**UNIT – 1 ECONOMIC FLUCTUATION AND INFLATION**

**PART-I ECONOMIC FLUCTUATIONS**

**What is meant by business cycle? Explain the characteristics of business cycle.**

**Introduction:**

Business cycle represents cumulative ups and downs in the economy thereby generating inflation and unemployment in repeated booms and depressions. The economic activity in the country at times expands with production, employment, income and prices rising in a cumulative manner. During depression, economic activity slows down and the production, income, employment as well as prices decline gradually. Economic fluctuation is a routine phenomenon in the economy.

**Meaning and definition of Business Cycle:**

―A trade cycle is composed of periods of good trade characterized by rising prices and low unemployment percentages, altering with period of bad trade characterized by falling prices and high unemployment percentages‖.

**J.M. Keynes**

―A trade cycle may be defined rather badly as a period of prosperity followed by a period of

depression. It is not surprising that economic process should be irregular, trade being good at some time, and bad at others‖.

**Frederic Benham**

One of the important specialties of capitalistic economy is that waves of boom and recession continue to follow each other. The boom and recession in the economy found in the economy is called business cycle fluctuations. The cyclical fluctuations consist of four stages of boom, down trend, recession and revival. With the completion of these four stages, one cyclical

fluctuations is completed.

**Characteristics of Business Cycle:**

**(1) Free Market Capitalist System:**

Most economists suggest that business cycles occur in a free market capitalist system.

There is sufficient evidence to support this view because such occurrences of ups and downs have commonly been found in laise-faire economies of the world.

**(2) Direction of cycle:**

Business cycles are wave-like movements of the economic components marked by ebbs and tides. They are not secular in character moving in one single direction alone.

**(3) Different in Manner:**

Business cycles do not have a fixed rhythm. Each cycle differs in this regard from the other.

**(4) Unpredictable in nature in respect of the timing:**

Business cycles are unpredictable in nature in respect of the timing. The depth and the length of the period of its occurrence. Economists have actually detected a large number of business cycles of different lengths and amplitudes in the past. From very short rhythms of expansion and contraction to a large vibrations and swings covering almost fifteen to eighteen years.

**(5) Not Uniform frequency:**

Business cycle do not have a uniform frequency, nor are they identical in content, although they exhibit a few common features in the explanation of Prof. A.C. Pigou, trade cycles are not twins but they are members of the same family.

**(6) Universal in application:**

Business cycles are universal in application. They encompass the entire gamut of the economy in which they appear, influencing in the process most economic aggregates like output, employment, income, prices etc.

**(7) Business cycles are cumulative:**

The phases of business cycles are cumulative, each phase feeding itself from within till it gathers momentum. For instance, once recession sets in the economy, it eventually gathers speed and ends into depression. Similarly, once revival sets in, it eventually culminates into expansion or boom.

**(8) Cyclical Speed:**

The movement of a business cycle from the phase of boom to the phase of contraction is abrupt and fast, but its movement from the phase of contraction to the phase of boom is relatively predictably slow. In other words, the downswing of the economy is sudden and more violent than the upswing.

**(9) Show a tendency to occur periodically in a regular fashion:**

Business cycles show a tendency to occur periodically in a regular fashion. For example: the phase of boom is followed by the phase of depression and the phase of depression in its turn is followed by the phase of boom. In other words the four phases of business cycles namely, the boom, the recession, the depression and the revival occur and are repeated in the same clockwise order.

**(10) International Phenomenon:**

Business cycles tend to cross the borders of the countries where they origin and become in international phenomenon in course of time.

**(11) More marked in the industrialized countries:**

Business cycles are more marked in the industrialized countries than those whose economy is based on agriculture. Business cycles occur more in industry oriented countries than agriculture-oriented countries. The fact that business cycles were found occurring more after the industrial revolution in 19th Century in itself is self-proving.

**Conclusion:**

With the changes in time, situations change, new upheavals(disturbances) are created in the economy. These upheavals are in the form of boom, down-trend, recession and revival. When one cycle is completed, then it is called the business cycle. Due to this business cycle, the economic stability gets disturbed and there is adverse impact on production, employment and incomes of people.

**Make clear the meaning of economic fluctuations, and describe its types.**

**Meaning of Economic Fluctuations:**

The statistical records of economic activities indicate that during certain time period economic activities get expanded. During such period there is rise in production, employment and incomes get reduced. In this manner, the economic activities get fluctuated.

Economic fluctuations is a routine phenomenon in the economy. Economic fluctuations indicate upheavals in the economic sector.

**Types / Kinds of economic fluctuations:**

**(1) Seasonal Fluctuations:**

Seasonal fluctuations are variations, in economic activity that take place because of the effects of changing seasons. Seasonal fluctuations occur during one year. E.g. There is a spurt in the demand for woolens during winter, for umbrellas during monsoon and for electric fans during summer.

Some of the seasonal fluctuations are natural, which are created due to the physical effects of the season; while some others are artificial. They are created due to institutional factors, conventions and government rules.

**(2) Secular Fluctuations:**

Constant movement of economic activity for years together in the same direction indicate long term trends which are called secular fluctuations. Economic activity going on for a longer

period either upward or downward, indicates secular fluctuations. E.g.: All throughout the 19th Century production, income, employment, etc. increased under the impact of industrial revolution. Some economists also dub such long run changes as ―Long Cycle‖.

**(3)Random fluctuations:**

The term Random Fluctuations refer to changes in economic activity caused by unexpected natural calamities as also all sorts of other distributing factors. Factors like earthquake, fire, storms, flood, cyclones, etc. cause such irregular and uncyclical changes. Even war, elctions, etc also bring about upheavals of economic activity. Unregulated fluctuations are never regular and nothing can be known in advance about it. So, they are called Random fluctuations. However it effects on the economy can be based on how intense and extensive are such events.

**(4)Cyclical fluctuations:**

The waves of recession and boom in the economy are called cyclical fluctuations. In such types of fluctuations there is no specific trend or tune. Even then they are found frequently and in specific form. Generally, such cyclical fluctuations are found in industrially progressed countries. Such fluctuations are hardly found in agricultural countries.

Different waves found in the cyclical fluctuations include boom down trend, recession and revival stages. The business cycle consists of those four stages. Cyclical fluctuations are spreads over relatively longer period than that of seasonal changes, although their life-span is much shorter than that of secular trends. The life of a normal business cycle is about 7 to 11 years.

**Describe the various phases of a business cycle or model business cycle**

**OR**

**Define business cycle and explain the process of the boom and depression.**

**Phases of trade cycle/ Business cycle/ Model Business Cycle:**

The entire life span of a trade cycle can be classified into four distinct and well marked phases by Mitchell in ―Encyclopaedia of Social Sciences‖. They are as follows:

**(1) Expansion/ Boom:**

In the stage of boom the prices continue to go up time and again slowly and gradually and the extent of profit gets increase. There is extra ordinary rise in production. The employment moves towards perfect employment.

Since there are bound to be some unemployed resources to start with the earlier expansion is marked more by increase in output and employment than increase in prices. But such a situation does not last long. As the economy approaches full employment level, output cannot be increased any more, hence, prices start rising.

Rising profits and expectations of further rise in profits generate boom conditions in the stock exchange market. The mood of optimism and confidence is reflected in the stock piling by merchants and manufacturers. Commercial banks encourage further addition to fixed capital by liberal lending policies. This adds further fuel to fire and prices soar high.

But this common belief is proved wrong. After some extent, the factors ending the boom in the economy get activated. Following are these factors:

**(A) Rise in production cost:**

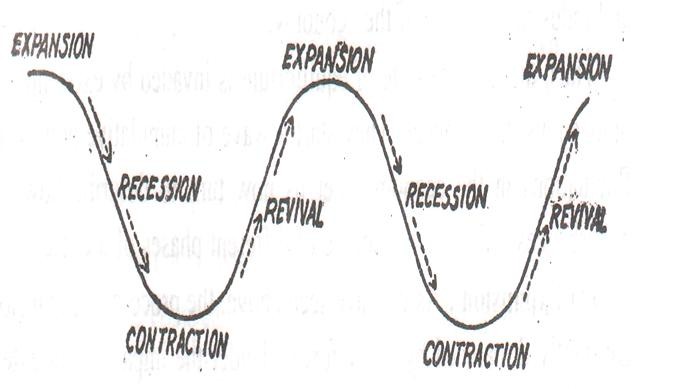
After gaining the condition of perfect employment, the prices of production tools go up due to rise in its demand. So, this leads to increase in production cost. Consequently the manufacturer‘s profit decreases.

**(B) Reduction in credit creation:**

The activity of credit creation of banks cannot proceed uncontrollably. The credit creation depends on the quantum of cash and on hand by the banks. Moreover, with the rise in credit creation there is increase in responsibility of the banks also. Banks would not obviously allow their increasing responsibility beyond their capacity. So, banks are compelled to reduce credit creation after certain limits. Banks increase rate of interest in order to reduce credit creation. So, the investment becomes costlier than previous time.

**(C) Reduction in marginal consumption attitude:**

People‘s income increases during the inflation. With the rise in income, their consumption attitude gets decreased. Hence, after reaching certain limits there is decrease in consumer goods. This slows down the productivity activity.



**(2) Recession:**

In the stages of down-trend the prices tend to go down slowly and gradually, but with passage of time, the price reduction becomes rapid and the economy is gripped by recession. All the economic activities are covered by recessionary trend. Slowly and gradually there is reduction of production, employment and incomes.

Companies do not go in for new issues of securities and cut their orders with the manufacturers of machinery and other capital equipment. Dealers in commodities, clear off their stock in the anxiety to get out of the market.

Banks do not consider new credit creation but concentrate on getting repayment of issued loans. This leads to reduction of effective supply of money in the economy. Consequently, the prices reach to its bottom. Though the reduction of prices in the economy is not uniform in comparison to retail prices, wholesale prices get reduced more. The time period of recession stage is more in comparison to boom stage.

All that it seems that the economy would forever be gripped by recession, but it reality certain trends are created in the economy which takes the economy from the grips of recession towards the revival.

**(3) Contraction/ Depression:**

It is characterized by a sharp reduction of production, mass unemployment, falling profits, low wages, contraction of credit. A rate of business failures and an atmosphere of all-round pessimism and despair. A decline in output or production is accompanied by a reduction in the volume of employment.

Falling prices are greatly supported by reduction in money supply. Not only the volume of physical money is reduced but the velocity of the circulation of money is also reduced. This cut in money supply exerts a further downward pressure on the price level, which falls down still further. As in expansion, so also in contraction the price fall is universal but not uniform. Prices of raw materials fall by a larger margin than prices of semi-finished goods and prices of semi-finished goods fall much more than prices of goods ready for the consumers.

All this is very upsetting and disheartening to industry and business. Thus starting from a mild fall in price level, the economic activity gradually slow down, till it is caught into the clutches of deep-seated depression.

**(4) Revival/ Recovery:**

It implies increase in business activities after the lowest point of the depression has been reached. During this phase, there is a slight improvement in economic activity, to start with. The entrepreneurs begin to feel that the economic situation was after all, not so bad as it was in the preceding stage.

This leads to further improvement in business activity. The industrial production picks up slowly and gradually. The volume of employment also increases steadily. There is a slow but sure rise in prices, accompanied by a small rise in profits. The wages also rise, though they do not rise in the same proportion in which the prices rise.

Attracted by rising profits, new investments take place in capital goods industries. The banks expand credit. The business inventories also start rising slowly. The recovery continues until business activity reaches approximately the same level that it had achieved before the decline set in. The rate of recovery' is generally related directly to that of the preceding depression. The more severe the depression, the more rapid will the recovery be.

**PART-II INFLATION**

**1 What is inflation? Discuss the reasons/factors responsible for inflation. OR What does inflation mean? Discuss the causes of inflation.**

**ANS:**

**Introduction:**

When variations are found in the purchasing power of money, we can see two situations Prevailing in economy inflation and depression. When there is continuous decrease in the purchasing power of money, such a situation is called inflation, inflation refers to a persistent upward movement in the general price level. According to most economist inflation does not occur until price increase average less than 5% per year for a sustained period.

**Meaning of Inflation:**

In common words, inflation means speedy rise in the prices, but these definition is not scientific because sometimes it happens that there may be a price rise, but not inflation in the country. It has been tried to explain the context of inflation scientifically. Of course, inflation is result of many factors so it becomes very difficult. Here follows some of the definitions:

**(1) According to Kemmerer:** ―Excessive currency notes means inflation‖.

**(2) According to Crowther:** ―Inflation is a state in which the value of money is falling and price are rising‖.

**(3) Prof. Cotlar says:** ―When excessive supply of quantity of money, runs after the purchase of

things and services, inflation comes into existence‖.

**(4) Prof. Keynes:** ―Rise in every kind of price is not inflation but inflation is caused due to rise

in price level after full employment‖.

**Characteristics of inflation:**

From the above explanation, we can conclude the following characteristic for inflation: (1) Inflation is a dynamic process which is experienced in due course of time.

(2) Inflation is mostly not a state but a trend.

(3) Inflation is economic phenomena. Once, it arise in an economy, by economic activities, it gets strength.

(4) When the value of money decrease or price of commodity increases it is inflation. (5) When demand for goods exceeds supply, inflation arises.

(6) When the supply of money increases after the point of full employment inflation appears.

(7) We know that inflation is a result of price rise, but every price rise is not an inflation. Some times prices rise may be seasonal also.

**Reasons/ Factors responsible for inflation in India:**

Inflation is a situation in which prices are rising continuously. Inflation is a dynamic process. Mainly, it is an economic incident. Economic and non-economic factors play important role for inflation. Reasons/ factors responsible for inflation may be broadly classified into two categories as under:

**Type:1 Reasons/Factors responsible for bringing rise in financial income: (Upward**

**Shift in Demand Curve )**

Financial income increases with the rise in supply of money. It results into increased demand of commodities and services. On other hand, immediate increase in proportion of production and supply is not possible. Thus, imbalance is caused between demand and supply. The following reasons/ factors are responsible for it:

**1. Financial policy of the Government:**

The government increases the money supply to meet the requirement of economic growth. It results into increase in money supply which results into price rise at initial level, but as the time passes and because of lack of control, the price rise spreads and inflation may be there.

**2. Increasing velocity and supply of money:**

Increase in money supply leads to increase in the velocity of money. Due to it, purchase of people increases. This results into price rise and the increasing prices don‘t keep pace with production and it may bring inflation.

**3. Credit Policy of commercial banks:**

Sometimes, commercial banks undertake credit creation just to earn more profit. It does not consider the limit of credit creation. This is called ‗Credit Expansion Policy‘. Due to this, supply of money increases in economy and results into inflation.

**4. Deficit Financial Policy:**

When an acute need arises to meet the requirement of economic development, the income of government is not sufficient. The government has no other option and it takes the support of deficit financing policy. The government prints new currency notes. Thus, new supply of money is added in the economy. Production of goods or services is not increased as per requirement. This imbalance leads to inflation.

**5. Natural Resources:**

Where natural currency exists in the country and when new mines of gold, silver and other metal are found, it increases the supply of money. It can result into inflation.

**6. Increase in non-productive expenses:**

Expenditure of war, defense expenditure and expenditure for increase in salary – all these expenditures are examples of non productive expenditure. Moreover, we know our irresponsible politicians spend crores of rupees for self indulgence and meaningless schemes. In fact, politicians have created a great burden of non productive expenditure in the country. Under the circumstances, money is spend but nothing is produced. It results into inflation.

**7. Black money/financial mis-management:**

There are two problems with our taxation policy:

(1) Our taxes are very high. Mostly, we are the highest tax payers in the world.

(2) There are many loopholes in our taxation policy, so taxes cannot be collected fully due to loopholes.

This generates black money or unaccounted money. Such a money has a greater velocity than white money. It gives tremendous rise in demand. It Increases prices and ultimately results into inflation.

**Type:2 Reasons/ Factors responsible for bringing decrease in proportion of production: (Downward Shift in Supply Curve)**

Such factors are as under:

**1. A Production according to rule of decreasing/diminishing return:**

There is a shortage of means of production in our country. Due to this, the law of diminishing return gets implemented in production. As a result, there is increase in the cost of production and prices of goods and services go up. If such a price rise remains constant, it becomes inflation.

**2. Tax Policy of the Government:**

If the taxation policy of government is faulty, it brings down the production. When the government imposes new taxes or increases the existing rates of tax, it gives rise to the price of

commodities and services. As a result, the demand decreases. Due to decreases in production there is a shortage of goods and such a shortage again pushes the prices up. Thus the defective and faulty policy of government creates vicious circle resulting into firstly price rise and ultimately inflation.

**3.Demands of labour:**

Due to price rise, labour demand more wages and salaries. If their demand is not satisfied, they switch on to strikes, lockouts and industrial disputes. It leads to decrease in production and price rise. On the other hand, if the demand of labourers are satisfied, it brings production cost to higher level which results into price rise and ultimately inflation.

**4. Policy, regarding international trade:**

When the government encourages exports to earn foreign exchange or reduce imports by imposing import duty, the consumer goods supply decreases and prices go up. As the time passes, it results into inflation.

**5.Natural Factors:**

Natural calamities such as earthquakes, cyclone, scarcity of rain all these natural factors decrease agricultural and industrial production. Thus, the prices go up and with the passage of time, it turns into inflation.

**6.Technological Changes:**

Modern era is the time of technological invention, Innovation and discoveries. Naturally, a particular time duration is required for a new technology. Till this time, production decreases in quantity and there is a rise in prices of commodities and services. If it is not controlled, inflation may be there.

**7.Crises of raw materials:**

Due to one or another reason, crises of raw material is experienced very frequently in our country. As a result, production decreases and initially prices rise and ultimately there may be inflation.

**8. Increase in population:**

Indian population is increasing at a galloping rate. There is a short supply of goods and services. It becomes difficult to satisfy the requirement of increasing population. We should accept that there is no ‗Population increase‘ but ‗Population explosion‘ in our country. As a result, firstly prices rise and then comes inflation.

**Conclusion:**

Thus, when there is increase in financial income of people and on other hand, when there is decrease in production of commodities and services, there is an imbalance between supply and demand. As a result, a greater Quantity of money supply runs after less quantity of commodity and services. Naturally, it results into price rise and ultimately in inflation.

**2Discuss the steps/measures to control inflation.**

**Introduction:**

Inflation has an unfavorable effect on each and every sector of economy. Inflation is not desirable for stable economic growth. It generates economic and political instability. Inflation is a result of excess demandand decreased supply. If the purchasing power of people is controlled and imbalance between demand and supply is removed, inflation remains under control.

**Steps/ measures to control inflation:**

Inflation, i.e. reduction of purchasing power, can be controlled mainly through the following steps/measures. They are as under:

**Type -1 Measures under Monitory Policy:**

Monitory Policy is considered one of the important tools to control inflation. This policy is implemented by the RBI. The RBI applies the following steps/ measures under its financial policy/ monitory policy to control inflation:

**1. Bank Rate:**

Sometimes, the businessman borrows loans and advances at low rates and they misuse the facility. Traders and producers store the goods unnecessarily and they create artificial shortage in the market and inflation is resulted. The RBI increase the bank rate. This makes loans and advances costlier. As a result of this, all kind of speculation, trading activities and hoardings get slow down. The artificial shortage decreases and inflation is controlled to some extent.

**2. Open Market Policy:**

If the bank rate proves to be ineffective, the RBI takes the step of open market policy. According to this, RBI sells securities and accumulate excess money from bank and public. This decreases the purchasing power of people and reserves of commercial banks remain less able to generate credit money. Thus inflation may be controlled. This measure is more effective than bank rate.

**3. Changes in CRR:**

When the both of the above measures don‘t work effectively, RBI takes more effective and strict measures. It instructs the commercial banks to increase the proportion of CRR. Commercial banks have to keep certain amount of cash as the reserve with RBI. When this proportion is increased, the capital of commercial bank decreases and it automatically decreases credit creation. This is the most effective measure.

**4. Qualitative Measures:**

When the commercial banks lend money not only for productive purpose but also for speculative purpose the prices of commodities and services go up. According to this policy, the RBI, the Apex bank, orders the commercial banks to increase the rate of interest for every kind of loans and advances. As a result, lending for speculative purpose come down. Advertisement, publicity, rationing of credit, direct measures are included in qualitative measures. Qualitative measures is considered to be better for credit control.

**Type No. 2 Measures under Fiscal Policy:**

The Fiscal Policy of the government includes the following tools:

**1. Taxes:**

We know inflation is result of excessive purchasing power of people. The government increases the rates of taxes and thus it recovers/draws back the excess money from the people. When the people pay higher taxes, their purchasing power decreases. The prices start falling down and there is control over inflation. Of course, the government should increase income tax, wealth tax, corporate tax such a way that it may not adversely affect savings, investment and ultimately the production. There are two types of taxes, direct taxes and indirect taxes. The government should impose them properly.

**2. Implementation of saving policy:**

The government implements savings scheme to regulate the purchasing power of people. The government acts such a way that people are attracted to save and interest. When these both increase, the expenditure of people decreases.Demand also decreases. Prices will fall down and there would be controlled over inflation. Government loans, NSC, Indira VikasPatra, KishanVikasPatra are the examples of government savings policy. Sometimes, government makes such schemes compulsory for government employees.In July 1974, these measures were introduced for a period of 2 years.

**3. Reduction in Public Expenditure:**

We know government incurs expenses on various schemes. This is called. ―Public Expenditure‖. The government reduces such expenses and keeps control over non productive expenses. It decreases the income of the people. As a result, the demand decreases, price fall and inflation is controlled.

**Type No. 3 Measures under Administrative Policy:**

It includes the following:

**1. Encouragement to production:**

The chief reason for inflation is, naturally, more demand and less supply. The government tries to increase the production to the level of demand so that inflation may be controlled. Innovation, research, latest technology and training may be helpful here. Government tries to remove the imbalance between demand and supply. This is the best tool, a positive tool to control inflation.

**2. Regulation of salaries and wages: (wage freeze policy)**

When there is a price rise, the employees demand higher wages and salaries. When it is satisfied, the cost of production increases. This again pushes the prices to higher level. Again comes the demand of higher salaries and wages. It results into increase in production cost. Thus, price rise runs after rise in salary and consequently rise in salary and wages runs after price rise. It is called vicious cycle. The government regulates the wages and salaries, and thus only, it can control inflation through the income-freeze system. This will keep down the disposable income.

**3. Rationing:**

Inflation has adverse effect on common people in the country. To save them from it, the government undertakes the distribution of essential commodities by the way or rationing. Sugar, food grains, kerosene, oil and other necessary commodities are distributed among the people at comparatively cheaper rate through fare price shops. Such an action of government decrease the living cost of the people in the country and they may not demand for higher wages and salaries, and thus inflation is controlled.

**4. Increased imports and reduced exports:**

In the context of a serious inflationary situation in the economy, it may become necessary to increase the supplies of essential articles, particularly of wage goods, through increased imports. Similarly, reduction in exports also may increase the domestic supplies and help to contain inflation try pressures under check. The feasibility of these measures, however, will depend upon the balance of payments situation of the country.

**Conclusion:**

Inflation enters a healthy economy and brings adverse effect on the different sectors. Economic progress may not be achieved, the people and the society have to suffer political and social instability and overall imbalance. Thus, inflation is not desirable from any view point. The steps must be taken to control inflation before the society, economic progress and the nation becomes its victim.

**3 Explain types of Inflation.**

Inflation can be divided into following types:

**Types of Inflation**

**According to the reasons of evolution of inflation**

(A) Demand-Pull inflation

(B) Cost-push inflation

(i) Inflation encouraged by wages (ii) Inflation encouraged by profit (iii) Inflation encouraged by deficit

(iv) Inflation encouraged by development

**According to the time of inflation**

(A) Types of inflation at times of war

(i)Inflation at times of peace (ii) Inflation at times of war (iii) Inflation after war

(B) Types of inflation in context to duration of time

(i) Short term inflation (ii) Long term inflation (iii) Prolongated inflation

**Types according to forms of inflation**

(A) Partial inflation and full inflation

(B) Open inflation and restricted inflation

**(1) According to the reasons of evolution of inflation**

According to the reasons of evolution inflation is divided into the following

**(A) Demand-Pull inflation**

Many economists consider excess demand responsible for causing inflation. According to them when demand for goods increases in a market, supply is less then demand,it generates rise in prices and inflation is caused.

Increase in monetary income of people, increase in population, artificial demand; hoarding by consumers etc reasons are responsible for an increase in demand. At this stage, producers try to install extra production capacity to increase supply. By the time, supply equals the demand, the demand increases more and supply again falls short. Due to this, public faith in currency trend in prices, consumers starts hoarding of essential commodities. Artificial demand is created due to hoarding of commodities by consumers. Artificial demand acts like adding more fuel to the fire. In this way prices keep on increasing.

**(B) Cost-push inflation**

Increase in production cost becomes the reason for causing inflation. Increase in production cost increases the selling price of a product. Increase in selling price increases inflation. This is divided into the following parts:

**(i) Inflation encouraged by wages**

Laborers get success in fulfilling the demand for more wages raised by them through labor unions. This increases the production cost. Increased production cost increases the price of a production. This rise in wages is not as per the productivity of laborers. Despite of increasing prices, their productivity remains low. If wages are increased as per the productivity of laborers, than there is no place for inflation. Once the demand for increase in wages is satisfied, within a short duration again the same demand will be raised by laborers. This increases inflation.

**(ii) Inflation encouraged by profit**

Earning more profit also leads to inflation in an economy. Profit is considered as a part of production expenses. Production cost goes high when proportion of profit increases. Inflation comes into existence. In oligopoly, producers earn more profit and generate inflation.

**(iii) Inflation encouraged by deficit**

Every country of the world aims at economic development. To meet the expenditure incurred for economic upliftment, country recovers this amount by levying taxes, incurring external and internal debts. Despite of taking all the precautionary measures, income from sources employed is less than the expenditures made after economic growth. This is called deficit budgeting. To meet the deficit aroused by less income and more expenses, Government prints out more currency notes. This method is known as deficit financing.

Production does not increase with the proportional increase in money. So inflation is experienced in a country.

**(iv) Inflation encouraged by development**

Most of the underdeveloped countries of the world are developing. For development, these countries launch many projects of development. For promotion of these projects huge amount of capital is needed. Internal savings are not made in proportion of capital invested in initial stages. To meet the huge capital investment, more currency is printed by way of deficit financing. Besides this, foreign capital is also utilized. Monetary income of people is increased by this. The production of consumption goods is not increased in this stage because in this stage, we find lack of technological knowledge, scarcity of raw materials, scarcity of means of production, rigidity of social structure etc.

On the other hand, people buy more due to increase in their money income. Supply is not sufficient for more demand raised by the people for consumption goods. This gives rise to inflation. In India, constant rise in prices is experienced from 1956 to 1977.

**(2) According to the time of inflation**

This can be divided into following types.

**(A) Types of inflation at times of war**

**(i) Inflation at times of peace**

When peace is going on in an economy, we find rise in prices. This rise in prices brings inflation. For e.g. increase in prices at the time of 2nd five year plan.

**(ii) Inflation at times of war**

Inflation and war are correlated. Where there is a war, there is inflation. Several reasons are responsible for war. They are:

At times of war, many warfare items like bombs, arms and ammunitions, etc. are needed in abundance. To meet this expenditure, Government has to print currency immediately. During war period, industrial machineries are engaged in producing warfare items. This creates shortage in the production of consumption goods.

During war, more work is taken from laborers. So their income increases. 'If war is continued for long duration, public faith in currency decreases. In this situation, the vicious circle of artificial demand artificial shortage is created.

Due to all the above reasons, inflation is created.

**(iii) Inflation after war**

After the completion of war, their devastating effect continues. Inflation is included in this devastating effect. The inflation which continues after war is called after war inflation. This kind of inflation was experienced by Germany after the completion of 1st world war in 1923. England, America, Japan etc suffered from such kind of inflation in 1920.

**(B) Types of inflation in context to duration of time**

**(i) Short term inflation**

Short term inflation indicates the short term rise in prices. When Government takes the measures to curb the rising inflation and becomes successful in curbing inflation than it is called short term inflation. Generally, the duration of short term inflation is 1 to 2 years.

**(ii) Long term inflation**

Long term inflation indicates rise in prices. When Government becomes unsuccessful in curbing the inflation than inflation lasts long in an economy, it is called long term inflation. This kind of inflation is unfavorable for economy. Its duration is from 5 to 15 years.

**(iii) Prorogated inflation**

It indicates the rise in prices for more than long term period. Government makes many efforts to curb such kind of inflation but does not succeed in curbing such inflation. Than we can say that prolongated inflation prevails in an economy. Once this inflation arises, everyday prices break the records and problematic situation is created. Due to this, economic development becomes stagnant. After 1970, India's inflationary trend is moving towards prolongated inflation.

**(3) Types according to forms of inflation**

It can be further divided into two types.

**(A) Partial inflation and full inflation**

Keynes and other economists divided inflation into two parts based on its forms:

When the impact of inflation is not overall the universe, but is restricted for few items then it is called partial inflation. To meet the financial requirements of economic growth Government prints more currency. The supply of money increases but the production of goods does not increase to that extent. So, price starts rising. The general rise in prices inspires the producers to increase more production. In long duration, utilization of manpower & natural resources is possible in production activity. This gives break to rise in prices. So this type of inflation continues for a longer period, economic growth gets good nourishment. Another peculiarity of partial inflation is that, it is not permanent. Moreover, it is controllable by the Government.

Keynes says that when money supply is increased after the level of full employment then production will not be feasible. To keep pace with increased money supply in initial stage. This gives good support to rising prices. The inflation which results from this is full employment. According to Keynes, this is real inflation. Its impact is overall and universal. At all the places, the prices of all the goods will rise. This type of inflation is seen in developing nations.

**(B) Open inflation and restricted inflation**

When Government do not restrict rise in prices and allows the price to rise independently then such inflation is called open inflation. This type of inflation was experienced after Second World War in Poland, China, Japan, etc. Such inflation is not invited in an economy. During this inflation, prices daily break the records. People in such situation instead of saving money, immediately buys the essential commodities. This gives rise to artificial demand. Sellers take the advantages of this situation and they themselves creates artificial shortage. Again the price rises. The process of rise in prices goes on continuously like endless story.

As soon as the price rises in an economy, Government puts the restrictions on such price rise then that inflation is called restricted inflation. In other words, Government itself does the work of distribution of goods at reasonable prices. In this situation, Government fixes the highest prices. So, despite of all kinds of restrictions, traders are in a position to take higher prices. Once the highest price is decided, the prices do not increase any further. So, consumers are protected. To regulate the purchasing power of consumers, measures like compulsory savings, taxes, rationing, arrangement by Government for proper selling, etc. are made.

**4 State the effects of inflation.**

**Effects of Inflation:**

**(1) On Economic development:**

When the underdeveloped countries join in the process of economic development then the increasing prices are considered to be welcoming in the initial stage. But, in the long run it is not considered desirable, as it becomes obstruction for economic development.

**Due to inflation, following good effects are found on the economic development.**

New investment gets encouragement as profit is increased.

The price-rise nourished the growth of economic development.

The foreigners find it favorable to make investment in countries having inflation.

More employment opportunities are created.

**Inflation in the long run proves to be harassing, because it creates bad effects.**

Due to inflation, people get several opportunities to earn huge profit, because there is constant rise in the prices of gold, land, building, etc.

Inflation increases imports and exports are reduced.

As the value of money gets reduced in the inflation, people choose to purchase goods

instead of saving money. So, it has bad impact on the saving tendency of people.

**(2) On the Manufacturers and traders:**

Manufacturers get profit due to inflation, because they would have purchased the raw material earlier at a cheaper rate. Moreover, the wage rates do not rise immediately. So, there is no increase in the production cost, while sudden rise in prices leads to substantial profit.

**(3) On debtors:**

Debtor class of people get benefit from inflation, because value of money gets reduced due to inflation, the real burden gets reduced at the time of repayment.

**(4) On Creditors:**

Creditors, on the other hand, are losers in inflation because they receive less in terms of goods and services than they would have received in times of low prices. This however, does not mean that debtors always welcome inflation because usually they too are members of one or another group which is adversely affected by inflation.

**(5) On investors/Shareholders:**

Investors in debentures and fixed-interest-yielding securities lose during period of inflation. Similarly, the small middle-class investors who generally invest most of their savings in fixed interest-bearing securities, insurance and savings accounts also lose during this period. On the other hand, those who have invested in shares and other equities, benefit.

**(6) On Fixed Income Class:**

Persons with fixed salaries are also adversely affected in times of inflation, because while their money incomes are fixed, its purchasing power is greatly reduced due to rising prices.

Those people whose incomes are fixed, inflation plays havoc with them, because they are not able to get the number of quantum of goods or services they used to get previously. So, people have to face many types of difficulties.

**(7) On Middle Class:**

The Middle class would have bad effect of inflation, because, their hard-earned money is engulfed by the inflation in no time. In fact, the worst sufferers during inflation are the middle classes which are considered as the backbone of any stable society.

**(8) On the Moral life of people:**

Traders, manufacturers and black marketers earn limitless profit by creating artificial shortage, adulteration and black marketing**.** The activities of hoarding and black marketing get encouragement. Some of the people adopt the way of theft, loot etc. by becoming victim of inflation. The moral values of the society declines. Thus, due to inflation, moral value go down everywhere in the country.

**(9) On the distribution of incomes:**

As said previously, inflation brings about a redistribution of income in favor of the rich. The adverse effects of an inflationary price rise are felt more by the poor than by the rich. Inflation, thus, causes a great social injustice and breeds more degeneration. In fact, it breaks down public morale.

**UNIT - II INTERNATIONAL TRADE**

**What is International Trade ? Explain the need (importance) for international trade.**

International trade is the trade between the home country and other countries. It is also called international or external trade e.g., trade between India and America or India and England etc. The country in which we stay is called 'home country'. It consists of:

1. **Import trade**

It refers to inflow of goods in the home country from other countries. It arises from purchase of goods by a home country from another country, e.g., India purchases machinery from America. **(2)**

**(2) Export trade**

It refers to outflow of goods from a home country to other countries. It arises from sale of goods by a home country to another country, e.g., India sells sugar to England.

**(3) Entrepot Trade**

When goods are imported for the purpose of re-export after carrying out some processing operations-on them, it is called entrepot trade.

**Basis of foreign trade**

All countries cannot produce or manufacture all the products required by the people. Hence all the countries cannot become self-sufficient. This is because all countries differ from one another in respect of certain factors such as climate, soil, natural resources, labour, transportation, technological development, etc. Each country thus specialises in the production of those goods in which it has a comparative cost advantage. As a result, it produces such type of goods more than its requirements. The surplus production in each country can thus be exchanged by countries among themselves. In this way, foreign trade i.e., trade among countries takes place.

**Need And Importance**

Need for International Trade is as under:

**(1) International specialisation and division of labour:--**

Natural resources are not equally distributed among the countries of the world. On account of favourable climatic conditions and natural resources every country produces only those goods

for which climatic and other conditions are favourable. As a result, every country specialises in the production of certain goods only. Due to this specialisation and division of labour, every country can produce at its maximum capacity with minimum costs. Such international specialisation and division of labour benefits to all the countries of the world.

**(2)Optimum allocation and utilisation of resources:--**

Due to specialisation every country concentrates on the production of such goods and services for which it is best suited in terms of availability of natural resources. Hence unproductive lines can be eliminated and wastage of resources can be avoided. In other words, resources are channelized for the production of only those goods, which would give highest returns. Thus there is rational allocation and utilisation of resources at the emotional level due to international trade.

**(3)Better utilisation of surplus production**

International specialisation and division of labour leads to increased production of specific goods in every country. International trade makes possible to export the surplus production to areas of scarcity, where there is demand for it. Thus due to international trade, surplus production

is better utilised which would have been wasted otherwise.

**(4)Equalisation of prices**

Due to international trade it is possible to establish balance between demand and supply. This results into equalisation of prices throughout the world after making allowances for transport, taxes and other marketing expenses.

**(5)Economic development**

Due to international trade, underdeveloped countries get ready markets for their raw materials. By exporting raw materials they get scarce foreign exchange. With the help of this foreign exchange they import technology and capital goods. Thus, international trade contributes to theeconomic development of the developing countries.

**(6) Higher standard of living**

Due to international trade, each country can obtain goods, which it cannot itself produce at an advantage. It can get a wide range of goods from other countries. This helps to raise the standard of living of the people in the home country.

**(7) Useful during natural calamities**

During natural calamities such as earthquakes, famines, flood, drought, etc., the suffering countries face the problem of shortage of even essential goods. International trade enables a country to meet the shortage of such essential goods by importing goods from other countries having surplus of such goods.

**(8) Quality and standardised goods**

International trade is highly competitive in nature. To maintain and increase the demand for goods, the exporting countries have to keep up the quality of goods. Frequent changes in the methods of production are necessary in order to manufacture high quality goods in relation to those of the other countries. Thus, international trade makes available latest varieties and better quality goods to people all over the world.

**(9) Employment**

International trade provides directly and indirectly a lot of employment opportunities both in the importing country as well as in the exporting country.

**(10) Expansion of the Service Sector**

Due to international trade, the service sector organisations grow. Thus, there is expansion in insurance, banking, transport, communication services, etc.

**(11) International Co-operation and Peace**

International trade develops closer cultural relations between different countries. It facilitates the transfer of technology and other assistance from the developed countries to the developing countries. It thus reduces the gap between the developed and developing countries.

It brings different countries closer due to economic relations arising out of trade agreements, pacts etc. Thus, international trade creates atmosphere for avoiding wars and conflicts. It promotes world peace, as the countries involved in such trade try to maintain friendly relations among themselves.

**Difference between Internal and International Trade :**

As said there appears little difference between internal and international trade. However, the classical economists emphasized certain fundamental differences between these two types of trade which has necessitated a separate theory of international trade. The following are some of the main differences between internal and international trade.

**(1) Differences in Factors Mobility:**

Within the same country, factors of production are perfectly mobile as a result of which factor prices are equalised, but not so in the case of different countries. For example, labour and capital are freely mobile within the same country or its different regions, but not so in the case of different countries. If, within a country, the rates of wages are higher in one region or occupation than in another, more people would move to that region or enter the occupation where wages are higher. As a result, workers of equal efficiency will obtain equal wages within the country. But there is hardly such tendency between different countries.

**(2) Separate Market** :

Markets in different countries are separated from each other not only by distance but also by languages, usages, weights and measures, terms of sales and purchases, unit of currency etc. In the same country, such differences may exist but are not so much pronounced. Classical writers, therefore, advocated the need for a separate theory of international trade which can take these differences into consideration.

**(3) Differences in Gegraphical and Climatic Conditions :**

There are differences in natural factors, like geographical and climatic conditions in different countries. These lead to 'territorial division of labour and localisation of industries'. For example, some countries may have particular mineral resources like coal, iron ore, copper, mineral oil and petroleum etc.; while others may have land or climate peculiarly suitable for certain crops, like jute in West Bengal, cotton in Gujarat etc. These advantages either cannot be transferred to other countries at all or the cost of moving them is extremely prohibitive.

**(4) Different Economic Policies:**

There are marked differences in the economic policies pursued by monetary and fiscal authorities of different countries. Thus, while country A may be pursuing an expansionary monetary policy, country B may be adopting contractionary monetary policy. Likewise, wide differences in policies relating to wages, taxation, trade unions, social security measures, foreign trade etc. exist in different countries. These problems hardly arise in the case of internal trade.

'The citizens of one country are subject to same system of national and local taxation, to the same regulations for health, sanitation, factory organisatioin, education and social insurances, the same policy regarding transport and public utilities. Thus, the facilities for production and other economic activities differ in different countries because regulations and rules are not similar. The general level of costs is, therefore, very often different, it is lower in one country and higher in another.

**(5)Sense of Nationalism** :

There is a greater degree of cohersion among the people living in their own country than between the people of two different countries. This is well illustrated in the remark, "Internal trade is between us, while international trade is between us and them." Thus, it is often argued that people should try to be self-sufficient and reliance on imports should be avoided. Many governments are tempted to follow policies that might benefit their respective nationals a little, but would almost certainly harm the people of other countries.

**(6)Different Currency Systems:**

All transactions within the country are conducted through a single uniform currency. On the other hand, transactions between two different countries involves the use of two different currencies and hence, there arises the problem of acceptable exchange rates which is absent in all internal transactions. The determination and fixation of an appropriate exchange rate by

governments of different countries raises several issues. Again, exchange rates in the open market fluctuate every now and then which ultimately affects the course of international trade. Thus, these foreign exchange operations often give rise to many complications in the course of trade. Besides, each country, is under the control of a separate Central Bank, each following a separate monetary policy which vitally affects the foreign trade of the country.

**(7)Existence of Independent Sovereign States :**

It has been said that in international trade, certain problems arise out of the fact that countries are independent sovereign States and can pursue independent policies in respect to the movement of goods, money matters, wages and prices, fiscal matters, banking law, foreign investments etc. Several kinds of restrictions are found to be in operation on the movement of goods beyond their frontiers by these States; on the other hand, in the case of internal trade, the same laws, rules, regulations etc. prevail across the country.

**Causes of International Trade:**

The basis of international trade is the difference in prices of goods and services between different countries. The comparative cost difference theory ascribed the differences in relative. prices between countries to differences in relative costs of production. According to **Ricardo,** differences in relative costs of production arise because of differences in labour productivity in the production of two goods in two countries. These are as follows :

**(1) Difference in FactorProportions :**

Different countriesare differently endowed with the supply of factor proportions. In some countries, for example, capital is scarce and labour is abundant. In some other countries, labour is scarce and capital is abundant. Hence, countries rich in labour can produce labour intensive goods at a low cost, while countries rich in capital can produce capital intensive goods at a low cost. This is why countries like India produce and export labour intensive goods, while countries like the U.S.A. produce and export capital intensive goods.

**(2) Differences in Technology:**

Technological changes bring about a change in factor productivity and thereby in costs of production. At present most of the developing countries are importing capital goods like machinery and equipments. But if they succeed in reducing costs of production in their own capital goods industries by introducing more efficient technology, they may begin to export capital goods.

**(3)Differences in Demand** :

Even if costs of production are similar in two countries, trade will emerge if, due to the differences in demand conditions prices in the two countries are different. In fact, demand conditions can reverse the direction of trade from the one expected on the basis of comparative cost advantage. This will happen because consumers may have a strong liking for a particular commodity. For example, countires of South-East Asia (China and Japan) may import rice to meet the high demand for rice by their people despite the fact that these countries produce rice at a low cost.

**(4)Product Differentiation** :

A good part of world trade takes place because of the fact that goods are not identical. For example, Italian Fiats are exported to England, while British Fords are exported to Italy.

**(5)Transport cost**:

Transport costs also influence the direction and volume of international trade. A country may have comparative cost advantage but this advantage may be nullified by transport cost in which case the commodity will not be traded. There are also examples showing that one part of a country imports a commodity while the other part of the country produces and exports the same.

**4 Explain the comparative cost theory of International Trade. Introduction:**

The principle of comparative costs is based on the differences in production costs of similar commodities in different countries. Production costs differ in countries because of geographical division of labour and specialisation in production. Due to differences in climate, natural resources, geographical situation and efficiency of labour, a country can produce one commodity at a lower cost than the other.

In this way, each country specialises in the production of that commodity in which its comparative cost of production is the least. Therefore, when a country enters into trade with some other country, it will export those commodities in which its comparative production costs are less, and will import those commodities in which its comparative production costs are high.

This is the basis of international trade, according to Ricardo. It follows that each country will specialise in the production of those commodities in which it has greater comparative advantage or least comparative disadvantage. Thus a country will export those commodities in which its comparative advantage is the greatest, and import those commodities in which its comparative disadvantage is the least.

**2. Assumptions of the Theory:**

The Ricardian doctrine of comparative advantage is based on the following assumptions: (1) There are only two countries, say A and B.

(2) They produce the same two commodities, X and Y. (3) Tastes are similar in both countries.

(4) Labour is the only factor of production. (5) All labour units are homogeneous.

(6) The supply of labour is unchanged.

(7) Prices of the two commodities are determined by labour cost, i.e. the number of labour-units employed to produce each.

(8) Commodities are produced under the law of constant costs or returns.

(9) Trade between the two countries takes place on the basis of the barter system. (10) Technological knowledge is unchanged.

(11) Factors of production are perfectly mobile within each country but are perfectly immobile between the two countries.

(12) There is free trade between the two countries, there being no trade barriers or restrictions in the movement of commodities.

(13) No transport costs are involved in carrying trade between the two countries. (14) All factors of production are fully employed in both the countries.

(15) The international market is perfect so that the exchange ratio for the two commodities is the same.

**3.Cost Differences**

Given these assumptions, the theory of comparative costs is explained by taking three types of differences in costs: absolute, equal and comparative.

**Cost Differences**

(1) Absolute Differences in Costs

(2) Comparative Differences in Costs

**3.1 Absolute Differences in Costs**

There may be absolute differences in costs when one country produces a commodity at an absolute lower cost of production than the other.

**Table 1: Absolute Differences in Costs**

**Country Commodity-X Commodity- Y**

A 10 5

B 5 10

The table reveals that country A can produce 10 X or 5 Y with one unit of labour and country B can produce 5X or 10Y, with one unit of labour. In this case, country A has an absolute advantage in the production of X (for 10 X is greater than 5 X), and country B has an absolute advantage in the production of Y (for 10 Y is greater than 5 Y).

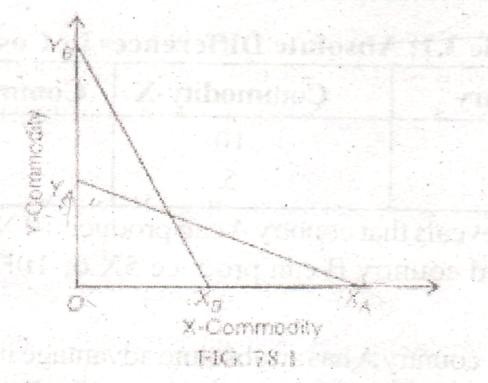
Trade between the two countries will benefit both, as shown in Table 2.

|  |  |  |  |
| --- | --- | --- | --- |
| Country | Production before Trade | Production after Trade | Gains from Trade |
| Commodity | (1) | (2) | (2-1) |
|  | X Y | X Y | X Y |
| A | 10 5 | 20- | +10-5 |
| B | 5 10 | - 20 | -5 +10 |

Total Production 15,15,20,20, +5, +5.

Table 2 reveals that before trade both countries produce only 15 units each of the two commodities by applying one labour-unit on each commodity. If A were to specialise in producing commodity X and use both units of labour on it, its total production will be 20 units of X. Similarly, if B were to specialise in the production of Y alone, its total production will be 20 units of Y. The combined gain to both countries from trade will be 5 units of X and Y.

Above Figure1 illustrates absolute differences in costs with the help of production possibility curves. YAXA is the production possibility curve of country A which shows that it can produce either OXA of commodity X or OYA of commodity Y. Similarly, country can produce OXB of commodity X or OYB of commodity Y. The figure also reveals that Ahas an absolute advantage in the production of commodity X (OXA> OXB), and country B has an absolute advantage in the production of commodity Y(OYB>OYA).

Adam Smith based his theory of international trade on absolute differences in costs between two countries. But this basis of trade is not realistic because we find that there are many underdeveloped countries which do not possess absolute advantage in the production of commodities, and yet they have trade relations with other countries.Ricardo, therefore, emphasised comparative differences in costs.

**3.2 Comparative Differences in Costs**

Comparative differences in cost occur when one country has an absolute advantage in the production of both commodities, but a comparative advantage in the production of one commodity than in the other. The comparative cost differences are illustrated in Table 3.

**Table 3 Comparative Differences in costs: Country Commodity -X Commodity –Y**

A 10 10

B 6 8

or 8X.

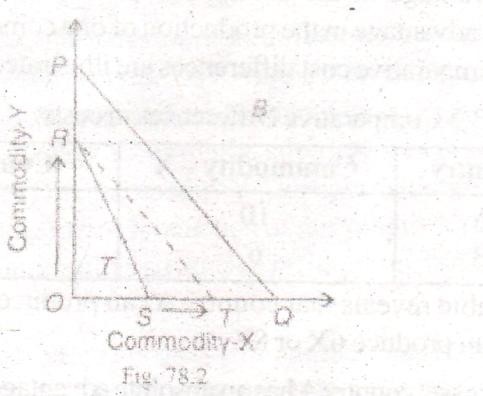
The table reveals that country A can produce 10 X or 10 Y, and country B can produce 6X

In this case, country A has an absolute advantage in the production of both X and Y, but a comparative advantage in the production of X. Country B is at an absolute disadvantage in the production of both commodities but its least comparative disadvantage is in the production of Y. This can be seen from the fact that before trade the domestic cost ratio of X and Y in country A is

10:10 (or 1:1), while in country B, it is 6:8 (or 3:4). If they were to enter into trade, country A's advantage over country B in the production of commodity X is ‗10X of A or 6X of B‘ or 5/ 3. and in the production of Y, it is ‗10Y of A or 8Y of B‘ or 5/4. Since 5/3 is greater than 5/4, A's advantage is greater in the production of commodity X, A willfind cheaper to import commodity Y from country B inexchange for its X.

In other words, country A has a comparative advantage in the production of commodity A', and B has least comparative disadvantage in the production of Y. Thus, trade is beneficial for both countries. The comparative advantage position of both countries is illustrated in Figure 2.

Let PQ be the production possibility curve of country A and RS of country B. The curve PQ shows that country A has an absolute advantage in the production of both commodities X and Y respectively over country B. This is due to the fact that the production possibility curves RS of

country B lies below the production possibility curve PQ of country A. Country B produces OR units of commodity Y and OS units of commodity X.

To show comparative advantage position in trade, draw a line RT parallel to line PQ. Now country A has a comparative advantage in the production of commodity X only because it exports OT (>OS) units relatively to country B. On the other hand, country B has a comparative disadvantage in the production of commodity Y only. This is because, if it gives up resources required to produce OS units of X, it would be able to produce commodity Y by an amount less than OR. Thus

country Ahas a comparative advantage in the production of commodity X, and country B has a comparative disadvantage in the production of commodity Y.

**-5 State the main points of Criticisms against the Theory of comparative cost theory. ANS:**

**(1) Unrealistic Assumption of Labour Cost:**

The most severe criticism of the comparative advantage doctrine is that it is based on the labour theory of value. In calculating production costs, it takes only labour costs and neglects non- labour costs involved in the production of commodities. This is highly unrealistic be- cause it is money costs and not labour costs that are the basis of national and international transactions of goods.

Further, the labour cost theory is based on the assumption of homogeneous labour. This is again unrealistic because labour is heterogeneous of different kinds and grades, some specific or specialised, and other non-specific or general.

**(2) No Similar Tastes:**

The assumption of similar tastes is unrealistic because tastes differ with different income brackets in a country. Moreover, they also change with the growth of an economy and with the development of its trade relations with other countries.

**(3) Static Assumption of Fixed Proportions:**

The theory of comparative costs is based on the assumption that labour is used in the same fixed proportions in the production of all commodities. This is essentially a static analysis and hence unrealistic For instance, less labour is used per unit of capital in theproduction of steel than in the production of textiles.

**(4) Unrealistic Assumption of Constant Costs:**

The theory is based on another weak assumption that an increase of output due to international specialisation is followed by constant costs. But the fact is that there are either increasing costs or diminishing costs. If the large scale of production reduces costs, the comparative advantage will be increased

**(5) Ignores Transport Costs:**

Ricardo ignores transport costs in determining comparative advantage in trade. This is highly unrealistic because transport costs play an important role in determining the pattern of world trade. Like economies of scale, it is an independent factor of production. For instance, high transport costs may nullify the comparative advantage and the gain from international trade.

**(6) Factors not fully Mobile Internally:**

The doctrine assumes that factors of production are perfectly mobileinternally and wholly immobile internationally. This is not realistic because even within a country factors do not move freely from one industry to another or from one region to another.

**(7) Two-Commodity Model is Unrealistic:**

The Ricardian model is related to trade between two countries on the basis of two commodities. This is again unrealistic because, in actuality, international trade is among countries trading many commodities.

**(8) Unrealistic Assumption of Free Trade:**

Another serious weakness of the doctrine is that it assumes perfect and free world trade. But, in reality, world trade is not free. Every country applies restrictions on the free movement of goods to and from other countries. Thus tariffs and other trade restrictions affect world imports and exports.

**(9) Unrealistic Assumption of Full Employment:**

Like all classical theories, the theory of comparative advantage is based on the assumption of full employment. This assumption also makes the theory static. Keynes falsified the assumption of full employment and proved the existence of underemployment in an economy. Thus the assumption of full employment makes the theory unrealistic.

**(10) Self-interest Hinders its Operation:**

The doctrine does not operate if a country having a comparative disadvantage does not wish to import a commodity from the other country due to strategic, military or development considerations. Thus often self-interest stands in the operation of the theory of comparative costs.

**(11) Neglects the Role of Technology:**

The theory neglects the role of technological innovations in international trade. This is unrealistic because technological changes help in increasing the supply of goods not only for the domestic market but also for the international market. World trade has gained much from innovations and research and development (R & D).

**(12)One-Sided Theory:**

The Ricardian theory is one-sided because it considers only the supply side of international trade and neglects the demand side. In the words of Professor Ohlin, "It is, indeed, nothing more than an abbreviated account of the conditions of supply."

**(13) Impossibility of Complete Specialisation**

Professor Frank Graham has pointed out that complete specialisation will be impossible on the basis of comparative advantage in producing commodities entering into international trade.

Thus according to Graham, "The classical conclusion of complete specialization between two countries can hold ground only... by assuming trade between two countries of equal opportunity, consumption value and between two countries of approximately equal economic performance.‖

**(14) A Clumsy and Dangerous Tool:**

Professor Ohlin has criticised the classical theory of international trade on the following grounds:

1. The principle of comparative advantage is not applicable to international trade alone, rather it is applicable to all trade.

2. Factors are immobile not only internationally but also within different regions.

3. It‘s a two country two commodity model based on the labour theory of value which is sought to be applied to actual conditions involving many countries and many commodities.

He regards the theory of comparative advantage as cumbersome, unrealistic, and as a clumsy and dangerous tool of analysis. As an alternative, Ohlin has propounded a new theory which is known as the Modern theory of International Trade.

**(15) Incomplete Theory**

It is an incomplete theory. It simply explains how two countries gain from international trade. But it fails to show how the gains from trade are distributed between the two countries.

**6 What is Multilateral Trade?**

Ricardo's theory is based on the assumption of two- countries two-goods model. In reality, international trade is multilateral in the sense that a large number of countries exchange among them a large number of goods and this exchange is conducted in terms of money. But, as Samuelson has remarked, even if we take into account the real situation, the validity of the comparative cost advantage theory remains unaffected. Its conclusion is applicable to the real world situation also.

**Meaning:**

When more than two countries are engaged in external trade, the issue of comparative cost advantage is not sufficient to know which commodity will be produced and exported by a particular country. To know it, we shall need information also about the actual rate of exchange between two goods as determined by the reciprocal demand along with the cost conditions.

Suppose, ten days of labour can produce :

**CountryX Commodity Y Commodity**

A 10 units 30 units

B 10 units 20 units

C 10 units 10 units

In this case, country A has comparative cost advantage in Y as compared to countries B and C, while country C has comparative cost advantage in X as compared to countries A and B. Hence, country A will produce Y and country C will produce X.

Now, which commodity will country B produce depends on the rate of exchange between commodities X and Y. The internal rate of exchange between X and Y is 1X = 3Y in country A, while it is 1X = 1Y in country C. Hence, the trade will be beneficial to both the countries A and C, if the rate of exchange is between the two limits of 1X = 3Y and 1X = 1Y. The actual rate of exchange between these limits will of course depend on the reciprocal demand.

**Money cost of Production** :

In reality commodity prices are expressed not in terms of labour, but in terms of money. We shall therefore convert labour cost into money cost as follows :

**CountryPer unitPer unit**

**labour cost of X labour cost of Y**

A 12 8

B 4 4

In this case, country A has comparative cost advantage in the production of commodity Y, while country B has Comparative cost advantage in the production of commodity X. Hence, country A will produce and export Y, while country B will produce and export X.

But, labour is more productive in country B as compared to A, therefore wage rate in B will be higher than that in A. Wage rate in B will be as high as three times (12) and as low as two times

4

(8)as compared to that in A. Let us suppose that wage rate is Rs. 1 per day in A, and Rs. 2.5 per

4

day in B. In this case, the money cost of X and Y would be as shown below.

**Country Per units cost of X (Rs.) Per unit cost of Y (Rs.)**

A 12 8

B 10 10

It follows that trade pattern will be same as before : Country A will produce and export Y, while country B will produce and export X

**UNIT - III BALANCE OF PAYMENT**

**QUE-1Explain Meaning and difference between Balance of Trade and Balance of Payment**

**OR Explain the Structure of Balance of Payment. ANS:**

**1. Meaning of balance of trade:**

The balance of trade of a country represents a systematic record of transactions pertaining to all visible items of exports and imports during a given period. The value of all goods and commodities imported and exported are shown therein. A country has to make payments for the goods imported, while it receives payments for the goods exported. The balance of trade of a country thus, indicates the relationship between the aggregate value of exports and the aggregate value of imports during a given year.

The balance of trade of a country is said to be in balance when the money value of its exports is equal to the money value of its imports. However, if the money value of exports is higher than the money value of imports, the balance of trade is said to be favourable. On the other hand, if the money value of imports is higher than the money value of exports, the balance of trade is said to be unfavourable for the country.

**2. Meaning of balance of Payment:**

According to Kindleberger, "The balance of payments of a country is a systematic record of all economic transactions between the residents of a reporting country and residents of foreign countries during a given period of time." Balance of payments is, thus, a flow account and is a record of all economic transactions of a country with the other countries of the world. It indicates the total payments which a country has to make to the other countries of the world and the total payments which it has to receive from the other countries of the world. Balance of payments, thus, refers to total receipts and payments of a country-in terms of foreign exchange during a given period of time.

**3. Difference between BOT and BOP: (3.1) Meaning:**

BOT refers to the merchandise account of exports and imports only.

BOPisabroaderterm, it includes Balance of Trade, it encompasses international economic transactions and items such as merchandise trade, services, banking, insurance, capital flows, gold buying and selling, etc.

**(3.2) Nature and Scope:**

A country may export and import many items, both visible and invisible, balance of trade refers to the visible items only.

BOP covers the total debits and credits of all items, visible as well as invisible.

**(3.3) Constituents:**

BOT is only a partial study of the BOP. It refers to the difference between the value of exports and visible imports. It is represented in the trade or merchandise account section of the current account in the BOP statements.

The BOP includes apart from Balance of Trade or merchandise account the invisible account which is again composed of the service sector and gifts and charities account comprising a variety of invisible items, a record of capital account.

**(3.4) In the Accounting Sense:**

BOT may be deficit or surplus. Thus, it may be imbalanced.

BOP always balances, since the BOP statement is drawn up in terms of debits and credits based on a system of double entry book-keeping, therefore total debits must equal total credits.

**4. Structure of Balance of Payments:**

The balance of payments of a country has two accounts : (i) Current Account (ii) Capital Account.

**(i) Current Account** :

The current account balance of payment refers current international transactions which lead to an addition or utilisation of national income.

It should be noted here that the current account balance of payments is a record of current international transactions and a country tries to achieve a balance in its current account. However, if there is a deficit, it is met out of transfer from the capital account.

(ii) **Capital Account** :

Capital account balance of payments indicates long term investments and capital movements as also gold transactions and changes in the currency reserves including changes in the foreign exchange assets with the central bank of the country.

**We give below an illustration of balance of payments:**

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  | | --- | --- | | **Receipts (credit)** | **Payments (debit)** | | **CURRENT ACCOUNT** | | | (1) Merchandise (visible exports on private and government account)  (2) Invisible items of exports :  (a) Services like shipping, banking, insurance, commercial and technical etc.  (b) Expenditure in the country by foreign tourists. (c) Receipts of interest, dividend, profit etc. on investment made in foreign countries.  (3) Receipts on account of gifts, grants, donations, war indemnity, etc.  (4) Inward Remittances  (5) Miscellaneous receipts for the services rendered by -experts, technicians and others in the foreign countries. | (1) Merchandise (visible imports on private and government account)  (2) Invisible items of imports :  (a)Services like shipping, banking, insurance, commercial, technical, etc  (b)Tourist expenditure incurred by the citizens of this country in foreign countries.  (c)Payment of interest, dividends, profits, etc. to foreign countries on account of investment made by them in this country.  (3) Payments on account of gifts, grants, donations, war indemnity, etc.  (4) Outward Remittances  (5) Miscellaneous payments for the services rendered by foreign experts, technicians, etc. |  |  |  | | --- | --- | | **CAPITAL ACCOUNT** | | | (1) Long term foreign investment in the country in the form of:  (a) Equity  (b) Investment by foreign countries in securities.  (2) Receipts on account of short term; and long term loans, credit, etc. from :  (a) International Financial Institutions.  (b) Foreign governments.  (c) Private foreign investors.  (3) Receipts from sale of gold  (4) Change in currency reserves including changes in the foreign assets of the central bank of the country. | (1) Long term foreign investment made in foreign countries in the form of :  (a) Equity  (b) Investment in foreign securities  (2)Repayment of short term and long term loans, credit etc. to : (a) International financial institutions.  (b) Foreign governments  (c) Private foreign investors  (3)Payment for purchase of gold.  (4)Changes in the currency reserves including changes in the foreign exchanges assets of the central bank of the country. | |

It should also be noted here that it is the balance of payments and not the balance of trade which presents a real picture of the overall economy of a country. A surplus in the balance of trade is not necessarily an indication of a country's prosperity nor a deficit in the Balance of trade an indication of a poor state of the country's economy.

Thus, for example, the balance of trade of a country may be in surplus, but if it has to make large payments on account of invisible items of imports, the over-all balance of payment may be in a deficit.

**QUE-2Discuss the main causes of deficit or disequilibrium in the Balance of Payments**

**ANS:1. Types of disequilibrium**

There are two main types of disequilibrium in the balance of payments of a country :

**(a) Temporary or Transitory Disequilibrium :**

This type of disequilibrium is purely of a temporary nature and is self-correcting. It does not involve the complex problem of adjustment.

**(b) Fundamental Disequilibrium:**

When the balance of payments situation of a country progressively deteriorates and if it is chronic and long term, it is known as fundamental disequilibrium in the balance of payments. Such a disequilibrium requires correction and adjustment.

**2. Causes/reasons of deficit in balance payment:**

Some of the major important reasons/causes of deficit (disequilibrium) in balance of payments may be caused due to number of factors. These factors can be divided into three groups:

**2.1 Economic Factors**

**(i) Developmental activities:**

Developing countries depend on developed nations for supply of machines, technology and other equipment. This leads to increased levels of imports, thereby, resulting in a deficit in the BOP account.

**(ii) High rate of inflation:**

When there is inflation in the domestic economy, foreign goods become relatively cheaper as compared to domestic goods. It increases imports which causes a deficit in the BOP.

**(iii) Cyclical fluctuations:**

When the domestic economy is going through a phase of boom, then domestic production may be unable to satisfy the domestic demand. It leads to a deficit in BOP, due to increase in imports.

**(iv) Change in Demand:**

Fall in demand for country's goods in the foreign markets leads to fall in exports and it adversely affects the balance of payments.

**(v) Import of Services:**

Underdeveloped countries import services from developed countries for which, they have to pay huge amounts of money. It leads to a deficit in the BOP.

**2.2 Political Factors**

**(i) Political Instability:**

Political instability may lead to large capital outflows and reduce the inflows of foreign funds, thus, creating disequilibrium in the BOP.

**(ii) Political disturbances:**

Frequent changes in the government, inadequate support to the government in parliament also discourage inflows of capital. This leads to a deficit due to higher outflows than inflows.

**2.3Social Factors**

**(i) Demonstration Effect:**

When the people of underdeveloped countries come in contact with those of advanced countries, they start adopting the foreign pattern of consumption. Due to this reason, their imports increase and it leads to an adverse balance of payments' for underdeveloped country.

**(ii) Change in tastes, preferences, fashion and trends**

An unfavorable change for the domestic goods leads to a deficit in the balance of payments.

**QUE-3 Examine the measures to correct the disequilibrium in the balance of payment**

**ANS:** There are two ways to correct the disequilibrium in the balance of payment:

1. Monetary Measures 2. Non-Monetary Measures

**1. Monetary Measures:**

**1.1 Deflation**

Deflation refers to a continuous, decline in general price level. A lower price level makes goods and services cheaper to foreigners, thus encouraging exports. At the same time deflation reduces the income with the people which in turn reduces their demand for imports. To correct the disequilibrium in the balance of payments deflation has to be deliberately brought in through monetary and fiscal policies.

Monetary policy aims at reducing the demand for money by making it costly and less available. For achieving this, the monetary authorities of the country employ quantitative and qualitative methods of credit control. Fiscal policy reduces income and expenditure by imposing more taxes and reducing public expenditure.

Deflationary situation corrects the disequilibrium by promoting exports and discouraging imports. This policy is also known as Expenditure Reducing Policy.

The success of deflation as a method to correct disequilibrium depends on:

**(i)Flexibility of income and prices:**

Both these variables should respond to the policy measures. Rigidity in prices will defeat the attempts of the government to introduce the deflationary style.

**(ii) Elastic demand for exports and imports:**

A lower price level at home should encourage exports. Similarly low income should discourage imports. If demand for exports and imports is inelastic, deflation will not succeed in correcting the disequilibrium.

**(iii) Co-operation by other countries:**

Other countries which get affected by the deflationary or expenditure reducing policy may react through appropriate policy measures to safeguard their exports. Retaliation by the affected countries reduce the effectiveness of deflation followed by the deficit country.

**1.2 Devaluation& Depreciation:**

Devaluation or Expenditure Switching method aims at influencing the prices of only traded goods and not the general price in the case of deflation. Devaluation refers to an official announcement or act of monetary authority through which the exchange rate is changed i.e. the value of domestic currency is reduced vis-a-vis foreign currency. For example if the existing rate is Rs. 30=$ 1, the decision to devalue currency by 50 percent will make the new exchange rate Rs.

45 = $ 1.

Similarly devaluation makes imports costlier in terms of domestic currency. A student in India purchasing a foreign book costing $ 1 will pay Rs. 30 but requires to payRs. 45 after the devaluation.

Depreciation like devaluation lowers the value of domestic currency or increases the value of the foreign currency. Depreciation of a currency takes place in free or competitive foreign exchange market due to market forces. An existing exchange rate, say Rs. 35 = $1 may depreciate to Rs.35.50 or anything more than Rs.35 per dollar. A change in the exchange rate may be continuous or sporadic but is not brought out by an official declaration as in the case of devaluation.

**Conditions for Success**

Depreciation and devaluation which make exports cheaper and imports costlier are expected to increase exports and reduce imports thus bringing the balance of payments into equilibrium. The success of both, however, depends on a number of conditions.

**(i) Elasticity of demand for exports:**

As we know, demand is elastic if change in demand is more than change in price. In this case if the currency is devalued by 10 percent, the exports must increase by more than 10 percent. If the elasticity of demand for exports is equal to one or less, then a change in the exchange rate will not help 'reduce the deficit in the balance of payments.

**(ii) Elasticity of demand for imports:**

One of the requirements for correcting disequilibrium in the balance of payment is to reduce imports. The above-mentioned measures make our imports costlier and accordingly it is expected that demand for imports would reduce. Here also for the success of the change in exchange rate, the import elasticity of demand must be greater than one.

**(iii) Elasticity of supply of exports:**

If the demand for export increases then the country whose exchange rate has changed must be in a position to increase the supply of export goods to meet the increased demand. It is possible to do so only if the supply of exports is elastic.

**(iv) Co-operation by other countries:**

When exports become cheap due to devaluation or depreciation, the competiting countries whose currencies have remained stable, find their exports suffer. To be competitive in the world market they too are compelled to devalue their currencies; Competitive devaluation will wipe out all the advantages enjoyed by the country which devalued its currency initially. It is, therefore, essential to secure co-operation by other countries, which is rather difficult.

**(v) Control of domestic price level:**

A devaluation or depreciation by itself does not affect the domestic price level. However; imports in the form of consumer goods or inputs for further production having 'turned costlier affect the domestic price level. Increased exports also bring in more foreign exchange which in turn may increase domestic money supply resulting in an increase in domestic price level.

**1.3 Exchange Control:**

Deficit in the balance of payments is a result of demand for foreign exchange exceeding its supply. Therefore, one of the methods adopted by the government or monetary authorities is to control the use of foreign exchange. Under the system of exchange control foreign exchange earners are expected to surrender the foreign exchange earned to the government against the domestic currency, importers who are permitted by the government to import goods and services will receive foreign exchange from the government. The amount of foreign exchange allottedto various importers is determined by the government depending on the importance of goods or services imported.

**Limitations of Exchange control:-**

Exchange control measures are no solution for solving long-run disequilibrium. They do not correct the root cause of the problem. Besides, implementation of these methods leads to corruption resulting in misuse of scarce foreign exchange.

**2. Non-monetary Measures:**

Non-monetary measures adopted to correct balance of payments deficit are as follows:

**2.1 Tariff:**

It refers to a schedule of duties imposed on imports. It is also called custom duties. Import duties raise the prices of import goods. Hence, the demand for import goods tends to contract. But if demand for import goods is inelastic, total value of imports will increase. If demand is elastic, it brings deficit through a contraction of foreign trade.

**2.2 Import Quota:**

The government may fix and permit maximum quantity or value of a commodity to be imported during a given period. This is known as import quota. The effect of import quota is direct, certain and immediate. It is therefore more effective than import duties as a measure of correcting balance of payments deficit. But import quotas bring no revenue to the government, create monopolistic situation and breed corruption in administration.

**2.3 Export Promotion:**

To increase total exports, the government may implement export promotion programmes such as export subsidies, tax concessions to exporters, marketing facilities, exhibitions and fairs in foreign market, loans at low interest to the exporters etc. If properly planned and executed, export promotion measures can be best solution for the developing countries in need of changing export structure to suit the pattern of world demand.

**2.4 Import Substitution:**

It refers to the deliberate policy of the government to encourage the local industries to produce goodswhich may serve as substitutes for import goods so that demand may be satisfied through domestic production in place of imports. Consequently, the country may be more self- reliant and less dependent on imports.

**QUE-5 Write a note on: Devaluation of Currency**

**ANS: 1.00 Meaning Of 'Devaluation':**

Devaluation is a deliberate downward adjustment to the value of a country's currency relative to another currency, group of currencies or standard. Devaluation is a monetary policy tool used by countries that have a fixed exchange rate or semi-fixed exchange rate. It is often confused with depreciation, and is the opposite of revaluation.

Devaluing a currency is decided by the government issuing the currency, and unlike depreciation, is not the result of non-governmental activities. One reason a country may devaluate its currency is to combat trade imbalances. Devaluation causes a country's exports to become less expensive, making them more competitive in the global market. This, in turn, means that imports are more expensive, making domestic consumers less likely to purchase them, further strengthening domestic businesses.

**2.00 Examples of Devaluation :**

The devaluation of currencies arises in many situations, but comes about due to specific government action. For example, Egypt has faced constant pressure from a black market for U.S. dollars (USD). The rise of the black market came about due to a foreign currency shortage that hurt domestic businesses and discouraged investments within the economy. To stop the black market activity, the central bank devalued the Egyptian pound in March 20216 by 14% when compared to the USD)

**3.00 Reasons for Devaluation of Currency**

Reasons for Devaluation of Currency are:

**(1) To Boost Exports:**

On a world market, goods from one country must compete with those from all other countries. Car makers in America must compete with car makers in Europe and Japan. If the value of the euro decreases against the dollar, the price of the cars sold by European manufacturers in America, in dollars, will be effectively less expensive than they were before. On the other hand, a more valuable currency make exports relatively more expensive for purchase in foreign markets.

In other words, exporters become more competitive in a global market. Exports are encouraged while imports are discouraged. There should be some caution, however, for two reasons. First, as the demand for a country's exported goods increases worldwide, the price will begin to rise, normalizing the initial effect of the devaluation. The second is that as other countries see this effect at work, they will be incentivized to devalue their own currencies in kind in a so- called "race to the bottom." This can lead to tit for tat currency wars and lead to unchecked inflation.

**(2)To Shrink Trade Deficits:**

Exports will increase and imports will decrease due to exports becoming cheaper and imports more expensive. This favors an improved balance of payments as exports increase and imports decrease, shrinking trade deficits. Persistent deficits are not uncommon today, with the United States and many other nations running persistent imbalances year after year. Economic theory, however, states that ongoing deficits are unsustainable in the long run and can lead to dangerous levels of debt which can cripple an economy. Devaluing the home currency can help correct balance of payments and reduce these deficits.

**(3) To Reduce Sovereign Debt Burdens:**

A government may be incentivized to encourage a weak currency policy if it has a lot of government issued sovereign debt to service on a regular basis. If debt payments are fixed, a weaker currency makes these payments effectively less expensive overtime.

Take for example a government who has to pay $ 1 million each month in interest payments on its outstanding debts. But if that same $1 million of notional payments becomes less valuable, it will be easier to cover that interest. In our example, if the domestic currency is devalued to half of its initial value, the $ 1 million debt payment will only be worth $500,000 now)

Again, this tactic should be used with caution. As most countries around the globe have some debt outstanding in one form or another, a race to the bottom currency war could be initiated. This tactic will also fail if the country in question holds a large amount of foreign bonds since it will make those interest payments relatively more costly.

**(4) The Bottom Line:**

Currency devaluations can be used by countries to achieve economic policy. Having a weaker currency relative to the rest of the world can help boost exports, shrink trade deficits and reduce the cost of interest payments on its outstanding government debts. There are, however, some negative effects of devaluations. They create uncertainty in global markets that can cause asset markets to fall or spur recessions. Countries might be tempted to enter a tit for tat currency war, devaluing their own currency back and forth in a race to the bottom. This can be a very dangerous and vicious cycle leading to much more harm than good.

**UNIT - IV EXCHANGE RATE AND INTERNATIONAL MONETARY FINANCIAL INSTITUTIONS**

**QUE-1What is foreign exchange rate? Discuss the methods for determining foreign exchange rate. OR**

**Write a short note on Mint Parity Theory. OR Write a short not on Purchasing Power Parity Theory. OR Write a short note on demand and supply theory.**

**ans**

**1. Introduction:**

Foreign exchange rate plays important role for economic aspects. It is taken into consideration for export-import transactions. Economics lay prime emphasis on stability of foreign exchange rate, exchange rate determination, etc. Foreign exchange rate means exchange rate between two currencies. For example, we take two countries into consideration. The first country is India and the second country is Japan. How many Indian rupees make one Japanese Yen? Or how many Japanese Yen make one Indian rupee? In this way, currencies of two countries are valued through foreign exchange rate.

**2. MEANING:**

Foreign exchange rate is also known as foreign currency rate. Exchange rate indicates the purchasing power of currencies of any two nations. For example, the purchasing power of Indian rupee is more as compared to Japanese Yen. The foreign exchange rate occupies importance because through it difference in valuation of two currencies is equal up.

**3. Exchange Rate Determination**

Various theories prevail for exchange rate determination. Exchange rates are determined according to these principles. These principles are of utmost importance for exchange rate determination. These theories are as under:

1) Mint Parity Theory

2) Purchasing Power Parity Theory

3) Demand and Supply Theory

**(1) Mint Parity Theory:**

Exchange rate is determined as per gold standards according to mint parity theory. According to gold standards, gold in proportion to issue of currency is kept as reserves. If currency is not issued and currency of foreign country is kept as reserves then gold equivalent to the proportion of foreign currency is kept as reserves. If any foreign currency is held by the government of India and if there is appreciation in the value of said Currency then proportion of gold is increased upto the appreciated value of respective currency. The same rule is applicable for reduction in value of foreign currency.

The gold can be obtained from the government in exchange of currency. The value of one unit of currency is associated with specific weight of gold. By doing so, no bias remains for exchange rate determination. At present, gold standards are abolished universally. Paper currency is in existence.

**(2) Purchasing Power Parity Theory:**

According to purchasing power parity theory, the currencies of two nations are equal up. The point at which the value of two currencies becomes equal is set as exchange rate. We find different currencies in different countries of the world. Due to this, relative importance of currency of each and every country is different. The reason responsible behind such difference is the actual purchasing power of each and every currency is different. For determining the exchange rate, the valuation of currency of both the countries is made. Relative importance of currencies is determined on the basis of valuation. The purchasing power parity theory exists in two forms.

**Forms of Purchasing Power Parity Theory:**

These forms are as under:

A) Relative form

B) Non-relative form

**(A) Relative form:**

According to this method, relative prices of different items are taken into consideration. Moreover, changes in their prices are also considered. New exchange rate is determined by considering internal purchasing power of currencies of both the nations. The said calculation is done in the following manner:

**New Exchange Rate**= Exchange rate of Base Year X Domestic Index

Foreign index

If we put values in the above formula, then we get exchange rate asunder: Exchange rate of base year Rs 48

Internal (domestic) index Rs 200

Foreign index Rs 100

Here Rs 48= One Dollar

New Exchange Rate = 48 x200= Rs 96

100

Therefore, Rs 96= One Dollar.

**(B) Non-relative form:**

The value of currencies of both the nations is made equal as per this method. The point at which the purchasing power of currency of both the nations becomes equal is decided as exchange rate. For example, for purchasing a moped in India costs Rs 24,000. The similar kind of moped is available for $ 500 in U.S. It means that Rs 24,000 of India is equal to $ 500 of U.S. If we see as per the aforesaid aspect then forty eight Indian rupees make one U.S. dollar. ;

The biggest disadvantage of this method is that it is based upon unrealistic assumptions.

Practically, the domestic purchasing power of no two nations is same at a single point of time. The reason behind dissimilarity is variations in quality standards adopted in both nations. When qualities of products are different then it is meaningless to compare them finally.

**3. Demand and Supply Theory**

The demand and supply theory is helpful for determining long run exchange rate. Aforesaid two theories are used for determining short run exchange rate. As per this theory, the demand for currencies is taken into consideration. Such demand is market oriented. The balance of payments comes into existence due to this aspect. When the demand for domestic currency is more as compared to its supply, we find deficit in balance of payments. Due to this, we find reduction in exchange rate. Reverse of the aforesaid situation, we find increase in exchange rate when the demand for domestic currency is less in foreign markets as compared to its supply.

In this way, exchange rate is determined on the basis of surplus or deficit balances. The demand for foreign currency is shown on the debit side of balance of payments. The supply of foreign currencies is shown on the credit side of balance of payments. On the debit side of balance of payments both visible and invisible imports are recorded. On the credit side of balance of payments, both visible and invisible exports are recorded.

**The demand for foreign exchange can be determined in context of rupees as under:**

**Rupee Equivalent to the Value of Dollar**

25=1

35=1

**Demand for Dollar**

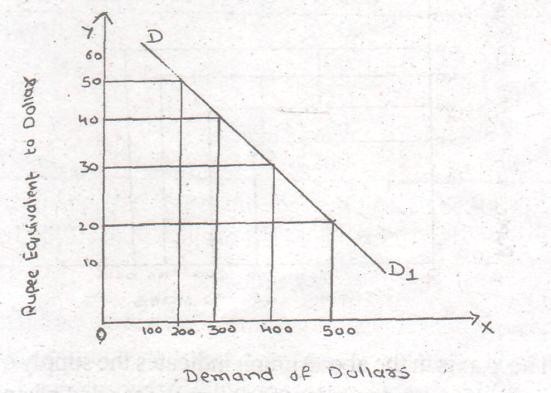
500

400

45=1 300

55=1 200

From the figures of above illustration, we find that when there is increase in the value of dollars, there is reduction in its demand. The said aspect can be revealed graphically in the following manner:

The x-axis in the above graph indicates the demand for dollars and y-axis indicates rupee equivalent to the value of dollar. When there is rise in the value of dollars there is corresponding reduction in the demand for dollars. Due to this, the demand for dollars moves towards x-axis from y- axis.

**The supply of foreign exchange with relation to rupee is decided in the following manner:**

**Rupee Equivalent to the Value of Dollar**

25 = 1

35 = 1

45 = 1

55 = 1

**Demand for Dollar 1**

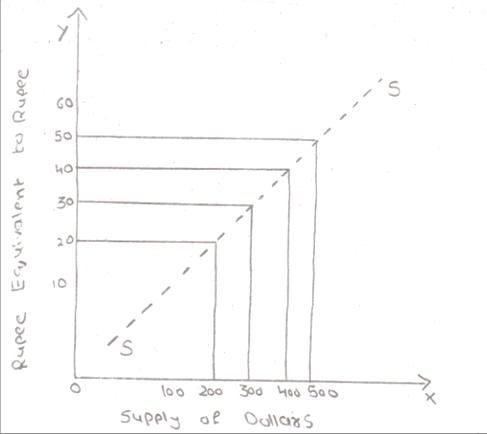
200

300

400

500

From the above illustration we see that the supply of dollar increases with the increase in its value. The said aspect can be represented graphically in the following manner.

The x-axis in the above graph indicates the supply of dollar and y-axis indicate rupee equivalent to dollar. We see that when there is rise in the value of dollar in relation to rupee, there is corresponding increase in its supply. The said graph indicates that there is high demand for dollars in India.

For determining exchange rate, the point at which the demand for dollar equals its supply is taken into consideration. If we analyze both the above illustrations, then we find the following situation:

|  |  |
| --- | --- |
| **Rupee Equivalent to the Value of Dollar** | **Demand for Dollar** |
| 25=1 35=1 | 500 400 |
| 45=1 | 300 |
| 55=1 | 200 |

From the above illustration, we find that at no point the demand for dollar equals its supply. Suppose forty Indian rupees equals to one U.S. Dollar and at such point the demand and supply of dollar is 350 then new table obtained will be as under:

|  |  |  |
| --- | --- | --- |
| **Rupee Equivalent to the Value of Dollar** | **Demand for Dollar** | **Supply Of Dollar** |
| **25=1** | **500 >** | **200** |
| **35=1** | **400 >** | **300** |
| **40=1** | **350 =** | **350** |
| **45=1** | **300 <** | **400** |
| **55=1** | **200 <** | **500** |

The exchange rate as per the above table will be Rs. 40. In other words, one U.S. Dollar equals to Rs. 40 of India.

**4. Conclusion :-**

From the above discussion, we can conclude that, at present, gold standards and mint parity theory are not in existence. At present the demand and supply theory is in existence. Due to this, it becomes necessary to take into consideration balance of payments position. The exchange rate is determined at the point at which the demand for and supply of foreign currency equals up. The application of said theory is limited because it does not take into consideration. The aspect of perfect competition. Practically, we do not find the existence of perfect competition anywhere in the world. The said theory is based on the assumption of free trade. Practically, we do not find free trade anywhere in the world.

Despite of few defects, we find the application of said theory. It is applied practically because it is more practical as compared to other theories.

**QUE-2 Explain Exchange Rate and Discuss the Factors Affecting Exchange Rate: ANS: Introduction:**

The theories of exchange rate discussed above attempt to explain the determination of equilibrium exchange rates or long period normal rate of exchange. In fact, however, the market rate of exchange are influenced by a number of factors affecting demand and supply of foreign currency. The main factors responsible for short term fluctuations in exchange rate are as follows : **(1)Trade Transactions:**

A change in the relation between total amount of imports and exports will surely bring about a change in exchange rate. If imports exceed exports, demand for foreign currency will exceed its supply and hence, price of foreign currency will move up. Exchange rate will rise. If exports exceed imports, supply of foreign currency will exceed its demand and hence, price of foreign currency will move down. Exchange rate will fall.

**(2)Capital Transactions**:

Capital transactions result into the movements of capital from one country to another in the form of short term and long term loans and investments. Exports of capital from India due to loans and investment abroad will raise the demand for foreign currency and hence, exchange rate will tend to move up. Imports of capital due to foreigners' lending and investing in India will increase the supply of foreign currency in India and hence, exchange fate will tend to move dowii1. **(3)Speculative Transactions:**

These transactions cause fluctuations of exchange rates. For example, if speculators expect price of American dollar to go up in terms of Indian rupee, they will buy dollar and sell rupees in the foreign exchange market. Consequently, dollar will appreciate and rupee will depreciate. In fact, the speculators tend to take a very short view and reinforce price movements in a destabilizing manner.

**(4)Structural Changes:**

These refer to the changes in cost structure, invention and innovation resulting in new techniques and new products etc. These changes affect the pattern of comparative cost advantages among the countries of the world. If a country is less progressive as compared to its competitors, consumer demand will shift away from the home products to the imported goods, resulting in the depreciation of its currency's exchange rate. Similarly, changes such as oil price hike and development of oil substitutes will cause major changes in exchange rates.

**(5)Differences in Rates of Inflation:**

If rate of inflation in India is higher than that in other countries, India's exports will fall and imports will increase and therefore, external value of rupee (that is, exchange rate) will fall in the same manner as its internal value. This infact is the essence of **Gustav Cassel's** purchasing power parity theory.

**(6) Political Conditions:**

Political stability in a country helps to maintain a high exchange rate of its currency, because foreign capital gets attracted to the country where political conditions are stable. Conversely, political instability causes a panic flight of capital from the country resulting in depreciation of its currency.

**QUE-3 Describe the performance of World Bank. State objective & function of World**

**Bank(IBRD).**

**ANS:**

**1. Introduction:**

The world bank is also known as the international bank for reconstruction & development [IBRD]. It was established in 1945. It begins its operation of 25th June, 1946. It was established under the Bretanwood agreement of 1944. It‘s main purpose was to establish easy economy for world to peace. At that time international monetary fund & the World Bank was established under Bretanwood considered as sister of IMF.

**2. Membership & organization of the world bank:**

Any country acquiring membership of the IMF automatically becomes the member of World Bank. The country holding the membership of the bank must subscribe to the charter of the bank. The member countries subscribed to it according to their economic position & size of their quotas with IMF. The USA is the largest subscriber. Each country‘s subscription quota was initially divided into:

(1) 2% of the subscription to paid in gold or US dollars

(2) 18% of the subscription is to be paid in members on currency & remaining 80% subject to call, if an only when require to meet banks obligation.

About 183 countries are the members of the World Bank.

**Organization of the World Bank:**

The world bank is a 3 tier structure, the three tier structure comprise of president, executive director & board of governors.

The president is selected by the executive directors. The no. of directors are 21, 5 executives are appointed by 5 big share holder of the World bank. These 5 big share holder are USA, UK, France, West German & Japan & remaining 16 directors are appointed by board of governors.

The meeting of board of governors is held on every onth.

For the period of the 5 year, each member country has to appoint governor & optional governor. The voting right of every governor depends upon financial contribution made by the respective countries.

**3. Capital structure:**

The initial authorized capital of the world bank was 10 billion dollars. The members country subscribe to it according to their economic position & the size of their quotas in IMF. The authorized capital of the bank is been increased in subsequent year in July 1992. The total authorized capital of the bank was 184.1 billion dollars.

**4. Objectives of the World bank:**

The objectives of the world bank is set out in the article one are as under.

**1. Main object for reconstruction & development:**

It‘s main function was to provide long term capital for reconstruction & development of economy of various countries of the world which have suffer during world war 1939 to 1945.

**2. Balance in balance of payment:**

It‘s object is to give financial assistance to remove imbalancing in the balance of payment. It‘s aim is to encourage international trade & help under developed & developing countries.

**3.Economic stability:**

To make efforts to bring about economic stability in the country suffering from economic balances due to the world war.

**4. International investment:**

It‘s aim is to promote and encourage international investment by partnership & guardian.

**5. Lending policies of the bank:**

The World Bank lends to member countries in any of the following ways : (a) by making or participating in direct loans out of its own funds.

(b) by making or participating in direct loans out of funds raised in themarket.

(c) by guaranteeing in whole or part loans made by private investorsthrough investment channels.

The amount of loan granted by the bank should not exceed 100 percent of its total subscribed capital and surplus. Before granting or guaranteeing a loan, the Bank takes into consideration the following:

(i) the project for which loan is asked has been carefully examined byan expert and competent committee as regards the merit of theproposal.

(ii)the loans are for specific projects for reconstruction or developmentexcept in special circumstances.

(iii)the loan is meant for productive purposes.

(iv)the borrower or the guarantor is in a position to meet its obligationsunder the loan.

**5. Functions of World bank:**

The main functions of the Bank are:

(1) To assist in reconstruction and development of the territories of its member-governments by facilitating investment of capital for productive purposes.

(2) To promote foreign private investment by guarantees of or through participation in loans and other investments of capital for productive purposes.

(3) Where private capital is not available on reasonable terms, to make loans for productive purposes out of its owned resources or out of the funds borrowed by it.

(4) To promote the long-range growth of international trade and the maintenance of equilibrium in the balance of payments of members by encouraging international investment for the productive resources of members.

**6. Conclusion:**

Country suffering from balance of payment prices can get structural loan from the bank on easy installment. India is one of the founder member of the world bank & held on permanent sheet on its board of executive directors for a long time.

**QUE-4Write Short Note On: India And The World Bank. ANS:**

India is one of the founder members of the World Bank and held a permanent seat on its Board of Executive Directors for a long time. The Bank has made valuable contribution in helping India in its planned economic development by granting loans, conducting field surveys in various sectors of the economy, rendering technical advice, deputing various missions and study teams and imparting training to Indian personnel at the Economic Development Institute. The Bank has also appointed a Resident Representative in New Delhi to maintain close liasion with the Government of India in regard to development plans and projects of the country. It also monitors and holds consultations as to the progress and performance of the projects aided by the Bank.

It is worthwhile to mention here that India is one of the largest receivers of the World Bank assistance. The Bank has provided assistance for projects like improvement and modernisation of railways, highways, ports and aircrafts, oil exploration including Bombay High and gas power projects, coal, iron and steel, aluminium, fertilizer and power projects etc. India has borrowed around 65.8 billion dollar from the world bank so far.

The Bank has also extended technical assistance to India. The experts from the World Bank have been providing valuable suggestions to the Government for the formulation and effective implementation of the various development projects. The Bank has been an instrument in the setting up of Aid India Consortium with a view to providing more economic aid to India. Initially, the consortium consisted of five big creditor countries — England, America, France, West Germany and Japan. This Consortium has now been replaced by India Development Forum since

1995 and consists of twelve developed countries. Likewise, the Bank has also helped India in the amicable settlement of Indo-Pakistan Canal Water dispute.

Thus, the World Bank has proved to be a very useful international lending agency for India and has played an important role in our economic development, particularly in the field of agriculture, industry, energy, transport and other infrastructural projects. However, the following points need to be mentioned:

(a) Loan assistance by the World Bank has proved to be too inadequate in relation to our requirements.

(b) most of the loans are tied-loans. (c) interest rates are also high.

**QUE-5What is WTO(World Trade Organisation)? Explain its various objectives or functions and various agreements.**

**ANS:**

**1.INTRODUCTION:**

The signing of the Dunkel Draft paved the way for setting up of the World Trade Organisation. The agreement to this effect, signed by 104 member countries, came into force on January 1, 1995. At present the membership of WTO is 151 countries. India was a founder member of the WTO also.

**2.OBJECTIVES:-**

The objectives WTO are laid down in Article III of its Constitution. These are as follows :

(1) To remove impediments in the way of free flow of international trade and thereby promote world trade.

(2) To raise the living standards and income of the people, attain full employment, expand production and trade, make optimum use of world's resources and to apply all these objectives to the service sector.

(3) To attain sustainable development in the context of optimisation of world's resources and to preserve and protect environment consistent with the level of economic development of the country.

(4) To initiate positive steps to ensure that developing countries, in particular the least developed ones, get a fair share of the increase in world trade.

**3. Functions of WTO:**

The WTO is a new international organisation and is set up as apermanent body. Its functions are as follows :

(1) It shall facilitate the implementation administration and operation of this agreement and of multi lateral trade agreements.

(2) It shall provide the forum for negotiations among its members concerning their multilateral trade relations.

(3) It shall administer rules and procedures governing the settlement of disputes. (4) It shall administer the trade policy review mechanism

(5) To achieve greater coherence in global economic policy making, the WTO shall co-operate with the IMF, IBRD and its affiliated agencies.

**4.WTO Agreements:**

The main WTO agreements as incorporated in the Dunkal Draft are as follows :

**(i) Agreement on Agriculture** : This provides a framework for the long term reform of agricultural trade and domestic policies regarding it.

**(ii) Agreement on Trade in Textiles and Clothing :**This agreement provides for phasing out of import quotas on textiles and clothing in force under the multi-fiber arrangement since 1974 over a span of 10 years, that is, by the end of the transition period on January 1, 2005. As a result, quotas on textiles and clothing have now been abolished.

**(iii) Agreement on Market Assess** : The member countries will cut tariffs on industrial and form goods by an average of about 37 per cent. The USA and European Union will cut tariff between them by one-half.

**(iv)Agreement on TRIMS** : The agreement on Trade Related Investment Measures calls for equal treatment of domestic and foreign investments and removal of quantitative restrictions. **(V)Agreement on TRIPs:** In many countries, patent laws were loose and were against the trade interests of developed countries. The developed countries therefore forced the adoption of stringent conditions for the protection of the intellectual property rights. Under the TRIPs, the scope of protection was widened to cover patents, copyrights, industrial designs, etc. In the field of drugs, medicines, chemical products and food, TRIPs Agreement provides for granting product patents (instead of process patents) for 20 years and in the case of copyrights, protection will be available for 50 years.The transition period expired on January 1, 2005. At present the regime of product patents is in force.

**(vi) Agreement on Services:** It was in the Uruguay Round of negotiations that an agreement was effected for the first time, as regards services such as banking, travel, insurance and mobility of labour etc. It is shown as General Agreement on Trade in Services. The Agreement provides a multilateral framework for the trade in services under the conditions of transparency and gradual liberalization.

**(vii) Dispute Settlement Body** : The Dispute Settlement Body has been modified and empowered to provide security to the multilateral trade system. A dispute must be settled within 18 months at the most and the findings of the dispute settlement panels will be final and binding on all parties concerned.

**4.Benefits likely to Accrue to India:**

It is claimed that India is likely to derive a number ofbenefits from its membership of the

WTO. Some of these are as follows:

**(i) Increase in World Trade:** it is estimated that as the result of the implementation of the WTO agreements, world trade will increase by 213 to 274 billion dollars annually, and the largest increases will be in the areas of clothing (60%), agriculture, forestry and fishery products (20%) and processed food and beverages (20%).

**(ii) As the result of the phasing out of Multi Fiber Arrangement,** India willbenefit to the extent its exports of textiles and clothings increase, though it is widely believed that the main benefits of liberalisation are most likely to accrue to China.

**(iii)India hopes that under the WTO** regime, the U.S.A. and European countries will reduce their agricultural subsidies and therefore the prices of agricultural goods in the world market will shoot up, increasing the earnings from its agricultural exports.

**(iv)Therules and disciplines of the WTO** such as anti-dumping subsidies and countervailing measures, safeguards and dispute settlement etc. are likely to ensure greater security and predictability of the international trading system.

**(v)The competition in the domestic and foreign markets** willcompell Indian producers to improve quality and reduce costs through increasing technological and managerial efficiency. Consequently, output, employment and income will increase in India. The consumers will also gain because better quality goods will be available to them at low prices.

**(vi)** Technological progress will gather momentum in India because of 'the easy availability of foreign capital, foreign techniques and foreign skills and knowhow under the WTO regime.

**5. Disadvantages likely to Hit India**:

India and all other developing countries are likely to face some serious disadvantages and challenges under the new international economic order that is taking shape .under the WTO. These are as follows :

(1) There is extreme inequality within the structure of WTO such that basic agreements and subsequent amendments are more in favour of developed countries. For example, every country is required to accept all the Uruguay Round of Agreements irrespective of its level of economic development. The dispute settlement mechanism of the WTO is also biased in favour of the developed countries and against developing ones.

(2) The Agreement on TRIPs is likely to work against India. The patent Act of India, 1970 granted only process patents to drugs and medicines, so that an Indian company could develop and patent its own process of manufacturing a drugs even if it was protected under a product patent abroad. But the introduction of product patents from January 1, 2005 means that now Indian drugs companies will not be allowed to produce drugs patented by MNCs. The result would be monopoly of MNCs in Indian drugs market, high prices and shortages.

(3) Agreement on Trade Related Investment Measures is also designed to protect the interests of foreign investors in developing countries. It provisions will undermine any plan or strategy of self- sustained growth based on the technology and other resources available locally to the developing countries.

(4) Inclusion of trade in services will benefit developed countries more than the "developing countries like India, because the developed countries like U.S.A, Japan, France and Netherlands account for about 60 per cent share in world trade in services.

(5) Non tariff barriers continue to act as barriers to exports from developing countries. Such

barriers are stiffer for agricultural goods, leather products and textiles which are of decisive importance for developing countries like India.

(6)The WTO has the powers to enact international laws on matters that were under national jurisdiction so far. Thus, the WTO is tress passing the sovereignty of member countries.

**QUE-7 Discuss the ADB (Asian Development Bank)in detail. ANS:**

**1. Introduction:**

It was during the 1950 that a very strong view gain as to the need for a separate bank for Asia. A suggestion to this effects were put forward at the ―ministerial conference on asian co- operation‖ held at Manila in 1963. This conference constituted a Working Group Of Experts which submitted its report to the U.N. Economic Commission For Asia And Far East (ECAFE) in March

1965. Asian development bank is multilateral development finance institution dedicating the reducing poverty in Asia & specific. It was set up in 1966. Almost line with the world bank to the cater to financial need of development on the Asia specific region. It is on by 64 members. Its headquarter is in Manila.

**2.Membership**:

The membership of Asian Development Bank comprises of the following : (a) Members of the ECAFE

(b) Associate members of ECAFE

(c) Other countries of ECAFE region which are the members of the United Nations or any of its specialised agencies.

(d) Developed countries outside the ECAFE region which are the members of the United Nations or any of its specialised agencies.

The total number of member-countries of the Bank at present is about 56.

**3. Financial resources of ADB:**

The initial authorized capital of the ADB was 2.9 billion dollar which was subsequently raise to 25 billion dollar in 1992.

The member country are required to pay 50% of their respective subsequence immediately in gold or convertible currency and remaining half in their own currency in 5 annual installments. The bank also issues debentures from its special funds. Bank also raises additional capital by

selling its bonds & securities in the international money market and also borrows from the capital markets of the world.

**4. Financial Assistance:**

The Bank provides to its member countries financial assistance in the form of grants and loans. It gives three types of loans:

**(a)Project loans** : These are tied to specific projects in the region.

**(b)Sector loans** : These are given to a number of related projects in a given sector. **(c)Programmeloans** : These cover more than one sector and relate to the implementation of a policy or programme for bringing about certain changes.

The Bank may also guarantee loans granted for the projects. Most of the loans granted are hard loans or tied loans. However, loans from special funds set aside by the Bank upto 10 per cent of its paid-up capital are granted under soft loan term for which purpose it has set up a separate window known as Asian Development Bank. Soft loans are normally granted to projects of high development priority and requiring longer periods of repayment with lower interest rates.

**5. Technical Assistance:**

Technical assistance to the member countries out of the Technical Assistance Special Fund is also provided by the Bank through their governments, agencies, regional institutions and private firms. The two main objectives of providing technical assistance are :

(i) to prepare and finance and implement specific national and / or regional development plans and projects.

(ii) to help in the working of existing institutions and / or the creation of new institutions on a national or regional basis in areas like agriculture, industry, public administration etc.

The Bank also conducts surveys and research in order to formulate policies for the future and to promote regional economic integration. The Bank provides advisory services also under its technical assistance programme.

**6. Objectives of ADB:**

1. To promote public & private investment for economic development.

2. To utilize available resources for financing development, giving priority to those projects which will contributes most effectively to the harmonies growth.

3. To provide technical assistance for preparation financing & execution of development projects.

4. To co-operate with the United Nations and its organs and subsidiary bodies including in particular ECAFE and with public international organisations.

**7. Functions of ADB:**

1. ADB lends to government & public & private enterprise & its developing member countries.

2. Extending loans and equity investments to its developing member countries for their economic

& social development.

3. Providing technical assistance for the planning & execution of development projects and also provides advisory services.

4. Promoting & facilitating investment of public and private capital for development.

5. Responding to request for assistance in coordinating development policies & plans of its developing member countries.

**8. India and ADB:**

The Asian Development Bank commenced its lending operations to Indiain 1986 and at

present, the Bank is the third largest creditor to India after World Bank and Japan. The Bank has been providing assistance in the fields of agriculture and agro-based industries, energy, industry, financial sector and infrastructure projects like transport and communications, water supply, urban development, education, health and population planning etc. As of 31 December 2004, the bank had approved 83 loans to India. Cumulative disbursements till 31 December 2004 were about

7.304 billion dollar.

**9. Conclusion:**

The ADB commenced its lending operations to India in 1986 and at present the banks is third largest creditor to India after world bank& Japan. The bank has been providing assistance in the field of agriculture energy and infrastructure projects.

**on**

**QUE-8 Write a note IMF (International Monetary Fund). ANS:.**

International Financial organizations came into existence because of international trade. In international trade goods and money both are exchanged but both of them in opposite directions. To facilitate the exchange of money International Financial Organizations came into existence.

Before First World War, Gold standard based International Financial Organizations were in existence. But during First World War 1914 to 1918 Gold standards based system was removed. Till the end of Second World War, another system was not developed. As new system was not introduced, international trade collapsed. Then experts framed new system in which stable exchange rates were possible, restrictions laid on exports and imports were removed & regulations were made free from restrictions.

**Evolution of International Monetary Fund-IMF**

International Monetary Fund was established by 44 nations. It was established under Bretanwoods Agreement on July 1930, all the countries of the world were forced to leave the gold standards. So, all nations adopted clear nation policy. Almost all the countries impose restrictions on trade and exchange rate for increasing their exports and for decreasing the rate of exchange. It resulted in the decrease of international trade and thus, depression got momentum. To come out from this situation, from 1st July to 22 July in 1944,44 nations came together and took part in Bretenwoods - New Hampshire (U.S.A.). For the economic and financial co-operation between the members of these countries International Monetary Fund was established. It started its working from 1st March 1947 and in June 1996 it had 181 members.

**Goals of IMF**

The goals of IMF are mentioned in Article 2. Changes were made in it, in 1969 and in 1978. Following are the goals of IMF.

(1)To provide advice and co-operation for international financial problems and to encourage international co-operation by this way.

(2)To make easy and to boost international trade, to boost high standards of employment and real income and to provide co-operation in maintaining it and to develop production wealth of its members as primary economic policy.

(3)To encourage stabilized exchange rates, to arrange proper exchanges among its members and to avoid competitive exchange value.

(4) To help in establishing multi party system for payment of current transactions among members and to abolish sanctions that are regarded as hurdles in growth of foreign exchange in international trade.

(5)The members of fund are given benefits of funds under sufficient safety. They are given an opportunity to correct maladjustments in payments. It also works for encouraging trust among its member nations.

(6) Decrease in dissimilarity in less time among its member nations by performing above functions.

**Organization and structure of IMF**

According to the 2nd Amendment of Articles of Association of IMF, Board, Managing Directors and Advisory Committee were formed at its headquarters in Washington, USA. Adhoc and Standing Committee were formed by the Board of Governors and Board of Executive. Board of Governors also appointed the interim committee. In this entire management body, Board of Governors and Board of Executives are main organs. Members of IMF have to follow the decision of both these Boards. Governor occupies the apex position. There is a governor and an additional governor appointed by its members. Generally the member nations appoint their finance minister

or the Governor of Reserve Bank as its Governor. Additional Governor can participate in the Board meeting but he can give vote in absence of Governor.

The meeting of Board of Governors is held once in a year. In this meeting they discuss the working of previous year. Many important decisions regarding policies are taken in this meeting. At present there are 21 members in Board of Executives. USA, UK, France, West Germany and Japan are its five members. They have the major share compared to others. They have appointed five executive directors. Saudi Arabia has appointed the sixth executive director as it holds the major share in IMF. Remaining member nations elect fifteen controllers every two years.

Board of Executives is the powerful organ of IMF. It is given wide powers from the Board of Governors and by the agreement. 85% majority is needed in Board of Executive for making wide changes in the procedure of lMF.

In October 1974, development committee was formed having 22 members. This committee provides reports and advices to the Board of Governors on financial resources transferred to developing nations. Committee also gives instruction for its implementation to the Board.

IMF keeps general account for the share contributed to its members. When any nation joins IMF the regulated right of voting and right of withdrawal is assigned as per the size of its subscription. At the time of formation of IMF, every member has to pay 25% of decided share in gold or 10% of acquired gold or US dollars, whichever is less.

From 1 April, 1978 second amendment was made applicable. As per this amendment the method of keeping gold reserves with IMF was abolished.

**Working of IMF**

IMF works according to the goals decided by the Bretanwoods agreement. It is the duty of IMF that its member nations follow the provisions laid down by the fund. IMF is considered as the guardian of good conduct. It is the duty of IMF is to survey the policies implemented by its member nations.

IMF provides technical advice to its member nations in context of financial and fiscal policy.

IMF carries research studies and then it publishes it. n provides technical experts to the nations having problems of Balance to payments. It runs short term training programs on its Central Bank Service Account for problems in fiscal policy, financial policy and Balance of Payments. Besides this it provides Buffer Stock Financing Facility-BSFF from 1969. hi 1974, it started the Extended Fund Facility (EFF); in 1977, it started the Supplementary Financing Facility (SFF); Structural Adjustment Facility (SAP) in 1986; Enhanced Structural Adjustment Facility (ESAF) in 1987 and Compensatory and Contingency Financing / Facility (CCFF) in 1988.

**India and the International Monetary Fund :**

India is one of the founder members of The International Monetary Fund and was one of the 45 countries that had participated in the Brettonwoods Conference in 1 944 and had become an original member of the Fund. India had signed the Fund Agreement on 27th December- 1945. Initially, India was assigned a quota of $ 400 million or about 5.2 per cent of the total. Being the fifth largest quota holder, India was also given a seat on the Fund's Executive Board. However,

with the increase in the Fund's quota after May 1970, the quotas of Japan, Canada and Italy increased more than that of India and accordingly India ceased to hold a permanent position on the Executive Board of the Fund. India's present quota of Special Drawing Rights is about $ 3055 millions which is about 2.05 per cent of the total IMF quotas and ranks 13th amongst the Fund shareholders.

The initial par value of Indian rupee when India became a member of the International Monetary Fund was fixed at 0.268601 gram of gold or 30.225 US cents, per rupee. When the rupee was devalued on 18th September 1949, its par value was reduced to 0.186621 gram of gold or 21 U.S. cents; this was further reduced to 0.118489 gram or gold on 13.33 U.S. cents when the Indian rupee was further devalued on 6th June in 1966. The Indian rupee remained linked to pound sterling in foreign exchange market for the purpose of exchange rate determination upto September 1975.

However, the Indian rupee was delinked with pound sterling in September 1975. The exchange rate of rupee thereafter was pegged to a weighted basket of currencies pertaining to our principal partners in foreign trade.

Since March 1993, the Indian rupee is floating like other currencies and is linked to SDR; the exchange rate being determined by market forces. The rupee has become fully convertible on current account since April 1994. With this, India has moved to Article VIII status of the I.M.F.

As a member of the International Monetary Fund, India has derived a number of benefits. (1) India has been receiving aid from the various Fund agencies from time to time.

(2) India has also been receiving assistance from the Fund under the Special Drawing Rights scheme which provide unconditional liquidity since the participants have access to foreign exchange resources at will.

(3) By virtue of being a member of the Fund, India is also a member of the World Bank from which it has been receiving financial assistance for its various development projects.

(4) India has been getting advisory help from the Fund under the Fund surveillance conditionally. A team of economists from the Fund often, visits India for interacting with the Indian officials on problems like balance of payments and exchange rate and offer valuable suggestions relating to monetary, fiscal and other measures to solve the concerned problems.

(5) The Fund has also been providing valuable short-term training courses, for the Indian personnel on monetary, fiscal, banking, exchange rate and balance of payments policies.