iv) Financing related to trade

The Head quarters of the UNCTAD are in Geneva. The conference which is a plenery body of over 140 countries, meets normally at intervals of not more than 4 years. Thus far the plenary body of UNCT AD has met four times. The last meeting was held in May, 1976 in Noirobi, Kenya.

SUMMARY

World Bank and IDA both provide development assistance to the member countries. However both the institutions and complementary whereas the bank insists on the economic feasibility of projects and on the absorptive capacity of the country applying for aid. The IDA credits are designed to help the weaker-most member countries. India has not only been participating in tariff negotiations organized under GATT, but has also been emphatically presenting the problems and new points of developing countries in various meetings of the committees appointed by the GATT.

KEYWORDS

- Amortization
- Explicitly
- Conspicuous
- Reciprocity

REVIEW QUESTIONS

1. Critically examine the lending policy of the International Bank for Reconstruction and Development, and evaluate its role in the promotion of economic development in the developing countries.

2. Give critical account of the work and services of the World Bank.

3. Examine the role of IBRD in assisting the economic development of developing countries.

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,4. The IMF and IBRD are complementary institutions and show how far they have been able to achieve the objectives for which they are meant. 5. Discuss the organisation and objectives of the World Bank.

To what extent has the Bank helped India.

6. Critically examine the aims, objectives and working of the International Finance 'Corporation or International Development Association.

7. Write short notes on the following:

(i) IBRD, (ii) IDA, and (Hi) International Finance Corporation.

8. What are the main objectives of the GATT? To what extent they have been accomplished? What practical suggestion can you give for improving the present situation?

9. State briefly the contribution of GATT in facilitating and expanding the world trade.

10. Under what circumstances is it desirable to resort to trade and exchange discrimination? Explain the provisions of GATT in this regard?

11. What do you understand by Kennedy Round Agreement? How far does it sub serve the purpose of GATT? Explain carefully.

12. What are the basic principles of GATT? How have they been affected by the process of planned economic development in developing countries?

13. Write short notes on GATT.

14. Indicate the benefits to developing countries from the I system of general preferences as recommended by the UNCTAD.

15. What are the basic principles of UNCT AD? How have they been affected by the process of planned economic development of developing countries?

16. State briefly the contribution of UNCTAD in facilitating and expanding world trade.

17. The increasing volume of international trade and economic co-operation during the post- World- War II period has widened the scope of International Economics Discuss.

18. Examine critically that working of UNCTAD and account for its failure to solve the problems of developing countries.

19. Analyse the international economic relations of the developing countries with the developed countries and examine the case.

SUGGESTED READINGS

1. Jiwitesh Kumar Singh- International Trade and Business

2. G. M. Meir - International Trade and Development.

LESSON 19

REGIONAL ECONOMIC CO-OPERATION

OBJECTIVES

After reading this lesson, you should be able

- to know the European common market.
- to understand the provision of the treting, experience and performance
- to find the impact of India.

STRUCTURE

19.1 INTRODUCTION

Modern techniques of production involve the concept of mass production. This requires not only a large size of market in the sense of inhabitants, but equally distributed purchasing power too. Where nations constitute smaller regions, economies of scale (internal and external) can be achieved only through the constitution of a viable larger unit. The attainment of economic power, with which is allied the notion of political supremacy, thus becomes a function of size, which may be described as an economic size in so far as growth considerations are concerned.

Moreover, the historical fact of two devastating world wars during the span of a single generation, evoked the thesis that the balance of power in Europe can be secured only through a unified Europe. This idea was spurred on by the fact of maturity of communism in Russia and the objective of World domination propounded by the advocates of International Communism. This ambition hatched by the Soviet leaders would naturally . become a reality, if Europe retained the resembalance of 'scattered, non-united, national sovereign states. Thus economic and political considerations led to the birth of the movement towards greater Europe in the post-war period. It was, of course, realised that such integration would take years to accomplish. Yet, the ball had to be set rolling. In the beginning it was felt, that obstacles to a movement aimed at economic integration would be perhaps much less than a similar approach towards a political union. Current events seem to have indicate this mode of thinking. The success in Europe has let loose the forces of regional economic co, operation elsewhere.

Economic co-operation, however, can be anyone or a combination of the following types:

1. Economic Union
2. Customs Union
3. Free Trade Area
4. Sectoral or Partial Integration
5. Long-term Trade Contracts

This classification is based on the criterion of the degree of economic co-operation contemplated. The case of an absolute integration is the economic union, which may be defined as the complete economic integration of a group of countries, in which capital, labour, commodities, and services move unrestricted, and the economic activities and policies of the constituent countries are harmonised, co-ordinated and collectively cooperated. The classical examples of economic unions are Benelux (Belgium, the Netherlands and Luxembourg) and the European Common Market (ECM). The principal foundations on which the Economic Union is to be achieved include, inter alia, the customs union; the absolution of loans inhabiting free movement of persons, services and capital; common transport; common agricultural policies; collective measures for remedying the balance of payment disequilibria; the establishment of a development bank (European Investment Bank; formulation of rules ensuring competition; and the creation of a (European) Social Fund in order to promote employment and labour mobility.

A customs union can be defined as the "The substitution of a single customs territory for two or more customs territories, so that; (i) Duties and other regulations of commerce are eliminated with respect to substantially all trade between the constituent territories of the Union or at least with respect to substantially all the trade in products originating in such territories, and (ii) the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the Union." J.E. Meade follows this definition closely, for the defines a customs union as the one in which "there is complete freedom for the movement of goods and services between the outside world and the partner countries."

A free trade area on the other hand, may be defined as a group of two or more customs territories in which duties and other restrictive regulations of commerce are eliminated on substantially all the between the constituent territories in products originating in such territories. A comparison of the definitions relating to a customs union and a free trade area shows that in a customs union the members adopt a common tariff policy applicable to the outside world, whereas under a free trade area members apply uniform tariff rates to each other, but separate individual tariffs to third countries. The examples of free trade areas are the European Free Trade Association (EFT A) and the Latin American Free Trade Association (LAFTA). In one way, a free trade area may be considered desirable by members, because the absence of a common external tariff-wall may give its members freedom to maintain separate, tariffs and trade policies with respect to third countries, while at the same time, participating in a common market between themselves.

Another types of economic co-operation are a sectoral or partial integration. It may be defined as the establishment of a common market in a given product or products. A good example is that of the European Coal and Steel Community (E.C.S.C). Here the arrangement eliminates import and export duties, quantitative reductions (restrictions) discriminating practices, subsidies or state assistance and restrictive practices preventing competition such as the division, or exploitation of markets.

Further, long-term trade contract is a type of bilateral arrangement, either in a single product or many products entering into trade between two countries. To some extent the phrase 'long term contract' should be qualified, for it merely means a period exceeding one year. India, for instance, has entered into a trade agreement with Japan for the purpose of supplying iron ore over a period of 5 years. This type of co-operation stabilises the exports of that product or products, at agreed prices, so that it leads a measure of stability to the balance of payments. Moreover, it also assists in planning ahead for a given period on the basis of known export earnings.

As against this, it prevents a contracting party from taking advantage of price fluctuations in the commodity markets.

Now we discuss the important regional economic co-operations in some detail under the following headings:

19.2 EUROPEAN COMMON MARKET (ECM OR EEC)

One of the most significant events after the II World War was the formation of the European Economic Community. European countries in their attempts to deal with various post war problems had worked out a number of arrangements through which co-operation among them could increase. Such arrangements were, for example, the Organisation for European Economic Co-operation (O.E.E.C.) formed in 1948, the European Coal and Steel Community (E.C.S.C.) formed in 1952, and the European Payments Union (E.P.U.) formed in 1955. Even -before the end of the II World War, Belgium, Luxemburg, and the Netherlands had formed a Customs Union known as the Benelux in 1944. The setting up the E.C.M. was a further proof of the fact that Europe was moving towards a more co-operative approach for solving the various problems facing it.

The birth of the European Economic Community may be dated to May 9, 1950, the day of the historic call by France's then Foreign Minister, Robert Schumann. He proposed for the pooling of French and German coal and steel resources under a common high authority with superanational powers to put Europe, devastated by World Warn, back on its feet again. He saw this as "the first solid foundations of the European federation which is indispensable. for the preservation of peace." Legally three are there European communities which were to be merged eventually.

They Were:

The European Coal & Steel Community (E.C.S.C.), which was established in August 1952, under a treaty signed in Paris, with France, Germany, Italy, and three Benelux Countries as members. The major object of the Community was to set up common markets (or single market) in coal, steel, iron-ore and scrap resources and by 1953, most of them had come into existence. The United Kingdom refused to join it.

The success of the European Coal and Steel Community showed scope for supra-national organisations. These experiences set the pattern and provided the basic frame work for the more comprehensive economic union visualised by the Rome Treaty of 1957. The European Economic Community (E.D.C), usually called the Common Market, was created by the Treaty of Rome signed on March 25,1957. Its institutions began work on January 1, 1958, with the aim of gradually integrating the policies for the signatories the E.C.S.C. member states for all their economic resources.

The European Atomic Energy Community also called Euratom, became operational at the same time as the E.E.C. under a second treaty signed in Rome in 1957, to promote cooperation among the six in nuclear technology and research.

Since July 1, 1967, the three communities (E.C.S.C. E.E.C.and Euratom) have shared a single set of institutions.

These are:

19.3 THE EXECUTIVE COMMISSION

This is a unique institution because it is independent of national administrations. It is responsible for initiating, developing and executing community policies. It employs about 6,000 Eurocrats' and is housed in a star shaped 14 storey building in the centre of Brussels. It is responsible for ensuring that national governments carry out agreed community policies and can issue binding orders that overrule national policies in certain spheres. Its powers are perhaps, best known in the anti-trust field where it has brought successful suits against multi-lateral corporations on charges of monopoly practices. There are 14 commissioners who are appointed by national government but take an oath to be independent of their governments' policies.

The Council of Ministers - This is the inter-governments decision-making body. Which ministers meet in the council depends on which issues are being discussed. The foreign ministers look after the major political issues, but are also called on to decide on more technical matters and to give policy stands on questions that other ministers fail to agree on. They meet at least once a month. The Treaty of Rome provides for majority decisions by the council but all important matters are decided unanimously. The chairmanship rotates every six months on January and July 1.

The European Parliament - It is a largely consultative body made of 142 members of national parliaments. The Treaty of Rome Provides for the Parliament to be elected by direct sufferage but some countries, led by France, have stead fastly opposed this. The Parliament holds eight sessions a year alternately in Iuxembourg and Strasbourg, France.

The court of justice-Based in Luxembourg dispute under the treaties. It can overrule decisions by national courts on questions relating to community policies.

The economic and Social Committee -- This is a consultative body which consist of 153 members, including representatives of employers, consumers, workers and the liberal professionals.

The Davingnon committee - This is an inter-governmental body of discuss foreign policy questions. It is not directly linked to the community since foreign policy does not fall under Common Market competence as defined, at present political director of the Belgium Foreign Ministry.

The monetary committee-- It advises the Commission and the council of Minister on international monetary problem. It comprises national experts and central Bank officials as well as representatives of the Commission.

Other important community institutions include: the committee of permanent representatives (coreper). The groups permanent representatives or ambassadors from member states to the community/ Draft legislation produced by the Commission goes on the Council to be decided on. But it is first examined and debated by the Coreper, which has a very important role, because issues are often decided on at Coreper level and passed on to the council simply for former approval. Conversely. if the minister find themselves deadlocked on some questions, it is referred back to the Coreper for further negotiation to expert level.

January 1, 1973 witnessed the historic, when Britian, Ireland and Denmark formally joined the six-member European Economic Community to form the World's largest trading power, and the second biggest unit after the United States. The success of the negotiations a year ago was the first clear indications that the Common Market was entering a new phrase. Since then, the nine have made clear their determination to accelerate the process of European integration of which 6 nations customs union was only a stage/ As the nine move towards monetary and economic union, the increasingly political nature of many of the decisions to be taken will add a new dimension to the Community - the political one. The fact is, the member state will be co-ordinating their policies in the political field long-before they reach the stage of political union. The process may, indeed be said to have begun already. At the Paris Summit conference, the Nine were actively seeking to establish the community as a distinct entity in its relations with other industrialised countries, and with the third world. Their Mediterranean policy is based on political considerations as much as an economic ones. The Summit committee the community to achieve full economic and monetary union by the end of 1980, and to entering a new phase of the step by step process towards this is 1974. It also agreed to set up a monetary co-operation fund. It was known that economic and monetary union was seen as the chief driving force for European integrations by the participants and France had been pressing hard particularly for a strong commitment on this point.

19.4 PROVISION OF THE TREATY

The main provisions of the Treaty provided for a customs union which have a common external tariff at the level of the average of the previous tariffs of the six-countries restrictions between each other. These changes were to be bought about in three stages covering 12 to 14 years. This means that 1971 was the dead line by which the work of abolition of tariffs was to be completed. In actual fact, it took only 11 years for the last of the series of duty restrictions to become effective. By July 1968, all duties on industrial goods were abolished and a common external tariff came into force.

The second main provisions of the Treaty of Rome was to promote economic integration. Mere eliminations of trade barriers would not be enough to achieve integration. National tax systems, public expenditure policies, monetary and balance of payment disturbances between might all result in a situation on which the association between member countries would remain incomplete. Therefore, it was felt that national policies should be harmonized, so far to encourage mobility of labour and closer economic relations between member states. To accomplish this, the treaty provides for

(i) the abolition of all obstacles to the free movement of labour and capital.

(ii) a common transport policy

(iii) a common agricultural policy

(iv) the establishment of a system ensuring that competition shall not be distorted; and

(v) the applications of procedures which shall make it possible to co-ordinate the economic policies of member states and to remedy the balance of payments.

The Treaty also provides for the setting up of a Special Aid Fund and a special investment Fund which would concern with the problem of the relatively back ward regions within the Community, and will undertake programmes for education and retaining of workers who might be displaced as a result of competitive forces.

Agricultural policy provided an area in which agreement was more difficult to reach. As s result of severe post-war shortages of food-stuffs, scarcity of foreign exchange to meet the requirements of imports and because of political pressure from farmer interest in various had imposed a variety of complex import restrictions and different kinds of price support programmes. harmonization's of these widely divergent policies became a difficult problem. In fact, even to this day, conflict between member-countries has centred round the differences with respect to how agricultural problems need to be tackled. The variety of Rome provided for certain general principles of a common agricultural policy.

In order to implement the provisions of the Treaty of Rome, a number of agencies set up. The administrative body is the European council which consists of one member from each state. Assisting the council its work is a nineman European Commission Which studies problems and makes recommendations to the Council which is the executive agent of the community. The court of justice is meant to adjudicate disputes of the Community.

19.5 EXPERIENCE AND PERFORMANCE OF THE E.E.C

The gradual abolition of tariffs provided a strong and growing stimulus to the mutual trade of the community countries. The enlarged community would account for roughly 40% of the world trade and its special trading relations would encompass about 500 nations. Obviously, the commercial policies of such a monopolistic trading block would have considerable global implications. In the words of the former British prime Minister, Mr. Heath, it is rather a community in which we can work together to achieve our common objectives.

In 1958, the community obtained 29.6% of its imports from the E.E.C countries. This figure increased to 38.25 in 1964 and it was realised that by 1972 the value of this intra-trade in manufactured goods was about 50% higher than it would have been without the formation of E.E.C. Again, abolition of tariffs had its impact on the efficiency of industries. By the same token, prospects foe exporting improved dramatically. The intra E.E.C trade as a share of global trade increased from 9 % in 1960 to 14% in 1970. However, the share of import from the developing counties to the community declined from 35% to 30%.

Again, the increase in productivity was accompanied by a low level of unemployment. The rate of growth in 1964 for the Community as a whole was 5.6% for Belguim, 5.5% for France, 6.5% for Germany, 2.7% for Italy, 8.2% for Netherlands and 6.5% for Luxumberg. A comparision of average earnings between U.K and the community countries makes the position still clearers. In 1958, average earnings in U.K were similar to those in France, Germany. Belguim and Netherlands and over half as high as those in Italy. By 1969, the average earnings in Italy had become equivalent to the U.K's earnings and in the community countries earnings were now betweenm a quarter and half higher on average than those in Britian. Similarly, all E.C.M countries enjoyed rates of growth of G.N.P. per head of populations or of private consumption per head twice as great as Britain's.

Moreover, a high proportions of the Community's output countries to be invested. in the period 1959-63, the six devoted 24% of their G.N.P to investment. The community as a whole has maintained as a strong balance of payments positions, earning surplus on current account of more than $ 25.000 million over the period 1958-69; by comparison, the U.K had a small cumulative deficit on current accounts over these years. The community has become the world's greatest importers and exporter. Moreover, its share is continuously increasing.

Of considerable significance is the fact that Britain's membership of the E.E.C will put an end to the special trade links with the common wealth countries. The common wealth preferences will soon disappear and countries like Australia , Newzeealand and India will be forced to divert their exports to markets other than Britain. It is not possible to visualise at present what satisfactory trade arrangements with the E.E.X can be made.

Britains entry into the common market

For many years. the United Kingdom has been trying to enter the Common Market. The first applications was made in 1961. and it is only recently that the application for entry into E.C.M. has been accepted and the treaty has been signed by U.K. on January 1, 1973. U.K has become a full fledged member of the E.E.C later this received the approval of the British Parliament.

Britain's entry into the Common Market was held up for many years because of the difference arising out of the Common Wealth preferences which Britain wanted to retain but the E.E.C wanted U.K to withdraw. Secondly, E.C.M counties wanted that U.K must agree to open her market to French agriculture an to impose common tariff U.K on the other hand, wanted to retain the agricultural tariff which it had, as a result of which she was able to import most of her food requirements from the common wealth that low world prices and free from tariffs. Thirdly, French oppositions to U.K. entry was also motivated by political reasons.

The agreement recently arrives at between U.K and the E.C.M has the following main provisions.

1. Like other members, U.K will contribute to the common budget as well as to the special aid funds of the community. This would involve a net cost about $ 100 million to Britain in the first year. This would increase to $ 200 million in the 5th year.

2. U.K will open her market of French agriculture and a common tarrif will be imposed on the agricultural imports.

3. Industrial tariffs between U.K and the E.E.C will be removed in 5 equal stages. By July, 1977 such tariffs will be removed and the common external tariff will become operative.

4. Common wealth preferences will be given up.

19.6 IMPACT OF INDIA

From the point of view of India there have been certain disquieting factors. For example, the formation of a special preferential area in Mediterranean, region, the enlargement of the free trade are in Europe, the rapid erosion of India's traditional markets for Indian products. It imports 48% of India's non-manufactured tobacco, 37% of its tea, 26% of its woolen carpet, 24% of cotton piece goods and 21% of its leather and sugar. These enjoy duty free entry and other tariff and non-tariff advantages, but they will suffer a serious set back now that Britain has joined the E.E.C. Britain has terminated the Indo-U.K. trade agreement of 1939, under which Indian enjoyed common Wealth preferences. It had been expected that the Common Wealth preferences would continue till 1974 when U.K's tariffs would get linked to that of the European Common market.

About Rs.75 crores worth of Indian export to Britain would be affected, if adequate safeguard were not worked out before the tariff rates of the European Economic Community came into force from January, 1914. This works out nearly to 40% of India's total exports worth about Rs.171 crores in 1970-71. Tobacco, cotton textiles including yarn and oilcakes opium, crude and cardemon exports would suffer most besides jute goods, coir goods and cashew kernels. On the enlargement of the Community, India's competitive position by virtue of the guaranteed margin of preferences it enjoyed under U.K -India's trade agreement will become worse, not only in relation to developed member countries of the community, but also in respect of other affluent nations under Canada. At the same time, it has become equally urgent that the commercial trade agreement with E.E.C on which Indian has been working hard, should be finalized as early as possible. In the meantime, is has become obligatory for India to re-structure its export promotion policy of offset the loses on export due to Britain's entry into the Common Market. While undoubtedly grater importance has to be given to the enlargement of the non-traditional component to slacken on our traditional item, which have a large weightage in our total export.

The effect on India exports depends largely on two factors:

(i) The existence or non-existence of alternative sources of supply within the E.C.M and its associate members; and

(ii) The elasticity of demand in Britain for these goods

To sum up, we can say that Indian exports to E.C.M would be reduced to the extent that Britain's exports to the E.C.M increases. The commodities that are not likely to be affected are the coffee, and iron ore. Roughly 45% of export to U.K consist of these commodities. The fact is that since 1964 Indian tea has enjoyed duty free onto the EE.C following a bilateral agreement between the community and the U.K under which both side agreed to remove the duty on all imports of tea, regardless of their origin.

Moreover, the enlarged European Common market has started a move towards political Union. India's relations with the community, which have hitherto remained only at the trading level, will have to make room for political recognition too, especially in view of the changing relations of India with the Soviet Union and the east European countries. Hence, it is necessary for India to maintain good relations with the E.E.C countries.

For quite sometime now, India has taken up the question of safeguard for her trade with the enlarged E.E.C to compensate for the loss of common wealth preferences. In a comprehensive side memoire presented sometime ago to the European Economic commission. India's stand was made clear. India has taken the position that with Britain's entry as also of three members, and the consequent removal of tariff barriers against the entry of products of these new members into the Community markets, the advantages of the Generalised Scheme of Preferences covering exports from developing countries would be neutralised. It is not as though the E.E.C and Britain were not aware of the adverse effects of India's trade due to intent was included in the Brussels's Treaty of Accession" to examine (with India and Srilanka , Malaysia, Pakistan and Singapore) such problems as may raise in the field of trade with a view to seeking by appropriate solutions".

Britain's then Common market nogotator. Mr.Rippoin who visited Delhi sometime age, gave the assurance that even after Britain's entry into the E.C.M and adoption of common external tariff and E.E.C agricultural leveies, at least 2/3 of India's present exports to that country would either continue to enjoy zero rates of duty or would be included within the scope of the Generalised Scheme of Preferences 9G.S.P.) of the E.E.C yet, he admitted that after Britain's entry onto the Common Marker, export of some Indian goods may be adversely affected. As a consequences, the manufacturing of jute and coir goods voluntary reduced the production of these goods. Infact, Indian cotton textiles are subject to treaty tariffs in the European Common Market. Eventhough, the European Economic Community has recently offered some concession to Indian exporters, but these concession are not adequate.

It should be mentioned in this context that U.S.A has introduced G.S.P only since January 1976. Since, she was not in positions to help out developing countries, it was imperative that E.E.C adopt a sympathetic attitude towards India.

In December, 1972 the council of Ministers of the E.E.C approved of a suggestion that negotiations between Indian and the E,C,M be held. The objective of these negotiations was to prepare and enforce a three year non-preferential trade agreement under which preference given to one country would be equally given to all the exporting countries og goods kept in those categories. India however, insisted that such negotiations could deliver goods if only they included following considerations.

1. In the proposed agreement tariffs concession granted on Indian tea, black pepper, hides and skins etc., are also included. Further, tariff concessions on imports should be in accordance with the rules prescribed by the General Agreement on Tariffs and Trade.

2. This agreement should also include the tariff concessions granted independently by the members of European Economic Community especially by France, West Germany and Italy to India.

3. The proposed agreement should also incorporated the already prevailing tariff concessions in Indian goods such as jute goods, cotton textiles and handicraft granted by the E.C.M.

4. The proposed agreement should remove all the adverse effects of Britain's entry onto the E.C.M

Member of E.E.C as well as Indian authorities feel that the agreement should help tackle the problems of India's foreign trade and at the same time, do a way with the balance of' payments deficit of this country with the E.E.C. However, the members of E.E.C. are not willing to grant long-term concessions for Indian goods. They are not willing even to provide any tariff concessions for the Indian goods like raw tobacco, Sugar, tea etc.

There were series of meetings of the Indian officials with their couner parts in the European Economic Commission, in May and June 1976, Initially the attitude of the commissions representatives was not favourable to Indian exporter's of Jute goods, sugar, tobacco and cotton textiles. Later, the attitude became positive and sympathetic. Agreement in respect of sugar and tobacco were signed. Further, the E.E.C. also granted concessions to Indian exports in GSP announced in July, 1976.

For the exports of raw and white sugar from India the European' Commission has offered higher prices for the latter's pruchases during 1976-77. A new four year pactfor jute exports from India is also under consideration. India hopes that jute tariffs will bephased out by the end of 1979.

The proposals contained in GSP announced by E.E.Q. in July 1976 are favourable to Indian exporters in more than one way. The Commission has proposed substantial increase in the quota of unmanufactured Virginia tobacco as well as hand knotted carpets. The Commission has conceded India's demand for including a number of agricultural and fishery items.

India's GSP exports rose by 18% to $ 255 million in 1975-76. The increase was 20 percent in sensitive and semi sensitive items other than textiles and about 24 percent in non-sensitive items and agricultural products. Only in textiles did India's GSP exports decline a little (5.5. percent).

According to the European Commission, India was fourth in its list of the 10 developing countries that between them accounted for 72 per cent of the EEC's imports under its GSP scheme in 1974. Yugoslavia was the principle beneficiary, with exports of some $ 350 million, followed by Hong Kong ($ 265 million) and Brazil ($ 228 million). India. was next with $ 216 million, ahead of South Korea ($ 185 million), Singapore ($ 144 million) and Pakistan ($ 138 million).

Details of the improvements which the European Commission has proposed are given here, together .with an assessment of the prospects of their being adopted by the member states. But in view of India's constant efforts to secure such improvements it is necessary to look first at the statistical information collected by the commission on GSP utilisation by the beneficiary counmes.

The broad conclusion to be drawn from this information is that India, the 9th or 10th industrial power in the world, is not doing so well as some other developing countries. Thus she was almost at the bottom of the list of the half-a-dozen countries exporting footwear under the GSP and was well behind Pakistan, with exports of $ 1,68,000 compared to Pakistan's $ 3,622,000. (All figures are for 1974). Her exports of sensitive and semi-sensitive industrial products other than textiles amounted to a paltry $ 12 million, as against Hong Kong's $ 80 million. Yugoslavia's $ 85 million, South Korea's $ 40 million and Singapore's $ 35 million.

India's exporters did much better in the textile sector, with exports of approximately $ 54 million. They accounted for 21 per cent (or 3,527 tonnes) of EEC's GSP imports of cotton textiles subject to quotas (as against 29 per cent, or 4,823 tonnes, for Pakistan, which headed the list) and 12 per cent (784 tonnes) of non-cotton textile imports (as against 19 per cent, for South Korea). As f!Jr the semi-sensitive cotton textiles (i.e., those whose imports are subject to ceilings rather than quotas). India and Pakistan together accounted for nearly 80 per cent of the EEC's imports, with Pakistan edging out India by 65 tonnes.

As the EEC keeps a close watch only on imports of sensitive and semi-sensitive items (in order to re-impose duties as soon as the corresponding quotas and ceilings have been reached) its figures regarding imports of non-sensitive items and agricultural products (which are quota free) are less reliable in that they are no more than estimates. Even so, according to the commission imports from India of the former amounted to $ 97 million and of agricultural products of $ 48 million in 1974.

All official sources here are agreed that Indian exporters are not making the best use of the GSP. Its complexity and restrictive character are only part of the answer. It is clear from the commission's figures that a number of beneficiary countries are exporting relatively substantial amounts of the sensitive and semi-sensitive products which, by definition, are those in which the developing countries are the most competitive. Indian exporters presumably have either been put off by the extent of the competition in these items or have not been as competitive themselves, except for textiles.

Although the commission has not made available detailed information regarding GSP utilisation, it nevertheless is clear that India's exports tend to be concentrated on a certain number of items, many of them with a low value-added content (cotton grays, unmanufactured tobacco, hides and skins, agricultural products, etc). Moreover a pre-occupation with the respective features of the GSP seems to have prevented exporters from looking so far at the wide, range of manufactured products, including engineering goods, chemicals, electrical equipment, etc., on the non-sensitive list. It is perhaps significant that India's exports of non-sensitive products represented only 4 per cent of the ceilings for such products.

As mentioned earlier the commission has proposed a number of improvements for 1977 which should benefit India. They are discussed in the context of the draft resolutions in which they appear:

Regulations 1: sensitive products (non-textiles) - The list of 18 products is unchanged from 1976. However, the base year for calculating quotas has been changed to 1974, as against 1971, with the result that the 1977 quotas will be upto 50 per cent higher (e.g. bovine cattle leather, travel goods, leather clothing and accessories, furniture and parts etc). This is an amount which more than offsets the increase due to inflation.

Some quotas remain unchanged, however, including those for footwear and primary cells and batteries, two items of particular interest to India. Moreover, a number of the butoirs, including those for bovine leather and travel goods, have been reduced to 20 per cent. The bitoir, expressed generally as a percentage, is the maximum proportion of a given quota or ceiling to which a developing country is entitled under the GSP. The butoiris rigidly enforced in the case of sensitive products, less so in the case of semi-sensitive products and generally disregarded in the case of non-sensitive products - as are the ceilings themselves.

The quotas would be distributed among the 9 EEC countries on the basis of the key used in previous years (which allocates 22 per cent of each quota to the U.K. and 27.5 percent to Germany). The commission however is proposing a so-called "community" reserve for another 2 products, diodes, transistors and similar semi-conductor devices and parts and chairs. Under this system, designed to prevent the quota being partly sterlised through lack of demand in a given EEC country, 20 per cent of the quota is allocated to the European Commission, to be drawn on by member countries which have exhausted their quotas.

Regulation 2: Semi sensitive products. The number of products has been reduced to 27, with 2 (basket work and porcelain table ware and toilet articles) transferred to the nonsensitive list. These items are subject to ceilings, which are not distributed among the member states as in the case with quotas.

All ceilings have been increased by upto 50 per cent, but as figures for ceilings are never published importers have no way of knowing whether the limits set by the butoir have been reached, until the announcement; in the E.E.C.'s official journal, when the normal tariff is re-established on imports from the developing country reaching the butoirs.

The butoir is fixed at 50 per cent, as a general rule; however, it has been set at lower amounts for a number of items (e.g. wigs 30 per cent; glassware - 30 percent; insulated electric wire - 20 percent dolls, other toys and novelties - 20 percent). The butoirs is also lowered to 15 per cent, in the case of countries which have reached it during two consecutive years since 1972. Countries with very low per capita incomes are exempt from this provision, so that it affects mainly Yugoslavia and Hong kong.

Products on the semi-sensitive list of export interest to India include rubber tyres and inner tubes, umbrellas and sunshades, jewellery, iron and steel-tubes and pipes, electrical generators and motors and vaccum flasks.

Regulation 3: non sensitive products. Although imports of these items are also subject to ceilings, they are never published, presumably because they are seldom enforced. However, the change in the base year reportedly has meant increase or upto 57 percent, over the last year. The butoir is fixed at 50 per cent, although it is to be reduced to 30 per cent even less for certain products (protective gloves of leather or composition leather; glazed sets; articles for electrical light fittings, for example). In some cases a specific ceiling is proposed (gelatine, wood, some iron and steel items, generators and motors, for example).

Regulation 4: Textiles: The commission has proposed that the distinction between cotton and non-cotton textiles be abolished so that only one regulation will be needed (in place of 6 this year). The other important change proposed by the commission is to list of beneficiary countries Which, for the first time, Would include Hong Kong. However, the beneficiary countries would be divided into the (1) more competitive and (2) other, on the basis of two objective criteria; a per capita income of $ 300 or more and a share in the EEC's imports from developing countries of at least 6 per cent for any given product.

This distinction would apply in the case of 28 products, including terry towelling, hand kerchieves, men's undergarments and women's outer garments items for which India has already reached the butoir this year. The quota for each product would be divided into two paris, one of which amounting to 60 per cent of the quota, would be reserved for the more competitive exporters while the balance would be reserved for the other beneficiary countries (i.e., virtually all developing countries as well as all dependent territories, with the exception of Hong Kong, classed as most competitive for 20 of the 28 products). The 30 per cent would be treated as a quota i.e., it would be divided among the 9 EEC countries, although 10 per cent would be set aside as a community reserve. As the number of countries entitled to this 30 per cent is never more than three sometimes it is only one - on butoirs are envisaged.

The 70 per cent reserved for the less competitive countries would be treated as a ceiling for a semi-sensitive products; it would not be distributed among the member states but imports would be carefully watched and the tariff reimposed as soon as the ceiling had been reached. Imports from anyone beneficiary country would be limited to 50 per cent.

For the rest, the textile regulation would be very similar to those currently in force. The commission has proposed that seven items (yarn and gray cloth) be treated as sensitive items, subject to quotas, while another 67 items, including hand knotted carpets, as semi-sensitive (14) and non-sensitive (53). All quotas and ceilings would be increased by a flat 5 per cent and would therefore amount to 79131 tonnes 1977 as against 75.323 tonnes this year.

Regulation 5: Jute and coir products. The tariff reductions which have been negotiated by India will be implemented through the GSP as before, with the beneficiary countries limited to India, Bangaladesh, Sri Lanka and Thailand. Under the terms of the new jute agreement, the U.K. and Denmark will continue to grant duty free entry. In other countries jute yam will be duty free while the tariffs on all other products will be reduced to 20 per cent of the rates initially applied.

In the case of coir mats and matting, whose tariffs, have been reduced to 4.6 per cent since July 1 under the new agreement, this will be the preferential rate for 1977 also.

Regulation 6: Unmanufactured Virginia Tobacco. The terms of this regulation are based on the EEC's offer on tropical products, made in the frame work of the Geneva multilateral trade negotiations. The regulation covers both the more expensive (24.01 A) and the cheaper (24.1 ex B) tobaccos and, for the first time, both flue cured and suncured varieties. The latter variety represents the largest single agricultural product exported by India to be excluded from the GSP.

The quota has been raised to 60,000 tonnes(as against 38,000 tonnes) and the tariff further reduced to 7 per cent (as against 10.5 per cent this year), with a minimum of 15 units of account per 100 kg. for the cheaper tobacco and a maximum of 45 units of account for the more expensive ones. (one unit of account is equal to approximately $ 1.20).

Official India sources here are still hoping they can persuade the EEC to adjust the minimum and maximum rates so that they fully reflect the proposed 50 per cent reduction in the ad valorem duty. The effect, of the commission's proposals, which as they stand at present involve an increase in the minimum rate, would be to raise by about 1 per cent the effective incidence on India tobaccos; on both those valued at below 140 units of account (essentially stems and bits exported to France and some other EEC countries) and those valued between 214 and 280 units of account (i.e. the bulk of India's exports).

Although the principal beneficiary should be India (hence the absence of a butorir all independent developing countries and all dependent territories are entitled to the concession.

The quota dividend among various EEC countries are: Germany 6, 720 tonnes, Benelux 6,360 tonnes. France 840 tonnes, Italy 4,500 tonnes, Denmark 2,340 tonnes, Ireland 2,640 tonnes, U.K. 36,000 tonnes.

Regulation 6B: Unmanufactured Tobacco other than Virginia. For the first time a tariff quota of2,500 tonnes is being made available for the other varieties of tobacco. The principal beneficiaries are expected to be Indonesia and the Philippines. Regulation & agricultural products covered by chapters 1 to 24 of the Brussels Tariff Nomenclature: There are no quotas or ceiling for these items but with a few exceptions, nor to they quality for duty free entry. The preferential rates are often well below the most favoured nation rates. However, for 1977 the commission has proposed deeper cuts in the case of some 70 products.

The EEC's tropical products offer has been incorporated into the 19(7 proposals, raising the number of products covered to 296, an increase of 46 over this year. But this the EEC's offer still under negotiation with the developing countries taking part in the GATT Multilateral Trade Negotiations, Common . Market sources here do not rule out the possibility of further improvements, as regards both product coverage and depth of cut.

As this is the first that beneficiary countries can actually negotiate with the Common Market on any element of the GS P. India is pressing for improvements which it would not be possible to secure during the annual revisions carried out by the European Commission and the member states. During a meeting in Geneva in May the Indian delegation, led by Mr. M.S. Aiyar of the mission to the EEC in Brussels, indicated to the Common, Market's representatives the further improvements that were needed. They include: (1) additional cuts in tariffs on a number of products, especially shrimps and prawns on the one hand and castor oil on the other: (2) better products coverage, i.e. GSP treatment for items such as walnuts, the largest Indian agricultural export to be excluded from the preferences scheme after sun-cured Virginia tobacco; (3) a coherent policy for lentils and pulses. The 1977 proposals provide GSP treatment for some of these items but lndia wants all those exported by her brought into the GSP; (4) GSP treatment for

Indian specialities like vegetables, fruits and spices. India has been seeking duty free entry for these groups of product since Britain's entry, but has been faced with the problem that most of them are covered by relatively broad tariff headings in the EEC's external tariff. She has suggested that the entire tariff position be included in the GSP or, alternatively, Indian products be-identified separately and sub or expositions be included in the GSP at zero rates of duty.

The vegetables for which GSP treatment is sought include bringals, okra and gourds, while among the fruits is the whole range of mango products, (fresh mangoes, fresh sliced mangoes mango pickles, jams, juices, etc.). The main spices are pan masala, saffron, anardana and other crushed and ground seeds. Products of export interest to India which are being added to the product list include cocoa butter and coffee.

Regulation 8, 9 10: These three regulations renew the concessions already in force for the agricultural products like cocoa, butter, instant coffee and tinned pineapple.

How far are the member states likely to accept the 'commission's proposals? The most controversial of them relates to textiles, of course. It must not be forgotten that when the commission last year suggesed that Hong Kong be included , among the beneficiary countries for a certain number of nonsensitive items some of the EEC countries refused to go along.

The European textile industry also is hostile to extending preferences to Hong Kong: it would rather see them withdrawn from all competitive suppliers. But the British government is determined that Hong Kong shall no longer be discriminated against, whatever the views of its own textile industry.

Member states may also object to the very substantial increase in quotas and ceilings, or at least for certain products, although the commission has tried to forestall their objections by limiting certain increases to 57 per cent whatever the effective increase indicated by the new base year. In any case, the EEC has little choice but to use a more recent base year.

19.7 EUROPEAN FREE TRADE ASSOCIATION (E.F.T.A.)

When attempts were being made to form the European Common Market, Britain prepared a scheme to counter the adverse effects of the double-tariff policy of E.E.C. on foreign trade and balance of payments. In November, 1960 Britain, Austria, Norway, Sweden, Denmark, Portugal and Switzerland signed the Draft agreement of the European Free Trade Association (E.F.T.A.) Like the BCM, these countries also eliminated all tariffs on the trade conducted within the E .F. T.A. However, for their trade with non-EFT A countries, they decided to follow an independent tariff policy. Further, unlike E.C.M., labour and capital were not freely mobile from one E.F.T.J country to the other. Thus, E.F.T.A., was a loose economic' organisation of seven European countries and provided only concessions for mutually traded goods. It is interesting to note that as per their decision, the members of E.F.T.A. would eliminate their prevailing tariffs in stages rather than putting an end to them once for all, albeit within the E.F.T.A. all tariffs have been removed.

As a matter of fact, E.F.T.A. was formed by Britain for her own benefit. She imports most of her raw materials and foodstuffs from other countries, and she has obvious reasons to follow such policies as to procure these goods at their minimum possible prices. Britain has been enjoying preferential treatment from Common wealth countries for the goods imported from them. What was needed was the constitution of a forum through which low-cost goods may be imported from European countries too, and maximum quantity of goods may be exported to them. Organisation of the relatively rich European countries into European Economic Community compelled Britain to integrate the remaining European powers into E.F.T.A. Thus, E.F.T.A. was basically designed to promote Britain's economic interests. Yet, she was not willing to have a complete economic integration among the members of E.F.T.A. For this reason, only tariff concession in their mutual trade were a basis of economic co-operation among the members of E.F.T.A., while allowing them to follow an independent tariff policy for other countries. Since Britain has now joined the European Common Market, E.F.T.A. hall lost its significance.

European Payments Union (E.P.U.)

As an associate body of the' Organisation of European Economic Co-operation (OEEC), the European Payments Union (EPU) was set up in September, 1950. The Council of OEEC nominates a board every year for the management of E.P. U. This Board prescribes appropriate measures to correct a continuing surplus or deficit it the balance of payments of member countries.

The basic purpose of E.P.U. is to build up an atmosphere in which surplus or deficit balance of payments of member countries would automatically be corrected. The liabilities or credit balances of a country in respect of other member countries are entered in their accounts by the concerned central bank. Every month a statement of such accounts is sent to the Bank for International Settlements located at Bastle. The negative or positive balance of each account is worked out after examining net balances of all indivdiual accounts. The Payments Union settles these negative or positive balances.

For capital resources of the E.P.U. member countries of OEEC have deposited 15 per cent of the value of their trade conducted in 1949. The E.P.U. can provide an additional credit equivalent to 40 per cent of the individual member's quota. Such credit can thus be used to settle the payments due to the Union from any member country. Such credit limits are, however, to be used in that situation when the balance of payments situation becomes quite crictical. Thus, an amount equivalent to 20 per cent of the quota can be Used to meet the deficit or surplus balance of payments of a member country.

If the deficit exceeds this limit, then 20%, 40%,60%,80% and eventually 100% of the quota can be paid into gold or dollars for settling the deficit balance of payments of the concerned country. On the contrary, countries having surplus balance of payments can receive gold or dollars between 20% and 50% of their quota. However, the E.P.U. faced a serious crisis of liquidity soon after its formation, as the credit balances of member countries fell short of the deficit in the balance of payments of other countries. To a large extent, this crisis was resolved by using the U.S. subscription of$ 850 million given to the E.P.U.

Initially the E.P. U. was set up for a period of two years, and it was decided that it would be renewed after every two-year period. There was a provision for making adjustments in the agreement of E.P.U. with each such renewa. The settlement procedure was revised in 1952. The credit limit was placed at 60 per cent, but it was decided to settle the accounts in gold more promptly. Now all members could be required to make temporary payments in gold in order to maintain the reserves of E.P.U. at a specified level. Again, in June, 1952, the settlement procedure was revised. Accordingly, countries with deficit balance of payments were allowed to directly negotiate with the creditor-countries in order to settle their balance of payments. Between 1956-1958 many deficit countries (such as Austria, Iceland, Greece and Turkey) received special grants from U.S.A. and as a consequence, they got rid of their liabilities to a large extent. In 1958, a many member countries of the E.P.U announced changes in the convertibility limits of their currencies.

SUMMARY

The introduction of new techniques of production involve the concept of mass production. This requires not only a larger size of market in the sense of inhabitants, but equally distributes purchasing power. The attainment of economic power, with which is allied the notion of political supremacy, these becomes a function size, which may be described as an economic size for as growth considerations are concerned.

KEYWORDS

- Devastating
- Contemplated
- Abolition
- Disequieting

QUESTIONS

1. Write a detailed note on ECM and bring out its experience and performance.
2. Discuss – ECM's impact on India.
3. What are EPU and EFTA? Explain.

SUGGESTED READINGS

1. D.M. Mithani - Money, Banking and Foreigh Trade.

LESSON 20

INTERNATIONAL MONETARY FUND (I.M.F.) AND INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

OBJECTIVES

- to know the objectives of IMF and also its functions and operations.
- to know the objectives of IBRD
- to understand the Robert MAC Namarals Plan.
- to know about International Finance Corporation and Asian Development Bank.

STRUCTURE

20.1 Introduction

20.2 Objectives of IMF

20.3 Significance of Quotas

20.4 Function and operations

20.5 IMF and less developed countries

20.6 Objectives of IBRD

20.7 Lending operations

20.8 Robert MAC Namara's Plan

20.9 International finace corporations

20.10 Asian development Bank

20.11 ADB and India

Summary

20.1 INTRODUCTION

The International Monetary fund is an international monetary organisation established by different nations in the post-war period with the objective of establishing economic stability throughout the world by promoting balanced

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development of the world trade, and making possible the multiconvertability of nations, currencies.

Prior to World War I, gold standard was prevalent allover the world and monetary arrangements were based on the gold standard mechanism too. During and after the first world war, the volume of trade expanded at a very rapid pace while the gold supply was limited. In order to meet this difficulty gold bullion standard was given up by most countries in the earlyJ..930. In the place of gold standard, now paper standard was adopted. As a consequence exchange rates became highly unstable and most countries were forced to adopt various measures of exchange control. Economic conditions of almost all the countries of the world deteriorated very much due to war time and later due to the Great Depression of 1930. Therefore, after the collapse of the gold standard, a number of devices such as clearing agreements, blocked accounts, multiple exchange rates, different types of restrictions mostly on regional trade, and formation of customs union were resorted to. The conditions of the different nations had, however, changed, so fundamentally that no good substitute mechanism for gold standard could be evolved. Every country was adopting its own economic measures to meet its own problems. If a country tried to increase exports by exchange devaluation, other countries imposed import restrictions. Thus cut throat competition prevailed in place of monetary co-operation. Hence all these restrictions on trade and payments reflected a decline in trade. In 1929 the world trade was valued at . 55.9 billion dollars while in 1932 its value declined to $ 21.8 billion, but then rose to $ 24.3 billion in 1937. Many countries issued inconvertible paper currencies in excessive quantities, which led to severe fluctuations in prices. Such oscillations adversely affected the world trade.

These conditions deteriorated further after the end of World War II when the world faced a new problem of reconstructing the war-tom economies. The dollar had by now become the stongest currency. When Europe was engaged in war, U.S.A. was the only major country which had surplus goods to meet the growing demand. As a consequence demand for dollar rose substantially. Therefore, dollar shortage emerged. Though each country tried to solve her balance of payment difficulties in its own way, yet there was a need for some collaboration of different countries for solving the problems of international liquidity. In fact, individual effort made by a country can benefit her only in the short run, but in the long run it can expand its trade by seeking co-operation from its trading parties. As a result, U.S.A. and U.K. prepared comprehensive plans for international monetary co-operation even while the world war was going on.

The British Plan took the shape of "Keynes Plan" while the plan prepared by the experts in U.S.A. was known as the "While Plan". The elements of these two plans were finally merged into a common plan evolved at a United Nations Monetary and Financial Conference of 44 world nations held at Bretton woods. New Hampshire, in July 1944. It is also called the Brettonwood Conference which gave birth to the two most important international financial institutions, namely the I.M.F. and I.B.R.D.

In the view of the conference, the world was facing two types of problems in the early 1940s. First was the problem of the restoring of stability' to the monetary system of different countries which were forced by the World War to abandon all conventional rules of monetary discipline observed under the gold standard. To solve this problem the International Monetary Fund (I.M.F.) was established. The second problem was of finding ways to reconstruct the war-torn economies. To solve this problem the International Bank for Reconstruction and Development Fund (IBRD) was set up. In the present chapter we shall discuss the objectives and progress of IMF.

20.2 OBJECTIVES OF THE I.M.F.

The LM.F. was established in Washington on December 27, 1945 and it started its work on March 1, 1947. The main objectives of the I.M.F. as mentioned in the Articles of Agreement of the Fund, are the following:

1. It seeks to promote international monetary co-operation by providing a permanent machinery for consultation and collaboration. In other words, it seeks to establish a system of multilateral payments among the member countries.
2. It attempts to promote world economic growth and balanced expansion of international trade which in turn will contribute "to promotion and maintenance If high levels of employment and real income and to the development of the productive resources of members."
3. It tries "to promote exchange stability to maintain' orderly exchange arrangements among member-nations and to avoid competitive exchange depreciation." As we have already mentioned, fluctuations in exchanges rates hampered the growth of world trade in the year preceding World War. The Fund aims at stabilising exchange rates in the interest of steady development in international trade. However, there is no rigidity about the policy of stability of exchange rates and member nations ,are permitted by the Fund to exercise reasonable degree of flexibility and alterations in the par values of their currencies. Thus, the IMF tries to compromise between the rigid stability in exchange rates which was the main characteristic of gold standard, and the uncontrolled and widely fluctuating exchange rates under the paper standard.
4. To help in establishing a multilateral system of payments and thereby to eliminate foreign exchange restrictions hampering the growth of the world trade. In other words, the IMF gives confidence to the member countries by coming to their rescue, whenever they are facing balance of payment crisis and provides short term monetary assistance.

5. The Fund advance short term credits (under adequate safeguards) to member nations in order that they may overcome temporary disequilibrium in their balance of payments, "without resorting to measures destructive of national or international prosperity." The Fund does not aim at helping the member countries in correcting their fundamental disequilibrium in their balance of payments position. It rather advices them to devalue their currency to resolve their problem of fundamental disequilibrium.
6. In accordance with the above objectives, the Fund attempts "to shorten the duration and reduce the degree of disequilibrium in the international balance of payments of members countries." In this connection, Article VIII of Funds charter provides that "no member shall without the approval of the Fund, impose restrictions on the making of payments of transfers for current international transactions" under the I.M.F. Articles, however exchange control may be used to check speculative or politically motivated flight of capital from a given country.

Looking at these objectives, it may be said that the basic long term goal of the I.M.F. is to meet purely temporary deficits - their international balance of payments, without resorting to drastic internal adjustment and imposition of exchange control. Yet the fund would not use up its resources reckless\y nor it would make any efforts to correct the chronic or fundamental deficit in the balance of payments of a member country. .

The I.M.F. attempts to supplement the ordinary banking functions of the central banks of its member countries which normally take care of all kinds of international payments within their respective national credit system. George N. Halm states "The International Monetary Fund will be a bank of central banks, the capstone in the world's monetary system.

Yet the IMF is not a lending institution. It is merely a holder of currencies and gold deposited by members as subscription. It permits members to exchange one currency for another at fixed rates of exchange. The members of IMF may purchase or draw other members currencies and can repurchase its own currency by depositing gold or some other Currency.

Control And Management Of The I.M.F.

The control and management of the Fund have been vested the Board of Governors, the Executive Directors and a Managing Director. All the powers of the Fund are vested in the Board of Governors which is composed of governors nominated by each member nation and also an alternate appointed by the country concerned. The voting powers of the governors are roughly proportional to the size of their quotas. Each governor has 250 votes plus one additional vote for each lakh of his nation's quota. The appointment of the governor is made by the country concerned and the same is valid for 5 years in the first instance, albeit his reappointment after 5 years is not ruled out. Normally the Board of Governors meets once a year and exercises its powers such as the revision of quotas, admission of a new member, approval of a uniform change in the par values of the currencies of all members and the election of directors. At the Fund's annual meeting one of the governors of the Board is elected as Chairman. For executive purposes a smaller viable unit, called the Board of Executive Directors, is formed to whom the Board's functions are delegated. The Managing Director of the Board is also its chairman. He also functions as the Head of the Staff of the Fund. Of the 20 executive directors, five are nominated (one . each) by the five largest quota-holding countries U.S.A. U.K., West Germany, France and Japan. Rest are elected in the following way by African Countries (3), Countries of Latin America, Countries of Far East and Pacific area (5), and countries of the Continental Europe (4). It was also mentioned in the I.M.F. charter that its Head Office will be established in that country whose quota will be the highest. Accordingly its Headquarters are in Washington, D.C. (U.S.A.).

Few years ago, the Board of Governors appointed a Committee on Reform of the International Monetary System and Related Issues, generally known as the Committee of 20. The Committee of 20 in its report recommended in June 1974 that two specific committees be set up to carry out some major tasks. It also presented the outline of Reform for International Monetary System. The objectives of these committees have been discussed below:

1. The Interim Committee of J:M.F.: In October 1974 the Interim Committee of the International Monetary Fund was set up at the instance of the committee of20. The interim committee 1 is expected to meet three or four times in a year. It is supposed to I advise and report to the Board of Governors with respect to the Board's function in supervising the "management and adoptation" of the international monetary system, considering proposals by the Executive Directors to amend the Article of Agreement, and dealing with sudden disturbances that might threaten the system. The members of the Interim Committee are Governors of I.M.F. Ministers or others of comparable rank.

At its inaugural meeting on October 3, 1974 the Interim Committee discussed the problem of recycling and asked the Executive Directors to urgently consider the adequacy of existing private and official financial arrangements, to report on the possible need for additional arrangements through the Fund, and to make proposals for dealing with the problem. At its second meeting held in January ,1975 the Interim Committee considered reports prepared by the Executive Directors on oil facility for 1975, the sixth general review of quotas and draft amendments to the Articles of Agreement. The third meeting of the Interim Committee was held in June, 1975 and it considered reports prepared by the Executive Directors on key issues on amendment of the Arnles of Agreement, including gold exchange rates and other provisions, buffer stocks and compensatory financing, the oil facility for 1975 etc. The fourth meeting of the

Interim Committee was held at Kingston in January, 1976ip. which agreement for a new monetary system was resolved.

At its fourth meeting the Interim Committee also discussed the concessions which would be available to developing countries for obtaining accommodation from the IMF. The fund is now provided to use the balance of its gold holdings either to boost its own resources or provide more cases for developing countries.

2. The Development Committee: The Development Committee of the IMF was also set up in October 1974. As noted above, this Committee was also set up at the instance of the Committee of Twenty. The Development Committee recommends measures on the broad question of the transfer of real resources to developing countries, particularly to those countries, which may be most seriously affected by balance of payments difficulties. In fact, the Development Committee is a body sponsored jointly by the IMF and the World Bank, Governors of the IMF, Ministers, or other of the comparable rank. These members are appointed for a term of two years by members of the Bank and members of the IMF.

The Development Committee has so far met three or four times. At its first meeting (October 1974) the Committee considered the situation of the most seriously affected developing countries. At its second meeting the Committee discussed the flow of real resources to developing countries and reaffirmed that urgent treatment of the most seriously affected developing countries was needed. The Committee called the developed countries to show a more sympathetic attitude towards these problems. Need for setting up a special trust fund was also felt at this meeting so as to increase the flow of official assistance to developing countries. At its third meeting held in June 1975 it discussed mainly a report of the Executive Directors on the creation of such fund. However, in January, 1976, the Development Committee at its fourth meeting agreed to set up a Special Trust Fund to help the poorer countries having an annual per capita income of $ 360 or less. It was agreed to raise the IMF resources by 45 percent (in order to meet this objective) mainly by selling gold reserves but partly by attaining contribution from member countries.

Resources Of The IMF Quotas And Subcriptions

The principal financial source of the IMF are the quotas of member countries. Each member of IMF is assigned a quota. Quotas are important for several reasons. The quota assigned . to a country determines its contribution towards the capital of the Fund. It determines the borrowing rights and voting strength. Quotas for the members were decided in the beginning. The quotas for new members are determined by the Fund. According to IMF's articles Agreement (Amended) the Executive Directors are required to have a general review of the quotas after every five year period.

Oringally the quotas of each member country were determined on the basis of (a) the value of its foreign trade, (b) composition and variability of trade, (c) the value of its international monetary reserves, (d) its position as a debtor or creditor, (e) national income, (f) relative importance of foreign trade in GNP, and (g) its political position and such other factors. However, the original quotas were raised subsequently.

20.3 SIGNIFICANCE OF QUOTAS

In the organisation and operation of the IMF, quotas playa unique role that can best be described in forms of their functions:

(i) Quotas determine the subscription or contribution of each member to the resources of "the Fund and thus determine magnitude of the IMF's resources and their composition in gold and currencies. The usual way to increase the Fund's total resources is to increase the Fund's holding of currencies that are in short supply.

(ii) Quotas greatly affect the amount and rate of drawings from the Fund by a member country. For instance, a member may not draw more than 25 percent of its whole quota in total with certain exceptions, In addition, quotas greatly affect the interest charges that members pay on their drawings, the rate which they must pay and the currencies they may tender in repayment.

(iii) Quotas determine the relative voting strength of Fund's members which is based upon the formula that each member has 250 votes plus one additional vote for each one lack SDR of quota. Voting strength is designed to reflect approximately the relative economic strength of members. Since i1ndividual quotas are, therefore, the structure of Fund quotas that reflect economic factors heavily but not exclusively, In recent years these economic factors have been combined in some what different proportion for countries other than the large industrial ones in order to improve quotas.

20.4 FUNCTIONS AND OPERATIONS OF IMF

1. Determination and Changes in Par Values of Different countries: Article IV of the Fund Agreement requires that on becoming a member a country has to declare the par value of its currency in terms of gold as a common denominator, or in terms of the U.S. dollar of the weight and fineness in effect on July 1, 1944 (i.e., 0.888671 grams of gold per dollar). A member, if it so chooses, may refuse to declare a par value of its currency, as was done by Cyprus and Afghanistan. But once the par value is declared, all foreign transactions have to be conducted round it. The fund was authorised to reject any proposed par value if in its opinion it could not be maintained without excessive borrowing from the Fund by the concerned member country. However the Fund did not reject any of the par value proposed by the members which were based on the exchange rates prevailing in October 1946. At that time, almost all the currencies were overvalued in terms of dollar and were being maintained with the help/ of trade and exchange control. Therefore, in 1947 the prevailing exchange parties were assumed to be correct and-declared as par values by members. As such the Fund accepted them even though it was widely held certain parties were out of tune. Later on this led to the devaluation of the sterling (U.K.) in 1949.

It is obligatory for each member to maintain the par value of its currency stable. The Fund's objection is to ensure stability in the exchange rate but it does not intend to make them rigid. To this end the Fund allows floating of exchange rate by a member country but such divergence of spot exchange rate from the par value should not be beyond certain limit fixed by the IMF from time to time. The fund also permits changes in the par value of the currency for connecting a fundamental disequilibrium. The par value of a country's currency can be changed only at the proposal of the country concerned and after consultation with the Fund. Consultation with the Fund for any change in the par value of a currency is necessary if competitive depreciation is to be avoided.

A member can change the par value of its country by 10 per cent (in either directly or simply by informing the IMF). However, for change exceeding 10% but below 20% the concerned member country must obtain permission from the fund. For any change exceeding 20%, two-third majority of the Fund's members have to agree.

A member can change its exchange rate even without the approval of the Fund if the change does not affect the international transactions of the members of the fund. The Fund will approve the proposed change in a country's exchange rate if it is satisfied that the change is necessary for connecting some fundamental disequilibrium in the balance of payments. In such cases it shall not raise objections to the proposed change on the basis of the domestic, social or political policies of the members proposing the change. If the Fund is convinced, for example, that the fundamental disequilibrium so owing to domestic inflation of-prices and incomes, it shall not object to the proposed change in the exchange rate on this ground. This provision is meant to avoid any interference by the Fund in the internal affairs of a member country.

The fund is authorised to make uniform (proportionate) changes in the par value of the currencies of all members subject to the condition that such a change is not objected to by any member having 10% or more .of the total quota of the Fund.

If a member alters its exchange rate without the required consent of the Fund, it can be declared ineligible for using Fund's resources. Such a member can also be required to withdraw from the Fund by a majority vote.

2. Elimination of Exchange Restrictions: One of the principal purpose of the Fund is to promote the elimination of exchange restrictions, multiple exchange rates and discriminatory monetary facilities which hamper the growth of world trade and move towards a system of a free multi-lateral payments. All members pledge to remove exchange restrictions on current transactions as soon as the conditions permit. They also agree to employ exchange restrictions etc. only in accordance with the agreement. It is important to note that the use of exchange restrictions has not been completely outlawed by the IMF. Following are the causes of permitting exchange restriction by the IMF:

i) Their elimination would require some time

ii) The fund intends to eliminate only those restrictions which related to current international transactions, and

iii) In some cases transactions in national money that Fund declares to be scarce.

In order that this objection may be achieved it is envisaged that all members after a transitional period of varying duration will accept certain obligations set out in Article, VIII. This article provides that no member may without the approval of the Fund impose restrictions -on the making of international payments or transfers for current international transactions or would engage in discriminating currency arrangements or multiple currency practices.

3. Financial (or lending) operations of the Fund - The most important function of IMF is to provide short-term finances to the member countries. For this purpose, the firm purchases or sells the currencies of member countries.

The IMF's financial operations are generally confined to operating functions of the IMF to buy and sell the currencies of member countries. The Fund is to maintain a revolving character of its resources. This can be achieved by requiring member countries to repurchase their currency. As stated above, part of the Fund's resources is provided by member countries in the form of their currencies. These currencies are sold by the IMF to the needy members but later on the latter are 'required to repurchase their currencies either against gold or against some other currency.

Generally the capacity of purchasing foreign currencies of a member country is related to its quota. This capacity is determined on the basis of following rules:

(a) The purchases of foreign currency by a member within any period of 12 months must not cause more than 25% increase in the member country's currency holdings at the Fund.

(b) The total purchase must not exceed 200% of the member's quota in the Fund. Thus, any country cannot buy more than 25% of its quota in, a year and 125% of quota in all. For this purpose the quota of every member been divided into five parts. First part is limited to 25% of the quota. This is known as the gold limit of the quota. Normally no objection is made against the use of this part but for every successive bracket (upto 125%) the member country has to justify the purchase of foreign currency. However a country facing balance of payments difficulties are require full aid may not be able to benefit from the Fund if the 25% limitation is strictly followed by IMF.

Any member desiring to obtain a foreign currency gold can conveniently obtain it from the Fund. Members are free to sell their newly produced gold in any market.

A member can represent on currency from the Fund and pay gold even if such repurchases exceeds its gold quota. This revision is meant to enable the members with a better financial position to repurchase a large amount of their currencies and deposit gold with the IMF vis-a-vis those members whose financial position is not so good.

4. Checking the Accumulations of Currencies and Increasing their availabilities: Fund's one important financial function is to avoid excessive accumulation of certain currencies and excessive depression of other currencies. The Fund attempts to maintain balance between the demand for and supply of various currencies, specially in respect of those currencies which are scarce and face a pressure of demand and induce member countries to accommodate them unnecessarily. The Fund takes several steps to remedy such a situation.

(a) It can issue a report to the member bank whose currency is becoming scarce, giving the reasons of scarcity. The Fund may recommend various" measures for increasing the availability of such currencies.

(b) The fund can borrow currency from the member country whose currency is becoming scarce, or from some other sources or outside the domain of the Fund with the consent of the member concerned.

(c) The fund can purchase such scarce currency from the member country in exchange of gold.

(d) The fund can notify its members that the particular currency has become scarce and then may proceed to ration the supply of such currency in accordance with the needs of the member countries.

5. Charges and the Dividends - The Fund is Authorised to Impose Three kinds of Interest rates;

(a) On amounts not exceeding 25% of the quota; no charge for the first three months; one-half per cent per annum for the next nine months, and there after an increase in the charges of non-half percent for each subsequent year. .

(b) On amounts more than 25% and non more than 50% in excess of the quota, an additional one-half percent for each subsequent year. .

(c) On each additional bracket of 25% in excess of the quota, an additional one-half percent for the first year and additional one-half percent for each subsequent year.

The IMF levies a sliding scale of charges on each member when the Fund's average daily holding of the member's currency exceeds the quota. These changes become progressive depending on the size of a member's drawing and on the period for which such drawing and on the period for which such drawing is made. As a rule, such charges are payable in gold.

The income derived from the Fund's operation is used to meet its operating expenses and whatever is residual is distributed among member countries in the form of dividend.

6. Standby Arrangement In recent years the traditional policy of lending has taken a wide welcome change. In few cases borrowings in excessive amounts may have also been permitted by the IMF. A member may repurchase its own currency. even after the expiry of 5 years, despite the persistence of an adverse balance of trade position. A new procedure of lending was created in October 1952. This is known as "Stand by Arrangements." Under this policy a member can contract for a loan of a specified amount in advance of its actual need for foreign exchange. Such loan can be drawn at any time depending on the need for foreign exchange. The fund provides necessary accommodation to the member country without any further consideration of its balance of trade position.

The concerned member country is required to pay to the fund a charge of 0.25 per cent per annum on the entire amount and for the entire duration of the Stand by Arrangement. Sometimes a country does not want a loan immediately but wants simply an assurance that it will get the loan when it needs the same. In the absence of such an assurance, the country may have to institute exchange restrictions for safe" guarding against the possibility of a shortage of foreign exchange in the coming period. Loans under the stand by arrangements are generally for three years and sometimes under appropriate circumstances even for a shorter period. Several times members have repurchased their currencies even before the expiry of the times for which the loans were originally contracted. Sometime members entered into such agreement but did not make any drawing at all. Thus, this policy has so far served only as a second line of defence for the member countries.

7. Compensatory Financing: A few methods of compensatory finance have been created by the IMF. According to this provision a country can borrow from the Fund in excess of its permitted limits. It is to be used by those countries which are facing the balance of payment disequilibrium but whose such disequilibrium has been caused by the sharp decrease in the value of their exports. Such provision is mainly meant for the countries producing primary goods, and is available only as a temporary finance is 25% of the quota if an individual member. Before granting loan under such provisions the IMF has to ensure that the disequilibrium has been caused by those circumstances which were beyond the control of the member's banking system and exchange reasons.

8. Technical Assistance and Consultative Functions: The Fund has also provided the technical assistance to the member countries from time to time. Thus, the role of IMF has been dynamic, and the Fund has worked as a source of strength to member countries. The Fund also advises member countries on matters of their monetary and other economic interests. In the past the IMF has studied some of the World's economic and financial problems and has given advice to members on the ways to meet dollar-shortage and measures for boosting trade and investment.

Initially some of the European Countries were facing balance of payment difficulties caused by World War II. The Korean War worsened the balance of payments position and inflationary pressures developed in several countries. The Executive Director of IMF noted that the fundamental cause of inflation was the growing tendency to increase the government spending. The Fund advised its member countries to reduce government spending and increase exports. This was a concrete advice which was followed by most member countries.

Most of the member countries enjoyed a period of stability during the years 1953-56. Their savings and investment increased substantially. In some of the developing countries, however, private investment could not increase. The' Fund played an important role in advising these countries to increase private investment.

In 1957 again a world wide boon and inflation cropped up. It. created a problem of deficit balance of trade for several countries. The IMF helped member countries by sending teams of experts and advising them on measures to control inflation and reduce their balance of payments deficit.

The Fund has provided technical assistance to developing countries too. These countries are facing serious problems in gearing their monetary, fiscal and exchange policies for a perspective and steady growth of their economies. The Fund has all along been responsive to their problems, and has advised them to find solution from time to time.

The technical assistance given by the IMF has been of two types: (a) The first comprised of the deputation of Fund's officers to the member countries for a short duration ranging from a week to more than a year. These officers advise the government concerned on their specific problems and programmes of economic development.

In some countries these officers have assisted in the formulation of appropriate monetary, fiscal and exchange policies, or in the implementation of their stabilizing programmes. In other countries they have helped to draft legislation or to compile data on monetary and balance of payments phenomenon.

During 1973-74, 35 IMF officials rendered their services in 23 countries for a short duration. The second type of technical assistance involves the engagement of experts from outside the staff to assist member countries in various specialised fields. These experts may serve as executive officers or as advisors during 1973-

74,119 external experts were engaged by the IMF to work on different assignments in 51 countries.

In the recent years the IMF has expanded its capacity to render technical help by creating two new branches concerning (i) The Central Banking Services, and (ii) The Fiscal Affairs Groups. In the later, the experts in fiscal affairs such as tax policy, tax system, tax administration, budgeting and other aspects of control of revenue and expenditure are recruited and are used by the member countries. In the branch concerning banking services the personnel from the IMF as well as those recruited from outside are used to assist the member countries in tackling their monetary problems.

20.5 IMF AND THE LESS-DEVELOPED COUNTRIES

The Fund has concerned itself recently with the problems of UDCs.

(a) It has extended compensatory financing facilities to these countries to provide assistance to meet their balance of payments deficit, especially to compensate export short falls experienced by countries exporting primary products. In the last meeting of IMF, the need to improve the facility was considered and was suggested that compensatory assistance should be increased from 25%, to 50% of the quota. Now the compensatory financing is available equal to 25% of the quota. This is to be given when the fund is satisfied that the shortfall is temporary and largely caused by the circumstances beyond the control of the country concerned. However the member co un try must co-operate Fund for the solution. Upto September 1975 the Fund. had provide compenstory finance equivalent to 565 million SDRs of which 515 millions SDRs were obtained by the developing countries.

(b) The Fund is providing technical assistance to the developing countries, for tackling to their monetary, fiscal and exchange problems. The Fiscal affairs Centres and Central Banking Service departments of the IMF are primarily concerned with providing expert advice to these countries.

(c) The fund has from time to time discussed the financial problems of these countries. The financial problems generally studied by the IMF are: relations between inflation and economic development; trade and balance of payments difficulties and methods to cope with them; the problem arising from structural weakness in a country's fiscal system; and difficulties arising from excessive burden of short term foreign debt. It is on these problem that the Fund is focussing its attention in recent years.

(d) For tackling the problems of foreign debt the JMF has helped its members countries in the following ways:

i) It has provided good offices for renegotiations.

ii) It has provided the back ground information required to assess the need for debt re-scheduling and to understand the magnitude of the problem facing debtors.

iii) Some stand by agreements include conditions intended to discourage excessive debt burden.

iv) In its relation with the member countries the Fund is alert to the possibility of the problem emerging before them and the Fund encourages them to adopt such policies which will forestall the danger.

The recent keenness of IMF to help its developing member countries is evident from the Fund's decision to sell on sixth of its gold holdings at the market price of gold and use the profit of such sales for establishment of a Trust Fund. It is hoped that depending on the market price of gold, such an action would make available market price of gold, such an action would make available $ 25 to $ 28 billion to the currency holdings of the IMF and their use through the Trust Fund would benefit the developing countries, especially those countries which have badly suffered since the oil price hike in 1973. According to one estimate the balance of payments deficit of these countries during 1975 was around $ 35 billion. Creation of the Trust Fund for helping these countries would raise IMF's lending by almost 45%.

Impact Of imf On International Liquidity

The measures which IMF proposes to reform the existing international monetary system are really designed to increase the international liquidity. Recent decision to raise the IMF's quotas and to sell-about one third of its gold holdings are likely to have two effects smul1taneously. First, it would increase the loanable resources of IMF substantially, and secondly, it would also bring forth a revaluation of individual gold stock, which would in turn, result in an increased international liquidity. Professor Milton Sriedman, however, fears that increased gold stocks of central banks may bring about further hick-ups of inflation in the world economy. Yet, the immediate impact of the new international monetary system will be felt in the form of increased world liquidity.

Thus for the Fund was providing short term loans to member countries with or without conditions. The Conditional liquidity was made available to a member if only it had adopted the desired policies to correct its internal economic imbalances. The unconditional loans, on the country, were available without any such strings. However, most of the loans of IMF has taken many other steps in recent years to increase its own resources and to increase international liquidity."

(i) General Agreements to Borrow: The Fund has entered into agreements with ten industrialised countries. Under such agreements the IMF 'can obtain foreign exchange to help other countries remove their short term balance of payments difficulties. These agreements were first entered into in 1962, but have since then been renewed three times, in 1966, 1970 and 1974. By September 30, 1975 the Fund had borrowed 5509 million SORs under the General agreements to borrow. The contribution of different countries to such loans had been as follows: (million SORs).

U.S.A. 1717.8; West Germany 1286.2; U.K. 631.1; France 511.9; Canada 182.0 and others 1580. By 31st March member countries borrows about SORs. 31.66 billion (in foreign currencies) from the General Account of the Fund. This amount, .however, exclusive of the loans given by IMF's under SOR agreements.

(ii) Compensatory Financing: It has been stated above that countries suffering from serious balance of payment difficulties can obtain compensatory finance from the IMF. This Scheme is particularly helpful to the developing countries. This scheme was introduced by IMF in February, 1963, but was subsequently amended in 1966. Since its inception and upto June 1975 compensatory fiinancing worth 1087.55 million SDRs was made available to member countries. Interestingly enough, out of this amount a sum of 913 million SDRs was provided to 31 countries since 1966. Out of this amount compensatory drawings upto September 1975 amounted at 565.4 million SDRs.

(iii) Oil Facility: The Fund has introduced Oil facility loans-ul those countries whose balance of payments positions have suffered a set back since the OPEC decision to raise oil prices. Until September 1975 the IMF had entered agreement to borrow 4670 million SDRs from the oil exporting countries, and 1247 millions SDRs from industrialised countries (total amount of such loans agreed upon being 5917 million SDRs). By September 1975, actual Fund drawings against such agreements amounted at 3402 millions SDRs.

TABLE 20.1 Percentage Share of Principal Countries Using Oil Facility

Country	Percentage Share
Italy	26
Spain	10
India	8
Zaire	6

By the end of 1974 forty member countries had used a total amount of 2583 million SDRs under the Oil Facility. Percentage' share of principal countries using this facility has been given in Table 20.1.

Thus compensatory- financing and lending under the Oil facility has enormously increased the world liquidity in recent years. However since 1975 the Fund has adopted stricter conditions on the use of funds particularly under the member's policies to correct their balance of payments. In particular the Fund would examine the adequacy of the member countries measures taken to save conserve Oil or to develope alternative source(s) of energy. Further, the interest charges on such loans are higher as the duration of loans increases. The interest charge is 6% percent for the first three years, 7 percent in the fourth year and 7% percent from the fifth year until the end of seventh year. I

The recent decision to raise the IMF's quotas to 39 billion SDRs would further increase the Fund's role in tackling the problem of international Liquidity. Again, the decision to liabilise the procedures for Fund's loans would also increase the international liquidity.

(iv) Standby Arrangements: Since 1952 the IMF has introduced Standby Arrangements according to which a country makes an advance arrangement for some specified period and for a specified amount upto which it can borrow from the Fund as and when there is any need. However, the member country is not bound to draw that amount or any fraction thereof. In fact, this arrangement provides a "second line of defence" to those countries with fear to have a serious balance of payment deficit. However, a loan under such arrangements is given for six months, and under certain situations, for a maximum period of 3 years. It may be noted here that most developing countries have not been able to draw the agreed amount under such/arrangements. In 1973 the number of effective Standby Arrangements was 13 whereas in 1974 and 1975,14 such arrangements became effective each year. During 1974-75, 47. member countries made purchases for a total "'equivalent to SDR's 2585 million of which 981 million SDRs were purchased in gold tranche and an increase of SDR 374 million over 1973-74.

By March, 1975 loans amounting to SDR 21.14 billion were committed under Standby Arrangements.

(v) Social Drawing Rights: A detailed account about SDRs has been presented In the last chapter. In fact, SDRs have also enabled the members of IMF to reduce their balance of payments difficulties. As was stated in previous allotment of SDRs was started in January, 1970. According ,to its original plan, the average deposit OJ a member country should be 30 percent of the SDRs allotted to it. In other words. the average use of SDRs by any member should not exceed 70 percent of its allotted quota.

When a country obtains certain quota of SDRs, it obtains an unconditional reserve asset by which it can obtain convertible currencies from other allotters of SDRs without taking any resort to gold. Thus as back as in 1970, the IMF had taken steps to reduce the use of gold by provinding an unconditional asset to the member countries. For this reason, SDRs are also known as Paper Gold because SDRs themselves have an absolute gold value guarantee, Under this scheme no country is obliged to keep more than three times its quota in the form of SDRs. For additional SDRs (exceeding three times the allotted SDRs) the IMF pays interest to such countries, which is realised from the uses of SDRs.

In 1970, 1971 and 1972 three allotments of SDRs were made to 117 countries out of the 126 member countries ofIMF. The total amount of SDRs created in three years was 9.3 billion SDRs, of which 24.7% has been allotted to developing countries.

The participants in SDRs have used this facility in three ways:

(1) Transaction: With designation (2) Transactions by agreement and (3) Transactions with the General Account of the Fund. I

During the fiscal year 1973-74 the 'participating member countries used SDR1125 million under Transaction by Designation. During 1974-75 twenty four countries used SDR 440 million under Transactions by Designation of which SDR 135 million was used by Australia, SDR 150 million by Italy and SDR 57 million by New Zealand. Out of this amount SDRs 157 million were received from U.S.A. whereas France and U.K. provided SDRs 103 million and SI) Rs.96 million respectively. During the same year (1974-75) Under Transactions by Agreements among the participants, SDRs 248 million were used, of which almost 50% was used. West Germany and 25% was used by Denmark.

All these arrangements are designed to increase the international liquidity and thus help member countries to overcome their short term deficits in the balance of payments.

IMF and India

India was also a participant in the Brettonwoods Conference in 1944. In March, 1947 India paid its subscription of $ 400 million, in the following way: Gold subscription worth $ 27.486 million; subscription in the form of U.S dollars 40,000 whereas the rest was paid in the form of Indian rupees until January 1970. India continued to enjoy fifth position in the list of subscribers to the quotas of IMF but the increase in IMF quotas effected in February 1970 relegated India to the 9th position. As a result, India has ceased to be a permanent member on the Board of Executive Directors. On September the overall quota of India was 940 million SDRs of which 162.5 million SDRs was subscribed in the form of gold and the rest (777.5 million SDRs) in the form of currency subscriptions.

The initial par value of the Indian rupee established with the Fund on December 18,1946 was 0.268601 gram of the fine gold or 33.2250 U.S. Cents per rupee. This rate was, however, determined by the relationship between the pound sterling (to which India was linked till recently) and the U.S. dollar. After the delinking of Indian rupee, the rupee has now been linked with a basket of a currencies pertaining to our principal partners in international trade. The exchange rate of rupee is now floating in terms of these currencies.

Yet, India has borrowed funds from the IMF from time to time. First such loan amounting to $ 100 million was taken by India in 1948-49 against which India paid rupees. In February 1957 the Government of India entered into another Stand by

Agreement with the Fund for drawing $ 200 million to tide over her temporary balance of payments difficulties. Between 1947 and 1957 India obtained $ 300 million of total assistance from I the IMF. In 1961 India obtained currencies of six nations including Yen of Japan. In fact India was the first country to' purchase Yen from the Fund. In July, 1962 again India entered into a Stand by agreement with the Fund for $100 million. This agreement was renewed after the expiry of its duration, and lasted until July, 1964. In July, 1964 the IMF made an other Stand by agreement with India, but the amount committed this time was $ 200 million. This amount was raised to help India overcome its serious balance of payment difficulty. .

During the Third Five Year Plan India was once again in the grip of serious foreign exchange crises. This substantially raised India's drawings from the Fund. By the end of Fiscal Year 1968, India had purchased Rs.8.17 billion worth of foreign currencies from the IMF. India repurchased rupees in installments and the last repurchase was effected in March, 1971.

Under the scheme of Special Drawing Rights also India obtained SDRs. 326.2 million during the first three years of their .inception i.e., during 1970-72. Likewise, India has also been receiving loans from the Compensatory Financing Facility and Oil Facility of IMF. In February, 1974 under the Compensatory Financing Facility India obtained SDRs 62 million. Another loan worth SDRs 282 million was obtained in 1974.

In 1974 India was authorised to draw SDRs 250 million from the Fund under its Oil Facility arrangements. By October 1974 the country had drawn SDRs 239 million under this agreement: At the end of September 1974 India's outstanding loans for IMF amounted at $ 685 million or SDRs 822 million, whereas the total accommodation given to India since the inception of IMF has been about $ 2000 million or SDRs 2400 million. For 1975 the Fund authorised India to draw SDRs 201 million under Oil Facility. As per IMF rule, the country was obliged to return the outstanding SDRs obtained under oil Facility if it reserve position improved over the past year (Le 1974) Though the foreign exchange position of India had considerably improved in 1975, the country was still not in a position to payoff its loans taken under the Oil Facility. At the joint meeting of IMF and World Bank held in January 1976, the country was given an extension of another year (until December 1976) for repaying such loans.

Thus India has benefited a great deal from the IMF. The Fund has helped India at such occasions when the country was in the grip of serious foreign exchange crisis. Further, in recent years the position of Indian rupees has improved in comp8rlson to the pound sterling and the U.S. dollar. India has been considered as a leading participant among the developing countries and her opinion is given serious thought in the Fund's deliberations and policy formulation.

Assessment of the success of IMF

The success of IMF can be assessed in terms of the objections it was to achieve at the time or its origin.

1.Monetary Operations-- It has been accomplished with a marked success that IMF has provided an excellent forum for discussion practically on day to day basis of economic and financial policies of member countries with particular reference to their balance of payments impact. The Executive Directors (The Committee of Twenty) are continuously in session and conditions of countries are considered as promptly as the situation warrants the Fund reviews from time to time the policies of economic development of all member countries.

The Fund concerns itself with the problems of every member country. The reports of the consultants are placed before the Executive Directors and an opportunity is given to them to comment and critize the policies being followed by members and their impact on the international liquidity. This type of arrangement could have been hardly imagined 30 years ago. Besides the periodical visits of the Fund's staff Mission' s to the member countries, the annual meeting of the Board of Governors provides a good forum for high level discussions both formal and informal on international monetary problems and policies.

2. Expansion of Trade -- The Fund has contributed in a unique way to the expansion of international trade, albeit it is difficult to pay to what extent the objective of balanced growth has been achieved.

3. Exchange Stability -- It would appear that while the achievement falls short, of ideals, the measure of exchange stability that the world has been in the IMF era is markedly better than what was seen during the interwar period. There is general acceptance of the system of fixed borrowing. It is true that some of the leading countries, in particular Canada for a long time experimented with the system of fluctuating rate, but in general most member countries have come back to the fixed par value system. Even the recent legalization of floating rates is designed to promote stability in the exchange rates. There has been little tendency to resort to competitive exchange depreciations. The changes in exchange rates that have "taken place, have been orderly. Member countries consulted and took the required approval before depreciating their currencies. Some of the changes in exchange rates were brought about by the active participation of-the Fund. A number members have multiple exchange system. However, the Fund has tried to bring out a simplification in the multiple exchange system too.

4. Multilateral System of Payments -- A steady progress has been achieved in this direction. With the achievement of de facto convertibility in 1958 and de jure convertibility in 1960 of the majority of European Countries, multi-lateralism has grown in scope. The other exchange restrictions continue in/ case of majority of developing countries.

5. Availability of Fund's resources -- During the first decade after the Funds inception, there was undue conservation and reluctance to use Fund's resources

but during the last two decades a shift has evidently taken place in this attitude and the member countries have started taking loans from the Fund's more frequently. The marked increase in the use of Fund's resources is the result of change in its formal policy. It is largley due to liberalization of Fund's lending policy. Also it was partly due to the changed attitudes with regard to the use of Fund as a source of international liquidity, and partly due to better initiative of the management of the IMF. Today the Fund is more alive to the problems of developing countries. -The recent decision to create a special Trust Fund by selling-one sixth of the Fund's gold holdings is but one of the many ways in which the IMF wants to help the-third world.

6. Shortening the duration and lessening the magnitude of balance of payment disequilibrium --

It is doubtful if much have been achieved in this direction, albeit the Fund has been sincerely and seriously attempting in this direction. As a matter of fact, balance of payments disequilibria of most' countries are structural and supplementary assistance by the Fund alone cannot correct them. This would, however, require concerted efforts by the member countries themselves.

Limitations Of The IMF

The actual working of the IMF during last three decades shows that all has not been well with it. It has met with limited success in many areas. Some of the limitations of the Fund are as follows:

1. Violation of par Values -- Many countries have violated the Fund's rules regarding the alteration in the par values of heir currencies. Also, those countries whose currencies were in short supply, took to steps to rectify it. In 1948, France wanted to change its exchange rate by 44% and that devaluation took place even in the face of opposition from IMF. Similarly, in 1949, dollar shortage was experienced by most of the members but since U.S.A. was dominating the Fund, its dollar was not declared a "scarce currency" by the IMF...-0n the contrary, to accommodate the dollar interests, the Fund asked for' the devaluation of pound sterling. Such instances tend to reduce the strength of the Fund. Thanks to the recent events, dollar has lost its supremacy and U.S. is no more dominating the Fund.

2. Some provisions of the Fund are defective -- For example, when serious balance of payment disequilibrium takes place as a result of the internal policy of a particular country, it can devalue its currency upto 10% without seeking the Fund's approval and upto 20% with its approval. But unless inflation is checked devaluation would not be helpful in correcting the balance of payment disequilibrium. And this is what the Fund cannot do as it would mean unauthorised interference by the Fund in the member's internal policy. Persuation and consultations are the only weapons the IMF has so far considered right to deal with such difficult situations. But in such delicate situations, persuation and consultation are ineffective.

3. Failure to solve the problem of balance of payments disequilibrium of LOCs:

As regards its objective of providing financial assistance to deficit countries and of stimulating levels of income and employment, particularly in this third world, the Fund has not achieved much success. It is a matter of common knowledge that under developed countries are today faced with the dilemma of dwindling export prices and earnings on the one hand and rapidly rising imports on the other. The success of the ;Working of IMF towards the establishment of multilateral system of world trade will depend upon the degree-to which the LOCs implement" their development plans free from the j distorting effects of inflation.

In conclusion we can say that whatever progress the Fund l1as made towards its objective has been mostly on a regional basis. Even this is more due to the efforts of other international agencies such as ECM, IBRD etc. The most important cause of its limited and unsatisfactory success is the prevailing inflation in the Latin American, European and Asian countries. So long as inflation continues, these countries will continue to suffer from a disequilibrium in their balance of payment. And as long as they suffer from payment deficits, they cannot afford to remove exchange restrictions to restore convertibility of their currencies. The Fund has, however, no , right to interfere in the domestic affairs of any country.

Despite these limitations under which it has to work, the IMF has enormously contributed towards reducing the tendency bilateral agreements has reduced discriminations in international payments, and has increased the transferability of many currencies. Further recent changes in the operation of the Fund and its decisions to liberalize the lending procedures, to legalize the system of floating exchange rate and to create a Trust Fund for helping the developing countries will go a long way in promoting international monetary co-operation and minimizing the problem of international liquidity.

4. The Fund provides loan only for the current transaction and tries to tackle short run problem of the balance of payment disequilibrium of member countries, but it does not make any arrangement to promote the flow of capital investment. This limits the scope of Fund's operations.

5. The Fund continues to be dominated by the rich countries who mostly constitute the Board of Governors and the Executive Directors. In other words, developing countries are not adequately represented on these executive bodies.

6. The continued bycott of Soviet Union and her allies is also viewed as an area where the Fund seems to have failed in evolving a universally acceptable monetary system.

20.6 INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

The greatest need after the Second World War was that of the co-ordination of private capital investments for economies. If the world was to have a permanent Peace, it was considered essential to develop the economic resources of under -

developed countries and raise the living standards of their people. The Bank a sister institution of the International Monetary Fund came into existence on 27th December, 1945 and began to operate from 25th June 1946.

OBJECTIVES OF THE BANK

The objectives of the Bank are as follows:

1) To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes including a) the restoration of economies destroyed or distributed by War, b) the reconversion of productive facilities to peace-time need's and .

c) the encouragement of the development of productive facilities and resources in less developed countries.

2. To promote Foreign private investment by means of:

a) "guarantee or participations in loans" and their investments made by private investors. and b) "to supplement private investment" when private capital not available on reasonable term.

3) To promote the long range balanced growth of international trade and the maintenance of equilibrium in the balance of payments by encouraging long term international investments thereby assisting in raising productivity the standard of living and conditions of labour in their territories.

4) To encourage loans made or guaranteed so that the more useful and urgent projects will dealt with first, and

5. To conduct its operations so as to bring about a smooth transference from a war-time to a peace time economy.

Organisation Of The Bank

The membership of the IMF is a pre-requisite for the membership of the World Bank. Now, the Bank has 147 countries as members. The Bank has a "Board of Governors" on which every member country is represented by a Governor (normally the Finance Minister). The Chairman of this board is selected every year by the Governors. There are 20 executive directors of whom five are appointed by the five largest shareholders of the bank namely America, Britain, Germany, France and India. The remaining 15 directors are elected by other member countries. These directors are responsible for the 'general operations of the Bank. The president of Bank is elected by the executive directors and he simply enjoys a casting vote.

Bank Capital

The original authorised capital of the Bank was $ 10,000 million divided into 100,000 shares of $ 1,00,000 each. The subscription of any member country consists of three parts.

1. 2 per cent of the subscription is payable in gold or U.S. dollars. This is freely available for lending.

2. 18 per cent of the subscription is payable in the currency of the member. This is available for lending with the consent of the member whose currency is involved.
3. The remaining 80 per cent of the subscription is subject to call if and when required to meet the obligations of the Bank.

The value of the shares allotted to every member country generally corresponds to its quota in the IMF. From 31st December, 1979 the authorised capital of the Bank has been raised to $ 18100 million.

20.7 LENDING OPERATIONS OF THE BANK

The Bank IS authorised to make two types of loans.

(1) Reconstruction loans and (2) Development loans. In the early years reconstruction loans were granted liberally. The development loans are usually granted to develop modern transportation scientific agriculture and industrial expansion. Thus they are very important to the development of new productive facilities in order to create new employment opportunities.

Between May and August 1947, 4 major reconstruction loans amounting to $' 497 million were granted to four European countries namely France, Luxemburg, Denmark and Netherland. The bank granted 1731 direct loans amounting to $ 52,000 million between 1947 and 1979 (June). After the Mashall Plan was adopted in April 1968, the Bank shifted its interest from the reconstruction to the development loans. Nearly 25 per cent of the Bank's lending has been for electric power another 25 per cent has been for transport and communication, and other half has been for the development of industry, agriculture and irrigation. There has been rapid progress and all the targets to programme have been achieved. Some of the targets were

1. to double the total lending of the bank and International Development Association (the total has increased to 128%) 2. to triple lending to Africa (it has increased to 214 percent) 3. to double lending to Latin America (it has increased to 128 per cent) / 4) to quadruple lending for Agriculture (it has increased to 317 per cent) 5) to triple lending for education (it has exceeded 362 per cent)

The bank and the development countries

The International Bank annually prepares economic reports for some 30 largest developing member countries. Such studies provide valuable basis for the co-ordination of development assistance. The Bank has been instrumental in sponsoring many Consortia Aid Groups. Consultative Groups and Aid Clubs for many Asian, African and Latin American developing countries. The Bank has got its own contribution to the formation of the International Development Association which is providing hard currencies to under developed countries. The Bank also helped much in amending the Charter of the International Finance Corporation to provide equity capital to private industrial undertaking in developed countries. At the end ofJ982 the loan and investment amount increased to $ 10330 million from $ 8800 million in 1981 the Banks operations to totalled 150.

The bank and India

India is the largest single borrower of the Bank. Between 1949 and 1979 the Bank gave 57 loan to India amounting to $ TWO million. India also received a non-project aid of $ 3700 million from the Bank. India received $ 550"0 million financial help during III plan period from Aid India Consortium due to the efforts of the Bank. The World Bank group has committed a record of $ 1281.50 million to India during the fiscal year ended June 1978 taking its cumulative assistance to around $ 8000 'million. Of the total, interest, free 50 year IDA credits total $ 951.50 million and the Bank loans $ 330 million. The Bank paid the foreign exchange cost of two studies aggregating to nearly $ 11152 1akhs. In 1965 it paid $ 87200 as a part of the cost of the study made in connection with the feasibility constructing a new crossing road for transport over the river Hooghly.

Among the schemes for which India had obtained loans from the Bank are included those of land reclanation, power development, irrigation and hydro-electricity, installation of thermal power station, purchase agricultural machinery, transport equipment, transmission of power, and for the development of the Industrial credit and Investment Corporation and the Industrial Development Bank.

The World Bank which has made a special study of India's debt servicing problem, recommended in April 1972 that the Aid India Consortium should give £ 200 million to India for each of the two remaining years of the Fourth Plan. India borrowed $ 1265 million in 1981-82 from the Bank.

Criticism

The mode of operation of the Bank has been criticized on the following grounds:

1. It is said that the Bank charges a very high rate of interest even when the loans given by it are guaranteed by governments of the borrowing member countries and there is no risk of loss of capital. For example, the latest loans that India has received from the Bank bear interest of over 6 per cent. The Bank was created to be an active instrument in the establishment of permanent world peace by making it possible for the economically weak countries to come up by mobilising their resources.

2. The Bank's condition on the presence of transfer (or repaying) capacity of a borrowing country before granting the loan is not proper. The transfer capacity follows rather than precede the utilisation of the loan in a backward country with its vast untapped resources awaiting exploitation, search for transfer capacity before granting the loan as a misnomer.

3. The Bank claims to have given loans in an increasing amount to Asian and African countries during 19 years period (1954-55 to 1973-74) and the total

percentage of loan to these two areas has risen from 23 per cent to about 75 per cent. In spite of this there is another aspect of the picture. Asia and Africa nave the largest population area and unexploited economic resources in the World-Further more, the people are very poor and thus the phenomenon of actual poverty amidst potential plenty is prevailing in full swing in these continents. On the contrary Europe and Western - Hemisphere are much smaller both from population and -, area consideration and even then they have received huge amounts of loans. This cannot be defended on economic considerations alone.

4. It is felt that the Bank's help is relatively quite insufficient to the large financial requirements so essential for various development projects.

20.8 ROBERT MAC NAMARA'S PLAN

The President of World Bank, Mr. Mac Namara has announced a plan in 1974 to specially help the poor countries. As per the plan, the Bank will lend $ 22 billion as loan. (This is equal to Rs. 16500 crores). In this amount the World Bank will rise 14 per cent from the market.

20.9 INTERNATIONAL FINANCE CORPORATION

The International Finance Corporation (I.F.C.) is an affiliate of the IBRD. It came into existence in June 1956. The membership of IFC is open only to government, which are members of the World Bank. As on June 30, 1982, the membership of the IFC stood at 122.

Organisation

All powers of the IFC are vested in the Board of Governors which normally meets once a year. The responsibility for the conduct of the IFC's general operations is vested in a "Board of Directors" which consists of 20 Executive Directors of the World Bank. The President of the World Bank is the ex-officio chairman of the Board of Directors of the IFC. Since October, 1961 he has also been its President subject to his overall supervision, the routine day-to-day operations of the IFC are conducted by its staff under the direction of the Executive Vice-President.

Capital

The authorised capital of the Corporation is $ 110 million. It is divided into 1,10,000 shares of $ 1000 per value each. On June 30,1974, the total subscriptions of the members aggregated $107.22 million. The membership subscription are payable in full in gold and U.S. dollars at the time of joining and the voting powers of the members are in proportion to their capital subscription. For the first time in its history, the IFC is undertaking a major increase of its share capital. In a decision made by the Board of Governors in November 1977 IFC's authorised capital stock has been increased by $ 540 million, from $ 11 0 million to $ 650 million. Of the increase $ 480 million has been allocated for subscription by current member countries. More than $ 165 million has already been subscribed and $ 33 million paid in. The remaining capital 60 million has not yet been offered for subscription.

In addition, the IFC had a reserve against losses of $ 20 million derived from accumulated earnings. The IFC may supplement its resources by borrowing from the World Bank. The IFC has so far obtained $ 400 million from the World Bank and $ 5 million from the State Bank of the Netherland. The IFC can borrow from the IBRD for its lending operations an amount equal to four times its subscribed capital and surplus. As on June 30,1979 the total resources of the IFC totalled more than $ 820 million. The expansion of the corporation's paid-in capital stock significantly increases its capacity to borrow. If all of the stock capital offered for subscription are subscribed. the IFC's resources base would increase to about $ 3400 million.

Purpose of the IFC: The IFC is primarily an investing rather than a lending institution. Its chief aim is to promote economic development by encouraging the growth of productive private enterprise in member countries particularly in developing countries. Thus, it has laid down the following objectives.

1. "To invest in productive enterprises", in association with private investors and without a government guarantee where sufficient private capital is not available on reasonable terms.
2. "To serve as an intermediary" to bring together private capital management and investment opportunities.
3. "To help in stimulating the productive investment" of private capital, both domestic and foreign.

Activities Of The IFC

IFC operations represent a joint venture with private business firms. This is in contrast to the IBRD, which deals almost exclusively with government entities.

The major method by which the IFC stimulates private enterprise and investment is through the provision of funds to business firms located in member countries or their dependencies. These funds supplement resources which the firm must already possess. The IFC does not provide capital in excess of 50 per cent of the firm's total assets. However, the minimum capital contribution is normally $ 100,000, proviced the firm is unable to obtain credit elsewhere on reasonable terms.

As is true of the World Bank, IFC operations are conducted on a commercial basis. Unlike the World Bank, the private firm is not expected to obtain a government guarantee. In addition to that, IFC investments are restricted to underdeveloped countries which are members of the corporation.

The investments of the IFC are best classified as being intermediate between conventional loan capital and share capital. However during the fiscal year ended June 30,1962, a former restriction on equity investment was removed in practice IFC purchases non-voting securities of the applicant firm. This indicates that although the IFC shares in the profits and the growth, it does not expect to participate in managing the business. Second, after a period of time sufficient for the business to become established, the IFC sells its holdings to private interests. Purchasers of non-voting securities are able to convert them into voting stock which permits to holder to participate in the management of the business. Funds from the IFC security sales to private interests are re-used by the IFC for the purchases of participation in financing of other ventures.

Thus, a type of revolving fund is created for continued use in promoting private enterprise. The IFC also act as an intermediary to bring together private capital, management and investment opportunities.

"No restriction" stands between the operation of the IFC and the borrowing governments. The Corporation enjoys greater freedom compared to the Bank. In choosing its investments. The restrictions so far as they exist limit the IFC from investing in such 'social overhead' as housing, hospitals and schools also it is prohibited in engaging in refunding or refinancing activities and from investing in government owned and operated or government - managed undertakings.

IFC "does not have a policy of uniform interest rates" for investment. The interest rate is to be negotiated in each case in the light of risk and expected return. Generally the Corporation charges 7 per cent interest rate.

At the end of 1982, its investment was to the tune of $1800 million. In addition $ 1100 million was being held for participants in IFC financing.

Catalytic role of IFC: Since its inception in 1956 the IFC has invested over $ 2500 million in nearly 480 enterprises in 70 developing countries in total projects costing about $ 12600 million. For every one dollar that IFC has invested in a project, four dollars have been invested by others. Thus IFC plays essentially catalytic role in generating investment funds from local and foreign sources.

IFC and its associated external investors and lenders account for close to one tenth of the flow of direct private foreign investment (in fields other than petroleum) form OECD countries to the developing world.

IFC has made investment in a number of diversified fields like manufacturing, natural resource development, tourism developments made in the manufacturing enterprises. In the order of the total investments made, iron and steel tops the list with cement and other construction materials and textiles and fibre occupying the second and third places. An increase is expected in IFC's Involvement with projects such as agriculture forestry and fisheries. Most of the past investments in this area have been' in industrial processing and in plantation type ventures. Recently, IFC has begun to explore with agro industrial enterprises, in the developed countries, the various ways in which new ventures could be generated in the developing countries

India and IFC: Upto June 30, 1979, the IFC had made investment commitments in 12 manufacturing units totaling $50 million. The first investment commitment of $ 5.5 million was made in January 1959 to the Republic Forge Company Limited for the/manufacture of steels foregings. The second commitment of $ 0.85 million was made in April 1959 for the manufacture of diesel engines to Kirloskar Oil Engines Limited. The third investment amounting $ 0.898 million W. as given to the precision Bearingr India Limited at Baroda for the manufacture! of anti-friction ball and roll bearings and components! for use in industrial machinery, tractors and vehicles, pumps, motors and other types of engines. The fourth I investment! of $ 1.211: million was made with Fort Gloster Industries Limited to help enlarge and diversify electric cable production' by the Company. The fifth commitment amounting $ 1.31 million was made for setting up a new textile machinery company/to Lakshmi Machine Works Limited. The IFC made its sixth commitment of $ 3.3 million to Mahindra. U gine Steel Com pal Limited. The $ 18.9 million loan made to Zurai Agro Chemic Is Limited for urea and compound fertilizers plant costing 70 million has contributed to India's efforts to become self-sufficient in food and it is the IFC's biggest single investment in India.

20.10 ASIAN DEVELOPMENT BANK (ADB)

The Asian Development Hank popular known as ADB is the biggest regional financial institution in Asia. It was established on the initiative of the ECAFE and it began to function at the end of 1966.

The idea of an Asian Development Hank originated in 1954. However, a resolution was passed to this effect only at the first Conference on Regional Economic Co-operation of the countries of Asia held in December 1963. Once the proposals contained in the resolution received the support of the participants in principle, they were handed over to a "special experts commission" of the ECAFE for further elaboration and working out the details. By the second half of 1965, the prospective members of the ADH were able to arrive at a consensus about the tasks and aim of the Hank and to define the principles of its functioning. This made it possible for, a constitutive conference on ADH to be held in November December, 1965 in Manila, where the charter of the Hank was approved.

The Charter of the Bank was formally signed on December 4, 1965. It was, however, left open for additional signatures until January 31,1966, when 31 countries had signed the document. The charter became effective on August 22, 1966, with the ratification by 15 of 31 signatories. By September 30, 1966, 30 nations had satisfied conditions for membership and had remitted the first installment of their paid-up capital subscription. At the end of 1979, 43 countries were members comprising of 29 regional members and 14 non-regional members. The inaugural meeting of the Bank's Board of Governors was held in Tokyo on November 24-26,1966 and the Bank formally commenced business on December 19, 1966. The headquarters of the Bank are in Manila, Philippines.

Aims And Functions Of ADB

In the charter, the main aims of ADB were declared as follows:

(i) to assist the developing countries of the region, to increase the rates of their economic growth.

(ii) to help the regional members of the Bank, to build economic co-operation among them; and, (iii) to help in the development of the foreign trade of the member countries of Bank.

To achieve the above mentioned goals, the ADB performs the following functions:

(i) Promoting investment in the region of public and private capital for development purposes (ii) "Utilising the resources at its disposal" for financing development of its member countries in the ECAFE region, having special regard to the needs of the smaller or less developed member countries in the region.

(iii) Assisting the member countries in the region in the coordination of their development policies and plans with a view to achieving better utilisation of their resources, making their economies more complementary, and promoting the orderly expansion of their foreign trade, in particular, intra-regional trade.

(iv) Providing technical assistance for the preparation, financing and execution of development projects and programmes, including the formulation of specific projects proposals.

v) To undertake such other activities and provide such other servies as may advance its purpose.

Sources Of Funds

The ADB has authorised capital of U.S. $ 2985.71 million of which $1091.75 million has been subscribed. The Bank has increased this to $ 3700 million in 1972 and $ 8700 million in 1976. Of the subscribed capital, one-half is in the form of "paid" capital and the other half remains as "callable shares" to serve as security for the obligations of the Bank. The 'paid in' portion is to be paid in five equal annual installments. One half of each installment must be paid in gold or convertible currency and the other half may be paid in local currency. The Bank may also accept non-interest bearing demand notes in lieu of the amount payable in local currency provided such currency is not needed by the Bank for the conduct of its operations.

The Bank may increase its funds by increasing its capital" issuing bonds or accepting contributions to what are known as 'Special Funds'.

Membership

The developing countries of Asia were unable to raise the required financial resources within the region. Hence, they agree to any member of the UNO or its specialised organisations becoming a full member of the ADB. Thus, the membership in the ADB is open to

1. Members of ECAFE
2. Associate members of ECAFE and

3. Other countries in the ECAFE Region which are members of the UNO or any of its specialised agencies.

At the end of 1979, 43 countries were members of the Bank comprising 29 regional members and 14 non-regional members.

Organisation

The Bank has a Board of Governors, a Board of Directors , a President a Vice-President and other officers and staff. The Board of Governors, is the highest policy-making body of the ADB. Each member nominates one Governor and one Alternative Governor. All the powers of the Bank are vested in the Board" of Governors which may delegate its powers to the Board of Directors except on certain matters such as admission of new members, change in the authorised capital stock of the Bank, election of Directors and the President and the amendment of the charter. The Board of Governors meets atleast once annually. The responsibility for the general operations of the Bank rests with the Board of Directors. The Board consists of 10 Directors, 7 representing regional member and 3 non-regional members.

Twenty percent of the total voting powers of all\ the members is equally distributed among the members. The remaining 80 per cent is distributed according to the strength of the members (i.e.) proportionate to the strength of their shares.

The U.S.A. and Japan are the biggest share holders in the AD B and they have 34 per cent of the votes. The total votes for all the developing countries in Asia is only 35 per cent. Hence, the developing countries of Asia are unable to secure an effective say in the management of the Bank which would enable them to protect their interests. The economically advanced capitalist countries, primarily U.S.A. and Japan, have become extremely powerful in the Bank and to a large extent have made its functioning subservient to their own interests.

The lending operations of ADB are divided into ordinary and specialised operations. "Ordinary operations" consists of lending to specific development projects. In addition to this, it may also lend to national development banks or other suitable entities to enable them to lend to specific projects. These ordinary operations are financed out of the ordinary capital resources of the bank.

"Special lending operations" are financed from the various special funds such as the Technical Assistant Special Funds. Asian Development fund. Agricultural Special Fund and Multipurpose Special Fund which are managed by the Bank, Projects of high development priority and requiring loan for longer duration, longer deferred commencement of repayment and lower interests, rates are financed through special lending operations of Bank. The Bank may earmark 10 per cent of its 'paid-in' capital as its Special Fund that may be used for 'soft' lending on the lines mentioned above.

In addition to lending for specific projects, the ADB also' provides technical assistance to its member governments, their agencies or sub-divisions, private firms in their territories and regional institutions.

ADB has lent $ 5.4 billion for some 384 projects in 23 developing member countries until 1978. More than a quarter of this lending has been on highly concessional terms of the Bank's poorest member countries. ADB has a vigorous action plan to raise necessary funds.

20.11 AD AND INDIA

Addressing a press conference in India on June 9, 1977 Mr.Taroichi Yoshida, President of ADB said that India's partnership in the ADB is an outstanding example of self held and co-operation in the region. As one of the largest developing countries in the world, India had played a unique role in the ADB. India is made one of the major subscribers to the Bank's capital. The country's share of$ 280 million in the capital stock next only to that of Japan ,and the U.S. India has also made 5 contributions totalling $ 419,000 equivalent to the Bank's Technical Assistance Special Fund.

India's experts both at the management and staff level had been an asset to the Bank in the field of consultancy services the Bank had profited from the services of individual Indian experts, more particularly in the regional studies undertaken by the Bank.

Consultants from India have also helped in feasibility studies financed by the Bank in other technical assistance activities and project appraisal work. In Philippines, for instance, Indian experts are helping to improve the operation and management of the Philippine National Railways which is being rehabilitated and modernised with Bank assistance. Among the goods and services supplied by Indian and business industry for Bank assisted projects in the region are transmission, lines, high voltage switch gear, under ground cable, accessories and testing equipment, fishing vessel, construction of major bridge etc. In a co-financing arrangement with ADB \ and other donor countries including Kuwait, India is providing $ 12.5 million equivalent for the Urea Fertilizer Project in Sri Lanka.

This is thus in a unique position of sharing her financial resources, professional expertise and accumulated experience in the field of economic development with other developing countries of Asia.

Though a developing country India had decided not to borrow from ADB in order to increase the availability of funds to other developing members. This policy has been appreciated by all members. "The size of India's capital subscription" reflects the value which the Government of India attaches to membership in ADB, the most important regional institution in Asia.

SUMMARY

International monetary fund seeks to promote international monetary cooperation by providing a permanent machinery for consultation and colloboration. It attempt to promote world economic growth and balanced expansion of international trade and also promote exchange stability to maintain orderly exchange arrangements among member-nations and to avoid competitive exchange defortiation.

KEYWORDS

- Persuation
- Distorting
- Redanation
- Concessional

REVIEW QUESTIONS

1. Bring out the functions and objectives of IMF.
2. Explain the role of IMF in less developed countries
3. State the objectives of International bank for reconstruction and development
4. explain the organising and function of International Finance Corporation
5. What are the aims and function of ADB?

SUGGESTED READINGS

1. Dr. P.C. Jain - International Financing in India
2. Jiwitersh Kumar Singh - International Trade and Business

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